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By BARRY FINK*

I. INTRODUCTION

Much needs to happen, both on a political and on a jurisprudential level, before a true globalization of the securities market can occur. The cutting edge of legal and political change today, in both Japan and the United States, is not being sharpened by academics, but by businesspeople who are conducting real life transactions on a day-to-day basis. The legal and regulatory changes of tomorrow are being driven and shaped by today's business and economic needs.

Most merger and acquisition activity that has occurred to date between Japanese and American businesses has consisted of Japanese businesses acquiring American businesses. Americans hope that, in the immediate years to come, major American companies will successfully complete important acquisitions in Japan, so that investment capital will flow freely in both directions across the Pacific. When this process occurs, the political stage will be set for the legal changes required in order to support true globalization of securities markets and development of facilitating transactional laws. This paper attempts to focus specifically on merger and acquisition activities between citizens of Japan and the United States, and to spotlight several areas which merit particular attention.

My interest in this subject matter was sparked and grew out of my experiences with American-Japanese cultural differences which accumulated from a transaction handled by my law firm two years ago. Our client was a U.S. company, whose stock was being sold to a much larger Japanese company. After months of protracted negotiations, the parties finally executed a contract written in English, eighty-five pages long, and containing fifty-seven exhibits. Of the eighty-five pages of the agreement,

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at least sixty-five contained covenants, conditions, representations, warranties, and other commercial contractual assurances. At the celebration dinner which followed the signing, the president of the acquiring company, an eminent Japanese businessman, showed me an English translation of an acquisition agreement involving an even greater sum of money, which his company had simultaneously entered in Korea. The entire agreement was only five pages long and merely described the parties, price, terms of payment, and included a statement that all other terms and conditions would be negotiated in good faith by the parties.

As an American lawyer, I was greatly disturbed by this occurrence. It seemed impossible that a large Japanese corporation could spend one hundred million dollars to acquire a new business in a foreign country, and rely only on a five page agreement. Something had to be wrong. Either the Japanese system was flawed or the American system was at fault.

After further analysis and reflection, I concluded that these differences did not result from the fault of either system, but rather from each country's own internal rules of law and long-established business customs. Under the American system, the burden is on the buyer of a business to take care of oneself. The doctrine of *caveat emptor*, derived from the English common-law heritage, still governs. This is not due to a tradition of dishonesty or of government approved chicanery, but rather to the influence of modern America's trader predecessors, who placed the burden squarely upon the shoulders of the buyer to investigate and be certain. Furthermore, under the commercial law of most American states, deeply rooted in the objective rule of contract law, agreements to negotiate material terms in good faith are generally not held to be judicially enforceable. The American jurisprudential system does not leave issues of great and serious economic consequences to future good faith negotiation between the parties. The rule of law continues to be that "an agreement to agree" does not result in a legally binding and enforceable contractual obligation.[1]

In sharp contrast to the American jurisprudential system, the Japanese legal system and its unique ethnic and cultural foundations make

1. There is, however, a notable trend away from the objective standard rule of American contract law. This trend is evidenced by the judicial growth of such modern doctrines as unconscionability, good faith and fair dealing, mistake, and impossibility, C. FRIED, CONTRACT AS PROMISE (1981); Seaman's Direct Buying Serv., Inc. v. Standard Oil Co., 36 Cal. 3d 752, 768, 686 P.2d 1158, 1166, 206 Cal. Rptr. 354, 362 (1984); Graham v. Scissor-Tail, 28 Cal. 3d 807, 820, 623 P.2d 165, 173, 171 Cal. Rptr. 604, 612 (1981), as well as by the development of corresponding statutory rules (*e.g.*, Uniform Commercial Code "gap filler" rules).

possible the Japanese style of contracting. Under the more subjective Japanese system, the burden of diligence is placed on the seller, not the buyer. The seller has a good faith duty to satisfy the buyer's reasonable and good faith expectations in a business transaction. Moreover, a covenant to negotiate material provisions of an agreement in good faith is judicially enforceable. This legal structure is mandated by an ancient and still strong Japanese tradition of honesty in business dealings, and by the desire of businesspeople to maintain long-term relationships with each other. In part, this tradition reflects the relatively low, as compared to the United States, number of possible and potential business partners in Japan, and one of the core Japanese social values of preserving and enhancing one's business reputation and integrity. Finally, Japanese businesspeople place an exceptionally high degree of trust and confidence in the Japanese judicial system. All of this makes possible the five page acquisition agreement to which my new Japanese friend referred.

After seeing the five page agreement, I informed my Japanese friend that there is no way for a responsible Japanese buyer to make a Japanese style contract in the United States. Just as American companies desiring to go public in Japan must do so in the Japanese way, the Japanese company, whose transaction my friend handled had to do its U.S. acquisition the American way.

It cannot honestly be said that one style of contract is better or worse than the other. Americans who criticize the apparent slowness of the decision-making process in Japanese business frequently fail to understand or appreciate the sociological and cultural reasons underlying consensus management. Japanese who criticize Americans for being too impatient and for making decisions too rapidly sometimes fail to note that speed is made possible by highly refined information systems and an extensive network of lawyers, accountants, and consultants. Moreover, in America, decisiveness is generally considered a positive management quality to be developed, appreciated, and rewarded.

One area in which these differences in Japanese and U.S. business cultures are particularly relevant is acquisitions. Several questions present themselves. Who, as between purchaser and seller, should assume the risk of uncertainty concerning both past and future operations? Should a seller be required to assure future sales or profits? Should a purchaser be required to assume responsibility for future liabilities arising out of events or business operations prior to the sale? The following is a nontechnical, practical discussion of such questions offered in the hope of promoting greater understanding between multinational parties

to business sale and acquisition agreements in the United States and Japan.

II. REPRESENTATIONS, WARRANTIES, AND COVENANTS IN MULTINATIONAL CONTRACTS: TWO VIEWS

A. The Nature and Role of Representations, Warranties, and Covenants in General

A representation is a statement of fact made by one contracting party for the purpose of inducing the other party to enter into the contract. The party making the representation typically possesses unique knowledge, or has the best opportunity to obtain it, and is therefore required to give assurance to the other party. For example, a seller may represent to a purchaser that the seller knows of no reason why future sales and profits should not continue to be as good as they have been in the past, or that there are no collective bargaining or other long-term employment agreements entangling the business for sale.

A warranty is a guarantee or assurance that a particular fact is true, will be true at a future date, or both. For example, the seller may warrant to the purchaser that, as of the contract date, there were no liabilities other than those set forth in the financial statements of the business.

A covenant is a promise to do something or to refrain from doing something in the future. For example, a seller may covenant to maintain all machinery and equipment in good working condition prior to the closing date of the transaction.

All of the above are customary and normal means by which business transactions are facilitated and contractual confidence between purchasers and sellers created. However, they take on far greater importance in contracts between multinational parties. Language differences, unfamiliarity with local laws and accounting practices, tax and treaty restrictions, and even concerns about racial and religious prejudices intensify feelings of insecurity and heighten the need for strong contractual assurances.

The American philosophy of *caveat emptor*—let the buyer beware—does not help resolve these differences. *Caveat emptor* places the entire burden of investigation and discovery upon the purchaser. In large part, this explains the highly developed and extensive contracts that prevail in the United States. The principal means used to bridge the "insecurity gap" between purchaser and seller is the purchase investigation. A thorough examination by a team of lawyers, accountants, engineers, and other experts can do much to assuage a buyer's fears and provide infor-

mation useful in the negotiation process. Unfortunately, due to either a desire to maintain secrecy, to avoid unnecessary expenses, or to the impatience of one or both of the parties, a purchase investigation is frequently performed after a contract is signed, rather than before. Satisfaction with the purchase investigation thus frequently becomes a condition precedent to closing, rather than a condition precedent to signing.

B. Cultural Differences—The Decision-Making Process and Japanese Uniqueness

Japan is famous throughout the world for employee loyalty and employee continuity. When employees are hired by Japanese companies, they usually expect to spend their entire career with them. However, most Japanese employers will refuse to solicit or even hire an employee without a proven track record at another company. The result is that Japanese managers are seriously concerned about making a mistake. Every business transaction must be predictable in all respects. A major mistake in a business acquisition could disgrace and sideline the career of any Japanese executive, no matter how responsible the executive was perceived to be before the error. Consequently, Japanese purchasers of foreign businesses encounter extreme pressure to avoid unplanned and unforeseen negative events at all costs. This manifests itself in demands for extreme contractual assurances—both in scope of assurance and duration—that make many Americans recoil and sets the stage for lengthy and acrimonious negotiations.

This is not to suggest that the desire to avoid error is unique to Japanese managers. American executives are also rewarded for good performance. However, a higher level of risk-taking is inherent in the United States, particularly in the areas of litigation, taxation, and contractual undertakings. Postacquisition events rarely stigmatize the executive responsible for the event, and even if stigmatized, such executives can freely move laterally to similar positions with other employers. The result is that in a business acquisition or sale, U.S. executives are typically willing to accept a greater level of risk than their Japanese counterparts.

III. PARTICULAR SUBJECTS OF CONCERN AND CONFLICT

A purchaser may reasonably require assurance that the values for which the purchaser is paying are really present and will be present at the closing. Thus, there is concern about obtaining good title to assets, con-

firming sales and profits, and preserving trademarks and trade names. Similarly, where liabilities are being assumed, either directly or as a result of the purchase of seller's stock, a purchaser must be certain that liabilities are not greater than anticipated when the parties agreed upon the purchase price. Representations and warranties serve both of these ends.

A. Title

Title to real property is frequently a subject of controversy. Purchasers want sellers not only to warrant the quality of title, but also the condition of improvements, compliance with zoning and other land use regulations, and the absence of toxic and other adverse environmental and soil conditions. Sellers generally desire to sell real property in an "as is, where is" condition, and would have purchasers rely solely upon title insurance and due diligence for assurance as to conditions. However, title insurance contains numerous exclusions and exceptions for which a purchaser may properly require additional assurances. Moreover, title insurance may not be available in a sufficient amount to insure the real business values involved. For example, the total amount of monetary protection available in the United States for any single transaction is eight hundred sixty million dollars from Lloyds.

B. Environmental Issues

Environmental issues are the subject of much controversy and legislation in the United States and elsewhere. In the United States, statutes such as the Comprehensive Environmental Response, the Compensation and Liability Act of 1980 as amended by the Superfund Amendments, and the Reauthorization Act of 1986 (CERCLA), impose potentially immense burdens, not only upon the actual polluter of real property, but upon every subsequent owner in the chain of title. If the pollution affects adjacent property or migrates by way of subterranean aquifers, the resulting liability could result in the insolvency of many owners. Thus, even contractual assurances may not be sufficient to protect a purchaser, unless supported by testing and analysis by an independent environmental consultant.

C. Financial Statements

Financial statement warranties are the most frequent source of controversy in purchase and sale transactions. Initially, one should note that generally accepted accounting principals (GAAP) in the United States

are largely predicated upon the going concern concept, which assumes that a business enterprise is a going concern which realizes the value of its assets and discharges its liabilities in the ordinary course of business. Japanese GAAP, on the other hand, are more conservative and, in certain respects, adopt more of a realization concept, which assumes almost immediate liquidation. The inevitable result is, at the least, heated debate between the accounting professionals from each country, or worse. For example, where an American beverage company makes a large key money payment to a supermarket chain to secure certain display space for three years, U.S. GAAP permits (but does not require) the beverage company to capitalize the payments and amortize them over the three year period. Japanese accounting theory would strongly prefer expensing the entire payment in the first year. If such conflicts are to be avoided, careful definitions and very explicit language must be utilized. Acquisition agreements must be specific as to what areas may differ and what rules apply.

D. Taxes

The federal income tax system in the United States makes the predictability of the ultimate tax liability of a gains concern difficult, if not impossible. This is particularly true for corporate taxpayers with complex businesses, or those who are part of an affiliated group of corporations filing income tax returns on a combined or consolidated basis. Factors contributing to the state of uncertainty include:

(1) Internal Revenue Service (IRS) interpretations of tax laws are frequently not developed and published until long after (sometimes years after) the effective date of such laws;

(2) IRS audits of tax returns frequently do not occur for several years after the return is filed and the interpretative policy, audit policy, or both policies regarding many issues may change several times during this period;

(3) Hundreds of judicial decisions are published annually, interpreting and reinterpreting tax laws; and

(4) Even where the taxpayer knows that adverse tax return adjustments can be made, some returns may escape examination entirely and, even if these returns are audited, many issues will not be recognized by the auditor (this phenomenon is commonly referred to as the "audit lottery").

State and local taxes of all kinds including income, gross receipts, sales, use, property, and other taxes, are even more difficult to predict

and evaluate. Some states, such as California and New York, are regarded by many as being more aggressive than the IRS in enforcing tax laws and collecting taxes. Frequently, the period of time in which a state may audit a return and assess a tax deficiency is longer than the period allowed under federal law. Where a company is not primarily located in a particular state, but merely sells products to residents of that state, complex, esoteric legal principles govern whether the company has sufficient contacts or other relationships with the state to require tax return filing. If no tax returns have been filed in a state in which there are significant contacts, the statute of limitations may be open indefinitely, thus theoretically permitting future assessments for past activities for an indefinite period of time.

The net result is that U.S. businesses, no matter how honest and competent, may have a very limited ability to estimate future tax liabilities, pertaining to prior operating periods. Traditional financial statement warranties are generally regarded as insufficient to deal with income tax liabilities, so supplemental and separate tax warranties are thus usually given by the seller of a going concern. Ultimately, it is a matter of negotiation as to who bears the risk.

IV. PURCHASE AND SALE OF STOCK vs. ASSETS—AN AGE-OLD CONFLICT

A time-honored method for purchasers to reduce risk is to buy assets and assume only certain specified liabilities. Since the purchaser is not acquiring an entity, the purchaser will generally not be liable for unscheduled, undisclosed, or purely contingent liabilities of the seller. Although sometimes helpful, this approach can also have disadvantages, among which are the following:

(1) A corporate seller will be required to incur and pay a tax at the corporate level on the appreciation in certain assets, as well as a tax at the shareholder level upon liquidation (a second or double tax), thus diminishing the effective after-tax selling price to seller's shareholders;

(2) Thoroughness and diligence are required to insure that all of seller's business assets are being transferred;

(3) The seller may own intangible assets, such as contract rights and legal claims which either are not transferable at all, or the transfer of which requires the consent of third parties; and

(4) More time is required, the documentation is more complex, and the transactional costs (legal, accounting, and other costs) are greater than in the case of a sale of the stock of the selling corporation.

Thus, while this acquisition technique is sometimes helpful, it is not always a viable alternative.

V. LIMITING THE EFFECT OF REPRESENTATIONS, WARRANTIES, AND COVENANTS THROUGH THE USE OF SURVIVAL, BASKET, CAP, AND MATERIALITY PROVISIONS

A. Survival of Representations and Warranties

Except for warranties relating to the title of real property, which are expressed or implied by law in conveyance instruments, representations and warranties generally do not survive closing unless the agreement expressly so provides. Thus, a purchaser always desires to provide in the agreement that representations and warranties survive the closing for a period of years. Sellers typically are anxious to avoid and cut off obligations and, accordingly, attempt to either avoid survival of the closing or limit survival to the shortest possible period of time. Although this is ultimately a matter of negotiation and relative bargaining power, representations and warranties typically survive from one to three years. It is also possible to have separate survival periods for different warranties.

B. Baskets, Maximum Limitations, and Materiality

In business, the imprecision of books and records is a given fact. Nearly all businesses commit minor infractions of law. Financial statements, particularly reserves and other valuation accounts, as well as accruals, are mere estimates. Even the most well-managed business cannot be certain that it has filed all required tax returns in all applicable states and local jurisdictions. Thus, many representations and warranties are designed to assure approximate accuracy, not perfection.

One way to adjust contract rights to reality is by way of a materiality standard. Thus, a warranty may only apply to material agreements, and securities filings may be complete and accurate in all material respects. The best drafted contracts contain a definition of materiality. Otherwise, judges or arbitrators would be left to their own devices to resolve specific issues.

Another contractual shock absorber is a provision (commonly referred to as a basket or cushion) that no claim may be made for breach of representation or warranty unless the aggregate damages exceed some minimum amount, usually a percentage of the total consideration. Depending upon the magnitude of the transaction, the minimum may range from ten thousand dollars to one million dollars or more. A corollary

issue is whether, if damages exceed the minimum amount, the breaching party should reimburse the injured party from the first dollar of loss, or only for the excess. Such provisions are designed to do the following: (1) officially recognize that representations and warranties are intended to be true in an overall sense, not literally perfect; and (2) prevent constant harassment and disputes over relatively minor sums.

Finally, some contracts establish an aggregate maximum amount that can be recovered for breach of representations and warranties. Generally, such damages should not exceed the original purchase price paid. The concept of this provision is that the seller, in order to be induced to sell, must have some assurance that some minimum purchase price will be received in any event. Moreover, in the absence of an overall limitation on claims, it is theoretically possible that aggregate claims could exceed the purchase price (for example, a clean-up order issued under CERCLA). However, negotiations generally lead to far smaller maximums.

VI. REMEDIES—THE CONTINGENT PURCHASE PRICE

Businesses are sometimes bought and sold based upon the balance sheet net worth. At other times, prices are predicated upon past or future sales or earnings. Because of the direct relationship between the purchase price and the promise, a portion of the purchase price is sometimes reserved or deposited in escrow, to be disbursed only upon final confirmation of the agreed upon net worth or actual achievement of the sales or earnings promises.

This technique is also useful in cases in which the seller intends to distribute the purchase price to numerous shareholders after closing. It may be impractical for the purchaser to pursue rights against a liquidated corporation or a disbursed group of individual shareholders. A partial purchase price escrow or a deferred payment of a portion of the purchase price assures a fund out of which an injured party can obtain compensation.

Sellers also sometimes are concerned about the purchaser's financial ability to perform future obligations. A foreign purchaser may form an acquisition company to operate in the host country (purchase subsidiary). The purchase subsidiary may not have enough funds to close until the closing. Or, after closing, purchased assets may be transferred to other affiliates of the purchaser, leaving the purchase subsidiary with insufficient assets or liquidity with which to discharge assumed liabilities or pay warranty claims. A purchase escrow also addresses those needs.

VII. SUMMARY AND CONCLUSION

Buyers and sellers always have different goals in any transaction. Buyers want to minimize costs and risks, and maximize net values. Sellers want to maximize the price and terminate risk-taking. These two views are logical and natural, not artificial, having nothing to do with the nationality of the respective parties. However, the fact that parties are of different nationalities creates additional new challenges to understand and address concerns related to the social, cultural, and legal backgrounds of each party. Creativity in applying traditional legal aids is required. Above all, the parties must bring to the bargaining table a special willingness to do the following: (1) hear and understand each other's problems; (2) address issues of concern to the other party; and (3) establish trust and goodwill by their acts and deeds in the course of the conduct of their negotiations.