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LEXOLOGY
Getting The Deal Through

Market Intelligence

PRIVATE EQUITY 2023

Global interview panel lead by Simpson Thacher & Bartlett LLP

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Japan

Yasuhiro Kasahara is a partner at Nagashima Ohno & Tsunematsu. His main areas of practice are cross-border and domestic M&A, private equity, joint venture and other corporate transactions. He has extensive experience in North, Central and South American matters.

Masaki Mizukoshi is a partner at Nagashima Ohno & Tsunematsu. His practice focuses on a wide range of domestic and cross border M&A related transactions, including private equity investment and acquisition finance. He has represented global and domestic private equity firms in acquisitions of Japanese public and private companies.

Yoshitaka Kato is an associate at Nagashima Ohno & Tsunematsu. His practice focuses on a wide range of Japanese and cross border M&A and general corporate. He has represented global and Japanese private equity firms and Japanese companies expanding their business in the US.



1 What trends are you seeing in overall activity levels for private equity buyouts and investments in your jurisdiction during the past year or so?

Although the Japanese economy as a whole was affected by covid-19, the number of buyout deals by private equity funds (PE funds) actually increased from 2020. This indicates that PE fund activity remains strong despite the prevalence of covid-19. Buyout deals by PE funds in Japan tend to be relatively small-scale deals of several billion yen to medium-scale deals of several tens of billions of yen. This trend did not significantly change in 2022. However, as in 2021, there were several noteworthy buyout deals exceeding ¥100 billion in 2022. These large deals were performed by global PE funds based outside Japan, such as KKR and PAG, which shows the strong presence of global PE funds in the Japanese market. There is also an increasing number of deals involving the sale of subsidiaries and business units by major Japanese companies. This is being driven by the need for major Japanese companies to divest unprofitable and non-core businesses and concentrate on their core business. PE funds, typically offering a higher purchase price than other potential buyers and having no significant antitrust concerns, are often chosen as the recipients of these divestments. The number of acquisition deals for listed companies is also on the rise, but domestic and foreign shareholder activists are becoming more aggressive in Japan and some deals were prevented from reaching completion by shareholder activists successfully opposing them due to (according to them) a low purchase price.

As for the level of activity within existing investments, there were some cases where restructuring (eg, group reorganisation and workforce reduction) occurred in investee companies whose performance had deteriorated due to the impact of covid-19 and global economic downturn. Also, since the Russia–Ukraine conflict



Yasuhiro Kasahara



Masaki Mizukoshi

“In 2022, the year was marked by large acquisitions led by global based PE funds.”



Yoshitaka Kato

“There are an increasing number of buyouts of Japanese target companies by global PE funds based outside Japan. Close collaboration with overseas offices and local counsel is essential as multiple jurisdictions, including Japan, are involved.”

has caused the capital market to weaken, the number of exits through initial public offerings (IPOs) was significantly decreased. PE funds preferred exits through trade sales to strategic buyers and other PE funds.

2 Looking at types of investments and transactions, are private equity firms primarily pursuing straight buyouts, or are other opportunities, such as minority-stake investments, partnerships or add-on acquisitions, also being explored?

Many individual founders of small and medium-sized companies in Japan are aging, while their successors have not yet reached a stage where they can take over the business. This is a major driving factor behind business succession of owner companies accounting for approximately half of all buyout deals by PE funds. A typical case is where the founder of an owner company wants to sell their shares in the company upon their retirement, and the PE fund that makes the most attractive proposal in terms of both purchase price and business strategy takes over the management of the company. In most cases, the PE fund acquires 100 per cent or at least a majority stake (while the founder or co-investor either exits fully or becomes a minority shareholder). This is the same for both listed and unlisted companies, but there are cases where the investment is made in the form of a minority stake too. Buyout deals in the manufacturing and service sectors have traditionally been the most numerous, but in recent years there have also been many buyout deals in the healthcare, real estate and construction sectors. The number of buyouts of listed companies, including management buyouts (MBOs), is also on the rise.





3 What were the recent keynote deals? And what made them stand out?

In 2022, as in 2021, the year was marked by large acquisitions led by global based PE funds. KKR continued its strong presence in private equity investments in Japan. In 2022, KKR acquired Yayoi, an accounting software company, from Orix Corporation. The purchase price reportedly amounted to approximately ¥240 billion. Yayoi has been owned in the past by Advantage Partners and MBK Partners and has continued to grow under the investment firm. KKR also took Hitachi Transport System private through a tender offer for approximately ¥670 billion yen. Hitachi Transport System is a subsidiary of Hitachi, Ltd, and the sale of Hitachi Transport System is part of a restructuring within the Hitachi group.

Also, Bain Capital announced that it would acquire Evident, a subsidiary of Olympus that operates the science business, for approximately ¥400 billion in 2022, with the acquisition to be completed in 2023. Similar to KKR's acquisition of Hitachi Transport System, globally based PE funds have been on the prospected potential buyers in carve-out deals involving multinational jurisdictions by large corporations.

Another notable transaction was the acquisition of Huis Ten Bosch by PAG, a Hong Kong-based PE fund. Huis Ten Bosch is a resort facility located in Nagasaki, Japan, and was the parent company of HIS, a major Japanese travel company. The sale of Huis Ten Bosch was influenced by the deteriorating performance of HIS due to covid-19.

Fortress Investment Group, a US-based investment fund and owned by Softbank Group, has been also active in the Japanese market. In 2022, Fortress Investment Group concluded the acquisition of Accordia Golf for reportedly about ¥400 billion. Also, it was announced in 2022 that Seven & i Holdings, a Japanese retail giant, would sell its

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department store unit Sogo & Seibu to Fortress Investment Group. The sale of Sogo & Seibu, however, has been facing difficulties with discussion with the local communities and its employees and not been completed yet.

A notable buyout deal led by a Japanese PE fund is a proposal by Japan Industrial Partners to take Toshiba private. Japan Industrial Partners is reportedly seeking investments from about 20 Japanese companies and bank loans to finance the acquisition, which would total about ¥2 trillion. Toshiba has announced that it agrees with the proposal from Japan Industrial Partners and recommends that shareholders tender their shares in the tender offer. Toshiba received investments from foreign activist funds and others when its business deteriorated in 2017. The privatisation is expected to give Toshiba more management freedom without being influenced by such activists.

“Japanese mega-banks continue to be the main providers of LBO financing, but other banks, including regional banks, are increasingly becoming providers of funds.”

QUESTIONS



4 Does private equity M&A tend to be cross-border? What are some of the typical challenges legal advisers in your jurisdiction face in a multi-jurisdictional deal? How are those challenges evolving?

Many of the domestic PE funds tend to target companies in Japan for buyouts. However, in the case of M&A transactions involving domestic manufacturing companies, even if the headquarters of the target company are located in Japan, the company will frequently have manufacturing or sales and marketing companies outside of Japan, which means that there is a cross-border element to the buyout.

Conversely, there are an increasing number of buyouts of Japanese target companies by global PE funds based outside Japan. In both cases, close collaboration with overseas offices and local counsel is essential as multiple jurisdictions, including Japan, are involved.

In cross-border transactions, since it may be necessary to obtain competition law clearance, foreign direct investment (FDI) clearance,

and other industry-specific permits and approvals both in and outside of Japan, it is vital to collect the required information in the early stages of the project so that there is sufficient time to analyse in which jurisdiction(s) the buyer will require clearances and to manage the schedule when various types of permits and approvals are needed. In terms of due diligence, while legal due diligence should be performed on each legal entity of the target group, particularly when the target company has subsidiaries in many countries, it is not uncommon (especially in M&A transactions conducted through a bidding process) for there to be insufficient information on overseas subsidiaries, in which case the buyer may not be able to conduct adequate due diligence. For leveraged buyout (LBO) financing, it is also necessary to verify whether guarantees and collateral can be provided by legal entities in each country and how existing loans can be repaid. Furthermore, depending on the capital structure of the seller and the target company, it may be necessary to conduct closing procedures in Japan and overseas but due to time differences and local procedural issues, it might not be possible to close all jurisdictions simultaneously. In such cases, the closings in Japan and the other overseas jurisdictions typically are structured to take place in stages.

5 What are some of the current issues and trends in financing for private equity transactions? Have there been any notable developments in the availability or the terms of debt financing for buyers over the past year or so?

In terms of PE fund financing, interest rates in the Japanese market remained lower than other market in the US or Europe in 2022, making it relatively easy for PE funds to obtain financing. Japanese mega-banks (MUFG, SMBC and Mizuho) continue to be the main providers of LBO financing, but other banks, including regional



banks, are increasingly becoming providers of funds. The number of financiers offering mezzanine financing is also increasing, which is expanding the options for PE funds raising capital in Japan.

There have been no major changes in lending terms and conditions in recent years. The contractual terms and conditions for domestic PE funds raising funds from Japanese financial institutions are generally the same, although deal-specific contractual terms and conditions might sometimes be used. Japanese financial institutions often do not accept the terms and conditions of loans with 'certain funds' conditions, except in some cases of global PE fund deals or acquisitions of listed companies. However, depending on the bargaining power of the PE fund, there seems to be a gradual increase in the number of cases (such as where the buyer holds a competitive lender bid process) in which PE funds are able to obtain 'certain funds' conditions or almost similar conditions for their financing.

6 How has the legal, regulatory and policy landscape changed during the past few years in your jurisdiction?

Recent amendments to the Foreign Exchange and Foreign Trade Act of Japan (FEFTA) expanded the scope of the industries and actions that trigger an obligation for foreign investors to submit prior notifications to the specified government authorities. Due to these amendments, the number of transactions requiring prior notification has significantly increased. In many cases, overseas-based private equity firms can obtain clearance under FEFTA without substantial difficulties for M&A deals and subsequent actions such as the appointment of directors. Nevertheless, being required to file advance notifications under FEFTA not only when performing the acquisition itself but also for post-acquisition activities is an inconvenient extra step that overseas-based private equity firms must now take. In

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addition, in light of recent international events and supply chain instability, there is an increasing government tendency to prioritise and examine more critically transactions that may have an impact on the economic security of Japan. In May 2022, the Economic Security Promotion Act was enacted, which focuses on strengthening supply chains, ensuring the stable provision of key infrastructure, developing advanced technologies in the public and private sectors and protecting patents as non-public information. Although this Act does not directly restrict investment by overseas-based private equity firms, it is expected that future acquisitions of companies that manufacture 'critical substances' designated by the government or provide key infrastructure services will be subject to stricter scrutiny.

The Fair M&A Guidelines: Enhancing Corporate Value and Securing Shareholders' Interests issued by the Ministry of Economy, Trade and Industry (METI) have influenced M&A practices in buyout deals of listed companies. These Guidelines focus on MBOs and the acquisition of companies by controlling shareholders where conflicts of interest and information asymmetries between the buyer



and minority shareholders typically exist. The purpose of these Guidelines is to encourage best practice and, although they are not legally binding, the Guidelines have influenced MBO practices since their publication. In particular, following the publication of these Guidelines, there is a trend towards establishing special committees to examine the proposed transaction and for such special committees to become more deeply and actively involved at an earlier stage of MBO transactions. It is becoming common for such special committees to be established not only in MBOs and the acquisition of companies by their controlling shareholders but also in other public transactions involving squeeze-outs that are not directly covered by the Guidelines.

In June 2023, METI published the 'Guidelines for Corporate Takeovers (Draft)' for public comments. The purpose of the guidelines is to present principles and best practices that should be shared by the economic community for the formation of fair rules regarding M&A, with a focus on how parties should act in acquisitions of management control of listed companies. In Japan, it is expected that M&A will be used as a strategy for companies to tackle increasingly complex management issues and that the guidelines will facilitate acquisitions that are desirable for the Japanese economy and society. In particular, the guidelines include descriptions of actions to be taken by the target company and its board of directors, such as requiring 'sincere consideration' of an acquisition proposal that is a 'bona fide offer' even in the case of an unsolicited offer/bid. The guidelines may encourage more M&A activity targeting listed companies in Japan, and there may be cases where a company that receives an unsolicited offer from a competitor asks for the PE fund's cooperation as a 'white knight'.

There was also a notable Supreme Court decision in the area of takeover defence in 2021. Prior to the decision, it had generally been regarded that any takeover defence measure that could discriminately

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harm a specific acquirer (eg, poison pill) required the approval at the shareholders' meeting by at least a simple majority vote. However, the Supreme Court of Japan held that a majority vote at a shareholders' meeting excluding the acquirer's vote can be valid for introducing such takeover defence measures. After this Supreme Court decision, many Japanese public companies believe that they will have more effective defence measures against activist shareholders who stealthily become major shareholders. However, given that poison pills are not a perfect defence measure, the increasing number of activities by activist shareholders could potentially induce other types of investments by PE funds such as investments as a 'white knight'.

Also, there was another notable Supreme Court decision in the same area in 2022. In this case, a listed company faced a situation where some activist funds separately acquired relatively small portion of shares of the company and the company tried to trigger its takeover defence measures, claiming that those shareholders act in concert in the acquisition of shares of the company, which is sometimes called a 'wolf pack'. The Supreme Court decided that this defence measure



is not permitted, which indicated the difficulties in defending against wolf pack activists.

7 What are the current attitudes towards private equity among policymakers and the public? Does shareholder activism play a significant role in your jurisdiction?

PE funds have become a regular player in a wide variety of M&A deals in Japan, from small business succession deals to large carve-out deals of major Japanese companies, and are gaining recognition in Japan. Generally speaking, however, employees of target companies do not have a positive image of 'funds', and it is important for PE funds to build a relationship of trust with the officers and employees of the target company at an early stage.

The presence of activist shareholders in Japan is growing. They are increasingly making various demands of the companies in which they hold shares (including dialogue with management), and often submit proposals and express opposition to company proposals at general shareholders' meetings. There have even been cases in which proposals submitted by activist shareholders were approved and the company proposals withdrawn. In 2021, there were several cases where activist shareholders intervened in M&A deals for listed companies by announcing their opinion that the purchase price was too low or by buying up the target company shares themselves, resulting in the share price in the market exceeding the tender offer price and the tender offer being unsuccessful (including MBO deals by PE funds). Therefore, in going-private transactions of listed companies, especially in MBO transactions, it is necessary to fully consider the appropriateness of the price and the possibility of intervention by activist shareholders before proceeding with the transaction.

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8 What levels of exit activity have you been seeing? Which exit route is the most common? Which exits have caught your eye recently, and why?

The number of exit deals in 2022 was reported as significantly lower than the number in 2021. In particular, there was only one IPO exit deal in 2022, while 14 IPO exit deals were executed in 2021. After the Russia–Ukraine crisis, the IPO market has largely been dormant, and this trend was expected to continue for at least the immediate future resulting in there likely being fewer IPO exits in 2022.

On the other hand, the number of trade sale exits remain almost the same level as in 2021.

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9 Looking at funds and fundraising, does the market currently favour investors or sponsors? What are fundraising levels like now relative to the past few years?

The number and aggregate commitment amount of the PE funds raised in 2022 is reported to have been more than in 2021. It indicates that the Japanese fundraising market has still remained strong because of the Bank of Japan's negative interest rate policy. It appears to be steering Japanese pension funds, financial institution and investors into allocating more money for alternative investments. It is another feature of fundraising in 2022 that several successor funds of the PE funds that are experienced and mid-cap funds have been raised.

10 Talk us through a typical fundraising. What are the timelines, structures and the key contractual points (eg, choice of governing law)? What are the most significant legal issues specific to your jurisdiction?

Limited partnerships for investment business (JLPS) organised under the Limited Partnership Act for Investment are the legal structures most commonly used as vehicles for PE funds in Japan. Historically, PE funds managed by non-Japanese fund operators often used Cayman Islands exempted limited partnerships as the fund vehicles for private equity investments in Japan, and Japan-based fund operators mainly used either Cayman Islands exempted limited partnerships or JLPS. More recently, an increasing number of non-Japanese fund operators are offering limited partnerships organised in other offshore jurisdictions to investors in Japan, and an increasing number of Japan-based fund operators are using or considering using JLPS for offerings to investors in Japan and Cayman Island exempted limited partnerships for offerings to offshore investors and Japanese investors who choose to invest through offshore vehicles.

The METI has published on its website a model limited liability partnership agreement for a JLPS. Given that this model limited partnership agreement for a JLPS is published by METI, Japan-based general partners who choose to use JPLS tend to use this model agreement as the basis for preparing their limited partnership agreements. Under this model agreement, organising a JPLS is not onerous and can be completed within two or three weeks, depending on the nature of the sponsors and investors. However, experienced fund sponsors tend not to rely so much on the model agreement, and furthermore, there is an increasing trend to use offshore limited partnerships as an alternative fund vehicle for investments by non-Japanese investors. When this parallel fund





structure is employed, the terms regarding the JLPS tend to be adjusted to substantially match the terms regarding the parallel (offshore) vehicle.

One of the most significant legal issues under a limited partnership agreement in Japan is the extension of the commitment period. If a PE fund fails to exit a portfolio company before the commitment period expires, the sponsors and investors need to consider extending the commitment period. If the market is not active at the time that the extension is sought, the investors will likely not want to extend the commitment period unnecessarily and thereby incur additional management fees. Accordingly, extensions of commitment periods are typically negotiated as well as how management fees are to be handled after the extension of the commitment period.

Another legal issue that sponsors and certain investors, such as financial institutions and insurance companies, often heavily negotiate is the right for an investor to excuse investments that constitute a breach of the laws applicable to the investor or the investor's internal rules. Since the investor's exercise of its right to excuse an investment might interfere with and delay the sponsor's decision to make the investment, the conditions for investors to exercise their right to excuse an investment are often heavily negotiated with the aim (from the sponsor's perspective) of enabling the PE fund to determine its investments at its own discretion to the maximum extent possible.

11 How closely are private equity sponsors supervised in your jurisdiction? Does this supervision impact the day-to-day business?

The Financial Instruments and Exchange Act of Japan (FIEA), which is the main legislation in Japan regulating securities brokers and fund managers, is generally applicable if either an investor of the fund

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vehicle or a general partner of the limited partnership (LPS) fund is domiciled in Japan. As a general rule, unless one of the exemptions from registration applies, a fund operator of a foreign LPS or JLPS will be required to be registered as a financial instruments business operator under the FIEA to serve as the investment manager of the fund's assets in Japan.

Although the FIEA provides several exemptions from the registration requirement mentioned above, one of the exemptions used by many general partners is the exemption from both the investment management business registration and Type II registration requirements (known as the 'qualified institutional investor special business exemption'), which is available to the general partner of a fund structured in the form of a partnership. If a general partner qualifies for the qualified institutional investor (QII) special business exemption, the general partner must file a notification (an article 63 notification) with the local finance bureau (and in the case of a foreign general partner, with the Kanto local finance bureau) prior to commencing the contemplated fund business in Japan. In addition,

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the general partner who files the article 63 notification will be subject to additional compliance requirements (including adherence to code of conduct rules and disclosure requirements and maintenance of statutorily required books and records).

Requirements for the QII special business exemption were substantially amended with effect from 2016. Under these amendments, the qualifications and requirements imposed on fund operators engaging in solicitation of investors or management of fund assets under the QII special business exemption were significantly strengthened.

12 What effect has the AIFMD had or will it have on fundraising in your jurisdiction?

Given that the AIFMD applies only to a manager who operates a fund in the European Union, the AIFMD has had only a limited impact on fundraising in Japan and the practice of Japanese PE

funds. Generally, most PE funds in Japan are formed as a JLPS, and fund managers operating the PE funds are usually domestic fund managers. Accordingly, there would potentially be only a limited number of PE funds in Japan to which the AIFMD applies.

13 What are the major tax issues that private equity faces in your jurisdiction? How is carried interest taxed? Do you see the current treatment potentially changing in the near future?

Under tax reforms over the past several years, if certain requirements are satisfied, some corporate reorganisations may be treated as not incurring tax or permitting the incurring of tax to be deferred. For example, in relation to the method to squeeze out minority shareholders known as ‘share delivery’ (*kabushiki kofu*), the 2021 tax reform makes it possible for capital gains caused by a share delivery to be deferred subject to certain requirements.

JLPS are formed as a pass-through entity for Japanese tax purposes, which means that an investor in a JLPS is subject to tax. If a foreign investor is deemed to have a permanent establishment in Japan, the foreign investor is obligated to file a tax return in Japan. In addition, a foreign investor in a JLPS is subject to withholding tax on distribution from the JLPS business if (1) the foreign investor is a limited partner in a JLPS and (2) with respect to the business of the JLPS, the general partner has a permanent establishment in Japan. Although a foreign investor can become a limited partner without being deemed to have a permanent establishment in Japan if certain requirements are met, it is difficult in practice to meet these requirements. Accordingly, Japanese private equity funds typically form a foreign limited partnership for foreign investors as well as the JLPS that targets Japanese investors.





Japanese tax legislation does not generally impose tax on capital gains from the sale or disposition of shares in a Japanese company by a foreign shareholder (ie, a non-Japanese individual or foreign company) unless the foreign shareholder owns 25 per cent of more of the shares in the Japanese company and disposes of 5 per cent or more of those shares in the same tax year (the 25/5 Rule). In determining whether either the 25 per cent ownership or 5 per cent disposition is met, all shares held by the partnership are attributed to a foreign investor. However, if certain requirements are met, the shares held by the partnership are not required to be attributed to the foreign investor for the 25/5 Rule purposes.

14 Looking ahead, what can we expect? What might be the main themes in the next 12 months for private equity deal activity and fundraising?

In the world of post covid-19, the private equity market in Japan can be expected to be active in the next 12 months. At the same time, many Japanese companies have been facing difficulties in recovering from negative impacts caused by covid-19 and struggling with supply chain disruptions, a rapid increase of raw material prices and depreciation of the Japanese yen. For example, in June 2022, Marelli Holdings, one of the largest auto-parts suppliers and owned by KKR, entered into a court-led rehabilitation procedure because of the financial difficulties caused by covid-19 policies and supply chain disruptions. In 2023, DINAMIX, a multi-branded restaurant chain operator owned by Unison Capital, went bankruptcy, and FCNT, a manufacturer of mobile phones owned Polaris Capital Group, entered into a court-led rehabilitation procedure. In the next 12 months, other Japanese companies might face a similar situation, which may in turn create opportunities for private equity funds to take part in distressed M&A transactions.

Further, as mentioned above, activist shareholders have become aggressive in recent years in Japan (for instance, Dalton Group initiated a hostile takeover of T&K Toka Co, Ltd, a listed company in the Tokyo Stock Exchange Prime Market, in January 2023 but failed). This trend may create opportunities for Japanese private equity funds to acquire Japanese listed companies to save them from activist shareholder behaviour. On the other hand, since the Japanese stock market has been slow since the beginning of 2022, a trade sale may continue to be a more preferable exit method than IPOs.

In recent years, sustainability issues represented by the environmental, social and governance (ESG) movement have become an important factor in global private equity fund transactions. In Japan, interest in ESG is growing, and ESG may become one of the material factors in fundraising or in M&A transactions by private equity funds in Japan in the near future.

Yasuhiro Kasahara

yasuhiro_kasahara@noandt.com

Masaki Mizukoshi

masaki_mizukoshi@noandt.com

Yoshitaka Kato

yoshitaka_kato@noandt.com

Nagashima Ohno & Tsunematsu

Tokyo
www.noandt.com



The Inside Track

What factors make private equity practice in your jurisdiction unique?

Domestic PE funds are active in the area of small to mid-cap markets, mostly dealing with private companies while global PE funds are active in the large-cap market and cross-border transactions. Domestic PE funds are sometimes unable to get certain funds as Japanese banks typically have greater bargaining power on these terms. As to warranty and indemnity (W&I) insurance, while the number of domestic matters that use W&I insurance remains relatively low, we are seeing increased use of W&I insurance, especially where PE funds are the sellers.

What should a client consider when choosing counsel for a complex private equity transaction in your jurisdiction?

The counsel should be experienced as to PE fund transactions and the variety of transactional structures used in the Japanese market as well as possessing expertise in both the corporate and financing laws and practices of Japan. If the matter involves cross-border issues, the counsel should have its own foreign offices or access to strong network of foreign law firms that also have expertise in PE fund M&A transactions. In short, the client should confirm whether the law firm has a dedicated PE fund team as well as well solid M&A and LBO financing experience.

What interesting or unusual issues have you come across in recent matters?

Listed companies are experiencing stronger pressure from activist shareholders, and the expected role of PE funds is changing. For instance, if a listed company has a weak stock price, the company could perform an MBO transaction with support from a PE fund to avoid disruptions to its operations from the acquisition of its shares by activist shareholders. For listed companies that are already under attack from activist shareholders, PE funds can be a white knight. We feel that the Japanese market is entering into a phase where listed companies and PE funds may become strategically partners.



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Enquiries concerning editorial content should be directed to the Content Director, Clare Bolton – clare.bolton@lbresearch.com.