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Supreme Court Clarifies Fair Price in a Two-Step Merger

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A long-awaited decision on the fair price that a shareholder can seek in a two-step merger[1] was finally rendered by the Supreme Court of Japan on July 1, 2016 in the case involving Jupiter Telecommunications Co., Ltd. ("JCom"),[2] paving the way for a more predictable M&A framework in Japan. In sum, a share price negotiated and agreed through generally accepted procedures will constitute a fair price. However, courts may now subject the M&A negotiation process to strict scrutiny.

The JCom case

In February 2013, Sumitomo Corporation and KDDI Corporation, the majority shareholders of JCom, initiated a takeover bid of JCom. The tender offer price was JPY 123,000 per share. JCom assented to the takeover and recommended that its shareholders take the offer. The takeover bid was followed by a squeeze-out proceeding where the minority shareholders were cashed out based on the tender offer price. As a result, JCom was delisted and became a wholly owned subsidiary of the said companies. However, a dissenting shareholder later challenged the tender offer price, and the Tokyo High Court decided on a higher share price of JPY 130,206 per share. Nevertheless, on appeal of JCom, the Supreme Court set aside the said decision and ruled that the original tender offer price was a "fair price" because it was

negotiated and agreed upon through generally accepted procedures (the "JCom Decision").[3]

No clear framework for calculation of fair price

Like in many other countries, the Companies Act of Japan (the "Act") grants shareholders an appraisal right in certain situations including two-step mergers where the shares of a company are purchased by an existing shareholder or the management (i.e., a management buyout ("MBO")) via a combination of a tender offer and a cash-out proceeding with respect to the remaining minority shareholders. Under Section 172 of the Act, for example, a dissenting shareholder has the right to petition the court to determine the fair price of the subject shares. The Act, however, does not define "fair price." This lack of a clear standard, together with the absence of a Supreme Court decision regarding two-step mergers, has allowed lower courts to exercise a broad discretion in determining such fair price; thus, making it difficult for investors to estimate the cost of an acquisition.

For example, in the Cybird Holdings case in 2010, the Tokyo High Court questioned the fairness of the procedures in an MBO and did not consider the tender offer price a "fair price." The court instead used the average stock price one month before the announcement of the tender offer as the basis for determining the intrinsic value of the target company, and added a 20% premium on the stock based on what it considered was the average premium in other takeovers at that time.[4] This decision illustrates the large spectrum of potential facts that a court can take into account in determining the fair price of the shares in a two-step merger.

Despite criticisms from both the academe and legal community, for a long time there was an unclear framework in calculating the fair price by determining (i) the hypothetical price that the shares of a shareholder would have had if the subject transaction never happened (e.g., the average stock price one month before the announcement of the tender offer in the Cybird Holdings case), plus (ii) the value of the synergy of the transaction to be allocated to the shares of a shareholder (e.g., the 20% premium in the Cybird Holdings case).

Standard set for determining the fair price

The Supreme Court in the JCom case, however, debunked the above opaque framework, and instead provided for a simpler standard. The court held that, even if a two-step merger is not an arm's length transaction (since it involves the shareholders or management of the target company), as long as generally accepted procedures are implemented, the court should not second-guess the tender offer price but instead it should find that the price agreed upon between the acquirer and the target company is a fair price. Justice Koike, in his supporting opinion in this case, pointed out that a court is not competent in appraising the value of the shares of a company and thus, should basically focus on the procedural aspects of the transaction.

Conclusion

In light of the JCom Decision, the two-step merger process is now more standardized and the scope of any potential judicial review will usually be limited to the procedures of the subject transaction. However, this may lead courts to closely scrutinize whether the parties actually complied with the generally accepted procedures publicly disclosed or acted inappropriately by, for example, exchanging confidential information that an independent target company would normally never share with an acquirer. Parties to two-step mergers must now carefully plan and faithfully comply with generally accepted procedures.

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1. Sometimes called a “two-step acquisition.”
2. Saikō Saibansho [Sup. Ct.] July 1, 2016, 1497 Kin'yu shoji hanrei [Kin'yu hanrei] 8 (Japan).
3. Generally accepted procedures were not defined by the Supreme Court but practitioners can make reference to the *Guidelines on Increasing Corporate Value and Ensuring Regulatory Compliance in the Context of Management Buyouts* published by the Ministry of Economy, Trade and Industry in 2007, which have been accepted in the M&A practice in Japan. These guidelines are also embodied in securities regulations; *see, e.g.,* Tokyo Stock Exchange, *Guidebook for Timely Disclosure* (2015), at 203. According to the Supreme Court, an example would be for the target company to seek the advice of an independent third-party committee and experts to avoid making an arbitrary decision.
4. Tōkyō Kōtō Saibansho [Tokyo High Ct.] Oct. 27, 2010, 174 Shiryōban shōji hōmu [Shiryōban shōji] 322 (Japan).

Back to List of Articles

Superior Bargaining Position under Antitrust Law

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Small to medium-sized enterprises ("SMEs") in Japan enjoy generous protection from their superior business partners based on the notion of abuse of superior bargaining position ("ASBP") under the Antimonopoly Act (the "Act").[1] On August 2, 2016, the Japanese government approved the Economic Measures for Realizing Investment for the Future, which is a new economic revival plan that aims to, among others, further improve the terms and conditions for SMEs by actively enforcing the Act and the Subcontract Act.[2] Bigger enterprises must carefully comply with the guidelines[3] and recent issuances of the Japan Fair Trade Commission ("JFTC").

This article explains the status in Japan of ASBP, which is gaining interest even abroad.[4]

Concept of abuse of superior bargaining position

The Act prohibits a firm with a superior bargaining position from unjustly taking advantage of such position to force the counterparty to accept unreasonable transactions.[5]

The superior firm is not required to have market power or a dominant position but only needs to have a relatively superior bargaining position over its counterparty. A relatively superior bargaining position exists if the weaker party ("Party B") has no choice but to accept an unreasonable request made by the superior party ("Party A") because losing the business with Party A would substantially affect the business of Party B.[6] Such impact is measured by taking into account the degree of dependence by Party B on the business with Party A (which is calculated by dividing the amount of sales by Party B to Party A by the total amount of sales of Party B), the feasibility of Party B replacing Party A as the business partner, and other factors.[7] However, in practice, there appears to be a large gap between JFTC's Guidelines

and its decisions concerning the existence of a relatively superior bargaining position.

JFTC may find the existence of a relatively superior bargaining position even when the level of dependence is extremely low (e.g., below 1%) by giving greater weight instead to the fact that Party B accepted an unreasonable request of Party A. Such fact has been deemed to imply that Party A had a superior bargaining position in the absence of special circumstances.[8] In this regard, JFTC unexpectedly moved away from a strict interpretation of the Guidelines.

In JFTC v. Toys"R"Us-Japan, Ltd., the toys and baby products retailer was fined for forcing its suppliers to take back unsold products and/or paying suppliers reduced prices for those products. JFTC considered the acceptance of such disadvantageous terms by the suppliers to imply that their business with Toys"R"Us-Japan was necessary and important to them, and that they had no choice but to accept the unreasonable terms, regardless of their low level of dependence on Toys"R"Us-Japan (e.g., 0.5%-0.7% for one supplier). As a result, the level of dependence of the suppliers was not deemed a determining factor in finding the existence of the superior bargaining position of the retailer.

Elements of potential abusive conduct

Companies must not engage in transactions that may fall under any of the following categories of potential abusive conduct, which if unjust in light of normal business practices,[9] may be considered abusive:

(a) forcing Party B to purchase goods or services other than those subject of the transaction;
(b) forcing Party B to provide money, services or other economic benefits (e.g., monetary contribution or dispatch of employees at the time of the opening of a new store); and
(c) establishing or changing trade terms or executing transactions in a way disadvantageous to Party B (including refusing to receive goods, return of goods, denying or reducing payments).

If any of the above conduct results in an unexpected disadvantage to Party B because the terms of the agreement were unclear, or the burden on Party B exceeds the “direct benefit” to be obtained by Party B from such conduct, then it would likely be considered unjust in light

of normal business practices. To be clear, acceptance of such conduct by Party B without any objection is not relevant in determining whether such conduct is abusive.

Surcharge for abuse of superior bargaining power

In addition to cease and desist orders, a penalty for ASBP in the form of a surcharge was introduced in 2009 (calculated by multiplying the amount of sales of the weaker firm to the superior firm during the period of violation by 1%[10]). Depending on the sales amount and/or the number of weaker firms subject of ASBP, the surcharge can be substantial. For example, in 2012, a surcharge of about 4 billion yen (approximately 40 million dollars) was imposed on one of the biggest electronics retailers in Japan, the highest penalty so far for an ASBP since 2009.

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1. ASBP regulations can also apply to transactions between large enterprises.
2. The Subcontract Act (*Shitaukehō*) regulates ASBP by principal contractors. *See* http://www.jftc.go.jp/en/legislation_gls/subcontract.html.
3. Guidelines Concerning Abuse of Superior Bargaining Position under the Antimonopoly Act (JFTC, Nov. 30, 2010) at http://www.jftc.go.jp/en/legislation_gls/imonopoly_guidelines.files/101130GL.pdf (tentative translation) ("Guidelines").
4. The American Antitrust Institute recommended the introduction of ASBP in the U.S., making reference to ASBP in Japan. *See* Albert A. Foer, *Abuse of Superior Bargaining Position (ASBP): What Can We Learn from Our Trading Partners?* ,AAI Working Paper No. 16-20 (2016) at http://www.antitrustinstitute.org/sites/default/files/AAI%20Working%20Paper%20No.%2016-02.pdf.
5. The Act, art. 2(9)(v).
6. Guidelines, sec. II, 1.
7. Guidelines, sec. II, 2.
8. *See JFTC v. Toys"R"Us-Japan, Ltd.,* June 4, 2015. No report has been published. *See* http://www.jftc.go.jp/houdou/pressrelease/h27/jun/150604_1.html (in Japanese).
9. The Act, art. 2(9)(v). 10. The Act, art. 20-6.

Back to List of Articles

Arbitral Award Set Aside by Osaka High Court for Arbitrator's Failure to Disclose Potential Conflict of Interest

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Earlier this year, the Osaka High Court set aside an arbitral award for failure of the presiding arbitrator to disclose a potential conflict of interest,[1] thereby reversing the earlier decision of the Osaka District Court dismissing the annulment application filed by the foreign parties.[2]

Background

This international arbitration case originated from a sales contract between a Japanese manufacturer (one of the claimants) and its U.S. distributors (the respondents). The arbitration was administered by the Japan Commercial Arbitration Association ("JCAA") in Osaka, Japan, and was heard by a three-member tribunal.

The presiding arbitrator was a partner at the Singapore office of an international law firm. More than a year after his appointment as an arbitrator, a lawyer joined their San Francisco office who then represented the sister company of a Japanese claimant in an antitrust class action before a U.S. court and continued such representation throughout the arbitral proceedings. The arbitrator did not disclose such information to the parties in the arbitration, and based on the facts found by the courts, he appeared to have been unaware of such potential conflict of interest.

Subsequently, an arbitral award was rendered in favor of the claimants. Unsatisfied with the arbitral award, the U.S. distributors sought to set it aside because, among others, the composition of the arbitral tribunal

and the arbitral proceedings were in violation of the laws of Japan.[3] In particular, the U.S. distributors claimed that the presiding arbitrator failed to disclose circumstances that were likely to give rise to justifiable doubts as to his impartiality and independence.

Rulings

Both the Osaka District Court and Osaka High Court agreed that the representation by the colleague of the presiding arbitrator in the U.S. antitrust case fell within "circumstances likely to give rise to justifiable doubts as to his impartiality or independence," thereby finding that the arbitrator had a duty to disclose such fact. The arbitrator was thus found in breach of his duty to disclose a potential conflict of interest.[4] The Osaka High Court further dismissed the assertion by the claimants that such fact had already been disclosed in the advance declaration of the arbitrator.[5]

However, in determining whether or not the arbitral award should be set aside for such nondisclosure, the two courts reached differing conclusions:

- The Osaka District Court dismissed the challenge to the arbitral award because the undisclosed fact did not give rise to justifiable doubts warranting a challenge and did not affect the outcome of the case, and any flaw that may have resulted from the nondisclosure was minor since the respondents could have anticipated such conflict based on the advance declaration made by the arbitrator.

- The Osaka High Court, on the other hand, considered the breach by the arbitrator of the disclosure duty a significant procedural defect because the respondents were not informed of the potential conflict of interest, which was an important fact for them to decide whether to challenge the arbitrator. Such breach, by itself, was sufficient ground for setting aside the award in light of the significance of the disclosure duty in ensuring the fairness of the arbitral proceedings and the arbitrators. The Osaka High Court, thus, set aside the arbitral award.

This case is currently on appeal before the Supreme Court on a question of law.

Comments

This is the second reported case setting aside an arbitral award under the Arbitration Law. Generally, Japanese courts have been reluctant to set aside arbitral awards, thereby demonstrating their favorable attitude toward arbitration.

As to the disclosure duty of an arbitrator, in practice, the relationship between the law firm of an arbitrator and an affiliate of one of the parties in the arbitration, as in the present case, could be analyzed using the IBA Guidelines on Conflicts of Interest in International Arbitration 2014 ("IBA Guidelines"), which have been widely accepted in the international arbitration community as applicable standards. If the law firm of the arbitrator was concurrently providing services to an affiliate of one party, then such circumstance would fall under the "Orange List" (arbitrator has a duty to disclose) or the "Waivable Red List" (arbitrator may serve only if the parties make fully informed, explicit waivers), depending on whether the law firm has a significant commercial relationship with such affiliate.[6]

In the present case, it is not clear if, and to what extent, the parties argued that the representation by the San Francisco lawyer of the sister company in the class action suit was a "significant commercial relationship." If such significant commercial relationship existed, then the courts could have determined whether the circumstances thereof gave rise to a valid challenge of the arbitrator. If so, then the courts could have set aside the arbitral award depending on the likelihood of such undisclosed fact affecting the outcome of the case.[7]

Although the decision of the Osaka High Court is still on appeal, this case gives us a glimpse of how the courts in Japan view the disclosure duty of an arbitrator in the exercise of their discretion in upholding or setting aside arbitral awards.

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1. Ōsaka Kōtō Saibansho [Ōsaka High Ct.] June 28, 2016, Hei 27 (La) no. 547, KAKYŪ SAIBAN HANREISHŪ [SAIBANSHO WEB] 1, 17, http://www.courts.go.jp (Japan).
2. Ōsaka Chihō Saibansho [Ōsaka Dist. Ct.] March 17, 2015, Hei 26 (chū) no. 3, 2270 HANREI JIHŌ [HANJI] 74 (Japan).
3. *See* ARBITRATION LAW (Japan), art. 44(1)(vi). This law took effect on March 1, 2004 and is based on the UNCITRAL Model Law on International Commercial Arbitration.
4. The Osaka High Court noted that the law firm could have done a conflict check.
5. Prior to his appointment, the arbitrator submitted a statement of independence declaring that any of the lawyers of the law firm may in the future advise or represent

parties and/or their affiliates in matters unrelated to the arbitration. The parties did not object to such advance declaration.

6. *See* IBA Guidelines, paras. 2.3.6 (Waivable Red List) and 3.2.1 (Orange List).

7. Tatsuya Nakamura, *Osaka High Court Decision Which Set Aside an International Arbitral Award,* 44–11 KOKUSAI SHŌJI HŌMU 1621, 1628–1629 (2016).

Back to List of Articles