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Japan – to win or to forget?

**Key Features of Law and Economy in Japan
in View of Foreign Direct Investment**



The Olymp(us) of Corporate Governance in Japan

Key Points of Corporate Law



Olympus and Daio Paper – result of an inverse practice of corporate governance in Japan!

Olympus: ,men of integrity‘ ,save‘ the company by breach of trust

- Olympus suffers losses in the amount of € 1.3 billion upon ,Bubble Economy‘ bursting (1990)
- Top-management hides losses in paper companies (from 1997 on)
- In profit phase Olympus pays a 100 times inflated advisor fees to compensate the losses
- Foreign CEO breaks the Japanese circle of silence while being disputed about his qualifications
- As advised by TSE, Olympus appoints a committee that finds that the Japanese Top Management did not enrich itself, but abused its power to cover up and compensate the losses in a hermetically closed system



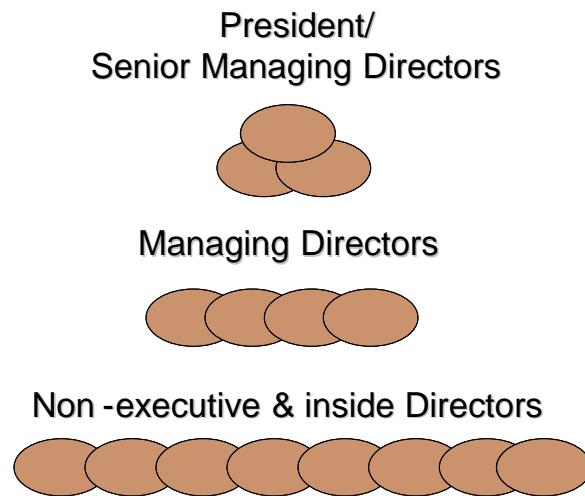
Olympus and Daio Paper – result of an inverse practice of corporate governance in Japan!

- **Also possible in Japan: the wayward heir**
 - Daio Paper: Heir of the founding family gambled away 8.4 billion Yen (app. 84 million Euro) in casino, embezzled by abuse of his power in a hermetically closed system
- **If unfaithful man of integrity or villain:**
 - The source of the evil is the unlimited power of the CEOs
- **Source of the power of the CEOs and the Boards of the Kabushiki Kaisha (KK):**
 - *Board of public KK is entitled to choose its shareholders by issuing new shares with exclusion of subscription rights up to 300% of the amount issued (i.e. dilution to 1/4 possible)*
 - One chamber system plans
 - The direct election and control of the Board by the shareholders' meeting –
 - But Board can create its own shareholders' meeting (see above)
 - Control of the Executive Directors by the Non-executives
 - But CEO controls shareholders' meeting and lets only his vassals be elected as directors

Company Law

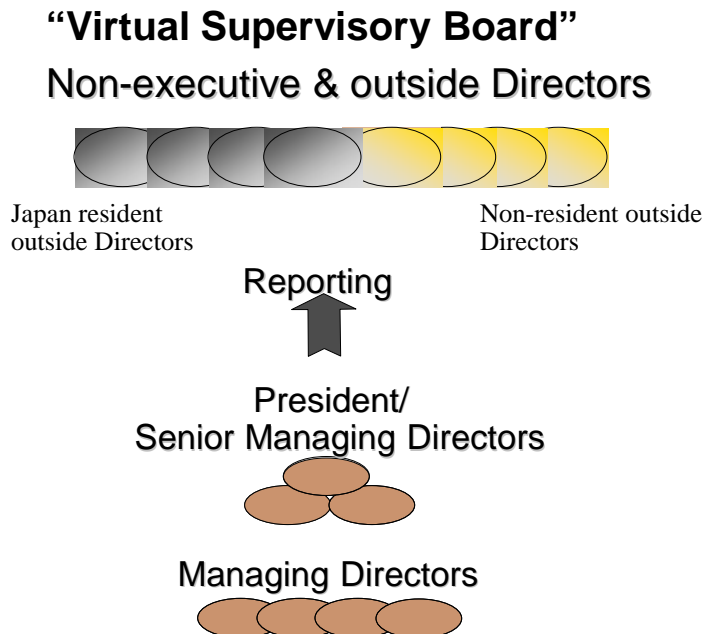
Board structure in Japanese corporate practice

Present common Board Structure



- ➔ Strictly hierarchic, controlled by President (and/or Chairman)
- ➔ No supervisory board
- ➔ Factually no control by shareholders
- ➔ Power to choose new majority shareholder by unilateral capital increase (within authorized capital)
- ➔ Practically no outside directors

Board structure intended by Companies Act



- ➔ “Put the Board back on its feet” (original intention of Commercial Code)
- ➔ Virtual Supervisory Board can be integrated into board by majority of outside directors
- ➔ Majority of non-resident directors enabled by MOJ’s reconfirmation of permissibility of ‘electronic-presence’
- ➔ Directors of Virtual Supervisory Board can control several Japanese group companies



Kabushiki Kaisha – „KK“ the standard entity with a one chamber system

- From grocery store to global player – all are organized as „KK“
- Structure matrix of the KK
 - small/large (capital </> 500 Million Yen a/o liabilities </> 20 billion Yen)
 - closed/open (shares transferable / non-transferable)
- Provides four ground models
 - small closed KK
 - large closed KK
 - small open KK
 - Large open KK
- **Even for large open KK (including market-listed KK) one chamber system is sufficient under the law**
- **Even Committee KK demands outsider majority only for each Committee, but not for the entire Board**



'Kaisha-Hoh' - The Japanese Companies Act

(1) Commercial Entities under Japanese Law

Companies Act	
Stock Companies (Kabushiki Kaisha, "KK") <small>"YK" (only old YK)</small>	
Membership Companies (Mochibun Kaisha): General Partnership Company <small>(Gohmei Kaisha)</small> Gohshi Kaisha (Hybrid Limited Partnership Company) Gohdoh Kaisha (new LLC) (Limited Liability Company)	
Tokumei Kumiai <small>(Silent Partnership)</small>	Commercial Code
LLP <small>(Ltd. Liability Partnership)</small>	LLP-Law
LPS <small>(Investment Ltd. Liability Partnership)</small>	LPS-Law
TMK <small>(Tokubetsu Mokutek Kaisha)</small>	TMK-Law

Practice and Function

Kabushiki Kaisha, "KK"
>90% of all companies standard business form from grocery shop to blue chip company

Membership Companies
TK, TMK, LLP, LPS
 -for structuring & investment

(2) Governance Models of the KK

	(Large Autonomy)	(Small Autonomy)
	Non-Large KK	Large KK
Non-Public KK <small>(Large Autonomy)</small>	<ul style="list-style-type: none"> Free to choose from only one Director up to all possible organs under Companies Act 	<ul style="list-style-type: none"> Number and structure of directors optional (at least one) Corporate Auditor mandatory Accounting Auditor mandatory
Public KK <small>(Small Autonomy)</small>	<ul style="list-style-type: none"> Board of Directors mandatory (min. 1) Corporate Auditor mandatory 	<ul style="list-style-type: none"> Board of Dir. mandatory Board of Corp. Auditors mandatory Accounting Auditor mandatory



'Kaisha-Hoh' - The Japanese Companies Act

„A painted shareholders' meeting!“

Board of the public KK is entitled to choose its shareholders:

- Articles can provide capital increase up to 300% of the existing shares
- Board can make use of this right with simple majority under exclusion of the subscription rights (as long as issued price of shares > 90% market price)
- i.e. dilution to 1/4 possible

Company Law

(2) Governance Models of a KK Third Party Allotment

- The shareholders' meeting can provide for authorized shares up to 4 times of the issued shares (i.e. 300% in addition to the issued shares, as opposed to 50% in Germany), which provision requires a special resolution (usually 2/3 majority of a quorum of 1/2).
- Most listed companies do carefully maintain a level of over 200% in order to vest the board with the power to issue enough shares within this frame to dilute even a majority shareholder with the support of a friendly third party (usually the guardian group of household shareholders).
- Major source of the power of Japanese boards of listed companies and their governance model; It is consistent and logical that the Company Act maintains such privilege for the board to make a third party allotment by simple board resolution within the authorized capital only for Public KKs, since for companies with transfer restrictions of shares a higher protection against dilution is required in form of a shareholders' resolution.
- **General rule for third party allotment**
 - For Non-Public KK resolution of SHM required with special majority (2/3 or more)
 - For Public KK board resolution (simple majority, unless provided otherwise) is sufficient
- **Special Rule at specially favorable conditions**
 - For Non-Public KK as well as for Public KK generally resolution of SHM required with special majority (2/3 or more);
 - However, if there is a resolution of SHM with special majority (2/3 or more) with respect to maximum subscription number and minimum price previously (valid 1 Year), the shares can be allotted by a resolution of the board of directors



Excursion on workers' participation in Japan

- Classical Answer: ‚Why workers' participation, we are owning the company!‘
- Nikkeiren (Association of Employers) created the model of in-house unions in the 1950s to prevent communist activities
- In-house unions worked as works committees and were responsible for workers' participation
- Within the classic governance model more than half of the in-house directors are former in-house unionists
- Effectively the personnel dominated most of the Japanese companies before the „outbreak of capitalism“ that came with the burst of the bubble
- Still today ‚Charitable Capitalism‘ is a declared core value of Keidanren and Nikkeiren (Associations of Industry and Employers)



'Acquiring publicly companies in Japan, pages 6, 9 Making use of the CEO's power for takeovers

- CEO can choose new majority shareholder:
 - By issuing with exclusion of the subscription rights (TPA)
 - By inviting Takeover Bids
 - By combining TPA & TOB
 - Limited TOB possible
 - TPA for following acquisition possible (factual non-cash contribution)

TOB Thresholds (III)

Summary

Tender as a result of	Offeror's Aggregate Ownership Percentage -Market Share Purchases	Number of Parties from whom the Tender Target's Shares in Off -Market Share Purchases	Offeror Purchases the
		Up to 10 parties (within 61 days)	More than 10 parties
Up to 5.0%		No Tender Offer Required	No Tender Offer Required
Above 5.0% and up to 33.3%		No Tender Offer Required	Tender Offer Required
Above 33.3%		Tender Offer Required	Tender Offer Required
(If the Tender Under 66.7%	Offeror already owns more than 50.0%)	No Tender Offer Required ²	Tender Offer Required
(If the Tender Under 66.7%	Offeror already owns more than 50.0%)	Tender Offer Required	Tender Offer Required

TOB and Third Party Allotment (TPA)

Empowerment of the Board

- Third Party Allotment: issuing new shares to a party irrespective of preemptive rights of the shareholders (i.e. allotment as to a third party, 'Third Party Allotment', or 'TPA')
- Company Act allows TPA by board decision within authorized capital at discount price. Our experience and legal precedents suggest that up to 10% discount can be decided by board though there are no clear rules.
- Authorized capital can be up to 4 times of issued shares
- SUCH ENORMOUS EMPOWERMENT OF THE BOARD ALSO IS (STILL) PERMISSIBLE FOR LISTED COMPANIES
- TPAs CAN BE MADE IN EXCESS OF 1/3 WITHOUT TRIGGERING TOB, AS LONG AS RAPID ACCUMULATION RULE IS NOT INFRINGED
- **Majority can be acquired by TPA (starting from 1/3 as well as from zero), as long as last purchase has been undertaken more than 3 months ago and TPA is justified by reasonable business plan - subject to strict review of TSE and FSA on circumvention**
- Most listed companies have authorized capital of at least more than double of issued shares and TPAs have been used actively in the past
- Discussion of review of these rules has started, and amendment of Company Act and Financial Instruments Exchange Law ("FIEL") is expected within the next three years



Q&A and Overview on M&A relevant structures



Questions and Prospects

- Company Law (see „Presentation „Companies Act““)
 - Legal structures and history of the Companies Act (pages 5-9)
 - Organs of the KK (pages 14-15, 17-20)
 - Majorities at the shareholders' meeting (page 15)
 - Threshold for shareholders' rights (page 16)
- Securities Law
 - SMEs at the stock market – dubbing for family businesses
 - Acquisition law as compared to international standards
- Labor law, IP law, tax law
- Prospects
 - Japan as M&A paradise?
 - No hostile takeover without own domestic power
 - Partner-like approach as a solution



„Proud Belle or Well-led Wallflower?“ -

M&A strategies and possible scenarios



The “Proud Belle”

- Market-listed family business with long tradition
- Strong position on the domestic market caused by technological innovations, stable sales market and/or embedding in a Keiretsu
- Limited international activity
- Founding family controls the shareholders' meeting with house bank, suppliers and costumers (,Family Shareholders')
- Acceptable profit margin
- Market capitalization only in amount of asset value



J-Co – assumptions (for the ‘belle’)

Employees	4,000
Employees (Japan)	1,500
Authorized Shares	250,000,000
Issued Shares	100,000,000
Net Equity	50,000,000,000
Market Capitalization JPY	40,000,000,000

Shareholder	Ratio %	Shares
Bank 1	5.00	5,000,000
Bank 2	5.00	5,000,000
Insurance 1	4.00	4,000,000
Insurance 2	4.00	4,000,000
Trust 1	4.00	4,000,000
Trust 2	4.00	4,000,000
Strategic Partner 1	4.00	4,000,000
Strategic Partner 2	3.00	3,000,000
Bank 3	2.00	2,000,000
Insurance 3	2.00	2,000,000
Other Shareholders	63.00	63,000,000
Shareholder Chosen as Partner:		
Strategic Partner 1	4.00	4,000,000



The „Well-led Wallflower“

- A family business
- Embedded in the supply system of only a few customers leading to a stable supply market
- Antiquated Management (from the founding period) with problems to find a successor, without international standing
- No visions or assets for long term business development, but reliable quality production
- Modest margins despite money saving cost structures
- Shareholder: Family, house bank, employees, suppliers



J-Co – Assumptions (for the “Wallflower”)

Employees	400
Employees (Japan)	350
Authorized Shares	250.000
Issued Shares	100.000
Net Equity (JPY)	5.000.000
Market Capitalization (JPY)	400.000.000
Market Capitalization (Euro)	4.000.000



Proud Belle -

M&A strategies and possible scenarios



What does regularly not work in Japan:

- **“Hostile takeover”** –
 - not manageable without own strong infrastructure in Japan to replace existing management
 - high risk of hollow-out or loss of business, even if takeover successful (kind of ‘Napoleon in Moscow’)
- **“Friendly takeover”**
 - 100% of the shares of a “target” and outright control for purchaser: acceptable at best against unacceptably high premium
 - Usually not convincing Japanese management and shareholders, who adhere to non-financial values
 - Even in case of successful takeover of immediate full control at high price: risk of golden exit for sellers with loss of business for purchaser

So what will work in Japan??



Innovative control structure

“Multidimensional Governance” – “2x 51%”
instead of one dimensional control

- Multidimensional Governance instead of unilateral control:
 - “Integration Path” defined in acquisition agreement granting pre-merger integration of equal partners as well as undivided ownership
 - J-CO management retains operative independence as long as it complies with Integration Path
 - Goal is undivided ownership and undivided profit
 - EU-Co consolidates J-Co and gains fully integrated partner in Asia
- Approach board of directors (or its top) on equal terms
 - Form and modalities of first approach must be carefully prepared

Multidimensional Governance

Ownership

- EU-Co 50.1%
- J-Co Family 2.1%

Pooled Voting Rights

- EU-Co 50.1% - α
- J-Co Family 2.1% + α
- Pooled rights control board of J-Co and other strategic decisions

Integration Path

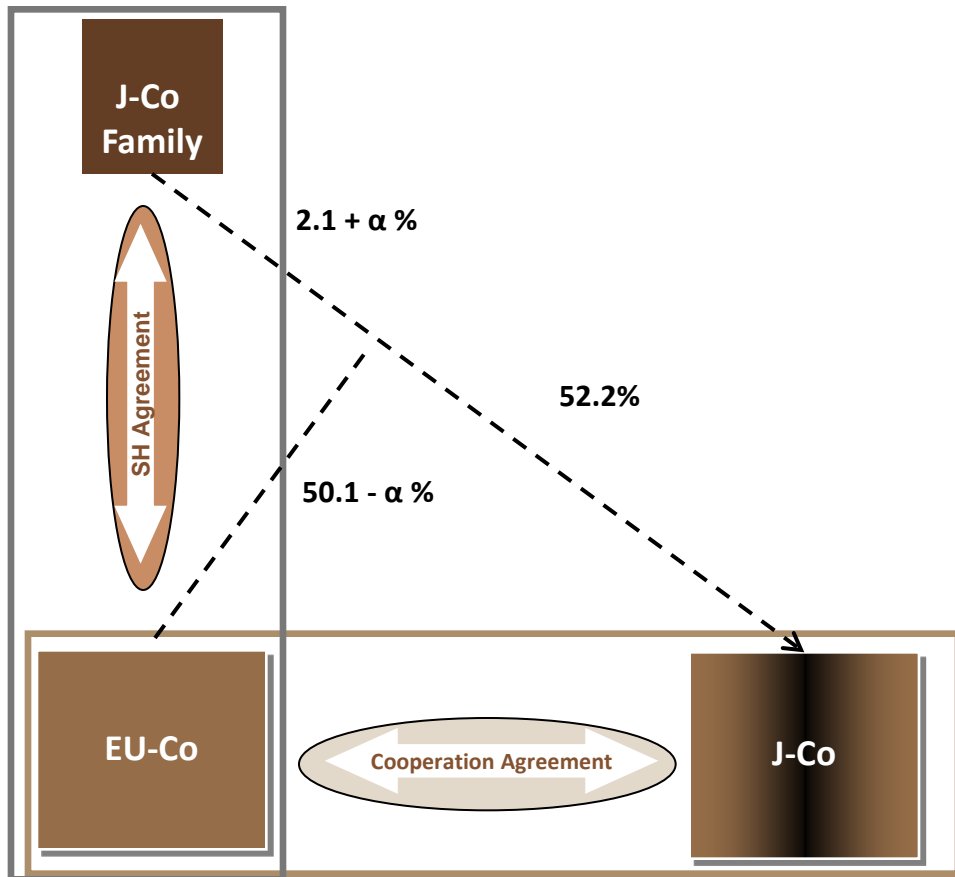
- Processes and objectives for integration of complementary businesses and for J-Co into EU-Co under the Cooperation Agreement

Operative Management

- Fully entrusted in hands of J-Co as long as Integration Path is observed

Time frame

- Up to 10 years
- Agreements expire no later than 10 years
- Thereafter full integration



Multidimensional Governance in the Crisis

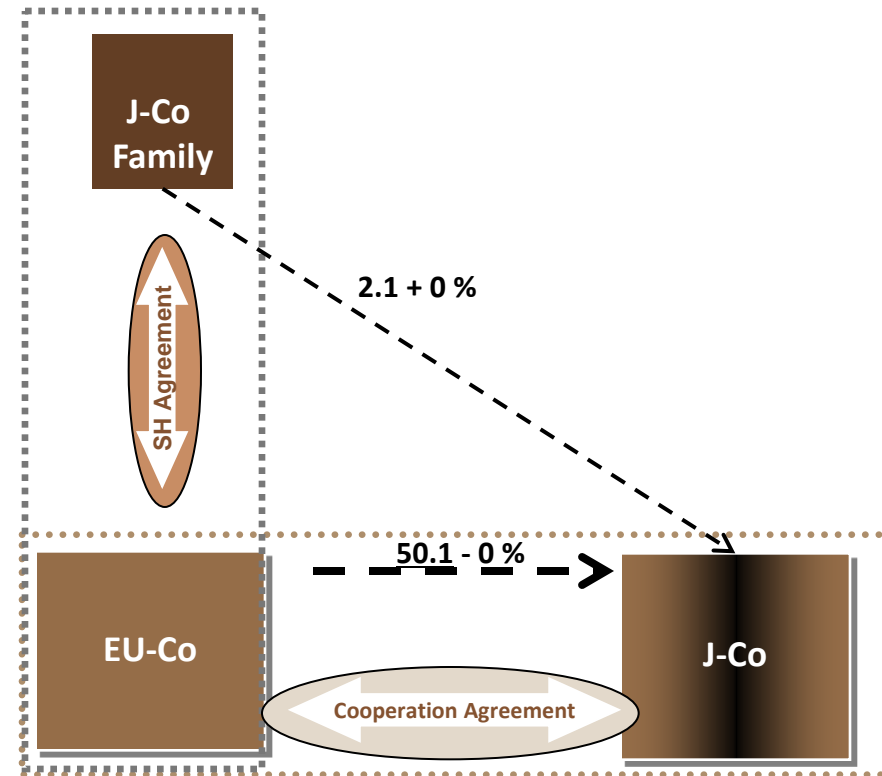
1. Ownership

- EU-Co 50.1%
- J-Co Family 2.1%

2. Non-pooled Voting Rights

- EU-Co 50.1% - **0%**
- J-Co Family 2.1% + **0%**
- Pooling agreement suspended, until integration path is reached again under leadership of EU-Co.
- EU-Co may exchange the management (Board of Directors) or name additional members so that it has control over the operative business

What does crisis mean and how is it determined?





Multidimensional Governance in the Crisis

- **Discrepancy from the integration path does not automatically lead to a crisis, e.g.**
 - E.g. quantitative criteria of the integration path are not met and J-Co acknowledges this
 - Other discrepancy, which solution is settled between J-Co and EU-Co
- **“Crisis”:**
 - EU-Co alleges a discrepancy from the integration path; repeated warnings and settlement negotiations did not have any effect
 - J-Co disputes discrepancy and/or refuses settlement.
- **Interim situation until completion:**
 - EU-Co may use its majority under corporate law by invoking the discrepancy from the integration path
 - EU-Co bears the risk of later finding that denies discrepancy
- **Finding:**
 - Expert statement by a CPA (quantity criteria) or
 - Arbitral award (lack of duty concerning quality criteria)
- **Protection of J-Co** (Claims for the case that arbitral tribunal denies a „crisis“)
 - Damages/penalty payments
 - Indemnity payments for recalled board members
 - Payment of a control premium
- **Protection of J-Co** (enforcement of majority rights)
 - CPA expert statement or Request for arbitration sufficient for the suspension of the pooling agreement (not completion of the arbitral proceedings)
 - J-Co may not invoke preliminary injunctions **(t.b.c.)**
 - J-Co claims staggered for „simple cases“ and „abuse“



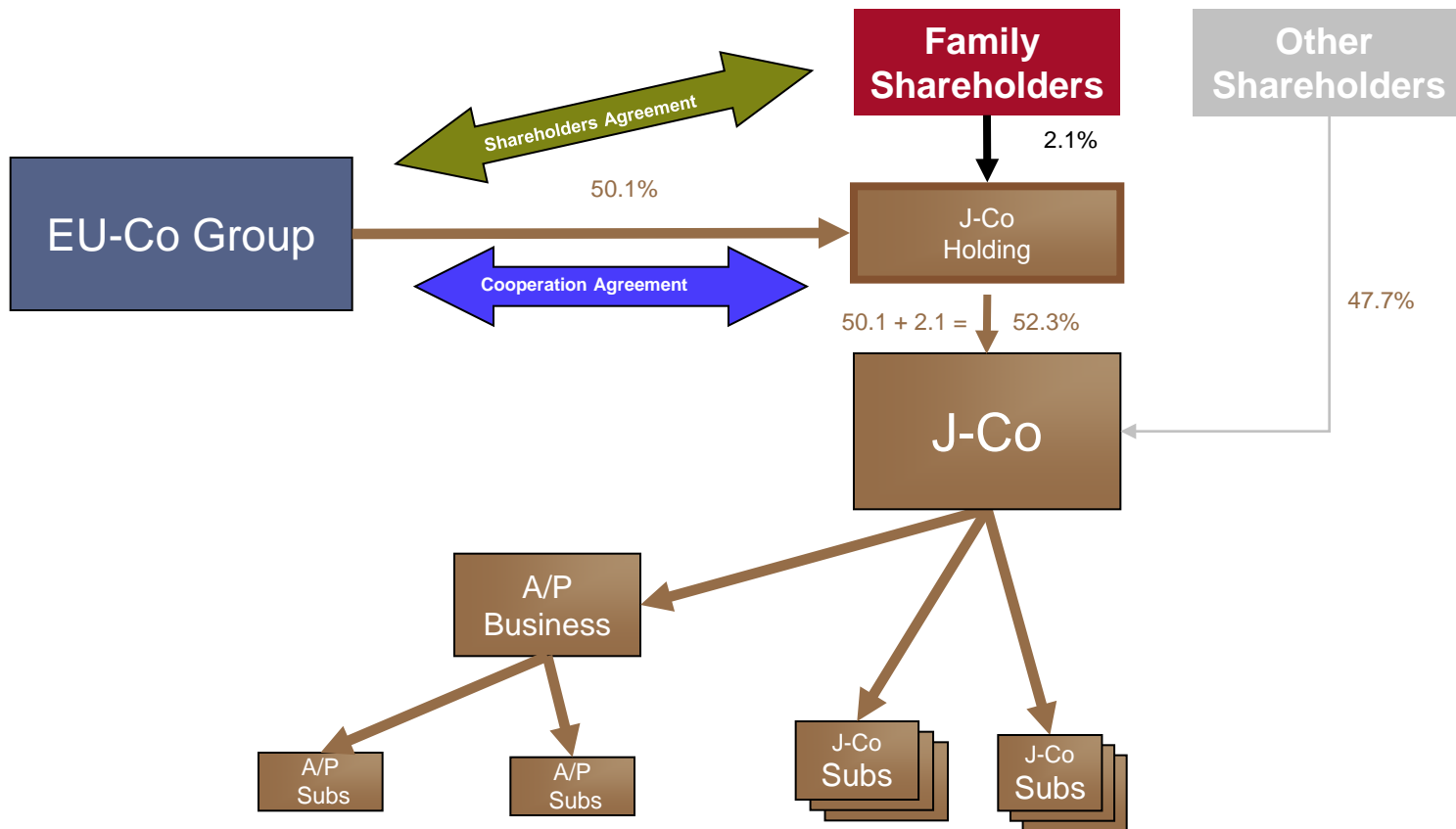
Innovative Acquisition Structures

Reduce cost and increase acceptance
by entrusting EU-Co business to J-CO

- EU-Co offers to J-CO cash and/or contribution of complementary business in exchange for a majority of the shares in J-CO.
- “Complementary business”:
 - Such business units where both companies fit best
 - E.g. operations in Japan or Asia (China)
- Possible alternatives include exchange of shares of EU-Co against issuance of new shares in J-CO to EU-Co

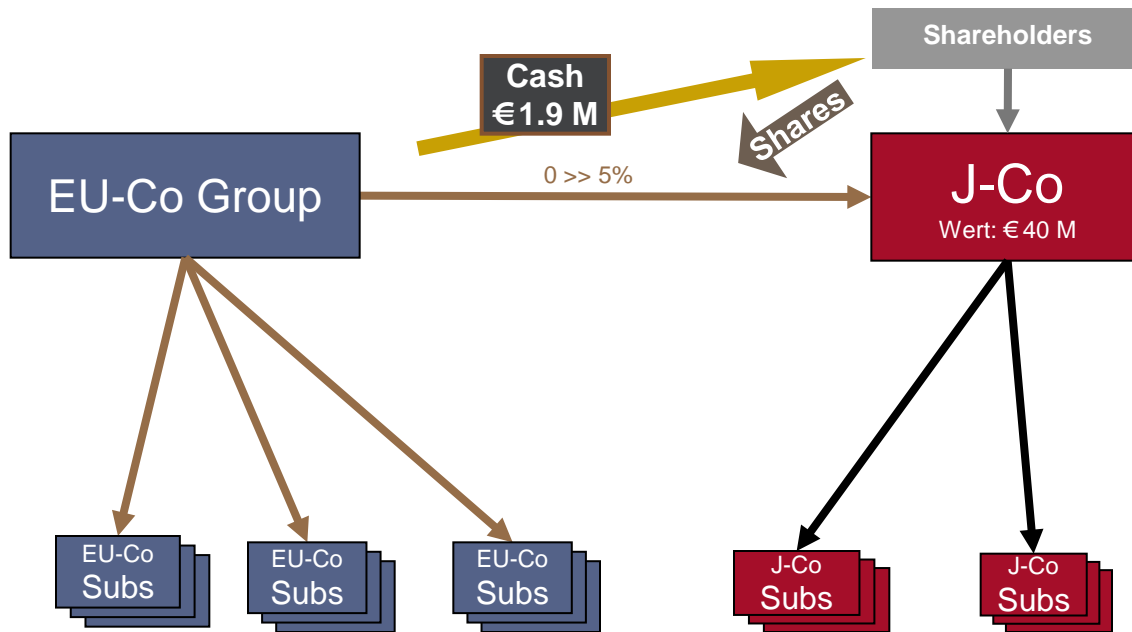


Structure after completion of the transaction



(1) Capital increase and takeover bid (TPA + TOB)

(1a) TOB: Acquisition of J-Co shares through public offer



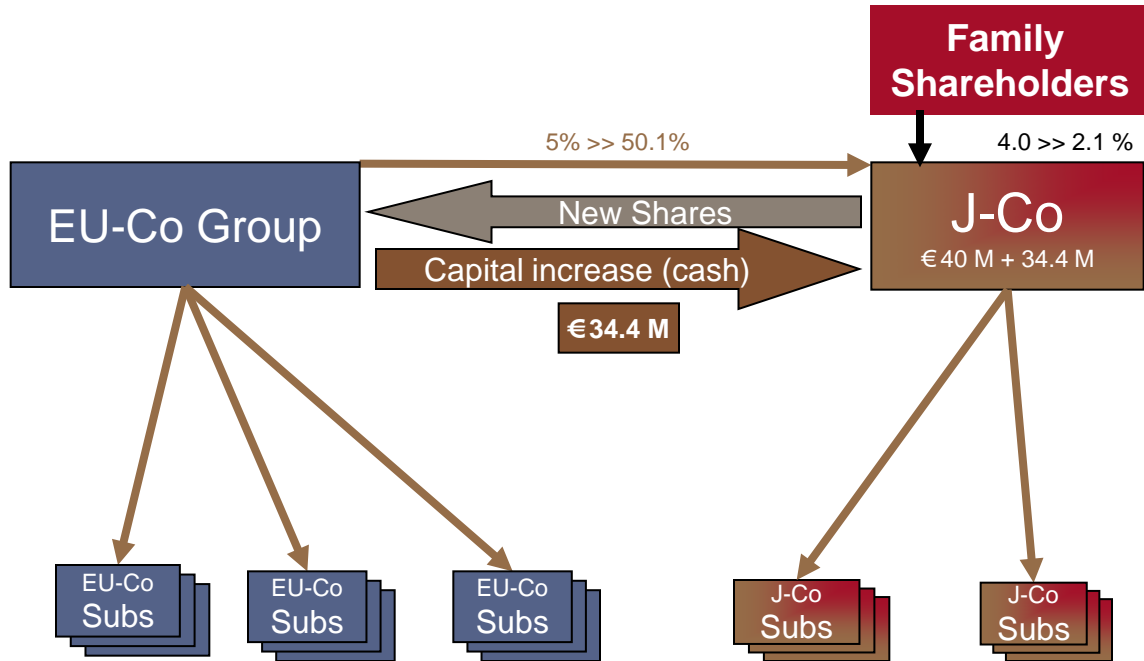
- Public offer by EU-Co., limited to 10 % of the issued J-Co shares
- Price offer: Average course
- After expiration of offer limit EU-Co holds for example 5% of the J-Co shares

Note: There are no detailed rules displayed here

Assumption: Family Shareholders sell no shares within the public offer.

(1) Capital increase and takeover bid (TPA + TOB)

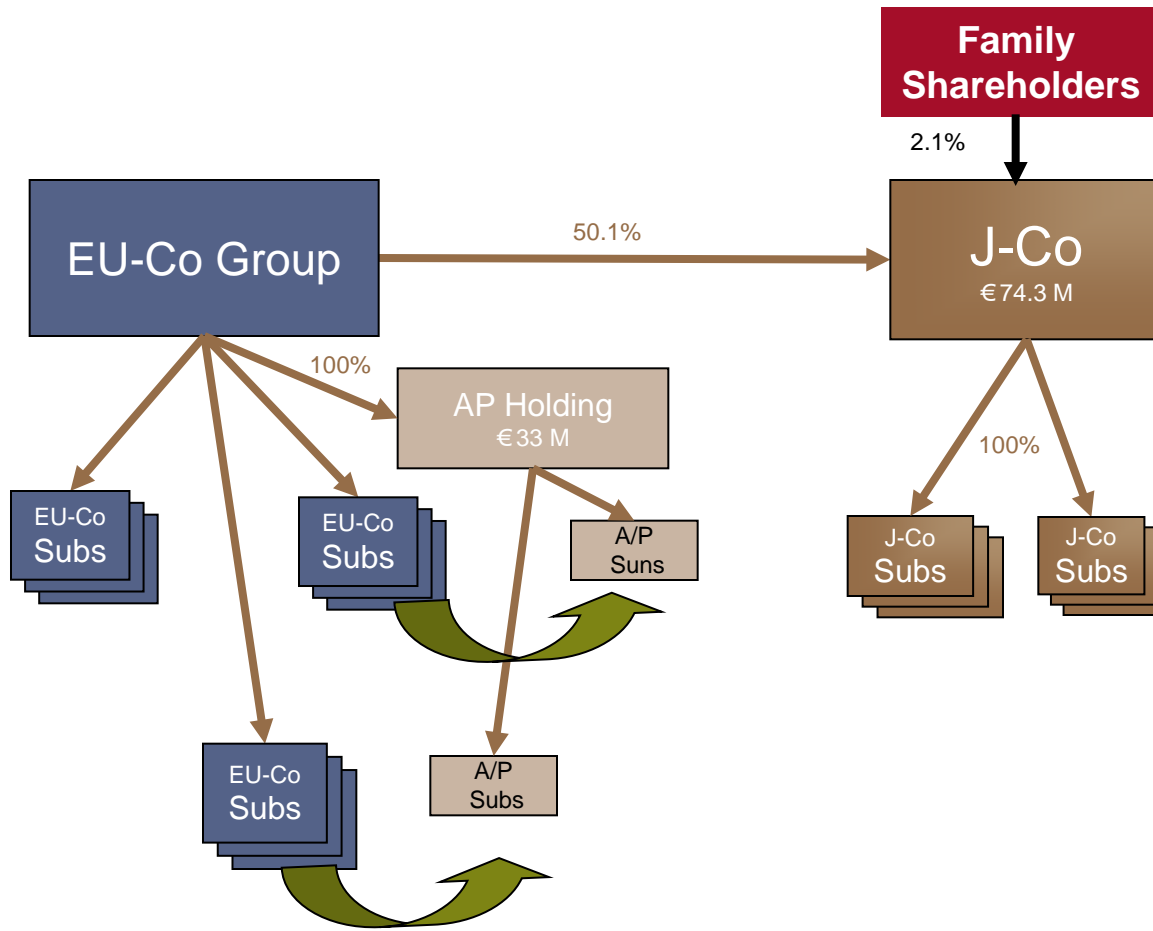
(1b) TPA: Capital increase against cash payment



- Issuing of new shares within the authorized capital for a “non-profitable price” (at least 90% of the stock price) by board decision
- EU-Co Group pays issuing price (€ e.g. 34.4 M) in cash
- Result: EU-Co holds 50.1% of the shares
- Family Shareholders hold 2.1% significantly increased control rights despite less voting rights (according to the Shareholders’ Agreement)



(2) Outsourcing of the Asia-Pacific business of EU-Co into a Asia-Pacific Business Holding (‘AP Holding’)

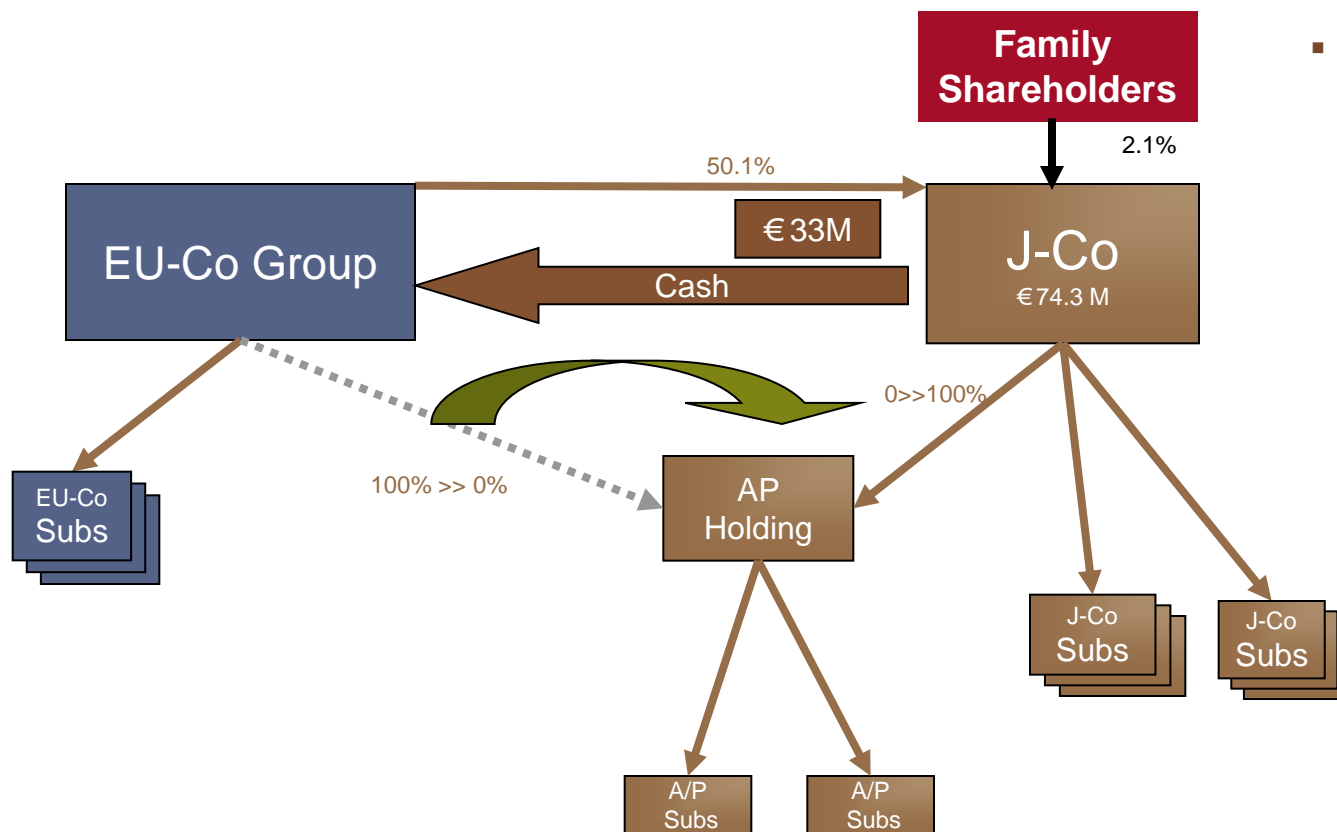


- Outsourcing of the Asia-Pacific business of EU-Co into AP Holding

Assumption:

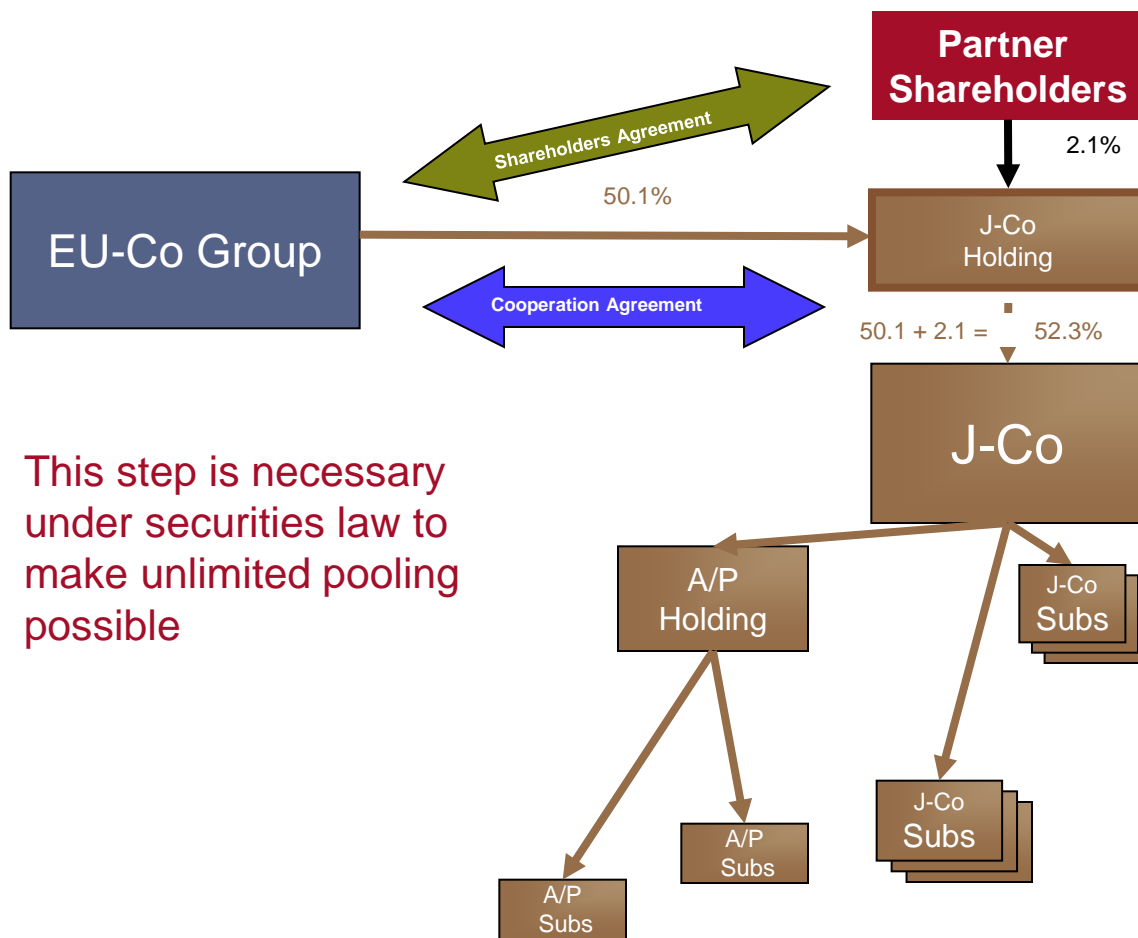
Value of the EU-Co A/P Asia Business (outsourced into AP Holding) amounts to app.. € 33 billion.

(3) J-Co acquires AP Holding funds from the capital increase



- J-Co acquires 100% of the AP Holding for the Fair Market Value (€33 M)

(4) Incorporating a J-Co Holding



This step is necessary under securities law to make unlimited pooling possible

After waiting period of one year

- Cooperation Agreement and "Integration Path" for integration of J-Co Business into EU-Co.
- Incorporation of a Holding
- Shareholder Agreement with Partner Shareholders for common control of the J-Co (indirectly through J-Co Holding)



Well-led Wallflower

M&A strategies and possible scenarios

Risk, requirements and advantages

- Also wallflowers have its pride in Japan („Thanks for the invitation to the Olympics, but not as ball-boy“)
- Especially small family businesses preserve non-monetary values
- Acceptance of financial arguments alone is a signal for the risk of a “golden exit” for the J-Co Family
- Without time-consuming negotiations also with a solid ‚Wallflower‘ innovative concepts will be needed
- EU-Co should have strong team in Japan, to make use of the network and sales market of J-Co
- Simpler transaction structures and contracts

**Only the right questions lead to the right answers –
We find both with you for your business!**



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