Due Diligence for Private Acquisitions in Japan

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Practice notes | Law stated as at 01-Apr-2022 | Japan

A Practice Note considering the purpose, scope, and practical aspects of a legal due diligence investigation for the purchase of a private company or business in Japan. This Note outlines the process for legal due diligence in Japan, including organizing the investigation and various sources of information. It also considers issues of confidentiality and data protection during due diligence in Japan.

Due diligence is the investigation of a person or business. In the context of business acquisitions, the parties use the due diligence process to gather information about each other and about the target business or assets that are for sale. Although the seller occasionally conducts due diligence on the buyer (see *Box, Seller Due Diligence*), the due diligence process is usually more significant for the buyer.

The primary purpose of a due diligence review is to obtain enough information about the target's business to enable the buyer (or other parties with an interest in the transaction, for example, lenders financing the transaction) to decide whether the proposed acquisition represents a sound commercial investment. Due diligence is effectively an audit of the target's affairs: legal, business, and financial. It is therefore a crucial bargaining tool for the buyer.

Completing a due diligence investigation of a business can be more challenging and complex for a buyer in cross-border transactions. Due diligence practices can vary significantly between countries because of different:

- Legal and regulatory practices.
- Financial reporting systems.
- Business practices, expectations, and customs.

If different jurisdictions are involved, it is important for the buyer to understand the local legal and financial systems, operations, and culture.

This Note considers, from the buyer's perspective, the purpose, scope, and practical aspects of a due diligence investigation for a private share or asset purchase in Japan. It outlines the process for legal due diligence, including:

- How to organize the due diligence process.
- The various sources of information in a typical due diligence investigation.
- How the information gathered should be reviewed and presented.

It also considers issues of confidentiality and data protection in Japan.

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Unless otherwise indicated, references in this Note to "company" means a stock company that is not listed on a financial instruments exchange and is incorporated under Article 25 of the Companies Act (Act No. 86 of 2005).

Types of Due Diligence

Legal Due Diligence

In any significant acquisition, a legal due diligence investigation should establish the following key information about the target business:

- What is the status of the target company and is it validly incorporated?
- Does the seller have good title to the shares in the target company, and does the target have good title to its assets? Does the target company issue share certificates (see *Corporate Information Provided by the Seller*)?
- Are there any unstated or understated liabilities or risks associated with the target company or assets?
- Are there any restrictions on the business or transfer of ownership?
- Is the declared condition of the property and assets as stated?
- Are there key contracts for the target business and what is the impact of the transaction on the contracts?
- What are the contractual terms with directors and employees of the target business (see *Employment Matters*)?

Detailed information on the target business is required, so that the buyer is in a better position to:

- Confirm the value of the target business or assets.
- Determine the preferred structure of the transaction.
- Determine any consents or approvals that may be required for the transaction, or any contractual prohibitions on the transfer of key contracts or assets. For example, is the consent of industry regulators, employees or trade unions, competition authorities, shareholders, or important customers or suppliers of the target required?
- Plan the integration of the target business.
- Determine whether any ancillary documents are needed, for example, a transitional services agreement.
- Bargain with the seller.

Compared to the acquisition of a listed company that passes a listing examination and discloses an annual securities report, the acquisition of a private company or business requires the buyer to carry out more extensive legal due diligence.

The buyer will inevitably seek contractual protection from the seller in the form of warranties and indemnities but, in practice, remedies such as indemnification or a claim for damages for breach of warranty after closing may be limited because:

- The remedies may take time to resolve the situation.
- It can be difficult to establish damages in litigation.

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- The seller may have no financial resources when the buyer seeks the remedies.
- Large economic damages sometimes cannot be compensated by monetary remedies.

While due diligence is not a substitute for contractual protection, it is an aid for the buyer to determine what contractual protection it requires from the seller and what risks it is not prepared to assume.

Commercial (or Business) Due Diligence

In addition to the legal due diligence review, specialist advisers may be required to contribute commercial (or business) due diligence. Commercial (or business) due diligence is conducted by the buyer or, in some cases, a consulting firm. Depending on the buyer's interests in the target, commercial due diligence looks at issues such as the market in which the business operates, competitors, the business's strengths and weaknesses, production, sales and marketing, and research and development. Some of the results of this part of the due diligence review will be relevant to the legal due diligence. Since knowledge on the target company's business is also useful for legal due diligence, it is useful for the legal due diligence team to attend commercial due diligence interviews in addition to reviewing publicly available information on the target.

The commercial due diligence aims to test the assumptions already made in the buyer's acquisition plan and to identify the management action required by the buyer to take effective control of, and reduce risk in, the business once the deal has closed.

Financial Due Diligence

As part of the due diligence process, the buyer may instruct accountants or financial advisers to prepare a report on the financial aspects of the target business, including a review of the target's financial statements. Financial due diligence is not the equivalent of a financial audit. Financial due diligence focuses on the areas of the target's financial affairs that are material to the buyer's decision to proceed with the transaction. The buyer can then assess the financial risks and opportunities of the deal and whether, given these risks and opportunities, the target business will fit well into the buyer's strategy. Financial due diligence may also help quantify:

- Potential synergies.
- The best acquisition and financing structure.
- The impact of the acquisition on the buyer's performance metrics. When the buyer's accounting policies are more conservative than those followed in the target business, it may be necessary to make appropriate adjustments to measure the true impact.

Tax Due Diligence

Tax due diligence is usually carried out by tax advisers. This is a key exercise to confirm that the target company is properly accounting for tax, the possibility of additional tax obligations of the target or buyer after the transaction, and that there are no potential tax liabilities which could be triggered by the sale.

In particular, the tax due diligence may include a review of:

- Copies of all returns related to corporate income tax, consumption tax, and withholding tax returns.
- All correspondence with any national or local tax authorities concerning adjustments or questioning compliance.

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- The list of returns that have been audited by national or local tax authorities.
- The list of the relevant taxes applicable to the target company (and any subsidiaries).
- Copies of documents concerning any tax litigation proceedings.
- Copies of all legal and accounting tax opinions received by the target company.
- Information required for tax return analysis, including information related to entertainment expenses, bad debt losses, research and development expenses, and foreign tax credits.

Tax due diligence is also carried out on intragroup transactions. For example, it may be possible to defer capital gains and losses, and to preserve loss carry-forwards, on application of the corporate reorganization taxation system.

In addition, the tax due diligence team provides advice from a tax perspective on the structure of the transaction. Tax issues often have a significant impact on the economic effects of M&A transactions, and therefore the legal due diligence team needs to collaborate with the tax team in structuring the acquisition.

Due Diligence for Industry Risk

The buyer needs to identify the main areas of risk and liability inherent in the industry in which the target operates. This sets the emphasis of the legal due diligence exercise and enables the buyer to seek appropriate contractual protections from the seller. The buyer should consider the following issues:

- What are the “normal” risks in this industry?
- What is the known reputation of the target company and how has it been run?
- What is the assessment of those who are selling the business and, if different, those who have been running it?
- Does the buyer have the personnel to run the business if the management team it acquires are not up to task?

If a buyer operates in the same industry as the seller and is purchasing the target business or assets for growth or consolidation purposes, the buyer may not need to engage in much operational due diligence or require a thorough legal review of certain standard contracts.

If personnel are important, enquiries will need to focus on employment conditions and motivation. If the industry sector is heavily regulated, such as financial services or pharmaceuticals, questions about compliance with applicable regulations need to be satisfactorily answered in advance. If the post-acquisition performance depends on a few critical contracts, it will be very important to ascertain the attitude of the other parties to those contracts to the acquisition before it takes place.

Scope of Due Diligence Review

Many factors influence the scope of the due diligence investigation. It is important to determine the scope at the outset because it dictates how many people are needed, how much time is required, whether outside experts are engaged and depth of review. Common factors that influence the scope of a due diligence review include:

- **Deal Structure.** For example, if the transaction is a share acquisition or merger, the buyer will likely need information on the entire business. Generally, on a share purchase, the buyer will take over the target company by purchasing all (or a majority) of its share capital, with the benefit of all of the target company's assets and rights, subject to all of its liabilities and obligations, including contingent liabilities. On an asset or business acquisition or corporate split, the

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buyer may only focus on the specific assets or business and liabilities it is acquiring. The buyer should also confirm whether the employees are to transfer as part of the business transfer and, if so, the buyer will need information on the employees (see *Employment Matters*). For information on asset acquisitions and company splits, see *Practice Note, Asset Acquisition Documents: Private Acquisitions (Japan)*.

- **The size of the target company and the number of subsidiaries and affiliates.** Materiality and assessment methods can differ depending on the size of the company. Subsidiaries and affiliates that are not included in consolidated accounts are often excluded from the scope of legal due diligence.
- **Industry.** The industry of the target business may influence areas of due diligence on which the buyer will concentrate (see *Due Diligence for Industry Risk*).
- **Global presence.** If the target business has global operations, it is important to assess compliance with applicable trade controls and bribery and corruption laws, including:
    - the Foreign Exchange and Foreign Trade Act (Act No. 228 of 1949), which is applicable to foreign exchange, foreign trade, and foreign transactions; and
    - the Unfair Competition Prevention Act (Act No. 47 of 1993), which regulates bribery of foreign public officials.

  When compliance with foreign local regulations is an issue, it may be necessary to engage a local law firm for necessary advice.
- **Competition.** If the buyer and seller compete, they may want (or be required by competition (antitrust) laws) to keep certain information (such as, pricing) confidential until after the transaction is completed. In cases where a confidentiality provision is included in a contract between the target company (or the seller) and a third party, for example a customer or supplier, the existence and contents of the contract may not be able to be disclosed to the buyer as part of the due diligence, especially where the buyer is a competitor of the third party (see *Disclosure of Sensitive Information*).
- **Purpose.** For example, if two companies are looking for a trade advantage or element of synergy through a merger, the investigation will focus on matters such as economies of scale, marketing advantages, and competition issues.
- **Risk tolerance.** The buyer may be willing to purchase a target business or assets without engaging in much due diligence if the price is right. The buyer's legal advisers should engage in a thorough discussion with the buyer about its risk tolerance level and advise their client about potential risks involved in the transaction.
- **Labour related regulations.** See *Employment Matters*.
- **Elimination of anti-social forces such as organised crime groups (*Yakuza, Boryokudan*).** Companies are required to eliminate relationships with anti-social forces such as organised crime groups based on government guidelines (see Guidelines for Enterprises to Prevent Damage Caused by Antisocial Forces), local governmental regulations for eliminating organised crime groups, and other regulatory agencies' guidelines. The buyer should be satisfied that the target complies with the requirements.
- **Protection of Personal Information**. See *Data Protection Restrictions*.
- **Anti-money laundering (AML) and Combatting the Financing of Terrorism (CFT) regulations.** Certain business operators such as financial institutions, real estate brokers, jewellery and precious metal handling business operators, postal items handling business operators, telephone reception, and forwarding service business operators are required to conduct customer due diligence at customer onboarding and, if required, submit suspicious transaction reports based on the Act on Prevention of Transfer of Criminal Proceeds (Act No. 22 of 2007) and the Act on Punishment of Organized

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Crimes and Control of Proceeds of Crime (Act No. 136 of 1999). Depending on the nature of the target, the buyer will need information on the processes for compliance.

- **Anti-bribery and corruption.** Criminal penalties are imposed on the bribery of public officials by the Penal Code (Act No. 45 of 1907) and the bribery of foreign public officials by the Unfair Competition Prevention Act. The buyer should be satisfied with the target's anti-bribery and corruption policies.

The extent of the investigation is also likely to be governed by practical realities, such as:

- **Access to seller and target business.** The seller often restricts access to itself or the managers of the target business to limit interference and protect its proprietary information.
- **Expense.** The buyer may limit the scope of the due diligence investigation to reduce its expenses. Sometimes, a buyer conducts its investigation in stages and only increases spending when the likelihood of the deal closing increases.
- **Time constraints.** The parties may wish to complete the transaction by a certain date (such as fiscal year end) or the seller may have enough bargaining power to limit the time allowed for due diligence (for example, in an auction).

Even if the investigation is well-focused, there will need to be a limit on the information to be supplied. For example, a due diligence request to review all current contracts of the target business could turn up many small contracts entered in the ordinary course of business that will have little impact on the price or risks of the transaction. Solutions to limit the scope of disclosure of contracts include:

- To request only contracts entered without using the target's standard terms and conditions.
- To put a monetary threshold on the value of contracts to be disclosed.
- To classify the contracts from the perspective of importance for business continuity after the acquisition.

Although contractual protection is no substitute for a thorough due diligence exercise, it may offer some comfort where, for example, time is short and due diligence is limited. In these circumstances, the buyer should at least seek to investigate key issues and take other steps to protect itself. For example:

- Ensure that warranties and indemnities are sufficiently wide and specific.
- Consider negotiating a retention of the purchase price to cover potential warranty claims.
- Propose a price adjustment.
- Purchase warranty and indemnity insurance protection. When using insurance protection, the terms and conditions of the insurance policy should be negotiated with an insurance company, in addition to the negotiations between the buyer and the seller for warranties and indemnities. It tends to make the M&A contract preparation process more complicated and take a longer time, so the parties need to ensure they agree a sufficient timetable in advance.

Depending on the nature of the target’s business, the buyer may also want to instruct experts such as environmental experts, real estate appraisers, IT consultants, or other relevant specialists.

Real Estate and Environmental Due Diligence

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Real estate and environmental due diligence is required where there is the acquisition of a company that is a manufacturing or processing company, or whose assets include real estate used or previously used for industrial processes, or whose assets are located in the contaminated areas designated by the government authorities under the environment laws, such as the Soil Contamination Countermeasures Act (Act No. 53 of 2002).

The issues to investigate include the value of the target and its assets, title to real estate, potential responsibility for any clean-up, and liability generally in relation to environmental damage.

If these concerns are relevant, a buyer must decide on the level of investigation it wishes to undertake. This may range from a brief site visit and a desktop review of information including real estate registries or other governmental documents, contracts, engineering reports, historical maps, geological or hydrological surveys and process information, to a more detailed survey involving detailed sampling of soil and ground water.

The aim will be to determine and allocate responsibility for clean-up and to obtain protection where appropriate from the seller.

IT Due Diligence

If the target company is heavily dependent on IT, or its business is the provision of IT services or products, then IT due diligence can be important to both buyer and seller.

The following three factors are key to due diligence in an IT context:

- **The relationship between target and seller, which may not cease on completion.** Following a sale, the target may continue to provide IT services to the seller (or vice versa). This continuing relationship raises the importance of due diligence, as the buyer may be reluctant to look to warranties and indemnities. Parties may have to enter into transitional service agreements ("TSA") where services are continued after the transaction closes.
- The parties may be negotiating the TSA concurrently with the main acquisition agreement and may execute the TSA at the same time as the acquisition agreement. However, due to time constraints, if the TSA is not executed at the same time as the main acquisition agreement, the parties may stipulate in the acquisition agreement that:
    - the seller covenants to enter into the TSA by the closing date;
    - the main terms and conditions of the TSA are as set out in the acquisition agreement; and
    - execution and existence of the TSA is a condition precedent for closing.
- **IT assets are generally intangible intellectual property rights.** Due diligence will be focused on intellectual property rights to ensure that the sale of the target will not affect licenses or other rights, to establish what consents may be necessary, and to determine ownership of copyright.
- **Skilled personnel are key assets for an IT company dependent on know-how.** Investigating this asset requires diplomacy and speed to prevent disgruntled personnel from leaving the target business.

Additionally, cyber security risks and data privacy breaches can result in potentially significant regulatory sanctions (including criminal sanctions) and, more generally, the risk of litigation. These risks and liabilities are all relevant to the determination of the target company's value.

Organizing the Due Diligence Process

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Discuss Scope of Due Diligence with Buyer

It may be helpful for the legal adviser to meet with the buyer at an early stage to agree on the parameters of the investigation. At this meeting, the adviser should find out how much its client already knows about the target business and ask the buyer to highlight any areas of concern.

Before beginning the due diligence review, the buyer's lawyers should establish with their client:

- A due diligence budget.
- The scope of review (see *Scope of Due Diligence Review*).
- What type of oral or written report is required (see *Due Diligence Report*).
- The deadline for completing the due diligence review and delivering the report.
- Whether any outside consultants should be engaged.
- If certain areas should be a primary focus.
- If there are any threshold issues that could make or break the deal (known as deal breakers).
- The process for communicating with the seller and the management of the target business. For example, the buyer's lawyers may be required to communicate through a third party such as an investment banker.

The extent of the due diligence investigation should be in keeping with the value and importance of the acquisition to the buyer and the potential risk. It is important to agree on the scope of the legal due diligence investigation at the outset and for the buyer to understand the limits of the scope.

The Due Diligence Team

It is essential that the acquisition team is made up of appropriate people under clear leadership and with good reporting structures. The team carrying out the due diligence must involve the buyer's own personnel as well as its legal and financial advisers and accountants. In some cases, it may also be necessary to retain outside consultants in other areas such as regulatory compliance, environmental, or human resources. The due diligence team can be large and comprised of multiple organizations and it is important to have a point person to organize and coordinate the process. The point person may be the buyer, but often the buyer delegates this responsibility to its lawyers.

Generally, the legal team consists of corporate lawyers and other specialists (such as environmental, employee benefits, real estate, and intellectual property lawyers). Lawyers doing the due diligence investigation must be fully briefed as to the purpose of the acquisition, the depth of investigation required and the key areas of importance for the client. If this information is not given, the onus is on the lawyers carrying out due diligence to check publicly available information and ask the relevant questions rather than proceed with an unfocused investigation.

The general practice is for representatives of the relevant parties, such as the buyer, the seller, the target company, and their advisers, to hold a kick-off meeting before starting the legal due diligence process to discuss the specific process for carrying out the due diligence. This includes the timetable, the materials to be disclosed, and the process of disclosure. The parties also can share their respective understanding of what will be involved in the due diligence exercise.

Due Diligence Checklist and Questionnaire

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One of the most important preliminary activities in the context of a due diligence exercise is to prepare the due diligence checklist, which is a list of the documents and information to be requested from the seller and the target company that should be uploaded in the data room. To prepare the due diligence checklist, the buyer's advisers should read the main publicly available information on the target company (see *Other Sources of Information*).

In drafting the due diligence checklist, the adviser should consider the scope of the due diligence exercise that has been agreed with the client (see *Scope of Due Diligence Review*).

The cornerstone of any due diligence exercise is the questionnaire or information request that sets out the areas of investigation and a list of questions and enquiries to be put to the seller. The due diligence questionnaire should be well organized and easy to update. Ideally, the questionnaire should not be too technical and each section should be stand-alone so that it can be considered by the appropriate adviser.

These questions will usually be supplemented by further requests as the negotiations proceed and as the buyer learns more about the target. Care should always be taken to tailor standard due diligence questions so that they are relevant to the target and the relevant transaction. The legal due diligence team should explain the contents and purpose of the information request and questionnaire to the representatives of the seller or the target who are responsible for the transaction, for example, the general affairs department and legal department. To the extent not agreed at any kick-off meeting, the legal due diligence team should consider how to effectively proceed with the due diligence process and make the appropriate disclosure of materials.

Data Room

The bulk of the due diligence review involves reading documents of the target business, including contracts, financial reports, and corporate records. A seller usually sets up a data room, in which relevant information on the target will be made available. Sometimes, especially in smaller transactions, the seller may either send the buyer electronic or hard copies of documents.

Nowadays the data room is often virtual rather than a physical data room at the seller's offices or the office of the seller's attorney. If the materials are stored on an online data site, the seller determines who is invited to the data site and gives password-protected access. It is important to determine which due diligence team members need access to the data site so that the buyer's lawyers can submit a comprehensive request for access to the seller. When using a virtual data room (VDR), due diligence inquiries and answers may also be submitted through the VDR.

Vendor Due Diligence Reports

In auction sales, the seller may conduct a formal seller due diligence process culminating in the preparation of one or more vendor due diligence reports (also referred to as VDD reports or VDDR) by the seller's advisers to be provided to prospective buyers.

The types of VDD report commissioned by a seller vary from transaction to transaction. Financial VDD reports are common. Other VDD reports may cover legal, tax, commercial, and property matters.

VDD reports are initially given to prospective buyers on a non-reliance basis, but on the understanding that the reports will be addressed to the successful bidder who can then rely on them in the same way that they rely on the bidder's own due diligence reports, subject to the report provider's terms of business.

The main purpose of providing VDD reports is to accelerate the bidders' due diligence on the target company. While they require considerable management input before the sale process begins, once it is underway, management tends to spend less time answering due diligence questions from bidders.

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VDD reports are not commonly used in Japan for private acquisitions, especially in small-sized private acquisitions. In Japan, a practical example similar to the VDD reports process is a consulting company acting as an intermediary matching the seller and the buyer on a share or asset purchase transaction. After executing a confidentiality agreement and an M&A consulting agreement, the consulting company receives disclosure of internal materials from the target company to prepare a valuation report, a non-name sheet (teaser), information package, and other proposal materials.

Other Sources of Information

Information about a target company can be derived from a variety of sources, including the website of the seller or the target business. The amount of publicly available information has expanded rapidly, particularly with the growth of the internet.

As part of the due diligence exercise for private acquisitions in Japan, the buyer may:

- Obtain a certified copy of the commercial register of the target company and the seller from the Commercial Registry.
- Obtain registration information of real estate owned or used by the target company or seller from the Land and Building Registry (see *Sources of Information about Real Estate*).
- Obtain registration information of movable assets owned or used by the target company or seller (see *Sources of Information about Movable Assets*).
- Confirm newspaper and magazine articles.
- Obtain reports from credit research companies.

For further information, see *Sources of Corporate and Financial Information*.

Sources of Corporate and Financial Information

Key corporate information can be obtained from:

- **Commercial Registry or Trade Register (*Shogyotoukibo*).** The basic information about a company, for example its status and the names of its directors, can be confirmed by an inspection of the Commercial Registry maintained by the Ministry of Justice. Anyone may request a certified copy of a company's commercial register to be issued by the Legal Affairs Bureaus, online, or by post. There are eight Legal Affairs Bureaus and 42 District Legal Affairs Bureaus nationwide.

  Information is also available using the *Registration Information Provision Service*, where registry information can be accessed online, and PDF files obtained. Temporary use of the service is available by a credit card without advance application.

  For further details of the information available at the commercial registry, see *Company Searches*.

- **Annual Securities Report (*Yukashoukenhoukokusho*).** Even in cases where its securities are not listed on a financial instruments exchange, an issuer of shares shall submit an annual securities report for each business year, if the issuer is obliged to submit a securities registration statement at the time of the public offering or secondary distribution (Article 24, paragraph 1, Financial Instruments and Exchange Act (Act No. 25 of 1948)). The annual securities report is available for public inspection for five years and can be viewed online (free of charge) using *EDINET: Electronic*

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Disclosure for Investors' Network. The annual securities report contains information such as general corporate information, the status of the business, and financial information.

- **Accounting Books.** If the buyer is a shareholder holding at least the required percentage, the buyer can request to inspect the target company's accounting books, and the target must allow the buyer to do so unless certain exceptional grounds apply. The required percentage is 3% (or, if a lesser proportion is prescribed in the articles of incorporation of the target company, such proportion) of:
    - the total shareholders' voting rights of the target company; or
    - the issued shares (excluding the treasury shares) of the target company.

  (Article 433, paragraphs 1 and 2, Companies Act.)

- **Financial Statements.**Without delay after the conclusion of the ordinary annual shareholders' meeting, a company must give public notice of its balance sheet (or a summary of the balance sheet). A large company must give notice of its balance sheet and the profit and loss statement (or summaries of both) (Article 440, paragraphs 1 and 2, Companies Act). A company may select the method of publication in its articles of incorporation, including publication in the official gazette, a daily newspaper, or an electronic publication on a website. In the absence of any provision in the articles of incorporation, it must give public notice by publication in the official gazette. (Article 939, Companies Act.)

  Despite the legislation, there are a considerable number of cases where public notices of financial statements have not been made, particularly for small#to#medium#sized companies.

- **Beneficial Ownership Information.** In Japan, there are no published materials available to obtain information regarding the beneficial owners of corporations. However, during the due diligence process, the information can be obtained from the target in relation to the following:
    - **Specified business operators.** For example, financial institutions are required to obtain and record information regarding the beneficial owners of corporations as part of their customer management under the Act on Prevention of Transfer of Criminal Proceeds (Article 4, paragraph 1(4) and (6), Act on Prevention of Transfer of Criminal Proceeds). In response to such customer management, the target may have submitted its beneficial ownership information to financial institutions, and the buyer may obtain such information from the target through the due diligence process.
    - **Notary public.** When articles of incorporation are certified by a notary public at the time of incorporation of a company, a person who is to be a beneficial owner of the company is reported to the notary public (Article 13(4), paragraph 1(1), Regulation for Enforcement of the Notary Act (Attorney-General's Office Order No. 9 of 1949)). As a notary public must, if requested, issue to an incorporator a certification of the report, the beneficial ownership information can be obtained by the certification during the due diligence process. While the notary public manages the database on the beneficial owners' information, it is not generally accessible and does not record any change in the beneficial ownership after incorporation (see *Japan National Notaries Association*).
    - **Registry office.** Effective on 31 January 2022, the commercial registry office stores the beneficial owner list of a company that voluntarily reports the information. If requested, the commercial registry office will issue a copy of the report (see the website of the *Ministry of Justice*) and the beneficial ownership information can be obtained from the report as part of the due diligence process. However, a copy can be issued only to the company which registered the beneficial owner information (see Article 2 and 8, Regulations Concerning the Keeping of the Beneficial Owner Information List at the Commercial Registry Office (Ministry of Justise Public Notice No. 187 of 2021)).

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- **Online insolvency searches.** To ensure that the target, its subsidiaries, or the seller have not been declared bankrupt or are not subject to rehabilitation proceedings, the official gazettes should be reviewed for bankruptcy proceedings, civil rehabilitation proceedings, and corporate reorganization proceedings. These are required to be announced in the official gazette. Fee-based online searches are available on the Official Gazette Information Search Service (see *National Printing Bureau: Introduction to Official Gazette*). Application is required in advance to use of the Official Gazette Information Search Service.
- **Regulators.**Various administrative bodies publish information about companies under their supervision such as companies having operating permits and administrative dispositions (that is, among other things, a business suspension order, business improvement order, and revocation of operating permits). For example, the Financial Services Agency publishes the "List of Business Operators Who Have Obtained Licenses, Permits, and Registrations" and the "List of Cases of Administrative Dispositions." The Japan Fair Trade Commission also publishes a list of legal measures implemented under the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade (Act No. 54 of 1947) and a list of recommendations implemented under the Act against Delay in Payment of Subcontract Proceeds to Subcontractors (Act No. 120 of 1956). In addition, the Ministry of Economy, Trade and Industry publishes a list of companies under administrative sanctions implemented under the Foreign Exchange and Foreign Trade Act.

Non-public corporate information may also be obtained through credit research companies such as *Teikoku Databank* and *Tokyo Shoko Research*, and news service providers such as *Nikkei Telecom*. Although it can be useful, the reliability of this information needs to be assessed carefully.

Sources of Information About Real Estate

Various information about real estate can be obtained from the Land and Building Registry (*Fudousanntouki*) on payment of a fee, including:

- Ownership titles (*shoyuken*).
- Usage rights such as superficies (*chijoken*) (that is, above-ground rights).
- Easements (*chiekiken*) and leaseholds (*chinshakuken*).
- Collateral such as mortgages (*teitoken*) and revolving mortgages (*neteitoken*).
- Information on litigation encumbrances such as provisional dispositions (*karishobun*), provisional seizures (*karisashiosae*), and seizures (*sashiosae*).

Real estate registers can be requested by anyone and are issued at the Legal Affairs Bureaus, online or by post. Registration information also can be accessed online, and PDF files obtained through a Registration Information Provision Service. Temporary use of such service is available without advance application.

While registration in the real estate registry is a requirement to enforce acquisitions of, losses of and changes in real rights to real estate against a third party, a mere description in the real estate registry that a person is the owner of real estate does not by itself make the person the legal title owner (Article 177, Civil Code (Act No. 89 of 1896)). However, registered owners are presumed to have an ownership title to the real estate, unless there is evidence to the contrary. Unless there are circumstances which could be known by the buyer through due diligence, such as relevant disputes, the actual risk is low that the registered owner of the real estate does not have ownership sufficient to pass good legal title to the buyer.

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Sources of Information About Intellectual Property (IP)

Searches for patents, utility model rights, and design rights can be conducted through checking online databases such as the *National Center for Industrial Property Information and Training: J-Plat Pat*. However, there is a time lag for the entries in the registry (*tourokugenbo*) to be reflected on the database. The contents of exclusive licenses and security rights are also not recorded on the database. Important items should be checked on the registry by application to the Patent Office. In relation to non-exclusive licenses, it may not be possible to confirm their existence from a search of the registry or on an online database, such as J-Plat Pat, because from April 2011, non-exclusive licenses can be enforced against any third party without registration of the licenses.

Searches for trademark rights can be conducted in the same way as searches for patents, utility model rights, and design rights. However, the establishment and content of non-exclusive licenses may be confirmed by a search in the registry (*tourokugenbo*) because transfer, modification, termination, or restrictions on disposal of non-exclusive licenses of trademarks cannot be enforced against any third party unless the license is registered.

Searches for copyrights can be conducted through a search of the registry (*tourokugenbo*). Under the Copyright Act, it is possible to register the author's true name of a work published anonymously or pseudonymously, or to register a transfer of, or establishment of a pledge on the copyright (Article 75 and 77, Copyright Act (Act No. 48 of 1970)). The content of the registry can be checked by using the Copyright Registration Status Search System provided free of charge by the *Agency for Cultural Affairs, Government of Japan*, and by requesting a certified copy of the entries in the copyright register.

However, copyright is automatically generated when work is created, and no procedures are required to create it. It is necessary to confirm copyrights through interviews with the target company and by a review of relevant contracts.

An author also obtains moral rights in addition to the copyright by creating a work (Articles 18 to 20, Copyright Act). Moral rights cannot be assigned, licensed, or waived, and therefore if there are holders of moral rights, other than the target company, consider entering into an agreement with the holders where they agree not to exercise their moral rights.

In a due diligence process, it is not advisable to rely on the results of these searches alone. Comprehensive searches should also be conducted by a patent attorney, trademark search specialist, or design specialist, as applicable.

Sources of Information About Movable Assets

Public information on ownership and charges on movable assets such as cars, ships, airplanes, and industrial machinery can be obtained from various sources, including:

- The certificate of registration on vehicles (Article 22, paragraph 1, Road Transport Vehicle Act (Act No. 185 of 1951)).
- The certificate of registered matters on ships (Article 33, paragraph 1, Ship Registration Order (Cabinet Order No. 11 of 2005) and Article 29, paragraph 1, Detailed Regulation for Enforcement of the Ship Act (Order No. 24 of the Ministry of Communications and Transportation of 1899)).
- A certified copy of the aircraft register (Article 8, Aircraft Registration Regulations (Order No. 50 of Ministry of Transport of 1953)).
- The certificate of summary of registered information and information recorded in summary of registration of assignment of movables (Article 11, paragraph 1 and Article 13, paragraph 1, Act on Special Provisions of the Civil Code Concerning the Perfection Requirements for the Assignment of Movables and Claims (Act No. 104 of 1998)).
- A certified copy of the registry of construction machinery (Article 13, paragraph 1, Construction Machinery Registration Order (Cabinet Order No. 305 of 1954)).

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- The certificate of registered matters on agricultural movables (Article 16, paragraph 1, Agricultural Movables Mortgage Registration Order (Cabinet Order No. 25 of 2005)).

Contact with Target's Management

An important aspect of due diligence can be to establish contact with the target's management and to discuss the business with them. The buyer will often ask to visit the target business site and talk with members of management. The buyer's lawyers may also have follow-up questions after reading due diligence materials which can be answered more completely during a phone call.

However, due to confidentiality concerns, the target business or seller may not want its employees to be aware of the transaction, so it may only grant access to a few members of management. Accessing management of the target business or seller (in an asset sale) during the due diligence process can be a hotly negotiated matter.

Confidentiality and Data Protection

Although a seller typically requires prospective buyers to enter into a confidentiality agreement, it is not always easy to enforce it in practice. If the buyer is a competitor or potential competitor, a seller may be particularly reluctant to disclose sensitive information about the target business until it can be sure that the sale will go through. For information on disclosing sensitive information, see *Disclosure of Sensitive Information*.

The knowledge that a business is for sale can also be unsettling for employees, customers, and suppliers. It can lead to a loss of customers or key staff during the sale process. In some cases, the seller will wish to keep its intention to sell the target confidential from all but the most senior management. This will limit the scope of the information available for a full due diligence investigation.

The seller will want to ensure that no approaches are made to its customers, suppliers, management, or employees either with a view to poaching them or obtaining more information. In an auction sale, it is more difficult to maintain confidentiality because of the number of parties involved. Bridging the gap in expectations between the seller, who is concerned to restrict the release of information, and the buyer, who wants to gather as much information as possible, is a crucial element of the initial stages of any transaction.

Disclosure of Sensitive Information

There are legal restrictions on the disclosure of sensitive information which the seller will have to be very careful to respect when providing information to the buyer in the context of a due diligence investigation. For example, it is a criminal offence to disclose information on, among other things, national defense, diplomacy, or prevention of terrorism which is designated as a "Specially Designated Secret" (Article 23, paragraph 1, Act on the Protection of Specially Designated Secrets (Act No. 108 of 2013)).

Information that is commercially or competitively sensitive (in particular, if a buyer is a potential competitor of the target or the seller) should only be shared where an agreement has been put in place to strictly limit the exchange of such information to certain advisers of the buyer or certain employees of the buyer who do not have past, current or anticipated operational responsibilities within the buyer (for example, they are not involved in customer facing or decision making roles on competitively sensitive issues regarding the buyer's business for competing products). A team composed of such advisers and employees is called a "clean team," and in some cases, members of a clean team are required to submit written pledges to protect the sensitive information. In addition, an information management system may be adopted to protect sensitive information.

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Data Protection Restrictions

Under the Act on the Protection of Personal Information (Act No. 57 of 2003) there are restrictions on the disclosure of "personal data" to a third party (Article 27 and 28). Where the seller is disclosing information to the buyer, including personal information, such as personnel-related data, it is necessary to examine whether the information includes information falling under the category of personal data (see Article 16, paragraph 3, Act on the Protection of Personal Information). For example, if a particular item of information is personal data and the seller is a "Personal Information Handling Business Operator" (that is, a person providing a personal information database for use in business) it must not, subject to certain exceptions, provide personal data to a third party without obtaining the prior consent from the data subject (Article 27, paragraph 1, Act on the Protection of Personal Information). The seller must therefore consider whether the data subject's consent is required before the disclosure of personal data to the buyer.

Among other exceptions, the data subject's consent is not required if personal data is provided to a third party for the purposes of business succession by way of, among other things, merger, corporate split, or business transfer (Article 27, paragraph 5, Item 2, Act on the Protection of Personal Information). This exception is applicable to the provision of personal data by the seller to the buyer as part of the due diligence process during the negotiation of a business succession. However, the seller must execute an agreement with the buyer requiring the buyer to comply with certain security control measures (Personal Information Protection Commission "Guidelines Pertaining to the Act on the Protection of Personal Information (General Rules)" *(Revised in October 2021), p.79)*. A share acquisition does not fall within the meaning of business succession. Consequently, the exception does not apply to the provision of personal data if the transaction is a share acquisition.

For cross-border transactions, there are different requirements for the disclosure of personal data. A seller that is a Personal Information Handling Business Operator must not provide personal data to a third party in a foreign country without obtaining the prior consent from the data subject (Article 28, paragraph 1, Act on the Protection of Personal Information*)*. There are exceptions to this restriction depending on, among other things, the buyer's location and the effectiveness of the buyer's information management measures. For example, if the buyer receiving personal data is located in the UK or a European Union member country, including Iceland, Liechtenstein, and Norway, the disclosure of personal data is subject to the same rules applicable to domestic transactions in Japan.

In practice, because M&A deals tend to be highly confidential and it is difficult for the seller to obtain the data subject's consent, the seller should consider disclosing only information that does not fall under the definition of personal data if consent is required for the disclosure of the personal data.

Information on the laws and guidelines related to the Act on the Protection of Personal Information is available in English on the website of the *Personal Information Protection Commission*.

For information on disclosing sensitive information, see *Disclosure of Sensitive Information*.

Reviewing Information: What to Look For

Following the due diligence investigation, the first step in the review is to consider the completeness of the responses to the enquiries and whether all documents requested have been supplied and all questions satisfactorily answered (see *Due Diligence Checklist and Questionnaire*).

A review of the target's contracts may raise various issues for consideration. Are there any contractual covenants that could be triggered by the transaction, such as a change of control clause? Any provision in the target's organizational documents imposing limitations on anyone obtaining more than a specified percentage of the voting rights might also act as an obstacle to

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assuming control of a business. Anti-trust or other regulatory issues may require the buyer to dispose of various brands owned by itself or the target before the acquisition can proceed.

The sections below are a guide to assessing corporate information, material agreements, licenses, and litigation disclosed as part of the due diligence investigation. It does not provide an exhaustive list, as each transaction may bring its own particularities.

Corporate Information

Company Searches

A company search at the Commercial Registry can reveal a wealth of information about a target company, such as:

- Details of directors.
- Whether share certificates have been issued.
- Total number of authorized shares or total number of issued shares.
- Details of the shares and the share options in relation to dividends, liquidation preference, conversion, voting rights and other matters.
- Organizational structure, for example, the establishment of a board of directors and, if applicable, a board of company auditors.
- Existence of provisions concerning restrictions on the transfer of shares.
- Liquidation or winding-up resolutions.

The companies to search depend on the nature of the transaction. On most share acquisitions, the buyer or its advisers should search against the target and its subsidiaries, any companies in which it has a significant shareholding, the corporate seller, and corporate guarantor (if applicable). On an asset purchase, where there is no separate target company to search, a search against a corporate seller may be helpful.

The information available at the Commercial Registry will not necessarily be completely up to date. In principle, any change to the information required to be registered at the Commercial Registry must be registered by the company within two weeks (Article 915, paragraph 1, Companies Act). However, in practice, it is possible that information in the Commercial Registry has not been updated in a timely manner. A buyer should verify the registered information by other disclosed materials during the due diligent process.

It is advisable to run a search against all relevant companies at the outset of the due diligence investigation. It may then be possible to confirm whether there are any omissions in the significant matters registered in the Commercial Registry by checking the minutes of the shareholders' meetings and the board of directors' meetings. The buyer typically also requires a seller to warrant under the purchase agreement that all the information included in the Commercial Registry is complete, correct, and up to date.

Corporate Information Provided by the Seller

In addition to information obtained through a Commercial Registry search, the buyer normally requests copies of the following documents from the seller in its due diligence questionnaire:

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- **Articles of incorporation.** The articles of incorporation of the company may contain provisions that would be of interest to the buyer, such as:
    - basic information on the company, including what types of boards or committees are established by the company, whether the company issues class shares, and if so, what rights are attached to the different classes, whether the company issues share certificates and whether liability of officers is limited;
    - procedures required under the articles of incorporation for carrying out transactions, for example, whether the resolution at a general meeting of class shareholders is required, and in the case of a share acquisition where the company has issued shares with restrictions on transfer, what approval is required;
    - whether the provisions of the articles of incorporation comply with the requirements of the Companies Act, for example, whether all the matters required to be specified in the articles of incorporation are specified;
    - whether there are any other notable matters specified or if any shareholder is treated differently in the articles of incorporation, and, if so, whether the provisions are valid; and
    - whether there are any matters in the articles of incorporation which require amendment prior to or concurrently with completion of the transaction. For example, whether the business purposes stated in the articles of incorporation cover the business the seller or the target company actually conducts or whether the transaction requires a change of business purposes to take into account the business the buyer plans to conduct after the transaction, and in the case of third-party allotment, whether it is necessary to increase the total number of authorized shares.

- **Details of Share Transfer Provisions.** Shares are freely transferable, in principle, but the articles of incorporation may provide that the approval of the company is required for the acquisition of shares by transfer (Article 107, paragraph 1(1) and paragraph 2(1), Article 108, paragraph 1(4) and 2(4), Companies Act). In practice, the majority of companies have articles of incorporation providing that the approval of the company is required for the acquisition of shares by transfer.

    Where the articles of incorporation include restrictions requiring the approval of the company on the transfer of shares, a request to change the shareholder in the shareholder register may not be allowed, unless the change is approved by the company (Article 133, paragraph 1 and Article 134, paragraph 1, Companies Act). This is important because unless the change of the shareholder is recorded in the shareholder register, a buyer does not have rights enforceable against the company or a third party in relation to the shares, even if the transfer of shares is effective between the parties (Article 130, paragraph 1, Companies Act). On the other hand, where the target has issued share certificates, the buyer acquires the shares together with the share certificates and has rights enforceable against a third party. However, the buyer's rights are not enforceable against the company unless the change of the shareholder is recorded in the shareholder register (Article 130, paragraph 2, Companies Act).

    Generally, to approve a transfer of shares, a resolution of the board of directors' meeting is required (where the company has a board of directors) and a resolution of the shareholders' meeting is required for other companies. However, as it is possible to provide otherwise in the articles of incorporation, it is important to check the share transfer provisions when checking the articles of incorporation as part of the legal due diligence (Article 139, paragraph 1, Companies Act).

- **Internal rules.** In general, internal rules are subordinate to the rules of the articles of incorporation. Common internal rules include:

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  - the rules of the board of directors (where the company has a board of directors), which stipulate the procedures for convening the board of directors' meetings, the procedure for proposing and passing resolutions, the criteria for matters requiring resolution by the board of directors, and other operational matters;
  - the rules of the board of company auditors, where the target company has a board of company auditors; and
  - the share handling rules that set out how to make changes to the matters entered in the shareholder register and how to exercise shareholder rights.

- **Shareholder register (*Kabunusimeibo*).** A company is obliged to prepare a shareholder register to record the shareholders and the details of their shareholdings. The shareholder register:
  - helps confirm the shareholder composition of the target company;
  - reveals the existence of any minority holding that could limit the buyer's freedom to act after the acquisition; and
  - may show any discrepancies between the shareholding as described by the seller and the shareholding as recorded by the company.

  However, in practice, it is possible that the shareholder register is not kept up to date. A buyer should verify the information on the shareholder register by other disclosed materials as part of the due diligence process.

  The shareholder register cannot be relied on to conclude that a certain entity or person has good title merely because they are registered as a shareholder in the shareholder register. To confirm whether the seller is a shareholder of the target company depends on whether the company does or does not issue share certificates. Where the target company:
  - **does not issue share certificates**, check whether all transfers of shares are valid (known as, the chain of title investigation), starting from the shareholder who first subscribed for the shares until the time the seller acquires the shares after successive transfers; or
  - **issues share certificates**, the possessor of a share certificate is presumed to be a lawful shareholder, and the entity or person that receives the share certificate acquires the rights to the shares represented by the share certificate. Unless the acquirer is in bad faith or has committed gross negligence, a so-called bona fide acquisition is permitted (Article 131, Companies Act). A bona fide acquisition does not apply to the shares of a company not issuing share certificates. If the share certificates have been delivered to the seller, the seller is likely to have acquired the shares effectively. In addition to the shareholder registry, a buyer should check the entries of share certificates and the location of share certificates to verify title.

- **Pledges.**It is important for the buyer to check that the corporate seller has not pledged its shares in the target company and that the target has not pledged any of its assets. On an asset sale, it is important to check whether there are any pledges on the assets being sold.

  Shares may be pledged by entering the name and address of the pledgee in the shareholder register (Article 152, Companies Act). A buyer should check the shareholder register to determine whether a pledge has been granted. In the case of a company issuing share certificates, the pledge may be created by delivering the share certificates to the pledgee without entering them in the shareholder register (Article 146, paragraph 2, Companies Act). In addition, a buyer should check that the seller has not mortgaged its shares or created a trust for shares (Article 154(-2), Companies Act).

- **Board of directors' meeting minutes and shareholders' meeting minutes.** All material actions of the company should be reflected in the minutes. Both board of directors' meeting minutes and shareholders' meeting minutes can

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be a rich source of information, containing references to, for example, acquisitions and disposals, financing, litigation, poor or unusual operating results, or issues of guarantees of, and security interests in, the company's assets. In addition, it may be possible to check whether:

- the procedures and the contents of resolutions are not in violation of laws and regulations or internal rules;
- the meetings were held at the times required by laws and regulations; and
- the resolutions required by laws and regulations were obtained, for example, the resolutions required to approve share transfers were obtained.

- **Minutes of board or management committees.** A review of board of directors' meeting minutes alone may not be enough if the board of directors has formed a management committee, for example, an executive committee, that engages in significant business.
- **Minutes of board of company auditors.** A company may establish a company auditor or a board of company auditors as prescribed by its articles of incorporation (Article 326, paragraph 2, Companies Act). Companies with a board of directors must, in principle, have a company auditor (Article 327, paragraph 2, Companies Act). However, it is common for a company not to establish a board of company auditors.

  The role of auditors is to audit the directors' execution of their duties. The auditors:

  - request reports on the business from the directors to investigate the business and financial status of the company (Article 381, paragraph 2, Companies Act);
  - attend the board of directors' meetings, and must state their opinions if they find it necessary (Article 383, paragraph 1, Companies Act);
  - may demand the directors cease acting in a particular way if there is a risk of substantial detriment to the company by the directors violating the laws, regulations, and articles of incorporation of the company (Article 385, paragraph 1, Companies Act); and
  - audit the financial statements of the company and prepare the audit reports to be provided to the shareholders (Article 436, paragraph 1 and Article 437, Companies Act).

  If a company establishes a board of company auditors as prescribed by its articles of incorporation, the number of auditors shall be three or more, and more than half of them shall be independent company auditors ("*Shagai Kansayaku*") (Article 335, paragraph 3, Companies Act). The board of company auditors may decide on audit policies and methods for investigating the status of the operations and financial status of the company, and prepare audit reports (Article 390, paragraph 2, Companies Act). As part of the legal due diligence, the buyer can confirm these matters by checking the minutes of the board of company auditors meeting.
- **Financial statements.** It is important to review the financial statements and tax returns of the last three to five years of the company to understand its financial situation. The legal due diligence team should interact with the financial adviser to coordinate their findings and better understand the target's accounting data.
- **Management accounts.** The seller may be reluctant to provide management accounts if the company has recently published its annual accounts.

Material Agreements

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Every business has agreements that are material to the success of its operation. Depending on the proposed deal structure and the nature of the target business or assets, the content and types of contracts to review in due diligence vary, but generally include:

- Supply agreements for crucial raw materials.
- Sales agreements (for example, output or requirements contracts).
- Distributorship agreements or agency agreements.
- Business outsourcing agreements, for example, original equipment manufacturing agreements.
- Development outsourcing agreements or joint development agreements.
- Intellectual property licenses (for example, patent or trademark licenses).
- Intellectual property rights transfer agreements.
- Computer system-related agreements.
- Service or management contracts for key staff.
- Collective bargaining or trade union agreements.
- Leases for important equipment (for example, computers).
- Real estate leases for facilities.
- Joint venture agreements.
- Shareholders’ agreements.
- Loan and other debt agreements to provide capital to run the business.
- Agreements regarding the provision of guarantees and security for obligations of third parties.
- Agreements regarding derivative transactions.
- Insurance agreements.

Other agreements, such as agreements to dispose of assets, businesses, or shares may subject the company to continuing liability with respect to a business sold previously.

In addition, when buying a company out of a group, intra-group transactions involving the target company need to be investigated to ensure they do not give rise to any contingent tax liabilities.

The due diligence enquiries need to identify those agreements that are material to the target’s business, that is, those that will affect the price the buyer is willing to pay for the target or which pose material business or liability risks. The due diligence questionnaire will typically indicate the criteria by which a contract is considered material, for example, by quantitative standards such as value and qualitative standards such as how easy it is to substitute the contract.

Having identified the material agreements of the business, the reviewer should check that the contracts are effective, that they have been executed properly and that they do not contravene any competition law or regulatory requirements.

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The principal commercial terms of these agreements should be noted. The following questions are relevant to almost all enquiries:

- **Parties.** Are the parties to the agreement the persons to whom the agreement relates? For example, in a license of intellectual property, is the company using the intellectual property the company named in the agreement or is the named party the parent or associated company of the user? Is the grantor of the license the legal and beneficial owner of the intellectual property?
- **Execution of the agreement.** Has the agreement been properly executed? Did the person signing the agreement have the proper authority?
- **Effectiveness of agreement.** Is the agreement too vague to be enforceable?
- **Assignment clause.** Is there any restriction on the transfer of a contractual party or contractual rights? For example, is the consent of, or notice to, a third party required to transfer the benefit of the contract? If so, when is such consent or notice necessary, and must such consent or notice be in a prescribed form?
- **Change of control clause.** Does the agreement stipulate that the consent of the other party to an agreement must be given on a sale of shares in the business or a change of control of the business? Does the change of control affect any employees, for example, will it require any payment or result in an extended notice period?
- **Event of Default.** What events of default are stipulated? Are there any events of default that may interfere with the transaction or the business planned by the buyer after the transaction? Is the target already in default, possibly giving a right to damages against the target should it be acquired?
- **Compliance with applicable laws and regulations.** Does the contract comply with the requirements of applicable laws and regulations, for example:
  - Money Lending Business Act (Act No. 32 of 1983*)*;
  - Act on Prohibition of Private Monopolization and Maintenance of Fair Trade;
  - Act against Delay in Payment of Subcontract Proceeds to Subcontractors;
  - Act on the Protection of Personal Information; and
  - Act on the Use of Numbers to Identify a Specific Individual in Administrative Procedures (Act No. 27 of 2013).

  In the event of a breach of laws and regulations, what kind of sanctions may be imposed (for example, denial to the validity of the contract, administrative guidance, administrative dispositions such as surcharges, cessation of business, revocation of licenses or permits for the business, or penalties such as fines)?
- **Warranties, guarantees, indemnities.** Warranties in most commercial contracts either relate to compliance with applicable laws and regulations or compliance with the quality standards and the specifications of the contract. Additionally, there are certain standard indemnities relating to breach of third-party rights, breach of contract, and liability for damages. The extent of these warranties and indemnities should be noted.
- **Term and termination.** What is the date of commencement of the agreement? Is the agreement subject to any conditions precedent, for example, a regulatory approval? When does the agreement terminate? Are there automatic renewal provisions in material agreements, for example, major supply contracts which the buyer wishes to continue after the transaction? If not, is it possible to renew such contracts and what procedures and periods are required for renewal? Is there any risk that a material agreement will be terminated imminently by the other party exercising a unilateral termination right? What actions entitle the other party to terminate for breach? Will any compensation have

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to be paid on termination of an agreement? What notice must be given to terminate the agreement? What actions entitle the target to terminate for breach?

- **Liability.**What is the liability of the other party or the target in the event of a default under the agreement, for example, monetary liability or an obligation to make specific remedies, such as, to provide substitutes? Is the liability of the other party or the target limited in respect of breach of the agreement? Is there an exclusion of liability in respect of the target's or the other party's obligations under the agreement? Does the agreement pre-set the damages recoverable for a specified breach by the target or the other party (known as, the agreement of liquidated damages)? If so, is such agreement likely to be enforceable?
- **Intra-group transfers.** Are all intra-group transfers to which the target is party made at arms' length? Do any such transfers give rise to any contingent tax liabilities?
- **Restraint of trade.** Are any restrictions imposed on any party's ability to conduct its business? For example, is the target restricted to conducting a certain business within a certain area within a certain period under the agreement? Is the target restricted from granting a license to a third party because it has granted an exclusive license to the other party?
- **Contingent liability.** Will the target assume liability in the event of a certain event arising in the future? For example, is there a defect liability warranty (*kashi tanpo sekinin*), is there liability for contract non-conformity (*keiyaku futekigo sekinin*), or could liability arise for a breach of a representation and warranty?
- **Elimination of anti-social forces (*Yakuza, Bouryokudan*).** Do the parties represent and warrant that they and their related parties are not anti-social forces and covenant that they and their related parties will not become antisocial forces? Will a breach of the representation, warranty, or covenant be a cause for termination of the agreement? Eliminating relationships with anti-social forces is important when conducting business in Japan (see also *Scope of Due Diligence Review*).

The significance of issues raised by a review of the target's material agreements will often depend on whether the proposed deal structure is a share or asset acquisition. For example, depending on the deal structure, it may or may not fall under the definition of "a change of control" specified in a change of control clause.

Inevitably, material agreements will raise their own specific issues. The buyer's intentions also have a bearing on the review of material agreements. For example, if a loan to the target is to be repaid on completion, the provisions of the loan agreement relating to prepayment and redemption are critical. If it is to be left outstanding, the buyer will want to be sure that the terms are appropriate when applied to it as the new borrower.

Licenses and Authorizations

Depending on the business performed by the target company, it may be obliged to hold certain licenses, permits, registrations, approvals, and authorizations issued by the public authorities, or to carry out certain procedures required by laws and regulations.

The due diligence review should identify that all necessary licenses are in place, are duly held by the target company, and are still in force. The necessary licenses and authorizations will depend on the nature of the business. For example, when operating a restaurant business, the target is required to obtain a restaurant approval from the prefectural governor for each restaurant business facility (Article 54, paragraph 1 and Article 55, paragraph 1, Food Sanitation Act (Act No.233 of 1947)). However, there are certain procedures that need to be taken regardless of the nature of the business, for example procedures under the Fire Service Act (Article 8, paragraph 2, Fire Service Act (Act No.186 of 1948)).

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A share sale, share exchange, and statutory share transfer will normally not impact the status of the licenses and authorizations since the entity holding the given license or authorization (that is, the target company) does not change. However, in an asset sale, merger or corporate split certain procedures may be required to transfer the license or authorization. In some cases, it may be necessary to obtain new licenses and authorizations because a transfer is not permitted. If the buyer wishes to carry on the target's business after the transaction and the business requires licenses and authorizations, the buyer must confirm the necessary procedures to obtain the licenses and authorizations as part of the due diligence.

Employment Matters

In Japan, on a corporate split or merger, the employment agreement with the employees of the target company will continue. For information on company splits, see *Practice Note, Asset Acquisition Documents: Private Acquisitions (Japan)*. On a share acquisition, share exchange, statutory share transfer, or a third-party allotment, the employment agreements will continue because there is no change to the employer (the target company). It is difficult to dismiss employees or change employment conditions after completion. Therefore, it is important to determine whether there are any unreasonable employment conditions in the employment agreements and, if so, whether the buyer can amend the employment conditions after completion.

On a business transfer, it is possible for the employment agreements not to transfer to the buyer. However, if the buyer wishes to succeed to the employment agreements either:

- The employer status of the target company can be transferred to the buyer.
- The employees can terminate their employment with the target company and enter into an employment agreement with the buyer.

Both methods require the consent of the employee.

If the employees are to continue, as part of the due diligence the buyer must confirm the terms and conditions of employment and determine:

- **Materials regarding conditions of employment.** The buyer should request the seller or the target company to submit materials such as labor agreements stipulating the terms and conditions of employment. If there are employees whose employment conditions vary from the standard employment conditions, the buyer should also request the seller or the target company to submit materials stipulating the varied employment conditions.
- **Rules of employment.** The buyer should confirm the rules of employment which form part of the employment agreement. To form part of the agreement, the employee must have been informed of the rules and the rules must be reasonable (Article 7, Labor Contracts Act (Act No. 128 of 2007)).
- **Labor-management agreement.** The Labor Standards Act (Act No. 49 of 1947) provides the minimum standards for conditions of employment. However, these standards may be excluded by entering into a written agreement (labor-management agreement) with a labor union which has been organized by a majority of the workers at the workplace, or if there is no such union, with a person representing a majority of the workers at the workplace. Typical labor-management agreements cover:
  - working more than statutory working hours (off-hours work) and working on statutory holidays (work on day off) (so-called “Article 36 agreement (*saburoku kyotei*)”) (Article 36, paragraph 1, Labor Standards Act); and
  - wage deductions, as an exception to the principle that wages must be paid in full (Article 24, paragraph 1, the Labor Standards Act).

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A buyer must also confirm that the conditions of employment are not in breach of employment laws and regulations. The employer must:

- Not have received guidance or recommendations for correction of employment practices from the regulatory authorities.
- Not have caused any harassment to its employees.
- Have implemented measures provided under the Industrial Safety and Health Act (Act No. 57 of 1972).

Breaches of employment laws and regulations constitute a risk of contingent liabilities for the buyer. For example, if an employee is entitled to additional pay where overtime or holiday work is carried out based on a labor-management agreement, any outstanding additional pay will be a liability for the buyer. It is possible to exclude liabilities in the case of a company split or a business transfer. However, in the case of a merger, share acquisition, share exchange, statutory share transfer, or a third-party allotment where liabilities remain with the target company, it is important to check whether there are any triggers of this type of liability.

If there is a collective agreement between the target company and the labor union concerning the employment conditions, there may be an obligation to notify the labor union in advance of the sale and an obligation to consult with the labor union depending on the proposed deal structure. This should be confirmed as part of the due diligence as this may affect the timetable for the transaction.

Litigation and Outstanding Claims

Most businesses experience litigation or other claims from time to time. Common due diligence issues include:

- **Pending claims.** How many claims are currently pending? What is the estimate of damages? What is the status of each claim? What is the likelihood of success on the merits?
- **Litigation history.** Were there any large claims paid out in the past? Any class actions? What kind of claims is the target business a party to? It is unlikely that a company which operates solely in Japan and has only litigation in Japan will be caught up in a class action where the company is exposed to the risk of liability for substantial damages comparable to those in a US class action.
- **Litigation trends.** What are the common types of litigation? What is the average amount of damages? Are most claims settled or litigated?

In Japan, there is no comprehensive search system for the presence of litigation against a company. The buyer cannot independently investigate litigation history of the seller or the target company. It is important for the buyer to have the seller or the target company voluntarily disclose litigation information.

Communicating Results of Due Diligence

During the Due Diligence Investigation

Part of the key to a successful due diligence investigation is communicating the results to those responsible for assessing the proposed transaction and making the decisions.

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The due diligence review is usually carried out in parallel with the negotiation of the acquisition and the drafting of the acquisition agreement. Any significant information that might affect negotiations or the drafting should be communicated immediately to a senior lawyer or the client even though the due diligence exercise is not complete. All members of the team must be alerted to potential deal-breakers so that they understand what information is important and must be shared as soon as it is discovered.

Important information that comes to light during due diligence must be communicated to the buyer and to the directors of the buyer. Any problematic issues which come to light should then be raised at a full board meeting so that they can be properly considered by those responsible for approving the deal.

Due Diligence Summaries

The implementation of M&A transactions is a decision for a company's directors. In certain circumstances, directors may be liable for negligence on the grounds that they have breached their duty to act with due care as a prudent manager. In Japan, the buyer’s lawyers generally create a written record summarizing the key terms and conditions of each document they have reviewed as part of the due diligence, before submitting a final due diligence report. This means the directors may, where the parties negotiate the acquisition concurrently with the carrying on of the due diligence, negotiate with the seller or the target company based on the executive summary of due diligence. The buyer can change the deal structure, resolve problems prior to concluding a definitive agreement for the transaction, add new terms and conditions such as condition precedents to closing and covenants, revaluate the value of the target company, or suspend the transaction.

Due Diligence Report

Once the investigation is complete, the information may be consolidated in a due diligence report, which should cover the business, financial, legal, and other specialist areas of the investigation. However, in practice, it is common to submit a report describing only the outcome of the legal due diligence. For certain transactions, this may be an informal report focusing only on matters material to the transaction. For others, it will comprise a complete audit of the target’s business including an in-depth summary of the target’s material contracts.

While the report will often be addressed to executive management, it should be in a form that can be circulated to the board in advance of the meeting at which definitive approval of the acquisition will be considered.

Third-Party Reliance on the Due Diligence Reports

In Japan, the due diligence report is usually delivered only to the client (the buyer) and is restricted from being made available to third parties by the buyer. However, sometimes (such as when the buyer finances the acquisition) the buyer is asked to share the due diligence report with a third party (such as the financing bank or members of the buying syndicate). Some firms permit the client to share the report, provided that the third party executes a non-reliance letter or, if that is not possible, certain disclaimers are included in the due diligence report. Lawyers should find out from their client whether it plans to share the report with any third parties and whether any third parties expect to rely on the reports. They should then consult with the deal team to determine the appropriate course of action. If the client shares the report, lawyers should remind their client that the third party may review the report with a different objective and that the information in the report may reveal sensitivities about the target company that the buyer may want to keep confidential.

Seller Due Diligence

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Although this Note is focused on the buyer, a prospective seller may wish to conduct its own due diligence of the target business or assets before and during the transaction to help it identify risks, deficiencies, and liabilities, enabling it to mitigate them before conducting the transaction.

In M&A practices in Japan, it is uncommon for a seller to use outside legal experts to conduct its own due diligence because:

- The seller understands the target's internal information.
- The seller may already have conducted due diligence when acquiring the target from a third-party.
- Generally, the seller does not have an incentive to conduct due diligence with the purpose of reviewing the target for business continuity after the M&A transaction.

Sellers usually conduct an examination in relation to financial or tax due diligence to verify matters, including the reasonableness of the transaction price, even if the process is not conducted as a formal due diligence process.

In addition, a seller conducts legal due diligence where the seller does not fully understand the target due to reasons such as lack of "double hatted" officers (that is, directors of the company who are also involved in the day-to-day management of the target), and where the seller needs the target's internal information to consider whether it is possible to accept the representations and warranties in the acquisition agreement.

A seller should also conduct due diligence on the buyer, for example, in the case of a statutory share delivery ("*Kabushiki Koufu*") where the buyer acquires the target as its subsidiary (Article 2(32-2), Companies Act), and the buyer issues its own shares to the shareholders of the target in exchange for the target shares. The target or its shareholders, as the seller side, conduct due diligence on the buyer because the shareholders of the target will hold shares of the buyer, and must consider the liabilities and obligations of the buyer as well as its assets and rights. The points to be verified by the seller will be similar to the points addressed in a buyer's due diligence investigation.

Due Diligence Considerations for Private Equity Buyers

In recent years, there has been a fully-fledged movement by private equity buyers to support business succession of companies in Japan. A private equity buyer may have a different view of certain due diligence issues. Private equity buyers are often more risk-averse because they are trying to make a relatively quick profit on a highly leveraged acquisition. Private equity buyers often conduct more extensive due diligence reviews than other types of buyers and may seek greater contractual protections.

For example, the private equity buyer may:

- Require the target to be reviewed by their auditing firm, even though the target does not conduct statutory audits. In these circumstances, the private equity buyer conducts a due diligence close to a statutory audit, and the workload of accounting due diligence for the seller or target company may be more than double.
- Emphasize business due diligence and personnel due diligence. For example, in the case of an owner-managed business, if the president and owner will not remain in the business after completion, the private equity buyer will consider how much the value and stability of the business depends on the president and

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owner, and even if the president and owner remain with the business for a period after completion, the private equity buyer will decide the candidates for the next president.

- Depending on the strengths of the business and the differences from other businesses, a private equity buyer may consider appointing a different management team after completion, for example, they may consider hiring experts from outside the business.
- Identify points for improvement in the agreements with third parties, for example, customer and supplier contracts, as part of the legal due diligence (see *Tatsuhiro Takahara et al., [Round-table Discussion] Actual Approach to and Support of Business Succession Projects by PE Funds, MARR vol. 323 (2021)* and *Tamotsu Adachi et al., [Roundtable Discussion] Business Succession and the Roles of PE Funds, MARR vol. 252 (2015)*) (subscription required).

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