MEANS FOR CHINESE INVESTORS TO PROTECT MINORITY INVESTMENTS IN U.S. BUSINESSES©

Chinese companies have acquired all of, or at least controlling stakes in, a meaningful number of businesses in the United States. There are other Chinese companies which believe that an ownership interest in a U.S. business would provide valuable benefits to it, but for various reasons are unable or unwilling to obtain a controlling stake. This can be due to the unwillingness of existing owners to sell a majority position, the desire of the Chinese company for existing management owners to remain fully involved with the business, the high cost involved in obtaining control, or the reluctance of the Chinese company to commit the necessary capital to acquire control, among other reasons. While in many cases this leaves open the possibility of taking a minority position, many Chinese executives are reluctant to do so, believing that as minority stakeholders they cannot adequately protect their position and therefore their investment and the other objectives they may seek to obtain therefrom could be harmed. The purpose of this article is to explain how, with proper planning and the assistance of experienced U.S. legal counsel, in many cases these concerns can be so substantially ameliorated that a minority position becomes an acceptable basis to engage in a transaction in the United States. It is a given that in either a majority or minority stake deal, the transaction must be one which makes business sense for a Chinese company.

Preliminary Comments

To meaningfully address these matters, a proper focus in required. In the United States, business is conducted through many different types of entities, such as corporations and limited liability companies. and can be formed under the laws of any of the fifty states of the United States or the

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District of Columbia[1], and even non-U.S. companies can be used. The laws of each jurisdiction generally differ to varying degrees, including as between the same types of entities, so the choice of entity and the jurisdiction under the laws of which it is formed are very important in regard to what exposures, protections and other rights minority investors may have and the level of certainty they can have regarding these matters. In addition some businesses are "publicly traded" and thus subject to various U.S. securities laws as respects this article, while others are either privately held and thus not subject to such laws, or are divisions or subsidiaries of public companies which are not so material to the public company as a whole that these securities laws come into play.

The state of Delaware is the most common jurisdiction under which U.S. businesses are formed, and thus this article will focus on entities formed under its laws. Also, this article will focus on entities which are not subject to U.S. securities laws and subsidiaries of public companies which do not trigger securities laws issues. Notwithstanding this article's focus, in general adequate protections can also be obtained in other circumstances, and it is also the case that a non-Delaware entity can be redomiciled to Delaware and thus obtain these protections. With respect to the form of entity, this article will focus on corporations and limited liability companies due to the prevalence of their use. Moreover there is more well developed case law regarding these Delaware entities than regarding other jurisdictions and entities, thus providing a greater ability to understand how the courts will handle matters, and thus what deal terms are or are not likely to be enforced.

[1] Note, that with very limited exceptions, such as national banks, there are no federal laws of the United States under which businesses can be formed, and although the phrases "a U.S. company" or a "U.S. business" are common, in reality they mean businesses formed under the laws of a state or the District of Columbia.

In determining the rights and protections available to minority investors in a particular entity, it is necessary to first consider the relevant statute under which that entity is formed (in Delaware this is the General Corporation Law (the "GCL") for corporations and the Delaware Limited Liability Company Act (the "LLC Law") for limited liability companies ("LLCs")). Also essential is case law, *i.e.,* the decisions of applicable courts interpreting these laws, and then within the context of all these, the terms of the organizational documents (Certificates of Incorporation and Bylaws in the case of Delaware corporations and Limited Liability Company Agreements (together, "Organizational Documents") in the case of Delaware LLCs as well as contractual rights. The relevant laws and cases do provide meaningful opportunities for minority investors to negotiate important protections for themselves in separate contracts and, preferably, in the Organizational Documents. These protections are negotiated in advance of the proposed investment and if the minority investor is ultimately not satisfied with the rights and protections it has negotiated then it does not have to proceed with the investment. For purposes of this article it is assumed that the Chinese investor is buying a sufficiently meaningful stake in the particular business entity (the "Target Company"), and the Target Company and its majority investors[2] are sufficiently desirous of obtaining this investment and other benefits that the Chinese investor might offer[3], that the Chinese investor has at least a reasonable, if not a strong, negotiating position. This article will not go into detail regarding the full terms of the provisions discussed, or how they are implemented. Instead the purpose is to advise Chinese companies that these rights can be provided and thus to take them into account when considering making a minority investment.

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[2] In this article the term "majority investor" means either one party or several investors which act together as a group and together make up a majority, rather than multiple non-unified investors, since in such latter case the so-called minority investor could actually become the controlling investor.

[3] For instance an investment might be coupled with a mutually beneficial distribution or manufacturing arrangement in China.

For purposes of analysis this article is divided into three main parts – Knowledge, Rights and Remedies and Enforcement. The term "Knowledge" in this context means the legal rights and action steps for a minority investor to keep itself well informed as to what is transpiring with the Target Company; if one does not have sufficient knowledge one does not know if one is being treated properly. The term "Rights" in this context means both affirmative rights held by a minority investor, such as the right to a certain number of directors on a corporation's board of directors, as well as defensive or approval rights, such as veto rights over certain major actions, such as a sale of the business as well as provisions establishing obligations by the majority owner for the benefit of the minority. "Remedies and Enforcement" obviously means having valid legal means to enforce one's rights and taking appropriate legal action to do so.

Knowledge

There are several means by which a potential investor for a minority investment can position itself to receive adequate material information regarding the Target Company on an ongoing basis post-investment. These approaches can be used in conjunction with each other, rather than just separately. One means is by having representatives of the minority investor serve on board of directors of a corporation or board of managers in the case of a limited liability company (in either case the "Board"), and key committees (as discussed below) of the Board, and thus enabling the minority investor's representatives to receive information provided to the Board and these committees. An additional means is for the Target Company to agree at the time of the investment to provide to the minority investor specified future information on a specified schedule. A common example is to require the Target Company to provide agreed upon financial information, such as internally prepared financial statements together with management reports, either monthly or quarterly. In addition, the Target Company can be required to provide

audited annual financial statements. Generally the Target Company would also be required to provide any other material information as it arises and if there are specific matters which are material to the business, information can be required regarding these as well. An example of this latter type of information, in the case of bio-tech companies, might be the results of research tests or submissions to requisite government agencies. Depending upon the working relationship between the parties, it can also be the case that employees of the minority investor are working together with the Target Company, such as in the case of certain joint ventures, thus providing an additional basis for information. Also, the GCL and the LLC Law provide stockholders and members, respectively, with certain rights to information, although less than the above. Specifically, the GCL provides stockholders with a right to examine the corporation's books and records for a stated purpose which is "reasonably related to such person's interests as a stockholder" and the LLC Law provides:

> "Each member of a limited liability company has the right, subject to such reasonable standards (including standards governing what information and documents are to be furnished at what time and location and at whose expense) as may be set forth in a limited liability company agreement or otherwise established by the manager or, if there is no manager, then by the members, to obtain from the limited liability company from time to time upon reasonable demand for any purpose reasonably related to the member's interest as a member of the limited liability company:
>
> (1) True and full information regarding the status of the business and financial condition of the limited liability company;
>
> (2) Promptly after becoming available, a copy of the limited liability company's federal, state and local income tax returns for each year; …[and] …
>
> (6) Other information regarding the affairs of the limited liability company as is just and reasonable."

However, if the minority investor has been successful in negotiating rights as per the above then the statutory rights would be largely subsumed by the negotiated rights. Moreover, as can be

seen from the above quotes, the statutory provisions contain language which can be used to in fact limit what information is required to be provided

Rights

As noted above, there are a multitude of provisions which a minority investor can seek that give it certain rights as well as protections against actions of the majority investor. One set of rights is the right to information discussed above. Another right is to have representation on the Board and to have that representative sit on key committees, such as the compensation and audit committees. A related right is to require that one or more independent representatives sit on the Board and key committees. In this regard "independent" means someone who does not have any ties to either the majority or minority investors, and thus should act solely based on their perception of the best interests of the Target Company. Of course, the representatives of the minority investor will not make up the majority of the Board and, often, the minority's representatives plus any independent members also will not make up a majority of the Board. Thus, while these Board and committee positions are important, especially in terms of providing knowledge of what is occurring and the opportunity to influence the majority, almost always it is only when either sufficient super-majority quorum and/or voting requirements are provided for or that matters are specified as requiring the specific approval of the non-majority representatives, that the representatives of the minority investor, and/or such representatives and the independent Board members, can block proposed actions by the majority. This is often the case with respect to major events, such as a potential sale of the Target Company and transactions between the Target Company and the majority investor or its affiliates. Ultimately, what items require minority approval and their specifics are a matter of negotiation which are effectively based on several principles which the parties must agree upon: first, to what extent

should major actions or events or matters outside the ordinary course of business require the involvement and approval of the minority investor or its Board representative; second, to what extent should the minority investor or its Board representative have a say in defining how the business should be operated in the ordinary course – for example having a right of approval of the budget and material deviations from it once approved; and third, within the scope of the budget and the ordinary course operations of the Target Company, should the minority investor or its Board representative have a right of approval with respect to any matters. Examples of potential covered matters are the payment of dividends or other distributions (either blocking them or, under certain circumstances, requiring them), redemptions, prohibitions on the issuance by the Target Company of any equity or superior classes of equity and/or preemptive rights in the case of any such issuances, any amendments of the Organizational Documents pertaining directly to the equity held by the minority investor, or amendments to other provisions of the Organizational Documents which may have a material adverse effect on the rights of the minority investors.

As can be seen, the foregoing rights are basically defensive in nature – that is they prevent the majority from causing certain events to occur without minority consent. Conversely, the right of the minority investor or its representatives on the Board to force the Target Company to take specific actions is often quite limited, if not non-existent.

Provisions are also often agreed upon restricting the rights of the parties to sell their equity interests. In some cases there is an absolute prohibition on any sale or other transfer, at least for a specified number of years. In other cases, if the majority seeks to sell all or any more than a *de minimums* amount of its equity, the minority can have a right of first refusal or derivations thereof with respect to it buying the majority's equity. In addition, the minority often has "tag

along" rights, meaning that if the majority is seeking to sell its equity then the majority cannot do so unless the buyer also buys the minority's equity, at the same price and on the same terms.[4] This right is of importance to the minority in that, absent it, the equity interests of the majority are not only much more saleable, but, relative to the minority interests, can also command a "control premium" meaning a higher price based on the power to control the Target Company. The minority can also seek to include an express provision prohibiting the majority investor from receiving a control premium even if there is no tag along.

The GCL and the LLC Law also impose certain obligations, including "fiduciary duties" on majority equity holders and on their representatives on the Board which serve in certain circumstances as additional protections for minority investors, although some of these can be eliminated or reduced by provisions to that effect in the appropriate Organizational Document. For example, a director of a Delaware corporation has a fiduciary duty to all stockholders of the corporation, and not just to the particular investor who caused such person to become a director. In general, if the minority investor has been successful in negotiating its rights and protections, these statutory protections will be of secondary importance, but should not be ignored.

Remedies and Enforcement

As noted above, there are certain protections and remedies provided by statute which a minority investor can look to in order to enforce its rights. In addition, if the Organizational Documents or other applicable documents are properly drafted, a minority investor can generally prevent a Target Company from acting contrary to the negotiated provisions, thus, for example, preventing

[4] Commonly, this "tag along" right is coupled with a "drag along" right, whereby the majority can force the minority to sell its equity on the same terms as the majority is doing. For the minority, this trade-off is generally worthwhile in light of the majority's greater ability to liquidate its investment and its inherent greater value per unit.

the majority from causing the Target Company from acting in certain cases – such as selling the assets of the Target Company without the approval of the minority investor or its Board representative contrary to the terms of the Operating Documents – or in other cases causing the Target Company or the majority investors to take agreed upon actions which could range from providing required financial or other information to causing the majority investor to sell its interests in the Target Company to the minority investor pursuant to a right of first refusal provision. In other cases, actions taken by the majority investor, its representatives on the Board and the Target Company itself provide a valid basis for the minority investor to sue for any monetary damages it suffers as a result of such actions.

Under the GCL, a minority stockholder does not have a statutory right to seek judicial dissolution of the Target Company. However, under the LLC Law, any member, including a minority member, and any manager can require dissolution upon the happening of any events specified for this purpose in the Limited Liability Company Agreement and can obtain judicial dissolution as a "deadlock remedy," *i.e.*, when "it is not reasonably practical to carry on the business [of the LLC] in conformity with the limited liability company agreement." These are obviously extreme measures with severe consequences and are only pursued as a last resort. In seeking protections short of this, in some instances the minority investors obtain the right to take control of the Target Company or to take specified actions (including in some cases the right to put in additional money on pre-agreed terms so as to become the majority investor or puts and calls). These rights may only be exercisable in the event of the failure of the Target Company to meet specified performance metrics which thereby is taken as proof that the majority investors have not managed it well.

In regards to the matters discussed in this section, a key point is not only that the minority investor must have the particular legal rights which it wants to seek to enforce, but that it is willing and otherwise able to take the necessary legal steps to enforce its rights. This can mean commencing a lawsuit or arbitration proceeding (depending upon the terms of the documents) and thus incurring legal and related fees and expenses, as well as needing to devote management attention to the matter. However, unless a minority investor is prepared to take such action and the majority investor believes the minority will in fact do so, then the rights and protections held by the minority investor may prove to be of limited value.

Conclusion

Some Chinese companies believe that an ownership interest in a U.S. business would provide valuable benefits to it, but for various reasons are unable or unwilling to obtain a controlling stake. While in many cases this leaves open the possibility of taking a minority position, many Chinese executives are reluctant to do so, believing that as minority stakeholders they cannot adequately protect their position, and therefore their investment and the other objectives they may seek to obtain therefrom could also be harmed. However, as explained in this article, with proper planning and the assistance of experienced U.S. legal counsel, in many cases these concerns can be so substantially ameliorated that a minority position becomes an acceptable basis to engage in a transaction in the United States which otherwise makes business sense for a Chinese company.

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