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Dissenting Shareholders, Fair Value Petitions and Statutory Appraisals: New Guidance from the Cayman Islands

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On 25 April 2017, the Honourable Justice Segal published his judgment in In the matter of Shanda Games Limited (FSD 14 of 2016, 25 April 2017) ("Shanda"). The judgment, which is over 100 pages long, comprises a careful and extremely detailed examination of issues arising in the course of litigation in the Cayman Islands ("Cayman") concerning the statutory shareholder appraisal rights regime set out in Section 238 of the Companies Law (2013 Revision) (the "Law"). It is a significant judgment for the jurisdiction, being only the second judgment regarding the operation of the appraisal regime. Together with the other recent judgments of the Grand Court of the Cayman Islands (the "Court") in this area, discussed in our article here, it provides practitioners and litigants with further guidance in this area.

To recap, Section 238 provides for shareholders, who dissent to a merger or consolidation involving a Cayman company, and who are not able to agree to the fair value of their shares with the company, to have the fair value determined by the Court. As is reflected in the Shanda judgment, applications under Section 238 (which are commenced by petition filed either by the company or a dissenting shareholder) can raise a variety of complex issues requiring detailed expert evidence on, and extensive argument about, the valuation of the shares in question. While many of the conclusions reached in the judgment are fact specific, the approach taken by Segal J in reaching those conclusions provides useful guidance to parties contemplating, involved in or objecting to a merger involving a Cayman company.

Dissenting Shareholder Applications in the Cayman Islands

Shanda was only the second contested fair value petition to reach trial. Until the release of the judgment in Shanda, the only case which had considered how the valuation process was required to be undertaken pursuant to Section 238 was that of the Honourable Justice Jones QC in In the Matter of Integra Group (unreported, 28 August 2015) ("Integra"). In that case, and in the absence of an express definition of "fair value" in the Law, Jones J relied on case law originating in Canada and Delaware to determine that the concept of fair value was the value to the shareholder of his proportionate share (without any minority discount or increase in value as a result of the power of compulsory acquisition) of the business as a going concern without taking into account any enhancement in value (or reduction in value) as a result of the merger.

The guidance of Jones J in Integra also extended to confirming that it was up to the Court, with the assistance of experts - not pursuant to any statutory test - to determine fair value. In reaching these conclusions, Jones J noted that all relevant evidence concerning the particular circumstances of the company must be made available and considered by the parties and the Court. Taking all of these matters into account, and having been asked to choose between various valuation methodologies presented to the Court, Jones J ultimately based his determination of "fair value" in Integra by putting a 25% value on the market value of the company (including a reference to market comparables) and a 75% value on the Discounted Cash Flow Approach ("DCF") which involves ascertaining value by converting the company's cash-flows to a single current capital value.

The facts of the Shanda case

In Shanda, a petition was presented by Shanda Games Limited ("Shanda"), a Chinese online gaming company, pursuant to Section 238 of the Law in connection with a merger (the "Merger") between Shanda and Capital corp Limited, a Cayman exempted company. The Merger was essentially a "take-private" deal led by the principal shareholders and management of Shanda, and was completed on 18 November 2015, whereupon Shanda became a wholly owned subsidiary of Capitalhold Limited. The respondents to the petition were three minority shareholders (collectively, the "Dissenting Shareholders") who together were the registered owners of close to 9 million ordinary Class A shares. Prior to the extraordinary general meeting, and pursuant to Section 238(2) of the Law, the Dissenting Shareholders had given notice of their objection to the Merger and received an offer from Shanda to purchase their shares for the price of US$3.55 per share. That offer was rejected by the Dissenting Shareholders and negotiations between them and Shanda to agree an alternative price (as required by Section 238(8) of the Law), ultimately failed. Shanda then proceeded to file the petition, and the matter came before the Court for a consideration of the fair value of the Dissenting Shareholders' shares.

Following the filing and service of the petition, the parties had agreed to a consent order ("the Consent Order") pursuant to which various directions were made as to the future conduct of the Section 238 proceedings. It provided, in quite some detail, for a process for the pre-trial discovery of documents and the establishment of a data room, the provision of undertakings as to confidentiality, the preparation of expert reports, and the conduct of the trial. The Court noted that the issuing of a summons for directions in matters such as these is not currently provided for in the Grand Court Rules, but has become standard practice in Section 238 applications and is a necessary procedural step. It is also consistent with the approach to discovery taken in Homeinns Hotel Group -v- Maso Capital Investments Limited & Ors (unreported, 7 February 2017).

Valuation Approach

Unlike in Integra, the Court was not asked to determine which valuation methodology was appropriate in the circumstances of the case, because the respective experts were agreed that the company should be valued using a 100% DCF methodology.

Although the experts were agreed as to the applicable valuation methodology, their respective DCF calculations produced very different valuations for the company. While Shanda's expert initially valued the equity of Shanda at US$2.6 billion, the Dissenting Shareholders' expert valued it at US$7.3 billion. During the course of the trial Shanda's expert increased his valuation, but nevertheless the Judge was left with a very significant gap between the experts in their respective valuations.

The Judge determined that the correct approach to the evidence in the court appraisal process, is that neither party bears the burden of proof and the Court reaches an independent assessment of value. Reflecting this effectively neutral position, the Court determined that it would be up to Shanda and the Dissenting Shareholders to each establish on the balance of probabilities that the valuation their particular expert had presented on the issue in question was reasonable and reliable. If only one valuation met these criteria, then this was the valuation to be followed and applied to the exclusion of the other. If neither appeared reasonable and reliable, then it would be up to the Court to make its own determination by conducting a fresh assessment of all factors relevant to value.

Application of Delaware Law

Importantly, the Court noted that, in the course of conducting the appraisal, it would be appropriate to have regard to the judgments in a number of leading cases in Delaware, which has a similar statutory appraisal regime. Acknowledging that there were nonetheless differences between "procedural law and litigation culture" between Cayman and Delaware, the Court determined that Section 238 had been drafted using the same core concepts and terms and the case law decided there and referenced throughout the judgment offered considerable assistance in the appraisal process. This was particularly so, having regard to the extent to which many of the economic principles relevant to valuation had been considered already by the courts in Delaware. There is very little, if any, legal principle involved in a fair value appraisal, which is primarily a factual expert driven process. The court has to decide between competing experts, and where disputes arise, these are disputes of valuation principle or economic theory rather than disputes of law or legal interpretation. This position is generally consistent with the approach taken in Integra, but offers much greater clarity for future litigants.

Minority Discount

One issue of principle which arose in Shanda was whether a minority discount should be applied when valuing the shares of the Dissenting Shareholders. It was the view of Shanda that in this case a minority discount should be applied, on the basis that the shares to be valued constituted a very small minority of the total shares in the company and such a discount would be applied in any market-based sale of the company's shares. This position reflected the approach under English law when dealing with unfair prejudice cases where a minority discount was typically applied. However, the Court distinguished the English authorities and in reliance on Delaware law, found in favour of the Dissenting Shareholders and determined that no minority discount should be applied, on the basis that it was the Dissenting Shareholders' proportionate interest in Shanda considered as a whole that was being valued. This is consistent with the remarks of Jones J in Integra, although in that case it was common ground that no minority discount should be applied.

The DCF Calculation

Given the significant difference in the respective expert's DCF calculations, it was necessary for the differences in approach between the experts to be extensively explored and tested during cross-examination.

In the judgment, the Judge identified eight points of disagreement between the experts which he had to determine in order to arrive at a fair value, but some were much more significant than others in determining the overall result. The judgment resulted in a valuation that fell between the figures put forward by each expert, but which was actually closer to the figure of Shanda's expert than to the Dissenting Shareholder's expert, albeit over twice the amount of the merger price.

By way of explanation, a DCF valuation has two components: a cash-flow and a discount rate. In Shanda both were the subject of dispute.

Cash-flow

Shanda had produced a detailed cash-flow projection for five years, which the Dissenting Shareholder's expert had subjected to detailed scrutiny and forensic analysis. He identified certain inconsistencies, questionable assumptions and internal errors in the spreadsheets. Shanda's expert, on the other hand, had determined that a detailed review of the origins of Shanda's cash-flow projections was unnecessary on the basis that a proper valuation in this context must start with and rely on management's projections. The Court determined that Shanda's projections were potentially erroneous and, as the company had not provided a suitable explanation for the potential errors, the approach of the Dissenting Shareholders' expert, which closely examined all of the data provided and was forensic in nature, was to be preferred in the circumstances of this case. Accordingly, the Judge based his DCF valuation on revised cash-flow forecasts taking into account various errors and corrections which had been agreed during the course of cross-examination and made other corrections (three of the eight issues) he determined were appropriate after having heard both experts give oral evidence.

Another issue relating to cash-flow was a technical question of whether the growth model to be used should or should not include a transitional stage to bridge the gap between the predicted growth in the final projected year and the terminal growth rate, and if so how long that should be. This is fact specific and will depend upon the particular circumstances of the company being valued.

Discount Rate

The argument between the parties as to the appropriate discount rate and the inputs to its calculation, pursuant to the DCF approach, was complex and involved disputed aspects of evolving economic theory.

The most significant of the inputs into the discount rate is beta. A relatively small change in beta can have a substantial effect on the outcome of a discounted cash-flow model. Beta is a measure of systemic risk and is a function of the expected relationship between the return on an individual security and the return on the broader market. Shanda's expert's approach to beta was to seek to directly measure beta by using monthly stock price movements over the two year period prior to the announcement of the merger. The

Dissenting Shareholders' expert suggested that for various reasons it was not possible in this case to obtain a reliable directly measured beta and so considered it more appropriate to use the beta of two comparable companies. That approach itself suffered from being based on only two comparable companies in quite a specialised high-tech sector. Determining that both approaches had some merit and both had some difficulties, the Judge decided to combine the experts' measurements and used the average of the two.

A further input into the discount rate concerned Shanda's "small stock risk premium", agreed by the experts as applicable to Shanda's costs of equity. The Court preferred Shanda's approach on this front, which was slightly higher than that proposed by the Dissenting Shareholders.

Calculation of the Dissenters' Proportion of the Company

Having arrived at a DCF valuation for the company as a whole, it is necessary to adjust that valuation in respect of any other amounts to be added in and then determine the Dissenting Shareholders' proportionate share.

One issue of dispute related to the treatment of the costs of the merger. The Court determined that the fees and costs incurred by Shanda in obtaining advice concerning the Merger and in implementing the Merger, prior to the Valuation Date, should be deducted from the equity value of Shanda. This was consistent with Shanda's argument that it was appropriate for the Dissenting Shareholders to meet their own costs and expenses associated with the merger.

In order to determine the Dissenting Shareholders' proportionate share of the company it was in this case necessary to consider the correct treatment of restricted stock and employee share options. The Judge held that if the employees or holders of restricted stock had rights to subscribe which were exercisable at the valuation date, but which were not conditional upon the Merger, then these shares had to be included in the share count for the purposes of calculating the Dissenting Shareholders' proportionate interest.

Conclusions

The most significant conclusion to be drawn from this lengthy and detailed judgment is that a company faced with a Section 238 application should not underestimate what is involved. The Court appraisal process is no superficial exercise. It involves an in depth forensic analysis of the company's financials, its projections and a detailed and thorough consideration of expert evidence. It is a very different exercise from the typical fair value opinion exercise which will ordinarily have been carried out by a financial adviser prior to the merger. It may very well, as it did in this case, lead to a valuation which is significantly higher than the fair value opinion, even if it may also be significantly less than the value being proposed by the Dissenting Shareholders.

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