BRIEFING NOTE

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Cayman Islands Merger Take-Privates from NASDAQ and NYSE – Trends and Frequently Asked Questions

The privatization of Chinese businesses incorporated in the Cayman Islands that are listed on the NASDAQ Stock Market ("**NASDAQ**") or the New York Stock Exchange ("**NYSE**") has continued to surge throughout the Covid-19 pandemic and there are currently no signs of a slowdown. For example, JOYY's two largest shareholders, its chairman David Li and Xiaomi founder Lei Jun, are reportedly planning to take the NASDAQ-listed company private in a deal that could value it at up to US$8 billion[i]. This is a significant trend because there are approximately 250 Chinese companies[ii] listed on US stock exchanges, with a total market capitalization of more than US$1.5 trillion[iii].

There are various factors which have arguably contributed to the surge in privatizations. For example, escalating political tensions between the US and the Chinese governments and downward pressure on the share price of many Chinese businesses that are listed on NASDAQ or the NYSE have made listed status less attractive. Furthermore, volatility in stock markets and the growing focus on regulation and compliance have also contributed to this trend. We have seen that many Chinese businesses that de-list from NASDAQ or the NYSE seek to re-list on another stock exchange, such as the Shanghai Stock Exchange or the Hong Kong Stock Exchange, in order to achieve a higher valuation. This is a relatively unsurprising development considering that indices such as the NASDAQ Golden Dragon China Index, which captures the equity market performance of large and mid-cap Chinese securities on NASDAQ, are down by over 30% so far this year[iv].

In this article, we address some frequently asked questions with respect to Cayman Islands merger take-privates from NASDAQ and the NYSE and examine why they continue to be relatively popular.

1. What is a Cayman Islands merger take-private?

A Cayman Islands merger take-private is the process whereby two "constituent companies" – namely, a Cayman Islands company ("**MergerCo**") and a listed Cayman Islands company (the "**Target**") – merge pursuant to Part XVI (the "**Cayman Merger Law**") of the Cayman Companies Act (2021 Revision) (the "**Cayman Islands Companies Act**"). Upon the merger becoming effective (the "**Effective Time**"):

(a) MergerCo is struck-off the register of companies;

(b) the rights and property of the constituent companies vest in the Target as the surviving company; and

(c) subject to any specific arrangements entered into by the relevant parties, the Target is liable for and subject to all mortgages, charges and security interests, and all other liabilities of the constituent companies.

2. What key steps have to be taken as a matter of Cayman Islands law to consummate a merger take-private?

The following is a summary of the key steps that need to be taken from a Cayman Islands law perspective in order to consummate a statutory merger:

1. **Forming MergerCo.** In a typical take-private transaction, MergerCo[v] is incorporated in the Cayman Islands by the investors adhering to the takeover group (often involving the founders/managers of the listed company, its parent company and/or several private equity investors acting as sponsors for the purposes of the take-private transaction) (the "**Buyout Group**") in order to obtain finance and ultimately merge with the Target.

2. **Take-Private Offer.** After obtaining legal and financial advice, the Buyout Group agrees on the terms of the proposed merger take-private, including the consideration which will be offered to the shareholders of the Target, and makes an offer to the board of directors (the "**Board**") of the Target (the "**Initial Take-Private Offer**"). As a matter of best practice, since most take-private transactions are initiated by, or with the involvement of, the management or certain shareholders represented at Board level, the merger process requires that a special committee formed of independent directors of the Target (the "**Special Committee**") be designated to review the take-private offer and negotiate on behalf of the Target with the Buyout Group. This is both to ensure that the Board is in compliance with the fiduciary duties it owes the Target, and to avoid any accusation of self-dealing.

3. **Negotiations.** The Special Committee reviews and negotiates the offer with the help of its own independent legal and financial advice. Overall, the typical mission of the Special Committee is to:

   (a) investigate and evaluate the Initial Take-Private Offer;

   (b) discuss and negotiate the terms of the merger agreement (the "**Merger Agreement**");

   (c) explore and pursue any alternatives to the Initial Take-Private Offer as the Special Committee deems appropriate, including maintaining the public listing of the Target or finding an alternative buyer;

   (d) negotiate definitive agreements with respect to the take-private or any other transaction; and

   (e) report the recommendations and conclusions of the Special Committee to the Board with respect to the Initial Take-Private Offer.

4. **Board Approval.** The directors of each constituent company in a merger are required to approve the terms and conditions of the proposed merger in a written plan of merger (the "**Plan of Merger**"), including, among other things:

    (a) how shares in each constituent company will convert into shares in the surviving company or other property (e.g. cash payable to shareholders);
    (b) what rights and restrictions will attach to the shares in the surviving company;
    (c) whether the memorandum of association and articles of association of the surviving company will be amended and, if so, then how; and
    (d) any amounts or benefits paid or payable to any director of either constituent company or the surviving company consequent upon the merger.

5. **Shareholder Approval.** The Plan of Merger is required to be authorized by a special resolution of the shareholders of each constituent company who have the right to receive notice of, attend and vote at the relevant shareholders' meeting, voting as one class with at least a two-thirds majority[vi]. The resolutions of the MergerCo are often passed by its shareholder(s) unanimously in writing.

6. **Consents.** Each constituent company must obtain the consent of any creditor(s) holding a fixed or floating security interest in the relevant company[vii]. To the extent that debt finance is being provided in the context of a privatization, the consent of any relevant secured creditor(s) are typically included in the intercreditor agreement if there is one, or in the relevant facility agreement if there is not. Any other relevant authorizations and consents, such as under the articles of association of a constituent company or pursuant to any regulatory laws, must also be obtained prior to consummation of the merger.

7. **Declarations, Undertaking and Certificate of Good Standing.** A director of each constituent company must provide a written declaration which confirms:

    (a) that the relevant constituent company is, and the surviving company will be, immediately after the merger, able to pay its debts as they fall due;
    (b) that the merger is *bona fide* and not intended to defraud unsecured creditors of the constituent companies;
    (c) that no petition or other similar proceeding has been filed and remains outstanding and that no order has been made or resolution adopted to wind-up the relevant constituent company in any jurisdiction;
    (d) that no receiver, trustee, administrator or other similar person has been appointed in any jurisdiction and is acting in respect of the relevant constituent company, its affairs, or its property or any part thereof;
    (e) that no scheme, order, compromise or other similar arrangement has been entered into or made in any jurisdiction whereby the rights of

creditors of the constituent company are, and continue to be, suspended or restricted;

(f) the assets and liabilities of the relevant constituent company made up to the latest practicable date before the making of the declaration;

(g) in the case of a constituent company that is not the surviving company, that the relevant constituent company has retired from any fiduciary office held or will do so immediately prior to the merger; and

(h) that the relevant constituent company has complied with any applicable requirements under any relevant regulatory laws.

A director of each constituent company must also undertake to give a copy of the certificate of merger to all of its members and creditors, and to publish a notification of the merger in the Cayman Islands Gazette.

A certificate of good standing must also be obtained by each constituent company.

8. **Filing and Registration.** After obtaining all necessary authorizations and consents, the Plan of Merger is required to be signed by a director on behalf of each constituent company and filed with the Cayman Islands Registrar of Companies (the "**Cayman Islands Registrar**") along with the other merger documents detailed above. The Cayman Islands Registrar registers the Plan of Merger and issues a certificate of merger so long as all of the requirements of the Cayman Merger Law have been complied with. A certificate of merger is *prima facie* evidence that all such requirements have been complied with. It is market practice to pre-vet unsigned copies of all of the merger documents with the Cayman Islands Registrar prior to filing them to ensure that all of the requirements of the Cayman Merger Law will be complied with upon submission.

3. When does a Cayman Islands statutory merger take effect as a matter of law?

Unless the Plan of Merger provides for a later specified date or event[viii], the merger will be effective on the date that the Plan of Merger is registered by the Registrar of Companies. At the Effective Time, all of the rights and assets of each of the constituent companies immediately vests in the surviving company and, subject to any specific arrangements, the surviving company assumes all of the assets and liabilities of each of the constituent companies.

4. What is the position with respect to dissenting shareholders?

Each shareholder of a constituent company is entitled to payment of the fair value of its shares upon dissenting from the merger under section 238 of the Cayman Islands Companies Act. Fair value can either be agreed between the parties or determined by the Cayman Court. There is considerable case law with respect to the meaning of "fair value" and that is outside the scope of this article.

5. How is a take-private transaction typically financed by the Buyout Group?

Many take-private transactions are financed by a combination of cash, equity and debt in our experience.

With respect to equity commitments, the investors adhering to the Buyout Group typically execute an equity commitment letter undertaking to finance the transaction, subject to completion of the merger and any regulatory approvals. They typically also provide guarantees for any costs and expenses and termination fees in case the merger is not completed. Within the Buyout Group, relations between the various parties are governed by an interim investors' agreement or a consortium agreement, which is negotiated prior to finalizing the merger terms.

A portion of the financing that is needed for a merger is typically provided by one or several banks, through a bilateral or a syndicated lending facility, or in the form of a bridge loan that is to be repaid shortly after the completion of the merger. As there is no prohibition on financial assistance under Cayman Islands law, a company may fund or guarantee the acquisition of its own shares, as long as the transaction taken as a whole is deemed by its board of directors as being in the best interests of the relevant company.

6. To the extent that the Buyout Group requires debt finance, what is the usual security package that is put in place?

The security package that is put in place will ultimately depend on the creditworthiness of the borrower group and other commercial considerations, but as a general rule will include:

(a) an equitable share mortgage over the shares of MergerCo prior to the Effective Time (the "**Merger Sub Share Security**");

(b) an equitable share mortgage over the shares of the Target from the Effective Time;

(c) security over the assets of MergerCo prior to the Effective Time (the "**Merger Sub Asset Security**"); and

(d) security over the assets of the Target from the Effective Time (the "**Target Asset Security**").

It is worth noting that:

(a) the Merger Sub Share Security sometimes contains an automatic discharge provision from the Effective Time, but certain lenders resist this in case the merger is subsequently unwound;

(b) many lenders are happy to rely on a debenture that is entered into as part of the Merger Sub Asset Security package for the purposes of the Target Asset Security, though the security is typically drafted to make clear that it will attach to the Target's assets from the Effective Time; and

(c) the register of mortgages and charges of the Target at the Effective Time should include details of the security interests granted by MergerCo prior to the Effective Time as the Target is, subject to any specific arrangements, liable to all such security interests.

7. What merger-related documents typically need to be provided to the lender(s) as conditions precedent to a financing in a privatization?

Copies of the following merger specific conditions precedent typically need to be delivered to the lender(s):

(a) the executed merger documents (other than the Plan of Merger), which usually include the acquisition agreement, the company disclosure schedule and any other document designated as a "merger document";
(b) the agreed form Plan of Merger, which is typically expressed to be subject to any amendments recommended by the Cayman Islands Registrar;
(c) the form of constitutional documents and statutory registers to be issued by the registered office service provider of the Target at the Effective Time;
(d) a merger costs certificate, which is usually satisfied by providing a funds flow statement;
(e) a merger conditions certificate with respect to the satisfaction of conditions under the Merger Agreement, as well as certain solvency conditions;
(f) the corporate authorizations, which include board and shareholder resolutions of the constituent companies and resolutions of the Target's special committee;
(g) the "section 233(9) documents", which include the declarations and undertaking referenced above, as well as a certificate of good standing in relation to each constituent company; and
(h) the secured creditor consent.

8. What merger-related documents typically need to be provided to the lender(s) as conditions subsequent to a financing in a privatization?

In our experience, closing of the merger typically occurs within 2 business days of the utilization date. Copies of the following merger specific conditions subsequent typically need to be delivered to the lender(s):

(a) the application letter to register the Plan of Merger stamped by the Cayman Islands Registrar;
(b) a certified copy of the Plan of Merger;
(c) the certificate of merger;
(d) a certificate of good standing of the Target as the surviving company issued after the Effective Time;
(e) certified copies of the Target's updated constitutional documents and statutory registers; and
(f) a Cayman Islands law legal opinion with respect to the effectiveness of the merger.

9. What factors have historically contributed to the listing of Chinese businesses on NASDAQ and the NYSE and their subsequent privatization?

In the 1990s, many Chinese companies chose to list on NASDAQ or the NYSE to gain credibility and access to capital from US investors. In or around 2011 and 2012, this trend changed[ix]. While US listings remained attractive for Chinese companies, the cost of complying with reporting standards continued to increase. Additionally, a lack of comprehension by US investors of the corporate structures being utilized by these companies and of the underlying business environment in China led to lower market valuations for these Chinese companies.

This opened the door for arbitrage opportunities. A Chinese company which was listed on NASDAQ or the NYSE but which had a stock market value lower than its intrinsic value would be taken private and de-listed with help from private equity sponsors and either: (i) continue to be privately held and later sold to a strategic or a financial buyer, or (ii) re-listed on the Shanghai Stock Exchange, the Shenzhen Stock Exchange or the Hong Kong Stock Exchange for better pricing. A wave of merger take-private transactions followed and this trend has resurfaced throughout the Covid-19 pandemic.

Since 2010[x], the Cayman Merger Law has offered a more streamlined and efficient offshore alternative to the onshore merger law regimes (e.g. in New York and Delaware). The popularity of the Cayman Islands for merger take-privates further increased in 2011 when the shareholder voting threshold for approving a merger was reduced to a special shareholder resolution requiring only two-thirds of the votes cast[xi].

10. Why have Cayman Islands merger take-privates generally proven to be a popular means of privatization?

The Cayman Merger Law is attractive for both companies and investors due to the process being relatively straightforward and simpler than either a tender offer under section 88 of the Cayman Islands Companies Act or a court-approved scheme of arrangement under sections 86 or 87 of the Cayman Islands Companies Act. Cayman Islands merger take-privates are also well tried and tested in practice.

11. What is driving the current privatization of Chinese companies from NASDAQ and the NYSE?

Despite tensions between the US and China, Chinese companies raised a total of US$17.55 billion in US IPOs by the end of the first quarter of 2021, which is more than four times the amount raised during the previous 12-month period[xii]. However, the tides are arguably turning and we foresee that a large number of Chinese companies that are currently listed on NASDAQ or the NYSE will be de-listed in the short to medium term for a variety of reasons.

Firstly, the Holding Foreign Companies Accountable Act (the "**HFCA Act**") now requires companies that are listed in the US to declare whether they are owned or controlled by a foreign government. In addition, in response to the fraud perpetrated in connection with Luckin Coffee, which culminated in trading of the company's shares being halted on 6 April 2020 and de-listing by NASDAQ on 29 June 2020, the HFCA Act also authorizes the de-listing of foreign companies from US stock exchanges if they fail to provide the US Public Company Accounting Oversight Board with access to auditing records covering a three consecutive year period[xiii]. We anticipate that these requirements will prove unappealing to certain businesses.

Secondly, US-listed Chinese companies are facing enhanced levels of scrutiny from both US and Chinese regulators. For example, the US Securities and Exchange Commission is scrutinizing variable interest entities ("**VIE**") and requiring enhanced disclosures to be provided to investors regarding the key risks of investing in VIE structures[xiv]. This is in addition to the blacklisting of over 130 Chinese companies by the Trump and Biden administrations, as a result of which new investors are unable to purchase stocks in these entities on the US stock market[xv]. The Cyberspace Administration of China has also imposed additional conditions on Chinese businesses that want to list of overseas[xvi] and the crackdown has wiped hundreds of billions of US dollars off the market capitalizations of certain listed companies, particularly in the education and technology sectors[xvii].

Thirdly, the prospect of listing in Hong Kong or China is understandably appealing to US-listed Chinese companies that wish to avoid blacklisting and onerous auditing regulations and achieve better valuation levels. For example, US-listed DQ, a leading player in the solar energy supply chain with significant operations in Xinjiang, recently listed its key operating subsidiary in Shanghai's STAR Market at a valuation level 3 times higher than in the US[xviii]. We predict that other companies are likely to follow this path given the trends which have been identified in this article.

This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific advice, please contact:

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[i] Reuters: https://www.reuters.com/article/joyy-privatisation-idCNL1N2PX0LL.

[ii] We use the term "Chinese companies" to refer to entities within a corporate structure (e.g. as part of a VIE structure) where the operating entity is based in the People's Republic of China.

[iii] East Capital: https://www.eastcapital.com/Look-East/Experts/Dmitriy-Vlasov1/the-returnee phenomenon/.

[iv] NASDAQ Global Indexes: History for HXC (nasdaqomx.com).

[v] MergerCo is typically a newly incorporated Cayman Islands special purpose vehicle.

[vi] This is on the assumption that a higher threshold is not specified in the memorandum of association and articles of association of the relevant Cayman Islands company.

[vii] If a secured creditor fails to grant such consent, the relevant constituent company may apply to a court of the Cayman Islands for a waiver.

[viii] Such date or event must be no more than 90 days after the Plan of Merger is registered by the Cayman Islands Registrar.

[ix] A number of companies were de-listed for fraud and accounting scandals in 2011 and 2012.

[x] The statutory merger regime was introduced into Cayman Islands law in 2009 and used for the first time for a Chinese take-private in 2010 with respect to Tongjitang Chinese Medicines Company (NYSE: TCM).

[xi] This is on the assumption that a higher threshold is not specified in the memorandum of association and articles of association of the relevant Cayman Islands company.

[xii] SCMP: https://www.scmp.com/business/article/3133420/despite-delisting-concerns-number-chinese-companies-us-equity-markets.

[xiii] Congress.gov: https://www.congress.gov/bill/116th-congress/senate-bill/945.

[xiv] US SEC: SEC.gov | Statement on Investor Protection Related to Recent Developments in China.

[xv] CNBC: U.S. adds 14 Chinese companies, to economic blacklist over Xinjiang (cnbc.com).

[xvi] CNBC: China's cyberspace regulator lays out conditions for IPOs (cnbc.com).

[xvii] Reuters: Factbox: China crackdown wipes hundreds of billions off top companies' values | Reuters.

[xviii] East Capital: https://www.eastcapital.com/Look-East/Experts/Dmitriy-Vlasov1/the-returnee phenomenon/.