September, 2024 No.47

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INTELLECTUAL PROPERTY, IP TRANSACTIONS

IP Licensing and Insolvency - Recent Developments in the Protection of Licensees and Remaining Issues under Japanese Law

I. Introduction

For a licensee, the sudden termination of an IP license agreement, whether in whole or in part, can be tantamount to a withdrawal from the licensee's business. Therefore, it is advisable to carefully review the terms of the agreement and make sure that everything is in place to prevent such a situation from occurring. However, over the relatively long term of an IP license agreement the licensor's financial situation may change over time, and it is possible that insolvency proceedings may be initiated against the licensor. Prior to the series of amendments to the Japanese intellectual property laws described below, IP license agreements were often subject to termination upon the commencement of insolvency proceedings, and IP license agreements were unstable in that they could be suddenly terminated by the trustee.

Over the past decade, there have been vigorous debates about strengthening licensee protections in the above context, and the Patent Act was amended in 2011 (the "**2011 Amendment**")[1] and the Copyright Act was amended in 2020 (the "**2020 Amendment**"). At the same time, however, some important issues remain unresolved. In addition, a report published in March 2023 by the Advisory Council of the Ministry of Economy, Trade and Industry (the "**Report**")[2] concluded that no amendment will be made to the law on trade secrets for the time being. This newsletter provides an overview of these key topics, with a focus on the bankruptcy of the licensor[3].

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[1] The same amendments were also made to the Utility Model Act and the Design Act.

[2] Designing the Unfair Competition Prevention Act in view of the diversification of business resulting from digitalization (March 2023) (Japanese only)

[3] Japanese law provides for four types of insolvency proceedings: bankruptcy proceedings, civil rehabilitation proceedings, corporate reorganization proceedings, and special liquidation proceedings.

II. Protection of Licensee

(i) General Rule - Trustee's right to cancel under Bankruptcy Act

Article 53(1) of the Bankruptcy Act provides that if both the bankrupt party and the counterparty under a bilateral contract have not yet fully performed their respective obligations at the time of the commencement of bankruptcy proceedings, the bankruptcy trustee may choose either to cancel the contract or to perform its obligation. However, Article 53(1) does not apply to the extent that (a) the contract grants a leasehold right or any other right of use or exploitation and (b) the counterparty has a registration or satisfies any other requirements enabling it to duly assert and enforce such right against any third party (Article 56(1) of the Bankruptcy Act). Prior to the 2011 Amendment, the only way to satisfy this requirement with respect to industrial property rights, which become effective upon registration with the Japan Patent Office (the "**JPO**"), was to register the license with the JPO. However, under Japanese practice, the number of registered licenses was extremely limited. In addition, there was no such system for registering copyright licenses, so this requirement could not be met with respect to copyright licenses.

(ii) Patents[4], Copyrights and Trademarks

The 2011 Amendment introduced a new rule that enables a patent licensee to assert and enforce an ordinary license[5] not registered with the JPO against any third party that acquired the licensed patent after the grant of the license (Art. 99 of the Patent Act). With effect from October 1 2020, similar amendment has been introduced to the Copyright Act so that a copyright licensee may assert and enforce a copyright license against any third party that acquired the licensed copyright after the grant of the license. Following these amendments, a licensee of a patent or a copyright is always entitled to assert and enforce such license against any such third party, and therefore, such license agreement will continue even in the event of the licensor's bankruptcy as the licensor's trustee is no longer able to cancel such license agreement.

The 2011 Amendment could have introduced the same rule for trademark licenses. However, the government decided not to amend the Trademark Act in view of the important differences between patent licenses and trademark licenses, for example, a trademark license imposes more material restrictions on a third party who acquires the licensed trademark without being aware of the existence of such license than does a patent license, because the trademark may no longer function as an indication of origin and quality if the existing licensee uses the trademark. Thus, the importance of registering trademark licenses remains unchanged in the context of the licensor's bankruptcy.

(iii) Trade Secrets

Under Japanese law, trade secrets (e.g., know-how) may enjoy legal protection if they meet certain requirements, such as being kept secret. Similar to copyrights prior to the Amendment 2020, there has been no system for registering trade secret licenses with the JPO, and in the event of the licensor's bankruptcy, the trustee may cancel trade secret license agreements. The protection of trade secret licensees had been discussed in recent years taking into account the different nature of trade secrets compared to other IP rights[6], and the Report was issued in March 2023. The Report concluded that no amendments to the Unfair Competition Prevention Act should be made for the time being, and that the review should continue. One of the reasons given by the Advisory Council for not amending

[4] The same licensee protection was adopted under the Utility Model Act and the Design Act when these Acts were amended in 2011.

[5] The Patent Act provides for two types of patent licenses: (i) a registered exclusive license (*senyo-jisshiken*); and (ii) an exclusive/non-exclusive ordinary license (*tsujo-jisshiken*). Since the former becomes effective upon registration with the JPO, before the 2011 Amendment the former is always protected from such cancellation by a trustee.

[6] The scope of trade secret protection is limited. For example, a trade secret holder is entitled to prohibit a third party from using the trade secret only if such use constitutes a violation of the Unfair Competition Prevention Act, such as use "for the purpose of wrongful gain, or causing damage to the trade secret holder" (see Art. 2(1)(vii) of the Unfair Competition Prevention Act). This means that in some cases a purchaser of the licensed trade secrets may not be able to prevent the licensee from cotinuing to use the trade secrets.

at this time is that "there have been no actual disputes that have come to light so far", and in practice the risk to licensees does not appear to be high. However, in the interim report issued prior to the Report, the Advisory Council's discussions suggested that if the licensor goes bankrupt and the trustee terminates the license agreement, then the licensee loses the right to use the trade secret thereafter, and thus in many cases it would be considered that the requirements for an infringement of a trade secret under the Unfair Competition Prevention Act have been met. For companies operating on the basis of a trade secret license, especially in the case of manufacturing, which often involves a huge investment in manufacturing facilities that use the licensed trade secret, it must be said that this would leave uncertainty in their business.

III. Remaining Issues - rights and obligations other than the ordinary license

As discussed above, the trustee cannot terminate the most types of IP license agreements, but it would still be possible for the trustee to transfer the licensed IP to a third party for the purpose of liquidation. Even in this case, the licensee may assert and enforce the ordinary license against the assignee, but whether the license agreement (i.e., the rights and obligations other than the ordinary license under the IP license agreement) is succeeded by the third party is a separate issue. Except in cases where an exclusive registered license is granted, this issue concerns, for example, the exclusivity of the license and the right to sublicense, which are only contractual rights and obligations agreed upon with respect to an ordinary license.

As a general principle, the Civil Code provides that contractual rights and obligations may not be transferred to a third party in the absence of an agreement between the parties concerned (except where there is a general succession by operation of law), while case law on real estate leases provides that when ownership of a leasehold estate is transferred from a lessor to a third party, the third party automatically assumes the lease agreement between the lessor and the lessee (including all rights and obligations thereunder) if the lessee is entitled to assert and enforce its leasehold right against the third party. Whether the general principle or the case law (or any other special rule) applies to IP licenses had been debated, however, both the 2011 Amendment and the 2020 Amendment took the position of leaving it to the courts to decide on a case-by-case basis-to date, no court in Japan has had the opportunity to provide any further guidance on this issue.

Since the law does not provide clear rules as to whether such a third party assumes all contractual obligations under a license agreement, from a practical point of view, new IP owners and existing licensees are expected to negotiate and agree upon the terms of a licensing arrangement following the acquisition of licensed IP. However, from a licensee’s perspective, it should be borne in mind that, if such negotiations fail, the worst case scenario is that exclusivity and a sublicensing right will be treated as follows: (i) exclusivity – the new IP owner does not assume the obligation and may grant licenses to other parties; and (ii) sublicensing right – the new IP owner does not assume the obligation and the licensee is no longer entitled to grant new sublicenses, provided that the new IP owner must assume all sublicenses granted to the sublicensees prior to its acquisition of the licensed IP because such sublicensees are entitled to assert and enforce their ordinary licenses against any third party that acquires the licensed IP after the grant of such license (i.e., the new IP owner) as discussed in II. above.

IV. Conclusion

While the series of amendments to Japanese intellectual property laws can clearly be seen as having successfully strengthened the protection of licensees, there are still some issues and uncertainties for licensees as discussed above. Since they cannot be directly addressed by contractual provisions, there are still situations where certain practical arrangements for licensees are necessary, such as operational measures to ensure that the licensor's financial situation is monitored in a timely manner and contractual clauses allowing certain actions to be taken prior to the commencement of bankruptcy proceedings.

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CORPORATE GOVERNANCE, MERGER & ACQUISITIONS

Amendments to the Large Shareholding Reporting System

I. Introduction

The large shareholding reporting system in Japan (the "**Large Shareholding Reporting System**") was introduced in 1990, and has not been the subject of significant amendment since 2006. However, in response to environmental changes in capital markets and enhancement of the fairness and transparency of the market, on December 25, 2023, the working group established by the Financial Services Agency (the "**FSA**") has released a Working Group Report regarding the Tender Offer and Large Shareholding Reporting System (the "**FSA Report**") in which the working group pointed out issues concerning the current tender offer and the Large Shareholding Reporting System and suggested some amendments thereto. In light of the suggestions in the FSA Report, the amendments (the "**Amendments**") to the Financial Instruments and Exchange Act (the "**FIEA**") were proposed and passed by the Diet on May 15, 2024. Since the Amendments may have a material impact on the practice of the Large Shareholding Reporting System, we are introducing an outline of these Amendments in this newsletter, as well as a recent enforcement case brought against a failure to submit a large shareholding report.

The Amendments related to the Large Shareholding Reporting System will be effective within two years from the date of their announcement. It should be noted that while the detailed rules of the Reporting System are prescribed in the FIEA enforcement order (the "**Enforcement Orders**") and the Cabinet office ordinances related thereto (the "**Cabinet Office Ordinances**"), the proposed amendments of the Enforcement Orders and Cabinet Office Ordinances are being discussed and will be released before the effective date of the Amendments.

II. Overview of the Amendments

(i) Scope of the "Material Proposals" (*Juyo-teian-koui*)

Since institutional investors repeatedly and continuously sell and purchase stock certificates (including shares in a listed company and defined in the FIEA) in the course of their day-to-day operations, the FIEA allows such institutional investors to use a special reporting system, in which the rules on the frequency and the period for submitting large shareholding reports and changes reports are relaxed to a certain extent (the "**Reporting Exception System**"). However, the Reporting Exception System is not applicable when such stock certificates are held for effecting material changes in or having a material effect on the business activities of the issuing company (collectively, "**Material Proposals**").

Because a narrower and more clearly-defined scope for Material Proposals would facilitate engagement between an issuing company and investors, the FSA Report suggests (i) that proposal concerning acts directly related to management control be deemed Material Proposals, but (ii) that a proposal concerning acts not directly related to management control be deemed Material Proposals only where the manner of such proposal is such that the proposal's adoption is not left to the management of the issuing company.

While the explanatory materials related to the Amendments published by the FSA indicated that proposals unrelated to management control such as change of the dividend policy or capital policy of the issuing company are not included in the scope of Material Proposals, how exactly this scope will be amended is not clear from the language of the Amendments. The details thereof are expected to be addressed in the amendments to the Enforcement Orders and the Cabinet Office Ordinance.

(ii) Scope of the Joint Holder

Under the Large Shareholding Reporting System, where there are multiple holders of stock certificates who agree to jointly conduct acquisition or disposal of such stock certificates and exercise shareholder's rights such as voting rights, such shareholders are treated as substantive joint holders. Because joint holder status affects whether shareholders are deemed to exert an influence on the management of the issuing company, the Amendments suggests that a shareholder be excluded from joint holder status if the following requirements are met:

- All of the holders are Financial Instruments Business Operators (defined in the FIEA), banks or other persons to be specified in the Cabinet Office Ordinances;
- The purpose of the agreement does not constitute a Material Proposal; and
- The agreement is an agreement to jointly exercise voting rights or other rights (which agreement shall be limited to an agreement specified in the Cabinet Office Ordinances).

As in the case of the scope of the Material Proposals, the detailed rules of the scope of the joint holders are expected to be clarified in the amendments to the Enforcement Orders.

III. Enforcement to breach of the Large Shareholding Reporting System

The amendments of the FIEA in 2008 introduced the imposition of administrative monetary penalties on persons who fail to submit a large shareholding report and/or make a false statement therein. Nonetheless, there have only been eight cases of the imposition of such penalties for the period between 2008 and May 2024. The FSA Report pointed out that many shareholders who are obligated to file a large shareholding report fail to do so, and the Large Shareholding Reporting System is not routinely enforced. Recently, there have been cases in which multiple shareholders were accused of implicitly cooperating to acquire shareholdings in an issuing company, taking advantage of the difficulty in accurately ascertaining the details of the agreements between shareholders in order to identify them as joint holders (so-called "**wolfpack tactics**"). In a notable case where the Japanese Supreme Court decided in 2022 that the takeover defense measures used by Mituboshi Co., Ltd. ("**Mitsuboshi**") were in violation of the Companies Act, the activist fund who had acquired the shares in Mitsuboshi implicitly cooperated to acquire such shares with multiple shareholders. This case, which attracted a great deal of attention, was also an example of the wolfpack tactics mentioned above.

In light of the foregoing, the Securities and Exchange Surveillance Commission (the "**SESC**") announced on June 28, 2024 its recommendation to the Commissioner of the FSA to issue an order to pay an administrative monetary penalty for non-submission of a large shareholding report and false statements in a change report in relation to the shares in Mitsuboshi. In accordance with this recommendation, the Commissioner of the FSA has decided to impose an administrative monetary penalty of JPY 320,000 on one of the shareholders subject to this recommendation as of Augst 28, 2024. It is notable that this is the first case where an administrative monetary penalty was imposed solely for a violation of the requirement to submit a large shareholding report.

IV. Conclusion

In addition to the above, the Amendments include material changes which would have impact on the practice of the Large Shareholding Reporting System; however, as mentioned above, it should be noted that the details of the Amendments will be clarified in the upcoming amendments to the Enforcement Orders and Cabinet Office Ordinances. We recommend keeping an eye on the developments with respect to these further amendments to the related orders and regulations, as well as changes to the practice of the Large Shareholding Reporting System.

Moreover, it will be important to monitor the FSA's enforcement of the Reporting System after the Mitsuboshi case, as this may have an impact on foreign investors holding stock certificates for listed companies.

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