Appendix 3

# Overview of Regulations and Practices in the U.S. Relating to MBOs and Subsidiary Conversions by Controlling Shareholders

Tokyo Stock Exchange  Listing Department

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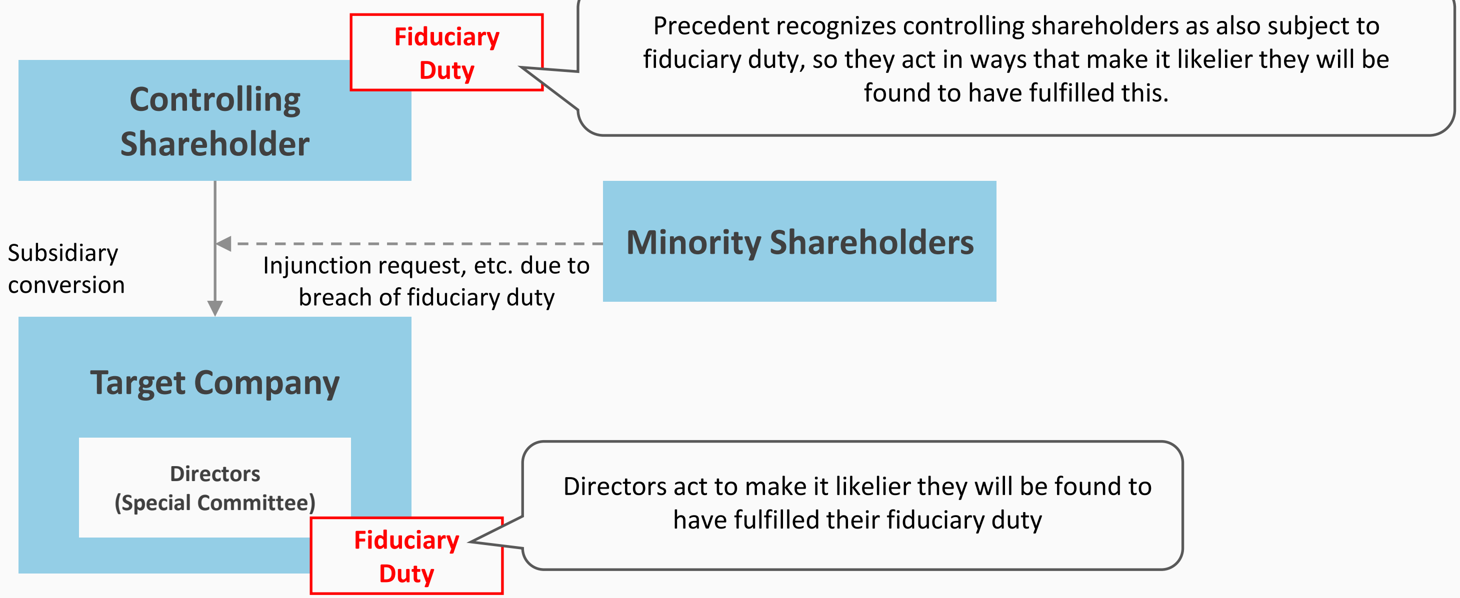
# Regulatory Framework in the U.S.

# Basic Regulatory Framework in the U.S.

- In the U.S., for transactions which squeeze out minority shareholders such as MBOs and subsidiary conversions by the controlling shareholder, the **fairness of the purchase price is ensured** by **imposing a fiduciary duty on the directors/controlling shareholder of the company being bought (hereinafter referred to as the "target company")**, and by **having a court strictly examine whether the fiduciary duty has been violated**.
  - If the price received was too low, it is **normal for injunction requests and requests for damages to be brought by class action** (if the shareholders win the case, it is possible for all the minority shareholders to receive damages after the fact).
- The discussion on whether a case should be recognized as a breach of fiduciary duty **is done by putting together previous examples of court decisions on specific cases, so the law of precedent plays a major role**.
  - Since many listed companies are incorporated under Delaware law, precedents from the Delaware Court of Chancery serve as the basis in practice.

**(Subsidiary conversions by a controlling shareholder)**



# Judicial Review Standards for Squeeze-outs of Minority Shareholders by Controlling Shareholder and MBOs (1)

- Under Delaware precedent, in a squeeze-out of minority shareholders by a controlling shareholder, the **"entire fairness standard," the most stringent standard of review for the fiduciary duty of a board member, is generally applied**.

| Entire Fairness Standard | • The **strictest standard for fair transactions**, applied mainly to **situations in which it is deemed that the independence of a board of directors' judgment is materially affected by a director's conflict of interest**.<br>• The **director has the burden of proof to demonstrate that the transaction is entirely fair to shareholders, both in terms of fair dealing and fair price**. |
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- However, if certain requirements are deemed to have been met, the criteria will be relaxed to the business judgement rule.

| Business Judgement Rule | • The **default criteria for breach of fiduciary duty with respect to actions taken by an independent director who is free from conflict of interest**.<br>➢ This is based on the idea of respecting the judgment of the board in order not to discourage it from taking risky actions in order to maximize the company's profits.<br>• The rule for the court's deliberations is that, **in making a business decision, the director is presumed to have acted (1) on an informed basis, (2) in good faith, and (3) in the honest belief that the decision was taken in the best interests of the company**.<br>• If a majority of the directors are entitled to the protection of the business judgment rule, the breach of fiduciary duty is basically **judged on the basis of whether there was gross negligence**. |
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# Judicial Review Standards for Squeeze-outs of Minority Shareholders by Controlling Shareholder and MBOs (2)

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- While the examination criteria for MBOs are not as well formulated as those for squeeze-outs by controlling shareholders, **when the entire fairness standard is applied due to an issue with a director's conflict of interest, the criteria will be relaxed to the business judgement rule if the same certain requirements are found to have been met**.
- **The Revlon rule may be applied** in cases where there is a shift in control of the target company close before or after the transaction.

| Revlon Rule | |
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| | • A standard for examining whether a director has **made a reasonable effort to obtain the highest price attainable for the benefit of shareholders** in an acquisition for cash or an acquisition resulting in a transfer of control of the company (stricter than the business judgement rule).<br>➢ This is based on the idea that the current stock price, not the long-term stock price, must be maximized for the sake of shareholders who will be unable to maintain their position as shareholders.<br>• The **director must prove both (1) the appropriateness of their decision-making procedures and (2) the reasonableness of the director's decision in light of the circumstances at the time the decision was made.** |

- ➢ For both squeeze-outs by a controlling shareholder and MBOs, when it comes to court, the director will first **look to prove that the business judgement rule will be deemed as applicable**.
- ➢ In anticipation of such a situation, at the time of the transaction, they will try to **make sure that the requirements for obtaining a relaxation to the business judgement rule are met** in practice.

# Requirements for Relaxation to the Business Judgement Rule

- Under Delaware precedent, in order for the standard of review to be relaxed from the entire fairness standard to the business judgement rule, it is generally required that **both (1) approval of the special committee and (2) approval of a majority of minority shareholders (MoM) are prerequisites for the transaction to proceed**.

## MFW Judgment (2014)

- In the MFW case, the Delaware Supreme Court held that in order to qualify for relaxation to the business judgement rule from the entire fairness standard in a case involving a squeeze-out merger by a controlling shareholder, **all of** the following six requirements must be met.

1. That the **approval of the special committee and the approval of the MoM** are prerequisites for the controlling shareholder to proceed with the transaction
2. That the **special committee is independent**
3. That the special committee is **free to appoint its own advisors**, and is not just given the **power to definitively reject** the merger, but has the **freedom to exercise this power in practice**
4. That the special committee **meets its duty of care in negotiating a fair price**
5. That the vote of minority shareholders **is informed**
6. That there is **no coercion of minority shareholders (pressure exerted on them to accept the proposal).**

- Explaining why the two procedural protections of the special committee's approval and MoM's approval are both required, the case cites the synergy that comes from their complementary effects.

# (Ref.) Shift of Burden of Proof Under Entire Fairness Standard

- Even in cases where the standard of review is not relaxed from the entire fairness standard to the business judgement rule, if **either of** the requirements of **(1) approval by the Special Committee or (2) approval by the MoM is satisfied**, it is recognized that the burden of proof regarding entire fairness shifts to the plaintiffs – the minority shareholders.

## Lynch Judgement (1994)

- In the Lynch case, the Delaware Supreme Court held that in a case involving an attempted squeeze-out merger by a controlling shareholder, **approval by a special committee of independent directors of the target company <u>or</u> approval by an MoM** would shift the burden of proof for entire fairness to the plaintiff.
- For the burden of proof to be shifted, at least the following two requirements had to be met:
  1. The controlling shareholder must not dictate the terms of the merger.
  2. The special committee must have genuine bargaining power to negotiate with the controlling shareholder on an equal footing.

➢ In this case, as a result of the fact-finding hearing, the special committee was found not to have genuine bargaining power to negotiate with the controlling shareholder on an equal footing (the controlling shareholder threatened to make a hostile TOB to the target company if its board of directors did not agree to the proposal, and the special committee, in response to this threat, agreed to the proposal).

# (Ref.) Application of MFW Framework to Transactions Other Than Squeeze-Outs

- In a recent Delaware precedent, the court held that transactions other than squeeze-outs by a controlling shareholder (a transaction in which the controlling shareholder can be judged to have stood on both sides and received a disproportionate benefit) would also require **(1) approval of the special committee and (2) approval of an MoM to be prerequisites for the transaction to proceed** in order to be eligible for relaxation from the entire fairness standard to the business judgement rule.

## Match Judgment (2024)

- In a case of a reverse spinoff by the controlling shareholder, the Delaware Supreme Court held that the **MFW framework, which requires both (1) special committee approval and (2) MoM approval as prerequisites** for the transaction to proceed in order to relax the standard of review from the entire fairness standard to the business judgement rule**, is not limited to controlling shareholder squeeze-outs.**

➢ In this case,

The plaintiffs argued that the **MFW framework should be applied to transactions with controlling shareholders other than squeeze-outs**, and that the business judgement rule was not appropriate in this case given that there were issues with the independence of the special committee and that the shareholder vote was conducted without sufficient information about the independence of the committee members.

The defendants countered that for transactions other than squeeze-outs, **either (1) approval by the special committee <u>or</u> (2) approval by an MOM should be sufficient**, and that there was no problem with the independence of the special committee.

# Ensuring Fairness in Practice

# Establishing Special Committees in Practice

- In a MBO or squeeze-out by a controlling shareholder, since the examination standards regarding the fiduciary duty of directors are relaxed when the approval of a special committee is a precondition for the transaction to proceed, it is **normal for a special committee consisting of independent directors to be established.**
  - ➢ The special committee **appoints its own advisors**, **negotiates with the offeror**, and has the **power (in practice) to make a decision on the transaction**.

### Overview of Special Committees in the U.S.

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| Timing of Establishment | • **Established at an early stage, prior to substantive negotiations** |
| Composition | • **Composed of independent directors**<br>➢ Independent legal advisors determine the suitability of each outside director to serve as a special committee member (distribute a questionnaire to directors on their backgrounds, mutual relationships, and other aspects to identify potential, actual, or perceived conflicts of interest).<br>➢ Under Delaware law, the determination of independence is based not only on financial relationships, such as transactions of a certain size, but also on social relationships. |
| Role | • As approval by the special committee is a prerequisite for the transaction to proceed, it **has the power to make a decision in practice**.<br>• The committee **negotiates independently** as a representative of the company (depending on the circumstances, the **special committee members may negotiate directly or through their own legal or financial advisors** ) |
| Appointment of Independent Advisors | • The special committee has the authority to **appoint its own legal and financial advisors** who are not legal or financial advisors to the target company.<br>• It is typical for the special committee request its own financial advisor to consider whether there are better alternatives and whether the price is fair by performing a market check and preparing a fairness opinion, with the **independent financial advisor directing the entire process**. |

# (Ref.) Typical Flow of M&A With Conflict of Interest

| Board of Target Company | Special Committee (SC) | Special Committee's Advisors |
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| 1. Board requests an independent legal advisor (LA) that is not the company's LA to establish SC (before transaction negotiations start)<br>■ Independent LA determines suitability of each outside director for the SC | 2. After establishment, SC appoints its own LA (usually the LA that established the committee for the company) and FA<br>■ As preconditions for ensuring a SC with adequate effectiveness, aspects such as the following are necessary: that the transaction cannot proceed without the SC's approval; that the SC can contact other candidates for the takeover; that there must be approval from an MoM, that the SC holds the power to definitively refuse the transaction in practice; that the SC has a duty of care to negotiate a fair price.<br>■ SC requests a market check and a stand-alone case calculation from its own FA | 3. (FA) Carries out market check, feeds back to SC, carries out or considers further negotiations with third parties or completing the transaction |
| | 4. Concurrently with the above, negotiates with offeror side (including price)<br>■ Records all progress of negotiations<br>■ Also requests the writing of a fairness opinion from its own FA and examination of this from its own LA | 5. Writes, submits, examines, explains fairness opinion<br>■ (FA) Writes/submits<br>■ (LA) Examines<br>■ (FA) Explains to SC, including the valuation |
| 7. Based on report from SC, resolves whether to approve the conflict-of-interest transaction (including whether to choose a transaction with another third party or to continue management as an independent company (stand-alone case)) | 6. Based on above opinion and explanation from advisors, makes decision and reports this to the board as the decision/resolution of the SC (including what choice the target company should make) | The SC will need from one to several months to complete the whole process, depending on the case (especially the negotiations and market check process) |

(Source) METI, Fair Acquisition Study Group - White & Case LLP "Overseas legislative investigation on M&A with conflicts of interest (interim report)" October 1, 2019

# Setting Majority of Minority Conditions in Practice

- In a MBO or squeeze-out by a controlling shareholder, since the examination standards regarding the fiduciary duty of directors are relaxed when the approval of a majority of minority shareholders (MoM) is a precondition for the transaction to proceed, it is **normal for an MoM condition to be set**.

## Setting of MoM Conditions in the U.S.

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| **One step merger: MoM of the general shareholders' meeting** | • The "minority" at the general shareholders' meeting for a one-step merger is the **number of voting rights executed at said meeting that are attached to shares held by "disinterested" shareholders**<br>■ Shares held by "disinterested" shareholders are, in general, shares other than those held by shareholders with a conflict of interest, the management of the company, and directors who approved the transaction.<br>■ Which shareholders count as disinterested is decided based on the specific facts/circumstances of each case given the relationships between said shareholders and related parties, in line with Delaware case law related to MoMs.<br>• The "majority" at the general shareholders' meeting for a one-step merger is the majority of voting rights of disinterested shareholders who voted (including by proxy) to approve the transaction at said meeting.<br>• In a merger agreement, approval by a MoM of disinterested shareholders is prescribed as a condition for closing, and the number of voting rights needed for approval is repeatedly explained in the proxy statement to make sure it stands out. |
| **Two-step merger: MoM of the tender offer** | • The "minority" in a tender offer is the **shares of the company which is the target of the offer** (excluding those held by related parties, etc.). These are counted whether or not the holder applies.<br>• The "majority" in a tender offer is the number of shares for which the holder applies.<br>• This differs from the general shareholders' meeting for a one-step merger in that shareholders who do not apply (those who do not take any action) are included in the minority, but this is not considered problematic in practice. |

(Source) METI, Fair Acquisition Study Group
White & Case LLP "Overseas legislative investigation on M&A with conflicts of interest (interim report)" October 1, 2019

# Obtaining Fairness Opinions in Practice

- Because **obtaining a fairness opinion is treated as one element that can ensure the fairness of an M&A**, they are **obtained in many M&A transactions, not limited to squeeze-outs of minority shareholders by controlling shareholders**. (Obtaining only a share valuation report from a third party is not common practice.)

➢ Acquisition of a fairness opinion does not immediately absolve a board member from liability, nor, conversely, does the absence of a fairness opinion immediately make the director liable.

## Overview of Fairness Opinions in the U.S.

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| Obtaining Entity | • In many cases, the fairness opinion is **obtained by the board of directors of the target company**.<br>• In a squeeze-out transaction or MBO by a controlling shareholder, in addition to the board of directors, the **special committee also usually asks its own financial advisor to prepare a fairness opinion and its legal advisor to review the opinion**.<br>• When a fairness opinion is submitted, a **share valuation report that serves as the basis for the fairness opinion is also submitted**. |
| Content | • A **judgement on whether the price is fair to shareholders from a financial perspective** (fairness of procedures is not covered) |
| Disclosure | • **Public inspection** through the SEC's disclosure system<br>• In the case of a transaction which intends to take the target company private, disclo**sure of all reports and other documents is required, not just the final versions** |
| Regulatory and legal responsibility regarding issuer | • FINRA regulations **require** a) **disclosure of conflicts of interest regarding the fairness opinion** and b) provisions in internal rules that **set out the types of transactions for which the fairness opinion will require deliberation by a fairness committee** under internal procedures.<br>• For financial advisors, there are cases of being held liable for aiding and abetting violations of a director's fiduciary duty (especially if the financial advisor had an interest in doing so), as well as a **risk of being caught up in reputational problems or litigation as the entity that evaluated the price.** |

# (Ref.) Discussion on Conflicts of Interest at Calculation Agents

- In the U.S., fairness opinions are generally issued by the investment bank handling the M&A.
- It is thought that an investment bank in this case has an **incentive to make the fairness opinion and valuation report favorable to the company, which is also its client**.
  - ➢ Although incentives to raise the price also arise when compensation is structured to be proportional to the purchase price, the former incentive is considered stronger from the perspective of maintaining an ongoing business relationship.
- Although the **use of a second opinion is considered effective to some extent** in addressing these structural problems, **some also doubt its effectiveness due to increased costs and the fact that the investment bank that provides the second opinion cannot be completely independent (there will be a conflict of interest in the business relationship).**
- In response to these issues surrounding conflicts of interest, FINRA enacted Rule 2290 in 2007, which **requires issuers of fairness opinions to disclose conflicts of interest and related information** (now replaced by Rule 5150).

**FINRA Rule 5150. Fairness Opinions**

If at the time a fairness opinion is issued to the board of directors of a company the member issuing the fairness opinion knows or has reason to know that the fairness opinion will be provided or described to the company's public shareholders, the member must disclose in the fairness opinion:
(1) **if the member has acted as a financial advisor to any party to the transaction** that is the subject of the fairness opinion, and, if applicable, that it will receive compensation that is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor;
(2) if the member will receive any other **significant payment or compensation contingent upon the successful completion of the transaction**;
(3) any **material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received** as a result of the relationship between the member and any party to the transaction that is the subject of the fairness opinion;
(4) if **any information that formed a substantial basis for the fairness opinion that was supplied to the member by the company** requesting the opinion concerning the companies that are parties to the **transaction has been independently verified by the member**, and if so, a description of the information or categories of information that were verified;
(5) whether or not the **fairness opinion was approved or issued by a fairness committee**; and
(6) whether or not the fairness opinion expresses **an opinion about the fairness of the amount or nature of the compensation to any of the company's officers, directors or employees, or class of such persons**, relative to the compensation to the public shareholders of the company.

# Market Checks in Practice

- In M&A situations where the Revlon rule may apply, such as MBOs, it is **normal for an active market check (market research to explore the possibility of other takeover bids) to be conducted in order to seek the "highest price reasonably attainable" for shareholders.**

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| Market check before signing the contract | • The target company negotiates with one potential buyer while also contacting many other potential buyers through its financial advisor to explore the possibility of a counter-offer at a higher price.<br>- This is considered a desirable method for finding fair value, and is also commonly used in practice. |
| Market check after signing the contract | • A method in which the target company actively solicits counter-offers for a certain period of time after the conclusion of the agreement (the so-called go-shop period).<br>- This tends to be used in cases where it is difficult to conduct a pre-contract market check (e.g., when a potential buyer strongly demands exclusivity during negotiations, or when the seller is in a very urgent situation and does not have time to conduct a pre-contract market check). |

➢ On the other hand, in transactions such as squeeze-outs by controlling shareholders who already have a majority of voting rights, market checks are not considered necessary as they lack effectiveness as a means of fulfilling the fiduciary duty.

# Regulations on Disclosure of Information

- In the **case of a transaction which intends to take the target company private**, the target company and related parties are **subject to additional disclosure obligations** under Schedule 13E-3 in accordance with SEC Regulation 13E-3, in addition to the normal disclosure requirements for M&A transactions.
- In addition, the board of the target company has incentives to make sufficient disclosure, given that a) the **duty to disclose information to shareholders is recognized as part of directors' fiduciary duty**, and b) in the case of an MBO or squeeze-out by a controlling shareholder, **minority shareholders must have had sufficient information when voting on said M&A in order for the examination standards for fiduciary duty to be relaxed**.

## (Ref.) Disclosure items under Schedule 13E-3

Schedule 13E-3, Transaction statement under section 13(e) of the Securities Exchange Act of 1934 and Rule 13e-3 (§ 240.13e-3) thereunder.

Item 1. Summary Term Sheet
Item 2. Subject Company Information
Item 3. Identity and Background of Filing Person
Item 4. Terms of the Transaction
Item 5. Past Contacts, Transactions, Negotiations and Agreements
Item 6. Purposes of the Transaction and Plans or Proposals
**Item 7. Purposes, Alternatives, Reasons and Effects**
**Item 8. Fairness of the Transaction**
**Item 9. Reports, Opinions, Appraisals and Negotiations**
Item 10. Source and Amounts of Funds or Other Consideration
Item 11. Interest in Securities of the Subject Company
Item 12. The Solicitation or Recommendation
Item 13. Financial Statements
Item 14. Persons/Assets, Retained, Employed, Compensated or Used
Item 15. Additional Information
**Item 16. Exhibits**

✓ The **purposes** of the transaction
✓ If alternative means were considered to accomplish the stated purposes, the **alternatives and the reasons for their rejection**
✓ The **reasons for the structure of the transaction** and for undertaking the transaction at this time
✓ **What effects the transaction will have** on the target company and its general shareholders (detailed description of the benefits and detriments, quantified to the extent practicable).

✓ Whether the target company believes it is **fair to the general shareholders** (if any dissenting directors, the reasons for the dissent)
✓ **Factors considered** in determining fairness
- Includes whether the consideration constitutes fair value in relation to the following prices: current and historical market prices, net book value, going concern value, liquidation value, historical purchase prices, reports from outsiders (fairness opinions), offers in the past two years

✓ Whether the transaction requires **majority-of-minority approval**
✓ Whether the transaction was **approved by a majority of outside directors** of the target company
✓ Whether a majority of outside directors **retained an unaffiliated representative** to act on behalf of general shareholders for negotiating the terms of the transaction

✓ **Whether there is a report (fairness opinion)** by an outside party that is materially related to the transaction
✓ **Preparer** of the report (representative, qualifications, method of selection, existence of material relationships), **whether the consideration to be paid was determined by the target company or recommended by the outside party, summary of the report, etc.** (procedures followed, findings/recommendations, basis, instructions from the target company, limitations in the scope of analysis, etc.)
➢ The above **report itself must be attached** to Item 16 (all reports/related documents, not just the final versions).

# Reference Documents

(All except the last two are available in Japanese only)


- White & Case LLP, "Overseas legislative investigation on M&A with conflicts of interest (interim report)," https://www.meti.go.jp/shingikai/economy/fair_ma/pdf/003_03_00.pdf (2019)
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- Okubo Ryo, Isaji Ryosuke, and Alexander Russo, "Update on Recent M&A Precedents in Delaware: First Half of 2023," Nagashima Ohno & Tsunematsu, LLP https://www.noandt.com/publications/publication20231122-2/ (2023)
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- Nagae Wataru, "The Development of the Debate over Fairness Opinions in the United States (1)," Nanzan Hogaku, Vol. 47, No. 1 (2023)
- Harvard Law School Forum on Corporate Governance "Going Private Transactions," https://corpgov.law.harvard.edu/2020/04/18/going-private-transactions/ (2020)
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