Japan

Financial Assistance

IBA Corporate and M&A Law Committee 2022

Contact

Takashi Toichi

TMI Associates, Tokyo

Takashi_Toichi@tmi.gr.jp

Junya Horiki

TMI, Tokyo

Junya_Horiki@tmi.gr.jp

Takahiro Fuchigami

TMI, Tokyo

Takahiro_Fuchigami@tmi.gr.jp

Contents

	Page
Introduction	2
General Overview	2
Other Related Matters	6

INTRODUCTION

This guide sets out an overview of the regulations dealing with the concept of financial assistance in Japan, as currently regulated under the Companies Act (Act No. 86 of 2005, as amended), and other relevant laws and regulations. Neither the rules and regulations applicable to the banking industry in Japan nor any Japanese tax benefits or implications are covered by this guide.

GENERAL OVERVIEW

What are the origins of financial assistance in Japanese law?

A company's acquisition of its own shares was generally prohibited under the former Commercial Code of Japan because of the potential problems such transactions might cause. These issues included:

- harm to creditors due to a reduction in the company's capital;
- inequitable treatment among shareholders, such as providing only certain shareholders with the opportunity to sell their shares and reducing the value of the remaining shares if the acquisition price was higher than a fair price, resulting in unfairness;
- potential misuse by management seeking entrenchment and retaining control of the company; and
- insider trading and market price manipulation.

This prohibition also applied to shares acquired by the third party 'on the issuing company's account'. Therefore, financial assistance – such as a company providing necessary cash to an acquirer of its shares – also was prohibited. Whether a share acquisition is made 'on the company's account' is determined by:

- the source of the funds for the acquisition;
- who makes decisions about the acquisition; and
- who controls the rights of the shares (eg, who will be entitled to receive dividends on the shares).

However, it has long been recognised that a company may have a need to acquire its own shares for legitimate purposes, such as increasing capital efficiency and returning unused capital to shareholders. The current Companies Act makes it legal in principle for a company to acquire its own shares by agreement with shareholders, albeit with certain requirements designed to ensure fairness among shareholders.

What should be understood as financial assistance under Japanese law?

Under the Companies Act, 'acquisition of own shares' refers to the acquisition of shares of a stock company (*kabushiki kaisha*) by the company from its own shareholders. This transaction is subject to that Act.

The Companies Act does not explicitly define 'financial assistance'. However, a company's provision of a loan to a third-party share acquirer, grant of security or issuance of a guarantee for a loan from a third party to the share acquirer will be treated as an 'acquisition of own shares', if the acquisition transaction is 'on the company's account' (ie, such financial assistance is provided to an acquirer which does not have the intention or the ability to repay). Such a transaction will be subject to the provisions of the Companies Act.

In many M&A transactions, a share acquirer obtains a loan from a financial institution through a newly established special purpose company, with the target company's assets being used as collateral. This is a common leveraged buyout (LBO) structure.

An LBO transaction will not be usually considered to be an acquisition of own shares since the share transaction is led not by the issuing company itself, but by the seller(s) and an acquirer; the post-closing rights of the shares will be controlled and exercised by the acquirer, rather than the issuing company itself. Consequently, an LBO does not raise issues surrounding an acquisition of own shares.

Some companies have employee shareholding programmes where companies encourage their employees to acquire the company's shares by providing them with cash. This is not generally considered to be an acquisition 'on the company's account' either, as it is considered to be an element of an employee benefit welfare programme. Such programmes are viewed as beneficial in increasing shareholding employees' productivity and motivation. Additionally, the rights of such shares are not under the control of the company.

Is financial assistance allowed under Japanese law?

Where a company's shares are acquired 'on the company's account' (such as lending cash to a person who has no ability to repay), a special resolution (resolution adopted by at least two-thirds of the voting rights) at a general shareholders meeting must be obtained. The approving resolution must specify the class and number of shares to be acquired and the amount of the financial assistance. In addition, other holders of the same class of shares may request that the company also acquire their shares on the same terms and conditions. The amount of such financial assistance cannot exceed the company's 'distributable amount' as set forth in the Companies Act (roughly speaking, the amount equivalent to the company's surplus).

A company is prohibited from providing financial benefits to any person in connection with the exercise of shareholders' rights (Article 120.1 of the Companies Act). Financial assistance to a share acquirer may be such a grant of benefits if it is considered to be made 'in connection with the exercise of shareholders' rights'.

The provision of benefits with the aim of influencing the exercise of shareholders' rights is considered to be made 'in connection with the exercise of shareholders' rights'. Where a shareholder/management group is fighting over control of a company, and where the company provides financial assistance only to the group which is supportive of current management so that this group will acquire shares using that financial assistance, the financial assistance provided may be considered to be 'in connection with the exercise of shareholders' rights'. However, considering that this prohibition ultimately purports to protect shareholders' interest, the prohibition does not apply if a company provides a sole shareholder that owns all the outstanding shares of the company with financial assistance.

In an LBO, the target company does not provide its assets as security for the acquirer to borrow the buy-out bank financing until the acquirer acquires all outstanding shares of the target company. On the other hand, in cases where a subsidiary of a target company has a minority shareholder and where the subsidiary provides its assets as security, the lender typically obtains the consent to that arrangement from such minority shareholders, in order for the executives to avoid the issue and discharge their duties as directors and auditors.

Are there any exceptions under Japanese law as regards the general prohibition of providing financial assistance to third parties?

Even where the Companies Act's provisions on acquisition of own shares apply to financial assistance, such assistance is not prohibited as long as the company complies with the Companies Act.

However, if lending money as a business falls within 'money lending business' under the Money Lending Business Act (Act No. 32 of 1983, as amended), it is illegal unless the company is registered as a money lender (Article 11.1 of the Money Lending Business Act). If a company intends to provide loans on a continuous basis to the extent that the making of loans is socially regarded as the performance of its business, the company is considered to be engaged in the money lending business, and the company is required to be registered as a money lender.

What are the consequences of providing financial assistance?

If shares are acquired 'on the company's account' without following the procedural requirements of the Companies Act, the acquisition may be null and void unless a transferee is not aware of the procedural defect. In addition, the company's directors/auditors involved may be subject to imprisonment for up to five years and/or a fine of up to JPY 5m (Article 963.5(1) of the Companies Act).

If financial assistance is provided in excess of the company's 'distributable amount', the acquisition of shares will be null and void, and the seller of the shares, the executive person of the company who was engaged in obtaining such financial assistance, and the person who made the proposal at the general shareholders meeting will be jointly and severally liable to the company to cover the amount of the financial assistance (Article 465.1(2) of the Companies Act).

If financial assistance is provided in breach of the prohibition on the provision of financial assistance 'in connection with the exercise of shareholders' rights', the person who received the assistance is obliged to return the amount of such assistance. The company executive who caused the company to commit such financial assistance also is liable for the amount of such assistance (Articles 120.3 and 120.4 of the Companies Act). The person who provided/received such assistance may be subject to imprisonment for up to three years and/or a fine of up to JPY 3m (Articles 970.1 and 970.2 of the Companies Act).

In addition, if a company is engaged in money lending business without a money lender registration, the company, its relevant officers and employees may be subject to imprisonment for up to ten years and/or a fine of up to JPY 30m (Article 47(2) of the Money

Lending Business Act).

OTHER RELATED MATTERS

Under the Companies Act, a company is generally prohibited from acquiring its parent company's shares (Article 135 of the Company Act). This statutory provision also applies to acquisitions of parent company shares by a third party on the subsidiary's account.

Therefore, the similar types of financial assistance by a subsidiary in the case of the acquisition of its parent company's shares may be also prohibited. Unlike the issuing company's acquisition of shares, a subsidiary's assistance is generally prohibited, regardless of whether the procedures provided in the Companies Act are followed.