Asset Acquisition Documents: Private Acquisitions (Japan)

by Yoshiki Tsurumaki, Ken Kato, Chisaki Kishi and Ryokei Abe, King & Wood Mallesons (based on material originally contributed by Latham & Watkins)

Practice notes | Law stated as of 01-Mar-2022 | Japan

A Practice Note describing the key documents, as well as certain legal and practical issues to consider, when acquiring the assets of a private company or a business as a going concern in Japan. It discusses the steps for an asset purchase or company split in Japan and the substantive clauses of a purchase agreement. It also considers the main legal issues involved, including approval requirements, the automatic transfer of any assets or liabilities, remedies for breach of warranty, and liability for misrepresentation.

Asset acquisitions generally involve a buyer purchasing a business or all or some of the assets of that business from the seller. The transaction process differs between countries depending on legal and regulatory requirements, M&A customs, and business practices. Before acquiring the assets of a private company or a business as a going concern in Japan, non-Japanese buyers should understand the local legal requirements and standard practices for completing these transactions.

This Note describes the key documents used when acquiring the assets of a private company or a business as a going concern in Japan. This Note also addresses certain legal and practical considerations when acquiring assets in Japan, including:

- Key features of Japanese asset deals or company splits.
- The structure of a framework agreement for an asset purchase or company split and key provisions.
- Key legal issues impacting asset purchases in Japan.
- Information on resolving disputes arising out of misrepresentation and breach of warranty.

This Note focuses on transactions involving a bilateral sale, where the buyer and the seller negotiate and enter a detailed purchase agreement to record and implement the transaction.

An in-depth analysis of tax, employment, competition, and regulatory implications in the context of an asset purchase or company split is excluded from the scope of this Note.

For more information regarding different acquisition structures in Japan, see Practice Note, Acquisition Structures: Comparing Asset and Share Purchases in Japan.

Unless otherwise stated, a reference in this Note to:

- Antimonopoly Act means the Antimonopoly Act (Act No. 54 of 1947, as amended).

- Building Lots and Buildings Transaction Business Act means the Building Lots and Buildings Transaction Business Act (Act No. 176 of 1952, as amended).
- Civil Code means the Civil Code of Japan (Act No. 89 of 1896, as amended).
- Companies Act means the Companies Act of Japan (Act No. 86 of 2005, as amended).
- Financial Instruments and Exchange Act means the Financial Instruments and Exchange Act (Act No. 25 of 1948, as amended).
- Foreign Exchange and Foreign Trade Act (FEFTA) means the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949, as amended).

Official translations of Japanese law that are publicly available may not timely reflect all revisions of the law.

Key Features of Japanese Asset Deals

A cross-border and domestic purchase of assets located in Japan typically consists of:

- A letter of intent phase. This phase usually entails the negotiation on the scope and term of a due diligence review, the range of consideration for the assets, other basic terms and conditions, and the outline of the transaction schedule.
- A due diligence phase.
- A contractual phase. This phase usually entails the negotiation and execution of a purchase agreement and related disclosures by the seller.
- A subsequent closing phase. This phase usually entails the procedures for perfecting the transfer of the assets in accordance with the provisions of the purchase agreement.
- A transition phase. This phase usually entails the transferor and the transferee together explaining the transfer of the contractual position to the customers or suppliers and the transferor explaining details of the business to the transferee.

Main Acquisition Structures

A share purchase is the most common way to acquire a private company in Japan because the procedure for share purchases is much simpler.

In relation to conducting an asset or business purchase in Japan, two structures are available:

- Company split (*kaisha bunkatsu*), which is a corporate transaction in which transferred businesses are spun off.
- Business or asset purchase (*jigyo jyoto*), which is a contractual transfer of individual assets, contracts, and employees.

Under either structure, the buyer can generally exclude liabilities of the seller, unless otherwise agreed between the parties (see Automatic Transfer of Assets and Liabilities).

Under the Companies Act, a company split means that a company (a split company) transfers all or part of the assets, debts, labor contracts, and other rights and obligations pertaining to its business to another company or a newly established company (a successor company). A company split is functionally similar to a business or asset purchase because both are used for causing a business of a company to be transferred to another company. However, significant differences exist between a company split and a business or asset purchase. In a company split, each contract pertaining to the business to be transferred will be succeeded by the successor company without consent from the opposite party involved in each contract, while in a business or asset purchase, consent to the contract transfer is a must. Parties planning on a business transfer will usually consider the number of contracts to be succeeded when deciding whether to adopt a company split or an asset purchase.

In a business or asset purchase, a selling company in Japan must obtain the consents of employees who are designated to be transferred in the asset purchase agreement. Those who do not agree to be transferred will remain with the selling company after the transaction. In a company split, an employee's consent to transfer is not necessarily required. However, in a company split the seller must provide certain protections to its employees.

In company splits, Japanese labor laws categorize employees into three groups:

- Employees who are "primarily" engaged in the target business and are listed as "target" employees in the statutory spin-off agreement (Group A Employees).
- Employees who are "primarily" engaged in the target business but are not listed as "target" employees in the statutory spin-off agreement (Group B Employees).
- Employees who are not "primarily" engaged in the target business but are listed as "target" employees in the statutory spin-off agreement (Group C Employees).

Governmental guidelines set out how to interpret whether an employee is "primarily" engaged in the target business. Initially, this categorization is made by the seller. However, if the relevant employee disagrees with the seller's categorization, the seller must make itself available for discussions with the employee to mutually agree on the employee's categorization. If the parties are still unable to agree, the dispute is submitted to the court.

Group A Employees have no right to refuse to be transferred to the buyer along with the target business. Group B Employees have a tag-along right to insist on being transferred to the buyer with the target business. Group C Employees have the right to refuse any transfer to the buyer, and to remain with the seller.

Under Japanese labor laws (assuming no labor union exists in which a majority of employees are members and the seller does not have a collective bargaining agreement (*rodo kyoyaku*) with any labor union), the seller must undertake the following steps with its employees before the sale of its target business:

- Engage in good-faith discussions with a representative of a majority of the employees to obtain their understanding and cooperation.
- Engage in good-faith discussions with each of the employees who are engaged in the target business in any way (including Group A Employees, Group B Employees, and employees who are not primarily engaged in the target business) and with each Group C Employee about whether:
    - their role is considered primarily engaged in the target business; and

- the employee intends to be transferred to the buyer, and if so, what the employee expects in terms of their new role following the spin-off.

- Provide a statutory notice to each of the Group A, Group B and Group C Employees. This statutory notice must include an overview of the target business and the Group category of the employee, including information on whether:
  - the seller believes the employee's role is considered primarily engaged in the target business; and
  - the employee will be entitled to tag-along rights or refusal rights.

The buyer must keep the salary, benefits, and other working conditions of transferred employees substantially the same as their working conditions at the seller.

For more information on employee issues arising in private acquisitions in Japan, see Practice Note, Employees: Cross-Border Private Acquisitions (Japan).

Main Documents

Company Split Structure Agreements

There are two available transaction structures involving a company split that use two different definitive agreements:

- **Share purchase agreement.** In a share purchase agreement, the seller covenants to either:
  - contribute its target business, including all related assets and rights, into an existing wholly owned subsidiary of the seller through a "merger-type" spin-off (*kyushu bunkatsu*); or
  - create a newly established 100%-owned subsidiary by contributing its target business to a new subsidiary through an "incorporation-type" spin-off (*shinsetsu bunkatsu*).

  Following either a merger-type or incorporation-type spin-off, the target business sits in a wholly owned subsidiary of the seller, and the seller sells 100% of the subsidiary's shares to the buyer through a share purchase agreement.

- **Merger-type spin-off agreement.** The buyer incorporates a 100%-owned subsidiary in Japan to which the seller merges its target business, including all related assets and rights, through a merger-type spin-off (*kyushu bunkatsu*). Japanese laws do not allow a foreign buyer to be a direct counterparty in a spin-off with a Japanese seller, so a Japan-incorporated subsidiary is required. The main document in such a transaction is the merger-type spin-off agreement.

Although the two available types of transaction structures involving company splits use different steps to complete the sale of the target business, the substance of the share purchase agreement used in the first structure is substantively similar to the merger-type spin-off agreement used in the second structure.

Business Purchase Agreement

In a business or asset purchase, the definitive document is typically referred to as the business purchase agreement.

A business or asset purchase is defined as a sale of a "material" business of the seller. Japanese law allows a foreign buyer to be a direct counterparty in a business or asset purchase with a Japanese seller, so a Japan-incorporated subsidiary is not required.

Like a company split, a business or asset purchase is a bundle of multiple contractual sales of each of the assets and rights that make up the target business.

The Companies Act requires the seller to obtain shareholder approval of the business or asset sale through a special shareholders' resolution (see Shareholder Approvals) and to grant appraisal rights to any objecting shareholders. The buyer must also obtain shareholder approval when it is purchasing the seller's entire business.

In addition, the Companies Act has certain statutory effects on a business or asset purchase, including:

- A default non-compete obligation on the part of the seller (see Restrictive Covenants).
- Statutory vicarious liability imposed on a buyer that continues to use the same trade name as the seller after the closing of the transaction. Any such buyer is vicariously liable to creditors for liabilities accrued by the seller in connection with the transferred business before closing. For the buyer to be exempted from these liabilities, the buyer must, immediately after closing:
  - provide written notice to the creditors jointly with the seller; or
  - file with the Legal Affairs Bureau an update to its corporate registration stating that the liabilities will not be assumed by the buyer.

If a buyer does not continue to use the same trade name as the seller after the closing of the transaction, it will not be liable to creditors for any liabilities accrued by the seller in connection with the transferred business before closing unless stipulated in the transaction agreement. However, even in this case, statutory liability will also be imposed on the buyer if it advertises that it will assume the liability.

If a buyer and a seller agree not to transfer all or part of the liabilities of the seller knowing that it will harm the seller's creditors, the creditors may demand from the buyer the performance of obligations up to the value of the succeeding business.

Framework Agreements

Company split structure agreements and business purchase agreements (in each case, not including the "statutory" split agreement or business purchase agreement discussed below) are substantially similar in substance and referred to collectively as "framework agreements" in this Note. The substance of the negotiations is substantially similar regardless of whether a framework agreement or a share purchase agreement is used.

As a framework agreement can be used in both the company split structure and the business purchase structure, this Note focuses solely on the components of the framework agreement. For information regarding the key documents featured in share purchases in Japan, see Practice Note, Key Documents for Acquiring a Private Company (Japan).

Under the Companies Act, the seller must pass a shareholders' resolution to approve the agreement effecting the company split or business sale, except where a statutory exemption is applicable.

In addition, the Companies Act sets out specific items that must be provided in a company split agreement. To avoid the requirement of sharing the detailed terms of the definitive framework agreement with all shareholders, listed companies commonly draft and disclose a second, brief split agreement or business purchase agreement (as the case may be) for the purpose of satisfying the statutory requirements. Items required to be included in these brief "statutory" agreements are outside the scope of this Note.

The initial draft of the framework agreement can be drafted by either the buyer or the seller, depending on the circumstances of the sale. In practice, the buyer usually conducts a due diligence review, chooses the transaction structure, and prepares the initial draft of the framework agreement, taking into account the due diligence findings.

The choice between the company split structure and the business or asset purchase structure is fact-dependent and is not a question of one or the other being more common. Parties planning on a business transfer will usually consider the number of contracts to be succeeded when deciding whether to adopt a company split or an asset purchase. Among transactions involving the company split structure, the "share purchase following spin-off" structure is generally used.

Preliminary agreements and documents produced before or during the due diligence phase in a company split or business or asset purchase, such as a letter of intent and confidentiality agreement, are similar to those typically used in a share acquisition.

For more information regarding preliminary agreements and due diligence documents, see Practice Note, Key Documents for Acquiring a Private Company (Japan): Preliminary Agreements and Due Diligence Documents.

Timeline

The timeline of the transaction can be affected by several factors, such as:

- **Statutory Process Under the Companies Act.** Any company split (but not a business sale) must go through a statutory process under the Companies Act, which includes a one-month waiting period to provide creditors of the parties with an opportunity to make objections to the split. However, the timing for initiating this process can be controlled by the parties.
- **Transfer and Perfection.** When the seller transfers its target business to the buyer, practical procedures, such as transferring existing contracts and licenses or permits and perfecting the transfer of real property or intellectual property, will affect the projected timeline (see Completion of Asset Sale). Procedures such as the process for obtaining consents from counterparties to existing contracts of the seller, as well as transferring applicable licenses and permits, can take months to complete, and parties should discuss timing and process as early in the negotiation as possible to minimize the risk of unanticipated timing challenges. Moreover, if certain licenses or permits are not transferable, the buyer will need to apply for new licenses or permits to operate the target business. Therefore, the timeline for applying for those new licenses and permits should be considered when determining the overall timeline of the company split or business sale.

Completion of Asset Sale

The legal steps required to effect or perfect the transfer of purchased assets depends on the type of assets and rights to be transferred. For example:

- In a business or asset purchase, public registration is required to effect the transfer of registered intellectual property, such as patents, designs, and trademarks. In a company split, public registration of the transfer of each asset is not required to effect nor perfect the transfer. However, it is necessary to notify the relevant authority that the registered intellectual property has been transferred due to a split.
- Public registration is required for the perfection of the transfer of real property.
- Notices delivered to debtors by certified mail or notarized consent executed by debtors is required for the perfection of the transfer of receivables. Where the seller is a corporation, the transfer of receivables may also be perfected to debtors by registering the transfer in a claim assignment registration file instead of delivering notice by certified mail to or obtaining notarized consent by debtors.

However, as a practical matter, when consummating a company split, notices by certified mail are not necessarily delivered to all the debtors if doing so would be overly burdensome. As a result, a typical approach is to include in the framework agreement a seller covenant requiring the delivery of those notices be made only to the debtors of material receivables.

In the case of a merger-type spin-off where the target business is contributed to the seller's spin-off subsidiary, depending on whether the spin-off subsidiary has elected to issue share certificates or uncertificated shares under its articles, the seller must either:

- Deliver a share certificate to the buyer.
- Deliver to the buyer a signed request to amend the shareholder registry of the spin-off subsidiary.

Depending on the materiality of the purchased assets, and the timing between the statutory effective date of the company split and the closing date, closing deliverables may also include the:

- Public registration of certain assets (and documentation evidencing that registration).
- Delivery of the requisite documents for the buyer to properly register the assets following the closing.

In a business sale or merger-type spin-off where the target business is contributed to the buyer's spin-off subsidiary, the buyer will need to cooperate with the seller to perfect the transfer of certain assets.

Initialed signature pages, schedules or appendices are not common practice in Japan. The standard practice is to simply have all parties sign the signature pages following the agreement and preceding the schedules or appendices.

For further information on the mechanics of signing and closing Japanese acquisitions, see Practice Note, Signing and Closing: Private Acquisitions (Japan).

Governing Law

In theory, a framework agreement can provide for a foreign governing law, but this is not common. If a foreign governing law is used, there are still many national laws of Japan that automatically apply to the framework agreement and overall transaction, including:

- Japan's employment law.

- The Civil Code.
- The Companies Act.
- The Financial Instruments and Exchange Act.
- Anti-trust laws.

When Japanese companies are a contracting party, they usually choose Japanese law as the governing law for asset deals in Japan because:

- The governing law will be a criterion for the parties to determine which lawyer to retain for the transaction, and for Japanese companies, Japanese law attorneys are the easiest to access and retain.
- For people in charge of the transaction inside Japanese companies, they can review transaction schemes and draft documentation based on Japanese law, with which they are most familiar, and can rather easily predict the outcome in the event of a dispute.
- When a lawsuit is filed in a Japanese court for a case that is governed by a law other than Japanese law, the court will investigate the foreign law in question, ask either party to submit a report or opinion on the foreign law, and apply it to the case; however, a court may find it difficult to investigate the law and may misapply the foreign law.

Key Provisions in a Framework Agreement

A framework agreement usually follows the structure below:

- Date and parties.
- Definitions.
- Agreement to purchase and sell the business.
- Price.
- Identification of assets to be purchased and rights and contracts to be assigned.
- Identification of liabilities to be assigned.
- Identification of liabilities to be retained.
- Representations and warranties (see Representations and Warranties).
- Conditions precedent (see Conditions Precedent).
- Covenants. The seller's covenants (which may be negotiated down to a lesser standard than "best efforts", such as "reasonable efforts", although there is no case law or established interpretation addressing the meaning of best efforts) typically include:
    - pre-closing conduct of the business;
    - performance of corporate actions to consummate the company split or business sale;

- best efforts to fulfill conditions precedent to the obligation of the buyer;
- best efforts to obtain consents of counterparties to contracts to be assigned;
- best efforts to transfer licenses and permits required to operate the business, including assisting the buyer in acquiring new licenses and permits;
- best efforts to collect consents of employees to be transferred (in a business or asset purchase);
- compliance with statutory procedures to transfer employees (in a company split);
- post-closing transition services;
- non-compete covenants (see Restrictive Covenants); and
- post-closing adjustments (such as adjustment of payment receivables) (see Price Adjustment Mechanisms).

- Indemnities, with limitation on claims (such as caps, floors, and duration limits (see Common Seller's Limitations)).
- General (boilerplate) clauses, including:
  - entire agreement (see Entire Agreement Clause);
  - confidentiality;
  - no assignment; and
  - governing law and jurisdiction.

Japanese companies, whether participating as the buyer or the seller, are inclined to prefer the laws of Japan as the governing law and arbitration as the dispute resolution mechanism, regardless of where the counterparty is located.

Recitals

Recitals are used at the start of a framework agreement to provide background information on the parties and the purpose of the agreement. It is not common that a framework agreement has recitals when the transaction involves only Japanese parties. However, recitals are very common for framework agreements involving foreign entities or individuals.

The substantive terms of the framework agreement are given more weight than the recitals, although there is no binding case law on this topic. Recitals themselves are not legally binding. However, according to a recent (April 2020) amendment to the Civil Code, judges must now look at the purpose of the contract when applying the contract's provisions, such as remedies for breach. As a result, more weight will likely be given to the recitals going forward as judges begin looking to the recitals as evidence of the purpose of the contract.

Price Adjustment Mechanisms

Net debt and working capital are the most common criteria for price adjustment mechanisms.

Under the typical approach, the base price for the target business is negotiated based on agreed figures for target net debt and target net working capital. Before closing, the seller prepares preliminary financial statements for the target business as of a fixed date before the closing date. The seller calculates estimated net debt and estimated net working capital based on these financial statements. The initial purchase price paid (subject to any holdback mechanism, which is not typically agreed to by sellers in Japan) is the sum of the base price, plus the difference between the target net debt/net working capital and the estimated net debt/net working capital (based on the pre-closing preliminary financial statements).

Within an agreed period after the closing date (usually 60 to 90 days), the buyer prepares definitive financial statements as of the calculation date and determines the final net debt and net working capital of the target business. During a specified review period, the seller has the right to inspect the buyer's books and review the definitive financial statements, including the calculations for final net debt and net working capital, following which the seller has a right to object to these calculations. If the seller objects to these calculations, the dispute is submitted to an independent accountant, and the independent accountant's determination is typically final and binding. Once those calculations are finalized, the difference between the final net debt/net working capital and the estimated net debt/net working capital is settled by payment of the additional price by the buyer to the seller, or a refund by the seller to the buyer, depending on the result of the process.

It is common to reduce the purchase price by the amount of any payment made under the warranties and indemnities. A clause providing for that price reduction is commonly used with the aim of avoiding tax on any indemnity damages received by the buyer. However, there is no binding case law or other binding guidance as to whether such arrangements would be respected by courts in Japan.

Conditions Precedent

The content of the conditions precedent depends on the circumstances of each transaction and the results of the due diligence process. Common conditions precedent to the obligations of the buyer include:

- No violation of representations and warranties.
- Compliance with pre-closing covenants.
- Approval or clearance of relevant authorities, commonly including foreign investment regulators and competition authorities.
- No court order or applicable law has been issued or enacted that makes the transactions illegal or otherwise prohibited.
- Consents from counterparties for contracts to be transferred (in a business or asset purchase, or with respect to contracts with change of control clauses in the case of a company split).
- Consents from key employees to be transferred (in a business or asset purchase) or absence of any of key employees' expression of intent to resign (in a company split).
- Completion of transfer of licenses and permits or obtaining new licenses and permits to operate the target business.
- No events or changes resulting in a material adverse effect on the target business.

Any of the conditions may include materiality qualifiers such as "material" or "in all material aspects", subject to negotiation on a case-by-case basis.

Standard and customary conditions precedent that appear in transactions are enforceable in Japan.

The following cases are assumed to render a condition precedent invalid or unenforceable:

- The party lacks mental capacity.
- The content of the condition precedent is contrary to public order and morality.
- There is concealment of the true intention of the party.
- There is the fictitious manifestation of intention in collusion between the parties.
- The party is in error.

(Article 90-95, Civil Code). However, in Japanese acquisitions, representations and warranties may also be made, and it is generally difficult to assume that a condition precedent will be agreed upon under the above conditions.

Representations and Warranties

Seller representations and warranties are typically included in framework agreements in Japan. The content may be decided on a case-by-case basis, mainly depending on the characteristics of the transaction and the target assets or business and the due diligence findings.

The main areas covered by seller's representations and warranties typically are the following:

- Organization and standing of the seller.
- Authorization and no conflict of the seller to enter into the agreement.
- Ownership of and title to the assets or business to be transferred, including real property and intellectual property.
- Company books and financial statements.
- Validity of commercial and financial contracts.
- Validity of permits and authorizations.
- Absence of litigation and third-party claims.
- Labor matters.
- Tax matters.
- Anti-bribery compliance.
- Environmental matters.

In any case, such a set of representations and warranties can expand to include specific additional representations and warranties, depending on the nature of the transferred business as a going concern.

For warranties related to real estate asset purchases, please see Real Property Purchases.

Framework agreements often include extensive warranty protection, particularly when a foreign party is involved in the transaction.

If there is a delay between signing and closing, it is common for representations and warranties to be brought down or repeated at the time of closing.

Common Seller's Limitations

Common limitations sought on warranties include "knowledge" and material adverse effect qualifiers. In addition, sellers tend to exclude certain matters from their representations and warranties in the form of disclosure schedules.

Indemnification provisions also typically include limitations, such as:

- A strict time limit for making claims.
- Floors (minimums), caps (maximums), de minimis thresholds, baskets, and deductible limits on the recoverable damages.

Disclosure by Seller

Warranties are usually qualified by disclosure, which is typically found in attached disclosure schedules or an appendix to the framework agreement.

Sellers tend to provide both general disclosures (matters which appear in public records or which the buyer out to be aware of based on searches or enquiries which a buyer ought to make) and specific disclosures (relating to actual matters which, if not disclosed, would be in breach of the given warranties) in the framework agreement.

Specific disclosures are usually cross-referred to the specific warranties to which they relate.

Unless the framework agreement explicitly includes a pro-sandbagging clause that allows the buyer to sue where it had actual knowledge of a matter that had not been formally disclosed by the seller in the disclosure schedule, it is not clear that the buyer would be successful in this kind of suit, given the unsettled case law in Japan. One lower court decision held a seller liable for a breach of warranty where the buyer was not aware, nor grossly negligent in not being aware, of the breach. However, the same court said that a buyer cannot sue if it does have actual knowledge, or is grossly negligent in being unaware, of the breach of warranty (*Tokyo District Court Judgment, Jan. 17, 2006; H.J. 1920, 136*).

As a result of this judgment, most buyers push to include a pro-sandbagging clause, whereas many sellers, unsurprisingly, negotiate for an anti-sandbagging clause. The result is often a framework agreement without either, as the parties agree to leave the issue to be addressed by a court in the event of a later dispute.

Restrictive Covenants

On the completion of a business sale, the seller is bound by a default non-compete obligation by operation of law. The geographical scope of the non-compete obligation is the same city and the neighboring city as the head office and/or branches that operate the target business, and the duration is 20 years (Article 21, Paragraph 1, Companies Act). The commonly accepted academic theory in Japan believes that the same Article and the same paragraph of the Companies Act should apply by analogy to a company split.

However, it is possible to contract around the statutory default non-compete requirement, and it is common to set out a less or more onerous non-compete clause in the framework agreement with a shorter duration or more extensive scope. A significantly more extensive scope or longer duration than the statutory non-compete can raise anti-trust concerns, but there are no clear-cut thresholds on the permitted degree of the duration and scope. As such, a case-by-case analysis of the relevant market (including the geographical aspect) should be conducted.

In addition, the maximum duration that can be extended by a special agreement is 30 years (Article 21, Paragraph 2, Companies Act). The commonly accepted academic theory in Japan believes that the same Article and the same paragraph of the Companies Act should apply by analogy to a company split.

Entire Agreement Clause

It is common to have an entire agreement clause (excluding liability for any representations or warranties made during negotiations that are not included in the agreement), and the use of an entire agreement clause has been upheld by lower courts (*Tokyo District Court Judgment, Dec. 13, 1995, H.T. 938, 160. Tokyo District Court Judgment, Dec. 25, 2006, H.J. 1964, 106. Nagoya District Court Judgment, Nov. 12, 2007, K.H. 1319, 50. Tokyo District Court Judgment, Feb. 27, 2019, K.H. 2142, 50*).

Real Property Purchases

In addition to the representations and warranties set out above (see Representations and Warranties), framework agreements that include real property typically contain also the following standard warranties:

- Title to property.
- Environmental matters.
- Compliance with zoning and planning regulations.

Key Legal Issues Impacting Asset Purchases

Shareholder Approvals

Company Split

In a company split, the seller must pass a special shareholders' resolution (*tokubetsu ketsugi*) approving the split by an affirmative vote of the shareholders (in person or by proxy) holding two-thirds or more of the issued and outstanding shares with voting rights in attendance at the meeting (Article 783, Paragraph 1, Item 3, Article 804, Paragraph 1, and Article 309, Paragraph 2, Item 12, Companies Act). A de minimis split where the book value of the target business constitutes 20% or less of the seller's total asset value on its non-consolidated balance sheet does not require any special shareholders' resolution (Article 784, Paragraph 2, and Article 805, Companies Act; Article 187 and Article 207 of the Ordinance for Enforcement of the Companies Act).

In a merger-type spin-off where the target business is contributed to the seller's spin-off subsidiary, if the book value of the stock of the spin-off subsidiary exceeds 20% of the seller's total asset value, the seller must also pass a special shareholders' resolution to separately approve the sale of all shares of the spin-off subsidiary to the buyer (Article 783, Paragraph 1, Item 3, Article 309, Paragraph 2, Item 12, and Article 784, Paragraph 2, Companies Act; and Article 187 of the Ordinance for Enforcement of the Companies Act).

In the structure where the buyer establishes a spin-off subsidiary to which the seller contributes its target business, the spin-off subsidiary must also pass a sole shareholder's resolution to approve of the spin-off, unless the transaction constitutes a de minimis spin-off where the price paid by the buyer's spin-off subsidiary to the seller is equal to or less than 20% of the spin-off subsidiary's net asset value on its non-consolidated balance sheet (Article 795, Paragraph 1, Article 309, Paragraph 2, Item 12, and Article 796, Paragraph 2, Companies Act; and Article 196 of the Ordinance for Enforcement of the Companies Act).

Business or Asset Purchase

The seller must pass a special shareholders' resolution (*tokubetsu ketsugi*) if the seller sells its entire business or the sale of the target business is considered material (Article 467, Paragraph 1, Item 2, and Article 309, Paragraph 2, Item 11, Companies Act). If the book value of the target business constitutes 20% or less of the seller's total asset value on its non-consolidated balance sheet, that business is not considered material and no shareholders' resolution is required (Article 467, Paragraph 1, Item 2, Companies Act).

The question of whether a business is "material" is examined from a substantive point of view rather than a strict numerical threshold, so while a shareholders' resolution is not required for the sale of a target business that constitutes 20% or less of the seller's total asset value, if the target business constitutes more than 20% of the seller's total asset value, a substantive review should be performed to determine if the target business is material to the seller.

The buyer must also pass a special shareholders' resolution when it purchases the entire business of the seller (Article 467, Paragraph 1, Item 3, and Article 309, Paragraph 2, Item 11, Companies Act).

Similar to a de minimis split, a special shareholders' resolution is not required when the price paid by the buyer to the seller for the target business is equal to or less than 20% of the buyer's net asset value on its non-consolidated balance sheet (Article 468, Paragraph 2, Companies Act).

Duty to Act in Good Faith

There is no statutory duty in Japan that parties must use reasonable endeavors to fulfill conditions precedent within their control, although Japanese courts may find an implied duty on a case-by-case basis. If the parties want a requirement to use reasonable endeavors to satisfy conditions precedent within their control, the covenant must be expressly set out in the framework agreement.

Parties are under a general duty to act in good faith under Article 1, Paragraph 2 of the Civil Code.

Implied Terms

Certain terms are implied by law in Japan. If there is a defect in the "subject" of a sale and purchase transaction, damages arising from that defect must be compensated on a basis of "non-conformity liability" under the Civil Code, even if the framework agreement itself is silent on the topic. Defects in the title or state of the underlying assets or rights held by the spin-off subsidiary would not be considered a defect of the purchased shares for purposes of applying the concept of non-conformity liability. In addition, in the case of business sale, it is assumed that non-conformity liability regarding the transferred assets or rights may be contemplated.

However, in practice, buyers do not rely solely on the implied concept of non-conformity liability, and the buyer will instead negotiate much more extensive representations, warranties, and indemnification rights in the framework agreement. In addition, if the buyer purchases 100% of the shares of the seller's spin-off subsidiary, non-conformity liability is applicable to only the specific subject of the transaction, that is, the shares of the spin-off subsidiary.

Automatic Transfer of Assets and Liabilities

Company Split

A statutory split agreement (see Main Documents) must include the specific assets, rights, and liabilities to be transferred to the buyer (after first being transferred from the seller to its spin-off subsidiary).

All the assets, rights and liabilities that are listed in the statutory split agreement transfer collectively by operation of law.

In practice, it is difficult to accurately and comprehensively specify the assets, rights, and liabilities to be transferred under the statutory split agreement, and so parties typically use catch-all clauses such as "any and all assets primarily related to the [target] business", in addition to specifically listing material assets.

Any assets, rights or liabilities that are not listed in the statutory split agreement will not transfer.

However, there are a few caveats to this general principle, including:

- The perfection of transfers of assets and rights such as real property, intellectual property, and receivables does not occur by operation of law in Japan (see Completion of Asset Sale). Parties must complete certain statutory procedures to perfect the transfer of those assets.
- Even if a contract between the seller of the target business and its counterparty (a third-party contract) provides that "neither party may assign this agreement, including through a company split", or words to that effect, the third-party contract can be transferred by operation of law without the counterparty's consent. However, the transfer of the third-party contract would constitute a breach of that contract by the seller and would result in liability of the buyer as the assignee of the third-party contract. To mitigate against those liabilities, it is common to include a seller's covenant in the framework agreement obligating the seller to use its best efforts to obtain consents from the counterparties to the transferred third-party contracts with anti-assignment clauses.
- It is also typical to qualify the seller's obligation if several third-party contracts are to be assigned from the seller to the buyer and obtaining counterparty consents for each third-party contract would be too onerous. For example, buyers are sometimes satisfied with the seller's obligation to send notices of the transfer to the counterparties stating that the recipient will be deemed to have given consent to the company split unless the recipient objects in writing.
- Tax and certain other statutory liabilities cannot be transferred.
- The buyer may be jointly liable for certain tax obligations even if the buyer is excluded from transferred liabilities in the company split agreement.

Business or Asset Purchase

There is no collective transfer of assets and liabilities that occurs by operation of law in a business sale. Therefore, any asset or liability transfers must be explicitly provided for in the business purchase agreement. A catch-all clause in tandem with a specific list of material assets is typically used for the purposes of the identification of assets and liabilities, as in the case of a company split.

The requirements to affect the transfer of an asset, a right or a liability depends on the nature of the item being transferred, and the required actions for transfer are the responsibility of both the buyer and the seller.

For example:

- If a third-party contract, including an employment agreement, is to be transferred, consents from the counterparties to the third-party contract are necessary. In practice, as in the case of a company split, buyers are sometimes willing to qualify the seller's obligation to obtain consents from every counterparty.
- If intellectual property, such as patents, designs, and trademarks, are to be transferred, public registration is generally necessary to properly transfer the asset to the buyer.
- If a liability is to be transferred, consents from each of the applicable creditors are necessary to properly transfer the liability to the buyer.

For more information on the liabilities which transfer automatically to the buyer in the context of an asset transfer agreement, see Practice Note, Acquisition Structures: Comparing Asset and Share Purchases (Japan).

Shares or Other Assets as Consideration

If the buyer is incorporated in Japan and subject to Japanese laws, the buyer's shares are not commonly used as consideration for an asset purchase due to:

- The onerous process of valuing the shares and the assets. If a buyer's shares are to be used as consideration, the buyer must ask a Japanese court to appoint an inspector to determine the fair value of the assets being purchased before closing.
- Compensation liability. If after closing it is determined that the fair value of purchased assets is lower than the parties' valuation of assets applied to determine the number of buyer's shares to be issued, the seller and the directors of the buyer who executed or approved the purchase are responsible (in their personal capacity) for compensating the buyer for the shortfall.

As a result, framework agreements typically use solely cash as consideration for the target business.

If the buyer is incorporated outside of Japan and not subject to Japanese laws, the buyer may not face similar hurdles for using its shares as consideration in its jurisdiction. From the Japanese law perspective:

- In a merger-type spin-off where the seller contributes its target business to a wholly owned spin-off subsidiary that the buyer has established in Japan, such a spin-off constitutes a triangular spin-off whereby the subsidiary uses its foreign parent company shares as the spin-off consideration. Although such a triangular spin-off is legally available in Japan, as a practical matter, the buyer must consider how the subsidiary acquires its parent's shares in compliance with laws of the parent's jurisdiction. In Japan, regulations on acquisition by a subsidiary of its parent shares is deemed to be governed by the laws of the parent's jurisdiction, even if the subsidiary is incorporated in Japan. In particular, a jurisdiction following English common law may have a prohibition on a subsidiary's acquisition of its parent shares (known as hook stock).

- Both the share purchase following spin-off structure and the business sales structure (assuming a foreign buyer directly purchases the target business from a Japanese seller) allow the buyer to use its own shares as consideration.

In such a cross-border stock deal, the share purchase agreement and framework agreement will contain a share exchange ratio in place of the monetary price of shares. Adjustment mechanisms are not commonly embedded into those share exchange ratios, although such an adjustment mechanism is legally permissible.

In addition, the seller may perform due diligence in respect of the buyer, and the relevant agreement provisions may become more reciprocal rather than asymmetrical, especially in terms of more extensive representations and warranties with respect to the buyer. However, that reciprocity may be more limited where the buyer's shares are listed on a major securities exchange, in which case the seller may be willing to rely on the buyer's public disclosures coupled with the buyer's representations and warranties about the accuracy and completeness of its statements filed with the relevant securities regulatory authority. However, there are very few precedents of non-Japanese buyers using share consideration in conducting purchases of assets from Japanese sellers.

License of a Housing Land and Building Dealer for Buying and Selling

In Japan, a license of a housing land and building dealer for buying and selling is required to engage in the sale and purchase of building lots or buildings "as a business" pursuant to the Building Lots and Buildings Transaction Business Act.

However, in the event of a company split or business transfer, neither the seller nor the buyer need to be registered as a licensor of a housing land and building dealer. Company splits and business transfers do not fall under the category of a "business" according to the guidelines of the Ministry of Land, Infrastructure, Transport and Tourism, assuming that they are one-time transactions.

Foreign Investment Control

The impact of Japanese foreign investment control rules varies depending on the investment structure and the size and nature of the target business. This Note assumes that each of the seller and the spin-off subsidiary is a corporation incorporated and placed in Japan, and the majority of the seller's voting stake is not held by foreign investors.

In a company split where the foreign buyer purchases all the shares of the Japanese seller's wholly owned subsidiary to which the seller has contributed its target business, a foreign buyer's acquisition of shares of the Japanese seller's spin-off subsidiary constitutes a "direct inbound investment" that is subject to Japan's foreign investment control regime under the Foreign Exchange and Foreign Trade Act (FEFTA).

If the spin-off subsidiary is engaged in a specified regulated business industry deemed relevant to the public safety or economic stability of Japan (such as weapons, aerospace, nuclear facilities, utilities, telecommunications, energy, public transportation, cybersecurity, and so on), FEFTA further requires each of the following:

- The foreign buyer must submit prior notification to the Ministry of Finance (MOF) and other regulatory authorities through a filing with the Bank of Japan (BOJ).
- The parties must observe a mandatory 30-day waiting period after the notification from the foreign buyer is filed with the BOJ before the parties can complete the transaction. In practice, the BOJ typically shortens this timeline to only 14 days.

If the spin-off subsidiary is not engaged in a specified regulated business industry, FEFTA requires the foreign buyer to submit a post-closing report of the acquisition to the MOF and other relevant regulatory authorities through a filing with the BOJ.

The FEFTA pre-closing filing requirement applies to any acquisition of shares (even if only one share is acquired) by a foreign buyer in a Japanese private company. The post-closing report applies to an acquisition that results in a foreign investor holding a 10% or greater ownership or voting stake of a private Japanese company.

A substantial amendment to FEFTA became effective in June 2020. This amendment includes the introduction of an exemption framework to the pre-closing filing and clearance requirement in respect of investments into private companies conducting business in the specific regulated industries, on the condition that the buyer must comply with statutorily specified negative covenants. The availability of this exemption varies based on the applicable category or categories of regulated industries, which are classified into two sub-categories for the purpose of the exemption framework (the core regulated industries and non-core industries).

Even when the exemption is available, another type of post-closing report must still be made on a prescribed form, including the acknowledgement of compliance with negative covenants (which is different from a prescribed form of the post-closing report required for an investment into a non-regulated industry). As illustrated above, the new FEFTA regime incorporating the exemption framework is complicated and fact-dependent.

An acquisition of a business by a foreign buyer through a business sale or company split where the seller contributes its target business to a wholly owned spin-off subsidiary that the foreign buyer has established also constitutes a "direct inbound investment" subject to the FEFTA regime, under which FEFTA may require, depending on the industry in which the target business operates, either:

- A pre-closing filing and clearance process.
- A post-closing report.

The new exemption framework above is not available to these structures in any circumstances.

More recent amendments to FEFTA affect prior notification to the MOF and BOJ. Currently, the range of regulated business industries deemed relevant to the public safety or economic stability of Japan requiring prior notification is slowly expanding. The following businesses now also require prior notification:

- Equipment and parts manufacturing industries related to information processing (applicable for transactions after August 1, 2019).
- Information processing software manufacturing industry (applicable for transactions after August 1, 2019).
- Industries related to information and communications services (applicable for transactions after August 1, 2019).

- Manufacturing industry concerning drugs for infectious diseases (applicable for transactions after July 15, 2020).
- Manufacturing industries related to highly controlled medical devices (applicable for transactions after July 15, 2020).

Taxation

In a company split, a stamp duty of JPY40,000 is required per original of the statutory spin-off agreement (see Main Documents). Consumption tax will also be applied to this transaction.

In a business or asset purchase, the stamp duty for the business purchase agreement depends on the consideration paid for the target business. For example, if the consideration is more than JPY5 billion, the stamp duty is JPY600,000 per original. Consumption tax will not be applied to this transaction. If there is a capital gain by conducting the business sale, corporation income tax or income tax will be applied.

Resolving Disputes in Asset Purchases

Arbitration and other alternative dispute resolution mechanisms are commonly used in framework agreements when a foreign party is involved in the transaction. However, if the framework agreement is between only Japanese parties, it is more common to specify a court in Japan for any disputes relating to the transaction.

When the agreement involves a foreign company, there are several factors to consider. From the foreign company side, they may prefer to avoid local courts because of their lack of knowledge of the local legal system. From the Japanese company side, they tend to check whether a Japanese judgment would be enforceable in the other side's country. If a Japanese court judgment is not enforceable, arbitration tends to be selected as the method of dispute resolution.

When the agreement is signed between Japanese companies, since both parties are familiar with the Japanese legal system, the parties typically select local courts as the method of dispute resolution.

Actions for breach of warranty have become more frequent in Japan, although it is still not common to bring such actions.

When issues arise, it is typical to send a notification to the other party stating the facts regarding the issue. If the other party responds to that notification, negotiation between the parties may be held. If negotiations go sideways and the parties have difficulty reaching a solution, the parties will solve the issue based on the dispute resolution clause in the framework agreement.

Warranty and Indemnity Protection

While Japanese law does not have precisely the same statutory concepts as warranties and indemnification, in practice, framework agreements often include both, following precedents from some foreign jurisdictions.

Remedies for Breach of Warranty

Damages can be sought for breach of warranty based on the terms negotiated between the seller and the buyer in the framework agreement. Those damages can be direct or indirect, and can include loss of profit, consequential damages, and so on.

The seller can also seek to terminate the agreement based on a breach of warranty, although in practice it is typical to limit such termination rights to:

- The period between signing and closing.
- Breaches that have a material adverse effect on the target business.

Third Party Enforceability

A framework agreement can confer the benefit of warranties, indemnities, or other terms to a third party, subject to the third party's acceptance.

The benefit of warranties cannot be assigned to a later transferee of the assets or the business in the absence of agreement. The parties must expressly state in the framework agreement if the benefit of the warranties in the agreement can be transferred to a later transferee.

Time Limit for Claims for Breach of Warranty

According to the Civil Code, claims are extinguished either:

- When the claimant fails to exercise its right for five years from the time when the claimant becomes aware that it may exercise its right.
- When the claimant has not exercised the right for ten years from the time when the claimant is able to exercise the right.

However, the parties may choose to shorten the period by agreement. One to two years is typical for claims for breach of general commercial warranties, depending on the specifics of the transaction at issue. Tax warranties may have a longer time limit due to the statute of limitations, which is seven years.

Protection Against Seller's Inability to Pay

The most common way to address a buyer's concern about the seller's ability to pay compensation for a breach of warranty is to use a parent guarantee by the seller's parent company, especially if the seller is a small company without many assets.

Other options include escrow arrangements or holdbacks on a portion of the purchase price. However, sellers tend to push back against these types of arrangements in practice. Also, escrow arrangements are not commonly used in Japan because there are no laws expressly allowing escrow, and the escrow system is not well constructed compared to other foreign countries. Some Japanese banks can accept the escrow, but the cost is expensive and it takes much time to check the background of the related parties.

Warranty and Indemnity Insurance Coverage

Representation and warranty insurance (RWI) started to draw wide attention in Japan in 2015.

Since RWI has started to appear recently, no official market data regarding its use is publicly available. However, the Small and Medium Enterprise Agency in Japan has shared its estimated budget for 2022, showing that the agency has secured a budget to fund certain small and medium enterprise regarding professional fees (which includes RWI fees) up to 50% (the fund cap is set around JPY4 million depending on the transaction). This suggests that the Japanese government is trying to promote RWI and the insurance market may change in the near future.

Pre-Contractual Misrepresentation and Misleading Statements

A seller can be liable for pre-contractual misrepresentation where the framework agreement fails to specify otherwise. Some lower courts have held that a seller can be liable to a buyer for making misrepresentations or misleading statements to the buyer before entering into a contract where the framework agreement was silent on the issue. However, other lower courts have held that a seller is not required to proactively disclose all relevant information regarding the target business to the buyer.

A diligent buyer should accordingly perform robust due diligence, asking the seller catch-all questions, and negotiate extensive representations and warranties to ensure that the seller is disclosing all pertinent information relating to the target business and that the buyer is adequately protected.

Advisors are unlikely to be held liable in Japan for pre-contractual misrepresentations in the absence of egregious conduct, mainly because there is no contractual relationship between the buyer and the seller's advisors.

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