Chinese take-privates: recent Delaware guidance

For special committees and advisors undertaking going-private transactions, much can be learnt from recent Delaware court rulings. Here's the latest best practice

A trio of cases decided in May by the Delaware Court of Chancery affect China's going-private landscape. Although these deals often involve companies incorporated outside the US, such as the Cayman Islands, practitioners often look to principles under US, and in particular Delaware, law for guidance.

Special committee and a majority of the minority vote

In *In Re MFW Stockholders Litigation* CA (2013), the Court of Chancery made an unprecedented ruling regarding controlling stockholder mergers that are conditioned from the outset on the approval of both:

- an independent special committee properly authorised and empowered to negotiate and consider the transaction with the ability to 'just say no'; and
- the vote of a majority of the unaffiliated stockholders (a so-called majority of the minority vote).

These mergers, the Court ruled, will be subject to the business judgment rule standard of review, rather than the entire fairness standard.

Special committees and their advisors in Asia are often confronted with the issue of whether to employ one or both of these conditions. This court ruling should provide future guidance on whether to employ these so-called cleansing devices.

Single bidder process

In a much-cited case, *Revlon Inc v MacAndrews & Forbes Holdings Inc* (1986), the Supreme Court of Delaware held that in a sale of control transaction, a company's board of directors has a singular duty to secure the best price reasonably attainable for stockholders.

In practice, the *Revlon* duty has meant that a board would, in almost every case in the US, conduct pre-signing market checks, or a post-signing go-shop, to canvass the market for higher bids. However, the commercial reality for going-private transactions in China, 27 years after *Revlon,* is much different. Compared to the US, it is more difficult for an outside third party purchaser to acquire a business with operations in China without the cooperation and support of the management team.

Since in very many instances, a Chinese company's chief executive and lead stockholder is also its founder, they are, in most instances, unwilling to agree to cooperate with a third-party bidder. This is even if that bid would be at a higher price than they have offered.

Numerous take-privates in China involve a sale-of-control, and *Revlon* can provide guidance to special committees and their advisors on best practice. However, two recent Delaware court decisions have significant implications for how boards carry out those duties in the going-private context, particularly in China, where auctions are, as noted, simply not practicable.

In re Plains Exploration & Production Co Stockholder Litigation (2013) and *Koehler v Netspend Holdings Inc* (2013), the Court of Chancery held that a single bidder process is not *per se* unreasonable and that there are circumstances in which a board might find a single bidder process strategically desirable and in the best interest of a company and its stockholders.

Nevertheless, well-advised boards intent on following international best practice should ensure that its other actions, when evaluated together as a whole, result in a fully-informed process that is reasonably designed to maximise the price to be received by the stockholders.

Practical guidelines

According to prevailing best practice for companies, special committees and advisers, the following guidelines should be observed when conducting a going-private deal.

The target's board of directors should form a special committee consisting of only independent and disinterested directors. The special committee should be granted a broad mandate with the authority to: retain independent legal and financial advisers; consider the proposed transaction; negotiate the terms of the proposed transaction; and approve or reject the proposed transaction, and consider alternatives.

The special committee should obtain a fairness opinion from its independent financial adviser that the merger consideration is fair from a financial point of view to the unaffiliated stockholders. In *Netspend*, the board was criticised for relying on a weak fairness opinion where the comparable companies in the analysis were dissimilar to the target company, the comparable transactions were out-dated and dissimilar, and the discounted cash flow analysis showed that the per-share consideration payable was below the bottom range of values implied.

The special committee should keep in mind that if it decides to forgo a market check and focus on a single bidder, its other actions – including relying on a fairness opinion and provisions (or a lack thereof) negotiated in the merger agreement – may be closely scrutinised. Therefore, the special committee must take steps to ensure that its actions, when considered as a whole, result in a process that a court would view as reasonably designed to maximise the price to be received by stockholders. A court will review the actions of a special committee on a case-by-case basis, weighing the actions *in toto* and looking at the overall picture.

Assuming the special committee decides to approve the transaction and make a recommendation to the full board of directors and stockholders, the board should consider the proposed deal with the interested directors recusing themselves from the discussions.

Special committees should consider conditioning approval of the transaction on a majority of the minority shareholder vote. As a result of *MFW*, a majority of the minority vote is now necessary for any going-private transaction to be reviewed under Delaware law's business judgment rule.

Advisors to companies incorporated elsewhere should keep this in mind when weighing the benefits and drawbacks of this condition.

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