

Fordham Journal of Corporate & Financial Law

Volume 17, Number 4

2012

Article 10

Private Equity Investment in the BRICs

Andreas Woeller*

*

Copyright ©2012 by the authors. *Fordham Journal of Corporate & Financial Law* is produced by The Berkeley Electronic Press (bepress). <http://ir.lawnet.fordham.edu/jcfl>

Private Equity Investment in the BRICs*

Andreas Woeller

Abstract

This Article investigates the legal and economic environment for private equity investments in Brazil, Russia, India and China (“BRIC”). In contrast with disappointing returns in the 1990s, private equity investment has soared in developing countries over the past decade. To explain what has led to the recent success of private equity in the BRICs, this Article will first give an overview of the challenges faced generally when investing in portfolio companies in developing markets and then analyze the legal and economic framework for each of the four BRICs. This Article finds that Brazil and China offer the best opportunities for private equity because investors can rely on strong domestic capital markets for the exit. While India is not far behind, Russia still has room for improvement, particularly with regard to the reliability of its legal system and the attractiveness of its capital markets.

KEYWORDS: Private Equity, International, BRIC, Investment, Markets

*LL.M., 2011, Fordham University School of Law; J.D. equivalent, 2010, University of Muenster, Germany. I would like to thank the editors and staff of the Fordham Journal of Corporate & Financial Law for this opportunity and their hard work. A special thank you to my parents for making this year possible and to Jiemei for her unwavering support.

VOLUME XVII

2012

NUMBER 4



FORDHAM

JOURNAL OF
CORPORATE & FINANCIAL LAW

PRIVATE EQUITY INVESTMENT
IN THE BRICS

Andreas Woeller

PRIVATE EQUITY INVESTMENT IN THE BRICS

*Andreas Woeller**

ABSTRACT

This Article investigates the legal and economic environment for private equity investments in Brazil, Russia, India and China (“BRIC”). In contrast with disappointing returns in the 1990s, private equity investment has soared in developing countries over the past decade. To explain what has led to the recent success of private equity in the BRICs, this Article will first give an overview of the challenges faced generally when investing in portfolio companies in developing markets and then analyze the legal and economic framework for each of the four BRICs. This Article finds that Brazil and China offer the best opportunities for private equity because investors can rely on strong domestic capital markets for the exit. While India is not far behind, Russia still has room for improvement, particularly with regard to the reliability of its legal system and the attractiveness of its capital markets.

TABLE OF CONTENTS

INTRODUCTION	1308
I. THE PRIVATE EQUITY LIFE CYCLE AND DIFFICULTIES WHEN INVESTING IN EMERGING MARKETS	1312
A. DUE DILIGENCE: CHOOSING MARKET AND TARGET	1313
1. <i>Choosing the Market</i>	1314
2. <i>Choosing the Target</i>	1314
B. MAKING THE INVESTMENT	1315
C. EXITING THE INVESTMENT	1317

* LL.M., 2011, Fordham University School of Law; J.D. equivalent, 2010, University of Muenster, Germany. I would like to thank the editors and staff of the Fordham Journal of Corporate & Financial Law for this opportunity and their hard work. A special thank you to my parents for making this year possible and to Jiemei for her unwavering support.

II. LEGAL ENVIRONMENT FOR PRIVATE EQUITY IN THE BRICs	1319
A. BRAZIL.....	1320
1. <i>Foreign Direct Investment</i>	1321
2. <i>Takeovers of Public Targets</i>	1322
3. <i>Corporate Law and Enforcement of Contractual Rights</i>	1323
4. <i>Exiting from the Brazilian Investment</i>	1328
B. RUSSIA.....	1330
1. <i>Foreign Direct Investment</i>	1331
2. <i>Takeovers of Public Targets</i>	1332
3. <i>Corporate Law and Legal Enforcement</i>	1333
4. <i>Exiting from the Russian Investment</i>	1338
C. INDIA	1340
1. <i>Foreign Direct Investment</i>	1340
2. <i>Takeovers of Public Targets</i>	1342
3. <i>Corporate Law and Legal Enforcement</i>	1343
4. <i>Exiting from the Indian Investment</i>	1346
D. CHINA.....	1348
1. <i>Foreign Direct Investment</i>	1350
2. <i>Takeovers of Public Targets</i>	1351
3. <i>Corporate Law and Legal Enforcement</i>	1352
4. <i>Exiting from the Chinese Investment</i>	1356
CONCLUSION	1357

INTRODUCTION

On November 30, 2001, Jim O’Neill, then Goldman Sachs’ Head of Global Economic Research, coined the term “BRICs,” referring to the growing economies of Brazil, Russia, India, and China.¹ He predicted that, “over the next 10 years, the weight of the BRICs and especially China in world GDP will grow”² and that “by 2011 China

1. JIM O’NEILL, GOLDMAN SACHS, GLOBAL ECON. PAPER NO: 66, BUILDING BETTER GLOBAL ECONOMIC BRICs (2001), available at <http://www.goldmansachs.com/our-thinking/topics/brics/brics-reports-pdfs/build-better-brics.pdf>; see Beth Kowitz, *For Mr. Bric, Nations Meeting a Milestone*, CNN MONEY (June 17, 2009, 2:52 PM), http://money.cnn.com/2009/06/17/news/economy/goldman_sachs_jim_oneill_interview.fortune/index.htm.

2. O’NEILL, *supra* note 1, at 1.

will actually be as big as Germany on a current GDP basis, and Brazil and India not far behind Italy.”³ Another Goldman Sachs Economics paper later forecasted that “[t]he BRICs economies taken together could be larger than the G6 by 2039.”⁴ In 2007, China already surpassed Germany in current gross domestic product (“GDP”), outrunning Jim O’Neill’s prediction by four years.⁵ By 2011, Brazil was the sixth largest economy, Russia ninth, and India tenth.⁶ The BRIC phenomenon has now taken a political dimension as well. In May 2008, Russia hosted the first BRIC summit, followed by Brazil in 2010.⁷

As competition for attractive targets within the United States increases steadily, American private equity firms gradually look for more investments in the global markets.⁸ Europe would be a potential market as it provides the appropriate legal infrastructure, but it cannot compete with the high growth rates of the emerging markets.⁹ Additionally, low company valuations in markets with capital shortages provide more opportunity for high returns.¹⁰ Therefore, capital in the private equity industry is increasingly flowing from developed countries into developing markets. Over the past decade, fundraising for emerging markets private equity funds has grown exponentially from \$3.2 billion in 2002 to a record high of \$66.5 billion in 2008.¹¹ During the same period, investments in emerging markets rose from \$2 billion to \$47.8

3. *Id.* at 6.

4. DOMINIC WILSON & ROOPA PURUSHOTHAMAN, GOLDMAN SACHS, GLOBAL ECON. PAPER NO: 99, DREAMING WITH BRICS: THE PATH TO 2050, at 3 (2003), available at <http://www2.goldmansachs.com/ideas/brics/book/99-dreaming.pdf>.

5. See *Indicators, GDP (current US\$)*, WORLD BANK, <http://data.worldbank.org/indicator/NY.GDP.MKTP.CD> (last visited Oct. 3, 2012).

6. *Id.*

7. Gillian Tett, *The Man Who Named the Future*, FIN. TIMES (London), Jan. 16, 2010, at 30.

8. See HEINO MEERKATT & HEINRICH LIECHTENSTEIN, ET AL., NEW MARKETS, NEW RULES: WILL EMERGING MARKETS RESHAPE PRIVATE EQUITY? 3 (2010), available at <http://www.bcg.com/documents/file64907.pdf>.

9. See Gonzalo Pacanins, *Private Equity in Developing Countries* (1997) (unpublished MBA essay, Harvard Business School), available at <http://www.people.hbs.edu/jlerner/develop.html> (last visited Oct. 3, 2012).

10. See Roger Leeds & Julie Sunderland, *Private Equity Investing in Emerging Markets*, 15 J. APPLIED CORP. FIN. 111, 112 (2003).

11. EMERGING MKTS. PRIVATE EQUITY ASS’N, FULL-YEAR 2011 INDUSTRY STATISTICS (2012) [hereinafter EMPEA], available at <http://www.empea.org/research/data-and-statistics/full-year-2011-em-pe-industry-statistics/>.

billion, with a record high of \$53.1 billion in 2007.¹² A record amount of \$92.5 billion flowed into emerging market funds in 2010.¹³

In many regards, these emerging countries have even benefited from the recent financial crisis. The BRICs' contribution to global growth has risen to forty-five percent since the beginning of the financial crisis in 2007, up from twenty-four percent in the years 2000–2006.¹⁴ The stagnant U.S. economy contributed to the trend towards international diversification.¹⁵ The economic downturn in the U.S. has reduced the number of available private equity deals, thus requiring firms to look for targets globally in order to compete successfully and deliver expected returns.¹⁶

Private equity in emerging markets not only benefits investors from developed countries; it can also have substantial benefits for a developing market economy and the businesses operating therein. Often, private equity bridges the gap in corporate financing needed for growth, offering a mature business an alternative between costly debt financing and an Initial Public Offering (“IPO”).¹⁷ Additionally, a private equity firm will often provide experienced management teams¹⁸, and in the event of an investment exit through an IPO on an international exchange, the private equity backing allows the target initial access to

12. *Id.*

13. Alison Tudor, *Baring Raises \$2.46 Billion*, WALL ST. J. (Feb. 1, 2011, 10:17 AM), <http://online.wsj.com/article/SB10001424052748703445904576117543100479536.html>.

14. See JIM O'NEILL & ANNA STUPNYTSKA, GOLDMAN SACHS, GLOBAL ECON. PAPER NO: 192, THE LONG-TERM OUTLOOK FOR THE BRICS AND N-11 POST CRISIS 6 (2009), available at <http://www.goldmansachs.com/our-thinking/topics/brics/brics-reports-pdfs/long-term-outlook.pdf>.

15. See Chris Snow, *The Credit Crisis of 2008: Impact of Credit Crisis on Private Equity Markets*, 28 REV. BANKING & FIN. L. 71, 74 (2008).

16. See Thomas W. France, *Seeing Beyond the Cycle: Understanding the Long- and Short-Term Effects of the Economic Downturn*, in PRIVATE EQUITY AND VENTURE CAPITAL TRENDS IN A TURBULENT ECONOMY: LEADING LAWYERS ON DEVELOPING STRATEGIC ALLIANCES, EVALUATING NEW GROWTH OPPORTUNITIES, AND ANALYZING SHORT- AND LONG-TERM MARKET CHANGES *3 (2009).

17. See DAVID P. STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS, AND PRIVATE EQUITY 342 (2010).

18. See *id.* at 325.

international capital markets.¹⁹ The increase in liquidity in the domestic capital markets of a developing country through foreign investment also reduces the cost of raising capital domestically.²⁰ It encourages other domestic and foreign issuers to come to the capital markets, thereby creating further liquidity.²¹

Expectations were not realized, however, during the first surge of emerging markets private equity in the mid-1990s. Returns were often even lower than those of comparable funds in the United States and Europe, despite the significantly higher risks involved.²² As a result, emerging markets private equity funds had difficulty raising funds at the turn of the century.²³ Leeds and Sunderland name three principal reasons for the initial underperformance. First, targets in emerging markets often suffered under low corporate governance standards, including a low level of accountability resulting in high agency costs.²⁴ Second, many private equity funds found legal recourse limited as key contractual protections were unenforceable in the jurisdictions where they made their investments.²⁵ Third, domestic capital markets could not offer the necessary liquidity to allow for high return IPO exits, and international capital markets proved to be a realistic option only for the largest companies of developing countries.²⁶

This Article will analyze the current legal and political environment faced by private equity funds investing in the BRICs. In what ways have the BRICs embraced the potential benefits offered by foreign private equity investment and created a more investment-friendly framework that can explain the exponential growth in emerging markets private equity over the past decade? To answer this question, this Article will first briefly outline the private equity life cycle and describe the difficulties faced in each stage when applied to an emerging market environment, from the investment until the exit (Section II). Then, this

19. See, e.g., KPMG, HOW YOU CAN ACCESS THE PRIVATE EQUITY MARKET (2007), available at http://www.kpmg.com.cn/en/virtual_library/Private_equity/How_you_can_access_PE_market.pdf.

20. Christopher J. Mailander, *Searching for Liquidity: United States Exit Strategies for International Private Equity Investment*, 13 AM. U. INT'L L. REV. 71, 79 (1997).

21. *Id.*

22. Leeds & Sunderland, *supra* note 10, at 111.

23. *Id.* at 114.

24. *Id.* at 114–15.

25. *Id.* at 115.

26. *Id.* at 115–16.

Article will analyze the legal and economic conditions relevant to private equity in each of the four BRICs (Section III). In this context, the objective is not to provide an exhaustive treatise of all relevant aspects corporate counsel has to consider when advising a private equity firm investing in the BRICs, but rather to lay the foundation for a comparison of the investment climate for private equity in the four countries, which will provide insight regarding the key drivers for private equity growth (Section IV).

I. THE PRIVATE EQUITY LIFE CYCLE AND DIFFICULTIES WHEN INVESTING IN EMERGING MARKETS

A private equity investment—the private placement of money in a business venture²⁷—can take very different forms, such as a leveraged buyout (“LBO”), growth capital, mezzanine lending, and venture capital.²⁸ LBOs are less common in emerging markets private equity investments compared to the U.S. private equity market, due to less available leverage²⁹ and foreign direct investment (“FDI”) restrictions limiting foreign investors to certain percentages of the target’s outstanding shares.³⁰ Emerging markets also pose certain challenges to the potential for traditional venture capital investments. Among such challenges can be the lack of trained local talent and infrastructure and weak protection of intellectual property.³¹ The inherent risk of venture capital may be increased by the market circumstances to a degree that renders the investment inadvisable. Thus, growth capital investments are most common and, interestingly, also produce higher returns in emerging markets.³²

27. See, e.g., José Raúl Alcántar & David W. McCombie III, *Hispanic Private Equity: A Cultural Approach to Achieving Superior Investment Returns*, 10 HARV. LATINO L. REV. 233, 235 (2007).

28. STOWELL, *supra* note 17, at 283; see also Steven D. Bortnick & John I. Forry, *Structuring International Private Equity Investments in the People’s Republic of China*, 126 BANKING L.J. 195, 196 (2009).

29. Greg Bright, *BRICs offer old-fashioned private equity growth*, INVESTMENT & TECHNOLOGY, Mar. 1, 2011, <http://www.investmentmagazine.com.au/i-t-news/brics-offer-old-fashioned-private-equity-growth>.

30. See *infra* Part II for foreign direct investment (“FDI”) in the respective BRICs.

31. Pacanins, *supra* note 9.

32. See MEERKATT & LIECHTENSTEIN, *supra* note 8, at 3.

Independent from the underlying private equity strategy, the private equity lifecycle typically begins with raising funds from end-investors, then moves on to identifying and buying into appropriate target companies, and ends with an exit that liquidates the investment and enables the private equity firm to distribute the returns to the end-investors.³³ In a domestic private equity investment, the most important decision is the choice of an appropriate target company. The private equity investor will make this decision based on the information it receives from possible target companies and its experience in evaluating such information.³⁴ However, when investing in an emerging market, this decision can follow only after a determination of a proper market to invest in. Subsequently, the deal must be structured according to both the legal and economic frameworks of the market and the target company's individual situation. Right from the beginning, possible exit strategies must be taken into account because they influence the structuring of the investment. This is particularly true when investing in emerging markets, where the lack of a viable exit strategy is often a major concern.³⁵

This Section will investigate the particular difficulties that a private equity investment faces in each of the stages of the private equity life cycle. Part A will describe how the legal and economic frameworks of a particular country affect the investment decision, as well as the factors to be considered when choosing an appropriate target. Part B will discuss the deal structure and the instruments employed by a private equity investor to ensure its returns. Finally, Part C will illustrate the different means of exiting a private equity investment in an emerging market.

A. DUE DILIGENCE: CHOOSING MARKET AND TARGET

At the outset, a private equity investor has to decide which particular market it wishes to invest in. Numerous factors pose a particular challenge to private equity investment in emerging markets, and these factors can vary substantially depending on the individual

33. See Mailander, *supra* note 20, at 75–77; see also Wei Shen, *China's Dilemma: How Can a Weak Company Law Regime Support a Strong Market for International Private Equity Investments? A Real 'Piggybacking' Case*, 11 BUS. L. INT'L. 195, 196–97 (2010).

34. Mailander, *supra* note 20, at 76.

35. See *id.* at 78.

market. Risks to be considered include currency fluctuation, political instability, liquidity, accounting, tax, and volatility of capital markets.³⁶ Thus, private equity funds typically focus on a particular market in order to ensure that managers have the required expertise, as well as to offer investors the required risk profile.

1. *Choosing the Market*

There are several aspects that are particularly important when choosing an appropriate market. The first of these is the quality of the legal system and its suitability for foreign private equity investment.³⁷ A government might restrict access to foreign investment in certain key industries or the investment might be subject to government approval, the denial of which at a progressed stage of the investment may create significant costs. Moreover, the investor must consider how reliable the judicial system is in enforcing its rights in the event of a dispute. In this context, corruption or bias towards foreign investors may still be a potential risk.³⁸ The second concern is the liquidity and functionality of the local capital markets. The objective of a private equity investment—to obtain a higher return after a relatively long commitment of capital—relies on the availability of a profitable exit. When lack of liquidity or the underdeveloped regulations of capital markets in the domestic market bar access to an IPO in the domestic market, the investor must resort to alternative exit strategies that may require more preparation and offer substantially less certain returns.³⁹

Part III of this Article will scrutinize these legal and economic factors in the BRIC countries to determine their suitability for foreign private equity investment.

2. *Choosing the Target*

Once the appropriate market has been determined, the investor must identify an appropriate target company. Unlike in the U.S. private equity market, where investors often receive offers for potential targets,

36. See STOWELL, *supra* note 17, at 143.

37. See Leeds & Sunderland, *supra* note 10, at 115.

38. See Pacanins, *supra* note 9.

39. See Mailander, *supra* note 20, at 108; Leeds & Sunderland, *supra* note 10, at 115. Alternative exit strategies will be discussed in Part C of this section.

the investor must assume a more proactive role in identifying and selecting suitable targets.⁴⁰ In doing so, an investor should establish a local base of operations in order to generate the necessary market intelligence and learn of new investment opportunities, which are often communicated through well-connected business and social circles.⁴¹ An “ideal” target company should have highly qualified and motivated management because the high leverage employed in a buyout does not leave much room for error in the future operation of the company.⁴² Where a private equity firm provides growth capital, problems can arise particularly in family-run companies when management resists the influence of the financial investor.⁴³ Moreover, a target company should have a substantial and stable cash flow to service the new debt, low leverage at the outside, as well as suitable assets that can be used as collateral for the debt to be incurred.⁴⁴ Determining whether a potential target satisfies these requirements can be difficult in practice. Where sound financial and operating information is not available, it becomes almost impossible to evaluate a target company accurately during the due diligence process.⁴⁵ Even if financial statements are available, it can be difficult to assess their accuracy when they are not independently audited or based on accepted financial accounting standards.⁴⁶

B. MAKING THE INVESTMENT

When a suitable target has been identified, the private equity investor moves on to negotiate and consummate the deal. The structure of the deal depends largely on the investment strategy. In a LBO, the private equity firm will take control of the target company by the purchase of all or most of the company’s equity.⁴⁷ Thus, the LBO

40. Pacanins, *supra* note 9; Leeds & Sunderland, *supra* note 10, at 117.

41. Pacanins, *supra* note 9; *see* Leeds & Sunderland, *supra* note 10, at 116 (naming the reluctance of private equity funds to establish local operations as a major reason for the disappointing performance of private equity in emerging markets in the 1990s).

42. STOWELL, *supra* note 17, at 285.

43. Leeds & Sunderland, *supra* note 10, at 114; *see also* Érica Gorga, *Culture and Corporate Law Reform: A Case Study of Brazil*, 27 U. PA. J. INT’L ECON. L. 803, 813 (2006).

44. STOWELL, *supra* note 17, at 285.

45. Leeds & Sunderland, *supra* note 10, at 114.

46. *Id.*

47. STOWELL, *supra* note 17, at 284.

investor will be less concerned with ensuring additional control rights than a minority investor.⁴⁸ The focus in a buyout lies on ensuring that the target can meet its debt obligations, and on aligning management incentives with those of the investor.⁴⁹ In a growth capital scenario, however, the private equity firm will take only a minority position in order to provide capital to the target company without a change of control.⁵⁰ A minority position translates to a higher risk and the private equity investor will seek to ensure its return through the use of convertible equity or debt.⁵¹ Depending on the market, these instruments may not be available, or at least not to the same extent, in developing countries.⁵² Moreover, the investor will seek to gain influence over the target company's management through control rights.⁵³ Such control rights usually include, among others, anti-dilution clauses, tag-along clauses and supermajority provisions.⁵⁴ Therefore, the enforceability of such control rights in the event of a dispute is of extreme importance for a growth capital investor.⁵⁵ When private equity firms are faced with less efficient legal enforcement, they usually prefer majority ownership and more board representation over contractual rights.⁵⁶ However, where majority ownership is prevented by restrictions on foreign investment or the lack of available financing, the reliability of the local judicial system becomes again a major concern.⁵⁷

48. *Buyouts: Overview*, PRACTICAL LAW COMPANY, <http://us.practicallaw.com/4-381-1368?q=buyouts%20overview>.

49. *Id.*

50. STOWELL, *supra* note 17, at 283.

51. *Minority Investments: Overview*, PRACTICAL LAW COMPANY, <http://us.practical-law.com/1-422-1158?q=minority%20investments%20overview> [hereinafter *Minority Investments: Overview*]

52. See *infra* Part II, for the availability of financial instruments in each of the BRICs.

53. *Minority Investments: Overview*, *supra* note 51.

54. See Cinthia Daniela Bertan Ribeiro, *Financial Contracting Choices in Brazil: Does the Brazilian Legal Environment Allow Private Equity Groups to Enter Into Complex Contractual Arrangements With Brazilian Companies?*, 13 L. & BUS. REV. AM. 355, 368-69 (2007), for a description of these control rights.

55. See STOWELL, *supra* note 17, at 361.

56. Ribeiro, *supra* note 54, at 370 (citing Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, 120 Q. J. ECON. 223, 224-25 (2005)).

57. See *supra* Part I.A.1.

Another major determinant in the structure of a private equity transaction is tax efficiency. Private equity firms will often incorporate holding companies in one or more offshore jurisdictions in order to take advantage of tax havens and beneficial tax treaties.⁵⁸ Such tax considerations are complex and independent from the general legal, economic and political environment of private equity investments and are thus beyond the scope of this Article.

C. EXITING THE INVESTMENT

The exit enables the private equity fund to liquidate its investment and distribute the returns to its investors. Consequently, the exit determines the return for the investors and is therefore quintessential for a successful private equity investment.⁵⁹

The most profitable way of exiting a private equity investment is usually by way of an IPO on a domestic exchange.⁶⁰ Thus, private equity investment is most attractive where liquid and developed capital markets enable the investor to take the target company public. A major concern about emerging markets traditionally has been that capital markets are either not sufficiently liquid or lack the required regulatory infrastructure.⁶¹ However, the BRICs, especially Brazil and China, have taken significant steps to increase the liquidity and attractiveness of their domestic capital markets.⁶²

When a domestic IPO does not promise to achieve the required result, the listing of shares on an exchange in a developed market offers an important alternative. Traditionally, the U.S. has been the primary market for foreign listings due to its high liquidity and receptiveness for foreign companies.⁶³ Even though the majority of global IPOs are now conducted outside the U.S., listings in the U.S. still amounted to 31% of

58. See, e.g., Bortnick & Forry, *supra* note 28, at 198-99.

59. See *id.* at 197-98.

60. Leeds & Sunderland, *supra* note 10, at 115.

61. *Id.*; Pacanins, *supra* note 9.

62. See *infra* Part II, for an analysis of the BRIC capital markets.

63. Mailander, *supra* note 20, at 80. *But see* Christopher J. Mailander, *Tempering a Chill on Skittish Capital Markets: Illiquid Investments in the Wake of Global Volatility*, 13 AM. U. INT'L L. REV. 379, 384-85 (1997) (pointing out that U.S. investors have proven to be more receptive to offerings by foreign issuers from developed countries rather than those from emerging markets).

all IPOs launched in 2008.⁶⁴ In order to free potential investors from possible currency risk and limitations on the investment in foreign securities, offerings of foreign companies in the U.S. are usually executed through the issue of American Depository Receipts (“ADRs”).⁶⁵ Shares of the foreign issuer are deposited with a U.S. bank, which issues dollar-denominated ADRs that represent the underlying shares.⁶⁶ The U.S. depository bank is also responsible for collecting share dividends from the issuer and distributing them to the holders of ADRs, converted into U.S. dollars.⁶⁷ An ADR issue does not necessarily need to be listed on an exchange and registered with the SEC. A listing on an over-the-counter market or a private placement exempt from the registration requirements is also possible and can significantly reduce the costs and potential liabilities associated with registration under the Securities and Exchange Act of 1934.⁶⁸ These options may be particularly attractive for companies from emerging markets.⁶⁹ Despite its lower liquidity, this market now appears to be the predominant means for foreign companies to raise capital in the U.S.⁷⁰ The difficulties faced when offering in the U.S. market will, however, require the private equity firm to play an active role and assist the portfolio company in the preparation and execution of the exit.⁷¹ Also, a listing on an exchange in a developed market may only be realistic for large companies in the emerging market with sufficient visibility to attract foreign investors.⁷²

If a public offering does not appear feasible either domestically or abroad, the private equity firm can exit the investment through a private sale. Such a sale can be to a strategic buyer or to a later stage financial investor. Companies in emerging markets that received foreign private

64. STOWELL, *supra* note 17, at 146-47.

65. Mailander, *supra* note 20, at 83. See S. Eric Wang, *Investing Abroad: Regulation S and U.S. Retail Investment in Foreign Securities*, 10 U. MIAMI BUS. L. REV. 329 (2002), for a discussion of Regulation S restricting U.S. investment in foreign securities.

66. Mailander, *supra* note 20, at 83; STOWELL, *supra* note 17, at 151.

67. Mailander, *supra* note 20, at 84.

68. *Id.* at 99.

69. *Id.* at 105-07.

70. HAL S. SCOTT, *INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 52* (Foundation Press 17th ed. 2010).

71. Mailander, *supra* note 20, at 108.

72. Robert D. Stillman, *Alternative Exit Strategies for International Private Equity*, 13 AM. U. INT'L L. REV. 133, 134 (1997).

equity investment can present attractive opportunities for strategic buyers from developed countries because the private equity investor often will have introduced internationally accepted accounting standards and more efficient management structures.⁷³ Thus, when a private equity firm invests significant resources to add value by making operations and management more efficient, sales to strategic buyers have the potential to achieve similar returns as public offerings.⁷⁴ Otherwise, however, private sales tend not to achieve the same returns as public offerings.⁷⁵ In addition, it may be difficult to limit the seller's liabilities in regard to the portfolio company. Because of the private equity firm's objective to exit the investment entirely, such limitations on liability may have to be bought by way of a lower purchase price. Thus, it is important for the private equity firm to consider the likelihood of a private sale at the outset when making the investment. Potentially, the lack of a viable exit strategy renders an otherwise attractive investment opportunity infeasible.

II. LEGAL ENVIRONMENT FOR PRIVATE EQUITY IN THE BRICS

The previous section carved out the challenges generally faced by a private equity firm when investing in an emerging market. This section will look in more detail at the legal and economic environment for private equity in the four leading emerging markets: Brazil, Russia, India and China.⁷⁶ It is important to note, however, that these four countries cannot be understood as being representative of the larger geographical market they are located in. Especially in Asia, regulatory

73. *Id.* at 134-35; see STOWELL, *supra* note 17, at 325 (concluding that private equity-owned companies tend to be better managed).

74. See *infra* Part II.B.3.a.

75. Mailander, *supra* note 20, at 386.

76. In 2005, Goldman Sachs recognized another group of emerging economies, the Next Eleven (N-11), consisting of Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, South Korea, Turkey and Vietnam. See Jim O'Neill et al., *How Solid are the BRICs* (Goldman Sachs Global Econ. Working Paper No. 134, 2005), available at <http://www2.goldmansachs.com/our-thinking/brics/brics-reports-pdfs/how-solid.pdf>. However, in terms of current GDP, the BRICs are still the largest emerging economies. See World Bank, *Indicators, GDP (current US\$)*, <http://data.worldbank.org/indicator/NY.GDP.MKTP.CD> (last visited Mar. 24, 2011).

regimes differ significantly between China and other Asian markets, such as Japan or Southeast Asia.

In order to make the observations somewhat comparable, certain legal and economic aspects relevant to private equity will be investigated for each of the four countries. These include the treatment of FDI as the entry barrier for foreign investors, the law applicable to takeovers of public targets (public to private transactions), corporate law and the enforcement of contractual rights, and finally, potential exit strategies—in particular the strength of the domestic IPO market.

A. BRAZIL

In 2010, Brazil's GDP increased by 7.5% compared to the previous year, representing the highest level of growth since 1986.⁷⁷ In 2009, the GDP had reached about \$1.5 trillion, making Brazil the eighth largest economy in the world.⁷⁸ Growth slowed to 2.7% in 2011,⁷⁹ indicating that Brazil did not remain unaffected by a sluggish economy worldwide. However, this did not affect the growth of FDI, which amounted to \$66.7 billion in 2011, up from \$48.5 billion in 2010.⁸⁰ Brazil was forecasted to attract \$45 billion in foreign direct investment in 2010, which would mean a 74% increase from 2009.⁸¹ Even during the financial crisis, the private equity industry in Brazil has performed comparably well. After a record year in 2007 with investments of \$5.3 billion, investments dropped to \$3 billion in 2008 and \$1 billion in 2009, returning to the 2006 level, but rebounding strongly in 2010 to \$4.6

77. *Brazil's GDP Rises 7.5% in 2010, Achieving Best Result in 25 Years*, PR NEWSWIRE, Mar. 3, 2011, <http://www.prnewswire.com/news-releases/brazils-gdp-rises-75-in-2010-achieving-best-result-in-25-years-117329823.html>.

78. WORLD BANK, *supra* note 5.

79. WORLD BANK, *supra* note 5.

80. *Brazil record foreign direct investment more than compensates current account deficit*, MERCOPRESS (Jan. 25, 2012, 03:58 UTC), <http://en.mercopress.com/2012/01/25/brazil-record-foreign-direct-investment-more-than-compensates-current-account-deficit>; see also Kenneth Rapoza, *Slower Brazil Economy Doesn't Stop US Deal Flow*, FORBES (Aug. 25, 2011, 4:27 AM) <http://www.forbes.com/sites/kenrapoza/2011/08/25/slower-brazil-economy-doesn-t-stop-us-deal-flow/>.

81. *Brazil Economy Forecasted to Grow More than 5% in 2010*, PR NEWSWIRE, Jan. 20, 2010, <http://www.prnewswire.com/news-releases/brazil-economy-forecasted-to-grow-more-than-5-in-2010-82184502.html>.

billion.⁸² In large part, this seems due to the fact that Brazilian private equity investments rely to a much lesser extent on leverage.⁸³ Deals with less than 50% equity are rare, and many deals are even made with 100% equity.⁸⁴

Taking in private equity capital in the form of growth capital (25% to 30%) prior to an IPO is a common strategy for family-run Brazilian businesses.⁸⁵ A favorable legal regulatory environment combined with a large number of companies suitable for private equity investment contributes to a favorable climate for the private equity industry.⁸⁶ In response to the growing opportunities in Brazil, several foreign private equity firms, such as Carlyle and Actis, have opened offices in Brazil over the past few years.⁸⁷

1. Foreign Direct Investment

A preliminary concern for every private equity firm investing abroad, but especially for those looking for potential buyout targets, is a country's regulation of FDI. FDI regulation generally either bars FDI entirely in certain strategic sectors or limits it to a specific percentage of a company's outstanding stock.⁸⁸

In Brazil, three government authorities are responsible for the regulation of FDI. The National Monetary Council ("CMN") establishes the general rules concerning the registration of foreign investments.⁸⁹ The Central Bank of Brazil ("BACEN"), among other tasks, controls the foreign exchange markets and executes the rules established by CMN.⁹⁰ The Brazilian Security and Exchange Commission ("CVM") is

82. EMPEA, *supra* note 11.

83. Steve Rubens, *The Future of Brazilian Markets: A Private Equity Perspective*, SEEKING ALPHA, July 6, 2009, <http://seekingalpha.com/article/147086-the-future-of-brazilian-markets-a-private-equity-perspective>.

84. *Latin Flourish*, FIN. TIMES MANDATE, May 2009, http://www.ftmandate.com/news/printpage.php/aid/2060/Latin_flourish.html.

85. STOWELL, *supra* note 17, at 148.

86. Rubens, *supra* note 83.

87. *Latin Flourish*, *supra* note 84 (noting that most foreign private equity investment comes from the U.S. and Europe).

88. See *infra* Parts II.B.1. (Russia), II.C.1. (India) and II.D.1 (China), for FDI regulation in the other BRIC countries.

89. DEMAREST E ALMEIDA, BUSINESS LAWS OF BRAZIL § 3:1 (Sept. 2009).

90. *Id.*

responsible for foreign investor activities on the Brazilian capital markets.⁹¹

Investments in non-regulated sectors can be made without any prior authorization or license and are generally treated the same way as domestic investments.⁹² Invested capital can be remitted freely once it has been registered with BACEN.⁹³ BACEN does not have the authority to determine whether a certain investment is “desirable” or deny registration because of an adverse effect on the Brazilian economy.⁹⁴

Foreign investment in Brazilian companies is entirely prohibited only as it concerns the following activities: (1) exploring, exploiting, and selling radioactive minerals and its by-products; (2) health services; (3) business located on international borders; and (4) post office services.⁹⁵ Foreign investment is limited to 30% ownership of an entity operating newspapers, magazines, and other periodicals, as well as radio and television broadcasters,⁹⁶ and 20% ownership in airlines with concessions for domestic flight routes.⁹⁷

2. Takeovers of Public Targets

Takeover law is relevant for a private equity investor who plans to buy out a public company and take it private. In this case, a private equity investor has to make a mandatory public offering (“OPA”) for acquisition or exchange of securities under Brazilian law.⁹⁸ The OPA must (1) be launched by the company’s controlling shareholder or the company itself; (2) be aimed at the acquisition of all outstanding shares; and (3) achieve the tender by at least two-thirds of the free float.⁹⁹ The statute mandates a floor for the share price offered in the OPA, which

91. *Id.*

92. *Id.* § 3:2.

93. *Id.* § 3:2-3:3.

94. *Id.* § 3:3. The only exception to this rule is an investment in a financial institution.

95. *Id.* § 3:8 (citing CONSTITUIÇÃO FEDERAL [C.F.] [CONSTITUTION] art. 21, item X, XXIII, art. 199, para. 3 (Braz.); Law No. 9263, art. 7).

96. *Id.* § 3:9 (citing CONSTITUIÇÃO FEDERAL [C.F.] [CONSTITUTION] art. 222, para. 1 (Braz.)).

97. *Id.* § 3:11 (citing Lei No. 7,565 art. 181, Item II, de 19 de Novembro de 1986 (Braz.)).

98. *Id.* § 2:17 (citing CVM Regulation 361).

99. *Id.* § 2:18.

includes a certain premium over the share price.¹⁰⁰ Should the acquirer obtain 95% or more of the outstanding shares through the OPA, the remaining shareholders can be squeezed out for the same price.¹⁰¹

A mandatory OPA is triggered when an entity acquires a controlling interest in a public corporation.¹⁰² The CVM determines whether a controlling interest was acquired on a case-by-case basis and not solely on the percentage of stock acquired. In particular, a purchase of stock may be held to be an acquisition of a controlling interest when the acquirer, through a shareholders' agreement, prevails at shareholders' meetings and is able to elect a majority of the board.¹⁰³ Thus, even a private equity firm investing in growth capital may run the risk of being subjected to a mandatory OPA and should therefore carefully structure its investment so as not to be held to have acquired a controlling interest in the target company.

An investor who resides, is domiciled or has its head offices outside Brazil needs to appoint both a representative and a custodian in Brazil.¹⁰⁴ The custodian for the foreign investor's investment in Brazil must be authorized by BACEN and CVM.¹⁰⁵

3. Corporate Law and Enforcement of Contractual Rights

The main legal entities used in Brazil are the limited liability company (*sociedade limitada*) and the corporation (*sociedade anônima*).¹⁰⁶ Structuring the investment as a limited liability company offers simplicity and flexibility in the corporate structure, lower maintenance costs and fewer legal formalities compared to a corporation.¹⁰⁷ However, only a corporation can issue securities or

100. Daniella Tavares, *Using Brazil's Regulatory System as a Thoughtful Experience*, in BANKING AND FINANCE CLIENT STRATEGIES IN CENTRAL AND SOUTH AMERICA: LEADING LAWYERS ON INTERPRETING INTERNATIONAL BANKING LAWS, ADVISING CLIENTS ON ENTERING LATIN AMERICAN CAPITAL MARKETS, AND PREDICTING FINANCIAL MARKET DEVELOPMENT AND STABILITY (2009), available at 2009 WL 2511990, at *5.

101. DEMAREST E ALMEIDA, *supra* note 89, § 2:18.

102. *Id.* § 2:19.

103. *Id.*

104. *Id.* § 2:25.

105. *Id.*

106. *Id.* § 1:1.

107. *Id.*

become a publicly held company.¹⁰⁸ Thus, if the private equity firm aspires to exit the investment through an IPO, it must either structure the target as a corporation from the beginning or convert the limited liability company into a corporation at a later stage.

a. Corporate Governance

The Brazilian Corporation Law sets only minimum standards of corporate governance.¹⁰⁹ Mainly, the corporate governance standards of Brazilian corporations are influenced by the segment of the Brazilian stock exchange BOVESPA on which the company is listed or may aspire to become listed in the future. Law No. 10.303/01 (Oct. 31, 2001) created three corporate governance levels for listing on BOVESPA¹¹⁰ in order to enhance the valuation of companies' securities and attract investors to the market by strengthening transparency and confidence in the stock market.¹¹¹

In order to obtain a listing on one of these three segments, the corporation must voluntarily abide by higher corporate governance and disclosure requirements than those mandated by general Brazilian corporate law.¹¹² The lowest level of corporate governance out of these three segments is mandated by Nivel 1. The issuer must (1) ensure that at least 25% of the issuer's shares are in free float; (2) conduct public offerings in a way that promotes widespread ownership; (3) provide quarterly disclosures; (4) comply with stricter disclosure requirements in regard to insider transactions; (5) file shareholder agreements and stock option plans with BOVESPA; and (6) make a schedule of corporate events available to shareholders.¹¹³ In addition to the Nivel 1 requirements, a Nivel 2 issuer must: (1) grant tagalong rights for all shareholders in the event of a transfer of control; (2) grant voting rights to holders of preferred stock for certain corporate restructurings; (3) establish a board of directors that has at least five members and that

108. *Id.*

109. *See generally* Ribeiro, *supra* note 54.

110. Tavares, *supra* note 100, at *5.

111. Érica Gorga, *Changing the Paradigm of Stock Ownership from Concentrated Towards Dispersed Ownership? Evidence from Brazil and Consequences for Emerging Countries*, 29 *NW. J. INT'L L. & BUS.* 439, 450 (2009).

112. DEMAREST E ALMEIDA, *supra* note 89 § 2:32.

113. *Id.*

requires 1/5 of the board to be comprised of independent (outside) directors; (4) prepare annual financial statements in English and in compliance with U.S. GAAP or IFRS; and (5) agree to arbitration for disputes between the corporation and its shareholders.¹¹⁴

Finally, to obtain a listing on the Novo Mercado, in addition to complying with all Nivel 1 and Nivel 2 requirements, the issuer must issue only common shares.¹¹⁵ At first, the market did not respond as expected to the new segments with enhanced corporate governance levels, with only two companies listed on Novo Mercado, three on Nivel 2, and 31 on Nivel 1.¹¹⁶ This began to change, however, in 2004 and now 126 companies are listed on Novo Mercado, 19 on Nivel 2, and 32 on Nivel 1.¹¹⁷ 230 companies are still listed on the traditional BOVESPA segment.¹¹⁸ Research by Érica Gorga showed that young companies and first-time issuers constitute the vast majority of companies listed on Novo Mercado, whereas older, established companies are reluctant to migrate to higher levels of corporate governance.¹¹⁹ While most private equity firms invest in non-public targets that do not yet need to comply with Novo Mercado's high corporate governance standards, the prospect of a future listing may already induce companies to adhere to certain governance practices at an earlier stage. The evidence from the Novo Mercado listings seems to suggest that management of younger companies in particular are more willing to subject themselves to stricter corporate governance best practices.

One particular concern when investing in Brazilian companies is the often concentrated ownership. Research by Sílvia Mourthé Valadares and Ricardo Pereira Câmara Leal found that in 2000, 62.5% in a sample of 325 companies were controlled by a single shareholder who owned, on average, 74% of the voting shares, and even firms without a single majority shareholder were often controlled by three

114. *Id.*

115. *Id.*

116. Gorga, *supra* note 111, at 452.

117. *Company Search*, BM&FBOVESPA, <http://www.bmfbovespa.com.br/cias-listadas/empresas-listadas/BuscaEmpresaListada.aspx?Idioma=en-us> (last visited Nov. 13, 2012).

118. *Id.*

119. Gorga, *supra* note 111, at 455-56.

major shareholders.¹²⁰ Significant agency problems can occur because controlling shareholders may tend to extract value from the company at the expense of minority shareholders.¹²¹ Such private benefits do not necessarily have to be pecuniary. In Brazil, the prestige that comes with the control of a company can be an important factor, especially when the company has always been in control of the management's family.¹²² An entrepreneur who has built a business without the need of outside capital, and thus without accountability to others, may be difficult to convince to keep personal and business accounts separate and maintain proper records.¹²³ Yet a private equity investor must often rely on the experience and expertise of the incumbent management to run the target company. Thus, the accountability of the target's management must be carefully evaluated during the due diligence process and an investment, despite substantial growth opportunity, should not be made where the tension between family management and the outside investor cannot be overcome.

b. Enforcement of Contractual Rights

A private equity firm that takes only a minority position in the target company as part of its growth capital strategy must be able to rely on contractual provisions (control rights) that protect its investment.¹²⁴ Brazilian law explicitly permits the use of different classes of shares with different rights conferred to each class,¹²⁵ thus enabling a flexible deal structure. Shareholder agreements governing the purchase and sale of shares, preemptive rights and the exercise of voting rights, are enforceable against third parties as long as they are filed with the corporation.¹²⁶ The sale of a shareholder's right to vote constitutes a

120. Sílvia Mourthé Valadares & Ricardo Pereira Câmara Leal, *Ownership and Control Structure of Brazilian Companies* 22 (Working Paper, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=213409.

121. Gorga, *supra* note 43, at 818.

122. *Id.* at 823.

123. Leeds & Sunderland, *supra* note 10, at 114.

124. *See supra* Part II.B.

125. Ribeiro, *supra* note 54, at 365.

126. DEMAREST E ALMEIDA, *supra* note 89, § 1:20.

crime under Brazilian law and can therefore be the subject of neither a shareholder agreement nor a bylaw.¹²⁷

However, developing countries with a civil law origin like Brazil are believed to offer a low level of contractual protections and enforcement to private equity investors.¹²⁸ The Brazilian court system tends to operate very slowly,¹²⁹ and the right of parties to appeal a judgment continually delays obtaining a final judgment significantly.¹³⁰ In addition, there are not enough courts and judges to handle the many and diverse cases that arise.¹³¹ Lastly, there is no system of precedent as in common law legal systems, which impedes the ability to assess the likelihood of success in litigation.¹³²

Despite this less than favorable framework, Cinthia Daniela Bertan Ribeiro has found in her study that private equity and venture capital investors are increasingly open to minority positions and employ all of the protective control rights usually found in private equity investments.¹³³ She explains this phenomena in part with the fact that private equity firms base their decision on the quality of the target and the relationship with the target's management: through detailed due diligence and substantial efforts to develop a functioning relationship with management, disputes, and thus the necessity to rely on the contractual protections in court, can be avoided.¹³⁴ Another, and probably more important, reason is the broad use of arbitration in private equity investment.¹³⁵ The Brazilian Arbitration Law was passed in 1996 and established clear rules supporting arbitration in Brazil.¹³⁶ The parties can avoid the delay and lack of expertise of the Brazilian courts by selecting well-qualified arbitrators and restricting the right to appeal the

127. *Id.*

128. Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, 120 Q. J. ECON. 223, 224-25 (2005).

129. Maurizio Levi-Minzi & Pedro Seraphim, *Doing Deals in Brazil: A Primer*, in DOING DEALS IN EMERGING MARKETS: BRIC & BEYOND 101, 105 (2010) (PLI Corp. L. & Practice, Course Handbook Ser. No. 1826, 2010).

130. *Id.*

131. *Id.*

132. *Id.* at 106.

133. Ribeiro, *supra* note 54, at 370-72.

134. *Id.* at 373.

135. *Id.*

136. Tavares, *supra* note 100, at *4.

arbitral award.¹³⁷ The Brazilian Supreme Court in 2001 held the Arbitration Act to be constitutional, and arbitration clauses are now widely used in private equity agreements with Brazilian firms and often select Brazil-based arbitral tribunals that belong to Brazilian institutions (e.g., Sao Paulo's stock exchange BOVESPA) or international chambers of commerce.¹³⁸

4. *Exiting from the Brazilian Investment*

The capital market reforms beginning in 2001 have had a substantial effect on Brazil's IPO market. From 2003 to 2008, 103 IPOs were conducted on the Brazilian capital markets, accompanied by 95 secondary public offerings.¹³⁹ In the record year of 2007, 64 companies raised \$33.3 billion in IPOs.¹⁴⁰ While the Brazilian IPO market did not escape the consequences of the financial crisis, with only 4 IPOs in 2008, 6 in 2009, and 11 in 2010, it rebounded in 2011 with 22 IPOs.¹⁴¹ The overwhelming majority of IPOs has been listed on Novo Mercado. In 2007 alone, 41 out of the 64 companies conducting an IPO listed on Novo Mercado, compared to 7 on Nivel 2, and 8 on Nivel 1.¹⁴² These numbers show that Novo Mercado provides an excellent exit opportunity for private equity investors who, during the term of the investment, improve corporate governance and reporting standards in order to comply with the high Novo Mercado standards. Additionally, commitment to a high corporate government level has a positive effect on share value,¹⁴³ which might lead to higher returns for private equity investors.

137. *Id.*

138. Ribeiro, *supra* note 54, at 374-75.

139. Tavares, *supra* note 100, at *5.

140. Paulo Winterstein, *Brazil January IPO Plans Signal A 'Good Year,' Investors Say*, FOXBUSINESS, Jan. 19, 2011, <http://www.foxbusiness.com/markets/2011/01/19/brazil-january-ipo-plans-signal-good-year-investors-say/>.

141. *Public Offers and IPOs*, BOVESPA, available at <http://bmfbovespa.comunicase.com.br/en/list.aspx?idCanal=Sx5wS/XXeGxBbiBmVMzITA==>.

142. *Bovespa Facts & Figures 2*, BOVESPA 2-3 (Dec. 2007), http://www.bestbrazil.org.br/pages/publications/bovespa/FACTS_vers%C3%A3o_final.pdf.

143. See Antonio Gledson de Carvalho & George G. Pennacchi, *Can Voluntary Market Reforms Promote Efficient Corporate Governance? Evidence from Firms' Migration to Premium Markets in Brazil* 17-20 (Jan. 25, 2005), available at <http://ssrn.com/abstract=678282>; see generally Alexandre Di Miceli da Silveira &

In order to conduct a public offering in Brazil, as a general rule, both the issuer and the offering itself must be registered with CVM, and an intermediary must be responsible for distribution, clearing and settlement.¹⁴⁴ An offering is deemed to be public if any sales efforts are conducted in Brazil that target the “general public,” or if Brazilian investors have access to the offering information and no precautions have been taken to prevent such access.¹⁴⁵ “General public” means “a class, category, or group of people, even if individualized, either resident, domiciled, or incorporated in Brazil, except for those having close, regular, and prior commercial, credit, corporate, or labor relations with the issuer.”¹⁴⁶ In 2009, the CVM promulgated an exemption for small offerings targeted at no more than 50 qualified investors,¹⁴⁷ but only if no more than 20 such qualified investors subscribe, and all material information is disclosed without the need of a formal prospectus.¹⁴⁸ However, equity securities are excluded from this exemption.¹⁴⁹

If a Brazilian corporation wishes to offer depository receipts abroad, it must be publicly held and receive authorization from CVM and BACEN.¹⁵⁰ The securities underlying the receipts must be stored with a depository in Brazil.¹⁵¹

Lucas Ayres B. de C. Barros, *Corporate Governance Quality and Firm Value in Brazil* (June 2007), available at <http://ssrn.com/abstract=923310> (finding a positive and significant influence of corporate governance quality on a firm’s market value).

144. Thiago Giantomassi & Carolina T. Joop, *Securities and Capital Markets*, in BUSINESS LAWS OF BRAZIL, *supra* note 89f, § 2:14.

145. *Id.*

146. *Id.*

147. *Id.* § 2:15 (“[Q]ualified investors are: (i) financial institutions (ii) insurance companies and capitalization companies, (iii) private pension-fund organizations with public or private capital, (iv) individuals or legal entities holding financial investments which exceed R \$300,000 (approximately 100,000), and that additionally invest at least R \$1,000,000 in the exempted offering, (v) investment funds, and (vi) portfolio managers and securities advisers authorized by CVM, in relation to their own monies.”).

148. *Id.* § 2:15.

149. *Id.*

150. *Id.* § 2:13.

151. *Id.*

B. RUSSIA

Among the BRIC countries, Russia suffered the most from the financial crisis. Russia's GDP dropped by 7.9% in 2009, making it only the twelfth largest economy (after being the eighth in 2008).¹⁵² For this reason, commentators have questioned whether Russia still belongs in the BRIC. An article published in Forbes Magazine argued that Russia's overdependence on the oil and gas market was exposed when the oil bubble burst in mid-2008.¹⁵³ The article further held that corruption, government interference in the private sector and the erosion of civil liberties are reasons why Russia has performed poorly through the financial crisis compared to the other BRIC countries, and that these factors will continue to impede growth in Russia in the future.¹⁵⁴ However, unlike in the financial crisis of 1998, big banks and companies remained intact, and Russia still has the third largest foreign currency reserves.¹⁵⁵ Goldman Sachs' Jim O'Neill opined in 2009 that, while Russia's performance was disappointing in the financial crisis, it deserves its place in the BRIC if it recovers quickly.¹⁵⁶ One such indicator may be that Russian stocks increased by 20% in 2010, the largest gain among the BRIC countries.¹⁵⁷ Growth rates of 4.3% in both 2010 and 2011 also indicate Russia's recovery.¹⁵⁸

The macroeconomic picture in Russia is mirrored by the development of the private equity industry. While total private equity investment rose by more than 300% from \$0.8 billion in 2007 to \$2.6 billion in 2008, it dropped dramatically in 2009 to only \$0.2 billion, below the 2004 level.¹⁵⁹ Unlike in the other BRIC countries, private equity investment did not recover fully to the 2008 level in 2010.¹⁶⁰

152. WORLD BANK, *supra* note 5.

153. *Taking the 'R' Out of BRIC*, FORBES (Feb. 24, 2010), <http://www.forbes.com/2010/02/24/russia-brazil-bric-entrepreneurs-finance-wharton.html>.

154. *Id.*

155. Ben Aris, *Russia: The unloved Bric country*, TELEGRAPH, RUSSIA NOW (Mar. 4, 2010), <http://www.telegraph.co.uk/sponsored/russianow/business/7369006/Russia-the-unloved-Bric-country.html>.

156. O'Neill & Stupnytska, *supra* note 14, at 4, 27.

157. Tai Adelaja, *Ripe for Investment*, RUSSIAPROFILE (Dec. 30, 2010), <http://russia-profile.org/business/a1293730860.html>.

158. WORLD BANK, *supra* note 5.

159. EMPEA, *supra* note 11.

160. *Id.*

1. Foreign Direct Investment

FDI into Russia was impacted significantly by the financial crisis. After rising to \$75 billion from 2004 until 2008, it cut in half to \$36.8 billion in 2009 and recovered only to a small degree in 2010.¹⁶¹

FDI in Russia is regulated by the Law No. 160-FZ, July 9, 1999, On Foreign Investment in the Russian Federation¹⁶² (“Foreign Investment Law”) and Law No. 57-FZ, April 29, 2008, On Foreign Investment in Business Entities of Strategic Importance for National Defense and National Security (“Strategic Entities Law”).¹⁶³ The Foreign Investment Law defines FDI as “the acquisition by a foreign investor of at least 10 per cent stake . . . in the . . . capital of a commercial organization” and restricts FDI based on the “protection of fundamental constitutional principles, morality, health, or the rights and legal interests of others, or to provide for the defense of the country and security of the state.”¹⁶⁴ While the Foreign Investment Law left foreign investors with a lot of uncertainty about when the government would invoke its authority to restrict FDI,¹⁶⁵ the new Strategic Entities Law now names 42 areas in which FDI is restricted where such investment leads to the establishment of direct or indirect control.¹⁶⁶ Among the “strategic entities” are those that operate in, for example, nuclear energy, intelligence operations, certain activities in aviation and aerospace, radio and television broadcasting, as well as the publication of printed periodicals.¹⁶⁷ A foreign investor¹⁶⁸ seeking to invest in a

161. U.S. & FOREIGN COM. SERV., U.S. DEP’T OF COM., *DOING BUSINESS IN RUSSIA: A COUNTRY COMMERCIAL GUIDE FOR U.S. COMPANIES*, CH. 6, § OPENNESS TO FOREIGN INVESTMENT (2012) [hereinafter USFCS Russia].

162. Jesse Heath, *Strategic Protectionism? National Security and Foreign Investment in the Russian Federation*, 41 GEO. WASH. INT’L L. REV. 465, 478, n.103 (2009).

163. Natalia Drebezhina, *Overview of Regulations Applicable to Mergers and Acquisitions in the Russian Federation*, in *DOING DEALS IN EMERGING MARKETS: BRIC & BEYOND 2010* (PLI Corp. L. & Practice, Course Handbook Ser. No. 1826, 2010).

164. Heath, *supra* note 162, at 478-79 (citing Law on Foreign Investment in the Russian Federation arts. 2, 4-15, No. 160-FZ, July 9, 1999).

165. *Id.* at 479.

166. Drebezhina, *supra* note 163, at 179.

167. *Id.* at 170 n.11; for a more detailed list, see Heath, *supra* note 162, at 484-86.

168. Marat Altynbaev, *Investments in the Russian Federation*, in *CORPORATE COUNSEL’S GUIDE TO DOING BUSINESS IN RUSSIA* § 18:1 (Tomi P. Asanti et al. eds., 2d ed. 2010) (“[A] foreign investor is: a foreign legal entity the civil legal capacity of

“strategic entity” must obtain approval from the Federal Anti-Monopoly Service (“FAS”) and the Government Commission on Foreign Investment.¹⁶⁹ A foreign entity can be held to establish control through various means, including (1) the acquisition of more than 50% of the target’s voting stock, or a lesser percentage if this is sufficient to exercise control; (2) the right to appoint the CEO, or more than half of the target’s management or board of directors; or (3) the performance of management duties by the foreign investor.¹⁷⁰

Though the new Strategic Entities Law appears to be restrictive, commentators point to the improved clarity and transparency resulting from the legislation.¹⁷¹ However, legislation can be only as good as its implementation, an area in which Russia still needs substantial improvement.¹⁷² The Russian government has announced that it plans to ease access to certain sectors in 2011, including food, pharmaceutical, banking and natural resources sectors.¹⁷³

2. Takeovers of Public Targets

An investor who acquires more than 30% of a Russian open joint stock company (“OJSC”), the equivalent of a publicly held corporation,¹⁷⁴ is required to make a mandatory tender offer (“MTO”) to the remaining shareholders.¹⁷⁵ A tender offer aimed at acquiring more than 30% of the target’s stock must be made by way of a voluntary

which is determined in accordance with the legislation of the state in which it is founded, and which, in accordance with the legislation of this state, is entitled to invest in the Russian Federation; a foreign organization which is not a legal entity, the civil legal capacity of which is determined in accordance with the legislation of the state in which it is founded, and which, in accordance with the legislation of this state, is entitled to invest in the Russian Federation; a foreign citizen whose civil legal capacity and activity are determined in accordance with the legislation of his/her national state and who, in accordance with the legislation of this state, is entitled to invest in the Russian Federation.”)

169. Heath, *supra* note 162, at 486.

170. Drebezhina, *supra* note 163, at 182.

171. See Heath, *supra* note 162, at 494.

172. *Id.* at 500-01; see *infra* Part II.B.3.c.

173. Adelaja, *supra* note 157.

174. See *infra* Part II.B.3.

175. Drebezhina, *supra* note 163, at 168.

tender offer (“VTO”).¹⁷⁶ Both MTO and VTO must be accompanied by extensive documentation regarding the offer, and the minimum purchase price is determined based on the historic trading price and/or the price paid in previous acquisitions.¹⁷⁷ If the acquirer receives more than 95% of the target’s stock in the MTO or VTO, the acquirer may squeeze out the remaining minority shareholders, and the shareholders have the right to request the acquirer to purchase their shares.¹⁷⁸

3. Corporate Law and Legal Enforcement

The most common forms of legal entities used in Russia are the limited liability company (“LLC”) and the joint stock company (“JSC”).¹⁷⁹ A JSC can be organized as an OJSC, a public corporation with usually a large shareholder base, or as a closed joint stock corporation (“CJSC”), which must have 50 shareholders or less.¹⁸⁰ Unlike an OJSC, a CJSC cannot conduct a public offering of its shares and shareholders have a preemptive right to purchase shares sold by other shareholders of the CJSC (right of first refusal).¹⁸¹ In return, a CJSC is subject to less stringent disclosure requirements than an OJSC.¹⁸² Consequently, it may be preferable for a private equity investor to organize the target company as a CJSC upon investment in order to reduce regulatory costs. Moreover, the right of first refusal protects a private equity investor who takes a minority position against dilution. Should the investor wish to exit by way of an IPO, however, the target would need to be converted into an OJSC.

176. *Id.*

177. *Id.* at 169-70.

178. *Id.* at 174.

179. Sergei Orlov & Emily Barlass, *Corporate Legislation*, in CORPORATE COUNSEL’S GUIDE TO DOING BUSINESS IN RUSSIA, *supra* note 168, § 18:1.

180. *Id.*

181. *Id.*

182. *Id.*

a. Corporate Governance

Quick privatization of former state-owned enterprises has led to a high ownership concentration in Russian companies.¹⁸³ Studies found that about 40% of the Russian industry is controlled by only 22 business groups, which themselves are in the hands of “oligarchs.”¹⁸⁴ Consequently, conflicts generally do not arise between shareholders and management, but rather between controlling and minority shareholders.¹⁸⁵ In a survey by C5 and Squire, Sanders & Dempsey L.L.P., a majority of those surveyed named untrustworthy partners in the target companies as the primary reason for writing off deals.¹⁸⁶ The combination of high ownership concentration and weak legal institutions increases the value of control, making a LBO more desirable.¹⁸⁷ Buyouts by private equity firms, however, remain rare due to the lack of necessary leverage.¹⁸⁸

Another “layer” of conflict is added by the growing trend of government influence in private businesses to the extent that representatives of regional and local government authorities are included on the companies’ boards.¹⁸⁹ Regional governments often employ provincial protectionism by, for example, interfering with efficient restructurings of distressed companies or extracting benefits from large local companies in return for protection from creditors and foreign competitors.¹⁹⁰

On the upside, low corporate governance in many potential Russian target companies offers substantial opportunities for private equity firms willing to make the investment to unlock value and thus earn high returns. Russian companies are often undervalued and the implementation of higher governance standards can achieve a

183. See Olga Lazareva, Andrei Rachinsky & Sergey Stepanov, *A Survey of Corporate Governance in Russia* 4 (Ctr. for Econ. & Fin. Res. at New Econ. School, Working Paper No. 103, 2007), available at <http://ssrn.com/abstract=997965>.

184. *Id.* at 5.

185. *Id.* at 13.

186. Christopher Rose, *C5/Squire Sanders CIS Private Equity Report 4* (Autumn 2007), http://www.ssd.com/reprints/CIS_Private_Equity_Report.pdf.

187. Lazareva et al., *supra* note 183, at 13.

188. Rose, *supra* note 186, at 2.

189. Lazareva et al., *supra* note 183, at 13, 18.

190. *Id.* at 29.

significantly higher valuation.¹⁹¹ How this can be achieved through shareholder activism was demonstrated by the Hermitage Fund.¹⁹² By continuously generating news coverage about corporate governance abuses in reputable international media outlets such as The Wall Street Journal and The Financial Times, the fund was able to use the controlling shareholders' concern for their international reputation in order to invoke corporate governance changes.¹⁹³

Since 1996, Russia has amended its corporate law repeatedly in an attempt to strengthen minority shareholder rights and attract more foreign capital.¹⁹⁴ Among the amendments were anti-dilution provisions, such as the need for shareholder approval for substantial issues of new common stock, as well as governing rights, such as supermajorities, the right for 2%-shareholders to propose topics for the shareholders' meeting and the right to include candidates to be elected for the corporation's governing bodies.¹⁹⁵ In addition, the amendments provided for protection against self-dealing through mandated shareholder approval of interested transactions, and for access to the courts in order to challenge improper resolutions and to bring claims against the directors or managers on behalf of the corporation (derivative action).¹⁹⁶

To compliment the protections afforded in the JSC Law, the FFMS introduced a nonbinding Code of Corporate Conduct.¹⁹⁷ Among the principles laid out in the Code of Corporate Conduct are: (1) effective exercise of shareholder rights; (2) equal treatment of shareholders; (3) effective control of management by the board of directors, and accountability of directors; (4) full and accurate disclosure of information about the company; (5) maximization of company value; and (6) efficient control over business and financial operations of the company.¹⁹⁸

191. *Id.* at 2.

192. *Id.* at 30.

193. *Id.*

194. *Id.* at 34.

195. *Id.* at 34-35.

196. *Id.* at 35.

197. Lazareva et al., *supra* note 183, at 33.

198. *Id.* at 40-42.

b. Enforceability of Contractual Rights

Until recently, a major concern, in particular for private equity investors, was the unenforceability of shareholders' agreements.¹⁹⁹ Private equity firms typically include veto rights, drag along rights, tag along rights, and other covenants and warranties in a shareholder's agreement to protect themselves from dilution and to ensure that the target company fulfills specific performance benchmarks.²⁰⁰ Under the Russian Civil Code, however, only warranties with respect to the shares being acquired are enforceable.²⁰¹ Moreover, a Russian court held in the famous *Megafon* case that shareholders' agreements were unenforceable under Russian law even if the parties agreed on a governing law under which such rights would be enforceable.²⁰² In 2009, an amendment to JSC Law finally provided for the enforceability of shareholders' agreements. However, the statutory text does not go into much detail and significant uncertainties remain.²⁰³ In particular, the amendment does not afford the parties the right to choose the governing law.²⁰⁴ Consequently, under *Megafon*, a choice-of-law clause is still unenforceable and the contract will be reviewed under Russian law.²⁰⁵ Moreover, a shareholders' agreement is binding only on the parties, and not on the corporation.²⁰⁶ Thus, a breach of a shareholders' agreement does not affect the validity of a resolution made by one of the corporation's bodies.²⁰⁷

199. See Conaire Michael Hallisy, *Riches to Rubles: Problems Russia Must Address to Increase Direct Investment from U.S. Private Equity*, 16 TULSA J. COMP. & INT'L L. 137, 160 (2008).

200. *Id.* at 160; see *supra* Part II.B.

201. Hallisy, *supra* note 199, at 160.

202. Tatiana Neveeva, *Corporations*, in CORPORATE COUNSEL'S GUIDE TO DOING BUSINESS IN RUSSIA, *supra* note 168, § 11:58.

203. *Id.* § 11:59.

204. *Id.*

205. *Id.*

206. Orlov & Barlass, *supra* note 179, § 12:14.

207. *Id.*

c. Reliability of the Legal System

While corporate laws are in substance comparable to Western standards, implementation and enforcement by Russian authorities remain a major concern for foreign investors.²⁰⁸

Russia's judiciary faces several challenges. First, Russia's body of law is complex and often conflicting.²⁰⁹ This is exacerbated by the fact that the Russian Federation is comprised of 88 subunits, 21 republics, 49 regions, 10 autonomous districts, 6 territories, Moscow, St. Petersburg and 1 autonomous region, each possessing some degree of rule-making authority.²¹⁰ Second, lack of funding in the judiciary causes Russian judges to be burdened by a heavy caseload and insufficient training.²¹¹ In response, judges often dismiss cases prematurely for technical reasons or make ill-informed decisions on the merits.²¹² Third, political pressure and corruption in the legal system affect judicial decision making.²¹³ In addition, U.S. investors are confronted with the fact that Russian judges are trained under their civil law system, which results in a more literal interpretation of statutes and a lack of firm precedent. While this is not limited to Russia, it seems to contribute to U.S. investors' discomfort with the Russian legal system.²¹⁴ For these reasons, private equity firms are well advised to subject their investment to international arbitration. International arbitral awards are enforceable under Russian law,²¹⁵ and Russia is also a signatory to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.²¹⁶

Corruption remains a major concern in Russia despite the government's assurance to fight corruption and to create a more

208. Lazareva et al., *supra* note 183, at 12.

209. Hallisy, *supra* note 199, at 170-71; *see also* USFCS Russia, *supra* note 161, at ch. 6, § Dispute Settlement.

210. Hallisy, *supra* note 199, at 170-71.

211. USFCS Russia, *supra* note 161, at ch. 6, § Dispute Settlement.

212. *Id.*

213. *Id.*; Hallisy, *supra* note 199, at 168.

214. Hallisy, *supra* note 199, at 168-69.

215. USFCS Russia, *supra* note 161, at ch. 6, § Dispute Settlement.

216. *See* U.N. Comm'n on Int'l Trade Law (UNCITRAL), *Status, 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html (last visited Mar. 25, 2011).

favorable investment climate.²¹⁷ In 2011, the Transparency International Corruption Perception Index ranked Russia 143rd out of 182 nations, down from 90th place in 2004, and Russia came in last out of 54 countries surveyed in PricewaterhouseCooper's 2009 Global Economic Crime Survey.²¹⁸ By comparison, the Transparency International Corruption Perception Index ranks Brazil 73rd, China 75th, and India 95th.²¹⁹

As a result of these concerns, private equity firms generally do not invest directly in Russia. Rather, investors use an offshore holding company in which both the private equity fund and remaining shareholders of the target company invest.²²⁰ Primary offshore jurisdictions that U.S. investors use when investing in Russia include the Cayman Islands, Cyprus, Isle of Man, Guernsey and Jersey.²²¹ Aside from beneficial tax treatment, such a structure allows investors to employ all the incentives and protections usually found in private equity investments.²²²

4. *Exiting from the Russian Investment*

The first IPO on a Russian exchange was conducted in 2002 by OAO RBC Information Systems.²²³ After a slow start to new offerings, the market picked up significantly in 2006 and 2007, with about forty IPOs in these two years alone.²²⁴ However, liquidity remains relatively low. Only three state-owned companies provided for over 60% of the IPO volume.²²⁵

Equity securities are listed on one of several listing segments, depending on the recent trading volume.²²⁶ Thus, first-time issuers need

217. USFCS Russia, *supra* note 161, at ch. 6, § Openness to Foreign Investment.

218. *Id.* at ch. 6, § Corruption.

219. *Corruption Perception Index 2011*, TRANSPARENCY INTERNATIONAL available at <http://cpi.transparency.org/cpi2011/results>.

220. Hallisy, *supra* note 199, at 157.

221. *Id.*

222. *Id.*

223. Oxana Derisheva & Alexey Fedorov, *Capital Raising by Russian Companies on the Russian Stock Market*, in CORPORATE COUNSEL'S GUIDE TO DOING BUSINESS IN RUSSIA, *supra* note 168, § 17:5.

224. *Id.*

225. *Id.*

226. *Id.* § 17:6.

to first list on the lowest segments and subsequently transition to higher segments once the trading volume is established.²²⁷ The listing segment determines what type of investors can invest in the securities. For example, pension funds and insurance companies may only invest in securities listed in the highest listing segment A1.²²⁸ Therefore, these institutional investors cannot participate in an IPO.

The majority of Russian initial issuers, however, list their shares on foreign exchanges, traditionally on the London Stock Exchange (“LSE”).²²⁹ Investors in London are relatively familiar with the Russian market and there is a track record of Russian issuers who listed on the LSE.²³⁰ In January 2010, UC Rusal was the first Russian company to conduct an IPO on the Hong Kong Exchange (HKEx), potentially paving the way for other Russian issuers to follow.²³¹ Ultimately, an IPO on a global exchange can only be successful if the issuer can demonstrate “quality in all operational areas, quality corporate governance, quality information disclosure, quality risk management, quality internal controls and quality in all other aspects of their business.”²³²

Issuers who wish to conduct an IPO abroad (likely through an ADR/GDR program) must obtain authorization from the Russian Federal Financial Markets Service (“FFMS”). Such authorization is granted only if the company has also issued shares on a domestic stock exchange and the number of shares issued abroad does not exceed 30% of the issuers total same class of shares.²³³ These requirements were introduced in response to the strong preference of Russian issuers to list on a foreign exchange.²³⁴ The FFMS further limited the percentage of shares that can be traded on a foreign exchange in January 2010.²³⁵ However, companies may be able to circumvent these requirements by

227. *Id.*

228. *Id.*

229. Maxim Lubomudrov & Simon Molyneux, *The Russian IPO Market in 2010*, WORLD FINANCE REVIEW, May 2010, <http://www.worldfinancereview.com/may2010/therrussianipomarketin2010.html>; see also STOWELL, *supra* note 17, at 148.

230. Lubomudrov & Molyneux, *supra* note 229.

231. Lubomudrov & Molyneux, *supra* note 229.

232. Lubomudrov & Molyneux, *supra* note 229.

233. Lazareva et al., *supra* note 183 at 7.

234. *Id.*

235. Lubomudrov & Molyneux, *supra* note 229.

using a holding company in a foreign jurisdiction.²³⁶ This may be a viable exit strategy for private equity firms who structure their investment through an offshore holding company.²³⁷ It is thus argued that reforms directed at building trust in the domestic capital markets, combined with strict enforcement, would strengthen Russia's IPO market more efficiently.²³⁸

C. INDIA

India's economy was affected much less by the financial crisis than developed economies. After reporting GDP growth rates between 9.3% and 9.6% from 2005 to 2007, growth dropped to 5.1% in 2008, but recovered in 2009 to 8.2%.²³⁹ In 2010, GDP growth returned to pre-crisis levels.²⁴⁰

Private equity investment in India has increased substantially since 2004 and reached \$9.9 billion in 2007, the highest total investment in private equity among the BRIC countries.²⁴¹ After dropping to \$4 billion in 2009, investments into private companies regained momentum and reached \$6.2 billion in both 2010 and 2011.²⁴² Due to the relatively small capital base of most unlisted Indian companies, investors must allow for smaller deal sizes.²⁴³ Sectors that need extensive investment in infrastructure (such as telecommunications), however, offer larger investment opportunities.²⁴⁴

1. Foreign Direct Investment

FDI inflows into India have increased exponentially in recent years, totaling \$43.4 billion in 2008 from \$7.6 billion in 2005.²⁴⁵ A series of

236. *Id.*

237. *See supra* Part II.B.

238. Lazareva et al., *supra* note 183 at n.6.

239. WORLD BANK, *supra* note 5.

240. *Id.*

241. EMPEA, *supra* note 11.

242. *Id.*

243. Vaibhav Parikh, *Private Equity Fund Investments in Indian Companies*, in *ADVANCED VENTURE CAPITAL 2009* (2009), available at 1735 PLI/Corp 249, 256 (West).

244. *Id.*

245. WORLD BANK, *supra* note 5.

policy reforms have contributed to an improved environment for foreign investors.²⁴⁶ Foreign investment in Indian securities is governed by the Foreign Exchange Management Act of 1999 (“FEMA”) and the regulations promulgated under it by the Reserve Bank of India (“RBI”).²⁴⁷ Investments in Indian equities can be made through two alternative routes: the Automatic Route, which does not require approval by the Indian government, and the Approval Route.²⁴⁸ The Automatic Route is available to foreign investors in certain sectors and up to a certain percentage called “Sectoral Caps.”²⁴⁹ FDI is prohibited in the following sectors: (1) business of chit fund; (2) nidhi company; (3) real estate business; (4) trading in Transferable Development Rights (“TDRs”); (5) retail trading; (6) atomic energy; (7) lottery business; (8) gambling and betting; (9) and agriculture.²⁵⁰

A foreign private equity firm may also register with SEBI as a Foreign Venture Capital Investor (“FVCI”).²⁵¹ Registration as a FVCI has substantial benefits for the private equity investor both when acquiring the target and when exiting the investment through an IPO, which are discussed below in Parts II.C.2 and II.C.4, respectively. However, a registered FVCI is subject to the following conditions: (1) it must disclose its investment strategy to SEBI and achieve its investment targets by the end of a set life cycle; (2) at least 66.67% of the FVCI’s funds must be invested in unlisted equities; and (3) no more than 33.3%

246. Shardul S. Shroff, *An Overview of the Legal Regime Governing Capital Markets in India and Current Developments*, in *DOING BUSINESS IN INDIA 2009: CRITICAL LEGAL ISSUES FOR U.S. COMPANIES* (2009), available at 1720 PLI/Corp 51, 89 (West).

247. *Id.* at 90.

248. Shivpriya Nanda, *Structuring a Venture Capital/Private Equity Transaction into India*, in *OUTLOOK ON INDIA 2010: DELIVERING ON THE PROMISE IN TURBULENT TIMES* (2010), available at 1815 PLI/Corp 135, 139 (Westlaw).

249. *Id.* at 140; see also U.S. & Foreign Com. Serv., U.S. Dep’t of Com., *Doing Business in India: 2010 Country Commercial Guide for U.S. Companies* ch. 6, § Openness to Foreign Investment (2010) [hereafter USFCS India]. See Ketan Kothari, *Investments in India--Risks & Mitigation Strategies*, in *OUTLOOK IN INDIA: DELIVERING ON THE PROMISE IN TURBULENT TIMES* (Practical Law Institute Course Handbook, 2010), available at PLI Corp. 337, 352 (Annex), for a detailed list of all sectoral caps and their respective route as of May 31, 2010.

250. Nanda, *supra* note 247, at 141.

251. *Id.*; see also Sajai Singh, *Venture Capital Investment in the Indian Market*, in *ADVANCED VENTURE CAPITAL 2010* (2010), available at 1853 PLI/Corp 989, 996 (West).

may be invested by way of subscription to shares offered in an IPO, debt instruments of its portfolio companies or stock in a listed distressed company.²⁵²

Special rules are in place for portfolio investments by foreign institutional investors (“FII”).²⁵³ A FII can invest up to 10% of the equity capital of an Indian company and the aggregate investment of FII in a single company may not exceed 24%.²⁵⁴ The Indian company may increase this limit up to the Sectoral Cap by a board resolution that receives shareholder approval.²⁵⁵ Subject to these ownership restrictions, a FII may freely purchase and sell securities issued by any Indian company, and realize and repatriate capital gains.²⁵⁶

2. Takeovers of Public Targets

A traditional LBO, in which the acquisition of the target is financed through loans collateralized by the target’s assets, is prohibited under Indian law.²⁵⁷ However, the private equity investor can increase leverage shortly after the acquisition of the target through a recapitalization, in which the investor causes the target to make a dividend payment to the fund financed by debt.²⁵⁸

An investor seeking to acquire a stake in a listed company must report to the target when its holdings cross thresholds at 5%, 10% and 14%.²⁵⁹ If an acquisition would result in ownership of 15% or more of the voting rights of the target, the acquirer must make a public tender offer for at least 20% of the target’s outstanding shares.²⁶⁰

FDI regulations generally prescribe a minimum price for foreign investment in Indian equities, linked to the shares’ net asset value.²⁶¹

252. Nanda, *supra* note 248, at 143.

253. Parikh, *supra* note 243, at 262.

254. *Id.* at 262-63.

255. *Id.* at 263.

256. Shroff, *supra* note 246, at 94.

257. Nanda, *supra* note 248, at 157.

258. *Id.*

259. Kothari, *supra* note 249, at 343.

260. *Id.* at 343-44.

261. Parikh, *supra* note 243, at 265.

However, a registered FVCI is exempted from this purchase price restriction.²⁶²

3. Corporate Law and Legal Enforcement

Indian companies are governed by the Companies Act, 1956.²⁶³ Companies can be public or private, and shareholders can have limited or unlimited liability.²⁶⁴ A private company is limited to fifty members and subject to certain restrictions on the transfer of shares, including a prohibition of a public offering of its shares.²⁶⁵ Its minimum paid up capital must be Rs. 100,000 (approximately \$2,200).²⁶⁶ A public company must have a minimum paid up capital of Rs. 500,000 (approximately \$11,000) and may not impose any restrictions on the transferability of its shares.²⁶⁷

a. Corporate Governance

Even though room for improvement remains, India's corporate governance framework is relatively advanced for a developing country.²⁶⁸ SEBI first introduced mandatory corporate governance standards in India through Clause 49 of the Listing Agreement of Stock Exchanges, which contains corporate governance requirements for exchange-traded companies.²⁶⁹ Under Clause 49, the Chairman of the Board should be a non-executive director and at least one-third of the directors should be independent, and if the chairman is an executive director, half of the directors should be independent.²⁷⁰ Furthermore, two-thirds of the members of the audit committee must be independent

262. *Id.*; see *supra* Part II.C.1, for regulation of FVCIs.

263. Singh, *supra* note 251, at 1002.

264. *Id.*

265. *Id.* at 1003.

266. *Id.*

267. *Id.*

268. Varun Bath, *Corporate Governance in India: Past, Present, and Suggestions for the Future*, 92 IOWA L. REV. 1429, 1457 (2007); see also USFCS India, *supra* note 249, at ch. 6, § Transparency of Regulatory System. See John Paterson, *Corporate Governance in India in the context of the Companies Bill 2009*, I.C.C.L.R. 2010, 21(2), 41-53; 21(3), 83-95; and 21(4), 131-143, for an in-depth analysis of the development of corporate governance in India up to the Companies Bill, 2009.

269. Bath, *supra* note 268, at 1439.

270. *Id.* at 1441.

directors.²⁷¹ Finally, the exchange-traded firm must submit quarterly compliance reports detailing the firm's compliance with corporate governance standards.²⁷² The Companies Bill 2009, which had not yet been enacted by the end of 2011,²⁷³ makes further improvements, mainly in the areas of independent directors, board committees, director duties and liabilities, and internal control.²⁷⁴

Some Indian companies are owned by large families which may complicate deal negotiations.²⁷⁵ The process of getting every managing member of the family on board and adequately incentivized can take up a substantial amount of time.²⁷⁶

b. Enforceability of Contractual Rights

India is a common law country and U.S. investors can thus be comfortable with the availability and enforceability of contractual protections.²⁷⁷ Investors can enter into shareholders' agreements, and most instruments used by private equity firms to ensure returns and align incentives²⁷⁸ are available under Indian law. Besides common stock, investors are free to use convertible preferred shares, convertible debentures or warrants.²⁷⁹ For purposes of FDI restrictions it is important to keep in mind, however, that fully convertible shares or debentures are deemed equity and thus count towards possible FDI caps.²⁸⁰ Warrants, on the other hand, do not count towards FDI caps and can therefore be used as "stopgap instruments" in hopes that sector caps will be eased in the future.²⁸¹ However, should the investor choose to exit by way of an IPO, outstanding warrants have to be forfeited as all

271. *Id.* at 1441-42.

272. *Id.* at 1442.

273. *See, e.g., Gov't hopeful of getting Cos Bill passed in Winter Session*, FIRSTPOST (Nov. 11, 2011), <http://www.firstpost.com/economy/govt-hopeful-of-getting-cos-bill-passed-in-winter-session-140544.html>.

274. *See Paterson, supra* note 268, at 49-52.

275. Parikh, *supra* note 243, at 257.

276. *Id.*

277. Singh, *supra* note 251, at 993.

278. *See supra* Part II.B.

279. Parikh, *supra* note 243, at 283; *see also* Singh, *supra* note 251, at 1003-05, 1012.

280. Parikh, *supra* note 243, at 283-84.

281. *Id.* at 285.

convertible securities must be converted into equity shares prior to an IPO under Indian securities laws.²⁸²

Private equity investors commonly employ a ratchet as one means to protect against dilution. Such a provision stipulates that in the event the company issues additional shares to a third party at a lower price than the investor's entry price, the investor will be entitled to the amount of shares necessary to remain at the previous percentage of shares at no additional cost.²⁸³ However, implementation of this instrument is complicated in India because shares are prohibited from being issued at a discount to par value.²⁸⁴ Thus, a similar result must be achieved through alternative methods, such as a dividend payment to the investor or an issuance at the least permissible price.²⁸⁵ Alternatively, the investor must seek to obtain a veto right as protection against the issuance of additional shares.²⁸⁶

c. Reliability of the Legal System

As in other developing countries, litigation in India is slow due to the large number of cases judges are assigned to.²⁸⁷ Thus, it may be necessary, and is possible, for the investor to rely on arbitration as India is a signatory to the 1958 New York Convention.²⁸⁸ Seeking to improve the judicial system, the Companies Bill 2009 includes a provision under which the government is required to establish a National Company Law Tribunal ("NCLT").²⁸⁹ This tribunal would have exclusive jurisdiction over company law cases assigned to it by law and thus provide specialization and significant improvement to the speed in which cases are decided.²⁹⁰

Another concern for investors is the tendency of excessive rulemaking and broad authority for local authorities.²⁹¹ Many important regulatory decisions can vary from region to region and be subject to

282. *Id.* at 285-86.

283. *Id.* at 290.

284. Indian Companies Act, 1956 § 79 (India).

285. Parikh, *supra* note 243, at 290-92; *see also* Singh, *supra* note 251, at 1014.

286. Parikh, *supra* note 243, at 292; *see also* Singh, *supra* note 251, at 1014.

287. USFCS India, *supra* note 249, at ch. 6, § Dispute Settlement.

288. *See* UNCITRAL, *supra* note 216.

289. Paterson, *supra* note 268, at 47.

290. *Id.* at 48.

291. USFCS India, *supra* note 249, at ch. 6, § Transparency of Regulatory System.

strong opposition from local and political constituencies.²⁹² Broad discretionary powers of governmental authorities and the lack of transparent rules of governance also open the doors for corruption despite extensive legislation aimed at fighting these issues.²⁹³ Only in certain progressive areas can investors operate predominantly free from corruption.²⁹⁴

4. *Exiting from the Indian Investment*

Beginning in 1992, India has continuously liberalized and improved its capital markets structure.²⁹⁵ Companies raised a record high of \$8.8 billion in 2007, but IPOs were relatively small in size with an average of \$83 million.²⁹⁶ However, Reliance Power's \$3 billion IPO in 2008 raised hopes for larger deals in the future.

Though liquidity on Indian equity markets remains low, settlement mechanisms are comparable to international standards.²⁹⁷ A company seeking to raise funds through an IPO on an Indian stock exchange must first submit a "draft red herring prospectus" ("DRHP") with the Securities and Exchange Board of India ("SEBI").²⁹⁸ SEBI's comments are then incorporated in the Red Herring Prospectus ("RHP"), which includes a price band within which bidding can proceed.²⁹⁹ Once the issue price is determined by the bidding procedure, the issuer must file the Prospectus containing the issue price with the Registrar of Companies ("RoC") and the IPO can then be executed according to the rules of the stock exchange on which listing is sought.³⁰⁰ Generally, all pre-IPO share capital of an Indian company listing in India will be locked in for a period of one year following the IPO.³⁰¹ Thus, an investor would not be able to retain its stake (or part of it) in the portfolio

292. *Id.*

293. *Id.* at ch. 6, § Corruption.

294. *Id.*

295. Shroff, *supra* note 246, at 57.

296. STOWELL, *supra* note 17, at 149.

297. USFCS India, *supra* note 249, at ch. 6, § Efficient Capital Markets and Portfolio Investment.

298. Shroff, *supra* note 246, at 62.

299. *Id.* at 63.

300. *Id.*

301. Parikh, *supra* note 243, at 293.

company through the IPO and then exit its investment through a sale on the exchange. However, an exemption from the lock-in has been carved out for registered FVCIs who have held the investment for at least one year prior to the IPO.³⁰² SEBI Guidelines also include rules concerning so-called “promoters,” which are “a person (or persons) who are in overall control of the company who is instrumental in the formulation of a plan or program pursuant to which the securities are offered to the public.”³⁰³ Promoters are also subject to lock-in requirements following an IPO to ensure that parent companies continue to hold a stake in the issuer post-IPO.³⁰⁴ Since private equity funds often control their targets through shareholders’ agreements, they would easily be found to be promoters under the SEBI Guidelines.³⁰⁵ However, an exemption again exists for registered FVCIs.³⁰⁶

Due to the lack of liquidity on Indian capital markets, a popular way for Indian companies to raise capital is by way of a dual-listing on both an international and a domestic exchange. High-tech companies typically list in the U.S., but others mainly list on LSE’s Alternate Investment Market (“AIM”).³⁰⁷ AIM offers issuers the advantage of lower entry and reporting requirements.³⁰⁸ In November 2010, LSE announced that five Indian companies had listed on AIM in only ten weeks, raising an aggregate of \$344.4 million.³⁰⁹ Jubilant Energy’s listing took the total number of Indian IPOs on LSE’s markets in 2010 to 28, with an aggregate amount of \$2.3 billion in funds raised.³¹⁰ If the private equity investor wishes to exit through an ADR/GDR program, the portfolio company must conform with the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (Through Depository Receipt Mechanism) Scheme, 1993 (“1993 Scheme”).³¹¹ The Indian company

302. *Id.* at 293-94; see *supra* Part II.C.1, for regulation of FVCIs.

303. Singh, *supra* note 251, at 1013; Parikh, *supra* note 243, at 266-67.

304. Singh, *supra* note 251, at 1013.

305. Parikh, *supra* note 243, at 267.

306. *Id.*

307. Shroff, *supra* note 246, at 80; STOWELL, *supra* note 17, at 149.

308. Shroff, *supra* note 246, at 81.

309. Press Release, London Stock Exchange, Five Indian Companies Join AIM in Ten Weeks (Nov. 24, 2010), *available at* <http://www.londonstockexchange.com/about-the-exchange/media-relations/press-releases/2010/fiveindiancompaniesjoinaimintenweeks.htm>.

310. *Id.*

311. Shroff, *supra* note 246, at 79.

must either already be listed or simultaneously list on an Indian stock exchange.³¹² Significantly, depository receipts are treated as FDI so that foreign ownership of depository receipts is subject to Indian FDI sector caps.³¹³ Aside from being subject to FDI restrictions, however, Indian companies may issue ADRs or GDRs without prior approval by Indian regulatory authorities.³¹⁴

Alternatively, the private equity investor may seek to exit through a private sale to a strategic buyer or another private equity fund. A sale to a later-stage private equity investor is impeded by the prohibition of LBOs, but can be facilitated through subsequent recapitalizations.³¹⁵ Moreover, the exit price a foreign entity can demand when selling to an Indian buyer is capped under FDI regulations.³¹⁶ The maximum amount the foreign seller can ask for is the stock market price if the company is listed, or, more likely, the net asset value of the unlisted shares.³¹⁷ However, registered FVCIs are exempt from exit pricing restrictions.³¹⁸ Further, promoters will not be required to make a mandatory public offer under the Takeover Code if they buy back shares from FVCIs, provided that the portfolio company will be subsequently listed on an exchange.³¹⁹

D. CHINA

Even China's economy was affected by the global financial crisis. After having growth rates above 10%, from 2003 to 2007, China's GDP growth rate dropped to 9.6% in 2008 and 9.2% in 2009.³²⁰ While China's government responded quickly with a \$586 billion stimulus package³²¹ that brought its growth rate in 2010 back over the 10%-

312. *Id.*; see also Parikh, *supra* note 243, at 288.

313. Shroff, *supra* note 246, at 79. See *supra* Part II.C.1, for applicable sector caps.

314. Parikh, *supra* note 243, at 288.

315. See *supra* Part II.C.2.

316. Parikh, *supra* note 243, at 265.

317. See *id.* at 265, 294-95.

318. Parikh, *supra* note 243, at 265. See *supra* Part II.C.1, for regulation of FVCIs.

319. *Id.*

320. WORLD BANK, *supra* note 5.

321. Dexter Roberts, *China's Stimulus Package Boosts Economy*, BLOOMBERG BUSINESSWEEK, Apr. 22, 2009, http://www.businessweek.com/globalbiz/content/apr2009/gb20090422_793026.htm.

benchmark at 10.4%, it fell again to 9.3% in 2011.³²² According to JP Morgan Asset Management, China's rise in productivity will be the driving factor for high future returns in China.³²³

Chinese regulators have become increasingly sophisticated and, with experience, regulations are becoming clearer and more user-friendly.³²⁴ In addition, the Ministry of Commerce ("MOC"), which has traditionally exercised the authority to approve foreign investments, has delegated the power to approve smaller deals to local authorities, resulting in a faster and more certain approval process.³²⁵ In August 2008, MOC published the Foreign Investment Market Entry Administrative Guidance Handbook, providing detailed instructions on application procedures, documentation and applicable timelines.³²⁶

China has become the largest net importer of private equity and venture capital investment.³²⁷ Private equity in China is usually in the form of minority growth capital.³²⁸ LBOs face significant obstacles because Chinese foreign invested entities ("FIE") are subject to debt to leverage ratios between 0.43:1.00 and 2.00:1.00 depending on the

322. WORLD BANK, *supra* note 5.

323. Jarlon Tsang, *JP Morgan Asset Management: The Case for Asia: Rising Productivity, Higher Valuations and the Strategic Imperative for Investors*, in ADVANCED VENTURE CAPITAL 2009.

324. Henry H. Liu, *Recent Developments and Trends in M&A Activity Relating to China*, in BEST PRACTICES FOR MERGERS AND ACQUISITIONS IN CHINA: LEADING LAWYERS ON CLOSING A SUCCESSFUL TRANSACTION, NAVIGATING THE NEW ANTI-MONOPOLY LAW, AND UNDERSTANDING THE IMPACT OF THE GLOBAL ECONOMIC DOWNTURN (2010), available at 2010 WL 1976197, at *6.

325. Edward J. Epstein, *New Opportunities in China's M&A Market*, in BEST PRACTICES FOR MERGERS AND ACQUISITIONS IN CHINA: LEADING LAWYERS ON CLOSING A SUCCESSFUL TRANSACTION, NAVIGATING THE NEW ANTI-MONOPOLY LAW, AND UNDERSTANDING THE IMPACT OF THE GLOBAL ECONOMIC DOWNTURN, (2010) available at 2010 WL 1976201, *6.

326. Thomas Y. Man, *Tidal Waves and Undercurrents in Chinese Business: Recent Developments in Key Sectors*, in BEST PRACTICES FOR INTERNATIONAL BUSINESS TRANSACTIONS IN CHINA: LEADING LAWYERS ON NEGOTIATING IN CHINA, MEETING THE CHALLENGING NEEDS OF CORPORATE CLIENTS, AND UNDERSTANDING THE IMPACT OF THE ECONOMIC DOWNTURN, available at 2010 WL 1617873, at *3.

327. Joshua Aizenman & Jake Kendall, *The Internationalization of Venture Capital and Private Equity* 3 (Social Science Research Network, Sept. 1, 2008), available at <http://ssrn.com/abstract=1275544>.

328. Peter Feist, Anthony Wang & Sidney Qin, *China's Private Equity Landscape*, WEIL GOTSHAL PRIVATE EQUITY ALERT 1 (June 2008), available at <http://www.weil.com/news/pubdetail.aspx?pub=7829>.

entity's registered capital, and the MOC does not approve transactions in which debt financing is secured by the target's assets.³²⁹ Thus, the enforceability of minority shareholder protections is a major concern for private equity investors.³³⁰ Typically, private equity funds investing in China have been set up as offshore funds to take advantage of preferential tax treatment and to avoid oversight by Chinese authorities.³³¹ In a recent development, however, the Chinese government has permitted foreign investors to establish foreign-invested partnerships ("FIP") that mainly engage in the investment business.³³² Such FIPs will make it easier for private equity firms to set up onshore funds that operate in China's currency RMB (so-called "RMB funds"), thus avoiding both the approval difficulties associated with offshore investment structures and the risk of an appreciating RMB.³³³ The number of RMB funds has grown substantially in recent years and in 2009, the number of deals done by RMB funds for the first time exceeded those sponsored by foreign funds.³³⁴

1. Foreign Direct Investment

In 2009, China's net inflows of FDI amounted to \$147.8 billion, up from \$79.1 billion in 2005, making China only second in net FDI inflows behind the U.S.³³⁵ As any other country, China encourages or restricts FDI in certain industry sectors. Generally, FDI is deemed to be allowed unless restricted or prohibited in the Catalogue for the Guidance of Foreign Investment Industries.³³⁶ Moreover, the Catalogue contains industries that are marked as "encouraged."³³⁷ Currently, FDI is encouraged in high technology and certain service industries, but

329. David Patrick Eich & Chuan Li, *Private Equity Investments in China: Impact of Recent Legal Reforms*, 18 VENTURE CAP. REV. 9, 9 (2007).

330. See *supra* Part II.B.

331. Lutz-Christian Wolff, *China's Private International Investment Law: One-Way Street into PRC Law?*, 56 AM. J. COMP. L. 1039, 1068-69 (2008); see *infra* Part II.D.3.a.

332. Epstein, *supra* note 325, at *13.

333. *Id.*

334. Man, *supra* note 326, at *3.

335. WORLD BANK, *supra* note 5.

336. Bortnick & Forry, *supra* note 28, at 204.

337. See, e.g., Eich & Li, *supra* note 329, at 9.

prohibited in industries involving non-renewable natural resources, and businesses that may affect national security, such as news websites and internet providers.³³⁸ FDI is restricted in securities companies and discouraged in solely export-oriented businesses.³³⁹

Foreign investors can only invest through FIEs.³⁴⁰ The most common FIEs are equity joint ventures, wholly foreign owned enterprises and foreign invested companies limited by shares.³⁴¹ If no industry sector restrictions apply, a foreign investor is generally permitted to purchase equity securities of a domestic enterprise or to subscribe to newly issued shares of a domestic entity, but the price paid must constitute at least 90% of the securities' appraised value.³⁴² Moreover, participation in Chinese enterprises below 25% is not encouraged and may be excluded from certain preferential treatment of foreign investment.³⁴³ Purchase or subscription agreements must be governed by Chinese law, and the domestic enterprise must be converted into a FIE, unless the target is already a FIE.³⁴⁴

2. *Takeovers of Public Targets*

The Chinese mainland capital markets are divided in an A-share market and a B-share market.³⁴⁵ A-shares are denominated and traded in RMB, and traded on both the Shenzhen Stock Exchange and the Shanghai Stock Exchange.³⁴⁶ B-shares are denominated in U.S. dollars on the Shanghai Stock Exchange, but denominated in Hong Kong dollars on the Shenzhen Stock Exchange.³⁴⁷ In addition, H-shares are shares issued by Chinese joint stock companies, traded on the Hong Kong Stock Exchange, and denominated in Hong Kong dollars.³⁴⁸ Acquisition and trade of A-shares of a Chinese company listed on a

338. Bortnick & Forry, *supra* note 28, at 204.

339. *Id.*

340. Wolff, *supra* note 331, at 1041.

341. Wolff, *supra* note 331, at 1041-44; *see also* Feist et al., *supra* note 328, at 2; Shen, *supra* note 33, at 198.

342. Bortnick & Forry, *supra* note 28, at 205.

343. *Id.*

344. Wolff, *supra* note 331, at 1061-62; *see also* Bortnick & Forry, *supra* note 28, at 205.

345. Man, *supra* note 326, at *2; *see also* STOWELL, *supra* note 17, at 140-41.

346. Man, *supra* note 326, at *2.

347. *Id.*

348. *Id.*

Chinese stock exchange by foreign investors is limited. Certain foreign financial institutions can purchase and hold no more than 10% of outstanding A-shares of a listed company through the qualified foreign institutional investor scheme.³⁴⁹ “Strategic investors” are permitted to acquire a controlling stake in a Chinese listed company through a private purchase of shares from existing shareholders or a private placement of new shares by the listed company if they own offshore assets of at least \$100 million or manage offshore assets of at least \$500 million.³⁵⁰ The share purchase must exceed 10% of the target’s outstanding shares and must be submitted to the MOC for approval.³⁵¹ Importantly, the investor must agree to hold the purchased shares for at least three years.³⁵²

An investor who acquires shares of a listed company through a stock exchange must report its holdings once it crosses the 5% threshold and then upon every crossing of a multiple of 5%.³⁵³ An investor seeking to take over a publicly listed company must make a general offer to all target shareholders if it intends to acquire more than 30% of the target’s outstanding shares.³⁵⁴ The acquirer must prepare a detailed prospectus containing purchase price, shares to be acquired, sources of the necessary funds and any special terms of the offer.³⁵⁵ Upon receipt of the prospectus, the China Securities Regulatory Commission (“CSRC”) has 15 days to object to and stop the offer.³⁵⁶ To the benefit of the investor, however, the target is prohibited from employing dilutive measures, such as a poison pill, or other means to prevent the takeover.³⁵⁷

3. Corporate Law and Legal Enforcement

China’s new Company Law, which became effective on January 1, 2006, provided several changes that allowed for more flexibility in

349. TAO JINGSHOU & OWEN NEE, *MERGERS AND ACQUISITIONS IN CHINA* § 7:18; Bortnick & Forry, *supra* note 28, at 206, n.3.

350. Bortnick & Forry, *supra* note 28, at 206.

351. TAO & NEE, *supra* note 349, § 7:20.

352. *Id.*

353. *Id.* § 7:35.

354. Bortnick & Forry, *supra* note 28, at 205-06.

355. TAO & NEE, *supra* note 349, § 7:36.

356. *Id.*

357. Bortnick & Forry, *supra* note 28, at 206.

structuring foreign private equity investments.³⁵⁸ Subject to the consent of all shareholders, the company's profits may be distributed to shareholders independent from their proportionate stake in the company, suggesting that under the new Company Law, a private equity investment could be structured with different classes of shares.³⁵⁹ Going in the same direction, the corporate charter can provide that voting rights are allocated without regard to the respective shareholding percentage.³⁶⁰ However, the law governing FIEs still requires that economic interests in a FIE are distributed according to each shareholder's pro rata interest in the FIE, thus making it difficult for FIEs to adopt a multiple-class share structure.³⁶¹ Private equity investors can protect their investment against dilution by adopting a charter provision that gives shareholders a preemptive right to make further equity contributions in the event the company proposed to issue fresh capital.³⁶² Further, investors can be granted tag-along and drag-along rights.³⁶³

The new Company Law also introduced new corporate governance provisions, including express duties of care and loyalty imposed on a company's directors and senior management.³⁶⁴ Moreover, the company's information available to shareholders upon request has been extended to articles of association, financial reports, accounting books and board and shareholders' meeting minutes.³⁶⁵

a. Enforceability of Contractual Rights

While the new Company Law introduced many provisions that allow for a more flexible and thus more attractive private equity investment structure, these changes are still relatively new to Chinese law and the enforcement of vehicles such as tag-along and drag-along rights has not yet been tested in Chinese courts.³⁶⁶ "Contracting-out" by choosing the law of a different jurisdiction to govern the investment is not available to the investor as Chinese law is mandatory in regard to the

358. Eich & Li, *supra* note 329, at 35.

359. *Id.*; Shen, *supra* note 33, at 200-01.

360. *Id.* at 201.

361. *Id.* at 206.

362. *Id.* at 201.

363. *Id.* at 201-02.

364. Eich & Li, *supra* note 329, at 35.

365. Shen, *supra* note 33, at 202-03.

366. *Id.* at 202.

transfer of equity interests in Chinese companies.³⁶⁷ In order to avoid Chinese regulatory oversight and to choose a more certain governing law and venue, private equity investors have commonly employed an offshore investment structure dubbed “outbound-inbound,” “round-tripping” or “red-chip” investment.³⁶⁸ Under such a structure, the Chinese target’s shareholders invest alongside with the private equity fund in an offshore vehicle which then acquires the target as a wholly foreign owned enterprise.³⁶⁹ Thus, on the offshore level all the investment protections and structures commonly found in private equity deals can be implemented, including investment by the private equity fund through convertible preferred shares.³⁷⁰ However, in order to prevent significant loss in tax revenue, the State Administration of Foreign Exchange (“SAFE”) moved to curb round-tripping in 2005 by requiring Chinese residents to register and obtain approval from SAFE when intending to invest in an offshore vehicle.³⁷¹ In addition, the domestic entity must disclose the intended shareholding structure to MOC and obtain approval to invest in an offshore special purpose vehicle (“SPV”) under the Provisions on Acquisitions of Domestic Enterprises by Foreign Investors (the “2006 M&A Rules”).³⁷² The MOC has not yet approved any such transaction since the 2006 M&A Rules became effective.³⁷³ Consequently, private equity firms must now consider to “go onshore” by investing directly into Chinese target companies.³⁷⁴ So far, many private equity firms still benefit from the fact that investments made prior to the 2006 M&A Rules becoming effective, as well as subsequent restructurings of such investments, are not subject to the new regulation.³⁷⁵ Thus, it still remains to be seen to what extent private equity firms will be willing to invest onshore in the

367. *Id.* at 209.

368. *See id.* at 211; Feist et al., *supra* note 328, at 1-2; Wolff, *supra* note 331, at 1069.

369. Shen, *supra* note 33, at 211.

370. Feist et al., *supra* note 328, at 1.

371. Shen, *supra* note 33, at 217.

372. *Id.* at 219.

373. *Id.* at 220.

374. Feist et al., *supra* note 328, at 2.

375. *Id.*

future. In this context, shareholders' agreements will likely become more common to protect the investment.³⁷⁶

b. Reliability of the Legal System

China does not have a well-developed reporting system for judicial decisions, and judicial decisions do not have precedential effect comparable to that in common law systems.³⁷⁷ This creates uncertainty regarding the availability and enforceability of some of the typical investor protection devices found in private equity deals, such as preferred stock and redemption rights.³⁷⁸ In the context of government approvals, it is crucial to communicate with the responsible authorities at an early stage to assess how the statutory law will be implemented.³⁷⁹

Most agreements on foreign-related transactions include an arbitration clause.³⁸⁰ Chinese law provides for the enforcement of arbitration clauses and arbitral awards are typically enforced by Chinese courts without a review on the merits.³⁸¹ The Chinese government has established the China International Economic and Trade Arbitration Commission ("CIETAC") in Beijing which has a reputation for being fair and relatively experienced in transactional matters.³⁸² If the investor prefers a neutral location for the arbitration, Hong Kong is a frequent choice for its close proximity to China and yet Western approach to business transactions.³⁸³

376. TAO & NEE, *supra* note 349, § 7:22.

377. Henry Wang, *Developing Savvy M&A Strategies in China*, in BEST PRACTICES FOR INTERNATIONAL BUSINESS TRANSACTIONS IN CHINA, LEADING LAWYERS ON STRUCTURING AND NEGOTIATING TRADE TRANSACTIONS, UNDERSTANDING THE IMPORTANCE OF DUE DILIGENCE, AND WORKING AS A LEGAL PROFESSIONAL IN THE INTERNATIONAL BUSINESS COMMUNITY (2009), available at 2009 WL 1007716 *54.

378. Feist et al., *supra* note 328, at 2.

379. Wang, *supra* note 377, at 56; see also Jeanette K. Chan, *Tackling New Regulatory Challenges for M&A in China*, in BEST PRACTICES FOR MERGERS AND ACQUISITIONS IN CHINA: LEADING LAWYERS ON CLOSING A SUCCESSFUL TRANSACTION, NAVIGATING THE NEW ANTI-MONOPOLY LAW, AND UNDERSTANDING THE IMPACT OF THE GLOBAL ECONOMIC DOWNTURN (2010), available at 2010 WL 1976200, at *3.

380. Wang, *supra* note 377, at 60; see also Shen, *supra* note 33, at 209.

381. Wang, *supra* note 377, at 60.

382. *Id.* at 61.

383. *Id.* at 60-61.

4. Exiting from the Chinese Investment

With 259 deals for a total of \$66 billion, Greater China led the world in both number of deals and total funds raised in 2007.³⁸⁴ The Chinese domestic capital markets saw high volatility during the financial crisis, with the Shanghai Stock Exchange dropping from a record high of 6,124.04 points in October 2007 to 1,664.93 points in October 2008.³⁸⁵ This led to the CSRC suspending IPOs in September 2008.³⁸⁶ Post-crisis, however, an IPO on a domestic exchange is the most popular exit strategy for private equity firms.³⁸⁷ IPO volume on the Shanghai and Shenzhen Stock Exchanges combined reached \$72.1 billion in 2010, for the first time topping the volume of listings in Hong Kong and New York.³⁸⁸ This development is mainly due to two factors. First, the regulations restricting round-trip investments have effectively excluded a large number of Chinese companies from listing on a foreign exchange, such as in Hong Kong or New York.³⁸⁹ Second, the CSRC in 2009 launched the Growth Enterprise Market (“GEM”) on the Shenzhen Stock Exchange, allowing Chinese companies with a relatively low profit of RMB 5,000,000³⁹⁰ to list, provided that the revenue growth rate was at least 30% in the prior two years.³⁹¹ The GEM provides an attractive alternative to a listing on one of China’s larger market segments, and especially compared to a costly listing abroad.³⁹² As of April 2010, about 75% of IPOs on GEM were private equity-backed.³⁹³ Additionally, mainland Chinese companies historically trade at a premium compared to mainland Chinese companies listed in Hong Kong, mainly because the restrictions on mainland Chinese residents to invest abroad create a “shortage in supply” on mainland exchanges.³⁹⁴

384. STOWELL, *supra* note 17, at 149.

385. Man, *supra* note 326, at *6.

386. *Id.*

387. *Id.* at *4.

388. Alison Tudor & Peter Stein, *Two Banks Gain Access Within China*, WALL ST. J. (Jan. 5, 2011), <http://online.wsj.com/article/SB10001424052748704415104576066422954181368.html>.

389. Man, *supra* note 326 at *4; *see supra* Part II.D.3.a.

390. Approximately US\$790,000 (US\$ 1.00 = RMB 6.31 as of Jan. 13, 2012).

391. Man, *supra* note 326, at *2.

392. *Id.*

393. *Id.* at 7.

394. STOWELL, *supra* note 17, at 150.

Prior to the 2006 regulations restricting round-tripping structures, exits through listings on international exchanges were preferred by private equity investors.³⁹⁵ Since more and more investors now have to invest directly into domestic Chinese entities,³⁹⁶ listings abroad have become less popular and the investors can often obtain higher valuations for their portfolio companies on domestic exchanges.³⁹⁷ However, should the investor wish to exit through an offshore listing, it is possible for the investor to “swap” the interests in the Chinese company for shares of an offshore entity and subsequently list the now offshore entity on an exchange abroad.³⁹⁸ The domestic company and the offshore entity must obtain approval from the MOC and conduct the offshore IPO within one year from the approval date.³⁹⁹

Additionally, more private equity investors now consider a private sale or a stock repurchase by the portfolio company as a major exit strategy.⁴⁰⁰ In considering a private sale, the investor has to keep in mind that every M&A transaction in China, independent of its size and industry, requires government approval.⁴⁰¹ Especially large deals that require approval by the central government can be very time consuming.⁴⁰²

CONCLUSION

“One group comprises those that have displayed remarkable resilience during the global financial crisis. This group of ‘winners’ includes Brazil, China, India”⁴⁰³ “Russia has experienced a very difficult crisis, which raises concerns about its long-term growth trend,” but “Russia had performed better than our expectations until the crisis,

395. See Man, *supra* note 326, at *3.

396. See *supra* Part II.D.3.a.

397. Man, *supra* note 326, at *7.

398. Feist et al., *supra* note 328, at 2.

399. *Id.*; Shen, *supra* note 33, at 219.

400. Man, *supra* note 326, at *11.

401. Wang, *supra* note 377, at 55; see also Simone Yew, *Key Aspects of Chinese M&A Deals*, in BEST PRACTICES FOR MERGERS AND ACQUISITIONS IN CHINA, LEADING LAWYERS ON CLOSING A SUCCESSFUL TRANSACTION, NAVIGATING THE NEW ANTI-MONOPOLY LAW, AND UNDERSTANDING THE IMPACT OF THE GLOBAL DOWNTURN (2010), at *3-4.

402. Wang, *supra* note 377, at 56.

403. O’Neill & Stupnytska, *supra* note 14, at 6.

and, if it recovers strongly and quickly in 2010 and 2011, as we expect, we believe it will deserve its BRIC status.”⁴⁰⁴ Is this assessment of the larger economic development of the BRICs by Goldman Sachs’s Jim O’Neill also valid for the private equity sector? How has the legal and political framework in the BRICs developed to foster foreign private equity investment that can contribute to economic growth?

All four countries have significantly improved their corporate law. While many changes are still in their infancy and have not yet been thoroughly tested, the level of sophistication is in most cases comparable to that of developed countries. Thus, with a few exceptions, private equity investors generally find all the necessary tools, from convertible preferred stock schemes to covenants and anti-dilution protection, to structure a successful private equity investment. The need for improvement remains in regard to the uncertainties surrounding the enforceability of shareholders’ agreements in Russia and the availability of convertible preferred shares in China. Differences in the corporate governance level appear not so much in the black letter law, but rather in the actual ownership structures of the local businesses. In Brazil, as well as in Russia, concentrated ownership and family-dominated management can create agency costs and disputes between management and investor. However, while in Brazil this is a problem mainly associated with older, more mature companies, investors still name untrustworthy partners as the main reason to abandon deals in Russia, where many insiders benefited from large scale government privatizations. In India, it can be difficult to negotiate deals when companies are owned and run by large families and each family member’s approval must be sought.

Governments cannot directly regulate the factual ownership structures of their businesses. Thus, one could argue that this is an area beyond governmental reach. However, improving corporate governance structures is an important lever that private equity firms employ when seeking to increase the target’s value for a later exit, preferably through a public listing. Thus, by opening markets to the private sector and by further encouraging private equity investment, governments can invite the players they need to break up concentrated ownership structures and make management accountable. While all BRICs, just as any developed nations, restrict FDI in certain strategic sectors, government interference

404. *Id.* at 3.

appears to be particularly significant in Russia and China. In Russia, it is the vast amount of restricted sectors (42) that still limit foreign private equity investment in many areas. It remains to be seen whether the Russian government follows through with its promise to ease limitations in some of the industry sectors. In China, interference is manifested through the many obligatory government approvals, not only for FDI but also any domestic M&A transactions. Importantly, it seems that it is at least relatively predictable under what circumstances government approvals will be granted. In India, the relatively strict FDI regime is substantially mitigated for private equity investors by the possibility to register as a FVCI.

The analysis of the corporate laws and securities regulation in the BRICs shows that the legal framework is relatively developed in all four countries. Difficulties, however, arise in the implementation of legal rules. Judicial systems in the BRICs are slow and often still inexperienced or overwhelmed by a heavy case load. This can lead to major delays and/or hasty, ill-informed judicial decisions when judges attempt to reduce their docket quickly. Therefore, resorting to arbitration is a must and a viable alternative as all four BRICs are signatories to the 1958 New York Convention. A more difficult challenge to sidestep is corruption, which is still a major concern especially in Russia. Despite the Russian government's efforts to curb corruption, Russia still ranks only 143rd out of 182 nations on the Transparency International Corruption Perception Index. Corruption is a significant deterrent in particular for U.S. investors, given the liabilities U.S. entities face under the Foreign Corrupt Practices Act.

A common technique for private equity investors to evade weak legal systems is the so-called round-tripping or red-chip structure. Aside from advantageous tax treatment, this enables investors to structure their investment under a favorable and reliable legal system which allows for the legal instruments and investor protections commonly employed in private equity deals. The consequences of this form of regulatory arbitrage for the host countries are a loss of both tax revenue and regulatory grasp of foreign investment. Among the BRICs, round-tripping is still the prevalent structure in Russia and was in China until the 2006 M&A Rules introduced severe limitations. Many investments into China were made prior to the new regulation becoming effective and thus are not subject to the approval requirements. It still has to be seen whether foreign private equity investors will, to the same extent, be willing to invest through onshore structures in the future. However, it seems that instead of imposing restrictions on round-tripping, it would

be preferable to implement reforms domestically that render such arbitrage unnecessary.

Finally, the availability of an IPO exit, preferably on a domestic exchange, is the driving force for the growth of private equity in the emerging markets. The difficulties Russian companies face when seeking to access domestic or international capital markets appear to explain to a substantial degree why Russia is trailing behind the other three BRIC countries. Brazil took decisive steps to make its domestic capital markets more attractive and to entice liquidity, in particular through the introduction of Novo Mercado. China had large success with the establishment of the Growth Enterprise Market on the Shenzhen Stock Exchange, which compensates for the fact that offshore listings have become difficult under the more restrictive regulation. In India, while the domestic markets are still lacking liquidity, companies have relatively easy access to capital on LSE's Alternative Investment Market. In Russia, however, an IPO is often neither available domestically nor on an international exchange. While both the number and volume of domestic IPOs have increased in recent years, these numbers were mainly driven by large, often formerly state-owned companies. For the majority, the Russian capital markets still do not offer the necessary liquidity. Therefore, Russian companies routinely seek to list abroad, predominantly on the LSE. However, Russian securities regulation severely limits the amount of shares that can be listed abroad through an ADR/GDR program in order to induce issuers to list at home. Again, strengthening the domestic markets by reforming applicable regulation and further enhancing access for foreign investment seems to be a preferable response over imposing restrictions on listings abroad.

The analysis of the environment for private equity in the four BRICs indicates that Brazil offers the most attractive legal, economic and political environment for private equity investments. Yet, China leads the market for foreign private equity, partly by sheer size and growth opportunity, but also because it offers, despite its restrictions for foreign investors, a reliable legal system and viable opportunities for an exit by way of an IPO. Once China reduces the amount of government involvement, it will become an even more attractive market for private equity. India offers growth opportunities similar to those in China, but will have to improve the liquidity of its domestic capital markets, as well as the regulatory transparency. It appears that Russia has the most room for improvement. First, Russia will need to have more success in

fighting corruption. Second, it will need to offer private equity investors better exit strategies. In the short term, this would be possible by easing restrictions for listings on international exchanges. In the long term, Russia must increase the attractiveness of its domestic capital markets. Brazil's high corporate governance Novo Mercado and China's middle market GEM serve as model examples.