LEGAL INSIGHT

“Fair Value” under Cayman Merger Law Regime - Court Ruling on Minority Discount

Introduction

The Cayman Islands have been the leading offshore jurisdiction for merger and acquisition (M&A) activity over the last few years, with a steady flow of over USD77bn in combined value of target companies for 2016 and 2017, and a peak of over USD115bn in 2015. By way of comparison, for 2017, the combined value of transactions targeting companies incorporated in the British Virgin Islands (BVI) and Hong Kong was USD37bn and USD40bn respectively[1].

A significant portion of this M&A activity was related to merger take-privates involving Cayman-incorporated companies listed on U.S. stock exchanges, which were achieved through the Cayman Islands statutory merger regime (the “**Cayman Merger Law**”). The related transactions also generated a significant number of litigated cases in the Cayman Islands, as any shareholder who is unhappy with the consideration offered as part of a merger may dissent and is entitled to payment of fair value of its shares under Section 238 of the Cayman Islands Companies Law (2018 Revision) (the “**Companies Law**”), and such fair value, if not agreed between the parties, is determined by the Grand Court of the Cayman Islands (the “**Court**”).

2017 Cases Favourable to Dissenting Shareholders

In 2017, several decisions issued by the Court improved upon and clarified the rights of minority shareholders dissenting from a merger, both in respect to procedural matters[2], and by allowing the dissenting shareholders to benefit from interim payment relief[3]. However, the most significant development of the year 2017 had been the judgment issued on 25th April 2017 ***in the matter of Shanda Games Limited***, when the Court reaffirmed its seminal decision ***in the matter of Integra Group*** on 28th August 2015, and decided that “fair value” was to be determined on the basis of the Company as a going concern immediately prior to the merger, without any minority discount.

The Court had based its decision on fair value valuation principles in Delaware and Canada because it was the Delaware and Canadian merger law regimes that had inspired the adoption of the Cayman Merger Law. The judgment ***in the matter of Shanda Games Limited*** also addressed many technical issues of valuation methodology (including the use of the discounted cash-flow (“DCF”) model, how depreciation should factor into the valuation, taking account of trading at any point up until the valuation date, taking account of the actual or anticipated performance against the market, etc.).

Court of Appeal Judgment Regarding Shanda Games Limited

However, following an appeal brought by Shanda Games, the Cayman Islands Court of Appeal held on 6th March 2018 that, contrary to what had been previously decided by the Court, a “*minor-*

ity discount" should be applied in assessing the "*fair value*" of a dissenter's shares. In so doing, the Court of Appeal decided to follow Shanda Games' arguments that the trial judge should have taken into account English case law authorities before looking further to what the Delaware courts had determined.

The English case law authorities cited by the Court of Appeal discussed fairness (or rather unfairness) in the context of disputes with regard to schemes of arrangement and squeeze-outs mechanisms[4]. In ***Re Hoare & Co. Ltd (1933) 150 LT 374***, cited by the Court of Appeal in paragraph 35 of its decision, the paragraphs cited make it clear that the reasoning for the English court's conclusion that a minority discount did not make the scheme of arrangement unfair was that the scheme had gathered the approval of the required 90% of the shareholders affected by the offer. This fact, the English court reasoned, constituted prima facie evidence as to fairness and dissentients did not produce appropriate evidence to disprove it. In ***Re Linton Park plc [2005] EWHC 3545 (Ch); [2008] 17***, the English court similarly states that "*whether the package on offer is a fair price for the shares is a matter which the shareholders are far better to able to judge than the court, and for that reason the court will be very slow to depart from the majority view*". In ***Re Grierson, Oldham & Adams Ltd [1968] Ch 17***, that the English court issues a substantial view on minority discounts by stating that "*it is not unfair to offer a minority shareholder the value of what he possesses, i.e. a minority shareholding*".

Analysis

Admittedly, the adoption of a minority discount in the assessment of "fair value" is by itself a serious setback to dissenting shareholders utilising the Cayman Merger Law to obtain fair value for their shares. However, the consequences of the Court of Appeal's decision ***in the matter of Shanda Games Limited*** may be more far-reaching.

It has been so far generally accepted under Cayman Islands law that under a scheme of arrangement or a statutory squeeze-out under section 88 of the Companies Law dissenting shareholders would be "dragged along" if the scheme is approved or the conditions of the statutory squeeze-out are met without a requirement that the Court re-examines the "fair value" of the consideration offered to them. Also, it appears to have been generally accepted that the Court would not in fact intervene unless there is a clear case of unfair or prejudicial treatment of shareholders in these circumstances. It is this exact approach that is illustrated by the English case law authorities cited by the Court of Appeal and referred to above. This minimal level of intervention by the English courts with respect to valuation issues is well justified, as neither schemes of arrangement[5] nor squeeze-outs[6] are susceptible to the same measure of control (or abuse) by the buyout group in a merger take-private transaction as it is possible under the Cayman Merger Law:

i. a scheme of arrangement not only requires approval by 75% of shareholders <u>in each class</u> and 75% in value of creditors present and voting (a higher majority than required under the Cayman Merger Law), but
    a. founders or insiders may be treated by the Court as a separate class, which basically translates into a "majority of minority" requirement; and
    b. dissenting shareholder are entitled to actually appear before the Court and argue against the scheme; and

ii. a statutory squeeze-out requires that at least 90% in value of shares affected by the offer (*i.e.* the shares not held by the buyout group) agree to the offer.

The above requirements, if met, translate into strong evidence of fairness with respect to consideration offered given the high thresholds for approval. Accordingly, it could be reasonably argued that there is less need for the Court, and no opportunity under Sections 86 and 88 of the Companies Law, to examine valuation issues.

Not so under Section 238 of the Companies Law, where the approval threshold, two-thirds majority of votes cast, is significantly lower and may be easily controlled by the buyout group itself.

The fact that the Court of Appeal chose to treat mergers, schemes of arrangement and squeeze-outs in a very similar manner with regard to valuation methodology could now open the door (even though this was not necessarily intended) to a dangerous blurring of categories which could lead to further shrinkage of the "fair value" standard under Section 238 of the Companies Law. For now, however, the existing legal principles governing determination of "fair value" for the dissenters' shares remain unchanged subject to the exception of a minority discount being applied in recognition of the reality that dissenters hold a minority interest. The Honourable John Martin QC, in handing down the judgment of the Cayman Islands Court of Appeal stated:

> "*The position in the Cayman Islands is accordingly that there are now three mechanisms contained in the Companies Law by which the shares of dissentients may be acquired: by squeeze-out with a 90% majority, by scheme of arrangement with a 75% majority, and under section 238 with a two-thirds majority. Assuming, as I do, that the English approach to squeeze-outs and scheme of arrangement acquisitions would be applied in the Cayman Islands, those two mechanisms allow a minority discount to be applied to the cost of acquisition of dissentients' shares. It seems to me unlikely in the extreme that the simplified merger and consolidation regime introduced as Part XVI of the Companies Law was intended to depart from that approach; it is to be presumed that the three mechanisms, contained in the same piece of legislation and capable of serving the same purpose in different ways, are to be construed from the same standpoint. Nothing in the wording of section 238 suggests that a different approach was intended; indeed, as Shanda pointed out, there is nothing in the wording of the section that suggests that the focus is to be on the value of the company rather than on the value of the shares. (…) For these reasons, it appears to me that section 238 requires fair value to be attributed to what the dissentient shareholder possesses. If what he possesses is a minority shareholding, it is to be valued as such, if he holds shares to which particular rights or liabilities attach, the shares are to be valued as subject to those rights or liabilities*." (Paragraphs 49-50 of the Court of Appeals decision ***in the matter of Shanda Games Limited).***

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[1] Based on figures included in the Global M&A Review 2017 report published by Bureau van Dijk – A Moody's Analytics Company.

[2] In a decision Homeinns Hotel Group v Maso Capital Investments Limited and others dated 7th February 2017, the Court examined the extent of discovery by the parties which is necessary for valuation purposes and supported the dissenters' position that the Court could order certain classes of documents to be provided by the Company. In the matter of Qihoo 360 Technology Co Ltd., on 24th July 2017, the Court confirmed that it does have the power to order the appointment of an independent expert in forensic information technology to conduct an audit to verify the Company's compliance with its discovery obligations.

[3] In an interim judgement issued on 26th January 2017 in the matter of Blackwell Partners LLC et al v. Qihoo 360 Technology Co Ltd., the Court decided that interim payments pursuant to the Grand Court Rules (G.C.R.) could be requested by dissenting shareholders and granted by the Court during the judicial proceedings initiated to determine the "fair value" of the dissenters' shares under Section 238 of the Cayman Merger Law. A decision issued on 8th August 2017 in the matter of Qunar Cayman Islands Ltd. provided further guidance on interim relief when the Court re-affirmed that requests for interim payment can be made by dissenting shareholders as part of the Section 238 proceedings, and that the Court has jurisdiction to grant such payments, in an amount determined to be "just". Finally, in the matter of Trina Solar Limited, in written judgments dated 18th July 2017 and 25th August 2017, the Court held that a consent order for an interim payment entered into between the Company and the minority shareholders dissenting from the merger was binding upon the Company when made.

[4] The Court of Appeals specifically acknowledges this in paragraph 45 of the decision: "although the English cases do not concern an appraisal mechanism, or deal with a statutory standard of fair value, they are concerned with fair value of the shares".

[5] Section 86 of the Cayman Islands Companies Law

[6] Section 88 of the Cayman Islands Companies Law