The inside track on China related going-private transactions

Greg Puff and David Lee of *Akin Gump Strauss Hauer & Feld LLP* explain the nuts and bolts of China related going private transactions.

Over the past two years, more than thirty companies listed in the US with business operations primarily in China, have announced an intention to go-private. In these types of going-private transactions, typically the founder or a controlling shareholder acquires all of the shares of the company not owned by him and then de-lists that company. The legal issues involved differ depending on the jurisdiction of incorporation of the company.

This article focuses on going-private transactions involving listed companies incorporated in the Cayman Islands, as Cayman Islands is a popular jurisdiction of incorporation for many Chinese businesses listed in the U.S. This feature also discusses some of the reasons why going-private transactions are attractive to potential purchasers, outlines the process for a typical going-private transaction and provides practical guidelines for avoiding legal pitfalls.

The current economic climate, the perception of Chinese businesses listed in the US and the heavy regulation of US listed companies all contribute to the current trend of going-private transactions. The current economic climate and unfavorable valuations (especially against their peer companies) of Chinese businesses in light of recent fraud allegations against certain Chinese businesses listed in the US create a financial opportunity for potential purchasers to acquire these businesses at beneficial prices. Going-private can potentially save costs and management resources since listed companies in the US often incur significant costs to comply with US regulations.

A step by step rundown on One-Step Mergers

There are two ways for a purchaser to acquire 100 percent of a listed company. One way is to conduct a one-step merger - with which this article is concerned - in which a subsidiary of the purchaser merges into the listed company with the listed company being the surviving company wholly owned by the purchaser. Another way is to conduct a tender offer to acquire a sufficient number of shares from the public and then a back-end merger to squeeze out the remaining minority shareholders.

One-step mergers are more common due to greater pricing potential and deal execution certainty. In a one-step merger, once the deal has been approved by the required percentage of directors and shareholders of the company, the deal will bind all shareholders (subject to any dissenting rights).

The one-step merger process typically starts with the purchaser delivering a proposal to the board of directors of the company to acquire all of the shares of the company not owned by the purchaser and its affiliates. After receiving the proposal, the board will establish a special committee, and the special committee will engage legal and financial advisors in order to evaluate the proposal.

If the board approves the transaction based on the recommendation of the special committee, the purchaser and the company will enter into a merger agreement. The company will then file a Schedule 13E-3 (after it has been cleared with the US Securities and Exchange Commission) and circulate a shareholders' proxy to the shareholders calling for a shareholders' meeting to vote on the transaction. Once the required percentage of shareholders approve the transaction and the conditions precedent under the merger agreement have been satisfied, the target company will file a Plan of Merger with the Cayman Islands Registrar of Companies to complete the merger process.

An inherent conflict of interest

Going-private transactions contain an inherent conflict of interest, with a controlling shareholder being on both sides of the transaction, on the one hand as the purchaser of the company's shares and on the other as an officer and director of the

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company approving the transaction. Hence, the common legal issues include whether the transaction is fair to the company and whether the directors of the company satisfied their fiduciary duties to the company and its shareholders. Cayman Islands law is less developed in this area, but directors often look to principles under US law (in particular, Delaware law) for guidance, as US law is substantially more evolved in the area of directors' fiduciary duties in going-private transactions.

Systematically breaking it down

The following are some practical guidelines for directors and companies to minimise legal risks: as soon as the board receives a going-private proposal, it should form a special committee consisting of independent and disinterested directors to ameliorate the conflicts of interest; the special committee should be granted a mandate so that it can fully evaluate and negotiate the transaction with the purchaser; and the special committee should also obtain a fairness opinion from a financial advisor confirming that the consideration is fair from a financial point of view to the shareholders receiving cash in the merger.

Special committees sometimes attempt to initiate a bidding process to solicit competing bids for the company in an attempt to pressure the initial buyer to raise its price. However, the practical reality is that it is very difficult for an outside third party purchaser to acquire a business with operations in China without the cooperation and support of the management team, including the founder.

Special committees of Cayman Islands incorporated companies need to carefully balance the benefit of a possibly higher price against the possibility of a founder/controlling shareholder terminating his offer, without giving shareholders a chance to accept the offer. Third party bids are often fraught with deal uncertainty due to the unwillingness of the management team to go along with that bid, and with the possible need for regulatory approvals in China (and elsewhere).

Walking the line….

This uncertainty, coupled with the voting bloc of shares held by the management team, often make such third party bids illusory and difficult for a committee to accept. If the special committee's strategy backfires and the founder/controlling shareholder terminates his offer and there is no acceptable alternative third party bid, the shareholders of the company might challenge the directors for failing to act in the best interest of the company and the shareholders.

Going-private transactions involve issues relating to traditional M&A, listing and securities rules as well as laws of multiple jurisdictions with various complex and moving parts. The special committee of the board should always engage external legal counsel as soon as possible to ensure that proper procedures are followed to minimise legal risks.

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