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## Market Intelligence

# PRIVATE EQUITY 2022

Global interview panel led by Simpson Thacher & Bartlett LLP

Lexology GTDT Market Intelligence provides a unique perspective on evolving legal and regulatory landscapes.

Led by Simpson Thacher & Bartlett, this *Private Equity* volume features discussion and analysis of emerging trends and hot topics within key jurisdictions worldwide.

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# Contents

<u><a href="#">Global overview</a></u> .....	1
<u><a href="#">Brazil</a></u> .....	11
<u><a href="#">China</a></u> .....	21
<u><a href="#">Colombia</a></u> .....	36
<u><a href="#">Japan</a></u> .....	44
<u><a href="#">Mexico</a></u> .....	56
<u><a href="#">Switzerland</a></u> .....	66
<u><a href="#">United Kingdom</a></u> .....	83
<u><a href="#">United States</a></u> .....	98

**[About Market Intelligence](#) ..... 121**



While reading, click this icon to return to the Contents at any time





1

2

3

4

5

6

7

8

9

10

11

12

13

14

INSIDE TRACK



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# Japan

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## 1 What trends are you seeing in overall activity levels for private equity buyouts and investments in your jurisdiction during the past year or so?

Although the Japanese economy as a whole was affected by covid-19, the number of buyout deals by private equity funds (PE funds) actually increased from 2020. This indicates that PE fund activity remains strong despite the prevalence of covid-19. Buyout deals by PE funds in Japan tend to be relatively small-scale deals of several billion yen to medium-scale deals of several tens of billions of yen. This trend did not significantly change in 2021; however, there were several noteworthy buyout deals exceeding ¥100 billion in 2021. These large deals were performed by global PE funds based outside Japan, such as Blackstone Group and CVC Capital Partners, which shows the strong presence of global PE funds in the Japanese market. There is also an increasing number of deals involving the sale of subsidiaries and business units by major Japanese companies. This is being driven by the need for major Japanese companies to divest unprofitable and non-core businesses and concentrate on their core business. PE funds, typically offering a higher purchase price than other potential buyers and having no significant antitrust concerns, are often chosen as the recipients of these divestments. The number of acquisition deals for listed companies is also on the rise but domestic and foreign shareholder activists are becoming more aggressive in Japan and some deals were prevented from reaching completion by shareholder activists successfully opposing them due to (according to them) a low purchase price.

As for the level of activity within existing investments, there were some cases where restructuring (eg, group reorganisation and workforce reduction) occurred in investee companies whose performance had deteriorated due to the impact of covid-19. There was also an increase in the number of exits through initial public



Yasuhiro Kasahara



Masaki Mizukoshi



Yoshitaka Kato

“PE fund activity remains strong despite prevalence of covid-19.”



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offerings (IPOs) compared to previous years due to the strong Japanese stock market. However, the stock market landscape has drastically changed after the Russia–Ukraine conflict, which has caused the capital market to weaken. This trend is expected to continue, at least for the immediate future.

## 2 Looking at types of investments and transactions, are private equity firms primarily pursuing straight buyouts, or are other opportunities, such as minority-stake investments, partnerships or add-on acquisitions, also being explored?

Many individual founders of small and medium-sized companies in Japan are aging, while their successors have not yet reached a stage where they can take over the business. This is a major driving factor behind business succession of owner companies accounting for approximately half of all buyout deals by PE funds. A typical case is where the founder of an owner company wants to sell their shares in the company upon their retirement, and the PE fund that makes the

most attractive proposal in terms of both purchase price and business strategy takes over the management of the company. In most cases, the PE fund acquires 100 per cent or at least a majority stake (while the founder or co-investor either exits fully or becomes a minority shareholder). This is the same for both listed and unlisted companies but there are cases where the investment is made in the form of a minority stake too. Buyout deals in the manufacturing and service sectors have traditionally been the most numerous but in recent years there have also been many buyout deals in the real estate and construction sectors. The number of buyouts of listed companies, including management buyouts (MBOs), is also on the rise.

## 3 What were the recent keynote deals? And what made them stand out?

In 2021, four equity fund-led large transactions (reported transaction value for each exceeding ¥100 billion) were closed. In particular, CVC Capital Partners acquired the personal care business of Shiseido Company, Limited for ¥160 billion. In this transaction, the personal care business operated by Shiseido and two of its subsidiaries were transferred to a new company, Fine Today Shiseido Co, Ltd, by way of company split and all of the shares in Fine Today were then transferred to KK Oriental Beauty Holding. Shiseido acquired 35 per cent of the shares in the parent company of Oriental Beauty in order to support and operate the transferred business on a stand-alone basis. As the personal care business was operated not only in Japan, but also in China, Hong Kong, Thailand and other Asian countries, Oriental Beauty acquired the business in each Asian country through a carve-out transaction. We acted as CVC's legal counsel in negotiating with Shiseido and in handling the multi-jurisdictional closings. Also, as the products sold by the personal care business are subject to the Pharmaceutical and Medical Device Act of Japan and similar legislation in other jurisdictions, we also provided legal





support relating to the pharmaceutical regulations in the applicable jurisdictions. This transaction was awarded the M&A Deal of the Year (Premium) in the Asia Law Business Japan Awards 2022.

Another notable transaction in 2021 was the PE fund Carlyle's acquisition of two companies from the Japan Asia Group, those two companies being JAG Energy Co, Ltd, which is engaged in biomass power generation and the development renewable energy and Kokusai Kogyo Co, Ltd, which operates a transportation infrastructure business. Carlyle had previously supported an MBO of Japan Asia Group in November 2020, however, City Index Eleventh Co, Ltd, a Japanese activist investor, conducted a hostile takeover against Japan Asia Group in competition with Carlyle and the MBO failed. City Index subsequently withdrew the hostile takeover bid because Japan Asia Group decided to issue a special dividend to its shareholders. Japan Asia Group next sought to implement poison pill procedures and sell all of its outstanding shares in JAG Energy and Kokusai Kogyo,; however, this time the poison pill procedures were blocked by a court ruling. Eventually, Japan Asia Group accepted to be acquired by City Index but before being acquired by City Index sold its shares in JAG Energy and Kokusai Kogyo to Carlyle on August 2021. This deal is notable as the MBO, backed by a PE fund, was initially prevented by an activist investor but the target company eventually accepted a buyout by the same activist investor.

Also during 2021, Apollo Global Management, one of the largest PE funds in the United States, announced two carve-out deals involving large Japanese companies. First, the acquisition of the aluminium can and aluminium rolling business of Showa Denko KK, a leading Japanese producer of functional chemicals and industrial materials. Second, the acquisition of the thermal and emission control materials business from Mitsubishi Chemical Corporation, a leading Japanese diversified chemicals and advanced materials producer. Interestingly, the first deal was Apollo's first Japanese acquisition since it opened

“Global PE funds have a strong presence in Japan. This trend is expected to continue.”

its office in Japan in 2018 and this was immediately followed by the second deal in the same year.

As the above four transactions, all of which occurred during 2021, evidence, global PE funds have a strong presence in Japan. This trend is expected to continue in 2022.

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**4 Does private equity M&A tend to be cross-border? What are some of the typical challenges legal advisers in your jurisdiction face in a multi-jurisdictional deal? How are those challenges evolving?**

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Many of the domestic PE funds tend to target companies in Japan for buyouts. However, in the case of M&A transactions involving domestic manufacturing companies, even if the headquarters of the target company are located in Japan, the company will frequently have manufacturing or sales and marketing companies outside of Japan, which means that there is a cross-border element to the buyout.



Conversely, there are an increasing number of buyouts of Japanese target companies by global PE funds based outside Japan. In both cases, close collaboration with overseas offices and local counsel is essential as multiple jurisdictions, including Japan, are involved.

In cross-border transactions, since it may be necessary to obtain competition law clearance, foreign direct investment (FDI) clearance, and other industry-specific permits and approvals both in and outside of Japan, it is vital to collect the required information in the early stages of the project so that there is sufficient time to analyse in which jurisdiction(s) the buyer will require clearances and to manage the schedule when various types of permits and approvals are needed. In terms of due diligence, while legal due diligence should be performed on each legal entity of the target group, particularly when the target company has subsidiaries in many countries, it is not uncommon (especially in M&A transactions conducted through a bidding process) for there to be insufficient information on overseas subsidiaries, in which case the buyer may not be able to conduct adequate due diligence. In relation to leveraged buyout (LBO) financing, it is also necessary to verify whether guarantees and collateral can be provided by legal entities in each country and how existing loans can be repaid. Furthermore, depending on the capital structure of the seller and the target company, it may be necessary to conduct closing procedures in Japan and overseas but due to time differences and local procedural issues, it might not be possible to close all jurisdictions simultaneously. In such cases, the closings in Japan and the other overseas jurisdictions typically are structured to take place in stages.



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**5 What are some of the current issues and trends in financing for private equity transactions? Have there been any notable developments in the availability or the terms of debt financing for buyers over the past year or so?**

In terms of PE fund financing, interest rates in the Japanese market remained low in 2021, making it relatively easy for PE funds to obtain financing. Japanese mega-banks (MUFG, SMBC and Mizuho) continue to be the main providers of LBO financing, but other banks, including regional banks, are increasingly becoming providers of funds. The number of financiers offering mezzanine financing is also increasing, which is expanding the options for PE funds raising capital in Japan.

There have been no major changes in lending terms and conditions in recent years. The contractual terms and conditions for domestic PE funds raising funds from Japanese financial institutions are generally the same, although deal-specific contractual terms and conditions might sometimes be used. Japanese financial institutions often do not accept the terms and conditions of loans with 'certain



funds' conditions, except in some cases of global PE fund deals or acquisitions of listed companies. However, depending on the bargaining power of the PE fund, there seems to be a gradual increase in the number of cases (such as where the buyer holds a competitive lender bid process) in which PE funds are able to obtain 'certain funds' conditions for their financing.

## 6 How has the legal, regulatory and policy landscape changed during the past few years in your jurisdiction?

Recent amendments to the Foreign Exchange and Foreign Trade Act of Japan (FEFTA) expanded the scope of the industries and actions that trigger an obligation for foreign investors to submit prior notifications to the specified government authorities. Due to these amendments, the number of transactions requiring prior notification has significantly increased. In many cases, foreign-based private equity firms can obtain clearance under FEFTA without substantial difficulties for M&A deals and subsequent actions such as the appointment of directors. Nevertheless, being required to file advance notifications under FEFTA not only when performing the acquisition itself but also for post-acquisition activities is an inconvenient extra step that foreign-based private equity firms must now take. In addition, in light of recent international events and supply chain instability, there is an increasing government tendency to prioritise and examine more critically transactions that may have an impact on the economic security of Japan. In May 2022, the Economic Security Promotion Act was enacted, which focuses on strengthening supply chains, ensuring the stable provision of key infrastructure, developing advanced technologies in the public and private sectors, and protecting patents as non-public information. Although this Act does not directly restrict investment by foreign-based private equity firms, it is expected that future acquisitions of companies that manufacture

'critical substances' designated by the government or provide key infrastructure services will be subject to stricter scrutiny.

The Fair M&A Guidelines: Enhancing Corporate Value and Securing Shareholders' Interests issued by the Ministry of Economy, Trade and Industry (METI) have influenced M&A practices in buyout deals of listed companies. These Guidelines focus on MBOs and the acquisition of companies by controlling shareholders where conflicts of interest and information asymmetries between the buyer and minority shareholders typically exist. The purpose of these Guidelines is to encourage best practice and, although they are not legally binding, the Guidelines have influenced MBO practices since their publication. In particular, following the publication of these Guidelines, there is a trend towards establishing special committees to examine the proposed transaction and for such special committees to become more deeply and actively involved at an earlier stage of MBO transactions. It is becoming common for such special committees to be established not only in MBOs and the acquisition of companies by their controlling shareholders but also in other public transactions involving squeeze-outs that are not directly covered by the Guidelines.

There was also a notable Supreme Court decision in the area of takeover defence in 2021. Prior to the decision, it had generally been regarded that any takeover defence measure that could discriminately harm a specific acquirer (eg, poison pill) required the approval at the shareholders' meeting by at least a simple majority vote. However, the Supreme Court of Japan held that a majority vote at a shareholders' meeting excluding the acquirer's vote can be valid for introducing such takeover defence measures. After this Supreme Court decision, many Japanese public companies believe that they will have more effective defence measures against activist shareholders who stealthily become major shareholders. However, given that poison pills are not a perfect defence measure, the increasing number of





activities by activist shareholders could potentially induce other types of investments by PE funds such as investments as a 'white knight'.

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**7 What are the current attitudes towards private equity among policymakers and the public? Does shareholder activism play a significant role in your jurisdiction?**

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PE funds have become a regular player in a wide variety of M&A deals in Japan, from small business succession deals to large size carve-out deals of major Japanese companies, and are gaining recognition in Japan. Generally speaking, however, employees of target companies do not have a positive image of 'funds' and it is important for PE funds to build a relationship of trust with the officers and employees of the target company at an early stage.

The presence of activist shareholders in Japan is growing. They are increasingly making various demands of the companies in which they hold shares (including dialogue with management), and often submit proposals and express opposition to company proposals at general shareholders' meetings. There have even been cases in which proposals submitted by activist shareholders were approved and the company proposals withdrawn. In 2021, there were several cases where activist shareholders intervened in M&A deals for listed companies by announcing their opinion that the purchase price was too low or by buying up the target company shares themselves, resulting in the share price in the market exceeding the tender offer price and the tender offer being unsuccessful (including MBO deals by PE funds). Therefore, in going-private transactions of listed companies, especially in MBO transactions, it is necessary to fully consider the appropriateness of the price and the possibility of intervention by activist shareholders before proceeding with the transaction.



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**8 What levels of exit activity have you been seeing? Which exit route is the most common? Which exits have caught your eye recently, and why?**

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The number of exit deals in 2021 was reported as significantly exceeding the number in 2020, which shows that the private equity market in Japan was relatively active in 2021. In particular, the number of IPO exit transactions was reported as being the highest it has ever been in Japan. Although there were only five IPO exit deals in 2020, 14 IPO exit deals were executed in 2021. PE funds that invested in companies with high earnings even during covid-19 were likely able to exit such investments at a profitable investment rate. Of particular note is the example of PHC Holdings Corporation, formerly known as Panasonic Healthcare (acquired by KKR in 2014), which listed on the Tokyo Stock Exchange in 2021 with an aggregate market value of ¥452 billion, making it the largest IPO in 2021 in Japan. However, after the Russia-Ukraine crisis, the IPO market has largely been dormant.

**“The Japanese fundraising market has remained strong because of the Bank of Japan’s negative interest rate policy.”**



This trend is expected to continue for at least the immediate future resulting in there likely being fewer IPO exits in 2022.

The number of trade sale exits also significantly increased from 2020; however, the total transaction value of the majority trade sale exits was less than ¥10 billion. As in 2020, during 2021 there was increased activity in the secondary market in which PE firms sold their portfolio companies to other PE firms.

**9 Looking at funds and fundraising, does the market currently favour investors or sponsors? What are fundraising levels like now relative to the past few years?**

Since several large-cap PE funds were closed in 2020, the total amount of PE funds raised in 2021 is reported to have been less than in 2020. However, the Japanese fundraising market has remained strong because of the Bank of Japan’s negative interest rate policy. It appears to be steering Japanese pension funds, financial institutions

and investors into allocating more money for alternative investments. In addition, the aggregate commitment amount of PE funds in Japan since 1997 is reported as exceeding ¥7 trillion as at the end of 2021. A notable fundraising in 2021 was the establishment by Unison Capital of UC Healthcare Provider Co-Investment LPS with a commitment of ¥25.3 billion on December 2021. The purpose of this new fund is to make co-investments in transactions in which Unison Capital provided funds for medical service providers.

**10 Talk us through a typical fundraising. What are the timelines, structures and the key contractual points? What are the most significant legal issues specific to your jurisdiction?**

Limited partnerships for investment business (JLPS) organised under the Limited Partnership Act for Investment are the legal structures most commonly used as vehicles for PE funds in Japan. Historically, PE funds managed by non-Japanese fund operators often used Cayman Islands exempted limited partnerships as the fund vehicles for private equity investments in Japan, and Japan-based fund operators mainly used either Cayman Islands exempted limited partnerships or JLPS. More recently, an increasing number of non-Japanese fund operators are offering limited partnerships organised in other offshore jurisdictions to investors in Japan and an increasing number of Japan-based fund operators are using or considering using JLPS for offerings to investors in Japan and Cayman Island exempted limited partnerships for offerings to offshore investors and Japanese investors who choose to invest through offshore vehicles.

The METI has published on its website a model limited liability partnership agreement for a JLPS. Given that such model limited partnership agreement for a JLPS is published by METI, Japan-based general partners who choose to use JPLS tend to use this model



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agreement as the basis for preparing their limited partnership agreements. Under such model agreement, organising a JPLS is not onerous and can be completed within two or three weeks, depending on the nature of the sponsors and investors. However, experienced fund sponsors tend not to rely so much on the model agreement, and furthermore, there is an increasing trend to use offshore limited partnerships as an alternative fund vehicle for investments by non-Japanese investors. When this parallel fund structure is employed, the terms regarding the JLPS tend to be adjusted to substantially match the terms regarding the parallel (offshore) vehicle.

One of the most significant legal issues under a limited partnership agreement in Japan is the extension of the commitment period. If a PE fund fails to exit a portfolio company before the commitment period expires, the sponsor(s) and investors need to consider extending the commitment period. If the market is not active at the time that the extension is sought, the investors will likely not want to extend the commitment period unnecessarily and thereby incur

additional management fees. Accordingly, extensions of commitment periods are typically negotiated as well as how management fees are to be handled after the extension of the commitment period.

Another legal issue that the sponsor(s) and certain investors, such as financial institutions and insurance companies, often heavily negotiate is the right for an investor to excuse investments that constitute a breach of the laws applicable to the investor or the investor's internal rules. Since the investor's exercise of its right to excuse an investment might interfere with and delay the sponsor's decision to make the investment, the conditions for investors to exercise their right to excuse an investment are often heavily negotiated with the aim (from the sponsor's perspective) of enabling the PE fund to determine its investments at its own discretion to the maximum extent possible.

#### 11 How closely are private equity sponsors supervised in your jurisdiction? Does this supervision impact the day-to-day business?

The Financial Instruments and Exchange Act of Japan (FIEA), which is the main legislation in Japan regulating securities brokers and fund managers, is generally applicable if either an investor of the fund vehicle or a general partner of the limited partnership (LPS) fund is domiciled in Japan. As a general rule, unless one of the exemptions from registration applies, a fund operator of a foreign LPS or JLPS will be required to be registered as a financial instruments business operator under FIEA to serve as the investment manager of the fund's assets in Japan.

Although FIEA provides several exemptions from the registration requirement mentioned above, one of the exemptions used by many general partners is the exemption from both the investment management business registration and Type II registration requirements (known as the 'Qualified Institutional Investor (QII)





“JLPS are formed as a pass-through entity for Japanese tax purposes, which means that an investor in a JLPS is subject to tax.”

special business exemption’), which is available to the general partner of a fund structured in the form of a partnership. If a general partner qualifies for the QII special business exemption, the general partner must file a notification (an article 63 Notification) with the Local Finance Bureau (and in the case of a foreign general partner, with the Kanto Local Finance Bureau) prior to commencing the contemplated fund business in Japan. In addition, the general partner who files the article 63 Notification will be subject to additional compliance requirements (including adherence to code of conduct rules and disclosure requirements and maintenance of statutorily required books and records).

Requirements for the QII special business exemption were substantially amended with effect from 2016. Under such amendments, the qualifications and requirements imposed on fund operators engaging in solicitation of investors or management of fund assets under the QII special business exemption were significantly strengthened.

## 12 What effect has the AIFMD had on fundraising in your jurisdiction?

Given that the AIFMD applies only to a manager who operates a fund in the European Union, the AIFMD has had only a limited impact on fundraising in Japan and the practice of Japanese PE funds. Generally, most PE funds in Japan are formed as a JLPS and fund managers operating the PE funds are usually domestic fund managers. Accordingly, there would potentially be only a limited number of PE funds in Japan to which the AIFMD applies.

## 13 What are the major tax issues that private equity faces in your jurisdiction? How is carried interest taxed? Do you see the current treatment potentially changing in the near future?

Under tax reforms over the past several years, if certain requirements are satisfied, some corporate reorganisations may be treated as not incurring tax or permitting the incurring of tax to be deferred. For example, in relation to the method to squeeze out minority shareholders known as ‘share delivery’ (*kabushiki kofu*), the 2021 tax reform makes it possible for capital gains caused by a share delivery to be deferred subject to certain requirements.

JLPS are formed as a pass-through entity for Japanese tax purposes, which means that an investor in a JLPS is subject to tax. If a foreign investor is deemed to have a permanent establishment in Japan, such foreign investor is obligated to file a tax return in Japan. In addition, a foreign investor in a JLPS is subject to withholding tax on distribution from the JLPS business if (1) the foreign investor is a limited partner in a JLPS and (2) with respect to the business of the JLPS, the general partner has a permanent establishment in Japan. Although a foreign investor can become a limited partner without being deemed to have



a permanent establishment in Japan if certain requirements are met, it is practically difficult to meet such requirements. Accordingly, Japanese private equity funds typically form a foreign limited partnership for foreign investors as well as the JLPS that targets Japanese investors.

Japanese tax legislation does not generally impose tax on capital gains from the sale or disposition of shares in a Japanese company by a foreign shareholder (ie, a non-Japanese individual or foreign company) unless the foreign shareholder owns 25 per cent of more of the shares in the Japanese company and disposes of 5 per cent or more of those shares in the same tax year (25/5 Rule). In determining whether either the 25 per cent ownership or 5 per cent disposition is met, all shares held by the partnership are attributed to a foreign investor. However, if certain requirements are met, the shares held by the partnership are not required to be attributed to the foreign investor for the 25/5 Rule purposes.

#### 14 Looking ahead, what can we expect? What might be the main themes in the next 12 months for private equity deal activity and fundraising?

Although the Japanese government took several lockdown-like measures to deal with covid-19 during these past three years, more recently the government has been seeking to avoid implementing any measures that would have a negative impact on Japanese economic activity. Given this more recent flexible approach of the government, the private equity market in Japan can be expected to be active in the next 12 months. At the same time, many Japanese companies have been negatively impacted by the government's earlier covid-19 policies and are struggling to handle the resulting financial difficulties. For example, in June 2022, Marelli Holdings, Co, Ltd, one of the largest auto-parts supplier owned by KKR & Co, entered into a

court-led rehabilitation procedure because of the financial difficulties caused by covid-19 policies and supply chain disruptions. In the next 12 months, other Japanese companies might face a similar situation, which may in turn create opportunities for private equity funds to take part in distressed M&A transactions.

Further, as mentioned above, activist shareholders have become aggressive in recent years in Japan. This trend may create opportunities for Japanese private equity funds to acquire Japanese listed companies to save them from activist shareholder behaviour. On the other hand, since the Japanese stock market has been slow since the beginning of 2022, a trade sale may be a more preferable exit method than IPOs during 2022.

In recent years, sustainability issues represented by the environmental, social and governance (ESG) movement have become an important factor in global private equity fund transactions. In Japan, interest in ESG is growing and ESG may become one of the material factors in fundraising or in M&A transactions by private equity funds in Japan in the near future.

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## The Inside Track

### **What factors make private equity practice in your jurisdiction unique?**

Domestic PE funds are active in small to mid-cap markets, mostly dealing with private companies, while global PE funds are active in the large-cap market and cross-border transactions. Domestic PE funds are sometimes unable to get 'certain funds' conditions as Japanese banks typically have greater bargaining power on these terms. As to warranty and indemnity (W&I) insurance, while the number of domestic matters that use W&I insurance remains relatively low, we are seeing increased use of W&I insurance, especially where PE funds are the sellers.

### **What should a client consider when choosing counsel for a complex private equity transaction in your jurisdiction?**

The counsel should be experienced in PE fund transactions and the variety of transactional structures used in the Japanese market as well as possessing expertise in both the corporate and financing laws and practices of Japan. If the matter involves cross-border issues, the counsel should have its own foreign offices or access to a strong network of foreign law firms that also have expertise in PE fund M&A transactions. In short, the client should confirm whether the law firm has a dedicated PE fund team as well as solid M&A and LBO financing experience.

### **What key changes do you foresee in relation to dispute What interesting or unusual issues have you come across in recent matters?**

Listed companies are experiencing stronger pressure from activist shareholders and the expected role of PE funds is changing. For instance, if a listed company has a weak stock price, the company could perform an MBO transaction with support from a PE fund to avoid disruptions to its operations from the acquisition of its shares by activist shareholders. For listed companies that are already under attack from activist shareholders, PE funds can be a white knight. We feel that the Japanese market is entering into a phase where listed companies and PE funds may become strategic partners.