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Reversing Chinese Reverse Mergers

Law360, New York (November 07, 2011, 6:07 PM ET) -- Over 150 Chinese companies have gone public in the United States without undergoing a traditional initial public offering by way of a reverse merger. The reverse merger provides a quicker and cheaper method for Chinese companies to go public and achieve access to the U.S. capital markets without having to be subject to the lengthy and exhaustive registration process of an underwritten IPO.

Despite the excitement to invest in China and initial success of Chinese companies that have executed a reverse merger to go public in the United States ("Chinese Reverse Merger Companies"), the market has become highly skeptical of Chinese Reverse Merger Companies and their audited financial statements.

Many Chinese Reverse Merger Companies trade at discounts relative to similar companies listed in Asian markets. As a result, a trend has developed of Chinese Reverse Merger Companies going private in the United States, often involving a controlling or large stockholder forming a buying group with a private equity firm.

What is a Reverse Merger?

In a reverse merger transaction, the stockholders of a private company acquire a publicly registered "shell company" (i.e. a company with limited or no operations) and merge the two companies. This "shell company" becomes the surviving company (or parent in the case of a reverse triangular merger) and, because it is already publicly registered, can be traded either over-the-counter or on the exchange on which the "shell company" was listed, subject to pending U.S. Securities and Exchange Commission, New York Stock Exchange and NASDAQ rules.

This provides the stockholders of the private company with liquidity and the surviving company with access to funding. The private company's stockholders usually gain a controlling interest in the voting power and outstanding shares of stock of the public shell company that survives the transaction. While the public shell company is required to report the reverse merger on Form 8-K, the shares of the surviving company acquired by the stockholders of the private company are not subject to registration requirements under the Securities Act of 1933, as amended.[1]

Problems with Reverse Mergers

Due to concerns about accounting irregularities associated with Chinese Reverse Merger Companies, as well as a general view that the percentage of companies that either fail or struggle to remain viable is greater for foreign reverse merger companies than their IPO counterparts, the equity values of Chinese Reverse Merger Companies have fallen dramatically.

As of Oct. 25, 2011, shares of U.S. listed Chinese Reverse Merger have fallen 58 percent this year. By comparison, the Dow Jones Industrial Average and S&P 500 are up 1 percent and down 2 percent, respectively. Significant concerns have been raised about compliance with U.S. GAAP stemming from the fact that many Chinese Reverse Merger Companies have been using small U.S. auditing firms, some of which may not have the resources to meet its auditing obligations when all or substantially all of the company's operations are in China.

The SEC has revoked the registrations of at least eight China-based companies since December of 2010, and more than 24 firms have disclosed auditor resignations or accounting problems to the SEC since March of this year. The agency may sue at least one China-based auditor for obstructing a probe of reverse mergers after Chinese regulators blocked the firm from providing requested data. Furthermore, the SEC recently announced that prosecutors from the Justice Department were actively investigating Chinese Reverse Merger Companies for possible accounting fraud.[2]

Escaping the U.S. Market

As a result of these problems, many Chinese Reverse Merger Companies are trading at significant discounts to comparable companies listed in Hong Kong or Singapore. Having not maintained the valuations that attracted these companies to the U.S. market, a trend has developed to escape the U.S. market to go private with an eye toward possible relisting in Asia.

By going private, a Chinese Reverse Merger Company can deregister under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and cease its reporting obligations, whereas if it just delisted in the U.S. and relisted in Asia, it would remain subject to the Exchange Act's reporting requirements unless it had less than 300 holders of record.[3]

However, since many of these companies have controlling stockholders that will want to retain or increase their equity interest by joining the sponsor group these going private transactions will be subject to additional disclosure obligations under U.S. securities laws and higher standards for judicial review of the sale process and the consideration received.

Taking Chinese Reverse Merger Companies Private

There are two transaction structures which can be used by controlling stockholders and their affiliates (including private equity sponsors) to acquire the minority outstanding interests of a public company.

First, the buyer group can negotiate with a special independent committee to achieve a merger or it can launch a unilateral tender offer (including a tender offer that has been negotiated with the special committee but for which the company has not entered into an agreement to effect a merger). As Delaware law initially presumes that any negotiated transaction between a Delaware corporation and its controlling stockholder is inherently coercive, the company and its directors have the burden of proving the transaction's "entire fairness" (i.e., fair price and fair process) instead of being afforded the more deferential "business judgment" review.

But “entire fairness” can be avoided or the burden of proof can be shifted to the complaining minority stockholder through the use of a special committee comprised of independent directors and/or conditioning the transaction on the approval (or tender) of a majority of the unaffiliated stockholders.

In order for the special committee to be considered effective, its members must (i) consist of independent directors, (ii) have no financial interests that are adverse to the minority stockholders of the corporation, (ii) understand their role, (iii) be properly informed, motivated and have access to all material information, (iv) have the power to negotiate the transaction, including the power to “say no” and (v) have the authority to engage independent advisers including own legal and financial advisers. The special committee must also consider any alternatives to the transaction (including maintaining the status quo, if that is the only alternative) that might deliver greater value to the minority stockholders.

If the transaction is in the best interests of the corporation and all of its stockholders, the special committee must strive to negotiate a fair price that is also the best possible price. While this does not mean that the committee must obtain the controlling stockholder’s maximum price, it does mean that the special committee (like any arm’s-length adversary) must make a good faith attempt to negotiate for the best possible price. In negotiating with the special committee, the controlling stockholder must avoid coercive behavior, including retributive threats to the minority stockholders if the transaction is not approved.

Majority of the minority provisions in merger agreements typically provide for a single vote upon the merger, but require the vote to be subjected to two independent tests: (i) approval by the holders of a majority of the outstanding shares entitled to vote, and (ii) approval by the holders of a majority of the shares entitled to vote other than those held by the affiliated stockholders. Subjecting stockholder approval to the affirmative vote of a majority of the disinterested minority stockholders will shift the burden of proving that the transaction is unfair back to those who oppose the transaction.

Some recent Delaware cases have held that a lesser standard of review, the “business judgment” rule, rather than “entire fairness,” applies to a “going private” transaction when in the form of a tender offer resulting in ownership exceeding 90 percent followed by a short-form merger under Delaware law. Under such case law the tender offer must be effected in a “noncoercive” manner and include a nonwaivable majority of the minority minimum tender condition. The follow-on short-form merger should then not itself become subject to an “entire fairness” review.[4]

Other recent conflicting decisions, however, have placed some uncertainty into whether or not the business judgment rule can apply in cases where the tender offer is not negotiated and recommended by a fully functioning special committee even if subject to a nonwaivable majority of the minority minimum tender condition.

There are certain advantages and disadvantages arising from each of the alternative acquisition structures. Negotiating with the Special Committee has the advantages of providing the indicia of fairness required to shift the burden of proof to the person challenging the transaction or, in combination with a tender offer and majority of the minority approval, getting business judgment review. Buyers are also able to negotiate for access to nonpublic information. However, there will be timing considerations involved with negotiating with the special committee and may result in delaying in the transaction while price and other material terms are negotiated.

Disclosure Issues for Significant Stockholders

As discussed above, many Chinese Reverse Merger Companies have controlling or large stockholders. In many cases, they have sought continued ownership following the reverse merger transaction. Due to the reverse merger, their shares are not entitled to the exemption from continuous public disclosure regarding their plans and proposals pursuant to Schedule 13D normally afforded to founding stockholders who continue to hold a controlling interest following a registered IPO and have not acquired additional stock in excess of established thresholds.[5]

As a result, there is a need to carefully consider existing disclosure and process for discussions and negotiations with significant stockholders (i.e., 5 percent or more) in light of the Schedule 13D disclosure rules applicable to significant stockholders who desire to re-take a company private sometime following a reverse merger transaction. There has been recent activity in this area and courts and the SEC have taken an increasing interest in examining Schedule 13D disclosure with the benefit of hindsight.

Sponsors should not beneficially own any target stock to avoid forming a group with significant stockholders and triggering disclosure obligations. Under the U.S. Securities Laws, persons who do not separately have beneficial ownership of a company's securities cannot be part of a group with respect to such companies securities. However, if a sponsor were to own even a single share of the company's common stock, it may be deemed to be part of a group with a significant or other stockholder and forced to make premature disclosure of its intentions.[6]

Once a definitive agreement for a transaction has been signed or concurrently with the launch of a tender offer, additional disclosure will have to be made with the SEC and the public (either in the Offer to Purchase or Proxy Statement and the Schedule 13E-3) since the Chinese Reverse Merger Company has entered into a transaction with an affiliate.

Conclusion

Clearly, there are many issues to be considered when structuring and implementing a "going private" transaction in the United States. As more and more Chinese companies rethink their commitment to the U.S. markets in light of investor skepticism and decide to go private, the important issues discussed above, from structuring decisions to negotiating strategy and disclosure issues, will need to be considered at each stage of any given transaction.

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[1] SEC Investor Bulletin: Reverse Mergers, June 9, 2011

[2] See Azam Ahmed ,Chinese Stocks Plummet on News of Justice Department Inquiry, NY Times Sept. 29, 2011, at http://dealbook.nytimes.com/2011/09/29/chinese-stocks-plummet-on-news-of-justice-department-inquiry/.

[3] Rules 12g-4(a)(1) and 12h-3(b)(1) promulgated pursuant to the Exchange Act. A Chinese Reverse Merger Company would also be able to delist if it had less than 500 holders of record and its total assets were less than $10 million on the last day of its most recent three fiscal years.

[4] A dissatisfied stockholder would retain its ability to exercise appraisal rights under Delaware law.

[5] The SEC has taken the position that a person who acquired “beneficial ownership of more than five percent of a class of securities which at the time of acquisition was not registered pursuant to Section 12(g) [of the Exchange Act] but which subsequently became registered” are not required, subject to certain limitations on additional acquisitions, not required to file on Schedule 13D but can file on Schedule 13G. Filing and Disclosure Requirements Relating to Beneficial Ownership, Exchange Act Release No. 15348, 16 SEC Docket 228-02 (November 22, 1978). However, as a result of the Chinese Reverse Merger, the founding stockholders no longer own shares that were acquired prior to registration of the class of securities but instead were issued shares of the class of securities surviving corporation pursuant to the reverse merger that were at the time of the acquisition publicly registered.

[6] See Rosenberg v. XM Ventures, 274 F.3d 46 (3d Cir. 2001).

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