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■RISK AND CRISIS MANAGEMENT/COMPLIANCE

Japan's New Plea Bargaining System: A Tough New Compliance Risk for Companies with Japan Operations?

I. Introduction

Various initiatives in recent years have set in train a number of reforms to the Japanese criminal justice system, including the phased-in introduction of the video recording of interviews with criminal suspects. The reform of most interest to businesses operating in Japan, however, is without doubt the introduction for the first time in Japan of a plea bargaining system (the 'New System').

The New System, which was created pursuant to an amendment to Japan's Criminal Procedure Code in May 2016, is due to come into effect by no later than June 2018. Together with the introduction in recent times of the 'Principles for Listed Companies Dealing with Corporate Malfeasance' and the strengthening of the whistleblowing regime through the new Japan Corporate Governance Code, the New System will likely have the effect of further incentivising both Japanese and global companies in Japan to take meaningful steps to bolster corporate compliance in order to avoid the sometimes devastating consequences of serious corporate malfeasance.

II. Overview of the New Plea Bargaining System

In short, the New System allows for a prosecutor to enter into a formal plea bargaining agreement with a suspect or defendant (whether the suspect or defendant is a natural person or corporate entity) to drop or reduce criminal charges or agree to pre-determined punishment if such suspect or defendant provides certain evidence or testimony in relation to certain types of crimes.

In significant contrast to the plea bargaining system in the U.S., the New System is only available to individuals/companies who provide evidence or testimony in relation to the charges against or crimes of *other* individuals or corporate entities. Cooperation by a suspect or a defendant in relation to an offence s/he has (or allegedly has) committed does not entitle that person/entity to use the New System in relation to such offence. It is this unique aspect of the New System which is considered by observers to be aimed at promoting corporate compliance by allowing for a suspect or defendant to disclose their knowledge of the wrongdoing of *others* in order to have charges against that suspect or defendant dropped or

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reduced, even if the conduct of the other person/company is wholly unrelated to the allegations or charges against the suspect or defendant in question.

The types of criminal offences subject to the New System include not only narcotics and firearm related crimes but also certain categories of white-collar wrongdoing.[1] The principal offences most relevant to corporates which are subject to the New System include bribery,[2] fraud, embezzlement, certain tax and anti-trust related wrongdoing and criminal offences concerning the trade in financial products.

Cooperation on the part of a suspect/defendant is required in order for them to avail themselves of the benefits of the New System. Forms of cooperation contemplated by the New System include the provision of truthful and complete answers to questioning by the authorities at the investigation and/or trial stages and/or cooperation with the gathering of evidence and the use of same in any subsequent criminal proceedings against the other person/company.[3] As a *quid pro quo* for cooperation, the prosecutor is permitted to negotiate and enter into a plea bargaining agreement with such suspect/defendant to agree not to lay a certain charge, discontinue an on-going indictment, charge the suspect/defendant in relation only to a pre-agreed offence and/or with a pre-agreed punishment and also numerous other similar forms of arrangement.[4]

The prosecutor is required to take into account a number of factors when deciding whether to enter into an agreement. These factors include the significance of the (alleged) criminal conduct of the other person or corporate entity in relation to which the suspect/defendant is agreeing to provide cooperation, the probative value to the prosecution of the evidence the suspect/defendant is agreeing to provide and the relative seriousness of the charge against the suspect/defendant providing the cooperation in light of the proposed charge(s) against the other person or corporate entity.

Defence lawyers shall play a central role in the New System. Such lawyers are required to be involved in negotiations in relation to the terms of a potential plea bargaining agreement[5] and the defence lawyers themselves are required to consent to the terms of any agreement reached. This is to protect the rights of their clients and also, as explained further below, help prevent any misuse of the New System.

The New System also permits the parties to a plea bargaining agreement to be released of their obligations under the agreement in certain circumstances. In particular, in the event that it becomes clear (perhaps during a subsequent trial) that a suspect/defendant who is party to an agreement has given false evidence or testimony, the prosecutor may no longer be bound by the agreement.

III. Concerns about the New Plea Bargaining System

A principal concern raised in relation to the New System is that the suspect/defendant may seek to avoid or reduce their own criminal culpability by giving false evidence or testimony to the authorities in an attempt to implicate otherwise innocent third parties in criminal matters.

Certain safeguards shall, however, be put place to attempt to minimize these risks. These include the compulsory participation of defence lawyers in the agreement

[1] Criminal Procedure Code, Article 350-2, Subsection 2.
[2] Criminal Code, Article 198.
[3] Criminal Procedure Code, Article 350-2, Subsection 1.1.
[4] Criminal Procedure Code, Article 350-2, Subsection 1.2.
[5] Criminal Procedure Code, Article 350-4.

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negotiation process,[6] a procedure which allows the disclosure of the terms of a plea bargaining agreement in specific circumstances and criminal sanctions for persons who provide false evidence or testimony or who otherwise abuse the New System.[7]

Notwithstanding these safeguards, there will probably always be a risk that a suspect may give false information in questioning by police and/or the prosecutor purely in response to the psychological strain suspects sometimes experience during detention and questioning by the authorities given the Japanese justice system permits comparatively long periods of detention before a decision on whether charges shall be laid needs to be made by the prosecutor.

IV. Potential Implications of the New System for Companies with Japan Operations

As the New System will not be introduced until 2018, it is too early to know the actual impact that plea bargaining in Japan may have on both Japanese and global companies with business operations in Japan. However, there appear to be a number of quite easily envisaged scenarios where the New System may present serious corporate governance and reputational challenges to corporate players in Japan. In this article we deal with one such scenario and consider the compliance implications.

Scenario: middle-manager employee implicating senior management in criminal conduct

A number of accounting scandals have rocked Corporate Japan in recent years; most notably the Olympus fraud and the Toshiba accounting irregularities. Accordingly, after the New System comes into effect, a real-life scenario along the following lines seems quite plausible.

> *A middle-manager employee whose tasks include managing the financial reporting of a listed company engages in false accounting of the company's financial disclosures in an effort to hide certain losses from the regulators and the market. The employee claims he did this at the behest of the company president. After a whistle-blower alerts the authorities to the misconduct, the employee is interrogated by the regulator on suspicion of false accounting.*
>
> *The employee is advised by his personal lawyer that the New System may enable him to entirely avoid criminal charges if he provides information to the authorities about the involvement of the president in the misconduct. His lawyer advises him that the prosecutor will be far more interested in convicting the well-known president of a listed company rather than an unknown middle-management employee.*
>
> *The employee begins negotiations with the prosecutor about the terms of a plea bargaining agreement designed to facilitate criminal charges being laid against the president and the company itself.*

The risks for the company here are legion. First, if the employee succeeds in executing a plea bargaining agreement, not only the president but potentially other staff and the company itself may be exposed to criminal investigation and possibly criminal sanction. Second, the flow-on consequences may include derivative action by shareholders against the company with all the consequent risks, including potential impact on the company's share price and damage to its public reputation.

Crucially, these risks – and in particular the potential impact on the company's share price and corporate reputation – may manifest *regardless of the veracity of the employee's account of what happened vis-à-vis the false accounting*. If the employee's account is actually false and the president was not involved in the false accounting but rather the employee himself was the only person involved and despite the aforementioned safeguards being in place, these factors may not necessarily prevent such employee from entering into a plea bargaining agreement. This may potentially result in the (false) allegations being aired in open court, potentially creating a crisis situation for company management.

[6] Criminal Procedure Code, Article 350-4.
[7] Criminal Procedure Code, Article 350-15, Subsection 1.

V. Comment

The possibility of the aforementioned risks manifesting after the New System is introduced serves to underline the critical importance of having in place a robust compliance culture. Senior management involvement in risk assessment and management, clear and well-understood internal investigation protocols, effective whistle-blower hotlines, media management strategies and policies to prevent the recurrence of malfeasance will likely take on a new level of importance after the New System comes into effect.

Compliance officers should now start considering the practical steps they can take to protect the company in the event a suspect/defendant tries to misuse the New System by making false accusations against the company. These steps may include protocols about contacting the personal lawyer of a person who has entered into a plea bargaining agreement and who has made serious criminal accusations against the company. Consideration may also be made of effective media strategies to deal with what may be potentially damaging false accusations against the company and/or its management.

In the meantime, the relevant Japanese authorities are gradually releasing further details about how the New System is expected to operate. We will comment on these developments as matters progress.

■CORPORATE/M&A

The Recent Japan Supreme Court Decision on 'Fair Value' for Cash-out in Public M&A Transactions: A Further Step towards Process-oriented Judicial Review?

I. Introduction

Until recently, Japanese courts exercised relatively broad discretion when deciding 'fair value' for cashing out minority shareholders in public M&A transactions. Such trend created a degree of uncertainty and unforseeability for parties in relation to the determination of the cash-out price in going-private transactions.

However, the recent July 2016 Supreme Court decision with respect to the shares of Jupiter Telecommunications Co, Ltd. (the 'JCOM Decision') appears to have narrowed the courts' discretion by determining that in a transaction structured as a tender offer followed by a cash-out where shares subject to a call are utilized,[8] provided the tender offer was conducted pursuant to a process generally accepted as being fair, the cash-out price should, in principle, be the same as the tender offer price.

The JCOM Decision is important insofar as it provides the parties in public M&A transactions with a greater degree of certainty and foreseeability in relation to the cash-out price.

II. Legal Framework in relation to Fair Value for a Cash-out prior to the JCOM Decision

Under Japanese law, a shareholder who opposes the amount of a cash-out price in connection with a squeeze-out process has an appraisal right to request a court to determine the fair value price to be paid to the opposing shareholder. On the assumption that a series of transactions involving a cash-out would increase the corporate value of a target company, fair value has been generally considered by the courts as consisting of a combination of:

(i) the objective value of a share at the time of a cash-out; and

(ii) an increase in the corporate value of the target company as a consequence of the transactions which shall be allocated to the shareholders being cashed out.

In determining the fair value for a cash-out, prior to the JCOM Decision, the courts often took advantage of their relatively broad discretion and made their own assessments of the fairness of the price agreed between the parties. In doing so, the courts often revised upwards the cash-out price and hence deviated from the price agreed between the parties. These revisions were also often done regardless of the substantive fairness of the process adopted by the parties themselves to determine the cash-out price.

When looked at in the round, the courts' reasoning and decisions in relation to fair value in several previous cases did not present a unified and consistent standard to be adopted by judges when adjudicating the issue of fair value. Consequently, the outcome of the court appraisal process was, from the parties' perspective, rather unpredictable and therefore a source of uncertainty. This uncertainty had the potential to increase the acquisition costs for parties involved in cash-out deals.

III. Overview of the JCOM Decision

On February 26, 2013, the majority shareholder acquirers (who owned more than 70% of the voting rights of the target company) announced their acquisition of the target through a tender offer followed by a squeeze-out utilizing shares subject to a call at the same price of JPY123,000 per share for both the tender offer and the squeeze-out.

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[8] Shares subject to a call were usually used for a cash-out at around the time of the JCOM transaction. However, subsequent to a recent amendment to the Japanese Companies Act, such structuring has become less common because it is relatively complicated and time-consuming. Rather, an acquirer instead tends to take advantage of a controlling shareholder's right to request that shares be sold, with such right being available to a person holding 90% or more of the voting rights in a target company. Alternatively, a reverse share split for a squeeze-out may be used.

Following the deal announcement, the target company took, among other things, the following steps:

(i) the company excluded its directors who may have a conflict-of-interest in relation to the acquisition from the company's decision-making process in relation to the tender offer;

(ii) the company obtained from a financial advisor a valuation report which suggested that a per share value was under JPY123,000, as well as a fairness opinion on the purchase price); and

(iii) the company commissioned an independent committee comprised of external professionals and obtained their opinion which supported the board's decision to recommend that the shareholders tender their shares in the tender offer.

After the acquirers completed the transactions and consequently took ownership of all shares in the target company, the shareholders of the target company exercised their statutory appraisal rights, commenced proceedings and asked the court to determine the fair value of the cash-out.

Taking into account the bullish stock market trend until the time of the cash-out after the existence of the transaction was leaked to the media in October 2012, the Tokyo District Court held that the cash-out price should be JPY130,206 per share. This was higher than the tender offer price of JPY123,000 per share which was agreed between the parties. On appeal, the Tokyo High Court upheld the Tokyo District Court's decision.

However, on further appeal, the Supreme Court reversed the Tokyo High Court's decision. The Supreme Court held that even in the case of an acquisition of all shares in a target company via a tender offer followed by a squeeze-out involving a controlling shareholder who has a conflict-of-interest in relation to the deal, provided that the tender offer was conducted pursuant to a process generally accepted as being fair, the cash-out price should be the same as the tender offer price. This is subject to caveats which may apply in exceptional circumstances where the underlying circumstances of the transactions have unexpectedly changed.

The Supreme Court also provided some guidance as to what constitutes a fair process. It stated that if the parties:

(i) take certain steps, such as obtaining opinions from an independent committee or external experts in order to prevent an arbitrary decision-making process in relation to the cash-out price due to any conflict-of-interest between a majority and minority shareholders; and

(ii) explicitly disclose that a cash-out will be carried out for the same price as the first-step tender offer,

then the tender offer process should be deemed to be a 'fair' process. As such, the Supreme Court made it clear that the courts should respect and uphold the price agreed between the parties provided that the process used to arrive at such price was a fair one.

Of note, the Supreme Court has clearly limited the scope of the courts' discretion to determine fair value for a cash-out even if a conflict-of-interest situation exists as was the case in the JCOM transaction. The framework established by the JCOM Decision will also apply to transactions where there is no conflict-of-interest.

IV. <u>Outlook and Comments</u>

We believe that the JCOM Decision has increased certainty and foreseeability on cash-out price for parties involved in these types of transactions and accordingly is a welcome development. However, whilst the tenor of the JCOM Decision seems fair and reasonable and has generally been lauded in the market, there remain important unresolved issues.

For instance, it is still not entirely clear what measures parties should put in place to ensure the fair process emphasized by the Supreme Court in the JCOM Decision. Parties engaged in a similar transaction may potentially want to introduce a 'majority of minority' pre-condition to a first-step tender offer. It may be

also advisable for a target company to have an independent committee play a more expansive and active role in the deal process. This may be done by, for example, giving the committee the task of negotiating the price with a potential purchaser.

Consideration of these types of arrangements to promote a fair process is clearly key given if the cash-out price is subsequently litigated and the court determines the process adopted was not fair, the court would likely not shy away from making its own determination of what the cash-out price should be – thereby potentially not adopting the price agreed by the parties.

Furthermore, it still seems unclear what exceptional circumstances need to be found to allow a court to deviate from a first-step tender offer price when determining fair value. In our view, merely an upward market price trend until a cash-out after a first-step tender offer should not constitute such exceptional circumstance, but further clarification on this point would be desirable. We look forward to further sensible court rulings to address these outstanding issues.

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