Article

Shanda Games in the Privy Council: the beginning of the end of share appraisal litigation involving Cayman Islands companies, or just the end of the beginning?

Authors: Alex Potts QC, Partner | **Erik Bodden,** Partner

In *Shanda Games Ltd v. Maso Capital Investments Ltd* [2020] UKPC 2 (27 January 2020) the Judicial Committee of the Privy Council has considered one important aspect of s.238 of the Cayman Islands' Companies Law, relating to minority shareholder appraisal rights in the context of a corporate merger or consolidation involving a Cayman Islands company. While the case focuses on the law of the Cayman Islands, its wider discussion of fair value should be of broader interest to practitioners in the UK and beyond.

In summary, the Privy Council has concluded that in a corporate merger, a dissenting minority shareholder's shares should ordinarily be valued by the Cayman Islands Court as a minority shareholding, with the application of a "minority discount", subject to the facts of any particular case. This is the first time that the meaning and effect of s.238 of the Companies Law has been considered by the Privy Council at a final appellate level since its enactment in 2009.

It is unlikely to be the last time, since a number of other controversial, and high-value, s.238 shareholder appraisal cases still remain pending before the Grand Court and the Court of Appeal of the Cayman Islands, giving rise to significant potential for further appeals to be brought before the Privy Council (despite the fact that an appraisal action is particularly fact sensitive, and quintessentially a matter for resolution by a trial judge at first instance, with the benefit of expert valuation evidence).

The Privy Council's judgment in *Shanda Games Ltd* is particularly important for its general appellate guidance to the Cayman Islands courts (and to lawyers and expert witnesses dealing with valuation issues) as to the manner in which the Cayman legislation should be interpreted and applied, having regard to reported case law on similar, or related, statutory provisions from Delaware, Canada, England and Wales, Bermuda and the British Virgin Islands.

The judgment is almost as important, however, for what it has not yet decided, as much as what it has decided.

Summary of sections 238 and 239 of the Cayman Islands' Companies Law

Under s.238 of the Cayman Islands' Companies Law, where there has been a merger or consolidation involving at least one Cayman company pursuant to Pt XVI of the Companies Law, a dissenting shareholder is entitled to payment of the "fair value" of his shares.

If the dissenter and the company cannot agree on the "fair value", the company shall, or the dissenter may, present a petition to the Grand Court of the Cayman Islands for its determination of the fair value of his shares and a fair rate of interest, if any, to be paid by the company.

- The entitlement of the member to fair value is set out in subs.(1) of s.238. The right is limited to members.
- The dissenter must give notice that he objects to the merger and intends to demand payment for his shares before the resolution to approve the merger takes place (subss.(2), (3)).
- The company must give him notice that the merger has been approved within 20 days of the approval (subs.(4)).

- The dissenter then has 20 days to give notice of his decision to dissent, which he must do in respect of all his shares in the company (subs.(5), (6)).
- On giving that notice, he loses his status as a member save that he may pursue his claim to payment of fair value and bring a claim to have the merger declared void or unlawful (subss.(7), (12) and (16)).
- The company (or the surviving or consolidated company) must make an offer of what it considers to be the fair value of the shares within a further seven days following the expiration of the 20-day period for dissenting (subs.(8)).
- If that offer is not agreed, a petition must be presented within a further 20 days to the court for determination of the fair value (subs.(9)). The court must determine the fair value together with a fair rate of interest, if any, on that amount (subs.(11)). The shares of the dissenters are cancelled on acquisition by the offeror (subs.(15)).
- Section 239 contains an important exclusion for listed shares ("a market exception") but that exclusion is subject to an exception where, for example, the dissenter is required to accept a cash element.

What is meant by "fair value" in section 238, and does it require the application of a "minority discount"?

At first instance, Segal J of the Grand Court of the Cayman Islands held that, as the statutory appraisal right in s.238 had been modelled substantially on Delaware law, the Cayman Islands courts should adopt the Delaware courts' approach to valuation, which generally required the court to assess the full value of the dissenter shares as if there had been a sale or other realisation of all of the company's assets. In other words, the Grand Court followed the Delaware court's approach in giving "full value", without any "minority discount". Segal J found that the shares were worth $8.34 each, representing an uplift of 235% on the merger price. The judge awarded interest at the rate of 4.295%, being the mid-point between the rate at which the company could have borrowed the amount payable, and the rate at which the dissenting shareholders could have invested the amount payable. This resulted in an order for payment to the dissenting shareholders of US$73,575,995 plus interest of US$2,788,801.

The Cayman Islands Court of Appeal took a different approach to the "minority discount" issue, concluding that a "minority discount" should be applied on a principled basis in all s.238 cases, taking into account other analogous provisions under the Cayman Islands' Companies Law and in English law (and having regard also to Bermuda and British Virgin Islands' law). The Court of Appeal upheld the judge's award of interest, rejecting an argument advanced by the company's representatives for the first time on appeal, to the effect that any award of interest should be limited to the rate awarded on a judgment for payment of a debt or damages in ordinary civil litigation.

This difference in approach between Segal J and the Cayman Islands Court of Appeal gave rise to the particular, narrow issues before the Privy Council in the *Shanda Games Ltd* appeal. The parties and their expert valuation witnesses had already agreed that, on the facts of the case, the appropriate valuation date was the date of the extraordinary general meeting of the company's shareholders on 18 November 2015 (which approved the merger between Shanda Games Ltd and Capitalcorp Ltd, to which Maso Capital Investments Ltd and other parties had given notice of objection under s.238(2) on 17 November 2015); "fair value" was to be determined by reference to a discounted cash-flow methodology; and the burden of proof was to be approached on a neutral basis, with the evidential burden resting on each party that sought to advance or rely upon a particular factual contention, on the balance of probabilities.

The Privy Council's decision

Lady Arden gave the opinion of the Board on the two questions raised by the appeal:

- first, the question whether "fair value" should be taken to mean that there should be a "minority discount" to reflect the fact that the dissenters do not have control of the company, or whether it means a pro rata share of the full value of the company, as it has in a number of authorities been held to mean in Delaware law;
- secondly, the question whether an appellate court should interfere with a discretionary assessment of interest by the judge at first instance.

The Privy Council concluded that, in the circumstances of this case, and subject to the possibility of the circumstances of another case providing exceptional justification for an alternative approach (as the Privy Council stressed at [55] of its judgment, "the Board is not in a position to rule out the possibility that there might be a case where a minority discount was inappropriate due to the particular valuation exercise under consideration"), a "minority discount" should be applied.

It did so for the following reasons:

1. Comparable provisions of the Cayman Islands' Companies Law relating to the court's power to review the valuation of shares in a publicly-held company that are to be subjected to an involuntary disposition, for example those relating to schemes of

arrangement and "squeeze-outs" (under s.86 of the Companies Law: the UK's equivalent statutory provisions are ss.895-899 of the UK's Companies Act 2006), do not provide for pro rata valuation (the Privy Council was not persuaded that the valuation approach to be taken in unfair prejudice petitions involving quasi-partnerships was of much assistance).

2. The general "judge-made" principle of valuation of shares on sale[1] is that what has to be valued is what the shareholder actually has to sell (and not some other hypothetical share: the Privy Council explained, at [42], that this is because in a merger, the offeror does not acquire control from any individual minority shareholder. Accordingly, in the absence of some indication to the contrary, or special circumstances, the minority shareholder's shares should be valued as a minority shareholding and not on a pro rata basis).

3. The similarities between the Delaware appraisal remedy and s.238 do not justify departure from the general principle (absent a clear legislative intention to displace the general principle).

On the facts of the case, the expert valuation witnesses had agreed that the actual value of the shares fixed by the judge had to be reduced by about 23%, with the application of a "minority discount". Because of that agreement between the parties, the Privy Council did not, itself, have to consider any further question as to what constituted fair value on the facts of this case.

The Privy Council, notably, declined to re-visit or determine the substance of the arguments and authorities on the appropriate rate of interest, concluding that, on the facts of this particular case, the judge's discretionary decision on interest at first instance could not properly be re-visited by the Privy Council on appeal (particularly in circumstances where the appellate argument relied on an argument which had not been advanced before the judge).

Comment and analysis

Since 2015, there have been over 20 corporate mergers or consolidations involving Cayman Islands companies that have resulted in the commencement of minority shareholder appraisal litigation under s.238 of the Cayman Islands' Companies Law.

The list of mergers or consolidations that have encountered shareholder litigation in the Cayman Islands Courts includes Integra, Charm Communications Inc, Qihoo 360 Technology, Qunar Cayman Islands Ltd, E-Commerce China, E-House (China) Holdings Ltd, Bona Film Group, Homeinns Hotel Group, JA Solar Holdings, Trina Solar, Zhaopin Ltd, eHi Car, Mindray, Re KongZhong Corp, Nord Anglia Education Inc, Fountain Medical Development, Xiaodu, and Shanda Games Ltd.

In many such cases, the dissenting shareholders have been sophisticated hedge funds or private equity funds, deliberately purchasing shares in merging companies with a view to exercising dissenter appraisal rights, and thereby engaging in an "appraisal arbitrage" or litigation investment strategy of the sort that has also been successful in Delaware in recent years[2].

Four of these cases (including Shanda Games Ltd) have now resulted in substantial final judgments after trial (and two of which may yet be the subject of further appeals to the Privy Council), and a number of these cases still remain pending, having resulted in significant interlocutory rulings and intermediate appeals on a wide range of procedural, evidential, and costs issues (on which the primary legislation is effectively silent). The Grand Court of the Cayman Islands has also issued a specific Practice Direction (Practice Direction No.1 of 2019) dealing with s.238 litigation, in an effort to promote a standardised approach to the more routine issues that arise in the conduct of such litigation.

It remains to be seen whether the Privy Council's preference for a "minority discount" as a matter of principle will deter the pursuit of "appraisal arbitrage" claims: logically, it should have a deterrent effect, but, in practice, there are many merger cases (including "take-private" schemes effected by way of merger, as in Shanda Games) in which the expert valuation witnesses have not attributed any significant minority discount to the mere fact of minority ownership or lack of control.

The more valuable commercial issue, in many such pending (and future) cases, is whether the court should adopt a discounted cash-flow valuation methodology, a valuation based on the "transaction price" (the merger consideration) or the "market price" on the relevant stock exchange prior to the merger, or a "blended approach", using any combination of the three.

The fact that the Privy Council has not reduced the trial judge's award of interest at the rate of 4.295% means that there may still be some commercial incentive for investors to invest in this particular asset class, given interest rates prevailing elsewhere.

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[1] Following English common law: the general principle is said to have been established by the decision in *Short v.Treasury Commissioners* [1948] 1 K.B. 116, affirmed by the House of Lords, [1948] A.C. 534. In *Short*, the Crown had exercised its right to acquire the whole of the share capital of a company and was under the relevant legislation required to pay to each outgoing shareholder as compensation a price which was not less than the value of his shares as between a willing purchaser and a willing seller. The Court of Appeal of England and Wales held that, even though the Crown was acquiring the whole of the share capital, individual shareholders were not entitled to a pro rata share of the control premium because they were only selling their own (minority) shareholding. The House of Lords affirmed this decision.

[2] "Appraisal arbitrage" litigation was particularly common in Delaware between 2007 and 2017, but it has become less common since 2017 due to certain legislative amendments and three decisions by the Delaware Supreme Court: *DFC Global Corp v. Muirfield Value Partners LP*, 172 A. 3d 346, *Dell Inc v. Magnetar Global Event Driven Master Fund Ltd*, 177 A. 3d 1, 5, and *Verition Partners Master Fund Ltd v. Aruba Networks Inc* (Aruba II), 210 A., 3d 128.

The discretionary interest rate that may be awarded by the judge is unlikely to provide much commercial incentive, in practice, given the increasing frequency in which early interim payment is made of a substantial proportion of the sum that is likely to be payable to dissenting shareholders in due course, and given the ability of the paying company to make "Calderbank" or "without prejudice save as to costs" offers, to protect its position.

Ironically, despite the Privy Council's preference for a "minority discount" in most cases, it is likely that more corporate restructurings will now be implemented by way of schemes of arrangement, rather than through the provisions of s.238, in the absence of legislative reform being implemented so as to limit the uncertainties, costs and delays associated with the resolution of dissenter claims under s.238.

In any event, the Privy Council appears to be looking forward to the opportunity to revisit the meaning and effect of s.238 in due course. In an extra-judicial speech given on 3 February 2020 to The 9th Annual PRIME Finance Conference, entitled "The Judicial Committee of the Privy Council as an important source of financial services jurisprudence", Lady Arden asked a number of rhetorical questions about the meaning of "fair value", suggesting that she, at least, found the various legal, procedural, evidential, economic, and public policy issues that are engaged by s.238 to be of considerable interest and commercial importance.

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Authors:

Alex Potts QC
Partner and Head of Litigation
alex.potts@conyers.com
+1 345 814 7394

Erik Bodden
Partner
erik.bodden@conyers.com
+1 345 814 7754