ACQUISITION OF JAPANESE LISTED COMPANY BY US PE FIRM

Blakemore & Mitsuki held a web-conference on June 29, 2021, in which matters relating to the Nichii Gakkan/ Bain Capital MBO transaction were analyzed

July 16, 2021

Brief Minutes of Web Conference (June 29, 2021)

On June 29, 2021, Blakemore & Mitsuki hosted a web conference with a large Japanese financial institution to analyze the tender offer for the outstanding shares and stock acquisition rights of Nichiigakkan Co. Ltd. by K.K. BCJ-44, carried out as part of a management buyout with Bain Capital from May to August of 2020.

Following the introduction of the participants to the conference, Mr. Akimitsu Kamori, a partner of Blakemore & Mitsuki, was joined by Mr. Mark Stockwell, a foreign attorney （*gaikokuho-jimu-benngoshi*） of the firm, to discuss problems regarding the fairness of the transaction in light of the Fair M&A Guidelines, dated June 28, 2019, issued by the Ministry of Economy, Trade and Industry.

Mr. Kamori and Mr. Stockwell discussed three of the six different fairness ensuring measures recommended by the guidelines as a means to ensure procedurally the fairness of transaction terms for which it is difficult to establish unambiguous, objective criteria that potentially should have been implemented by the board of directors of Nichiigakkan: (i) obtaining independent expert advice from external advisors (specifically a fairness opinion), (ii) establishing a majority-of-minority condition, and (iii) ensuring opportunities for other acquiring parties to make proposals (market checks).

Mr. Stockwell noted that the board only obtained a valuation of the Nichiigakkan's shares, and not a fairness opinion regarding the purchase price. It would have been better to obtain a fairness opinion as recommended by the guidelines, as is typically done in almost all public acquisitions in the United States due to the high likelihood of litigation over the purchase price.

Mr. Kamori noted that litigation over acquisition price is relatively rare in Japan partly due to the substantial court charges[1] incurred just to file a complaint, in the range of JPY 16 million yen in case the plaintiff demands payment of JPY 10 billion. Consequently, the average shareholder would be reluctant to pay a relatively large amount of court charge to sue.[2]

He continued that the board may not have obtained a fairness opinion simply because no investment bank or other specialty firm could reasonably be expected to issue the same at the per share price of JPY 1,500 that was initially offered by Bain. Bain took advantage of the decline in stock price due to the coronavirus pandemic, which was likely to be transitory in nature. Prior to the pandemic the price per share had been as high as more than JPY 1,900[3]. Additionally, prior to the tender offer, Nichiigakkan had decided to exit the education business, which for years had been operating in the red. This should have had a positive effect on the stock price, with a conservative estimate for a price per share of at least JPY 2,000.

Mr. Stockwell noted that, in contrast to the valuation obtained by the board, Hong Kong Lim Advisors, which held an undisclosed stake in Nichiigakkan, calculated a fair price per share of JPY 2,400.

Mr. Kamori then briefly touched on the composition of the special committee and the fact that the representative director of the acquiror had also been sitting on the board of Nichiigakkan since 2015. Because of this relationship, it is likely that the special committee was in a difficult position of truly being independent. This led to a discussion of the absence of a majority of the minority approval.

Mr. Stockwell noted that the tender offer did not contain a majority-of-minority approval condition. According to the guidelines, establishing a majority-of-minority condition will lead to a greater emphasis on ensuring opportunities for general shareholders to exercise judgment by directly

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[1] In Japan, it is necessary for a plaintiff to pay a charge to the relevant court to file a civil lawsuit. Of course, such plaintiff is also required to pay legal fees to his/her counsel. Please also be informed that there is a class action system in Japan, but plaintiffs are limited only to qualified consumer organizations, which, together with other rigid restrictions, causes people in general in Japan to understand that with respect to MBO transactions, it would be almost impossible for plaintiffs to use a Japanese-version of the class action system.

[2] Even in Japan, ordinary shareholders sometimes file a petition for a request that a fair price per share be determined by a court, in which case they are required to pay merely JPY 1,000 to the relevant court, regardless of how many shares they have.

[3] The highest price per share in November 2019 was JPY 1,960.

confirming that a majority of general shareholders are satisfied with the transaction terms. This was especially true of the transaction because Bain had secured more than 53% of the outstanding voting shares of Nichiigakkan by signing tender offer agreements with members of management and the founder's family members, agreeing to purchase the shares of Meiwa Co., Ltd., Nichiigakkan's largest shareholder, and securing the pledge of Effissimo Capital Management Pte. Ltd., the second largest shareholder, to tender its entire holdings.

Mr. Kamori speculated that, although the pledge was not made until after the tender offer commenced, it might be possible that Effissimo and Bain had communicated before commencement[4] (to the extent that Japan's Financial Instruments and Exchange Act was not violated) because of the special treatment Effissimo received over other shareholders—at the time the pledge was disclosed, it was also disclosed that Effissimo would be co-investing approximately JPY 1.5 billion with Bain as part of the acquisition. The other general shareholders were not given such an opportunity. Mr. Stockwell agreed that this was highly problematic and questioned whether the written pledge was appropriate instead of simply tendering.

Mr. Kamori suggested that the disclosure of the pledge was the means of informing the general shareholders of Effissimo's special treatment and the opportunity to object. In the end, even without a majority-of-minority condition, Mr. Kamori calculated that tender by a majority of the minority was obtained.

The discussion then moved on to whether a market check would have been appropriate in this instance. Mr. Stockwell noted this was a management buyout and consequently, management was unlikely to entertain offers from other buyers. The guidelines recommend implementing market checks in certain circumstances. However, in cases where the management conducting the MBO is a controlling shareholder, the controlling shareholder seeking to acquire the target company already has a controlling interest in the target company, and it is unlikely that a serious competing proposal will be made in cases where the controlling shareholder is unwilling to sell to a third party.

Mr. Kamori noted that a competing bidder, Baring Private Equity Asia, did in fact emerge and allegedly offered JPY 2,000 per share. But this fact was not

[4] Effissimo had 11.40% of the outstanding capital stock of Nichiigakkan as of June 2019, which is approximately one (1) year before the tender offer commenced.

formally disclosed by the board. In fact, the competing offer was allegedly made on August 17, 2020, but the tender offer closed the following day.
Mr. Stockwell noted that such a substantial premium over the then current offer price per share of JPY 1,670 from Bain should have been given meaningful consideration by the special committee and board.
Thereafter, Mr. Kamori and Mr. Stockwell discussed simulated drafts of the following transaction documents that had been previously circulated to the attendees. Certain key provisions of the documents were analyzed from the perspective of the parties to the transaction and the actions that their respective advisors might have taken.

1. Management Services Agreement among Nobusuke Mori, Go Terada and Bain Capital Management
    a. Mr. Stockwell noted that there was no reasonableness requirement imposed on Bain in respect of expense reimbursement. Mr. Kamori noted that in M&A transactions in Japan, the owners of a business are often unsophisticated when it comes to using legal services and therefore may not use legal counsel, will use counsel that may be inexperienced in M&A matters or even use counsel recommended by the acquiror.
    b. Apart from this provision, it was noted this type of agreement is not typically heavily negotiated because usually the management-service provider is much more sophisticated than the recipient of such service.
2. Written Pledge issued by Effissimo Capital Management Pte. Ltd.
    a. Mr. Stockwell noted the written pledge was dated after the commencement of the tender offer so it appears the only purpose of the pledge was to cause Bain to allow ECM Master Fund to co-invest in the tender offer.
    b. Mr. Kamori noted again that Effissimo's right to subscribe for shares of the parent company of the offeror favored Effissimo over other tendering shareholders and was problematic under Japanese law because all shareholders must be treated equally under the Companies Act.

3. Stock Purchase and Sale Agreement (Meiwa) between Ms. Kuniko Terada and K.K. BCJ-44
    a. Mr. Kamori noted the importance of obtaining independent third-party determination of the closing debts of Meiwa that were determinative of the purchase price because Meiwa was a closely held business.
    b. Mr. Kamori also noted that the buyer's right to demand participation in the tender offer is a useful right to ensure successful consummation of the tender offer in the event Ms. Terada was otherwise in breach of the agreement.
4. Tender Offer Agreement between Mr. Nobusuke Mori and K.K. BCJ-44
    a. Mr. Stockwell noted that Mr. Mori could not rescind his tender once made and discussed certain circumstances under which he might desire to rescind. Mr. Kamori noted that because Mr. Mori was to continue in management, he would probably accept the provision, but for founder's family members exiting the business that had also signed tender offer agreements, such right to rescind would be important in the event of a better offer.
    b. Mr. Kamori noted that the offeror perhaps might have desired to have also included an obligation that Mr. Mori would not revoke his recommendation as a director of Nichiigakkan that shareholders and holders of stock acquisition rights should tender. Mr. Stockwell noted that under certain circumstances, such as in order to satisfy his fiduciary duties, Mr. Mori would want to ensure he could revoke his recommendation.
5. Subscription Agreement between Effissimo Capital Management Pte. Ltd. and K.K. BCJ-43
    a. Mr. Stockwell noted that Effissimo was not obligated to cause ECM Master Fund to purchase the shares until settlement of the tender offer has been consummated. This might present a timing issue in funding the tender offer settlement, but this

would probably be resolved by the purchase and the settlement of the tender offer being simultaneously conducted at the closing. Mr. Kamori also noted that Bain had promised to contribute JPY 27 billion in capital to K.K. BCJ-43, while, on the other hand, Effissimo had promised to contribute merely JPY 1.55 billion in capital to K.K. BCJ-43.

b. Mr. Kamori noted that ECM Master Fund was to be a non-voting shareholder, but he speculated that the shareholders agreement for K.K. BCJ-43 might give ECM Master Fund certain major decision approval rights and the actual subscription agreement might provide conditions on which the relevant non-voting shares would be converted into voting shares.

c. Mr. Stockwell noted that there was no indemnification in favor of K.K. BCJ-43, but it was possible that in the actual agreement there was an indemnity.

6. Acquisition Loan Agreement among K.K. BCJ-44, the Eligible Subsidiary Borrowers from time-to-time party thereto, the institutions from time-to-time party thereto as Lenders, and MUFG Bank, Ltd., as Agent

a. Mr. Kamori explained that this draft acquisition loan agreement was not a "simulated" one but rather a hypothetical one prepared by using as a base the previous credit agreement involving Black & Decker as borrower/acquiror and Citibank as agent.

b. Mr. Stockwell noted that the definition of "EBITDA" lacked many of the add-backs than a private equity sponsor would normally request. Mr. Kamori noted, for example, that Nichiigakkan might have made numerous payments to entities affiliated with the founding family members under non-arms' length transactions. Mr. Stockwell noted the absence of add-backs for non-cash charges and transaction costs.

c. Mr. Stockwell noted the presence of an excess cash flow sweep and the desire for the sponsor to restrict the definition of "Excess Cash Flow" as well as the relationship of the provision to other provisions in the loan agreement.
d. Mr. Stockwell noted that payment of the management fee to Bain is not subject to subordination or other restriction on payment (e.g., an existing event of default). Mr. Kamori pointed out the borrower in the simulated management agreement was not party thereto, but Mr. Stockwell speculated that the borrower would pay the management fee on behalf of Mr. Mori and Mr. Terada.
e. Mr. Kamori noted the presence of the termination provision, which is critical to enable the lenders to terminate their commitments if the tender offer is revoked.

7. Exhibits and Schedules to Acquisition Loan Agreement
   a. Mr. Stockwell noted the difference in the collateral packages between K.K. BCJ-44 and Nichiigakkan. Mr. Kamori noted that eventually, K.K. BCJ-44 would likely be merged with and into Nichiigakkan with Nichiigakkan as the surviving entity.

After concluding the analysis of the simulated documents, Mr. Kamori opened the conference to a question-and-answer session with the attendees. The discussion focused on a fairness opinion.

Brief Minutes for the question-and-answer portion of the June 29, 2021 web conference:

Participant A[5] : I would like to ask you about the concept of a fairness opinion that was discussed at the beginning of the session. I cannot share the actual transaction details, but it is a fact that Bain did not obtain a fairness opinion, and our understanding is that we have not obtained that many fairness opinions in recent deals. On the other hand, as Mr. Stockwell pointed out, it is necessary in the U.S. I would like to ask you about the background of the difference between the Japanese and U.S. markets, and where the disparity

[5] An employee of the above major financial institution.

between the Japanese market and the U.S. market comes from, since not that many fairness opinions are obtained in the Japanese market.

Mr. Kamori (BM): I think that is exactly the reason for the situation in the Japanese legal market. In the Japanese legal market, for example, in the recent Toshiba case, the audit committee report was prepared by lawyers from a law firm that is considered to be one of the best in Japan. Moreover, forensics were also conducted. However, only four people investigated the case, and they did not use a large number of associates (lawyers), nor did they use AI, which resulted in that kind of content in the report. If independent investigators appointed by Effissimo had issued a report on the same issue, the result would have been different. I think that's a pretty big budgetary issue as well. I'm sure it would cost several hundred million yen, but I don't think it exceeded one billion yen, but the lawyers who prepared the report for the audit committee probably cost several tens of millions at most[6]. Of course, it's not just a question of money, but also a question of how far to go. In the U.S., MBOs are quite rare. This is because they are very risky. Class actions occur almost without exception. You could say that it always happens. That is why they almost always end up in court. We do it in anticipation of that. In the U.S., we still have several MBOs a year, but there will be litigations. It is easy to understand if you think that in the case of litigations in the U.S., the lawyers of a kind who are like those who prepared the report of the audit committee of Toshiba would not emerge, but the ones of a kind who are like those appointed by Effissimo, and who would go to the maximum[7] would

[6] In terms of the accuracy of the report's content.

[7] This issue also leads to the question of who the lawyer/law firm is acting for when it is asked by the management (or audit committee) of the company to conduct an investigation. In other words, in such a case, the client is the company and not the management (or audit committee) (this may be different if the management (or audit committee) clearly states that the client is itself and not the company, and the person who is reached by the client accepts it, but otherwise the company is the client). In the U.S., the idea that a company belongs to its shareholders is so thoroughly established that lawyers have no choice but to hesitate to act without considering the interests of minority shareholders. In Japan, on the other hand, the idea that a company belongs to its shareholders is not always thoroughly understood by lawyers, and they may "consider" the interests of those who have directly requested them (the management team (or the audit committee)) and would need a lot of courage to prepare reports that are contrary to the results that the requesting party (the management team (or the audit committee)) would want. In Japan, it is not uncommon for a report to be prepared

emerge.

Participant A: You do it at that level?

Mr. Kamori (BM): We do it at that level. The court will allow you to do it at that level[8]. And then it's a question of who's going to pay the fees, but we always go to that level anyway. With that in mind, it would be rather unbelievable not to get a fairness opinion in a situation where conflict of interest could be an issue. In the U.S., when a special committee is formed, they usually ask one of the law firms, even if it is the law firm that they usually use, to give their opinion on who would be suitable as a member of the special committee from the independent directors[9], and then the special committee is formed in a way that respects that opinion. At that time, usually only the independent directors are considered as members. The independent directors are more like businessmen who are there to make business judgments. Usually, unlike in Japan, lawyers and accountants are not members of special committees (because they are not business professionals). Independent directors should be members. After the special committee is

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that might lead one to assume that the preparers (lawyers) make a conclusion before starting their investigation that would not be contrary to the results that the requesting individuals (management or audit committee) would desire. It takes a lot of courage to prepare a report that is contrary to the outcome that the requesting party (management (or audit committee)) would have desired. This is because doing so will usually result in the loss of the lawyer's client (the company). However, the top lawyers/law firms in the U.S. will do it if they think it is necessary. If it is discovered that they did not do so when it was necessary, not only the lawyers but also the law firm to which they belong will lose credibility in the entire legal market. In this regard, in the U.S., it is clearly understood that the law firm receives the work, not the lawyer, and the report is issued in the name of the law firm (even though the names of the partners and associates in charge are also mentioned). In Japan, not only the names of the lawyers but also the name of the firm is written in the report, but the report is considered persistently to have been prepared in the names of the lawyers and not the firm. In the U.S., if a report whose content is not reasonable is prepared without AI-used digital forensics investigations being fully conducted as against a substantial number of human targets by having an appropriate amount of time being spent, the firm, as a whole, in charge would lose credibility in the legal market as a whole, which would cause the firm to suffer a far greater amount of damages than if it loses only the client in question.

[8] If a court is involved.

[9] In Japan, there seems to be a tendency to think that an outside director is independent of management, but in the U.S., only an independent person who has no real interest in the company can be a non-executive director, so the term "independent director" is used to clarify this point.

formed, always choose a law firm for the special committee itself. This law firm may be the law firm that was first asked by the company to form the special committee, or it may be another law firm. The MBO is negotiated through communication with this law firm. The difference between Japan and the U.S. in the area of forensics is the privilege of confidentiality, which means that the communication between the lawyer and the client can be kept confidential. In quite a few cases, you would make the lawyers cc'ed. That is very strong compared to having no protection whatsoever. The other party's attorney can argue that it is not necessary to submit the information to forensics because it is subject to privilege[10]. The other side's lawyers will come up with all sorts of ways to get around that. In the U.S., a special committee usually has the authority to make substantive decisions on whether or not to engage in a transaction (including MBOs) where there is a potential conflict of interest. It would be practically difficult for the board of directors to overturn the conclusion of the special committee without clear and reasonable support. It may be possible to make a commitment with the board in advance that the conclusions of the special committee will be the board's conclusions unless they are clearly unreasonable. It is usually the case that if the special committee says something, the board will not just let it be heard as an opinion. As I said earlier, there will always be lawsuits, so it is clear that as a board member you will be a defendant, almost always. Then, you want to take as little responsibility as possible. Independent directors are proper businessmen. It is normal for the board to select independent directors who can make sound business judgments as members of the special committee, let them make decisions, and accept their decisions as the board. It is also possible that the decision to accept the decision is made in advance when the special committee is formed. In that case, if the special committee does not have a fairness opinion - since (i) there is a process called "Entire Fairness" and a method called the "Business Judgment Rule" in the U.S., and (ii) in

[10] Taking this into account, the management of Japanese companies, which are not granted confidentiality privilege regarding their interactions with lawyers, are in an extremely dangerous position compared to their counterparts in the US, while in Japan, Article 316(1) of the Companies Act gives strong authority to independent investigators. In Japan, unless the law is amended to establish attorney-client privilege as soon as possible, the management's thinking itself will become transparent to the other party (activists and, in some cases, special or third-party committees). This may make it difficult for the management team to have free and vigorous discussions to protect the company from undesirable forces.

principle, Entire Fairness is applied to issues involving conflicts of interest[11] - such situation itself would be deemed problematic. In the U.S., an MBO does not always mean cash as consideration, sometimes stock is used as consideration. In Japan, the tax system has recently changed, but there may be no MBO transactions where the consideration was stock, but almost always it was cash. In the U.S., the board is obligated to sell to the highest bidder under the Revlon rule, so I said that a market check may not be necessary[12] in the case in question. However, for those who are leaving with cash, i.e., minority shareholders (in the case of cash) - in this case, Baring made an offer of 2,000 yen one day before the completion of the offer -, I wonder if they have to follow the Revlon rule (for example, the Revlon rule says that if a higher offer comes in after the agreement is signed, that offer will take priority). However, it may not be common knowledge in the US that the Revlon rule applies to MBOs[13].[14] At the very least, regardless of whether an offer of a higher amount is made or not made, a fairness opinion must be obtained, otherwise the board members would not be persuaded. The members of the special committee would not be persuaded, either. If you don't get a fairness opinion, the members of the special committee will probably resign. If we can make a perfect presentation that we are doing Entire Fairness in a lawsuit, we can win, but if we fall short even a little bit, we may lose. If the presentation is not perfect, you may lose the case, in which case the amount of damages you would be required to compensate may be huge. Of course, directors' indemnity insurance covers the loss, but the exception to this is in cases of willful misconduct or gross negligence, and if the director loses, he or she will not be able to serve as an independent director elsewhere. For this reason, in the U.S., the practice of always obtaining a fairness opinion is thoroughly practiced. In Japan, as I mentioned earlier, you can file a

[11] Entire fairness, when applicable, always requires that a fairness opinion be obtained.
[12] However, in the case of Nichii Gakkan, it is not always clear whether this can be said, since an offer of 2,000 yen was submitted by Baring Private Equity Asia on the day before the closing date of the tender offer.
[13] MBOs where the consideration is cash. With respect to an MBO, the application of a business judgment rule is permitted if extremely rigid conditions are satisfied, but otherwise, Entire Fairness (pursuant to which, practically, obtaining a fairness opinion is required) is applied.
[14] According to our research after the June 29, 2021 web conference, it is our understanding that the Revlon rule may apply in many cases to MBOs with cash consideration in the US.

lawsuit for 8,200 yen in revenue stamps under the system of shareholder derivative suits, but this only means that the money will be returned to the company, not to you. You can file a lawsuit to get the money for yourself, but in the case of 10 billion yen, you will have to pay about 16 million yen for the stamps, and there is the question of whether the person filing the lawsuit can hire a high-level lawyer. Of course, there are many lawyers who can do this, but whether they have the manpower and skills to really win a case against a company is a very difficult question in Japan. Even if such situation is factored into the equation, the people who provide fairness opinions would become nervous about actually providing one even in Japan, and their fees would be reasonably substantial, and the more diligent they are, the more fees they charge. They are also afraid if they don't use lawyers and accountants to do due diligence, so even in Japan, if the transaction is large enough, they will demand a substantial amount of money when they are asked to provide a fairness opinion. Furthermore, I think that keeping the fees low can only be agreed upon if the client is aware of the increased risk. In any case, there is a limit to how low the fees can be kept. In addition, if the results are not good enough from the buyer's point of view, the transaction will not be possible. Owing to there having been many events of fighting each other, MBO transactions have become decreased in the U.S. It would, in the first place, be considerably difficult to find a company that will give a fairness opinion, and doing so would require considerable courage. Such a company will always be the defendant if there is a lawsuit. In particular, legal fees are high, and when obtaining a fairness opinion, the fees of the lawfirms hired by investment banks or other firms providing fairness opinions are particularly high in the U.S., so the overall cost would become considerably high. In Japan, there used to be transactions in which a fairness opinion was properly obtained, such as Sony's several decades ago, but they were not highlighted, and even if s fairness opinion was not obtained, many transactions were completed and no lawsuits were filed, so many people in Japan appear to think that there is no need to obtain one. However, if Bain hadn't brought Effissimo into the buyer's side, it would have been a completely different story. If the talks with Effissimo had broken down and it was decided that they would not come to the buyer's side, Bain would have either stopped because the risk was too great, or they might have done it, but if they had tried to make a tender offer with a tender offer price of 1,600 tens of yen, Effissimo

would not have remained silent. I think they had to put at least 1,000 yen on top of the 1,600-odd yen, and if they wanted to complete the MBO even after the talks with Effissimo had broken down, they would have had to get a fairness opinion and arm themselves accordingly.[15]

Participant A: Thank you very much. I understand now.

The conference was concluded thereafter. Blakemore & Mitsuki will host three additional web conferences analyzing topics the focus of which would be acquisitions of Japan target companies by US PE firms, in the coming months.

The responsible partner for this briefing is Akimitsu Kamori (Email: a-kamori@blakemore.gr.jp; Tel. (81-3) 3503-5591).

The attendees to this conference from Blakemore & Mitsuki are set forth on the next page.

[15] In the case of Nichii Gakkan, the fact that there were no conspicuous funds/institutional investors other than Effissimo was probably another factor that reduced the incentive for the buyer side to take a fairness opinion. In Japan, too, if an institutional investor accepts without saying anything about an MBO in which a fairness opinion was not obtained because of a takeover bid with a fairly strong element of conflict of interest, as in the case of Nichii Gakkan, and in which the takeover bid price was 290 yen per share lower than the high price of about six months earlier, its investors may complain to that institutional investor. In addition, considering that the weight of responsibility of outside (non-executive) directors will increase in the future as a result of the recent turmoil at Toshiba and other factors, it is likely that there will be more cases where outside (non-executive) directors will demand that a fairness opinion be obtained even if the management/buyer side says that a fairness opinion is unnecessary.

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