

Earn-Out, Locked Box, and Retention: Private Acquisitions (Japan)

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A Practice Note summarizing key features of earn-outs used in private company acquisitions in Japan, including earn-out periods, calculation principles, and dispute resolution. It also discusses the use of locked box pricing mechanisms and purchase price retention arrangements in Japan.

The valuation of a target company and determination of a final purchase price are challenging aspects of any acquisition, and a buyer's ability to defer payment or adjust the purchase price based on financial results is often highly negotiated. The challenge can be even greater in cross-border transactions where parties from different jurisdictions may have different financial systems, M&A customs, and business practices.

This Note considers the use of earn-outs in the acquisition of the shares of a private company in Japan, where all or part of the purchase price is calculated based on the future financial performance of the target company. It also summarizes key aspects of value protection tools common in private company acquisitions in Japan, namely locked box pricing mechanisms, as well as less common retention arrangements and escrow accounts.

This Note focuses on transactions where the seller and the target company are Japanese and Japanese law applies to the purchase agreement.

Unless otherwise stated in this Note, Civil Code means the Civil Code of Japan (Act No. 89 of 1896, as amended).

Earn-Outs

In Japan, it is possible in a purchase agreement to provide for payment of all or part of the purchase price to be deferred and payable by reference to the future performance of the target (known as an earn-out). However, earn-outs are still relatively rare in Japanese mergers and acquisitions transactions and are generally limited to cross-border or large-scale transactions because of the perceived complexity of earn-outs in Japan.

Earn-out clauses can serve the following purposes:

- To determine the acquisition price based on future business performance, if reasonable, when the fluidity of business performance is high.
- To bridge a gap between the valuations of the seller and the buyer of the target business.
- As a retention mechanism in case the founder remains with the business after closing.
- As collateral (offset) for the buyer's claims (indemnity or otherwise) against the seller.

Although there is no specific statistical data analyzing the use of earn-out provisions in Japan (for example, in which industries they are commonly used), earn-outs were included in the following publicly disclosed deals involving Japanese companies:

- Monex, Inc.'s large-scale acquisition of Coincheck, Inc. In this transaction, the earn-out clause was introduced because Coincheck, a cryptocurrency exchange operator, was still improving its management and internal control systems after the unauthorized transfer of NEM, a cryptocurrency, due to unauthorized access.
- GREE, Inc.'s large-scale acquisition of 3 Minutes, Inc. In this transaction, the target company was a start-up with less than 10 years of operating history, which may have been a reason for the transaction parties to include the earn-out clause.
- Uzabase, Inc.'s large-scale acquisition of Quartz Media LLC (a cross-border deal between Japan and the US). In this transaction, the target company was a start-up with less than 10 years of operating history, which may have been a reason for the transaction parties to include the earn-out clause.
- Euglena Co., Ltd.'s acquisition of MEJ, Inc. In this transaction, stock options with performance conditions were allocated to provide incentives for MEJ's growth and to retain the CEO of MEJ.

The Japan Ministry of Economy, Trade and Industry (METI) also introduced the use of earn-out provisions in its March 2021 report ("Research Paper on M&A between Large Companies and Start-ups").

Generally, earn-out clauses are expected to be most suitable when the target is:

- A company whose future performance is difficult to predict, such as a start-up.
- An R&D-oriented company, often in the biopharmaceutical field, where there is a high degree of uncertainty about the future achievement of operations.

Earn-Out Performance Indicators

Earn-out performance indicators used in Japan include financial indicators such as:

- **Sales.** Generally, sales amount as a performance measure is advantageous for the seller because it is difficult for the buyer to make adjustments or manipulate the results. In Uzabase's case, sales and the number of users were used as valuation indicators.
- **Net income.** On the other hand, for the buyer, net income as a performance measure is considered more favorable for the buyer because:
 - it can better reflect the actual state of the business; and
 - if the seller remains in the management team, appropriate cost controls can be included. In Coincheck's case, an earn-out clause was structured to pay an additional amount up to half of the total net income for the next three fiscal years, after deducting certain business risks.

- **EBITDA.** EBITDA as a performance measure is used as a compromise between sales and net income. Even when EBITDA is used as an indicator, certain adjustments are often made to make it a fair standard, such as excluding:
 - management fees paid by the target company to the buyer group; and
 - fees paid to advisors arising from M&A transactions.

If financial performance indicators are used for earn-outs, the contracting parties should agree on and stipulate in the transaction agreement:

- The accounting standards and methods for calculating the amount of the indicator.
- The procedures for determining the amount of the indicator (including the procedures for resolving any differences of opinion between the parties).

Non-financial indicators may also be used depending on the nature and status of the target company's business, such as:

- Achievement of product development milestones.
- Acquisition of permits and licenses for new businesses.
- Number of new contracts signed or products sold.
- Acquisition of regulatory approval for pharmaceutical companies.
- Number of PV (website access) for IT companies.

In the Uzabase deal, the number of users was also used as an evaluation indicator. Because it is often clear whether such non-financial indicators have been achieved, and their achievement is often in the interest of both the buyer and the seller, the seller's desire to restrict the buyer's management rights is not as high. Therefore, the earn-out may be effective for matters that are very important for the development of the target business, but its achievement is not necessarily clear at the stage when the business acquisition is executed

Earn-Out Periods

Although an earn-out mechanism is not common in Japan, an earn-out period of one to three years after closing is generally set. However, the longer the earn-out period, the more likely it is that problems will arise that were not envisioned by the parties at the time the acquisition agreement was signed. Additionally, if the earn-out period becomes longer, any restrictions imposed on management of the target company after closing for the earn-out clause will persist for a long time. Therefore, it is desirable to avoid setting an unnecessarily long earn-out period unless there are special circumstances.

Factors That May Shorten the Earn-Out Period

From the buyer's perspective, factors in favor of a shorter earn-out period include:

- Release from the deal covenants as soon as possible.
- Avoidance of limitations on its ability to operate the target company's business, which may increase management costs.

From the seller's perspective, factors in favor of a shorter earn-out period include:

- Recovering the acquisition consideration quickly.
- Reducing the cost of monitoring the buyer's compliance with the covenants.

Factors That May Lengthen the Earn-Out Period

From the buyer's perspective, factors in favor of a longer earn-out period include:

- Reducing the risk of business performance being influenced by short-term market conditions.
- Reducing the risk that the seller will prioritize short-term profits in operating the target company's business if the seller continues to be involved in the business operations after closing.

From the seller's perspective, a factor in favor of a longer earn-out period may be the possibility of a higher negotiated earn-out payment.

Specific Examples of Earn-Out Periods

Each of the Monex, GREE and Euglena transactions were subject to the achievement of performance indicators for three fiscal years after closing. On the other hand, the Uzabase transaction was subject to the achievement of performance indicators by the end of the fiscal year in which the acquisition occurred.

Accounting Principles Used for Earn-Out Reference Accounts

There are no specific rules in Japan requiring a certain type of accounting principle to be referred to in an earn-out mechanism.

The applicable financial statements (or reference accounts) of the target company are often defined as part of an earn-out clause. The following sample definition of "Reference Accounts" includes specific references to accounting standards used in Japan:

"Reference Accounts means, in relation to a Financial Year: the (audited) [income statement and statement of other comprehensive income OR statement of comprehensive income], statements of shareholders' equity, statement of cash flows and the supplementary schedules thereto (in each case as described under the accounting practices generally accepted as fair and appropriate in Japan) of the Company and each of its Subsidiaries, and the (audited) consolidated [income statement and statement of other comprehensive income OR statement of comprehensive income], statements of shareholders' equity, statement of cash flows and the supplementary schedules thereto, (in each case as described under the accounting practices generally accepted as fair and appropriate in Japan) of the Company and its Subsidiaries, in each case for not more than a 12-month period ended on the last day of that Financial Year and prepared in accordance with the Japanese enterprise accounting standards provided by the [Accounting Standards Board of Japan (ASBJ) OR [International Financial Reporting Standards \(IFRS\)](#)], if applicable, and the applicable accounting requirements under Japanese laws in force for that Financial Year."

Security or Indemnity for Earn-Out Payments

Where an earn-out mechanism is adopted, it is possible for the seller to request that the buyer deposit a certain amount into an escrow account to secure the earn-out payment. See [Escrow Accounts and Arrangements](#) and [Seller Protection Mechanisms in Earn-Outs](#).

Earn-Out Dispute Resolution and Expert Determination

It is common for the seller and the buyer to include a mechanism in the purchase agreement that provides that if the seller does not agree with the financial statement provided by the buyer, the seller and the buyer will consult with each other. If they are unable to reach agreement on the contents, the parties will refer the matter to a third-party expert to determine the calculation, for example, a reputable international accounting firm that includes Japanese CPAs.

Normally the buyer (and the target company) will have either or both:

- The information that will be the basis for determining the success or failure of the earn-out condition after the closing.
- The information that will be the basis for determining the amount of payment upon achievement of the earn-out condition.

Therefore, since the finalization process will take place a certain period after the closing, the seller should seek the right to examine the relevant accounting books and other documents of the target company to verify the accuracy of the information of the buyer (or the target company) and should also consider imposing an obligation on the buyer to prepare independent accounting books and other documents as necessary.

For an example of a UK-style clause providing for expert determination of disputes tailorable for Japan, see [Standard Clause, Earn-out: Cross-border: Schedule 1, paragraph 4: Expert Determination](#), which could be amended to include a reference to the use of the Japanese language instead of or in addition to English.

Challenging an Expert Determination

There is no rule for the grounds on which an expert determination may be challenged. A party may generally challenge the expert determination based on the following grounds:

- Partiality of the expert.
- Fraud or exercise of inappropriate influence of a party in electing the expert.
- Manifest error in the expert determination.
- Fraud, misrepresentation, or failure of a party to provide necessary materials for the expert to carry out their determination.
- Abuse of discretion of the expert.

Payments Between Buyer's and Seller's Lawyers

It is not common in Japan for cash payments that are part of the earn-out structure to be carried out from the buyer's lawyers to the seller's lawyers. However, this is a valid mechanism and there are no applicable laws or professional rules that would preclude the ability of the lawyers to perform or receive such payments.

Buyer's Right to Set Off Against Warranties and Indemnities

Regardless of any specific contractual right provided in the purchase agreement, a buyer in Japan may set off the earn-out payment against the buyer's claims in relation to the seller (including a claim for a breach by the seller of a representation or warranty), provided the parties have a monetary claim or debt to each other and the buyers' claim is due (Article 505-1, Civil Code).

Under the Civil Code, the buyer cannot set off payments under the following circumstances:

- The buyer and the seller agree not to exercise the set-off right (Article 505-2, Civil Code).
- A third party has seized the seller's monetary claim for the earn-out payment before the buyer's monetary claims against the seller has accrued (Article 511-1, Civil Code).

For an example of a UK-style clause providing a set-off right tailorable for Japan, see [Standard Clause, Earn-out: Cross-border: Schedule 1, paragraph 2.4: Set-off](#).

Seller Protection Mechanisms in Earn-Outs

The following provisions are usually included in an earn-out for the seller's protection:

- Prohibiting the buyer from conducting any action that could impede the achievement of the earn-out milestones.
- Allowing the seller to accelerate and require payment of the earn-out amount under the following circumstances even if the target company has not achieved the milestone:
 - the filing by or against the buyer of a petition for the institution of insolvency proceedings such as bankruptcy and corporate reorganization;
 - the reduction of the buyer's shareholding ratio of the target company below a certain threshold;
 - the buyer has caused the target company to sell certain important assets to a third party; or
 - the buyer has caused the target company to dismiss certain key staff members.
- Requiring the buyer to cause the target company to prepare and maintain an account book and other records so that the seller can determine whether the milestone has been achieved and calculate the earn-out amounts accurately.

For an example of a UK-style clause protecting the interests of the seller in an earn-out structure that can be tailored for Japan, see [Standard Clause, Earn-out: Cross-border: Schedule 1, paragraph 5: Conduct of business during the Earn-out Period](#), and [Standard Clause, Earn-out: conduct of business \(seller protection\): Cross-border](#).

Locked Box Mechanisms

A "locked box" mechanism is a mechanism through which the parties agree on a fixed price payable for the target company, generally based on a balance sheet drawn up and settled between the parties to an agreed date in advance of signing (the Locked Box Date). By this arrangement, the parties can avoid disputes regarding the determination of post-closing adjustments of the purchase price. This means the parties can fix the amount of the consideration at the Locked Box Date as well.

Typically, a locked box mechanism is a seller friendly method. On the transfer date (separately agreed in the transfer agreement), the ownership of the target company will transfer. However, on the Locked Box Date the economic value of the target company will transfer. Therefore, the risk of leakage regarding the target company's assets after the Locked Box Date is critical to the buyer and the buyer must implement covenants binding the seller not to conduct any action which may damage the value of the stock or which may lead to leakage of the target company's assets.

A fixed price arrangement (similar to the locked box mechanism) is widely used in Japan, especially in many small transactions. Completion account mechanisms are also common in Japan but are usually used in medium to large transactions.

When entering into a stock purchase agreement in Japan, generally there is a covenant restricting distribution of the target company's assets before the closing, and any violation of the covenant will be resolved by the indemnification clause. Damages based on the covenant breach must be proved by the buyer. Even if the buyer proves damages, the indemnification clause may stipulate certain restrictions over the amount of indemnification. Therefore, the buyer generally has certain difficulty using indemnification.

On the other hand, when utilizing the locked box mechanism, any leakage will be compensated based on the indemnification clause and the result will be the same as using the post-closing adjustment mechanism. However, since an action which may cause leakage would be strictly restricted, it is easier to prove damages and the indemnification amount is typically set wider than the cap agreed when using a post-closing adjustment mechanism.

For an example of a UK-style locked box clause for use in private company acquisitions tailorable for Japan, see [Standard Clause, Locked box mechanism: Cross-border](#).

Retention

It is possible in Japan to provide for a part of the purchase price to be retained by the buyer and paid after the closing date (which is separately agreed between the parties). The main reason for the buyer to select retaining part of the purchase price is because it is easier for the buyer to be compensated when an issue is confirmed after the closing that occurred before the closing. Any issue arising after the closing date will be solved based on the indemnification clause, and any damages which the buyer proves will be indemnified. However, if the seller does not have enough funds to indemnify the buyer, the buyer may have to bear that risk. Therefore, by retaining part of the purchase price, the buyer may lower the risk. For example, if the buyer spots during due diligence a potential lawsuit in which the target company may become the subject party, it is useful to select retention and set the payment date of the retained purchase amount when the outcome of the lawsuit is obvious for the buyer.

This practice is still relatively rare in Japanese mergers and acquisitions transactions and is generally limited to cross-border transactions.

For an example of a UK-style retention clause for use in private company acquisitions tailorable for Japan, see [Standard Clause, Retention \(warranty claims\): Cross-border](#).

Escrow Accounts and Arrangements

It is possible in Japan to put the consideration (or a portion of it) into an [escrow](#) account, however, this mechanism also is not commonly used. It is not common in Japan because there are no laws expressly allowing escrow, and an escrow system is not well constructed in Japan compared to other countries. Therefore, a similar concept is used in Japan involving either a trust agreement or a bank account.

A trust company or a trust bank usually serves as the escrow agent in Japan. However, opening a bank account for escrow purposes is generally difficult, and a joint bank account cannot be established by the parties or their lawyers in Japanese banks. Regulatory rules restrict the parties' lawyers from acting as escrow agents.

The process for using a trust agreement generally involves the following steps:

- The buyer and the seller enter into the stock purchase agreement (SPA).
- The buyer and the trust bank enter into a trust agreement.
- The buyer deposits the compensation relating to the SPA as the trust property into the trust bank.
- The trust agreement terminates and the buyer requests the trust bank to deliver the trust property.
- The seller agrees to the termination of the trust agreement.
- The trust bank delivers the trust property to the seller and the seller transfers the subject compensation of the SPA.

Any compensation relating to the transaction is deposited to the trust bank (Trustee) by the buyer (Settlor). The Trustee administers the compensation until the condition to terminate the trust agreement (separately agreed in the trust agreement between the parties) is fulfilled.

A trust agreement will typically have articles to protect the trust property stating the obligation of the Trustee to separate the trust property. Examples of protective provisions include:

- If an order for the commencement of bankruptcy is entered against a Trustee, no property that comes under trust property is included in the bankruptcy estate.
- No compulsory execution, provisional seizure, provisional disposition or exercise of a security interest, or an auction, or collection proceedings for delinquent national tax, is allowed to be enforced against property that comes under trust property.
- A Trustee must separate property that comes under trust property from property that comes under the Trustee's own property and that which comes under trust property of other trusts.

The trustee fee for a trust bank in Japan is considerably high in general and affects the decision whether to utilize a trust agreement.

Japanese practice would usually provide that the escrow agent (that is, a trust company or a trust bank receiving the trust property) would open the accounts and hold the trust property in them. It would receive instructions only from the parties as provided in the escrow agreement.

Trust companies or trust banks usually have their own standard escrow document. It is not certain if either a trust company or trust bank would accept any other form drafted by the parties because it is not common practice for the parties to prepare the escrow letter and there is no common practice about how they might be drafted.

The liability of the escrow agent is typically limited by contractual arrangement so that it arises only in cases of willful misconduct or gross negligence.

Security for Non-Cash Consideration

There is no common approach in Japan to secure the seller's obligations where part of the consideration is to be paid in a form other than cash. In Japan, most mergers and acquisitions use cash consideration.

To widen the selection for non-cash consideration, the Japanese government amended in 2018 the Act on Strengthening Industrial Competitiveness (Act No. 98 of 2013). This amendment deregulated the applicable criteria of exception of the Companies Act (Act No. 86 of 2005), such as the restriction on contribution in kind or favorable issuance, and established new registration regarding tax deferrals against shareholders of the target company. However, to receive an exception and the taxation merits, the company must obtain authorization from the applicable authority regarding their Corporate Restructuring Plan or Special Corporate Restructuring Plan.

Compared to other methods of acquisition (such as a cash transaction), a stock-based transaction requires extra steps, and it also may require extra costs in Japan. Therefore, at this point non-cash consideration is still not likely a common approach in Japan.

Since non-cash consideration is not common, security for non-cash consideration is not common as well.

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