Protecting China ODI – minority shareholder rights

Minority stake investments are prevalent in Chinese outbound M&A transactions. A key to safeguarding these investments is minority shareholder rights protection.

China's overseas direct investments (ODI) are achieved predominantly through outbound mergers and acquisitions. There has been a surge in Chinese outbound M&A recently – according to a report by Deloitte, over the first three quarters of 2009 the number of announced Chinese outbound M&A transactions jumped from 10 in Q1 to 26 in Q3. Quarterly deal values rose over the same timeframe from US$1.3 billion to US$8.9 billion.

It is tempting to link this phenomenon merely to China's bargain-hunting as a result of the recession. While distressed asset price is a reason for and helps explain the timing of the surge of deal flows, China's increased appetite for overseas expansion and investments is also attributed to the following key factors:

- China's need to diversify its foreign exchange reserves.
- Energy security and demand.
- The increased need of Chinese companies to integrate resources globally.
- Strong cash position of state-owned companies.
- Direct state policy support and deregulation.

Minority stake investments

It is common for Chinese outbound M&A to take the form of an equity or strategic minority investment. Some recent examples include:

- The acquisition of an 11% stake in JSC KazMunaiGas by China Investment Corporation (CIC).
- Industrial and Commercial Bank of China's acquisition of a 20% stake in Standard Bank.
- China Development Bank's acquisition of a 3.10% stake in Barclays.
- Anshan Iron & Steel Group's acquisition of a 23.68% stake in Gindalbie Metals.
- The proposed acquisition by Aluminum Corporation of China and Alcoa of a 12% stake in Rio Tinto.
- CIC's acquisition of a 17.2% stake in Tech Resources.

The background for each minority investment may be deal-specific. However, the prevalence of this investment method indicates that there may be some rationale behind it.

Whatever the reasons may be, a significant minority investment almost certainly gives rise to a joint venture between the Chinese acquirer and the target. A common structure of the joint venture is a joint venture company (JVC) with the Chinese party taking a minority stake. In managing ongoing relationship with its joint venture partners, protecting its minority shareholder rights should be a key task for the Chinese acquirer, even if its initial objective is to participate as a passive investor.

Minority shareholder rights

A JVC may come into being either under a civil law system or in a common law jurisdiction. In common law jurisdictions (e.g. England and Wales), the most significant source of minority protection often derives from contractual provisions governing the JVC. Statutory and corporate law can only afford a Chinese minority investor limited automatic protection.

In contrast, civil law jurisdictions generally regulate and intervene in the affairs of the JVC more than common law jurisdictions despite contractual arrangements. Nevertheless, a Chinese minority investor should consider the following areas of contractual protection, which relate to important minority shareholder rights with general application to JVCs subsisting under either legal system.

A seat on the board

A Chinese minority investor should seek a right to appoint a director to the board of the JVC. Subject to its duties to the JVC (see below), the appointed director will, through participation in board meetings and discussions, be able to exercise some influence over the affairs of the JVC. This ability is somewhat limited by the fact that, in practice, management is often conducted informally and not through board meetings.

The appointed director owes directors' duties to the JVC, which are essentially the same as the duties owed by a director of any other company. Examples include a duty to act in the best interest of the company, a duty to exercise reasonable care and skill, a duty to avoid conflicts of interest and a duty of confidentiality. The application of these duties in the context of the JVC is complex because of the appointed director's relationships with the appointing Chinese minority investor.

The appointed director in practice is often a director or officer of the Chinese minority investor. This is likely to give rise to a conflict of interest – a conflict between the director's loyalty and duties to the appointing shareholder and its duties to the JVC. The overriding duty to act in the best interest of the JVC means that, should a conflict arise, the appointed director's duties to the JVC must prevail.

Alternatively, a right to appoint an 'observer' to the board should be obtained. This right falls short of the right to appoint a director – an observer is entitled to attend board meetings but has no right to vote or speak.

Right to veto

If possible, the Chinese minority should obtain a right to veto decisions of the JVC regarding certain key matters (often called 'reserved matters') at either shareholder or board level. Reserved matters could include: (i) changes in the JVC's constitutional documents; (ii) changes to the share capital of the JVC; (iii) major acquisitions or disposals by the JVC; (iv) capital expenditure or contract commitment above an agreed limit; (v) borrowing by the JVC exceeding an agreed limit; (vi) dealings between the JVC and any of its shareholders; and (vii) voluntary winding-up.

If veto rights are adopted at the board level, directors will need to consider carefully their duties to the JVC in exercising their

veto rights. This could give rise to difficult conflict issues for directors who have been nominated by a particular shareholder.

Information rights

The Chinese minority investor should ensure that it has a right to receive financial and other information regarding the business of the JVC on a timely basis, as well as the right of access to accounting records and other material documents. The majority party could be required to keep the Chinese minority investor informed about important affairs of the JVC. The Chinese minority investor will need to be mindful of the proprietary and confidential nature of information it receives.

Distributions

One of the more important objectives of the Chinese minority investor will be the return of its investment and profits earned. This is typically achieved through distributions to shareholders, including dividends, but could also take the form of repayment of shareholder loans.

The Chinese investor should ensure that its investment is made in a tax efficient manner, as repatriation of invested capital and the payment of dividends and other distributions may be subject to withholding and other taxes. In addition, it may be appropriate for the JVC to agree to make certain dividend payments (as and when it is permitted to do so by the laws applicable to the JVC), and any policy on dividends adopted by the JVC should not be altered without the consent of the Chinese minority investor. Further, if possible, the JVC documentation should provide that the consent of the Chinese minority investor be required for any management or service charges payable by the JVC to any related party.

Anti-dilution

Measures should be taken to ensure that the Chinese minority investor's interests in the JVC are protected from dilution. This can be achieved by requiring that: (i) the Chinese minority party's consent is needed if the JVC wishes to issue any further shares or other securities; and/ or (ii) any new issue of securities in the JVC is subject to pre-emption rights in favour of all shareholders, i.e. it has to be made pro rata to existing holdings; and/ or (iii) any issue of securities by the JVC must be at not less than fair value.

Tax

The structure of the JVC should be carefully analysed to ensure that it optimises the tax consequences to all shareholders. Tax structuring advice should be taken at an early stage. The Chinese minority party should ensure that it is not adversely prejudiced by the tax arrangements between the JVC and the majority party.

Exit

Compared to investments in listed securities, a minority investment in a private company is typically illiquid because of the lack of any liquid secondary market, as well as the legal hurdles that typically restrict transferability of shares. As a result, absent any contractual protections, a Chinese investor may find it difficult to dispose of its minority investment. Accordingly, the JVC documentation should set out the circumstances where the Chinese minority investor can exit from the JVC.

The Chinese minority investor should be able to transfer its shares, subject to pre-emption rights. It should also consider obtaining a 'tag-along' right – a right to ensure that, if the majority party sells to a third party, the same offer per share must be made to the minority party. A put option may also be desirable, whereby the majority party is obliged to acquire from the minority investor all of its shares of the JVC at a pre-determined formula and at pre-determined times. Typically, if a put option is obtained, the minority investor will have to agree to a call option, whereby the minority investor may be required to sell its shares to the majority investor at a fixed price.

Governing law and dispute resolution

The law governing the JVC contract is important because it dictates whether the parties can regulate their affairs as they wish and what remedies are available if there is a dispute. When choosing the governing law, the Chinese minority investor should consider its options carefully. In addition, the investors need to decide whether they wish disputes to be resolved by national courts or by arbitration bodies. Such a decision depends on, among other things, cost, publicity and the recognition and enforcement of the award or judgment in the territory where enforcement may be necessary.

The majority party typically wishes to manage the JVC without much interference from minority shareholders. Because the Chinese business culture very much focuses on cooperation, not confrontation, the Chinese minority investor may inadvertently concede in negotiations more than it should in order to achieve a cooperative spirit. Therefore, before making an investment decision, the Chinese investor should examine carefully the above contractual protective measures and be prepared to negotiate at the outset the appropriate means to deal with potential conflicts with its joint venture partners.

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Conclusion

Minority investments (as opposed to majority investments or outright 100% acquisitions) are commonly seen in Chinese outbound M&A transactions. Regardless of the rationale for China's overseas minority investments, minority shareholder rights protection is a key to safeguarding China's ODI. Carefully negotiated and documented contractual minority shareholder rights should go a long way towards protecting a Chinese investor's minority stake in an international joint venture. A well protected minority interest in established companies in developed economies can also expose Chinese entities to good corporate governance and a vastly different business culture, as well as the opportunity to learn Western style management skills.

By Jay Ze, associate at the London office of Gibson Dunn and Crutcher LLP, with comments by partner Wayne McArdle