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Japan's New Triangular Merger Rules – Acquisition of Japanese Companies Through Share Exchanges

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Effective May 1, 2007, Japan's new Company Law rules will allow foreign companies to use their shares in acquiring Japanese companies. While the new law and related regulatory changes are intended to facilitate cross-border M&A activity, non-Japanese acquirers interested in using triangular mergers will need to consider various business, tax and other legal issues when planning to pursue this type of transaction.

The new form of acquisition is called "triangular mergers" (*sankaku gappei*). As the name suggests, this transaction scheme will allow a non-Japanese company ("Foreign Acquirer") with a Japanese subsidiary ("Japanese Subsidiary") to acquire a Japanese target company ("Target") by having such Target merge with and into the Japanese Subsidiary. In such mergers, the consideration given to the shareholders of the Target can be in the form of cash or other assets, including shares of the Foreign Acquirer.

Triangular Mergers

Use of triangular mergers will become possible in Japan as of May 1, as a result of the liberalization of the types of consideration usable in connection with reorganizations provided for under the Company Law. Before May 2007, a company seeking to acquire another company in Japan by use of shares as consideration in a merger could do so by exchanging the Target shares only with its own shares, except under limited circumstances. Thus, if a Foreign Acquirer wished to undertake a merger in Japan using its Japanese Subsidiary, it could only use the shares of the Japanese Subsidiary. Since the shares of the Japanese Subsidiary would usually not be registered, publicly traded shares, that type of merger was impractical. For transactions entered into on or after May 1, 2007, considerations for the Target's shares can include cash, bonds, or other assets, including shares issued by the Foreign Acquirer. Such relaxed consideration rules will be appli cable also to other forms of reorganizations permitted under Japanese law, including share swaps (*kabushiki kokan*) whereby the target company will remain as a subsidiary of the Japanese Subsidiary.

The Japanese government created these new rules in order to make corporate takeover procedures less restrictive and thereby increase foreign direct investment into Japan. The Japanese National Diet passed the new Company Law in June 2005. While other parts of the Law became effective during 2006, implementation of the triangular merger rules was postponed for one year until May 2007. The delay came in the face of concerns by representatives of various Japanese businesses, who believe that the new regime will invite a wave of hostile takeovers by foreign companies. This delay enabled many publicly traded Japanese companies to implement defensive measures to apply in hostile takeover situations.

It is hard to predict the extent to which the new triangular merger rules will actually be user-friendly to Foreign Acquirers. Triangular mergers represent a new regime under the Japanese law, and certain regulations relevant thereto are still being considered by Japanese Government agencies.

Several rules that have been disclosed do raise business-planning issues, tax issues, and other legal issues for Foreign Acquirers.

Reverse Mergers

The Company Law contemplates only *forward* triangular mergers where the Target is merged into the Japanese Subsidiary. Since the Target will be dissolved in connection with the merger, business licenses and permits held by the Target may need to be transferred on behalf of the surviving Japanese Subsidiary, which may require extensive negotiations with relevant Japanese Government agency.

The Company Law does not contemplate *reverse* triangular mergers. The Foreign Acquirer may, therefore, need to consider a two-step triangular merger, where (i) it would first implement a share-exchange between the Japanese Subsidiary and the Target to make the Target a wholly owned subsidiary of the Japanese Subsidiary, and then (ii) further implement a downstream merger of the Japanese Subsidiary into the Target.

Tax Treatment

The 2007 tax law that the Japanese Diet passed on March 23, 2007 allows capital gains tax deferral in certain qualified triangular mergers. Ministerial Ordinances issued by the Ministry of Finance prescribing the detailed rules were announced on April 13, 2007. The regulations provide that the government would not permit tax deferrals for triangular mergers that use as the merger vehicle a newly established Japanese shell entity. The reason for this concept is based on the fact that tax qualified mergers even between domestic Japanese businesses require the “relatedness of operations” of the two merging entities. These restrictive tax rules may render it impractical for many Foreign Acquirers to utilize the triangular merger regime unless and until they have a functioning Japanese Subsidiary, the business of which is “related” to that of the Target. If the Foreign Acquirer newly incorporates a special purpose company in Japan solely to execute a triangular merger, the tax deferral on capital gains would be denied, and shareholders of the Target would need to pay the capital gains tax upon share exchange.

On the other hand, the regulations provide that a Japanese Subsidiary which meets the following criteria may be sufficient to enable capital gains tax deferral treatment in a triangular merger: (i) it owns or leases a fixed facility in Japan, (ii) it has employee(s) in Japan, and (iii) it engages in sales, advertising, marketing research, or applies for or holds government permits or intellectual property rights necessary for the business being undertaken in Japan. Japanese business units engaged in marketing or advertising through the Internet or telephone to prepare for business may thus qualify as an appropriate Japanese Subsidiary to be used in a triangular merger, if the business is “related” to that of the Target. Until the practices are established, however, the minimum degree of activities that would satisfy the tax rules will not be known.

The following additional issues will also exist under the tax law.

- The shares used in qualified triangular mergers are those issued by the entity owning 100% of the Japanese Subsidiary. Thus, use of a Japanese Subsidiary that is an indirect wholly owned subsidiary of the Foreign Acquirer may disqualify the triangular merger from tax-free reorganization.
- Regardless of whether the triangular merger is qualified or non-qualified, the non-resident shareholders of the Target who have owned 25% or more of the Target within the past 3 years and dispose of 5% or more of such shares in a taxable year will be subject to Japanese capital gains taxation, unless exempted under a relevant tax treaty.

Disclosure Rules

The new Financial Instruments and Exchange Law, which is scheduled to become effective later this year, is expected to require the Foreign Acquirer to register its shares in Japan in connection with a triangular merger implemented to acquire a publicly traded Target.

If the Target has shareholders resident in the United States, certain disclosure rules under the U.S. securities laws will also be implicated, so that the Target would have to file a registration statement with the SEC, unless the transaction is exempted from registration. Given that the Target likely will have maintained financial statements in accordance with Japanese GAAP rather than U.S. GAAP, this issue must also be considered early in the planning process.

Enhancing Attractiveness of Foreign Shares

The foreign company seeking to use the triangular merger rules to acquire a Japanese business will have to consider with its financial advisors ways to enhance the liquidity of its shares in Japan. To implement a triangular merger, the shareholders of the Target must approve the merger proposal by passing a special resolution adopted by more than two-thirds of the voted shares. Unless the shares of the Foreign Acquirer are readily disposable in Japan, the shareholders of the Target likely will not want to accept such shares in exchange for their shares in the Target. Listing of the shares with the Tokyo Stock Exchange may be one option to facilitate liquidity and, thus, increase the attractiveness of the shares of the Foreign Acquirer being offered in the triangular merger. A Foreign Acquirer should also be aware that appraisal rights would be available to dissenting shareholders under Japanese Company Law.

Other Potential Issues

The Japanese business community has been continuing to lobby for additional legal restrictions on triangular mergers. One of the requested measures is to revise the Foreign Exchange and Foreign Trade Control Law (the “Foreign Exchange Law”) to afford protection to a broader scope of industries from the perspective of national security. Like the Exxon-Florio amendment in the United States, the Foreign Exchange Law imposes restrictions on foreign direct investments by requiring preliminary clearance for acquisitions of Japanese companies in certain industries. The Ministry of Economy, Trade and Industry has created an intra-ministry study group to consider the need to expand the scope of such legislative protection. Future amendments to the Foreign Exchange Law may raise additional barriers to foreign direct investment.

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