ACQUISITION OF JAPANESE COMPANY BY US PE FIRM

On December 10, 2022, Blakemore & Mitsuki hosted a web-conference with a large Japanese financial institution and a major US law firm to analyze a simulated stock purchase transaction involving a seller of a Japanese corporation, a buyer and its parent (each of such buyer and parent was assumed to be a subsidiary of a US PE firm).

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Brief Minutes of Web Conference (December 10, 2021)

On December 10, 2021, Blakemore & Mitsuki hosted a web conference with a large Japanese financial institution to discuss a simulated acquisition of a privately held Japanese target company by a US private equity fund. The participants were two personnel from such financial institution, a partner (the "**US Expert**") of a US-based international law firm, Akimitsu Kamori, a partner of Blakemore & Mitsuki, Munehiko Watanabe, a partner of Blakemore & Mitsuki, Atsushi Tsujii, an associate of Blakemore & Mitsuki, and Mark Stockwell, a foreign attorney (*gaikokuho-jimu-bengoshi*) of Blakemore & Mitsuki. Yasuo Shida, a partner of Blakemore & Mitsuki, was not able to participate due to unavoidable circumstances but contributed his capabilities relating to tax matters in connection with this web conference.

Following the introduction of the participants to the conference, Mr. Kamori was joined by the US Expert and Mr. Mark Stockwell to discuss relevant provisions of a simulated stock purchase agreement.

Mr. Kamori first discussed certain definitions pertinent to determining the scope of the non-competition obligation applicable to the seller. He noted competition by a seller may be prohibited in Japan and the scope of the prohibition would depend on the negotiating strength of each party.

The US Expert noted buyers tend to seek broad restrictions on scope, duration and territory but if too broad, the non-competition obligation may be unenforceable depending on the governing law under the purchase agreement and jurisdiction in question. Typically, in US deals, the obligation is limited to the territories where the target company currently operates and locations where the target company has plans to expand its operations. In such cases, under Delaware law, assuming that the seller is receiving adequate consideration in the sale transaction, the non-competition obligation is more likely to be upheld.

A participant from the financial institution asked whether rollover ownership should be excluded from the definition of what constitutes a competing business. The simulated purchase agreement contained a rollover component. The US Expert confirmed that it is best to explicitly do so, but the failure to do so is probably of no practical consequence because the buyer is unlikely to sue its rollover partners for their continued ownership in the post-closing business. He further noted that in deals where both the buyer and seller are private equity firms, there is usually no non-competition obligation but instead only non-solicitation, no-hire and/or non-disparagement obligations.

Mr. Kamori noted the de minimis carve out for ownership in publicly traded companies.

The discussion then moved to working capital. Mr. Kamori noted that the definitions of “Current Assets” and “Current Liabilities” used to determine “Working Capital” had specific exclusions and how those exclusions interacted with other definitions for purposes of determining the ultimate consideration payable to the seller.

The US Expert noted the definitions of “Current Assets” and “Current Liabilities” are heavily negotiated and the outcome will depend on the negotiating power of the parties. He stated that the current seller’s market in the US favors listing each component of the definitions on a schedule, and buyers are generally agreeable to such approach in competitive deals. By doing so, there is less chance for a working capital dispute because the parties will have agreed on the specific line items that will be included and excluded from Working Capital. In a buyer’s market, the buyer will often want to define “Current Assets” and “Current Liabilities” according to generally accepted accounting principles (GAAP) and use the flexibility of GAAP during the final working capital adjustment to determine the components of Working Capital in a manner that is more favorable to buyer, notwithstanding the fact that the seller may have historically used different methodologies under GAAP.

Mr. Kamori noted that “GAAP” was not defined as being consistent with the seller’s past accounting practices and that if the seller’s financial statements are not audited, then any deviations from GAAP should be scheduled.

The US Expert noted that depending on Working Capital negotiations between the buyer and seller, the sample calculation may or may not be binding on the parties.

Mr. Kamori queried whether a US private equity fund would expect the definition of "GAAP" to be based on US GAAP rather than Japan GAAP if the fund translates the Japanese financial statements and uses US GAAP for its financial analysis of the target company. The US Expert thought it may be done for diligence and financial analysis but the seller typically wouldn't be expected to make representations and warranties under a different country's GAAP in the event that the target company's financial statements are audited under Japan GAAP.

Mr. Kamori then noted certain items included in the definition of "Indebtedness," namely deferred revenue and bonus-related liabilities. The US Expert noted this definition is heavily negotiated and often these items are addressed through working capital instead. If these items are included in "Indebtedness," there is a dollar-for-dollar reduction in the purchase price; if in working capital, there may be no reduction. Therefore, buyers like to include these items in "Indebtedness."

Mr. Kamori then noted the reasonable inquiry requirement in the definition of "Knowledge." The US Expert noted the seller's effort to narrow the breadth of the definition will depend on the indemnification exposure of the seller. A seller may attempt to limit the definition to actual versus constructive knowledge. The knowledge group will almost always include the CEO, CFO and COO and, depending on the target company's business, may include, for example, the CTO for a technology company or operations personnel in a manufacturing business.

Mr. Kamori queried who ultimately determines whether there was "Knowledge" for purposes of a breach of a representation? The US Expert said it would be a fact-based determination based on the governing law of the purchase agreement.

Mr. Kamori then noted the division of the cost of the representation and warranty insurance policy (R&W policy) and directors and officers tail insurance policy (D&O policy). The US Expert noted the premium for the R&W policy is essentially just additional purchase price. In a seller's market, one tends to see buyers paying the premium and underwriting fees and, in a buyer's market, the premium is often split equally. The premium for the D&O

policy is usually paid by the seller but can be viewed as a purchase price adjustment as well.

The US Expert then noted the difference between accrued versus unaccrued bonuses that affect the purchase price. Accrued bonuses are typically accounted for in "Indebtedness" or "Current Liabilities." Certain unaccrued liabilities, such as transaction-based bonuses don't appear on the balance sheet and are typically included in "Seller Transaction Expenses."

Mr. Kamori noted R&W policies are uncommon in Japan.

The US Expert briefly described the process of obtaining a R&W policy. The underwriter will perform diligence based on buyer's due diligence report. The underwriter often issues the R&W policy at closing but sometimes at signing. R&W policies generally have a policy limit of 10-20% of the enterprise value of the target and a deductible/retention of 1%. The R&W policy covers breaches of representations and warranties of the seller and the target company. Mr. Kamori enquired about whether the insurer would pursue the seller on claims paid, but the US Expert noted only in the case of fraud.

The US Expert noted the simulated purchase agreement contained an earn-out. He noted sellers disfavor earn-outs because they no longer control the target company. Sellers should try to negotiate earn-outs based on revenue (rather than EBITDA or similar earnings metrics) to eliminate the lack of control over operating expenses. In the simulated purchase agreement, the earn-out was based on a gross multiple of invested capital (MoIC). The US Expert noted this metric can align the incentives of the buyer and seller so it was a reasonable compromise in the simulated purchase agreement.

Mr. Kamori queried if a seller should prefer MoIC to other metrics for determining an earn-out. The US Expert noted MoIC requires an exit so there is no certainty on the timing of payment of the earn-out compared to using a metric like revenue. The US Expert opined that revenue is probably the best choice for a seller.

A participant from the financial institution asked whether a buyer's obligation to pay the earn-out ever expires when using MoIC. The US Expert stated that a MoIC earnout typically does not expire unless the MoIC thresholds are not met at exist. Typically, non-MoIC earn-outs are determined within three years to bridge a valuation gap in the near term. That is why MoIC is less common due to the uncertainty of when the exit will occur.

A participant from the financial institution asked how MoIC would be calculated if the buyer sells non-core assets. The US Expert noted the definition of "MoIC" in the simulated purchase agreement required a full exit so the sale of non-core assets did not favor the earn-out in such a case. This is a point a seller should negotiate to protect itself. However, if the cash obtained from a sale of non-core assets is not distributed and retained by the target company, that cash should ultimately be factored into the MoIC calculation at exit.

The US Expert addressed post-closing operation of the business again and noted the provision tends to be heavily negotiated and sellers try to impose some control. But buyers almost always have nearly full discretion to operate the business post-closing but will agree to operate in good faith and not intentionally circumvent the seller's ability to earn the earn-out.

Mr. Kamori noted the earn-out is also subordinated to third-party financing but since the earn-out is based on MoIC, it would likely be paid on exit so the subordination was not a problem for the seller. The US Expert noted sellers may ask to see the buyer's credit agreement but most do not. As encouragement to promptly pay the earn-out, a seller may require that if the earn-out is earned and not paid due to subordination, then the seller receives interest on the unpaid subordinated amount.

Mr. Kamori noted the representations and warranties about the target company were customary for a stock purchase transaction. The US Expert noted in the current market in the US, where many buyers rely solely on a R&W policy, the representations and warranties are not heavily negotiated; if a seller has more exposure, though, the seller will try to negotiate more narrow representations and warranties. However, in deals with a R&W policy, sellers should be more amenable to giving reasonably broad representations and warranties requested by buyer, except where seller has concern regarding fraud claims or significant disclosure burden, so that buyer can obtain meaningful coverage under the R&W policy.

Mr. Kamori noted if all requested representations and warranties from the seller are given because of R&W policy coverage, then the insurer will pay close attention to the scope of representations and warranties.

The US Expert agreed and noted the insurer will exclude coverage for items discovered through diligence or that buyer has knowledge of and may even modify off-market representations and warranties for purposes of coverage under the policy.

With respect to the “NO OTHER REPRESENTATION” provision, The US Expert noted this representation has become standard in the US market and that if a buyer wants to rely on any statements or other materials, it needs to be in the purchase agreement.

The discussion then turned to indemnification. Mr. Kamori noted the varying survival periods for certain representations and warranties. The US Expert noted the US market regarding survival has dramatically changed recently, and he is currently seeing “clean walk” deals with no survival other than for fraud more often. Often, fundamental representations and warranties survive six years which is the length of survival for such representations under the R&W policy, the tax representation survival period is typically negotiated but is often the statute of limitations plus some tolling period, and general representations typically survive 12 months, which matches the period at which time the deductible/retention drops down from 1% of enterprise value to 50 bps under the R&W policy.

Mr. Kamori noted the so-called materiality scrape in the indemnity. The US Expert explained the scrape means you read the representations and warranties without materiality qualifiers. When a single scrape is used, materiality is read out when determining breach but is kept for determining the amount of damages. The simulated purchase agreement contained a double scrape, which ignores materiality qualifiers for both purposes of determining breach and losses. For purposes of coverage under the R&W policy, a double scrape is preferred, it is “market” for R&W insurers to accept a double scrape as long as the purchase agreement contains a double scrape, and most sellers will agree to a double scrape since sellers have limited exposure in the indemnity under the purchase agreement.

The US Expert noted that the specific indemnity for Seller Transaction Expenses and Indebtedness may seem contrary to the finality of the final balance sheet prepared for the final working capital adjustment, but these items are really purchase price items that merit indemnification.

With respect to the caps and baskets on indemnification, the US Expert noted that these items are always negotiated points but the market has trended to basing these amounts on the R&W policy. The deductible/retention under the R&W policy is typically 1% of enterprise value of the target company which is the risk borne by the parties before the R&W policy coverage begins. The current US market has developed such that the buyer and the seller share the 1%. The basket allocates the first 50 bps to the buyer and the cap allocates the second 50 bps to seller.[1] However, the 50 bps cap typically only applies to "general representations," but not fundamental representations, pre-closing taxes, covenants or other specific indemnity items. An amount of the purchase price representing the seller's risk is escrowed to cover indemnification claims. Additional funds may be escrowed in the event that specific risks are identified in diligence and/or if the R&W insurer excludes items from coverage under the R&W policy.

Mr. Kamori noted the priority of recovery for indemnification claims, including recourse to the R&W policy after initially exhausting the general indemnification escrow funds but before any other sources. The US Expert noted this provision is heavily negotiated; sellers want exclusive reliance on the R&W policy, but the carve-outs in the simulated purchase agreement are typically included.

Mr. Kamori noted the obligation to indemnify for pre-closing taxes of the target company in the simulated purchase agreement. The US Expert noted that about half of deals in the current US market contain no specific indemnity for pre-closing taxes. Such an indemnity is more often seen when the target company is a corporation that pays entity-level taxes. With a flow-through entity there is less concern, except with respect to sales and use taxes.

That concluded the discussion on the simulated purchase agreement. Thereafter, Mr. Kamori briefly discussed the acquisition structure of the Nichigakkan tender offer that was the subject matter of the web conference Blakemore & Mitsuki hosted with the financial institution on June 29, 2021. He explained the layered partnership structure used in the tender offer was likely done with two possibilities in mind: first, to make decisions at a lower tier without the need for upper tier approval and, second, for US tax purposes.

There were no further questions and the conference concluded thereafter. Blakemore & Mitsuki will host two additional web conferences analyzing topics the focus of which will be determined later, in the coming months.

Blakemore & Mitsuki is grateful for (i) the financial institution's participation in the discussion and (ii) The US Expert's participation in the presentation

[1] The buyer would not be entitled to recover for losses until the cumulative losses exceed 0.5% of the purchase price. After that point, the seller would be obligated to indemnify the buyer until the cap is reached, which is an amount equal to 0.5% of the purchase price.

and assistance in preparing the materials for the web conference.

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 below.

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