Liberalized Rules for the Restructuring of Japanese Companies: Mergers, Demergers, and Share Exchanges under the New Company Law

Moritz Bälz

I. INTRODUCTION

On 1 May 2006, the new Company Law (hereinafter "the Law" and abbreviated CL)[1] entered into force. The most comprehensive reform of its kind in half a century, it is the result of a tremendous effort to modernize Japanese corporate law (so-called *kaisha-hô no gendai-ka*). The reform brings about numerous amendments to the existing rules, including such fundamental changes as abolishing the form of limited liability company (*yûgen kaisha*),[2] creating new company forms like a Japanese LLC (*gôdô kaisha*),[3] eliminating the minimum capital requirement for stock corporations (*kabushiki kaisha*), and introducing even more choices with regard to corporate governance.[4] Most of these changes can be summarized as steps to further deregulate the legal framework for Japanese companies based on the philosophy that giving market forces more leeway will strengthen Japanese enterprises.

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1 *Kaisha-hô,* Law No. 86/2005.

2 Existing limited liability companies may continue to exist as so-called special limited liability companies (*tokurei yûgen kaisha*). As such they are entitled to keep their old firm name and, while in principle subjected to the new Law's rules on stock corporations (*kabushiki kaisha*), are governed by essentially similar rules as before. Alternatively, they can opt to become stock corporations at any time.

3 The LLC in essence combines liability protection for all shareholders as in a stock corporation with large flexibility regarding, *inter alia*, management structure and distribution of profits as in a partnership. For details, see M. DERNAUER, Die japanische Gesellschaftsrechtsreform 2005/2006, in: ZJapanR / J.Japan.L. 20 (2005) 123 *et seq.*

4 For first comprehensive treatments of the new Law, see H. KANDA, *Kaisha-hô* [Company Law] (8th ed., Tokyo 2006) and YANAGA, *Kaisha-hô* [Company Law] (10th ed., Tokyo 2006).

Besides the substantive changes, the new Law consolidates the rules governing the corporate law aspects of commercial companies (*kaisha*), which until now have been contained in the Commercial Code (CC)[5] or spread over various other laws,[6] into an entirely new, systematically structured body of 979 articles. As opposed to the arcane language of the Commercial Code, the new Law is written in modern Japanese (so-called *gendaigo-ka*).[7]

A special focus of the reform was on further liberalizing the rules on corporate restructuring transactions.[8] Leaving aside the amendment of the rules for changes of the corporate form (*soshiki henkô*) in 1990, this area of law had seen rather little legislative activity until the late 1990s.[9] Since then, however, in 1997 the procedures for mergers (*gappei*) were streamlined, in 1999 rules on statutory share exchanges (*kabushiki kôkan*) and statutory share transfers (*kabushiki iten*) were adopted, and in 2000, modeled on Continental European examples, the instrument of demergers (*kaisha bunkatsu*) was introduced.[10] The restructuring options and M&A tools available for Japanese companies have thus been considerably expanded. Book Five of the new Company Law now for the first time provides for a comprehensive set of rules governing all types of restructuring transactions as well as introducing some important improvements. This article is aimed at giving an overview of the most important changes.

The new rules are for the most part applicable both to stock corporations (*kabushiki kaisha*), including those organized as close corporations which from now on are to take over the function of the abolished limited liability companies, as well as to those company forms which Art. 575 para. 1 CL collectively defines as *mochibun kaisha*, *i.e.,*

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5 *Shôhô*, Law No. 48/1899; English translation: NISHIMURA & PARTNERS, Commercial Code of Japan (Tokyo 2004); German translation: O. KLIESOW / U.S. EISELE / M. BÄLZ, Das japanische Handelsgesetz (Cologne 2002). Unless specified otherwise, references to the Commercial Code herein refer to the version in effect before the enactment of the Company Law on 1 May 2006.

6 In particular, the Law on Limited Liability Companies, *Yûgen kaisha-hô*, Law No. 74/1938, the Special Audit Law, *Kabushiki kaisha no kansa-tô ni kan suru hôritsu*, Law No. 22/1974, and the Law on the Promotion of New Business Activities of Small and Medium-Sized Enterprises, *Chûshô kigyô shin-jigyô sokushin-hô*, Law No. 18/1999.

7 For a description of the policy of the Japanese legislator with regard to form, language, and structure of the new Law, see K. EGASHIRA, *Shin kaisha-hô seitei no igi* [The reasons for the enactment of the new Company Law], in: Jurisuto 1295 (2005) 2 *et seq.*

8 See K. EGASHIRA, *"Kaisha hôsei no gendai-ka ni kan suru yôkô-an" no kaisetsu* [Analysis of the "Basic Draft regarding the Modernization of Corporate Law"], in: Bessatsu Shôji Hômu 288 (2005) 1, 4.

9 H. KANDA, *Soshiki saihen* [Restructurings], in: Jurisuto 1295 (2005) 128.

10 For an overview of the development since the 1990s, see M. BÄLZ, Die Spaltung im japanischen Gesellschaftsrecht (Tübingen 2005) 33 *et seq.*; M. HASHIMOTO, Commercial Code Revisions: Promoting the Evolution of Japanese Companies, (NRI paper No. 48/2002) 1 *et seq.*, available online at: <*http://www.nri.co.jp/english/opinion/papers/2002/pdf/np200248.pdf*>; I. KAWAMOTO / M. KISHIDA / A. MORITA / Y. KAWAGUCHI, Gesellschaftsrecht in Japan (Munich/Bern 2004) 44 *et seq.*

general partnerships (*gômei kaisha*), limited partnerships (*gôshi kaisha*), and the newly introduced hybrid form of LLC (*gôdô kaisha*). While the variety of possible restructuring transactions has been broadened, still not all forms of restructurings are available to all types of companies.[11] In order to keep things reasonably simple, this article shall deal exclusively with the rules applicable to stock corporations.

II. BASIC TYPES OF RESTRUCTURING UNDER THE NEW COMPANY LAW

1. *Restructuring Transactions*

The definition section at the head of the new Law contains definitions of the following restructuring transactions (Art. 2 no. 26 through 32 CL): change of form, absorption-type merger, incorporation-type merger, absorption-type demerger, incorporation-type demerger, share exchange, and share transfer. These organizational acts all have in common that they, in general, amount to a fundamental change of the company and therefore, apart from certain exceptions,[12] require qualified shareholder approval. For convenience reasons, here they will be collectively called restructuring transactions (*soshiki saihen kôi*).[13] All these restructuring forms already existed prior to the enactment of the new Law. Nevertheless, before discussing the recent amendments, a brief recapitulation may be helpful.

a. Merger (gappei)

In a merger, two or more existing companies combine their respective assets by becoming one company. Like the Commercial Code,[14] the new Company Law defines two types of mergers: In an absorption-type merger (*kyûshû gappei*, Art. 2 no. 27 CL), one

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11 While a stock corporation or any type of *mochibun kaisha* can now merge with a stock corporation or any *mochibun kaisha*, general partnerships and limited partnerships may not act as a transferring company in a demerger (Art. 757, 762 para. 1 CL). For the reasons, see T. AIZAWA / M. HOSOKAWA, *Soshiki saihen kôi* [Restructuring transactions] Part I, in: Shôji Hômu 1752 (2005) 4, 7. Also, only stock corporations and LLCs can transform themselves into a parent company by way of a share exchange (Art. 767 CL). As under the Commercial Code, only stock corporations can transform themselves into wholly-owned subsidiaries by way of a share transfer (Art. 772 CL).

12 See below sub III.1.

13 The new Law itself does not use such a collective term. The term *soshiki saihen kôi* was, however, used in the legislative materials: *Kaisha-hô no gendai-ka ni kan suru yôkô* [Outline regarding the Modernization of Company Law], in: supplement to Jurisuto 1295 (2005) 192, 209. Commentators also make frequent use of the term: AIZAWA / HOSOKAWA, *supra* note 11, 7; H. KANDA, *supra* note 9, 128.

14 For a description of the rules under the Commercial Code, see KAWAMOTO ET AL., *supra* note 10, 221 *et seq.*; L. KÖDDERITZSCH, Rechtsvergleichende Anmerkungen zum japanischen Verschmelzungs- und Spaltungsrecht, in: ZJapanR / J.Japan.L 11 (2001) 65, 86 *et seq.*

company (the receiving company)[15] continues to exist and the other (the transferring company) ceases to exist without the necessity of a winding-up. All assets (including liabilities) of the transferring company are transferred by way of universal succession to the receiving company. In an incorporation-type merger (*shinsetsu gappei*, Art. 2 no. 28 CL), two or more transferring companies cease to exist and transfer their assets to a newly incorporated company (the new company).[16] Creditors of the transferring companies and the receiving company do not have to consent to the transfer of assets and liabilities. Instead they are protected by a special creditor protection procedure, which gives them the right to object to the envisaged merger. Upon such an objection, the company has to either fulfill the creditor's claim or provide adequate security, unless such a claim is unlikely to be prejudiced by the merger.

b. Demerger (kaisha bunkatsu)

Introduced in 2000 into Japanese law following Continental European models, demergers enable a company to transfer all or part of its assets (including liabilities) by way of partial universal succession to another company.[17] Like the Commercial Code, the new Law distinguishes between absorption-type demergers (*kyûshû bunkatsu*, Art. 2 no. 29 CL) and incorporation-type demergers (*shinsetsu bunkatsu*, Art. 2 no. 30 CL). By an absorption-type demerger, the transferring company transfers all or part of its assets to an existing receiving company. In case of an incorporation-type demerger, the assets and liabilities are transferred to a newly incorporated company.[18] Creditors are protected by a creditor protection procedure which is in many aspects similar to that of mergers.

The new Law abolishes the so-called *jinteki bunkatsu*. Under the Commercial Code, (absorption-type and incorporation-type) demergers could be carried out in two ways: As consideration for the assets transferred by the transferring to the receiving company (or the new company), the latter could issue shares either to the transferring company (so-called *butteki bunkatsu*) or the shareholders of the transferring company (*jinteki bunkatsu*).[19] The first alternative creates a subsidiary, the second a sister company. The new Law no longer contains the latter variant, which anyway has been used far less frequently in practice. Instead, in order to achieve the same result as in a *jinteki*-type

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15 Like the Commercial Code, the new Law permits absorption-type mergers of more than one transferring company combining their assets and liabilities by transferring them to a single receiving company (so-called *kyôdô kyûshû gappei*).

16 This main distinction is in line with the distinction between *Verschmelzung durch Neugründung* and *Verschmelzung durch Aufnahme* under German law.

17 For a comprehensive analysis, see BÄLZ, *supra* note 10. See also M. HAYAKAWA, Neue Regeln für die Gesellschaftsspaltung: Reform des japanischen Handelsgesetzes vom Mai 2000, in: ZJapanR / J.Japan.L 11 (2001) 37 *et seq.*; Ködderitzsch, *supra* note 14, 86 *et seq.*

18 For the question of whether the assets to be transferred must constitute a going concern, see below sub III.5.

19 This distinction corresponds to the distinction between *Ausgliederung* and *Abspaltung* under German law.

demerger, in a first step a *butteki*-type demerger is carried out. In a second step, the transferring company dividends out the shares received as a consideration for the transferred assets to its shareholders. Certain restrictions otherwise applicable to dividends from retained earnings do not apply (Art. 792 no. 2, Art. 812 no. 2 CL).[20] The new procedure can be considered as combining a Continental European-style *butteki bunkatsu* with the second step of a U.S.-style spin-off.[21]

c. Share Exchange (kabushiki kôkan) *and Share Transfer* (kabushiki iten)

Share exchanges and share transfers were originally introduced in Japan in 1999 following the model of the American Model Business Corporation Act (MBCA) in order to facilitate the formation of holding companies.[22] A share exchange (*kabushiki kôkan*, Art. 2 no. 31 CL) is a legal procedure by which a company (the future parent company) acquires 100% of the shares in another existing company (the future wholly-owned subsidiary) by granting the existing shareholders of the future subsidiary shares in the future parent company.[23] Similarly, by a share transfer (*kabushiki iten*, Art. 2 no. 32 CL) a future wholly-owned subsidiary incorporates a future parent company, which at the same time acquires 100% of the shares in the future wholly-owned subsidiary.

A share exchange or a share transfer normally does not imply a transfer of assets, but is limited to a change in the shareholder structure. Therefore, the Commercial Code did not provide for a creditor protection procedure. As there will soon be the possibility to grant consideration other than shares in the future parent company under the new Law,[24] in certain cases, a creditor protection procedure similar to that of mergers or demergers will be required.[25]

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20 Under the Commercial Code, most authors and – even more important – the ministry overseeing the Commercial Registers considered this kind of transaction impossible because dividends were limited to cash. BÄLZ, *supra* note 10, 38. Opposite views already arose under the rules of the Commercial Code: K. EGASHIRA, *Kabushiki kaisha, yûgen kaisha-hô* [The law of stock corporations and limited liability companies] (4th ed., Tokyo 2005) 556, 746.

21 Under German Law since 2002, the articles of association may also provide for such distributions in-kind (sec. 58 para. 5 Stock Corporation Law (Aktiengesetz)). For a comparative view of the various models of demergers and similar instruments, see BÄLZ, *supra* note 10, 2 *et seq.*

22 In 1997 Japanese legislators lifted the ban on holding companies introduced after the Second World War to prevent the re-emergence of the *zaibatsu* conglomerates. For a detailed analysis, see U.S. EISELE, Holdinggesellschaften in Japan (Tübingen 2004) 224 *et seq.* A general description can be found in M. HAYAKAWA, Erleichterung der Konzernierung durch Aktientausch und Aktienübertragung: Die Teilreform des Handelsgesetzes vom Oktober 1999, in: ZJapanR / J.Japan.L 9 (2000) 5 *et seq.*

23 For the possibility to compensate shareholders with other forms of consideration, see below sub III. 2.

24 See below sub III.2.

25 A creditor protection procedure will also be required where the future parent company succeeds into bonds with attached share purchase warrants of the future subsidiary, as from the bondholders' perspective this implies a change in the position of the debtor.

d. *Change of Form* (soshiki henkô)

Pursuant to the definition in Art. 2 para. 26 CL, a change of form (*shoshiki henkô*) enables a stock corporation to become a *mochibun kaisha* (*i.e.*, a general partnership, a limited partnership, or an LLC) or vice versa.[26] Until now, a change of form, which preserves the identity of the company, was only permitted between a stock corporation and a limited liability company on the one hand (Art. 64, 67 Law on Limited Liability Companies), and between a general partnership and a limited partnership on the other (Art. 113, 163 CC). As now a stock corporation can be transformed into a general partnership by entertaining an absorption-type merger, it seems only logical to permit a stock corporation to also transform itself into a general partnership by way of a change of form.[27]

2. *Structure of the New Rules*

While even under the Commercial Code the rules on mergers as the oldest form of restructuring transactions repeatedly served as a model for the other forms and cross-references were frequent, the new Law uses the common features of the various restructuring forms to set out rules in a more systematic way. It does so by exploiting the fact that absorption-type mergers, absorption-type demergers, and share exchanges have in common that an existing company, on the basis of an agreement entered into with another existing company, absorbs assets (in the case of a share exchange: shares) in exchange for consideration granted to the transferring company (in the case of a share exchange: the shareholders of the future wholly-owned subsidiary). As opposed to such absorption-type restructuring transactions, in the case of an incorporation-type merger, an incorporation-type demerger, or a share transfer, the consideration is granted by a new company simultaneously incorporated by the transaction.

Book Five of the new Law first stipulates the mandatory contents of the agreement or plan forming the basis of the respective transaction as well as its legal effects (Chapters One through Four). Then Chapter Five provides for the rules on procedure distinguishing between change of form, absorption-type restructurings, and incorporation-type restructurings. This systematic approach reflects the general policy of the new Law to aim at an improved manageability of the rules by substituting the existing patchwork of the Commercial Code provisions for a new systematic body of rules and by avoiding, to the extent possible, repetitions and confusing cross-references.

26 Changes between various types of *mochibun kaisha* can be accomplished by amending the partnership agreement (Art. 638 CL).

27 AIZAWA / HOSOKAWA, *supra* note 11, 6.

III. MAJOR CHANGES UNDER THE NEW COMPANY LAW

The new Company Law does not stop at rephrasing the existing rules on the various forms of restructuring transactions and putting them in a new systematic order, but also brings about important changes regarding the contents of the rules:

1. Liberalized Shareholder Approval Requirements

Several important changes concern the requirement of shareholder approval for the restructuring transaction.

a. General Rule

Like fundamental changes to the company structure, restructuring transactions under the Commercial Code in principle already required qualified shareholder approval. Under the new Law, absent stricter requirements in the articles of association,[28] generally a special shareholders' resolution (*tokubetsu ketsugi*) is required, meaning a two-thirds majority with a quorum of a majority of the voting rights being present (Art. 783 para. 1, Art. 795, Art. 804 para. 1, Art. 309 para. 2 no. 12 CL). Stricter requirements may apply depending on the consideration offered.[29] Where, e.g., the receiving company in an absorption-type merger or a share exchange offers to shareholders of a public company as consideration shares in a close corporation, (*i.e.*, shares that are not freely transferable), half of the shareholders entitled to vote and two-thirds of the votes cast must support the transaction (so-called *tokushu ketsugi*, Art. 783 para. 1, Art. 309 para. 3 no.2 CL).[30]

*b. Simplified Restructurings (*kan'i soshiki saihen*)*

The new Company Law considerably expands the scope of application for the rules governing so-called simplified restructurings (*kan'i soshiki saihen*). Simplified transactions, as an exception to the rule, do not require a shareholder resolution of a company because the effect on its shareholders is considered minor. Put differently, the transaction does not amount to a fundamental change (*kisoteki henkô*) for the shareholders of such a company.[31] Where, e.g., a large company absorbs a small company by way of a merger, the shares of the existing shareholders of the receiving large company cannot be diluted beyond a certain scale. Therefore, requiring their approval would be

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28 Stricter requirements could, e.g., be stipulated in order to make a cash-out merger in connection with a hostile takeover bid more difficult. KANDA, *supra* note 4, 305.

29 The details are regulated by ministerial ordinance. Special rules apply where a stock corporation has issued various classes of shares.

30 Where a stock corporation grants a partnership interest as consideration, even a unanimous resolution is required (Art. 783 para. 2 CL).

31 KANDA, *supra* note 4, 307.

inefficient and unnecessarily costly.[32] Already under the Commercial Code, with regard to the receiving company of an absorption-type merger, a shareholder resolution was not required where the shares granted by the receiving company in consideration of the transferred assets did not exceed 5% of the receiving company's issued stock (Art. 413-3 para. 1 CC). Similar rules existed for share exchanges and demergers (Art. 358 para. 1, Art. 374-6 para. 1, Art. 374-22 para. 1, Art. 374-23 para. 1 CC).

The Company Law now raises the aforementioned 5% threshold to 20%, while slightly modifying the calculation method (Art. 784 para. 3, Art.796 para. 3, Art. 805 CL). As long as the receiving company in an absorption-type merger does not grant shares or other consideration to the shareholders of the transferring company corresponding to more than 20% of the receiving company's net assets, the receiving company's shareholders are not entitled to vote on the transaction.[33] Similarly, a transferring company will be able to transfer up to 20% of its assets by way of a demerger to another company without holding a shareholders' meeting. A similar threshold exists under Delaware law.[34]

The new Law provides for a few counter-exceptions: Where shares in a close corporation are issued, where a restructuring loss occurs (Art. 796 para. 3 proviso CL),[35] or where shareholders holding a certain percentage of voting shares determined by ministerial ordinance have objected to a simplified merger or a simplified share exchange, a shareholders' meeting must be held (Art. 796 para. 4 CL). Before the reform of 2005, a 20% threshold was available only within the scope of the Industrial Revitalization Law (IRL),[36] *i.e.,* where the competent minister had granted his prior approval to the restructuring.

*c. Introduction of Short-Form Transactions (*ryakushiki soshiki saihen*)*

Furthermore, the new Company Law has introduced rules on short-form transactions. These rules also allow for expedited restructuring transactions without a shareholder resolution. Where a company carries out a restructuring with one of its firmly-controlled subsidiaries, it seems meaningless to require a shareholder resolution in the controlled subsidiary. Given the control of the parent company, the vote would constitute a

32 With regard to the transferring small company, a shareholder vote, of course, remains necessary.

33 Substantially the same rule applies to the receiving company in an absorption-type demerger or the future parent company in a share exchange.

34 See sec. 251(f) Delaware General Corporation Law (DGCL).

35 A restructuring loss occurs if at book value the liabilities transferred exceed the value of the assets transferred, or if the consideration granted by the receiving company at book value exceeds the net assets received due to the transaction.

36 *Sangyô katsuryoku saisei tokubetsu sochi-hô,* Law No. 131/1999.

mere formality.[37] Therefore, in such cases a shareholder vote in the subsidiary will from now on in principle be dispensable (Art. 784 para 1, 796 para. 1 CL). Similar relaxations for short-form transactions are known from Delaware Law.[38] In Japan, short-form transactions so far were only possible within the limited scope of the aforementioned Industrial Revitalization Law.

The new rules on short-form transactions allow a parent company to absorb a firmly controlled subsidiary by way of a merger without the formalities of a shareholder vote in the subsidiary. Often the resolution on the side of the parent company will in such a situation also be dispensable under the aforementioned rules for simplified transactions. However, where the subsidiary serves as a receiving company, a shareholder resolution in the controlled subsidiary is generally indispensable if the shareholders of the transferring company are given shares in a close corporation (Art. 784 para. 1 proviso, Art. 796 para. 1 proviso CL). This is because such a transaction may affect the liquidity of the shareholders' investment.

The prerequisite for a short-form transaction is that the parent company qualifies as a special controlling company (*tokubetsu shihai kaisha*, Art. 468 para. 1 CL). Generally, a special controlling company is a company holding at least 90% of the voting shares in the subsidiary (or any higher percentage stipulated in the articles of association) or fulfills other conditions determined by ministerial ordinance. Based on the rationale that the majority of two-thirds of the votes normally required for the transaction would be certain if a vote were taken, one could imagine the threshold to be lower. However, in the legislative process, those favoring the higher threshold modeled on European examples are said to have prevailed.[39]

In absorption-type restructurings (absorption-type mergers, absorption-type demergers, or share exchanges) carried out as short-form transactions, minority shareholders face the risk that the consideration granted to them might be set unfairly low. The legislators had doubts whether granting the dissenting minority sole remedy appraisal rights, *i.e.*, allowing them to sell their minority share to the company at fair value, would ensure an adequate protection in this case.[40] Even though the Japanese courts under the old Commercial Law have held that an unfair consideration as such was no sufficient ground for an action to nullify the transaction,[41] the prevailing view under the Commercial Code was that the underlying resolution could be voided where a resolution was

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37 T. AIZAWA / M. HOSOKAWA, *Soshiki saihen kôi* [Restructuring Transactions] Part II, in: Shôji Hômu 1753, 37, 43. YANAGA, *supra* note 4, 407.

38 See sec. 253 DCGL.

39 KANDA, *supra* note 4, 308.

40 With regard to the appraisal remedy under the new Law, see also below sub III.3.

41 Tokyo District Court, 24 August 1989, Hanrei Jihô 1331 (1999) 136 (*Mitsui Bussan* case); confirmed in Tokyo High Court, 31 January 1990, Shiryô-ban Shôji Hômu 77 (1993) 193 and Supreme Court, 5 October 1993, Shiryô-ban Shôji Hômu 116 (1993) 197. Opposite view, e.g., KANDA, *supra* note 4, 310.

grossly unfair because a conflicted shareholder had participated in the vote (Art. 247 para. 1 no. 3 CC; now a similar rule is contained in Art. 831 para. 1 no. 1 CL).[42] In the absence of a resolution, even this remedy is not available in a short-form transaction even though a similar conflict situation is given. Therefore, the new Law grants minority shareholders the right to bring an injunction against the transaction if (i) an absorption-type restructuring violates any law or the articles of association, or (ii) the consideration offered is grossly unfair (Art. 784 para. 2, Art. 796 para. 2 CL).[43] It is expected that in some cases a shareholder meeting will be held on a voluntary basis in order to avoid the risk of such injunctions.[44]

2. *Relaxation of Rules Regarding Consideration* (taika jûnan-ka)

a. *Offering Consideration Other than Shares*

Regarding restructuring transactions, probably the most important – in any case the most hotly debated – novelty introduced by the new Company Law is the relaxation of the rules on the kind of consideration which can be offered in cases of absorption-type restructurings.[45] In the case of an absorption-type merger, for example, under the Commercial Code the consideration offered by the receiving company to the shareholders of the transferring company was in principle limited to shares in the receiving company (Art. 409 no. 2 CC).[46] Squeezing out shareholders of the transferring company by offering them only cash was not permitted. There had always remained some doubt as to whether certain techniques developed by legal practitioners to squeeze out minorities by combining a tender offer with a share transfer, in the absence of a proper business

42 EGASHIRA, *supra* note 20, 698; NISHIMURA & PARTNERS, *M&A-hô taizen* [M&A handbook] (Tokyo 2001) 154.

43 See the comment by K. EGASHIRA in: *Zadan-kai: "Kaisha hôsei no gendai-ka ni kan suru yôkô-an" no kihonteki na kangaekata* [Panel discussion: The reasoning of the "Basic Draft regarding the Modernization of Corporate Law"] Bessatsu Shôji Hômu 288 (2005) 99, 127. As the chances to void a restructuring after it has become effective are small, one could think of applying injunctions as a preventive measure in other cases as well. Some have argued Art. 360 CL might be used here, which allows enjoining the management from illegal acts. YANAGA, *supra* note 4, 414 footnote 32. Unless courts are able to decide even complicated cases in a short time, permitting more injunctions might, however, easily block many restructuring transactions.

44 KANDA, *supra* note 9, 132.

45 In incorporation-type restructurings (incorporation-type mergers, incorporation-type demergers, or share transfers), as under the Commercial Code, the new company must issue shares. It may now, however, pay part of the consideration in bonds or share purchase options (Art. 753 para. 1 no. 8, Art. 763 para. 1 no. 8, Art. 773 para. 1 no. 7 CL).

46 While a Japanese company could transform another company into a wholly-owned subsidiary by way of a share exchange, the minority shareholders in such a case had to be given shares in the parent company. Furthermore, foreign companies could not use the share exchange scheme to transform a Japanese target into a wholly-owned subsidiary.

purpose, amounted to an abuse of shareholders' rights, and therefore such transactions bore the risk of being voided.[47] In any case, such transactions proved cumbersome and costly.[48]

The new Law permits offering cash or other assets (including shares in another company, bonds, or warrants) instead of shares in the receiving company (Art. 749 para. 1 no. 2, Art. 751 para. 1 no. 3 CL). Minority shareholders of the transferring company thus now can be "cashed-out" as under the laws of various states in the U.S. Furthermore, by offering shares in the receiving company's parent, U.S.-style triangular mergers (*sankaku gappei*) become possible, in which the acquiring company drops down an acquisition vehicle, merges the target into the vehicle, and compensates the target's shareholders by giving them shares in the acquiring parent.[49] Under which conditions shares in a foreign company may be offered is still under consideration. It might be necessary to have such shares first listed in Japan or to prepare a prospectus. Even foreign acquirers will, however, be able to squeeze out minority shareholders by way of a cash-out merger by merging the target company into a Japanese buyout vehicle and paying cash to the target's shareholders.[50]

The Company Law also contains rules on relaxed consideration requirements for absorption-type demergers (Art. 758 no. 4, Art. 760 no. 5 CL) and share exchanges (Art. 768 para. 1 no. 2, Art. 770 para. 1 no. 3 CL). Again, until now such flexibility regarding consideration had only existed under the Industrial Revitalization Law, *i.e.*, where the envisaged restructuring was carried out with ministerial approval.[51] As on earlier occasions, the IRL thus has served once more as a kind of laboratory for legislative reform.

It is not yet clear under which conditions cash-out restructuring transactions will in the future qualify for tax-free treatment. Under the existing Corporate Tax Law, it is one prerequisite for a tax-free reorganization that the consideration granted consists exclusively of shares in the receiving company (Art. 12 no. 12-8, no. 12-11 Corporate Tax Law[52]).

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47 T. SATÔ / D. MATSUBARA, Cash-out option means more flexibility, in: The IFLR Guide to Japan (2006) 29, 30 *et seq.*; W. TANAKA, *Soshiki saihen to taika jûnan-ka* [Restructuring and the relaxation of consideration], in: Hôgaku Kyôshitsu 304 (2006) 75, 81.

48 THE AMERICAN CHAMBER OF COMMERCE IN JAPAN (ACCJ), Specific Policy Recommendation #2 "Cash Mergers", February 2004, 3 (available online at: <*http://www.accj.or.jp/document_library/PolicyRecs/1077257473.pdf*>).

49 SATÔ / MATSUBARA, *supra* note 47, 29. If the receiving acquisition vehicle does not hold sufficient shares in its parent company, it may, by way of exception from the rule (Art. 135 para. 1 CL), acquire shares in its parent company for such a purpose (Art. 800 CL).

50 SATÔ / MATSUBARA , *supra* note 47, 32 *et seq.*

51 See BÄLZ, *supra* note 10, 159.

52 *Hôjinzei-hô*, Law No. 34/1965.

b. *Taking-Private Transactions and Minority Shareholder Protection*

Practitioners in particular see a strong need for squeeze-out transactions in the context of taking-private transactions. By delisting a target company, the acquirer often wishes to reduce administrative costs of disclosure, to streamline management, or to avoid having to accommodate minority shareholder interests in the future.[53] For this and other reasons, a relaxation of consideration requirement has long been a top priority both of the Japanese business community, in particular the influential Japan Business Federation (*Keidanren*), as well as of foreign and – last but not least – U.S. investors.[54] It also confirms an international trend to protect minority shareholders with regard to their investment, but not necessarily with regard to their position as a shareholder.[55] It seems increasingly common ground that a majority shareholder beyond a certain threshold should be able to acquire all shares in the company, provided the squeezed-out minority is fairly compensated for its economic sacrifice.[56]

To balance the increased flexibility for the majority shareholder with the interests of minority shareholders under the new Law, enhanced disclosure requirements apply where consideration other than shares in the receiving company is offered. It should be added that it is not yet entirely clear whether squeezing-out minority shareholders may be the only purpose of a cash-out restructuring, or whether in addition a proper business reason is required.[57] As already mentioned, the chances to void a transaction based on the argument that the consideration is unreasonably low are slim.[58]

c. *Fear of Hostile Takeovers and Postponed Effective Date*

It is now expected that two-step acquisitions combining a hostile tender offer with a subsequent cash-out merger (often entertained as a short-form merger) may become used in Japan as is common in the United States. Against the background of the takeover attempt by the internet company Livedoor Co. for Nippon Broadcasting System

53 SATÔ / MATSUBARA , *supra* note 47, 30.

54 For the latter, see, e.g., ACCJ, *supra* note 48.

55 German law so far does not permit cash-out mergers. However, the squeeze-out provisions of sec. 327a *et seq.* Stock Corporation Act, introduced in 2002 and since then widely used in practice, show that the idea of forcing minority shareholders out is accepted in principle, provided full economic compensation is offered. The constitutionality of this concept has been upheld by the highest German courts: Federal Constitutional Court (Bundesverfassungsgericht), in: Neue Juristische Wochenschrift 2001, 279; Federal Court of Justice (Bundesgerichtshof), in: Neue Zeitschrift für Gesellschaftsrecht 2006, 117. See also the reference to the German squeeze-out provisions by K. EGASHIRA, *Kaisha hôsei no gendaika ni kan suru yôkô-an no kaisetsu* [Comments on the Basic Draft for a Modernization of Corporate Law], in: Bessatsu Shôji Hômu 288 (2005) 1, 4 footnote 10.

56 For the calculation of the fair compensation, see below.

57 Some commentators consider a squeeze-out transaction without a proper business purpose to be voidable. EGASHIRA, *supra* note 55, 83 footnote 2. YANAGA, *supra* note 4, 383 footnote 8. For the opposite view, see: TANAKA, *supra* note 47, 81.

58 See *supra* note 41.

Inc., this scenario has caused considerable unrest in the Japanese business community. Some Japanese companies are seen as easy targets for hostile takeover attempts by foreign investors, which are feared to entertain triangular mergers, thus exploiting their large market capitalization abroad. Therefore, the ruling Liberal Democratic Party (LDP) decided to have the rules regarding the relaxation of consideration requirements enter into effect only one year after the other parts of the Commercial Law, *i.e.*, on 1 May 2007.[59] The idea is to give Japanese companies the chance to hold one ordinary shareholders' meeting prior to the effective date in which takeover defenses can be adopted.[60] Until May 2007, cash payments will thus be allowed only to compensate shareholders of the transferring company for fractions of shares which are not issued.[61]

*3. Amendments Regarding Appraisal (*kaitori seikyû-ken*)*

The increased flexibility under the new Company Law, in particular the relaxations with regard to consideration, has made the question of minority shareholder protection all the more important. In this field, Japanese law has traditionally relied heavily on the instrument of appraisal rights.[62] While the new Law clearly accepts the idea that minority shareholders can be squeezed-out, the new rules aim at the same time at improving the chances that such shareholders can at least regain their investment by exercising their appraisal rights.

Under the new law, the company has to buy the minority shares at "fair value" (*kôsei na kagaku*; Art. 785 para. 1, Art. 797 para. 1, Art. 806 para. 1 CL), whereas the Commercial Law provided for payment of "the fair value the shares would have had but for the resolution approving … [the transaction]" (*ketsugi nakariseba sono yû subekarushi kôsei naru kagaku*, Art. 374-3, Art. 408-3 CC). It is assumed that the new formula, as opposed to the old one under the Commercial Code, permits the courts to take into account synergies gained by the proposed transaction.[63] As factors which a court could take into account when deciding on the fairness of an offer, commentators, in addition to expert opinions, give the involvement of external directors in the transaction and its approval by other minority shareholders.[64] Where the share price has fallen due to the announcement of the envisaged transaction, some propose to take as fair value the value

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59 See para. 4 of the Supplementary Provisions (*Fusoku*) to the new Law.

60 AIZAWA / HOSOKAWA, *supra* note 11, 9. SATÔ / MATSUBARA, *supra* note 47, 29. TANAKA, *supra* note 47, 83 footnote 38.

61 For details, see AIZAWA / HOSOKAWA, *supra* note 11, 9.

62 M. BÄLZ, Appraisal Rights in Japanese Corporate Law, in: ZJapanR / J.Japan.L 13 (2002) 152 *et seq.* M. HAYAKAWA, Appraisal Rights in Japanese Company Law – Can They Be Used as Modern Weapons for Minority Shareholders?, in: European Business Law Review (EBOR) 2 (2001) 611 *et seq.*

63 EGASHIRA, *supra* note 55, 54. KANDA, *supra* note 4, 297, 162; SATÔ / MATSUBARA, *supra* note 47, 33.

64 TANAKA, *supra* note 47, 80 referring to U.S. standards.

the shares would have had but for the transaction,[65] or even consider the absence of any synergies as an indication for the transaction being voidable under Art. 831 para. 1 no. 3 CL as grossly unfair.[66]

The new definition of fair value strengthens the minority shareholders' position and should be welcomed as a major improvement. Nevertheless, one may have doubts as to whether the appraisal remedy, even in its improved form, is the panacea for minority shareholders' protection as Japanese corporate law seems to assume.[67] Still, the procedure seems rather cumbersome and will often discourage minority shareholders from seeking appraisal.[68]

4. *Effective Date of Absorption-Type Restructuring Transactions*

Japanese companies will from now on enjoy more flexibility with regard to the date on which the legal effects of an absorption-type merger or absorption-type demerger occur. Under the Commercial Code, the assets and liabilities of the transferring company were transferred by operation of law with effect as of the date of registration with the Commercial Register. This date could not be predicted with certainty. This is said to have created obstacles to the circulation of listed shares in the interim period.[69] Now, therefore, the parties to the restructuring agreement, *i.e.*, the transferring company and the receiving company, can agree on a date on which the transaction shall take legal effect (Art. 750 para. 1, Art. 752 para. 1, Art. 759 para. 1, Art. 761 para. 1 CL).[70] In order to protect third parties in the period between the effective date and the registration with the Commercial Register, in the case of an absorption-type merger the dissolution of the transferring company cannot be asserted vis-à-vis third parties before the registration has been made (Art. 750 para. 2 CL). A director of the transferring company could, for instance, sell a piece of land even after the agreed-upon effective date as long as the registration has not been accomplished. This rule applies irrespective of whether the third party was aware of the transaction or not.[71] In the case of an absorption-type demerger, rules on the assertion of the transfer of a specific asset vis-à-vis third parties

65 TANAKA, *supra* note 47, 80.

66 YANAGA, *supra* note 4, 408 footnote 22 and 23.

67 For a critical view under the new Law, see TANAKA, *supra* note 47, 80. For an assessment in the context of demergers under the Commercial Code, see BÄLZ, *supra* note 10, 110.

68 For a skeptical view of the remedy of appraisal rights in general, see from a comparative prospective E. ROCK / H. KANDA / R. KRAAKMAN, Significant Corporate Actions, in: R. Kraakman et al. (ed.) The Anatomy of Corporate Law – A Comparative and Functional Approach (New York 2004) 131, 140 *et seq.*

69 AIZAWA / HOSOKAWA, *supra* note 11, 13; EGASHIRA, *supra* note 55, 82.

70 The shareholder meeting must have approved the transaction (Art. 783, Art. 795 para. 1 CL) and the creditor protection procedure must have been completed before the effective date (Art. 750 para. 6 CL).

71 KANDA, *supra* note 9, 133; YANAGA, *supra* note 4, 387.

(so-called *taikô yôken*) have a similar effect.[72] Share exchanges already under the Commercial Code took effect on the date agreed upon in the share exchange agreement (Art. 353 para. 2 no.6 CC; now Art. 768 no. 6 CL).

In the case of incorporation-type mergers, incorporation-type demergers, or share transfers, as under the Commercial Code, the new company comes into existence and succeeds into the assets and liabilities upon the registration of the new company with the Commercial Register (Art. 754, Art. 764, Art. 774 CL).

5. *Possible Object of a Demerger*

The new Law has redefined the possible object of a demerger. Under the Commercial Code, a demerger enabled a company to transfer "all or a part of its businesses" (*eigyô no zenbu mata wa ichibu;* Art. 373, Art. 374-16 CL). This was interpreted as requiring the potential object of a demerger to qualify as a business (*eigyô*) in the sense of a going concern.[73] Whether or not certain assets constituted a business could, however, be a difficult judgment.[74] Excluding certain assets, contracts, or employees from the object of the transfer bore the risk of making the entire transaction voidable by way of nullification action.[75]

Under the new Company Law, a company can transfer by way of demerger "all or parts of the rights and obligation it has with regard to its businesses (*sono jigyô ni kan shite yû suru kenri gimu no zenbu mata wa ichibu*)."[76] This can be interpreted as also permitting the transfer of assets not forming a going concern.[77] As a requirement under corporate law (as opposed to tax law), the business requirement never seemed to have a convincing rationale. The new formula and the aforementioned interpretation thus should diminish legal uncertainty while leaving the protection of creditors and employees essentially untouched.[78]

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72 KANDA, *supra* note 4, 318.

73 EGASHIRA, *supra* note 20, 746 *et seq.* For a critical assessment of this restriction, see BÄLZ, *supra* note 10, 65 *et seq.*; H. KANSAKU, *Kaisha bunkatsu ni okeru 'eigyô' no igi* [The definition of 'business' in corporate demergers], in: Hôgaku Kyôshitsu 243 (2000) 24 *et seq.*

74 AIZAWA / HOSOKAWA, *supra* note 11, 6.

75 KANSAKU, *supra* note 73, 24 footnote 1; K. TAKEI / M. HIRABAYASHI, *Kaisha bunkatsu no jitsumu* [Corporate Demergers in Practice] (Tokyo 2000) 43.

76 The new Law uses the term *jigyô* instead of *eigyô*, but this is interpreted as a purely editorial change. KANDA, *supra* note 4, 290.

77 AIZAWA / HOSOKAWA, *supra* note 11, 5 *et seq.*; YANAGA, *supra* note 4, 390 footnote 14. This view is now also shared by KANDA, *supra* note 4, 313.

78 See AIZAWA / HOSOKAWA, *supra* note 11, 6. Also under the new Company Law employees remain protected under the Labor Contracts Succession Law, *Kaisha bunkatsu ni tomonau rôdô keiyaku no shôkei-tô ni kan suru hôritsu*, Law No. 18/2003.

IV. CONCLUSION

The enactment of the new Company Law has brought substantial improvements both to the form and to the content of the rules on corporate restructuring transactions under Japanese law. Like the modernization project as a whole, this reform deserves admiration for its bold and comprehensive approach. While at this point in time it is too early to assess the practical impact of the new rules, it will be interesting to see how Japanese companies make use of the additional options offered by the Law. Whether the relaxation of the rules on consideration really will trigger a wave of hostile takeovers in 2007 remains to be seen. It can be predicted with certainty, however, that for everybody interested in Japanese M&A, exciting times lie ahead.

ZUSAMMENFASSUNG

Zum 1. Mai 2006 ist das neue japanische Gesellschaftsgesetz (Kaisha-hô) *in Kraft getreten. Die wichtigste Reform des japanischen Gesellschaftsrechts in mehr als einem halben Jahrhundert bringt neben zahlreichen anderen Neuerungen eine weitere Deregulierung der Regeln für Umwandlungsvorgänge* (soshiki henkô). *Anknüpfend an jüngere Reformen werden den japanischen Unternehmen damit weitere Optionen eröffnet, ihre Struktur veränderten Marktbedingungen flexibel anzupassen. Der Beitrag rekapituliert zunächst knapp die bereits zuvor existierenden Umwandlungsformen, wobei das Recht der Aktiengesellschaft im Vordergrund steht, und geht dann auf die wichtigsten Änderungen ein.*

Das neue Gesetz faßt die Regeln für Verschmelzung, Spaltung, Aktientausch und Aktienübertragung sprachlich vollständig neu und ordnet diese erstmals in systematischer Weise. Aber auch inhaltlich beschreitet das Gesellschaftsgesetz neue Wege: So wird ein Hauptversammlungsbeschluß für Umwandlungen künftig häufiger verzichtbar sein, auch aufgrund der Einführung von besonderen Regeln für konzerninterne Umwandlungsvorgänge. Als noch wichtiger dürfte sich die Liberalisierung der Regeln für die Gegenleistung in Umwandlungsfällen herausstellen. So mußten den Aktionären der übertragenden Gesellschaft bei einer Verschmelzung unter dem alten Recht notwendig Aktien der übernehmenden Gesellschaft gewährt werden. Künftig können U.S.-amerikanischen Vorbildern folgend auch Barzahlungen oder Wertpapiere angeboten werden. Damit werden sog. Dreiecksverschmelzungen oder auch ein Herausdrängen von Minderheitsaktionären gegen Barabfindung (Squeeze-out) *möglich.*

Es darf mit Spannung erwartet werden, wie sich die neuen Regeln in der Praxis auswirken werden. In Wirtschaftskreisen war eine weitere Deregulierung seit langem vehement gefordert worden. Vor dem Hintergrund einiger spektakulären Übernahmeversuche fürchten manche in Japan nunmehr allerdings, daß japanische Unternehmen durch die neuen Instrumente für M&A verstärkt zu Opfern feindlicher Übernahmen werden könnten, insbesondere auch durch Investoren aus dem Ausland. Dies hat den japanischen Gesetzgeber bewogen, speziell die Regeln betreffend die Gegenleistung erst zum 1. Mai 2007 in Kraft treten zu lassen. Abwehrmaßnahmen werden bis dahin hoch im Kurs stehen. Spätestens 2007 wird sich auch zeigen, ob der mit dem neuen Gesellschaftsgesetz unternommene Versuch, zugleich den Schutz der Aktionärsminderheit zu stärken, von Erfolg gekrönt sein wird.