WHITE & CASE

# Management Buyouts of US-listed Chinese Companies

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The last twelve months has seen a wave of management buyouts of US publicly traded companies with Chinese operations. These companies, referred to in this article generally as "Chinese companies", were previously listed on the NYSE, the NASDAQ or other exchanges and have been taken private by the companies' own chairmen and management, in some instances backed by private equity financing and/or debt financing.

The reasons for conducting a take-private transaction vary. A number of Chinese companies have struggled with the reporting requirements of the Securities and Exchange Commission (the "**SEC**") under the US Securities Exchange Act of 1934 (the "**Exchange Act**") and corporate governance standards under the Sarbanes-Oxley Act. Some companies believe that by being listed abroad, they do not benefit from brand awareness, and thus their shares suffer from low trading volume and low p/e multiples. Evidence suggests that these companies' shares typically trade at a significant discount compared to their peer companies listed on the Chinese and Hong Kong stock exchanges. In many of these transactions, it is anticipated that once privatised, these companies will likely look for better listing opportunities closer to home in the medium term.

From a legal standpoint, the following are the key issues and concerns for these types of transactions:

- **Registered vs Listed:** It is important to distinguish between a company that is "registered" and one that is "listed". With the exception of issuers eligible for exemption under Rule 12g3-2(b) promulgated by the SEC under the Exchange Act, substantially all US publicly traded companies are SEC reporting companies with securities registered under Section 12 of the Exchange Act or are required to file reports under Section 15(d) of the Exchange Act by reason of having registered securities under the US Securities Act of 1933. These companies are required to comply with the reporting requirements under the Exchange Act, such as the filing of periodic reports and the disclosure of material developments on current reports.

  Not all "registered" companies, however, are "listed". Listing involves the process by which securities are available to be traded on an exchange, such as the NYSE and the NASDAQ. Securities must be approved for listing by the relevant exchange before they can be traded, and companies need to comply with their SEC reporting obligations and the ongoing listing criteria of the exchange in order to maintain their trading status. The securities of some "registered" companies are not listed on any exchange but are traded in "over-the-counter" markets, such as the OTCBB system (for which companies are required to be SEC reporting companies) and Pink Sheets (for which there is no such requirement).

- **Structure:** The most common take-private structure seen involves the establishment of an SPV vehicle ("**Holdco**") by one or more members of the management of the target company ("**Listco**") and a sponsor, such as a private equity investor. Once established, Holdco will in turn establish a wholly-owned subsidiary ("**Mergerco**"). A merger agreement is then signed between Listco, Mergerco and Holdco under which it is agreed that Mergerco will be merged into Listco, and shareholders of Listco who do not become shareholders of Holdco (and who are not dissenting shareholders—see further "*Dissenting Shareholders*" below) will be paid the agreed-upon merger consideration.


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- **Corporate Merger Regime:** The corporate laws of the jurisdiction in which Listco is organised significantly affect the manner in which the take-private transaction can be effected. The most common jurisdictions to date have been the Cayman Islands, Delaware and Nevada, each of which has a corporate law regime that facilitates the type of merger described above. A take-private transaction is typically effected through either a "one-step" transaction (in which a privatisation is accomplished through a merger of Listco into Mergerco, with the public shareholders receiving cash as consideration for the merger), or a "two-step" transaction (in which a privatisation is accomplished through a tender offer for the publicly-held shares of Listco and, assuming enough shares are tendered to take the bidder over a prescribed threshold, a subsequent short-form merger, commonly known as a "squeeze-out").
- **Percentage shareholding of "friendly" shareholders:** The percentage of shares in Listco held by the Chairman and other "friendly" shareholders (typically other members of management) is a key factor in determining the route to privatisation. Technically, if over 90 percent of the shares of Listco are held by the Chairman and such "friendly" shareholders, then a short-form merger can be used, in which case the consent of the remaining shareholders is not required. The remaining shareholders are simply paid the agreed upon cash consideration, subject to their appraisal rights (see "*Dissenting Shareholders*" below). Concerns for potential litigation risks, however, mean that a Listco under such circumstances may want to impose additional procedures before proceeding with the short-form merger. See "*Shareholders lawsuits and mitigation*" below.
- **Conditionality to funding:** The SEC does not require certainty of funding after a tender offer has commenced. However, management of Listco must be satisfied that there is a reasonable expectation of funding. A review of recent transactions suggests that banks are willing to move away from a full suite of traditional acquisition or leveraged finance conditions to funding.
- **Security:** As the funding for these take-private transactions typically comes from outside of the PRC, notwithstanding the fact that most of the substantive assets of these Chinese companies are in the PRC, due to PRC legal restrictions, security is typically limited to share pledges or charges over the offshore companies, including the merged entity.
- **SEC Compliance:** Certain SEC filing requirements apply to take-private transactions. The main filing requirement of the Exchange Act is the filing of a Schedule 13E-3 by Listco pursuant to Rule 13e-3 promulgated by the SEC under the Exchange Act. Rule 13e-3 applies when a significant shareholder (owning more than ten percent) or other affiliate of an SEC reporting company engages in a transaction that is intended or reasonably likely to result in the company's eligibility to deregister its equity securities under Section 12(g) or suspend its reporting obligations under Section 15(d) of the Exchange Act. Schedule 13E-3 sets forth background to and details of the take-private transaction, including any financing conditions. In addition, Schedule 13E-3 must set forth the "special factors" of the take-private transaction, including the purpose of the transaction, the procedural and substantive fairness of the transaction and any reports, appraisals and opinions from outside parties that are material to the transaction.

  For one-step transactions, Schedule 13E-3 should be filed at the same time as (i) the preliminary proxy statement on Schedule 14A, if shareholders votes will be solicited or (ii) the information statement on Schedule 14C, if no shareholders votes will be solicited. (Foreign private issuers are not subject to the proxy rules and therefore are not required to make any Section 14 filings with the SEC, but similar information is generally included in the circular for the shareholders meeting.) For two-step transactions, Schedule 13E-3 should be filed as soon as practicable after the date the tender offer materials are first published or given to shareholders of Listco. The contents of the Schedule 13E-3 are usually annexed to the shareholders meeting materials or combined with the tender offer materials. It should be noted that the SEC will likely review and comment on the Schedule 13E-3 after the initial filing and require the filer to respond with more information or amend the disclosure. Typically, this process can take one to two months, which may affect the overall timing of the take-private transaction.

  Also, pursuant to Rule 14e-2 promulgated by the SEC, Listco must file on a Schedule 14D-9 its recommendation to shareholders of Listco to accept or reject the tender offer, or it must state that it is offering no opinion on such matter. Schedule 14D-9 must be filed within ten business days of the commencement of the tender offer.

  Regulation 13D generally requires disclosure by a shareholder on a Schedule 13D (or in some cases, Schedule 13G) when it becomes the beneficial owner of more than five percent of a class of voting equity securities registered under the Exchange Act. Moreover, if there are any material changes to the facts contained in the initial schedule filed, such shareholder must file an amendment promptly. In the context of a take-private transaction, "friendly" shareholders may be required to amend their Schedule 13D or 13G filings to reflect one or more of the following: (i) the formation of a "group" in connection with different shareholders and the sponsor coordinating activities to acquire the subject securities; (ii) a change in their investment intent from a passive investor to one seeking to influence the control of Listco; and (iii) the entering into material agreements relating to the subject securities. Participants in a take-private transaction should note that, so long as the "group" owns more than ten percent of the subject securities, each member will become subject to the "short-swing" profits rule and short sales restrictions under Section 16 of the Exchange Act. (Securities of foreign private issuers are not subject to Section 16.) They should also consider and evaluate any reputational, regulatory and liability risks attributable to the actions of other members.

- **Dissenting Shareholders:** To effect a take-private transaction the consent of all Listco shareholders is not required. The key point to note is that so long as the requisite share voting percentages stated above are reached, dissenting shareholders do not have the right under corporate or federal securities law to stop the take-private transaction from occurring. Under many jurisdictions dissenting shareholders' rights are restricted to receiving fair value for their shares. If they dispute the cash consideration offered, they can exercise their appraisal rights through an established procedure where the value is ultimately determined by the court. It should be noted that a court could value the shares as less than the offered consideration. Any consideration for the dissenting shareholders' shares would be paid by the company surviving the merger, so this will need to be factored into in any cash forecasts.
- **Shareholder lawsuits and mitigation:** Generally speaking, lawsuits by shareholders are to be expected. As mentioned (see "*Dissenting Shareholders*"), they generally cannot stop the privatisation process. Most of the claims, which are typically made against Listco's board of directors, allege there is a breach of fiduciary duty by such board to the shareholders. Therefore, it is common for transactions to employ several safeguards to demonstrate that the transaction is fair and conducted on an arms'-length basis. These include the establishment of a special committee comprised of the independent directors of the board of Listco, which will evaluate and recommend acceptance or rejection of the deal on its merits. Such a committee may seek other bids, or require the delivery of an independent valuation/fairness opinion from a financial advisor. In addition, a common protection often seen as a condition to these transactions is a "majority of the minority" voting condition that requires that the majority of the disinterested shareholders approve the transaction. This is in addition to the more general voting conditions described above.
- **Timing:** Aside from commercial negotiations with relevant stakeholders, timing is usually dictated by the minimum notice periods specified under the relevant corporate law regime, the minimum tender offer period under the federal securities laws and/or the duration of the review process by the SEC. A short-form merger can occur in as little as a few days. However, the typical timetable ranges from three to nine months.
- **Delisting/Deregistration:** Once Listco has become "private" (i.e. the merger under the relevant corporate law regime has become effective), as a post-closing matter, the securities of Listco can be delisted (if applicable) and deregistered with the filing of relevant forms. There are specified minimum waiting periods, but in practical terms Listco no longer is required to meet SEC filing requirements and the relevant securities are no longer traded, from the date of such effectiveness.

The first batch of US publicly traded Chinese company buyouts focused mainly on traditional manufacturing companies, covering a variety of products. More recently, we have seen high-tech Chinese internet companies, which form a majority of the US-listed Chinese companies, start to follow the trend. On October 17, 2011 Shanda Interactive received a cash offer of about US$2.33 billion from its chief executive and key shareholder Tianqiao Chen to take the company private, representing the largest such transaction launched so far. This trend is likely to continue among US-listed Chinese companies through the remainder of 2011 and into next year, particularly as stock prices on US exchanges continue to underperform.

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Our White & Case team has advised on three financings of such take-private transactions in recent months, and continues to advise on others in the market. The three that have closed include Standard Chartered Bank's financing of the Chemspec take-private (NYSE) which closed in September (and was the first to close in the market), China Development Bank's financing of the China Security & Surveillance Technology take-private (NYSE and NASDAQ Dubai) which closed in October, and China Development Bank's financing for the take-private transaction of Harbin Electric, Inc. (NASDAQ) which closed in November.

Our dedicated Hong Kong-based team includes bank finance partner **John Shum** who is New York, English and Hong Kong qualified, with US securities and capital markets advice being provided by New York qualified partner **Anna-Marie Slot** and New York and Hong Kong qualified **Virginia Tam**.