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Acquisition Finance

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1. MARKET

1.1 Major Lender-Side Players

Japanese commercial banks, trust banks and government-related banks are major players as senior lenders. In particular, a substantial volume of Japanese acquisition finance is provided by Japan's three mega banks: MUFG Bank, Ltd, Sumitomo Mitsui Banking Corporation and Mizuho Bank, Ltd.

The early period of Japanese acquisition finance saw US and European-based banks playing bigger roles, but fewer non-Japanese banks are currently active in the Japanese acquisition finance market.

Certain Japanese mezzanine funds, bank subsidiaries and lease companies are major players as mezzanine financers. The mezzanine funds include:

- funds established by certain Japanese banks;
- funds established by certain securities companies; and
- independent funds.

1.2 Corporates and LBOs

The Mandated Lead Arrangers of senior loan facilities for acquisition finance in Japan are predominantly the three Japanese mega banks and several other corporate banks, such as Shinsei Bank, Ltd., Resona Bank, Ltd., Aozora Bank, Ltd. and The Tokyo Star Bank, Limited. On the other hand, corporate loans are widely arranged by local banks and corporate banks other than the mega banks, as well as by the mega banks.

The local banks recently came to the acquisition finance market as Mandated Lead Arrangers for small to mid-sized deals, in particular.

1.3 COVID-19 Considerations

The effect of the COVID-19 pandemic on new LBO finance deals has been limited, especially in terms of transaction timelines, required approvals and types of documentation, except that the physical meetings for negotiation and closing have tended to be replaced by virtual meetings. However, COVID-19 has generally had a more severe impact on the existing LBO borrowers.

In those industries that have been significantly affected by COVID-19, borrowers have been in difficult financial situations and have occasionally had to take measures such as:

- negotiating with lenders to relax the financial covenants;
- negotiating with lenders to reschedule the repayment terms of the principals and interests;
- requesting the lenders to permit the use of government-sponsored special relief measures in response to the COVID-19 pandemic, such as subordinated loans with low or substantially zero-interest for small to mid-sized business operators provided by quasi-governmental financial institutions; or
- adding mezzanine financing.

2. DOCUMENTATION

2.1 Governing Law

Japanese law will always govern pure domestic transactions, regardless of whether they relate to a corporate loan or to acquisition finance. Where the lenders are foreign financial institutions, however, the loan facility agreements may be governed by UK or New York law. If the secured assets relate to a jurisdiction other than Japan, the governing law of the security agreements may be the law of that jurisdiction, depending on the applicable conflict of laws rules.

2.2 Use of LMAs or Other Standard Loans

In pure domestic transactions, there is no official form for definitive agreements for senior facilities of acquisition finance; however, in practice, many lenders in the market use a form based on the model syndicated loan agreement form published by the Japan Syndication and Loan-trading Association (JSLA), which is predominantly used for corporate loans.

On the other hand, in cross-border transactions in which the lenders are Japanese mega banks, the globally used forms are becoming more common. When the buyer is a US or European private equity fund, sometimes the LMA form is used (although the governing law is the law of Japan) and sometimes they use their own form, incorporating some globally used terms (such as certain funds) into the Japanese-style form. When the target company is based in jurisdictions where the LMA forms are commonly used, such as the UK, the loan agreement is usually drafted based on the LMA form.

2.3 Language

The controlling language of definitive agreements is usually Japanese. However, when globally used forms are adopted, English is used as the controlling language (although the governing law is the law of Japan).

2.4 Opinions

Legal opinions are almost always required to be issued by the borrower's counsel. Mandated Lead Arrangers usually request the borrower's counsel to cover the following items:

- corporate existence;
- capacity and due authorisation;
- the legality, validity and enforceability of the loan-related documents;
- valid and perfected security; and
- choice of law and forum selection (in cross-border transactions).

3. STRUCTURES

3.1 Senior Loans

Usually, only senior loans are used for debt financing. However, if the size of the deal is large or the leverage of the deal is high, mezzanine finance is used for the debt financing, in addition to the senior loans.

Senior loans usually consist of Term Loan A, Term Loan B and revolver. A capital expenditure (CapEx) line is only sometimes used. Term Loan A is fully amortised, while Term Loan B is paid at maturity in lump sum. Term Loan A and Term Loan B are used to finance the closing of the acquisition, refinancing and the transaction costs. The revolver is used to finance working capital. The term is typically five to seven years. Financial covenants typically include the following:

- leverage ratio;
- debt service coverage ratio;
- minimum net worth;
- positive income; and
- maximum CapEx.

An unusual feature of the syndication market is that investors typically participate in all tranches on a pro rata basis, although this may change in the future. Credit ratings for acquisition finance loans by rating agencies are not yet common in Japan.

Senior loans are secured by a security package.

3.2 Mezzanine/PIK Loans

Mezzanine financing is provided by way of non-voting preferred shares or subordinated loans.

The preferred shares used for acquisition financing are usually non-voting, cumulative and non-participating shares, because the intention of mezzanine investors is to secure the agreed spread. In addition, to secure the mezzanine financer's position, conversion rights to the voting shares are usually attached to the preferred shares so that the financer can exercise the conversion right and seize control of the company in the event of the company's financial distress. In addition, it is common for redemption rights to be granted to the mezzanine financer to secure its exit.

Since dividends to shareholders are paid out after the company repays all creditors of the company, the mezzanine financer – as a preferred shareholder – is structurally subordinated to the senior lenders.

Subordinated loans are secured by a security package, which is almost the same as the security package for senior lenders except that it is second-ranking, subordinate to the first-ranking securities created for senior lenders. The subordinate nature of the subordinated loans is also created through an intercreditor agreement among senior lenders, mezzanine financers and the borrower.

3.3 Bridge Loans

Bridge loans are not commonly used in the context of acquisition finance.

3.4 Bonds/High-Yield Bonds

Bonds are not commonly used in the context of acquisition finance. One of the reasons for this is that, if secured bonds are used, an issuer of secured bonds is required to comply with a range of regulations under the Secured Bond Trust Act (Act No 52 of 1905), which are costly and burdensome.

A high-yield bond market has not yet developed in Japan and, as such, high-yield bonds are not used to finance acquisitions.

3.5 Private Placements/Loan Notes

Since loans for acquisition finance typically do not accompany an issuance of notes, loans are receivables and do not fall under the definition of securities under the Financial Instruments and Exchange Act (Act No 25 of 1948) (FIEA), which is the Japanese securities law. Accordingly, private placement rules are irrelevant. On the other hand, preferred shares used for mezzanine financing are securities, and the issuer typically relies on the small number private placement, which limits the number of offerees of solicitation to fewer than 50.

3.6 Asset-Based Financing

In Japan, asset-based financing is rarely included in the tranches of LBO finance. LBO lenders usually see the asset owned by the target company as a part of the security package for the LBO finance, and take the value of such asset into consideration when they decide on the debt capacity.

4. INTERCREDITOR AGREEMENTS

4.1 Typical Elements

If mezzanine finance is provided in the form of a subordinated loan, an intercreditor agreement is almost always executed between the borrower, the senior lenders and the mezzanine financers.

Contractual Subordination

It is very common to use contractual subordination arrangements, which are achieved by entering into an intercreditor agreement between the borrower, the senior lenders and the mezzanine financers. The contractual subordination arrangement is valid only among these parties,

and cannot be claimed against third parties such as general creditors.

Another way to create the contractual subordination of the subordinated loans is to make the subordinated loan a statutory subordinated claim by agreement between the borrower and the mezzanine financers. Such statutory subordinated claims were introduced in 2005 by amendments to the following:

- the Bankruptcy Act (Act No 75 of 2004);
- the Corporate Re-organisation Act (Act No 154 of 2002); and
- the Civil Rehabilitation Act (Act No 225 of 1999).

However, since statutory subordinated claims are subordinate even to general claims under the insolvency procedures, in practice the mezzanine financers do not prefer them and they are not used for mezzanine loans in acquisition finance.

Structural Subordination

Structural subordination whereby the mezzanine financer provides loans to a holding company of the borrower was historically rarely used in Japan, since the mezzanine finance player in Japan usually sought a position that was at least equal to the general creditors (in a structural subordination arrangement, the position of the mezzanine financer is inferior to the general creditors and equal to the equity holders). However, due to strong demand from private equity funds (especially US or European private equity funds), structurally subordinated mezzanine loans (usually called HoldCo loans) are starting to be used more frequently.

Payment of Principal

Usually, the agreement provides that the maturity of the principal payment of the subordinated loans must be six months or one year later than the maturity of the senior loans. If the senior loans are not fully repaid at the time of maturity of the subordinated loans, the principal of the subordinated loans will not become due and payable until the senior loans are fully repaid.

Interest

Usually, the agreement provides for the following:

- payment of the cash coupon portion of interest of the subordinated loans must be made one business day after the debt service date of the senior loans, subject to certain payment block events (see **Subordination of Equity/Quasi-equity**, below);
- payment of the payment-in-kind (PIK) portion of interest of the subordinated loan must be made on the maturity date of the subordinated loans; if senior loans are not fully repaid at the time of maturity of the subordinated loans, the PIK portion of interest will not become due and payable until the senior loans are fully repaid, as with the principal of the subordinated loans; and
- if any of the specified default events occurs or continues, or if any breach of certain financial covenants occurs on a certain interest payment date, the due date of the interest (cash coupon portion) to be paid automatically jumps to the next interest payment date.

Standstill

If an event of default under both the senior loan agreement and the mezzanine loan agreement occurs, or if any breach of certain financial covenants occurs, a common negotiation point is whether mezzanine financers may accelerate the mezzanine loan after the expiration of a certain agreed period of time (standstill period).

Fees

In practice, in Japan, an upfront fee is paid to the mezzanine financer only at the time of the

drawdown of the subordinated loans under a fee letter. Therefore, there is no provision relating to the payment of such fees in the intercreditor agreement.

Sharing Arrangements

Under Japanese law, it is generally possible to grant ranks of security interest, so it is common for only second-rank security interests to be given to the mezzanine financer. If the enforcement of the security interests is conducted through statutory enforcement procedures, no distribution is made to the second-rank security interest holders until and unless the first-rank security interest holders are fully repaid. However, this distribution rule does not apply if the enforcement of the security interests is conducted through private auction or private sale. Therefore, it is common for the intercreditor agreement to provide that the mezzanine financer must release its second-rank security interests if the security interests are enforced through private auction or private sale, and the senior lenders request this.

In addition, if any distribution is made to the mezzanine financer before the full repayment of the senior loans, it is usually provided under the intercreditor agreement that any such distributions received by the mezzanine financer must be turned over to the senior lenders.

Subordination of Equity/Quasi-equity

It is common for the senior lenders and the mezzanine financers to enter into an intercreditor agreement, even where the mezzanine finance is provided in the form of preferred shares. If so, the dividend claims or the monetary claims arising from the exercise of the redemption rights of the preferred shares are treated as the subordinated claims under the intercreditor agreement. Usually, the agreement provides that:

- the dividend claims must be paid one business day after the debt service date of the senior loans, subject to the same payment block events as those for subordinated loans; and
- the redemption rights cannot be exercised until and unless the senior loans are paid in full.

4.2 Bank/Bond Deals

As mentioned in **3.4 Bonds/High-Yield Bonds**, a high-yield bond market has not yet developed in Japan, and therefore bank/bond deals do not exist.

4.3 Role of Hedge Counterparties

In the Japanese acquisition finance market, it is not a prerequisite for borrowers to enter into interest rate swap arrangements, unlike in the EU/US market. Because of this, hedge counterparties are typically not parties to intercreditor agreements in the Japanese market.

5. SECURITY

5.1 Types of Security Commonly Used

Types of Security

A grant of one security interest over all of a borrower's assets is called "corporate collateral" (*kigyo-tanpo-ken)* in Japan, but corporate collateral is not used in acquisition finance transactions. One reason for this is that the use of corporate collateral is limited by statute to secure corporate bonds only, which are not commonly used for acquisition finance in Japan. Another weakness of corporate collateral is that, as a general security interest, it is subordinated to other types of security interests that are created on more specific assets. Accordingly, a lender who holds corporate collateral cannot assert priority over a creditor who subsequently obtains a security interest over particular assets, which

makes corporate collateral inappropriate for the purpose of acquisition finance.

Due to the weakness of corporate collateral, an acquisition finance lender in Japan usually creates security interests over each asset of the target and its wholly owned subsidiaries, and perfects these security interests. As opposed to the use of floating charges in other jurisdictions, this process incurs extra time and costs in completing the creation of the security interests and their perfection.

There are various kinds of security interests under Japanese law, such as:

- pledges (*shichi ken*);
- security interest by way of assignment (*jouto tanpo*); and
- mortgages (*teitou-ken*).

The kind of security interest used depends on the type of assets. As another classification, if the secured loan is a revolving facility, revolving security interests (such as revolving pledges) are used; if the secured loan is a non-revolving facility such as a term facility, ordinary (non-revolving) security interests (such as ordinary pledges) are used.

Shares

The lenders typically create a pledge over shares.

First, when the issuer of the shares is not a listed company and the articles of incorporation of the issuing company provide that share certificates are to be issued, the execution of a pledge agreement and delivery of the share certificates to the pledgee are required in order to create the pledge. Continuous possession of the share certificates by the pledgee is then required in order to perfect the pledge against the issuing company and third parties. Usually, the security agent receives delivery of the share certificates and keeps them as proxy for all the pledgees.

Second, when the issuer of the shares is not a listed company and the articles of incorporation of the issuing company do not provide that share certificates are to be issued, the execution of a pledge agreement is sufficient to create the pledge. Recording the pledge in the share ledger is required in order to perfect the pledge against the issuing company and third parties.

Third, if the issuer of the shares is a listed company, the pledge becomes effective when the pledgee has the increase in the number pertaining to the pledge described or recorded in the pledge column of the pledgee's account through application for the book-entry transfer (the Act on Book-Entry of Company Bonds, Shares, etc. (Act No 75 of 2001)).

A pledge of shares of partially owned subsidiaries, such as joint ventures, may require the other shareholders' consent, as this is typically required by the shareholders' agreement.

Inventory

See **Movable assets**, below.

Bank accounts

See **Receivables**, below. One additional note on bank account receivables is that, while a credit party can validly create a pledge over its receivable with respect to a fixed deposit account, it is unclear under Japanese law whether a credit party can validly create a pledge over its receivable with respect to an ordinary savings account, because the deposits vary over time through withdrawals, transfers and additional deposits.

Receivables

Receivables (such as trade receivables and bank account receivables) are included in the security

package by the use of a pledge, or by creating a security interest by way of assignment.

The execution of a security agreement is sufficient to create either a pledge or a security interest by way of assignment. Before the amendments to the Civil Code (Act No 89 of 1896) that came into force on 1 April 2020, if the underlying contract prohibits the assignment of the receivables or the creation of a security interest over the receivables (Non-assignable Receivables), obtaining the third-party debtor's consent was required in order to legally and validly create a pledge or a security interest by way of assignment; as such, the lenders usually excluded such Non-assignable Receivables from the security package. Currently, after the enforcement of the amendments to the Civil Code, the lenders are able to legally and validly create security interest over the Non-assignable Receivables without obtaining the third-party debtor's consent. However, since such creation of security still constitutes the borrower's breach of the underlying contract, the lenders usually allow exclusion of the Non-assignable Receivables from the security package, imposing an obligation to use commercially reasonable efforts to amend the underlying contact to remove the non-assignment covenant on the borrower.

There are three ways to perfect either a pledge or a security interest by way of assignment against third parties (other than third-party debtors):

- send a notice with notarisation (*kakutei hiduke*) to the third-party debtor;
- obtain consent with notarisation from the third-party debtor; or
- register the pledge or assignment with the competent legal affairs bureau (under the Act on Special Provisions, etc, of the Civil Code Concerning the Perfection Requirements for the Assignment of Movables and Claims (Act No 104 of 1998) (Registration Act)).

There is no additional requirement for notice or consent to perfect either a pledge or a security interest by way of assignment against the third-party debtor (rather, notarisation is not required for this purpose). However, for registration under the Registration Act, it is necessary to also deliver a certificate of registration to the third-party debtor in order to perfect either the pledge or a security interest by way of assignment against the third-party debtor.

If the third-party debtor is located in a foreign jurisdiction, it is recommended that perfection be made both in Japan and in the foreign jurisdiction. This is because it is possible that the local conflict of laws rules in the foreign country will require the security holder to comply with the perfection process in the jurisdiction in order to enforce the security interest there.

It is possible to create a security interest by way of assignment over future receivables. However, following a series of Supreme Court decisions from 1999 onwards, creating a security interest on future receivables by way of assignment is only valid if the scope of receivables to be assigned is clearly stated in the security agreement, by specifying the following, among other things:

- the period during which the future receivables will arise;
- the name of the creditor;
- the name of the debtor; and
- the transaction giving rise to the future receivables.

In addition, although there is no specific Supreme Court decision, it is widely believed that creating a pledge over future receivables is also possible.

Intellectual property rights

Intellectual property rights may be included in the security package by use of a pledge, or by

creating a security interest by way of assignment. However, since the assignee of a security interest over intellectual property is subject to a risk of infringement by the secured intellectual property, the lenders tend to avoid using the security interest by way of assignment.

For trade marks and patents, the execution of a pledge or assignment agreement and the registration of such is required in order to create and perfect the security interest. However, for copyrights, only the execution of a pledge or assignment agreement is required to create the security interest, and registration is required for perfection against third parties. A registration tax of 0.4% of the amount of the secured claim is imposed when registering the security interest over registrable intellectual property rights, which tends to be costly, so measures to mitigate the registration tax are often used in practice.

Real property

Lenders typically create mortgages (*teitou-ken*) over owned real property.

The execution of a mortgage agreement is sufficient to create a mortgage, and the registration of the mortgage is required in order to perfect the mortgage against third parties. The mortgage agreement is typically drafted to additionally create security interests over the proceeds from the real property. For example, a typical mortgage agreement creates a pledge over any future claim of fire insurance proceeds in connection with the real property. A registration tax of 0.4% of the amount of the secured claim is imposed when creating a mortgage over a real property asset, which tends to be costly, so measures to mitigate the registration tax are often used in practice.

Movable assets

Movable assets (including inventory) are typically included in the security package by creating a security interest by way of assignment.

The execution of an assignment agreement is sufficient to create a security interest by way of assignment. To perfect the assignment against third parties, the borrower must deliver possession of the movable assets to the security interest holder, but the borrower can constructively deliver them by:

- declaring its intention to keep possession of the assets for the security interest holder going forward (*senyu kaitei*); or
- instructing a third person who has direct possession of the movable assets to retain possession for the assignee going forward (*sashizu ni yoru senyu iten*).

As an alternative, under the Registration Act, the security interest holder can perfect the assignment against third parties by registering the transfer with the competent legal affairs bureau.

The lenders can perfect a security interest by way of assignment over not only particular assets but also a group of movable assets (including future ones, such as inventory in a particular storehouse), provided that the scope of the movable assets subject to the security is clearly specified.

In the case of movable assets, perfection is not sufficient to block a bona fide third party from obtaining the right to the movable asset from the borrower by statute (*sokuji shutoku*). To avoid this, the security interest holder should have a notice indicating the creation of the security interest attached to the movable assets.

5.2 Form Requirements

Generally, there is no statutory requirement with regard to forms such as deeds for security agree-

ments. However, for mortgages created over real property, a deed with enforcement acceptance language will enable lenders to enforce the mortgage without obtaining a court decision.

5.3 Registration Process

Please see **5.1 Types of Security Commonly Used**.

5.4 Restrictions on Upstream Security

There is no specific restriction on providing upstream security in Japan. While the directors of the security provider are subject to fiduciary duty, providing security over a subsidiary's assets to its direct or indirect parent company in acquisition financing does not contradict the fiduciary duty of the subsidiary's directors if and to the extent the subsidiary will receive direct and indirect benefits, such as financing through intercompany loans, from the acquisition financing as a group company of the parent. On the other hand, if the subsidiary is directly or indirectly wholly owned by the parent (or if all the minority shareholders consent to the creation of a security interest over the assets of the relevant company), the interests of the parent and the subsidiary align completely, and the fiduciary duty of the subsidiary's directors does not matter in terms of providing upstream security.

5.5 Financial Assistance

There is no statutory financial assistance restriction in Japan. However, the same discussion on the directors' fiduciary duty as noted under **5.4 Restrictions on Upstream Security** applies to providing security interests on behalf of the acquirer.

In the typical leveraged buyout structure, the target does not provide any security interest to the lenders until the target becomes the wholly owned subsidiary of the borrower acquisition vehicle.

5.6 Other Restrictions

Please see **5.4 Restrictions on Upstream Security**.

5.7 General Principles of Enforcement

Statutory enforcement will be implemented pursuant to the Civil Enforcement Act (Act No 4 of 1979), and the law provides specific methods of enforcement for each type of assets. However, in practice, the enforcement of security created for acquisition financing is primarily not supposed to be implemented by statutory method, but rather by way of private disposition. The security agreements and the intercreditor agreement typically provide the agreements among the parties when they proceed with the private disposition of the security assets, such as general guidelines on the sales price, how to proceed with the auction process, and the repayment waterfall. Having said that, it is still very rare for securities created for acquisition financing to actually be enforced in Japan.

6. GUARANTEES

6.1 Types of Guarantees

Joint and several guarantees are typically provided by each credit party other than the borrower, because they extinguish any structural subordination and make it possible to collect the loans from each credit party by way of set-off.

6.2 Restrictions

Providing a guarantee is also subject to the directors' general fiduciary duty. In principle, providing guarantees for the benefit of directly or indirectly wholly owned or wholly owning companies does not raise a fiduciary duty issue because the interests of the guarantee receiver and the guarantor are deemed to be aligned. However, providing a guarantee for the benefit of another group company without receiving corresponding benefits (such as guarantee fees or

financing through intercompany loan) or obtaining consent from all the shareholders raises a fiduciary duty issue. Other than the directors' general fiduciary duty, there are no restrictions on upstream guarantees or financial assistance, as seen in other jurisdictions.

6.3 Requirement for Guarantee Fees

Please see **6.2 Restrictions**.

7. LENDER LIABILITY

7.1 Equitable Subordination Rules

In Japanese terminology, lenders' liability in the broad sense means any liability of a financial institution in connection with its lending in the process of negotiation, closing, administration and collection. The lenders' liability in the narrow sense means the liability of a financial institution due to its excessive control of the borrower. There have been many court precedents about the former and a couple about the latter, but these are lenders' general obligations, and no special consideration on lenders' liability in the context of acquisition finance has yet been actively addressed in Japan. The application of equitable subordination rules to acquisition financers has also not been actively discussed in Japan.

7.2 Claw-Back Risk

Unlike in the US, the claw-back risk for LBO lenders under insolvency procedures in cases where a target company of a certain acquisition that has closed by using the proceeds of LBO finance goes into bankruptcy because of the heavy debt under the LBO has not been actively discussed in Japan.

8. TAX ISSUES

8.1 Stamp Taxes

The types of documents to which stamps must be affixed and the amount of stamp tax for each such document are provided in the Stamp Tax Act (Act No 23 of 1967). In a term loan agreement, a stamp is required on each original copy, in the amount of JPY600,000 if the amount of the loan is JPY5 billion or more. In the case of a revolving loan agreement, a stamp is required on each original copy, in the amount of JPY200. If any original copy of a loan application is issued, the same tax will be applied, so typically the loan application is submitted to the lenders by facsimile (on which tax will not be imposed because it is a copy for the purpose of the Stamp Tax Act). For guarantee agreements, a stamp is required on each original copy, in the amount of JPY200. For securities agreements, a stamp is required on each original copy if the agreement falls under a continuous agreement defined under the Stamp Tax Act, in the amount of JPY4,000.

8.2 Withholding Tax/Qualifying Lender Concepts

Under Japanese domestic tax laws, the interest payable by the borrower to a foreign lender would be subject to withholding tax, at a rate of 20.42%. Such withholding tax can be reduced or exempted under applicable tax treaties, where the conditions for treaty benefits are met.

8.3 Thin-Capitalisation Rules

Japanese thin-capitalisation rules are applicable to interest that is:

- paid by the borrower to its foreign controlling shareholders and certain third-party lenders (eg, those who received financing or guaranty from the foreign controlling shareholders); and
- not subject to Japanese taxation at the hands of the recipients.

A certain portion of such interest would not be deductible, if both the gross amount of interest-bearing debts owed by a domestic entity exceeds three times the amount of capital of the domestic entity, and the gross amount of debts owed by a domestic entity to its foreign controlling shareholders and such third-party lenders exceeds three times the amount of capital of the domestic entity multiplied by the ownership percentage of the foreign controlling shareholders.

In addition to the thin-capitalisation rules, Japanese tax laws also contain earning-stripping rules, which would generally deny the deduction of interest if and to the extent that the total amount of the interest that is paid to (both related and third-party) lenders and not subject to Japanese taxation at the hands of the recipients exceeds 20% of EBITDA of the domestic entity as calculated for this purpose.

9. TAKEOVER FINANCE

9.1 Regulated Targets

Regulated Industries

Certain industries are heavily regulated in Japan, including financial services, aviation, transportation, telecommunications, broadcasting companies, securities exchanges and utility companies. The laws that regulate these businesses often require prior approval from, or advance notice to, the regulator for a change of control or other types of acquisition.

In addition, the Foreign Exchange and Foreign Trade Act (Act No 69 of 1951) (FEFTA) requires a foreign acquirer to obtain advance approval from the government and to be subject to a 30-day waiting period (unless shortened) before being able to acquire shares in a Japanese company whose business relates to:

- national security;
- public order;
- public security; or
- certain protected businesses (such as software, agriculture, petroleum, leather, aviation and marine transportation).

The competent Japanese authorities may issue a recommendation or order the amendment of the terms of the acquisition, or even suspend it. The only example to date of a Japanese authority suspending an acquisition occurred in 2008 when The Children's Investment Fund (TCI), a London-based hedge fund, was ordered to refrain from acquiring up to a 20% stake in J-Power, a domestic electricity company that operates power plants, including nuclear power plants. This was because there was a concern that TCI's shareholding could negatively affect the supply of electricity and the nuclear power policy in Japan, and thereby potentially endanger public order. In addition, the FEFTA more broadly requires post-facto reports for share acquisitions conducted by foreign investors, but such reports are mere formalities.

Effect on Transaction

When the target is conducting a regulated business, it may affect the terms of the acquisition finance. For example, obtaining the necessary regulatory consent may be added as a condition precedent, and some of the assets owned by the credit parties may not be provided as security.

9.2 Listed Targets

Specific Regulatory Rules

Where the target is listed, the acquirer must follow the mandatory tender offer rules under the FIEA, which apply to the following:

- acquisitions in off-exchange transactions where, after the acquisition, the holding ratio (as defined in the FIEA) is more than 5% but less than one-third, except acquisitions of

such shares from ten persons or fewer within 61 days (commonly known as the 5% rule);
- acquisitions in off-exchange transactions where, after the acquisition, the holding ratio exceeds one-third (commonly known as the one-third rule);
- acquisitions in off-exchange transactions where the holding ratio before the acquisition exceeds 50% and is two-thirds or less after the acquisition, except acquisitions of such shares from ten persons or fewer within 61 days; and
- acquisitions of 10% or more of the total issued voting shares (whether in off-exchange or on-exchange transactions or whether already issued or newly issued shares) within three months, provided that this includes acquisitions of 5% or more of the total issued voting shares in off-exchange transactions (except for acquisitions through tender offer), where the holding ratio after the acquisition exceeds one-third (commonly known as the speed acquisitions rule).

In addition, where the holding ratio of the acquirer reaches two-thirds or more after acquisition, a tender offer is always required, and the tender offeror must purchase all classes of equity securities of the target offered in the tender without setting any limit on the number and the class of shares to be purchased (commonly known as the two-thirds rule).

Methods of Acquisition

If a tender offer is required for an acquisition, the tender offeror must file a tender offer registration statement with the regulator describing a wide variety of matters, including:

- the purpose of the transaction, including the management policy following the completion of the transaction;
- the terms of the second step of the transaction, such as a squeeze-out scheme;
- how the tender offer price was calculated, including:
  - (a) the method of the calculation (for example, the discounted cash flow method) and the calculated range of the price; and
  - (b) the ratio of the premium added;
- how the price was negotiated with the target and its principal shareholders;
- whether or not a stock price valuation report was obtained from an expert, and how the opinion of such expert was reflected in the tender offer price;
- agreements between the tender offeror and the target or its management; and
- in the case of management buyouts, the measures undertaken to secure the fairness of the tender offer price. The Ministry of Economy, Trade and Industry has recommended certain measures to secure the fairness of the tender offer price in management buyouts – such as the use of a special committee – in the Fair M&A Guidelines released in June 2019.

Funding

To support the existence of funds to close the tender offer, the tender offeror is required to attach the following to the tender offer statement:

- financing certificates issued by lenders; and
- investment certificates issued by equity investors.

The Financial Services Agency of Japan (FSA) has published its view that such certificates must be supported by a certainty of funding, and has provided examples of what will be required of such certificates in order to support a certainty of funding. The FSA also requires full disclosure on such certificates of the conditions precedent provided in the commitment letters. Generally speaking, the FSA's view on certainty of funding is less restrictive than the "certain funds"

requirements in the UK. In particular, business and market material adverse change provisions that are usually included in the commitment letters from banks are not viewed as impairing the certainty of funding.

Squeeze-Out Procedures

Two methods are typically used in order to squeeze out minority shareholders following a tender offer. The first method uses stock consolidation and requires a special resolution (requiring a two-thirds voting majority) at a shareholders' meeting. The second method is a statutory squeeze-out procedure. While this method is available only to a controlling shareholder holding 90% or more of the voting rights of its subsidiary, its process is simpler and does not require a shareholders' meeting (a board resolution suffices), significantly expediting the squeeze-out process.

Although a squeeze-out transaction can still be completed by securing two-thirds through a stock consolidation, it does not necessarily mean that the transaction will not be blocked by minority shareholders. While no reliable court precedents yet exist in this regard, the general understanding is that a cash-out transaction can be blocked if the relevant shareholders' resolution was made as a result of an abuse of rights of the majority shareholders, thereby making that resolution extraordinarily unfair. The most important factor to measure such extraordinary unfairness is the fairness of the purchase price offered to the minority shareholders. A high holding ratio of the majority shareholders after the tender offer would also be a significant factor.

Minority shareholders also have appraisal rights under the Companies Act, and exercising such rights is the most practical recourse for minority shareholders who are not satisfied with the purchase price. With an appraisal right, minority shareholders may request the target to purchase their shares, and a fair purchase price is determined by the courts if no agreement is made between the minority shareholders and the target. In some lawsuits, the courts have decided in favour of minority shareholders. The rules are gradually being established, but how the courts will decide future cases is not yet perfectly predictable due to a lack of abundant precedents.

10. JURISDICTION-SPECIFIC FEATURES

10.1 Other Acquisition Finance Issues

Unlike in the United States or Europe, the number of players in the LBO loan market is limited in Japan and the secondary market for LBO loan has not yet been matured. For example, hedge funds that invest mainly in distressed debts are not active in Japan. Because of this, an exit by assigning the loan receivables in case of the borrower's default is usually not a practical option for LBO lenders in Japan. Rather, the lenders usually have to give a waiver for an event of default to the borrower in exchange for requesting additional capital injection from the sponsor or adding or tightening the borrower's covenants. In such context, LBO lenders in Japan tend to broadly scrutinise the borrowers' business, assets and governance, and make their initial lending decisions very deliberately.

Nagashima Ohno & Tsunematsu is an integrated full-service law firm in Japan, and one of the foremost providers of international and commercial legal services based in Tokyo. The firm's overseas network includes offices in New York, Singapore, Bangkok, Ho Chi Minh City, Hanoi and Shanghai, as well as collaborative relationships with prominent local law firms worldwide. It represents leading domestic and international clients, having successfully structured and negotiated many of the largest and most significant acquisition finance transactions related to Japan, among many other finance and banking transactions. The firm has more than 500 lawyers, including over 40 experienced non-Japan qualified lawyers from various jurisdictions, who work together in customised teams to provide clients with the expertise and experience specifically required for each matter.

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