May 28, 2013

Koehler v. NetSpend Holdings Inc.

Delaware Court of Chancery Finds Board Likely Breached Duty of Care for Failing to Waive "Don't Ask, Don't Waive" Standstills and Relying on Fairness Opinion the Court Characterized as "Weak" in Single-Bidder Sale With No Market Check

Court Declines to Enjoin Transaction on Balance of the Equities

SUMMARY

In a preliminary injunction opinion issued on May 21, 2013, the Delaware Court of Chancery (VC Glasscock) found that the board of directors of NetSpend Holdings Inc., comprised of four directors representing private equity-affiliated stockholders that owned over 45% of NetSpend's shares, three independent directors and the CEO, likely failed to satisfy their so-called "*Revlon*" duties to attempt to secure the best value reasonably attainable when agreeing to sell the company to Total Systems Services, Inc. ("TSYS") in an all-cash $1.4 billion transaction. Specifically, the Court concluded that while the single-bidder sale process was not unreasonable per se it likely was unreasonable in the context of a fairness opinion the Court characterized as "weak" and a merger agreement that contained standard deal protection provisions, including a prohibition on waiving "Don't Ask, Don't Waive" standstills in confidentiality agreements with bidders that had previously been interested in a minority investment in the company.

However, despite finding a probability of success that the NetSpend directors had breached their duty of care, the Court declined to enjoin the transaction, concluding as in *In re El Paso Corp. Shareholder Litigation*[1] that the risk of losing the only available deal outweighed the harm from the flawed sale process because no rival bidders had emerged notwithstanding a longer-than-anticipated time between signing and closing the TSYS transaction and the fact that the "Don't Ask, Don't Waive" provisions had been waived shortly after oral argument on the plaintiff's preliminary injunction motion.

The Court's *NetSpend* opinion has the following implications for directors of Delaware corporations:

- Although there is "no single blueprint" directors must follow to maximize value in a change of control transaction,[2] when directors elect to forgo a market check, either before or after the deal is signed, they should be "particularly scrupulous"[3] about designing a sale process that ensures they are fully informed so that they can conclude that they have maximized value. Valuation analyses and fairness opinions from advisors and any actual or perceived barriers to the free flow of information to the board assume greater significance in such circumstances.
- While Delaware law remains unsettled with respect to "Don't Ask, Don't Waive" standstills, *NetSpend* (as the first written opinion on the merits to address "Don't Ask, Don't Waive" standstills) reiterates Chancellor Strine's view in *In re Ancestry.com* decided in December 2012 that "Don't Ask, Don't Waive" standstills are not per se impermissible, that they will be evaluated in the context of their use and that a board must understand the import to the sale process of agreeing with a successful bidder not to waive standstills with other bidders.[4] *NetSpend* also makes clear that in the context of a single-bidder process without a market check, they are unlikely to survive scrutiny absent a strong justification for their use.
- As we have noted in other recent publications, "Delaware courts remain hesitant to enjoin M&A transactions altogether, even where they find 'troubling' process concerns, where there is no challenging bidder and shareholders are not precluded from voting down the only transaction at hand."[5] *NetSpend* is consistent with this trend.

BACKGROUND

Between 2007 and 2009, NetSpend, then a private company, embarked on several failed attempts to sell itself that involved lengthy and disruptive negotiations and even signed a merger agreement that was abandoned for failure to obtain regulatory approval. As a result, NetSpend decided to remain independent and conducted its IPO in October 2010 at $11 per share; within a year, its stock price had fallen to $3.90. Despite two rounds of stock repurchases in 2011 and early 2012, NetSpend's stock price remained well below what the board believed was NetSpend's long-term value. As a result, the board explored its options on a high-level basis, including having preliminary discussions with three companies that had approached them about the possibility of a sale. The board concluded that the sale of the company would not, in light of the undervalued stock price, be in the best interests of the company or its stockholders.

Also in late 2012, NetSpend's two largest stockholders, which collectively held approximately 47% of the company's common shares, indicated their desire to sell all or a significant portion of their NetSpend holdings. Fearful that sales on the open market would depress NetSpend's stock price further, the NetSpend board authorized the CEO to provide confidential financial projections to two private equity firms that had expressed interest in privately buying a minority stake in the company, but explicitly instructed the CEO "that the entire company was not for sale."[6]

Before receiving the projections, the two private equity firms—referred to in the opinion as "Private Equity A" and "Private Equity B"—signed confidentiality agreements with customary standstills that restricted them from making any offer for the company's securities without an express invitation to do so from the board. These standstill agreements also contained so-called "Don't Ask, Don't Waive" provisions, in which the recipient of confidential information agrees not even to ask the target company, directly or indirectly, for a waiver of any of the standstills' terms.[7] In November 2012, Private Equity A offered to acquire 20% of the company from NetSpend's largest stockholder for $12 per share. At the time, NetSpend stock was trading around $11.65.

Around the same time, TSYS approached NetSpend and indicated an interest in acquiring 100% of the company for $14.50 per share conditioned on due diligence and on retaining management. Given the TSYS offer, NetSpend's largest stockholder indicated it was no longer interested in selling its shares to Private Equity A. Although the company's financial advisor had prepared a list of other potential suitors, the board decided not to contact other bidders based on (a) the company's previous history of disruptive failed negotiations, (b) the potential for leaks, (c) the board's perception, based on one market contact, that there was little interest in an acquisition,[8] and (d) the board's view that, by making it clear to TSYS that it was not for sale, TSYS would likely bid against itself without the risk of any potential damage to NetSpend.[9] As the NetSpend CEO testified at his deposition, "if you know that running an auction process isn't going to produce any serious bona fide bidders, then you don't go out and run an auction. You stick with what we've been saying . . . I ain't selling. So if you want it, you got to pay for it."[10]

After several rounds of negotiation, NetSpend and TSYS agreed on January 26 to a basic deal package that included a cash price of $16 per share (representing a 45% premium to NetSpend's stock price one week before and, ultimately, a 25% premium to the pre-announcement price on February 19 that had been buttressed by an interim favorable earnings report), a no-shop that has a fiduciary out for a superior offer and that precluded NetSpend from waiving any standstill restrictions with other parties (including Private Equity A and B) without TSYS' consent, and a 3.9% of equity value termination fee (or approximately $53 million). Over the next couple of weeks, the parties negotiated the details of the merger agreement as well as voting agreements that obligated NetSpend's largest stockholders to vote for the merger (other than if the merger agreement were terminated) and employment agreements with management, including the CEO, the principal negotiator of the transaction on behalf of NetSpend.

On February 19, the NetSpend board approved the merger agreement and ancillary documents and announced the transaction, including that they anticipated closing to occur sometime in April (subsequently delayed until May 31). At that meeting, NetSpend's financial advisor provided the board with a fairness opinion, but its analysis showed that the deal price was below the implied value generated by the discounted cash flow ("DCF") model, that the comparable public companies were comprised mostly of non-comparable companies, and a comparable transaction analysis that the NetSpend board acknowledged contained pre-financial crisis transactions and was thus dated. NetSpend had not received any offers from other bidders since announcing the sale.

THE COURT'S DECISION

On March 1, Brenda Koehler, an unaffiliated stockholder, filed suit in the Court of Chancery alleging disclosure violations with the company's proxy statement disseminated in connection with the stockholder vote and breaches of the board's *Revlon* duties to attempt in good faith to maximize the sale price of the company when selling control. The Court first disposed of the disclosure claims with little discussion. Most were mooted by supplemental disclosures, and the Court held that those that remained—requests for (1) additional information about how NetSpend and its financial advisor independently calculated the company's free cash flows and (2) disclosure of an earlier financial advisor-prepared DCF analysis erroneously yielding a higher range of implied values than the final DCF analysis disclosed to stockholders—were not material.

As to the *Revlon* claim, the plaintiff challenged the reasonableness of, among other things, allowing "conflicted management" to control the TSYS negotiations, NetSpend's single-bidder sale process without a market check, the board's reliance on its financial advisor's allegedly flawed fairness opinion, and the board's failure to waive the "Don't Ask, Don't Waive" provisions binding Private Equity A and B.

A. *Permitting CEO to Negotiate with TSYS Not Problematic*

At the outset, the Court "easily dispense[d] with" the plaintiff's argument that the board breached its fiduciary duties by allowing NetSpend's CEO to lead the negotiation.[11] Noting that the CEO's ownership of NetSpend stock aligned his interests with those of stockholders generally, the absence of any special interest on his part either to cash out early or ensure his continued employment as NetSpend's CEO, and the board's regular oversight of the negotiations, including its instruction that management's retention agreements not be discussed until agreement on the principal deal terms had been reached, the Court found the CEO's involvement in the negotiations with TSYS to be reasonable.

B. *Single-Bidder Process Not Unreasonable Per Se, But Directors Must Be "Particularly Scrupulous" to Ensure They Are Adequately Informed if They Forgo a Market Check*

The *NetSpend* Court found that the board's initial decision to engage in a single-bidder process in and of itself was reasonable under *Revlon*'s enhanced scrutiny test of director's actions.[12] Citing to established Delaware jurisprudence,[13] the *NetSpend* Court emphasized that Delaware permits a board to dispense with a market check in limited circumstances—ones in which it is clear that the board "had sufficient knowledge of the relevant markets, and a body of reliable evidence."[14] The Court found that the NetSpend board met the criteria established by that jurisprudence, including that the directors are sophisticated professionals with extensive business and financial expertise who were competent to evaluate the TSYS transaction, hired highly regarded and unconflicted financial advisors, and were well-informed about the process of selling the company (having gone through several failed full-blown sale processes). Furthermore, the Court concluded that it was reasonable for the board to have adopted a deliberate "no-sale" strategy that allowed NetSpend to focus on maintaining the business in the ordinary course while forcing TSYS to bid against itself. As the Court concluded, "[e]ach of these circumstances provided an additional level of context and knowledge of the relevant market to allow the [b]oard to reasonably determine that a single-bidder process was in the best interest of the Company" and that "its initial decision to engage in a single-bidder process was reasonable."[15]

This conclusion, however, did not end the Court's analysis. The Court emphasized that a board's decision to forgo an external market check must inform its approach to the entire sale process, "which in toto must produce a process reasonably designed to maximize price."[16] The Court cautioned that by choosing to forgo an external market check, a board must "be particularly scrupulous in ensuring a process to adequately inform itself that it had achieved the best price."[17] Reviewing the board's reliance on the fairness opinion the Court characterized as "weak" and the effect of the deal protection devices the company adopted in light of the absence of an external market check, the *NetSpend* Court concluded that the board was likely to be found to have failed to act reasonably.

1. Reliance on Fairness Opinion Not a Substitute for a Market Check

The Court concluded that the fairness opinion, based upon public company and transaction comparables of limited utility and a DCF analysis with a bottom end of a range that was 20% *above* the $16 deal price, was "weak" and that therefore it was "a particularly poor" substitute for a market check, a fact available to the board when it approved the merger agreement.[18]

Emphasizing in a footnote that the directors' reliance on the fairness opinion was not itself a breach of fiduciary duty since directors are entitled to rely in good faith on expert opinions,[19] the *NetSpend* Court found that the reliance did, however, push the totality of the decisions the board made "farther towards the limits of the range of reasonableness."[20]

2. Customary Deal Protection Devices and the Failure to Release "Don't Ask, Don't Waive" Standstill Provisions

The *NetSpend* Court noted that none of the traditional deal protection devices adopted in the merger agreement (*e.g*. the market break fee and matching rights) nor the entry into voting agreements with NetSpend's largest stockholders (representing over 45% of the shares) would deter a serious suitor since NetSpend retained a fiduciary out for superior offers and the voting agreements terminated on the termination of the merger agreement. The Court also noted that it was not per se unreasonable for the board to have forgone a go-shop as part of a trade-off for a higher deal price, which the record showed NetSpend had done.

However, the Court found the no-shop (or forgoing the go-shop) troublesome in the context of a short pre-closing period; the planned April closing indicated that the board could not have "intended that a leisurely post-agreement, pre-closing period would provide an adequate alternative to a market check."[21] Likewise, the Court concluded that in light of the no-shop and the single-bidder sale process, the board's failure to waive the "Don't Ask, Don't Waive" provisions in Private Equity A and Private Equity B's cases at the time that *Revlon* duties first attached (*i.e*. when it was likely that TSYS would acquire NetSpend) and instead to agree with TSYS in the merger agreement not to waive the "Don't Ask, Don't Waive" provisions was problematic. In so doing, the Court said, "the [b]oard blinded itself to any potential interest from Private Equity A and Private Equity B,"[22] noting that the fiduciary out was illusory insofar as without communication with Private Equity A or Private Equity B the NetSpend board would have no reason to invoke it and waive the standstills.

Furthermore, echoing comments made by Chancellor Strine in *In re Ancestry.com Shareholder Litigation*,[23] the Court stressed, "[m]ost problematically," that the record suggests that the board did not understand the import of the "Don't Ask, Don't Waive" clauses or of their importation into the merger agreement and did not "consider[] whether the standstill agreements should remain in place once the [b]oard began negotiating with TSYS."[24] That ignorance, according to the Court, belied any notion that the directors had designed a process that was informed, logical and reasoned.

Noting that "Don't Ask, Don't Waive" clauses can have value in an auction context, Vice Chancellor Glasscock, in the first written opinion addressing the merits of these clauses, makes clear (as Chancellor Strine articulated in *In re Ancestry.com*) that their validity will depend upon the context of their use in any particular instance. The Court stated: "Given that the clauses here are merely an artifact from an earlier [b]oard strategy (to remain an independent entity), and given that they are here employed to lock up a *single bidder sale*, none of that utility can apply here."[25]

3. Totality of Factors Indicate Sale Process Likely Was Unreasonable

The Court concluded that while several of the factors alone were within the range of reasonableness, the totality of the factors indicated that the sale process the NetSpend board pursued was unreasonable and that the directors would be unlikely to meet their burden of showing that they were fully informed. The Court stated that the combination of the single-bidder strategy, when combined with the no-shop, the fairness opinion considered "weak" by the Court and "in particular" the failure to waive the "Don't Ask, Don't Waive" clauses, left the board uninformed as to whether $16.00 per share was the highest price it could reasonably attain for the stockholders.[26] The Court reached this conclusion despite the sophistication of the directors representing over 45% of the NetSpend common shares and NetSpend's engagement with five potential purchasers (including TSYS) in the prior two years.

C. *Court Declines to Enjoin the Merger*

Despite finding a probability of success on the plaintiff's *Revlon* claim, and despite the fact that NetSpend's charter contains a provision under DGCL § 102(b)(7) exculpating its directors from monetary liability for breaches of the duty care (*i.e.*, foreclosing a money damages remedy after trial), the Court nevertheless declined to enjoin the closing of the merger. Citing *In re El Paso Corp. Shareholder Litigation*[27] as an example of Delaware courts' reticence to enjoin a premium transaction when no competing offer has been made and the plaintiff has shown irreparable harm, the Court stated that despite the showing of irreparable harm, the plaintiff had failed to adduce evidence that the quantum of harm and the benefit of the injunction outweighed the potential significant harm of losing the TSYS deal. The Court noted in that respect that the litigation and revisions to the proxy statement had delayed the anticipated closing for approximately six weeks and that both Private Equity A and B ultimately had been released from their “Don’t Ask, Don’t Waive” restrictions during the *NetSpend* litigation, yet no offer topping TSYS had emerged.

Thus, in balancing the equities, the Court concluded that an injunction (even for a temporary go-shop period) would be unlikely to result in a topping bid, but could—especially if there were a material adverse change in the interim—cause the only available premium transaction with TSYS to fail.

IMPLICATIONS

The *NetSpend* decision has the following implications for directors of Delaware corporations:

- Delaware directors are not required to conduct a pre-signing auction or post-signing market check when selling a company, but they nevertheless must avail themselves of all material information relevant to determining whether the sale process they have adopted is reasonably designed to maximize the sale value of the enterprise. Absent a traditional market canvas of some sort, whether prior to signing up a transaction or through a go-shop mechanism, directors must take care—indeed, be “particularly scrupulous”[28]—to ensure they “possess a body of reliable evidence with which to evaluate the fairness of a transaction” and conclude they are maximizing value.[29] To do so, directors must consider not only the information that actually reaches them but also whether any structural or factual dynamics of the proposed transaction itself might hinder the flow of information to the board.
- Although directors can rely on fairness opinions prepared by financial advisors, such opinions cannot obviate directors’ duty to consider information of which they already are aware in determining how much credence should be accorded to the opinions, and whether they can substitute for an external market check.
- As we have noted in past publications, “Don’t Ask, Don’t Waive” provisions are likely to engender greater scrutiny by the Court of Chancery of the facts and circumstances surrounding their use in any particular case and, because of their perceived potency, practitioners should counsel boards regarding the import of such provisions to pending negotiations and transactions.[30] This admonition applies equally to lingering “Don’t Ask, Don’t Waive” provisions entered into during previous, aborted transactions that have not yet expired. In the context of a single-bidder process without a market check, “Don’t Ask, Don’t Waive” clauses are unlikely to withstand scrutiny absent a strong justification for their use.

* * *

ENDNOTES

1 41 A.3d 432 (Del. Ch. 2012).

2 *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989).

3 *Koehler v. NetSpend Hldgs. Inc.*, C.A. No. 8373-VCG, slip op. at 37 (Del. Ch. May. 21, 2013) [hereinafter *Slip Op.*].

4 For a discussion of other recent cases addressing the use of "Don't Ask, Don't Waive" standstills, see our publication, dated January 9, 2013, entitled "In re Ancestry.com Inc. Shareholder Litigation" and our publication, dated November 30, 2012, entitled "In re Complete Genomics, Inc. Shareholder Litigation: Delaware Chancery Court Enjoins 'Don't Ask, Don't Waive' Standstill Provision and Conditionally Denies Injunction on Deal Protections."

5 In re Ancestry.com Inc. Shareholder Litigation, at 6, Jan. 9, 2013.

6 *Slip Op.* at 10.

7 One firm's standstill lasted for a one-year term and the other's terminated in two years. Additionally, neither agreement contained a fall-away or early termination provision that would release the standstill upon the announcement of another transaction, which sometimes are included in "Don't Ask, Don't Waive" standstills. *Id.* at 11.

8 NetSpend contacted one potential strategic bidder to whom it owed a contractual commercial obligation to provide notice of any consideration to sell itself. When that potential counterparty did not respond, "NetSpend took [that] silence as evidence of the marketplace's lack of interest in NetSpend, in general." *Id.* at 17.

9 *Id.* at 16 (quoting NetSpend's proxy statement in support of the pending transaction).

10 *Id.* at 20.

11 *Id.* at 37.

12 *Id.* at 45.

13 Specifically, the Court discussed three precedents: (1) the Delaware Supreme Court's decision in *Barkan*; (2) Vice Chancellor Parsons's decision in *In re Smurfit-Stone Container Corp. S'holder Litig.*, 2011 WL 2028076 (Del. Ch. May 24, 2011); and (3) Vice Chancellor Noble's decision from earlier this month in *In re Plains Exploration & Prod. Co. S'holder Litig.*, 2013 WL 1909124 (Del. Ch. May 9, 2013).

In *Barkan*, the target "board had sufficient knowledge of the marketplace to agree to a transaction despite the absence of a market check" because the target had been the subject of management takeover rumors for over a year and the board had knowledge of tax advantages unique to an MBO "which the board believed would allow management to complete a transaction at a price considerably higher than that of any outsider." *Slip Op.* at 40.

In *Smurfit-Stone*, the absence of a market check was held reasonable where the target recently had emerged from an 18-month bankruptcy that had failed to generate concrete bids, a competing company that previously had bid but withdrawn an offer declined to reengage when invited to do so by the board, and the board reasonably believed that few strategic partners would be interested in acquiring the company. "The combination of these circumstances was enough for the Court to find that the board had sufficient information to conclude that a market check was not worth the risks of jeopardizing the transaction with Rock-Tenn." *Slip Op.* at 41.

ENDNOTES (CONTINUED)

Finally, in *Plains*, "the combination of mild deal-protection devices (including a non-solicitation clause with a fiduciary out for superior proposals) and a five-month lag in time between the announcement of the merger and the merger's closing . . . created a de facto market check" during which time the target board "'retained significant flexibility to deal with any later-emerging bidder and ensured that the market would have a healthy period of time to digest the proposed transaction.'" *Slip Op.* at 42 (quoting *Plains*, 2013 WL 1909124, at *15).

14 *Slip Op.* at 39 (citing *Barkan*, 567 A.2d at 1287, 1288).

15 *Id.* at 45.

16 *Id.*

17 *Id.* at 37.

18 *Id.* at 49.

19 *See* Section 141(e) of the Delaware General Corporation Law ("DGCL"), 8 *Del. C.* § 141(e).

20 *Slip Op.* at 46 n.211.

21 *Id.* at 52.

22 *Id.* at 54.

23 See our publication, dated January 9, 2013, entitled "In re Ancestry.com Inc. Shareholder Litigation."

24 *Slip Op.* at 54.

25 *Id.* at 55 n.235.

26 *Id.* at 59.

27 41 A.3d 432 (Del. Ch. 2012).

28 *Slip Op.* at 37.

29 *Barkan*, 567 A.2d at 1287.

30 In re Ancestry.com Inc. Shareholder Litigation, at 6, Jan. 9, 2013.

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CONTACTS

New York

Francis J. Aquila	+1-212-558-4048	aquilaf@sullcrom.com
Audra D. Cohen	+1-212-558-3275	cohena@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Brian T. Frawley	+1-212-558-4983	frawleyb@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
John L. Hardiman	+1-212-558-4070	hardimanj@sullcrom.com
Matthew G. Hurd	+1-212-558-3122	hurdm@sullcrom.com
Alexandra D. Korry	+1-212-558-4370	korrya@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
Scott D. Miller	+1-212-558-3109	millersc@sullcrom.com
James C. Morphy	+1-212-558-3988	morphyj@sullcrom.com
Keith A. Pagnani	+1-212-558-4397	pagnanik@sullcrom.com
George J. Sampas	+1-212-558-4945	sampasg@sullcrom.com
Melissa Sawyer	+1-212-558-4243	sawyerm@sullcrom.com
Krishna Veeraraghavan	+1-212-558-7931	veeraraghavank@sullcrom.com

Washington, D.C.

Janet T. Geldzahler	+1-202-956-7515	geldzahlerj@sullcrom.com

Los Angeles		
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
Palo Alto		
Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
London		
Richard C. Morrissey	+44-20-7959-8520	morrisseyr@sullcrom.com
David Rockwell	+44-20-7959-8575	rockwelld@sullcrom.com
Paris		
Krystian Czerniecki	+33-1-7304-5880	czernieckik@sullcrom.com
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Frankfurt		
Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
Melbourne		
Robert Chu	+61-3-9635-1506	chur@sullcrom.com
Tokyo		
Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
Hong Kong		
William Y. Chua	+852-2826-8632	chuaw@sullcrom.com
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com
Beijing		
Garth W. Bray	+86-10-5923-5958	brayg@sullcrom.com