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Mergers and Fair Value Petitions: Cayman Case Law Update

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The Cayman Islands has recently seen a flurry of merger activity, in many instances as a result of listed entities seeking to engage in 'go private' deals involving companies incorporated in the jurisdiction. The statutory merger and consolidation process set out in Part XVI of the *Companies Law (2016 Revision)* (the "Law") is an attractive and increasingly well-used option for effecting such deals. However, as a result of a spike in the number of shareholders willing to exercise their rights under the shareholder appraisal rights regime set out in Section 238 of the Law, such deals are also resulting in an increase in litigation before the Grand Court of the Cayman Islands (the "Court").

In two recently published judgments, the Court has painted a clearer picture of the rights and obligations of the parties seeking a "fair value" determination pursuant to Section 238 of the Law, and clarified the avenues of relief available to dissenting shareholders in the pre-trial stage of such litigation. The judicial guidance in these judgments gives some insight into how applications for interim payments and discovery will be dealt with by the Court, and may assist those considering a statutory merger or consolidation in the Cayman Islands to become better informed about the likely issues they may face in pursuing such deals.

Merger/Consolidation Process

Part XVI of the Law provides for statutory mergers and consolidations, whether between Cayman Islands companies or between a Cayman Islands company and a foreign company. Approval of a plan of merger or consolidation prepared by the company in accordance with Part XVI must be obtained via a special resolution, passed by a majority of at least two-thirds of such members as, being entitled to do so, vote in person or, where proxies are allowed, by proxy at a duly convened general meeting of the company.

Historically, the primary advantage of pursuing a statutory merger under Part XVI has been that it potentially requires a lower threshold of shareholder approval to effect a merger in comparison to a scheme of arrangement under Section 86 of the Law (which requires the approval of a majority in number representing 75% in value of the members). The consequence of this is there is significantly less risk that a proposed merger or consolidation may fail due to lack of shareholder approval in comparison to a scheme of arrangement. Further, unlike a scheme of arrangement but subject to the commencement of fair value proceedings discussed below, the court is not required to be involved in the merger process, thereby making it, in theory at least, less costly and more efficient.

However, as has been made clear by the cases coming before the Court over the past 18 months, these advantages are slowly being eroded and big-ticket litigation is steadily creeping its way into the merger and consolidation process via the statutory appraisal rights regime.

Appraisal Rights and Mergers/Consolidations

The statutory appraisal rights regime is found in Section 238 of the Law and empowers shareholders of companies involved in certain mergers or consolidations to dissent to the merger or consolidation. It is worth noting that the dissent of a shareholder does not actually prevent the merger from proceeding, but instead ensures the shareholder receives 'fair value' for their shares as part of the merger process. The section prescribes various formalities that must be followed if shareholders wish to dissent; in particular, it prescribes notice periods and timetables within which shareholders may dissent and seek to agree the fair value of their shares with the company. Importantly, once the shareholders have given notice of their dissent under Section 238, their interest in the company is effectively altered to that of unsecured creditors, and they cease to be members of the company (although dissenting shareholders do retain the right to challenge the merger or consolidation on the grounds it is void or unlawful).

In the event that shareholders and the company cannot agree to the fair value within the time period allotted by the Law, the company must file a petition with the Court for a determination of the fair value of the shares of the dissenting shareholders. In the course of the resulting litigation, the company will be required to give discovery and at trial the Court will hear evidence from each party's experts regarding their assessment of the fair value of the company's shares. The Court will carefully consider the methodology by which fair value of the shares is best determined in the circumstances of the particular case, and determine the respective weight that the Court should give to each expert's evidence in making its own fair value assessment. Having carefully considered these matters, the Court will then make orders as to the fair value of the shares.

Cayman Islands Case Law

Up until 2015, and despite Section 238 being well used in a variety of commercial transactions in the Cayman Islands, there had not been any local case authority regarding the determination of fair value under Section 238. However, this all changed with the decision of Jones J in *In The Matter Of Integra Group* (Unreported, 28 August 2015, Jones J) ("Integra"), which analyses the section and its operation in detail.

In *Integra*, a management buy-out was implemented by way of merger with the approval of around 80% of shareholders. However, a minority of shareholders exercised their appraisal rights pursuant to Section 238 of the Law and petitioned the Court to determine the fair value of their shareholding. In considering the matter, Jones J approved of the definition of the concept of 'fair value' in this particular case as 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.

Jones J noted it was up to the Court, with the assistance of experts - not pursuant to any statutory test - to determine fair value, and held that a dissenting shareholder will be entitled to receive its *pro rata* share of the value of the company as a going concern as assessed at the date of the Extraordinary General Meeting at which the merger is approved (which was considered the valuation date for these purposes). In reaching these conclusions, Jones J noted that all relevant evidence concerning the particular circumstances of the company must be considered. Having considered the particular facts before him and the various valuation methodologies presented to the Court, Jones J chose to base 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" which involves ascertaining value by converting the company's cash flows to a single current capital value. On this determination, the dissenting shareholders were entitled to a further premium of 17% above the merger consideration together with interest, found to be 4.95%.

Recent Decisions

The Court has recently released two further judgments concerning Section 238 proceedings which deal with how pre-trial issues of interim payments and discovery will be addressed by the Court and have added to the guidance of Jones J in *Integra*.

Qihoo Judgment – January 2017

In *Blackwell Partners LLC – Series A -v- Qihoo 360 Technology Co Ltd* (unreported, 26 January 2017), Quin J considered an application by three dissenting shareholders (who had exercised their appraisal rights in relation to a merger) for an interim payment pursuant to Order 29 of the Grand Court Rules ("GCR"). In responding to the dissenting shareholders' application, the company argued that an application for an interim payment was outside what was a "self-contained statutory code" in Section 238 as the dissenting shareholders were not owed a debt or entitled to damages as required by GCR Order 29. The company argued that the dissenting shareholders were only entitled to be paid fair value for their shares as assessed by the Court when the company's petition was heard, and the interim payment provisions of the GCR did not apply. Quin J disagreed with the company, finding that a fair value determination by the Court in Section 238 proceedings falls within the category of proceedings in respect of which an "interim payment" could be made pursuant to GCR Order 29 Rule 9. The Court noted that the company had already offered to pay the dissenting shareholders US$17 million for their shares, so they could anticipate obtaining judgment against the company for "a substantial sum of money" as required by Order 29. Quin J found in this particular case that they would receive at least the amount of the company's statutory fair value offer made under Section 238 following the final determination of the fair value assessment by the Court, being the US$17 million, and ordered an interim payment in this amount. The judgment confirms that the Court will be prepared to make orders for an interim payment in the context of Section 238 applications, particularly if the company has not already voluntarily made an interim payment in the amount of its statutory fair value offer.

Homeinns Judgment – August 2016

In *Homeinns Hotel Group -v- Maso Capital Investments Limited & Ors* (a judgment concerning another merger case that was delivered to the parties on 12 August 2016, but not released for publication until 7 February 2017) the company petitioned for a determination by the Court of the fair value of the dissenting shareholders' shares. At an interlocutory stage, the "fundamental source of dispute" between the company and the dissenting shareholders was the process of discovery, pursuant to which the dissenting shareholders sought access to all documents relevant to the fair value assessment. Asked to issue directions on this issue pending trial of the Section 238 application, Mangatel J found that, in assessing fair value for the purposes of Section 238, the experts (on both sides) and the Court are to have regard to all relevant documents and information that the company has readily at hand, not just publicly available information. This included the provision of any additional documents or information that the experts involved in the matter considered necessary to conduct the assessment – all of which were also to be made available to the dissenting shareholders. Furthermore, the Court rejected the traditional 'list of documents' approach (where there is a mutual exchange of documents in the parties' possession, custody or power) and accepted the dissenting shareholders' submissions that it was more appropriate in such a case for production of specific categories of documents to be ordered at the directions stage, rather than being left to a subsequent specific discovery application. The judgment makes it clear that valuation experts on both sides are to have access to all material necessary for the preparation of their expert reports.

Together, the judgments in *Integra, Qihoo* and *Homeinns* comprise a helpful suite of general principles regarding the operation of Section 238 and related procedural issues that may arise in such litigation. Further judgments are likely in the coming months, and these will add to the guidance already given by the court – both as to the resolution of pre-trial issues and the conduct of Section 238 fair value determinations generally. It is clear that, in each case, the Court will carefully consider the terms of the particular merger deal, the conduct of the parties and the findings of their experts, and assess what outcome will ensure a fair result for the dissenting shareholders. However, there is no "one size fits all" approach to the assessment of fair value under the Law in the Cayman Islands, and each case will turn on its own facts. It is an area of law that is continuing to evolve, and certainly one to monitor closely.

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