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## Squeeze-Outs in Japan: Recent Developments

### Introduction

A squeeze-out typically occurs in a management buyout (MBO) scenario as a means of eliminating the remaining minority shareholders after a takeover bid (TOB) of a listed Japanese corporation.

This newsletter examines some of the key issues currently surrounding squeeze-outs in Japan with a particular focus on two recent cases, being the *Rex Holdings* and *Kanebo* cases.

In the case involving Rex Holdings Co., Ltd, the minority shareholders petitioned the court for a decision on the acquisition price of callable shares (*zenbu shutoku jokotsuki shurui kabushiki*). In the *Kanebo* case, the minority shareholders, who opposed the business assignment of Kanebo Ltd, petitioned the court for a decision on the share acquisition price, claimed damages against the buyer, and filed a derivative action against the directors.

### Squeeze-out Methods

The main squeeze-out methods available in Japan include:

- share consolidation;
- organizational restructuring through a merger and share exchange; and
- the utilization of callable shares.

### Share Consolidation

After acquiring a majority of the voting rights of the shareholders through a TOB, the share consolidation squeeze-out method involves the target company carrying out a share consolidation where only fractions of ownership in the company are allocated to the minority shareholders. The company then sells the number of shares equivalent to such fractions, and provides the proceeds from such sales to the minority shareholders corresponding to the fractions they own.

In practice, however, this method is generally avoided as it does not recognize the right to a share purchase demand, and the minority shareholders are not granted an opportunity to sell their shares at different prices. The resulting oppressive effect may, in fact, force shareholders to sell their shares during MBOs.

## **Organizational Restructuring by Merger and Share Exchange**

After acquiring the majority of the voting rights of the shareholders through a TOB, the organizational restructuring by merger and share exchange squeeze-out method involves the majority shareholder carrying out a share exchange between itself (or its special purpose company) as the 100% controlling company and the target company as a wholly-owned subsidiary, or amalgamating itself and the target company while making arrangements so that only fractions of ownership in the company may be allocated to the minority shareholders of the target company. The majority shareholder then pays the proceeds obtained from selling the number of shares which correspond to these fractions to the minority shareholders, or directly pays cash amounts to the minority shareholders as compensation for the merger.

Previously, this was the most popular method used as the target company's licenses remained and the target company was not subject to taxation upon a share exchange. However, due to the tax law changes in October 2006 which caused the taxation on share exchanges to increase, cases utilizing this type of squeeze-out have become rare.

## **Callable Shares Method**

Upon the acquisition of a majority of the voting rights of the shareholders through a TOB, the callable shares squeeze-out method involves the articles of incorporation of the target company being amended to change all outstanding common shares to callable shares. The target company then purchases all such shares and delivers different class shares to the shareholders of the target company as compensation for the purchased shares. At the same time, upon setting the rate of exchange in such a way that only fractions of ownership in the company may be allocated to the minority shareholders of the target company, the target company delivers the proceeds obtained to the minority shareholders by selling the number of shares which correspond to the fractions.

This callable shares technique was permitted by the enactment of the *Companies Act* in May 2006, and was originally intended to promote a prompt capital increase or reduction in major bankruptcy cases. However, because of the lower tax exposure, compared with the cash-share exchange squeeze-out method described above, the use of callable shares has now become the main method used in squeeze-outs in Japan.

## **Minority shareholder protection**

### **Types of protection**

There are a number of avenues open to minority shareholders under the *Companies Act* and *Civil Code of Japan* who oppose a squeeze-out. The types of concerns that the minority shareholders may have at the time of a squeeze-out can be broken down into three main categories:

- that the squeeze-out violates the law or regulations;
- that the compensation provided to the minority shareholders at the time of the squeeze-out is unjust; or
- that the squeeze-out itself is an abuse of rights by the major shareholder and is unjust.

## **Violation of Law**

There are not many cases where a specific violation of the law (*i.e.*, other than under general provisions, such as an abuse of rights) has been alleged as the basis for a claim during any particular squeeze-out situation. However, in the Tokyo High Court decision of the *Kanebo* case, it was held that the act of acquiring class shares other than through a TOB was a violation of the former *Securities and Exchange Law*, and that this constituted an unlawful act by the major shareholder (*i.e.*, the buyer).

## **Unjust Compensation**

Generally, minority shareholders attempt to recover their economic losses by having their shares purchased or a price determination conducted rather than try to invalidate the squeeze-out procedure itself through a claim for the revocation of the squeeze-out resolution.

Claims of unjust compensation are often due to a sense of unfairness arising from the “disparity of information”. For example, while the management of the target company may be well informed about information relating to the target company, general shareholders do not have access to such detailed information.

Alternatively, minority shareholders may allege that the management of the target company is manipulating the share price to make the purchase price unreasonably low. Consequently, the minority shareholders may seek revocation of the squeeze-out resolution either on the basis of an abuse of rights claim or an unjust compensation claim.

## **Unjust Squeeze-outs**

Other than in cases where the compensation is unjust, it is difficult to particularize the exact circumstances when the squeeze-out itself is unjust, particularly since the May 2007 changes to the law which provide for a squeeze-out to be considered “just” even though the effect is to eliminate minority shareholders. Under the new *Companies Act*, it has become possible to provide squeeze-out compensation in cash to minority shareholders as a consequence of organizational restructuring. The *Companies Act* acknowledges that this may result in the elimination of minority shareholders, although it is still possible that a squeeze-out conducted for the “sole purpose” of eliminating minority shareholders could be deemed to be unjust.

## **Relevant considerations by the Court**

In considering the concerns of minority shareholders in a court case involving a squeeze-out scenario, the court must have regard to a number of factors, including:

- the appropriateness of the compensation being offered;
- whether the transaction improved the corporate value of the target company; and
- whether there has been an adequate disclosure of relevant information.

### **Appropriateness of the compensation**

The appropriateness of compensation, including the role performed by the courts in evaluating such compensation, is currently causing a great deal of controversy in Japan, largely as a consequence of the *Kanebo* and *Rex Holdings* cases.

In the *Kanebo* case, there was a petition for a share purchase price determination by the minority shareholders who opposed the business transfer of *Kanebo*. On March 14, 2008, the Tokyo District Court determined that the appropriate price should have been ¥360 per share, which significantly exceeded the ¥162 per share actually paid by the company. This case is currently being appealed to the Tokyo High Court.

The minority shareholders in the *Rex Holdings* case called for a share acquisition price determination of the callable shares. On December 19, 2007, the Tokyo District Court rendered a judgment acknowledging the price of ¥230,000 per share (the same as the tender offer) paid by the company. However, on September 12, 2008, the Tokyo High Court subsequently determined that an appropriate price should have been ¥336,966 per share. The matter is now before the Supreme Court of Japan.

### **Improving Corporate Value**

The ability of a company to pay compensation to minority shareholders upon a merger or an organizational restructuring is intended to increase the company's corporate value. A squeeze-out which does not result in any improvement of the corporate value is inconsistent with this purpose. However, it is possible for a squeeze-out to not involve any corporate value improvement so long as the decision is made with the consent of the minority shareholders.

In this regard, the “*Guidelines on Increasing Corporate Value and Ensuring Regulatory Compliance in the Context of MBOs*” announced by the Ministry of Economy, Trade and Industry on September 4, 2007 (the “Guidelines”) note that, in connection with an MBO, “the decision whether or not an MBO is desirable should be made on the basis of whether it would improve the corporate value”.

### **Disclosure of information**

In transactions involving squeeze-outs, there are instances where the minority shareholders feel that the squeeze-out is unjust even if it aims to improve the corporate value in some way. This is quite often due to the insufficient disclosure of information regarding the transaction to the minority shareholders. Particularly in MBO cases, a significant asymmetry of information exists between the directors, who are the buyers of the company, and the shareholders who are the sellers. The non-transparency of the squeeze-out process engenders distrust and discontent among the minority shareholders.

Indeed, in the *Rex Holdings* case, immediately before the commencement of a takeover bid preceding the squeeze-out, extraordinary losses concerning *Rex Holdings* were announced. As a result, the share price dropped. As the tender offer price was based only on the share price for the month immediately preceding the commencement of the takeover bid, the minority shareholders were of the opinion that this takeover bid price was unjustly low. There were suspicions that the management of *Rex Holdings* was carrying out the MBO plan with knowledge of the extraordinary losses, and they had waited until immediately before the commencement of the takeover bid to announce these losses in order to deliberately depress the share price.

It is necessary, therefore, for any party conducting a squeeze-out to not only consider the appropriateness of the compensation given to the minority shareholders, but to also ensure adequate disclosure of information concerning the entire transaction is provided to all shareholders.

## Countermeasures to squeeze-out opposition

There are a number of precautions the major shareholder can take to attempt to avoid opposition to any squeeze-out activity. For example:

- ensuring the appropriateness of the compensation paid to the minority shareholders; and
- providing adequate disclosure of information.

### Appropriate Compensation

#### Legislative Guidance

Prior to the enactment of the *Companies Act* in May 2006, the *Commercial Code* provided, in the context of a squeeze-out, that a fair price is the price that the shares in question would have obtained if the organizational restructuring had not been conducted. However, the new *Companies Act* simply provides that the compensation be a “fair price”.

The drafting commentary accompanying the new legislation provides that “among the shareholders who intend to exercise their share purchase demand rights, there can be those who are in favor of the company carrying out a merger *per se*, but who are not satisfied with the compensation provided as a result of such merger”.

The purpose of the new language is to ensure that the purchase price is fair for these shareholders as well. In determining the reasonableness of the compensation, it can be assumed that the improvement in corporate value as a result of eliminating the minority shareholders - the so-called “synergy” - should also be taken into consideration.

#### Price setting methodology

The Guidelines provide that in an MBO situation where a squeeze-out is conducted after a TOB, the cash amount provided to minority shareholders should ideally be equal to the takeover bid price unless there is any particular reason to the contrary.

In the *Rex Holdings* case, however, while the Tokyo District Court determined that the takeover bid price of ¥230,000 paid by the company was fair, the Tokyo High Court disagreed and arrived at a “fair price” of ¥336,966. The Tokyo High Court determined that the takeover bid price, which the company used as the basis for the “fair price” at the time of the squeeze-out was unjust. Although the company set the takeover bid price as the simple mean value of the closing market share price for one month prior to the TOB plus a 13.9% premium, and implemented the squeeze-out with this price, the Tokyo High Court used the average mean value of the closing market share price for the six month period immediately preceding the commencement of the takeover bid as its basis for determining the objective value of the *Rex Holdings*. The court decided that 20% of this base value was an appropriate value for the premium for the “expectation of the appreciation of the share price” which was to be added to the average mean value.

Before this Tokyo High Court decision, there had been no clear basis under any law, regulation, guidelines or precedent for determining the “fair price” of shares at the time of squeeze-outs, or by extension how to set an appropriate takeover bid price. However, the Tokyo High Court decision in the *Rex Holdings* case illustrates that the press release in which *Rex Holdings* revised its earnings forecast downward came only two and a half months

prior to the TOB commencement. The court stated that “it is undeniable that the accounting process was carried out with the intention to induce the settlement of accounts downwards due to incorporation of the extraordinary losses, taking into consideration the implementation of this MBO which had already materialized with a respectable degree of certainty at this stage”.

### **Ensuring “appropriateness”**

There are a number of legal requirements concerning the disclosure of information that must be satisfied to ensure the “appropriateness” of a takeover bid price.

- *Securities and Exchange Law.* As a result of the former *Securities and Exchange Law* revision in December 2006, the items subject to disclosure in a TOB were expanded. With respect to the takeover bid price, the amendments required that the basis for calculating the purchase price be specifically stated, and, if the purchase price is different from the market value or from the price at which the buyer recently carried out a transaction, the details of such difference must also be stated. If the buyer of the takeover bid used the opinion of a third party to calculate the price, it is necessary to specifically state the name of such third party. They are also required to provide a summary of the opinion and the circumstances under which the purchase price was determined when taking such an opinion into account.
- *Companies Act.* Under the *Companies Act*, if the organizational restructuring method is employed at the time of a squeeze-out, it is necessary to make the documents stating the appropriateness of the compensation available at the main branch of the company for a prescribed period.
- *Financial Instruments Exchange Requirements.* With respect to MBOs, reinforced disclosure is required based on the relevant requirements of the relevant financial instruments exchanges. In order to ensure the “appropriateness” of the price, it is not sufficient to simply comply with these formal requirements, but it is necessary, in some cases, to respond voluntarily with further information.
- *Requirements under the Guidelines.* The Guidelines also point out that, when a buyer conducts a takeover bid, it may be possible to ensure competitive bidding opportunities by setting a relatively long purchase period, and to justify the reasonableness of the purchase price by showing that no competitive bid was offered during such period. However, in the *Rex Holdings* case, the opportunity to conduct due diligence was not granted to persons other than the buyer. The Tokyo High Court decided that, “the purchase price and the premium amount considered is unreasonable and can not be assumed to have been just,” as no competitive bids were offered. It is difficult to say whether the “appropriateness” of the price could have been justified if no competitive bids were offered, and it would be necessary to consider this in conjunction with other relevant background information. The Supreme Court’s decision on this point will be instructive.

### **Information disclosure**

In order for a squeeze-out itself not to be labeled unjust - that is, to show that the transaction is not aimed “only” at eliminating minority shareholders, but

at improving corporate value - consideration should also be given to disclosing the buyer's medium to long-term business plans.

Additionally, there must be adequate disclosure of information concerning the appropriateness of compensation. Mere compliance with the requirements of legal disclosure and the relevant financial instrument exchanges is not sufficient. It is also necessary to disclose all available share value assumption reports, any relevant business plans as required by the court in the *Rex Holdings* case and any explanatory memoranda concerning the proposed squeeze-out, particularly after any announcement of deterioration in earnings as in the *Rex Holdings* case.

The disclosure of relevant information at the time of a takeover bid will not only help to avoid subsequent lawsuits by eliminating any information asymmetry between the buyer and the seller in friendly takeovers and MBOs, and thereby reducing the minority shareholders' sense of uncertainty and mistrust, but will also help to achieve an advantageous result in the event of any subsequent lawsuits.

However, tempered against this incentive to disclose, is the need to exercise a certain level of caution. As the Guidelines point out, in some circumstances, revealing a medium to long-term business plan may, due to the high degree of uncertainty in the implementation of such a plan, cause confusion and therefore may actually not be an appropriate item for disclosure.

## Conclusion

The recent cases of *Kanebo* and *Rex Holdings* are instructive for companies in Japan planning an MBO after a TOB, particularly where invoking a squeeze-out method is proposed. A majority shareholder should invoke adequate measures to ensure that any proposed squeeze-out of minority shareholders involves (i) appropriate compensation, both in terms of the takeover bid price and any subsequent compensation payable in a squeeze-out scenario, and (ii) appropriate disclosure of information. These recent cases are also instructive concerning what is "appropriate" in each situation.

This area of law is ever-evolving particularly given that both cases are currently being appealed to higher courts. Stay tuned for an update to this newsletter upon the announcement by the appellate courts of their respective decisions in the *Kanebo* and the *Rex Holdings* cases.

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