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Acquisition Finance 2025

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Japan: Law and Practice
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Nagashima Ohno & Tsunematsu

JAPAN

Law and Practice

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Contents

1. Market p.6
1.1 Major Lender-Side Players p.6
1.2 Corporates and LBOs p.6

2. Documentation p.6
2.1 Governing Law p.6
2.2 Use of Loan Market Association (LMA) Agreements or Other Standard Loans p.6
2.3 Language p.7
2.4 Opinions p.7

3. Structures p.7
3.1 Senior Loans p.7
3.2 Mezzanine/Payment-in-Kind (PIK) Loans p.7
3.3 Bridge Loans p.8
3.4 Bonds/High-Yield Bonds p.8
3.5 Private Placements/Loan Notes p.8
3.6 Asset-Based Financing p.8

4. Intercreditor Agreements p.8
4.1 Typical Elements p.8
4.2 Bank/Bond Deals p.10
4.3 Role of Hedge Counterparties p.10

5. Security p.10
5.1 Types of Security Commonly Used p.10
5.2 Form Requirements p.14
5.3 Registration Process p.14
5.4 Restrictions on Upstream Security p.14
5.5 Financial Assistance p.14
5.6 Other Restrictions p.14
5.7 General Principles of Enforcement p.14

6. Guarantees p.15
6.1 Types of Guarantees p.15
6.2 Restrictions p.15
6.3 Requirement for Guarantee Fees p.15

7. Lender Liability p.15
7.1 Equitable Subordination Rules p.15
7.2 Claw-Back Risk p.15

8. Tax Issues p.15
8.1 Stamp Taxes p.15
8.2 Withholding Tax/Qualifying Lender Concepts p.16
8.3 Thin-Capitalisation Rules p.16

9. Takeover Finance p.16
9.1 Regulated Targets p.16
9.2 Listed Targets p.17

10. Jurisdiction-Specific Features p.19
10.1 Other Acquisition Finance Issues p.19

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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.

In addition to mega banks, local banks are becoming more active in acquisition finance. In the early days of Japanese acquisition finance, US and European banks played a larger role, but fewer non-Japanese banks are currently active in the Japanese acquisition finance market.

Certain Japanese mezzanine funds, bank subsidiaries, local banks and lease companies have become major participants in the mezzanine finance markets. The mezzanine funds include:

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

The three mega banks have notably expanded their activities to include mezzanine financing for large-cap deals.

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 and local banks, such as Sumitomo Mitsui Trust Bank, Ltd., SBI Shinsei Bank, Ltd., Resona Bank, Ltd., Aozora Bank, Ltd., Kiraboshi Bank, Ltd., and The Bank of Yokohama, Ltd. Corporate loans are also widely arranged by local banks and corporate banks as well as by the mega banks.

Local banks tend to participate in small to mid-sized deals, whether corporate loans or acquisition finance.

2. Documentation

2.1 Governing Law

Purely domestic transactions are always governed by Japanese law. However, where the lenders are foreign financial institutions, the loan facility agreements may be governed by English 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. There is no difference between corporate loans and acquisition finance.

2.2 Use of Loan Market Association (LMA) Agreements or Other Standard Loans

In purely domestic transactions, there is no official form for definitive agreements for senior acquisition finance facilities. 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 (the *"JSLA"*), which is predominantly used for corporate loans.

In cross-border transactions in which the lenders are Japanese mega banks, the globally used Loan Market Association (the *"LMA"*) forms are becoming more common. When the buyer is a US or European private equity fund, the LMA form is especially sometimes used (although the governing law is Japanese law) and they sometimes use their own form, incorporating some globally used terms (such as certain funds) into the Japanese-style form. When the target is based in a jurisdiction 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 Japanese law).

2.4 Opinions

Legal opinions are typically issued by the borrower's counsel. Mandated lead arrangers generally request the borrower's counsel to cover:

- corporate existence;
- capacity and due authorisation;
- 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

Senior loans are usually the only source of debt financing. However, in large or high-leverage transactions, mezzanine finance may be utilised in conjunction with senior loans.

Senior loans typically comprise Term Loan A, Term Loan B and a revolver. Capital expenditure (capex) lines are only used occasionally. Term Loan A is fully amortised, while Term Loan B is paid in a lump sum at maturity. Term Loan A and Term Loan B are used to finance the closing of the acquisition, refinancing and the transaction costs, while the revolver is used to finance working capital. The tenor is typically seven years but may be shorter in some cases. Financial covenants typically include:

- 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/Payment-in-Kind (PIK) Loans

Mezzanine financing is provided by way of non-voting preferred shares or subordinated loans. Subordinated loans have become more common in recent years.

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

Due to the fact that dividends to shareholders are distributed after the company has repaid all of its creditors, the mezzanine financier, as a preferred shareholder, is structurally subordinated to the senior lenders.

Subordinated loans are secured by a security package, which is almost identical to the security package for senior lenders except that it is second-ranking. This means it is subordinate to the first-ranking securities created for senior lenders. The subordinate nature of these subordinated loans is also created through an intercreditor agreement among senior lenders, mezzanine financiers 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. As a result, high-yield bonds are not used to finance acquisitions.

3.5 Private Placements/Loan Notes

Loans for acquisition finance are not typically accompanied by an issuance of notes, so they are considered receivables and do not fall within the definition of *"securities"* under the Financial Instruments and Exchange Act (Act No 25 of 1948, the *"FIEA"*), which is the Japanese securities law. Private placement rules do not therefore apply.

On the other hand, preferred shares used for mezzanine financing are considered *"securities"* and the issuer typically relies on the small number private placement, which restricts the number of offerees of solicitation to less than 50.

3.6 Asset-Based Financing

In Japan, asset-based financing is rarely included in the component of leveraged buyout financing structure. Leveraged buyout lenders typically view the assets owned by the target as integral components of the security package for the leveraged buyout finance and take the value of the asset into consideration when they determine 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, senior lenders and mezzanine financiers.

Contractual Subordination

It is very common practice to use contractual subordination arrangements, which are achieved by the borrower, senior lenders and mezzanine financiers entering into an intercreditor agreement. This contractual subordination arrangement is only valid 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 through an agreement between the borrower and the mezzanine financiers. These statutory subordinated claims were introduced in 2005 by amendments to the:

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

However, given that statutory subordinated claims are subordinate even to general claims under the insolvency procedures, they are not preferred by mezzanine financiers and are not used for mezzanine loans in acquisition finance.

Structural Subordination

Structural subordination whereby the mezzanine financier provides loans to a holdco of the borrower was historically rarely used in Japan. Mezzanine financiers 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 financier 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 becoming increasingly used.

In these cases, no intercreditor agreement will be executed unless guarantee or security interests over a senior loan borrower or target group companies are provided in favour of the holdco mezzanine lenders.

Payment of Principal

The agreement usually stipulates that the maturity of the principal payment of the subordinated loans is to be six months or one year after 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

The agreement usually stipulates:

- payment of the cash coupon portion of the interest on the subordinated loans is due one business day after the debt service date of the senior loans, subject to certain payment block events;
- payment of the payment-in-kind (PIK) portion of the interest on the subordinated loan is due 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, in the same way as 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 for the interest (cash coupon portion) 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 financiers 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 financier only at the time of the drawdown of the subordinated loans under a fee letter. There is therefore no provision relating to the payment of the 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 financier. 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. It is therefore common for the intercreditor agreement to provide that the mezzanine financier 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 financier prior to the full repayment of the senior loans, it is usually provided within the intercreditor agreement that any distributions received by the mezzanine financier must be turned over to the senior lenders.

Subordination of Equity/Quasi-Equity

It is common for the senior lenders and the mezzanine financiers to enter into an intercreditor agreement, even where the mezzanine finance is provided in the form of preferred shares. In these cases, 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. The agreement usually stipulates 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 bank/bond deals are therefore not currently available.

4.3 Role of Hedge Counterparties

Unlike in the US and European markets, borrowers are not required to enter into interest rate swap arrangements in the Japanese acquisition finance market. Hedge counterparties are therefore not typically parties to intercreditor agreements in the Japanese market.

5. Security

5.1 Types of Security Commonly Used

Types of Security

Acquisition finance lenders in Japan usually create security interests over each asset of the target and its wholly-owned subsidiaries and perfect 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 interests by way of assignment (*jouto tanpo*); and
- mortgages (*teitou-ken*).

The type 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 (*ne-shichi-ken*)) 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 (*futsu-shichi-ken*)) are used.

Shares

The lenders typically create a pledge over shares.

Firstly, 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. To perfect the pledge against the issuing company and third parties, the pledgee is required to continuously possess the share certificates. The security agent usually receives delivery of the share certificates and keeps them as proxy for all the pledgees.

Secondly, 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. It must be recorded in the share ledger in order for it to be perfected against the issuing company and third parties.

Thirdly, when 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 Transfer of Corporate Bonds and Shares (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.

Bank Accounts

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), it was necessary to obtain the third-party debtor's consent in order to legally and validly create a pledge or a security interest by way of assignment. The lenders therefore usually excluded these non-assignable receivables from the security package.

Currently, after the enforcement of the amendments to the Civil Code, lenders are able to legally and validly create a security interest over the non-assignable receivables without obtaining the third-party debtor's consent.

However, since the 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 contract to remove the non-assignment covenant on the borrower.

There are three ways to perfect 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) (the *"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 (notarisation is therefore 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 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 in both Japan and the foreign jurisdiction. This is because the local conflict of laws rules in the foreign country might 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 since 1999, 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, 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 ruling on this matter, 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 exposed to the 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 it 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 in practice measures are often taken to mitigate the registration tax.

Real Property

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

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 create additional security interests over the proceeds from the real property. For example, a typical mortgage agreement creates a pledge over any future claim for 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 are often taken in practice to mitigate the registration tax.

Movable Assets

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

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 not only over particular assets but also over 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.

Enterprise Value Charge

In 2024, a new enterprise value charge (EVC) was introduced pursuant to the Act on the Promotion of Cash Flow-Based Lending (Act No 52 of 2024). This new security interest will come into effect by the end of 2026. The Act is designed to address the limitations of traditional collateral frameworks, which necessitate individual security interests over each asset.

One of the notable features of an EVC is its ability to encompass all of a corporate debtor's assets, including intangible assets (eg, goodwill). Certain intangible assets are not generally covered in traditional security interests, leading to an incomplete valuation of the enterprise in the statutory enforcement of security. By including intangible assets, an EVC ensures that the full enterprise value is considered.

When an EVC is created, disposal of assets outside the ordinary course of business or the disposal of material assets is generally restricted. Despite these restrictions, the security interest holder cannot contest against a third party acting in good faith without gross negligence. This characteristic of an EVC indicates a weak effect when secured assets are diverted. It is likely therefore that lenders in acquisition finance will still need to create individual security interests on certain material assets even when an EVC is created. Depending on the asset composition of the borrower, a tailored approach may be necessary as to whether only traditional individual security interests will be created or both individual security interests and an EVC will be created.

5.2 Form Requirements

There is generally no statutory requirement for forms such as deeds for security agreements. However, for mortgages created over real property, a deed containing an acceptance of enforcement clause will enable lenders to enforce the mortgage without obtaining a court decision.

5.3 Registration Process

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 a 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, that the subsidiary, as a group company of the parent, receives direct and indirect benefits, such as financing through intercompany loans, from the acquisition financing.

On the other hand, if the subsidiary is wholly-owned, directly or indirectly, 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 are fully aligned and the provision of the upstream security by the subsidiary does not raise a fiduciary duty issue in terms of the subsidiary's directors.

5.5 Financial Assistance

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

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), which provides for specific methods of enforcement for each type of asset. However, in practice, the enforcement of security created for acquisition financing is not primarily intended to be enforced by the statutory method, but rather by way of private disposition.

The security agreements and the intercreditor agreement typically set out 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 allow the loans to be recovered from any credit party by way of set-off.

6.2 Restrictions

Providing a guarantee is also subject to the general fiduciary duty directors have. 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 an intercompany loan) or obtaining consent from all the shareholders raises a fiduciary duty issue.

Other than the general fiduciary duty of directors, there are no restrictions on upstream guarantees or financial assistance as seen in other jurisdictions.

6.3 Requirement for Guarantee Fees

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 over the borrower. There have been many court precedents about the former and a few on the latter, but these are general obligations of the lenders and no specific consideration of lenders' liability in the context of acquisition finance have yet been actively addressed in Japan. The application of equitable subordination rules to acquisition financiers has also not been actively discussed in Japan.

7.2 Claw-Back Risk

Unlike in the US, the claw back risk for lenders under insolvency procedures in cases where a target of a certain acquisition completed with the proceeds of leveraged buyout financing goes into bankruptcy due to the heavy debt under the leveraged buyout has not been actively discussed in Japan.

8. Tax Issues

8.1 Stamp Taxes

The types of documents stamps must be affixed to and the amount of stamp tax for each document are specified in the Stamp Tax Act (Act No 23 of 1967). In a term loan agreement, a stamp (the amount of which depends on the amount of the loan) is required on each original copy (for example, if the amount of the loan is JPY5 billion or more, a stamp of JPY600,000 is required). In the case of a revolving loan agreement, a stamp of JPY200 is required on each original copy.

If any original copy of a loan application is issued, the same tax is applied, so the loan application is typically submitted to the lenders by facsimile or by email (on which no tax is imposed as it is a copy for the purposes of the Stamp Tax Act). For guarantee agreements, a stamp of JPY200 is required on each original copy. For securities agreements, a stamp of JPY4,000 is required on each original copy if the agreement falls under the definition of *"continuous agreement"* under the Stamp Tax Act.

8.2 Withholding Tax/Qualifying Lender Concepts

Under Japanese domestic tax laws, interest payable by the borrower to a foreign lender is generally subject to withholding tax at a rate of 20.42%. The withholding tax may be reduced or exempted under applicable tax treaties if 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 receive financing or guarantees from the foreign controlling shareholders); and
- not subject to Japanese taxation at the hands of the recipients.

A certain portion of the interest is not deductible in calculating tax income if both the gross amount of debts (whether interest-bearing or not) 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 the 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 will 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 earnings before interest, taxes, depreciation and amortisation (EBITDA) of the domestic entity as calculated for this purpose.

9. Takeover Finance

9.1 Regulated Targets

Regulated Industries

Certain industries such as financial services, aviation, transportation, telecommunications, broadcasting companies, securities exchanges and utility companies are heavily regulated in Japan. 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 228 of 1949) (the *"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).

Certain exceptions were introduced in 2019 where the foreign acquirer satisfies certain requirements, which vary depending on whether or not the target business is *"core business'"* as defined in the FEFTA. 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 London-based hedge fund The Children's Investment Fund (TCI) 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 ex post facto reports for share acquisitions conducted by foreign investors but these 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.
- 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).

In May 2024, major amendments to the tender offer rules under the FIEA were promulgated. These included major changes to the rules such as adding on-exchange transactions to acquisitions subject to tender offer rules generally and lowering the one-third threshold under the one-third rule to 30%. These amendments will enter into force within two years from the date of promulgation but the exact date has not yet been decided.

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 following.

- 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 has been calculated, including:
  - (a) the method of the calculation (eg, 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 the expert was reflected in the tender offer price.
- Agreements between the tender offeror and the target or its management.
- 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 (the *"FSA"*) has published its view that these certificates must be supported by a certainty of funding and has provided examples of what will be required of these certificates in order to support a certainty of funding. The FSA also requires full disclosure on these 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, which are typically included in the commitment letters from banks, are not considered to impair 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 the second method is only available 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 there are no reliable court precedents in this respect, the general understanding is that a squeeze-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 rendering the resolution extraordinarily unfair. The most important factor in measuring the 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 will also be a significant factor.

Minority shareholders also have appraisal rights under the Companies Act (Act No 86 of 2005) and exercising these rights is the most practical recourse for minority shareholders who are not satisfied with the purchase price. With an appraisal right, minority shareholders may require the target to purchase their shares and a fair purchase price will be determined by the courts if no agreement is reached 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 fully predictable due to a lack of abundant precedents.

10. Jurisdiction-Specific Features

10.1 Other Acquisition Finance Issues

Unlike in the US or Europe, the number of players in the leveraged buyout loan market in Japan is still limited and the secondary market for leveraged buyout loans is not yet mature. For example, hedge funds that invest primarily in distressed debt are not active in Japan. As a result, an exit by assigning the loan receivables in the event of the borrower's financial difficulties is limited for leveraged buyout lenders in Japan.

Lenders therefore typically have to grant the borrower a waiver for an event of default in exchange for requiring additional capital injections from the sponsor or adding or tightening the borrower's covenants. In this context, leveraged buyout lenders in Japan tend to broadly scrutinise the borrower's business, assets and governance and be very cautious in their initial lending decisions.

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