Minority squeeze-outs under the amended Japanese Companies Act

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An amendment of the Companies Act of Japan finally passed the Diet on June 20, 2014, after a period of consideration that had continued for more than four years (the “Amendment”). It is currently expected that the Amendment will become effective on April or May, 2015.

I. Amendment of the Japanese Companies Act

The Amendment is the first substantial revision of the Companies Act since it was first enacted in 2006. While the Amendment is most often associated with the reforms it makes to the rules regarding corporate governance of listed companies (such as disclosure related to the nomination of outside directors and a stricter definition of outside directors), it is also important for M&A practitioners due to the substantial changes it makes to rules relevant to M&A transactions. In particular, the Amendment should change the landscape of squeeze-out transactions involving Japanese target companies. I discuss below the statutory changes relevant to squeeze-out transactions based on my experience as one of the drafters of the Amendment. I will try to describe the full picture of the new squeeze-out regime rather than focusing on the details of the various squeeze-out procedures.

II. Reform of squeeze-out rules

1. Current practice

Under existing Japanese law, buy-outs of listed companies involving a squeeze-out of minority shareholders are typically conducted through a two-step acquisition: (i) a first-step tender offer and (ii) a back-end squeeze-out of the remaining minority shareholders. While the Financial Instruments and Exchange Act applies to the first-step tender offer, the Companies Act applies to the back-end squeeze-out.

Under the Companies Act, the back-end squeeze-out could be conducted through a share exchange (kabushiki-koukan) with cash consideration, whereby the acquiring company obtains all shares of the target company and pays cash consideration to the existing shareholders. However, a share exchange with cash consideration is not commonly used in practice because it would lead to a realisation of capital gains on the target company’s assets (including goodwill), usually resulting in unfavourable tax treatment at the level of the target company. This tax treatment has been controversial and has been strongly criticised by M&A practitioners, but the tax authority in Japan has been reluctant to change the relevant rules on the grounds that a share exchange is organisational in nature, despite its economic effect being quite similar to a sale and purchase of the shares in the target company.

Therefore, to avoid the negative tax consequences of a share exchange, squeeze-outs have been most commonly effected through a more complicated “fractional share” procedure. In this type of squeeze-out, the target company, upon adoption of a shareholder resolution, reclassifies all outstanding shares as shares that are subject to a call option, which are referred to in Japanese as “wholly callable stock” (zenbu shutoku joukou tsuki shurui kabushiki).

Upon exercise of the call option, the wholly callable stock is then exchanged for a new class of stock. However, the exchange ratio for the new shares is set at a level that results in minority shareholders being entitled to receive only fractional shares. That is because there is a procedure under the Companies Act whereby fractional shares are not required to be issued, but rather may be sold to the acquirer upon court approval, with the cash proceeds distributed proportionately to the minority fractional shareholders.

Minority shareholders who are not satisfied with the amount of cash consideration are entitled to exercise appraisal rights; i.e., the right to file a petition to the court to determine the fair value of their shares. See Figure 1 for the basic structure of the fractional share squeeze-out by means of wholly callable stock.

2. Drawbacks of current practice

Despite its common use, the fractional share squeeze-out procedure has three major drawbacks.

(a) Shareholder resolution

First, a fractional share squeeze-out is time consuming due to the necessity of holding a shareholders meeting at the target company.
A shareholder resolution is always necessary even when the acquirer holds a very large percentage of the existing shares after the first-step tender offer, thereby making the result of the shareholder meeting self-evident. Due to the time consuming procedure for holding a shareholders meeting of a listed company, it typically takes a couple of months to complete the back-end squeeze-out after conclusion of the first-step tender offer. This means that the minority shareholders not tendering in the first-step tender offer would have to wait for that period before receiving the cash consideration for the back-end squeeze-out, which is seen by some as having a coercive effect to motivate shareholders to tender in the first-step tender offer even if they are not satisfied with the tender offer price.

(b) Consent of “potential shareholders”
Second, holders of “potential shares,” such as stock options (shinkabu yoyaku ken) and convertible bonds (shinkabu yoyaku ken tsuki shasai), cannot be squeezed out through a fractional share squeeze-out that uses wholly callable stock because the Companies Act does not provide any means of reclassifying potential shares as wholly callable stock. Therefore, unless a call option exercisable by the issuer is specifically provided in the terms of the potential shares, neither the acquirer nor the target company can acquire the potential shares without the consent of each of the potential shareholders.

Practically, a target company that has issued stock options or convertible bonds must persuade each of the potential shareholders to tender their potential shares in the first-step tender offer, or alternatively, waive them. Failing this, the potential shareholders will remain in place even after the squeeze-out of the minority shareholders, which would substantially impede the effect of the squeeze-out.

(c) Complexity
Third, the fractional share squeeze-out procedure is unnecessarily complicated and hard to understand.
for shareholders and the general public. The statutory procedure that permits, in essence, the redemption of fractional shares for cash is already complex, and the extra step of reclassifying existing shares as wholly callable stock as a tool to take advantage of that procedure further increases the complexity.

A consolidation of existing shares could also be used to create fractional shares without the complexity of first reclassifying existing shares as wholly callable stock. However, share consolidations are not commonly used in current practice because minority shareholders would not be entitled to appraisal rights in that scenario under the existing rules. In the absence of any comparable measure to protect minority shareholders, the use of a share consolidation to effect a fractional share squeeze-out has been seen by practitioners as entailing a significant risk that the entire squeeze-out transaction would be challenged as being unfair. Due to this concern, the use of wholly callable stock has been the only realistic option to conduct a fractional share squeeze-out.

3. Impact of the Amendment
To address the drawbacks described above, the Amendment (i) introduces an alternative squeeze-out right that can be easily implemented by a 90% controlling shareholder (the “Squeeze-Out Right”) and (ii) reforms the rules related to fractional share squeeze-outs.

(a) Introduction of Squeeze-Out Right
The Squeeze-Out Right introduced by the Amendment will eliminate each of the above described drawbacks of the fractional share procedure, provided a sufficient percentage of shares are held by the acquirer.

In sum, the Squeeze-Out Right enables a shareholder holding (directly or through one or more wholly owned subsidiaries) at least 90% of the total voting rights (a “Special Controlling Shareholder”) to force a cash acquisition of the remaining shares held by the minority shareholders. This alternative would only require a resolution of the board of directors of the target, instead of a shareholder resolution, and will therefore significantly expedite the squeeze-out procedure – making it possible to complete the back-end squeeze-out as early as 20 days after conclusion of the first-step tender offer.

It is notable that the Squeeze-Out Right would apply to potential shares such as stock options and convertible bonds. The Special Controlling Shareholder seeking to exercise the Squeeze-Out Right with respect to the existing shares would also have the right, but not the obligation, to force a cash acquisition of potential shares.

Upon exercise of the Squeeze-Out Right, the relevant shares and potential shares are transferred to the Special Controlling Shareholder, significantly reducing the complexity entailed under the currently used fractional share method. See Figure 2 for the basic structure of the Squeeze-Out Right.

Upon exercise of the Squeeze-Out Right, the Special Controlling Shareholder notifies the target company of the amount of cash consideration for the remaining shares (and potential shares, if applicable), which amount must be approved by the
board of directors of the target company. In making a decision on such approval, directors of the target company would owe a duty of care to consider shareholders’ interests; i.e., the fairness of the amount of cash consideration. Minority shareholders (and the potential shareholders) would also have appraisal rights to seek fair consideration in a court procedure. Further, if the price of the cash consideration is deemed to be extremely inappropriate, the minority shareholders (and the potential shareholders) would be entitled to seek an injunction of the entire squeeze-out transaction.

Unlike a share exchange with cash consideration, which has been categorised by the tax authority as an activity that is organisational in nature (as described above), a transfer of shares upon exercise of the Squeeze-Out Right takes the legal form of a direct sale and purchase between the minority shareholders and the Special Controlling Shareholder. Therefore, while there is not yet any definitive tax ruling, it is expected that there would be no resulting tax gain at the target company upon exercise of the Squeeze-Out Right.

(b) Reform of the rules related to fractional share squeeze-outs
The Amendment would grant appraisal rights to the shareholders dissenting to a consolidation of shares used to effect a fractional share squeeze-out. This reform would give the minority shareholders an appropriate level of protection and thus enable a share consolidation to be used as an alternative to the current method of using wholly callable stock for a fractional share squeeze-out.

This would not address the issues described in sections 2(a) and (b) above, because a consolidation of shares will also require a shareholder resolution and cannot be used to force a cash acquisition of potential shares. However, it would to some extent address the complexity issue described in section 2(c) by simplifying the procedure for changing the shares held by minority shareholders into fractional shares; the target company can simply consolidate the shares by a ratio that would result in minority shareholders holding only fractional shares (see Figure 3 below). Although the currently common method for a fractional share squeeze-out – i.e. the use of wholly callable stock – also continues to be available, consolidation of shares may come to be preferred by practitioners due to this simplicity.

Unlike the Squeeze-Out Right, a fractional share squeeze-out, including those conducted by means of consolidation of shares as described above, does not have a 90% voting rights requirement. Therefore, if the acquirer fails to obtain 90% of total voting rights upon completion of the first-step tender offer, a fractional share squeeze-out would be still available as long as it is approved by a shareholder resolution with a supermajority vote (two-thirds of the votes cast). The 90% voting rights requirement for the Squeeze-Out Right is only intended to set the bar for dispensing with a shareholder resolution; it is not intended as setting the threshold for all types of minority squeeze-out procedures.

Until recently, there had been an argument that the fractional share squeeze-out should be prohibited because it goes beyond the original purpose of wholly callable stock. However, the reform of the rules related to fractional share squeeze-outs under the Amendment clarifies that fractional share squeeze-outs are permissible under the Companies Act. Similarly, given that there was

Figure 3: Fractional share squeeze-out by means of share consolidation

Source: Mori Hamada & Matsumoto
no addition of a requirement of a “legitimate business purpose” for a squeeze-out, it is also now difficult to argue that any such purpose is necessary in general.

III. Summary
As described above, the Amendment would add two practical alternatives for squeeze-outs: (i) a Squeeze-Out Right that is available to a Special Controlling Shareholder and (ii) a fractional share squeeze-out by means of a consolidation of shares. Through these reforms, the Amendment will expedite and enhance the legal stability of squeeze-out transactions.

A full analysis of the pros and cons of the reforms implemented by the Amendment must wait until there is clarity as to the treatment under tax or other laws. However, based on currently available information, if the acquirer obtains at least 90% of the total voting rights through the first-step tender offer, the exercise of the Squeeze-Out Right would likely be the primary alternative for the reasons described above. On the other hand, if the acquirer fails to satisfy the 90% threshold, the Squeeze-Out Right would not be available and the fractional share squeeze-out by means of either a consolidation of shares or wholly callable stock would need to be considered.