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Triangular Mergers

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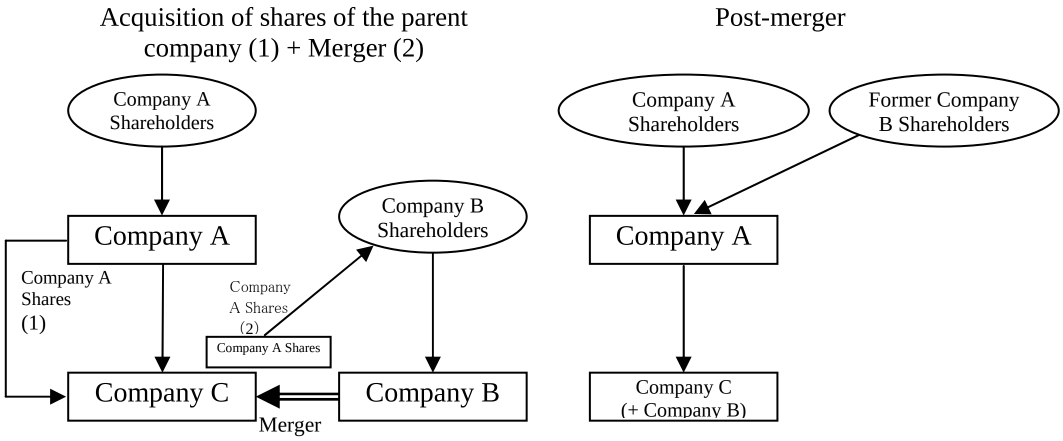
As of May 1, 2007, provisions of the Corporation Law[1] providing for "increased flexibility in merger consideration" came into effect[2]. This newsletter outlines how triangular mergers have been made possible[3] by this "increased flexibility in merger consideration", under the Corporation Law and other laws and regulations.

1. Introduction

A "triangular merger" refers to a merger in which the surviving company (Company C) delivers shares of its parent company (Company A) to shareholders of the merged company (Company B) instead of its own shares (see the following chart)[4].

Japanese and non-Japanese companies can use the triangular merger structure to complete acquisitions. This newsletter will look at triangular mergers from the perspective of a non-Japanese acquirer, in light of the attention that the triangular merger structure has received as a way for non-Japanese companies to complete acquisitions in Japan using their shares as the transaction consideration.



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[1] Article 749(1)(ii) and other provisions of the Corporation Law, and Item 4 of the Supplementary Provisions of the Corporation Law.

[2] For more information on increased flexibility in merger consideration, see the New Corporation Law Newsletter Vol. 12 (March 2006).

[3] Although triangular mergers have been available pursuant to regulatory approval under the Law on Special Measures for Industrial Revitalization, increased flexibility in merger consideration under the Corporation Law has made the structure available without such regulatory approval.

[4] Under the Corporation Law, a subsidiary is, in principle, prohibited from acquiring shares of its parent company. The exception to this rule is where a subsidiary is the surviving company in a merger and it acquires the shares of its parent company to the extent necessary to deliver them to shareholders and other parties of the merged company (Article 800(1) and Article 135(2)(v) of the Corporation Law, and Article 23(viii) of the Enforcement Regulations of the Corporation Law). The laws of the jurisdiction of incorporation of a non-Japanese parent company are generally thought to govern whether its Japanese subsidiary is permitted to acquire the non-Japanese parent company's shares.

2. Shareholder Approvals

In principle, a merger requires approval by a special resolution[5] of a general meeting of shareholders of the merged company (Articles 783(1) and 309(2)(xii) of the Corporation Law). If the merged company is a public company, and all or any part of the consideration for the merger consists of "Transfer Restricted Shares, etc." as prescribed by a Ministry of Justice Ordinance as shares subject to transfer restrictions and other similar securities, an extraordinary resolution,[6] whose requirements are even stricter than a special resolution, is required (Articles 783(1) and 309(3)(ii) of the Corporation Law).

As "measures will be taken to make adjustments or other changes approximately one year after the enforcement of the Enforcement Regulations of the Corporation Law based on the results of a review of merger consideration" (Item 9 of the Supplementary Provisions of the Enforcement Regulations of the Corporation Law) with respect to Article 186 of the Enforcement Regulations of the Corporation Law, which stipulates details of "Transfer Restricted Shares, etc.", some in the business world have argued that, for the protection of merged company shareholders and other reasons, "Transfer Restricted Shares, etc." should include shares of non-Japanese companies that are not listed on any securities exchange in Japan[7].

Ultimately, however, the shareholder approval requirements for triangular mergers were not made stricter. As with a normal merger, a triangular merger can be approved by a special resolution by the shareholders of the merged company[8, 9].

3. Additional Premerger Disclosures due to Partial Amendment to the Enforcement Regulations of the Corporation Law

Each party to a merger must maintain at its principal office documents or electromagnetic records ("Premerger Disclosure Documentation") stating or recording the terms and conditions of the merger agreement and other matters stipulated in a Ministry of Justice Ordinance from the date the merger agreement and other documentation are initially stored until six months after the effective date of the merger (until the effective date of the merger in the case of a merged company) (Articles 782(1)(i) and 794(1) of the Corporation Law). Furthermore, if each party submits a proposal to approve the merger to a general meeting of shareholders, it must deliver to the shareholders documentation stating any matters that should be considered by the shareholders in exercising their

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5 A special resolution (tokubetsu ketsugi) is a resolution of a general meeting of shareholders adopted by at least two-thirds (or, if a higher proportion is provided in the articles of incorporation, such proportion) of the voting rights of the shareholders present at the meeting who hold more than one-half (or if a proportion of one-third or more is provided in the articles of incorporation, such proportion of one-third or more) of the voting rights of the shareholders entitled to vote at such meeting (Article 309(2) of the Corporation Law).

6 An extraordinary resolution (tokushu ketsugi) is a resolution of a general meeting of shareholders adopted by one-half or more (or, if a higher proportion is provided in the articles of incorporation, such proportion) of the shareholders entitled to vote at such meeting who represent at least two-thirds (or, if a higher proportion is provided in the articles of incorporation, such proportion) of the voting rights of the shareholders entitled to vote at such meeting (Article 309(3) of the Corporation Law).

7 For instance, Nippon Keidanren (the Japan Business Federation) proposed on December 12, 2006 that if a merged company is a listed company, requirements for a merger whose consideration is not cash or securities listed in Japan (or securities that satisfy Japanese listing standards) should be stricter, including requiring an extraordinary resolution.

8 Article 186 of the Enforcement Regulations of the Corporation Law.

9 On April 24, 2007, Tokyo Stock Exchange, Inc. ("TSE") announced that it will develop a listing system in response to the enforcement of the provisions of the Corporation Law providing for increased flexibility in merger consideration. According to this announcement, TSE will, for instance, apply a "technical listings system" to triangular merger transactions which enables the listing of shares or other securities of a company not listed on the TSE soon after it acquires a company listed on the TSE (only those companies that apply for listing within six months after the effective date of the merger, etc.) by focusing on confirming compliance with the share float standards set out in the share delisting standards. Furthermore, in a triangular merger in which the surviving company delivers shares or other securities issued by its parent company when its parent company is a non-Japanese company, a technical listing will apply only when TSE considers appropriate. "When TSE considers appropriate" means a case where, in light of the status and other conditions of implementing and maintaining systems in the country of the incorporation of the non-Japanese parent company, it is expected that the shares or other securities of such non-Japanese parent company will be smoothly traded and settled.

voting rights ("Shareholders' Meeting Reference Documents") (Articles 301 and 302 of the Corporation Law).

The recently amended Enforcement Regulations of the Corporation Law[10] require that if shares of the parent of the surviving company are used as consideration under the provisions providing for increased flexibility of merger consideration, the following matters must be disclosed in addition to the existing disclosure requirements in the Premerger Disclosure Documentation and the Shareholders Meeting Reference Documents. This amendment was made to protect shareholders of the merged company by allowing each shareholder of the merged company to appropriately decide whether to approve the merger:

(1) The following matters must be disclosed with respect to shares of the parent of the surviving company as matters concerning the method of liquidating the merger consideration: (1) markets on which such shares are traded (e.g., securities exchanges), (2) brokers (e.g., securities companies) handling such shares, (3) details of any restrictions on transfer or other disposition of such shares, and (4) market prices and other matters concerning such shares (Articles 182(4)(ii)(i), 182(4)(i)(b) and (c), and 86 of the Amended Enforcement Regulations of the Corporation Law);

(2) The following matters must be disclosed as matters concerning the company issuing the merger consideration: (1) details of its financial statements and other similar documents, and (2) a summary of matters that would be stated in a business report (each item of Articles 118 and 119 of the Enforcement Regulations of the Corporation Law) for its most recent fiscal year (Articles 182(4)(ii)(f) and (g) and 86 of the Amended Enforcement Regulations of the Corporation Law); and

(3) The following matters must be disclosed as "other matters": (1) if the parent of the surviving company is not a Japanese company, details of the rights the shareholders of the merged company would be entitled to (e.g., rights to receive distributions of surplus funds and voting rights at general meetings of shareholders), (2) languages used by the parent of the surviving company to provide information to shareholders and other parties, and (3) the estimated number of all voting rights or other similar rights of the parent of the surviving company as of the effective date of the merger (Articles 182(4)(ii)(b), (c) and (d), and 86 of the Amended Enforcement Regulations of the Corporation Law).

4. Disclosure under the Securities and Exchange Law and the Financial Products and Exchange Law

(1) Issues under the Securities and Exchange Law (the "SEL")

Under the current SEL, the delivery of shares of the parent of a surviving company to the shareholders of the merged company in a triangular merger is not considered a "public sale of securities" (Article 2(4) of the SEL) and the delivery of the shares of the parent at the time of the triangular merger does not require the filing of a securities registration statement and are not otherwise subject to disclosure requirements because there is no solicitation to acquire securities for purposes of the SEL. Further, while a Japanese company with 500 or more shareholders is generally required to submit securities reports and is subject to continuous disclosure requirements (Article 24(1)(iv) of the SEL, Article 3-6(2) of the SEL Enforcement Order), if the parent of a surviving company in a triangular merger is a non-Japanese company, it would not be required to submit any securities reports and would not be subject to continuous disclosure requirements because, even if its shares are delivered to the shareholders of the merged company, these requirements do not apply to shares issued by a non-Japanese company.

Because of this, the disclosure system under the current SEL is regarded to be insufficient in terms of disclosure with respect to reorganizations and failing to protect investors.

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[10] The Ministerial Ordinance for Partial Amendment to the Enforcement Regulations of the Corporation Law was promulgated on April 25, 2007, and came into force on May 1, 2007.

(2) Disclosure Obligations under the Financial Products and Exchange Law (the "FPEL")

Under the FPEL, which was enacted on June 7, 2006[11], a new disclosure system has been established for the issuance of new shares and other matters in connection with restructurings[12].

As a result, if the number of holders of shares, stock acquisition rights, or other securities of the merged company in a merger exceeds a certain threshold level, certain acts of the parties involved in the merger under the provisions of the Corporation Law will be regarded as "specified restructuring delivery procedures" and therefore the delivery of existing securities in such merger is considered a "public sale of securities"[13]. If these conditions apply to a non-Japanese company whose securities are to be delivered in a triangular merger, it will be required to submit a securities registration statement prior to the merger (Article 4(1) of the FPEL).[14] Further, any non-Japanese company that is subject to these disclosure requirements at the time of merger will also be subject to continuous disclosure requirements under the FPEL and will be required to submit securities reports, etc. (Article 24(1)(iii) of the FPEL).

It should be noted that a non-Japanese company that is required to make continuous disclosures might be permitted to submit English language documentation similar to securities reports, etc. published outside of Japan instead of securities reports in Japanese (although it will be necessary to attach a supplementary summary in Japanese of each document) (see Article 24(8), Article 24(9) and other provisions of the FPEL)[15]. However, it is important to note that because, unlike continuous disclosures, English language disclosures for the delivery of shares in the merger will not be permitted, any non-Japanese company involved in a triangular merger will need to allocate time to prepare and submit a securities registration statement in Japanese.

5. Tax Reform

(1) "Capital gains tax on share transfer" imposed on shareholders of a merged company

In principle, the shareholders of a merged company are subject to tax on gains arising from the transfer of shares (Article 61-2(1) of the Corporation Tax Law and Article 37-10(1) of the Special Taxation Measures Law). Prior to the 2007 tax reforms, however, taxes on gains arising from a transfer of shares imposed on shareholders of the merged company were deferred as an exception where the consideration paid in the merger was

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[11] The FPEL will come into force from a day stipulated by a Cabinet Order that is within one year and six months of the day of its promulgation (June 14, 2006). According to an announcement by the Financial Services Agency on April 13, 2007, the FPEL is expected to come into force in or around September 2007.

[12] For more information on this point, see the December 2006 I&M Newsletter on the "disclosure system for the issuance of new shares and other matters in connection with restructurings."

[13] A delivery of shares will not be considered to be a "public sale of securities" if no disclosure about the share certificates of the merged company is made under the FPEL or disclosure about the share certificates of a non-Japanese company that are delivered to the shareholders of the merged company is made under the FPEL (Article 4(1)(ii) of the FPEL).

[14] According to the "Proposed Cabinet Office Ordinance Partially Amending the Cabinet Office Ordinance Concerning the Disclosure of Corporate Information, etc.", which was published by the Financial Services Agency on April 13, 2007, if a non-Japanese company wishes to submit a securities registration statement to carry out specified reorganization delivery procedures, it must, in addition to disclosing matters required when making a public offering of securities or a public sale of securities other than specified reorganization issuance procedures or specified reorganization delivery procedures, disclose (i) the purpose, etc., of the reorganization, (ii) summary information regarding the companies involved in the reorganization, (iii) any contract pertaining to the reorganization, (iv) allocation details and the grounds for calculating such allocation with respect to the reorganization, (v) differences between the securities issued by the company subject to reorganization and the securities delivered upon the reorganization, (vi) the rights of the holders of security certificates issued by the company subject to reorganization, (vii) procedures concerning the reorganization, and (viii) information about the company subject to reorganization (Form No. 7-4 set out in Article 8(1)(v) of the proposed Cabinet Office Ordinance Concerning the Disclosure of Company Details, Etc.).

[15] The related provisions apply as of March 31, 2009 or an earlier date prescribed by an ordinance.

limited to shares of the surviving company (Article 61-2(2) of the former Corporation Tax Law and Article 37-10(3)(i) of the former Special Taxation Measures Law).

This deferral did not apply in triangular mergers, however, because the consideration paid in a triangular merger is "shares of the parent of the surviving company", rather than "shares of the surviving company" . This led to tax reforms in 2007 that permitted the deferral of share transfer gains tax in triangular mergers.

Under the "Law for Partial Amendment of the Income Tax Law, etc." , which was enacted on March 23, 2007, tax on gains arising from the transfer of shares imposed on shareholders of a merged company in any merger or other reorganization on or after May 1, 2007 will be deferred not only where the consideration paid in a merger is limited to shares of the surviving company, but also where the consideration is limited to shares of a 100% parent of the surviving company (Article 61-2(2) of the Corporation Tax Law and Article 37-10(3)(i) of the Special Taxation Measures Law).

(2) "Tax on deemed dividends" imposed on shareholders of a merged company and "capital gains tax on asset transfer" imposed on the merged company

In principle, the shareholders of a merged company are subject to tax on deemed dividends (Article 24(1)(i) of the Corporation Tax Law and Article 25(1)(i) of the Income Tax Law) and the merged company is subject to capital gains tax on asset transfer (Article 62 of the Corporation Tax Law). If, however, a merger meets certain conditions[16], no tax on deemed dividends will be imposed on shareholders of the merged company (language inside brackets in Article 24(1)(i) of the Corporation Tax Law and language inside brackets in Article 25(1)(i) of the Income Tax Law) and taxation on any gains and losses from the asset transfer of the merged company will be deferred (Article 62-2 of the Corporation Tax Law).

As triangular mergers did not satisfy the conditions for qualified mergers prior to the 2007 reforms, they were subject to tax on deemed dividends and capital gains tax on asset transfer.

(A) Consideration for Mergers

One of the requirements for qualified mergers prior to the 2007 tax reforms was that "only shares of the surviving company be delivered to the shareholders of the merged company", which meant that a triangular merger, in which the shares of the parent of the surviving company are delivered to the shareholders of the merged company, would not qualify because this requirement is not met.

This was amended by the Law for Partial Amendment of the Income Tax Law, etc. so that the requirement is now that "only shares of either the surviving company or the 100% parent of the surviving company be delivered to the shareholders of the merged company"[17], which makes it possible for a triangular merger to also satisfy this requirement (Article 2(xii-viii) of the Corporation Tax Law).

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[16] Prior to the 2007 tax reforms, in the case of a merger for the purpose of engaging in a joint business, the requirements for a qualified merger were (1) only shares of the surviving company are delivered to the shareholders of the merged company, (2) there is business relevance, (3) the size of each business is not significantly different or specified officers are assumed by the surviving company, (4) more than 80% of employees are assumed by the surviving company, (5) the business is maintained, and (6) if the merged company has fewer than 50 shareholders, 80% or more of the shares of the surviving company are maintained (Article 2(xii-viii) of the former Corporation Tax Law, and Article 4-2(3) of the former Corporation Tax Law Enforcement Ordinance). As further explained below, items (1) and (2) above were regarded as requirements not satisfied in triangular mergers.

[17] The parent company is required to be a corporation that (1) directly holds all of the outstanding shares of the surviving company immediately prior to the triangular merger and (2) is expected to continue to directly hold all such shares after the merger (Article 4-2(1) of the Corporation Tax Law Enforcement Ordinance).

(B) Business Relevance

The Ordinance for Partial Amendment of the Corporation Tax Law Enforcement Regulations, which was enacted on April 13, 2007, clarified the criterion for another requirement for qualified mergers, which is that, in the case of a merger for the purpose of engaging in a joint business, “the business of the surviving company and the merged company must be related” (known as “business relevance”).

Specifically, business relevance is first determined with respect to the relationship between the surviving company and the merged company, not between the parent company of the surviving company and the merged company.

Business relevance has two prongs: “business” and “relevance”. To satisfy the requirement that the surviving company be engaged in a “business,” it must, immediately prior to the merger, (i) own or lease an office, store, factory, or other fixed facilities, (ii) have an employee (or an officer, as long as the duties of the officer are solely the business of the surviving company)[18], and (iii) be engaged in any act listed in Article 3(1)(i)(c) of the Corporation Tax Law Enforcement Regulations (such as selling or otherwise trading products, soliciting offers for or forming contracts concerning product sales, etc., through advertising, conducting market research to obtain data required to make product sales, or other activities) (Article 3(1)(i) of the Corporation Tax Law Enforcement Regulations).

To satisfy the requirement of “relevance”, one of the following relationships must be established immediately prior to the merger: (i) the business of the surviving company and the business of the merged company are the same type of business, (ii) the products, assets, services, and management resources of the business of the surviving company and the business of the merged company are the same or similar, and (iii) the business of the surviving company and the business of the merged company can be expected to utilize the products, assets, services, and management resources of the business of the merged company after the merger (Article 3(1)(ii) of the Corporation Tax Law Enforcement Regulations).[19]

Consequently, if a non-Japanese company establishes a Japanese company with no actual business for purposes of a triangular merger, it will not meet the “business relevance” requirement for a qualified merger. However, as seen above, if the Japanese company conducts certain limited activities such as market research that is the same or similar to the business of the merged company, then the merger would be able to be a qualified merger.

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[18] The Japanese language original text of the Regulations does not require “multiple” employees or officers to be employed or appointed. Therefore it is our view that a single employee or officer is enough to satisfy the requirement.

[19] If, after the merger, the business of the surviving company and the business of the merged company are integrated and carried out as a sole business by utilizing the products, assets, services, and management resources of the business of the merged company, these businesses are considered “relevant” (Article 3(2) of the Corporation Tax Law Enforcement Regulations).