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REAL ESTATE AND REITS / HOSPITALITY

Legal Issues Related to Branded Residences with Some Recent Updates on Relevant Laws

I. Introduction

Recently, in domestic and international real estate development projects targeting wealthy individuals, developers are increasingly engaging in mixed developments that incorporate branded residences (residences branded with luxury hotel names) centered in major domestic cities and resort areas.

These branded residences can expect unit sales to reflect a premium associated with the hotel brand, allowing developers to anticipate early and high return of funds. For purchasers, in addition to comprehensive hotel services, there are benefits such as maintaining and improving asset value through the brand and obtaining income opportunities through rental programs (as discussed below). It is expected that branded residence development will accelerate with the increase in the number of domestic and international wealthy individuals.

Although branded residence development is increasing year by year, there are cases with legal ambiguities from a Japanese law perspective. Accordingly, I would like to briefly describe some typical legal issues with introducing recent updates on relevant laws.

II. Act on Building Unit Ownership, etc. ("Unit Ownership Act")

The Unit Ownership Act is relevant to branded residence development in many respects. One particularly important issue concerns how to secure management and operation in compliance with the hotel's brand standards in a branded residence where multiple unit owners are involved following the sales of the units.

It should be noted that the management association established under the Unit Ownership Act differs from the homeowner's association in the U.S. or a similar association in other major foreign countries, and therefore management and operation matters in Japan cannot be structured in the same way as solutions to these matters in those foreign countries.

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(i) Common Area Management

In "majority type" ownership, where the developer continues to hold more than half of the voting rights in the management association, the developer can continue to have control over common area management through the following methods:

- Specifying in the management bylaws that the developer itself or its affiliated companies shall be the managers, and that common areas will be managed by the manager.

- Setting necessary restrictions on the use of common areas in the management bylaws. Since the management bylaws are binding on unit successors under the Unit Ownership Act, stipulating matters necessary for maintaining the hotel brand standards in the management bylaws will be helpful for stable management and operation.

- Ensuring that purchasers cannot change the bylaws contrary to the developer's intentions, as the developer holds the majority of voting rights. Thus, purchasers cannot abolish or modify the manager's provisions or common area usage restrictions.

In addition, the developer can pass ordinary resolutions (such as an annual budget approval) without purchasers' cooperation, and this mechanism contributes to the smooth operation of branded residences.

On the other hand, if the developer's voting percentage after unit sales is less than a majority, while the developer will have veto rights regarding management bylaw changes, the developer cannot pass ordinary resolutions with only its own affirmative votes (as it could were it the majority owner), so cooperation from purchasers will be essential for operations such as budget approval.

In cases where the developer's voting percentage falls below 25% after sales, management bylaw changes contrary to the developer's intentions become theoretically possible, and there is a risk of abolishing provisions regarding manager selection and their authorities. While it may be possible to include provisions in contracts between individual purchasers and the developer or operator that they should not agree to any management bylaw changes, the validity and enforceability of such provisions remain unclear.

(ii) Restrictions on Exclusive Area Usage

The use of exclusive areas under a rental program does not necessarily present issues on management. In a rental program, a purchaser allows a hotel operator to use its exclusive area in exchange for compensation. Under these programs, exclusive areas will be used and managed exclusively by the hotel operator based on contracts with each purchaser (lease agreements or management contracts), and accordingly it would not be necessary to impose restrictions on exclusive area usage by each unit owner.

When rental program participation is optional, exclusive areas can be freely used by purchasers. In branded residences, restrictions on usage of exclusive areas may be necessary from the perspective of maintaining uniformity and aesthetic appearance, particularly regarding decorations affecting the exterior, and it will be important to determine whether such restrictions can be established in the management bylaws.

(iii) Manager

The manager preserves common areas, executes unit owner's meeting decisions, and has rights to perform actions defined in the management bylaws. The manager's actions are effective for all unit owners, and the manager has the ability to represent unit owners in matters related to their duties. The manager also has the right to convene unit owner's meeting and is typically the chair. Managers need not be owners and can be corporate entities.

Selecting hotel operators or developer-affiliated companies as a manager and stipulating this selection in the

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management bylaws can contribute to establishing a stable structure that prevents manager replacement by the purchasers.

(iv) Unit Ownership Act Amendments

Recently, amendments to the Unit Ownership Act have been under discussion. The "Outline Proposal Regarding Unit Ownership Act Revisions" published on January 16, 2024, includes: (i) a proposed mechanism allowing majority decisions by attendees (excluding non-attending owners from the quorum) and (ii) the introduction of a domestic representative for overseas owners. Both appear to contribute to smooth branded residence operations, but it will be important to monitor any further developments with respect to the contemplated amendments.

III. Recent Updates on Natural Parks Act

In recent years, in response to the rising needs for condominium-type hotel developments, the Natural Parks Act Enforcement Regulations have been amended to allow the competent authorities issue approval on a condominium-type hotel development as a national park project under certain conditions. The approval requirements include the following:

(a) Not establishing rooms for exclusive use by specific individuals, and ensuring that 70% or more of the total annual guest room nights are available for general use; and

(b) Setting up a fixed-term land lease corresponding to the depreciation period of the hotel building, or implementing measures expected to facilitate large-scale renovations or rebuilding of the hotel.

IV. Act on Specified Joint Real Estate Ventures and Financial Instruments and Exchange Act

The Act on Specified Joint Real Estate Ventures and the Financial Instruments and Exchange Act both restrict certain collective investment schemes. Relevant to our considerations in this newsletter is whether rental programs, which have the character of collective investment in that the revenue generated by the hotel is received by each unit owner, are subject to the terms and restrictions of these laws. There is no established, consensus view as to this matter, which requires careful consideration on a case-by-case basis.

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MERGERS & ACQUISITIONS

Amendments to the Tender Offer Regulations

I. Introduction

The tender offer regulations in Japan were introduced in 1971, and have not been the subject of significant amendment since 2006. Recently, however, there have been efforts to enhance the fairness and transparency of the market, in response to environmental changes in capital markets. In this regard, the working group established by the Financial Services Agency (the "**FSA**") released a Working Group Report regarding the Tender Offer and Large Shareholding Reporting System (the "**FSA Report**") on December 25, 2023. In the FSA Report, the working group pointed out issues concerning the current tender offer regulations and suggested a number of 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. The Amendments may have a material impact on the practice of the tender offer regulations.

The Amendments related to the tender offer regulations will be effective within two years from the date of their announcement. It should be noted that while the detailed rules of the tender offer regulations 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) Expansion of Regulated Transactions (Applicable to On-Market Transactions)

In Japan, an acquisition of listed shares which materially affects the control of the target company necessitates the implementation of a tender offer in compliance with the procedures set forth in the FIEA (the "**Mandatory Tender Offer**"). Under the current tender offer regime, as a general rule, the Mandatory Tender Offer applies to (a) off-market transactions involving a large number of persons (more than ten persons within a 61-day period), resulting in the acquirer's ownership ratio exceeding 5% (the "**5% Rule**"); and (b) either off-market transactions (whether involving a small or large number of persons) or on-market transactions (off-floor transactions) that result in the acquirer's ownership ratio exceeding one-third (1/3) (the "**1/3 Rule**"). In contrast, on-market transactions (on-floor transactions) have not been subject to either the 5% Rule or the 1/3 Rule, based on the premise that such transactions inherently ensure transparency and fairness.

In recent years, however, there have been instances where more than one-third of company's shares have been acquired within a relatively short period through on-market transactions (on-floor transactions), and this has led to an increasing calls for the application of the 1/3 Rules to on-market transactions (on-floor transactions), in order to ensure that shareholders are provided with adequate information and time to assess and make informed investment decisions regarding such transactions. In response to these concerns, the Amendments have introduced the application of the 1/3 Rule to on-market transactions (on-floor transactions), thereby extending the scope of the Mandatory Tender Offer to such transactions.

(ii) Lowered Threshold (1/3 to 30%)

As noted above, under the current tender offer regime, the Mandatory Tender Offer applies to off-market transactions (whether involving a small or large number of persons) that result in the acquirer's ownership ratio exceeding 1/3. This threshold is understood to reflect the percentage of voting rights that can veto special resolutions (i.e., requiring two-thirds (2/3) of the total voting rights exercised) at a general meeting of shareholders, which could materially affect the control of the company.

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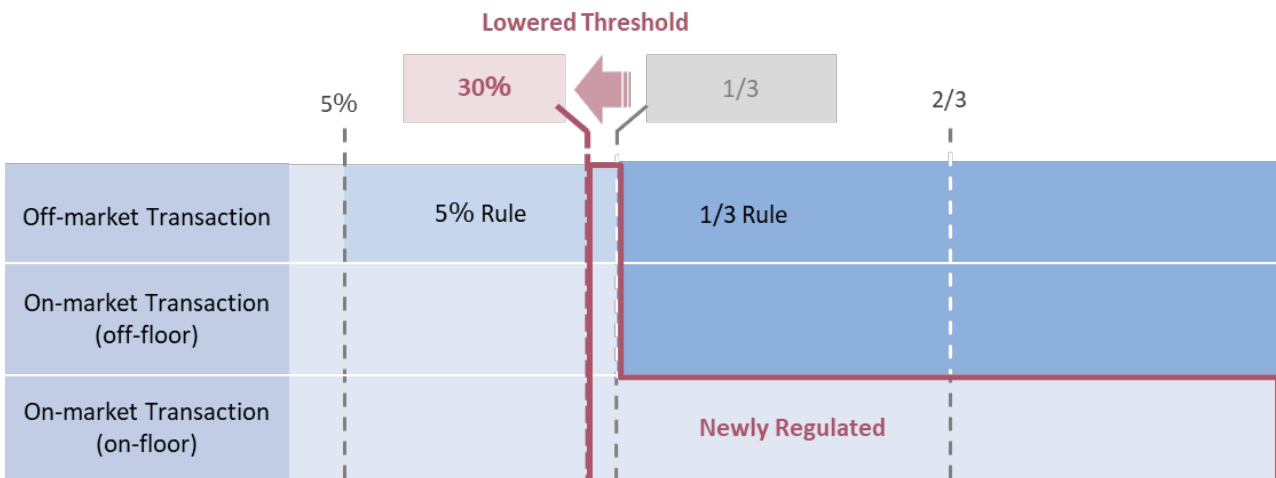
However, (a) based on the percentage of voting rights typically exercised by shareholders in Japanese listed companies, voting rights of 30% is generally sufficient to block a special resolution, and in certain cases, may also significantly influence the outcome of an ordinary resolution (requiring a majority vote) at a general meeting of shareholders; and (b) in most foreign jurisdictions, the mandatory tender offer threshold is set at 30%. In light of these considerations, the threshold of the 1/3 Rule has been lowered to 30% under the Amendment.

Illustrating the above, the newly regulated areas are shown in red below.



(iii) <u>Elimination of "Rapid Acquisition" Rule</u>

Under the current tender offer regime, there exists a "rapid acquisition" rule, which mandates that a tender offer be conducted for acquisitions that meet the following requirements.

A) Acquisitions of more than 10% of the company's shares (regardless of type of transaction, including new shares subscriptions, on-market transactions (on-floor transaction), tender offers or exempted purchases) within a three-month period;

B) Which acquisitions include more than 5% of the company's shares through off-market transactions or on-market transactions (off-floor transactions), excluding tender offers and exempt purchases; and

C) In which the acquirer's ownership ratio exceeds one-third (1/3) of the shares following such acquisitions.

The purpose of the "rapid acquisition" rule is to prohibit the combination of transactions that would be subject to the Mandatory Tender Offer if they exceeded the one-third threshold (see requirement B) above) with transactions that would not be subject to Mandatory Tender Offer regardless of whether they exceeded the one-third threshold (see requirement A) above), thereby preventing circumvention of the 1/3 Rule (see requirement C) above). Under the "rapid acquisition" rule, the combination of transactions, such as the acquisition of up to 32% of the shares off-market followed by the acquisition of an additional 2% through on-market transactions (on-floor transactions), is prohibited.

The original purpose of the "rapid acquisition" rule was to prevent circumvention of the 1/3 Rule, primarily through a combination with on-market transactions (on-floor transactions). However, if on-market transactions (on-floor transaction) become subject to the Mandatory Tender Offer as described in (i) above, such transactions will be prohibited regardless of whether or not the "rapid acquisition" rule exists. Consequently, the legislator has decided to officially eliminate the "rapid acquisition" rule through the Amendments.

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However, there is an effect of the elimination of the “rapid acquisition” rule over and above its obviation by the increase in scope of the Mandatory Tender Offer. For example, the following scenarios will be permissible if the rule is eliminated: (a) after acquiring 29% of a company’s shares from a major shareholder in an off-market transaction, the acquirer could then make a tender offer to acquire additional shares, resulting in a post-acquisition ownership exceeding 30%; (b) similarly, after acquiring 29% of the shares in an off-market transaction, the acquirer could make an offer to purchase additional shares through an exempted purchase, typically from a party with which the acquirer has had a “formal special relationship” (*keishikiteki-tokubetukankeisha*; e.g., affiliates) for more than one year.

While the elimination of the “rapid acquisition” rule would enable certain combinations of transactions that were prohibited under the current tender offer regulations, combinations of transactions may require a case-by-case analysis to avoid being deemed an attempt to circumvent the tender offer regulations even though the “rapid acquisition” rule is eliminated.

III. <u>Conclusion</u>

In addition to the above, the Amendments include material changes which would have impact on the practice of the tender offer; however, 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 developments with respect to these further amendments to the related orders and regulations, as well as changes to tender offer practices.

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