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No more games: An analysis of In the Matter of Shanda Games Limited

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Introduction

In the Matter of Shanda Games Limited, unreported, 25 April 2017 and 16 May 2017 (Segal J.), is the second time that the Grand Court of the Cayman Islands has determined the 'fair value' of a Cayman Islands company's shares in the context of a merger under Part XVI of the Cayman Islands Companies Law (Revised) (the "**Law**") (the "**Dissent Regime**") and the first time that it has done so in relation to a company with operations in the People's Republic of China ("**PRC**").

Following a five day hearing involving rigorous cross-examination of the parties' valuation experts, the Cayman Court concluded that the fair value of shares in Shanda Games Limited (the "**Company**") was more than double the final merger consideration (US$8.34 per share, up from US$3.55 per share) and that the fair rate of interest to be paid by the Company on the judgment amount was 4.295% per annum from 4 January 2017, being the date that the petition was filed with the Court for the determination of fair value.

In a decision that is being appealed by the Company and Dissenting Shareholders ("**Dissenting Shareholders**") to the Cayman Islands Court of Appeal[1], the Grand Court elaborated and provided further guidance on the various principles for determining fair value which were discussed in *In the Matter of Integra Group, unreported, 28 August 2015* (Jones J.), the first time that the Cayman Court determined a company's fair value under the Dissent Regime. In this article, we discuss a number of issues arising from this latest decision, handed down over two separate judgments on 25 April and 16 May 2017, which will be of particular interest to Cayman companies with operations in the PRC and to practitioners advising them. A more in-depth discussion on the other recent legal developments, can be found here and here in the Ogier series: Appraisal Actions in the Cayman Islands.

Facts in Shanda

The Company was incorporated on 12 June 2008 as an exempted limited company under the laws of

the Cayman Islands. It is an online game developer, operator and publisher and one of the PRC's largest video game companies.

On 25 November 2009, the Company completed an IPO of its American Depository Shares ("**ADS**") on the NASDAQ at an offering price of US$12.50 per ADS and remained publicly listed until it was taken private by way of a merger effected between the Company and Capitalcorp Limited **("Capitalcorp")**, with the Company as the surviving company, whereby Capitalcorp merged with and into the Company on 18 November 2015 (the "**Effective Date**" / "**Merger**") at a price of US$3.55 per share (US$7.10 per ADS) (the "**Final Merger Consideration**").

The Dissenting Shareholders who desired to be paid 'fair value' of their shares under section 238(1) of the Law converted their ADSs to registered shares in the Company after which they proceeded to trigger the Dissent Regime in accordance with section 238(2) by giving the Company a written notice of objection to the Merger. Unable to reach an agreement on the fair price to be paid, the Company presented the petition ("**Petition**") pursuant to section 238(9) of the Law seeking the Grand Court's determination of the fair value of the Dissenting Shareholders' 8,822,062 Class A Ordinary Shares together with a fair rate of interest, if any, to be paid by the Company upon the amount determined to be the fair value.

After determining the manner by which the Company's shares were to be valued, Segal J. held that the as at the Effective Date the Company's fair value was US$8.34 per share (US$16.68 per ADS).

The Company's Disclosure Obligations

At the same time as the Petition was issued, and as has become standard practice in appraisal actions in the Cayman Islands, the Company issued a summons seeking an order for the case management of the proceedings, including as to how evidence was to be adduced. In this case, the parties agreed directions, in the form of two consent orders ("**Directions Orders**"), designed to ensure that all the documents and information held by the Company and relevant to the fair value determination were disclosed. The Directions Orders also provided that all additional documents or information needed and requested by the parties' experts would be made available to them.

In this case, the Company was found to have been in breach of at least part of the Directions Order. Unlike in another dissent case brought under s.238 of the Law (In *In the Matter of Bona Film Group Limited*, Unreported, 13 March 2017 (McMillan J)[2]); however, the Court declined to sanction the Company's breach by debarring it from adducing evidence of fair value. Instead, the Court made it clear that the failure by a company to ensure that the parties' experts have sufficient documents and information to enable then to prepare their reports on a satisfactory basis would result in sanctions on costs against the defaulting company and possibly the appointment by the Court of its own expert with powers to take possession of the relevant documents and computers and exercise the Company's rights against third parties who have relevant documents.

The Court was also prepared to accept the Dissenting Shareholders' submissions that it could and should draw all available inferences against the Company on factual issues where (a) the Company could or reasonably ought to have been able to answer any question or respond to any factual point but failed to do so and (b) where the Company could reasonably have been expected to have had documents which would have shed light on an issue, then the court should infer that the Company's response and /or documents would not have assisted the Company's case.

The Court's Approach To Determining Fair Value

Significance of Delaware and Canadian Jurisprudence to the Dissent Regime

In *Shanda*, the Court noted that section 238 of the Law was drafted using the same core concepts and terms (as well as similar procedural mechanisms) as appear in the law of Delaware and (Canada). Accordingly, it considered that, in appraisal actions, it is appropriate to have regard to the decisions of the courts of Delaware (and Canada) *provided* that the law and practice in those courts fits and is consistent with the law and practice of the Cayman Islands.

This approach is consistent with the position Jones J. took in *Integra* save that whilst he sought guidance from both Delaware and Canadian jurisprudence, in *Shanda* the Court only referred to the Delaware cases noting that it is preferable, where possible, to ensure consistency of approach by focusing on one rather than a multiplicity of jurisdictions.

Fair Value Determination

Integra was the first time that the Grand Court considered the meaning of and approach to appraising 'fair value'. In his judgment, Jones J. made clear, *inter alia*, that 'fair value' for the purposes of section 238(1) of the Law:

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Similarly, as discussed further below, in *Shanda*, Segal J. held that when the Court determines a company's fair value in appraisal actions, it is the minority dissenting shareholders' shares in the corporation as a whole that is being valued.

Valuation Methodologies In Shanda

Valuing a company is a fact-sensitive exercise and the appropriate valuation approach will vary from case to case. The Delaware courts have relied on a variety of techniques to determine the fair value of a company's shares including the final merger consideration as evidence of fair value[3].

In *Integra*, Jones J. identified three possible valuation approaches (without giving regard to the final merger consideration as evidence of fair value),[4] namely:

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In *Shanda*, however, Segal J. took a firmer approach in relation to the merger price concluding that it is for the court to conduct a fresh assessment of all factors relevant to value rather than to start from the position of the final merger consideration as being the best evidence of fair value. Although this approach is broadly consistent with the Delaware jurisprudence's recent shift away from the final merger consideration being evidence of fair value , in *In Re: Appraisal of Dell, Inc* (Del, May 11, 2016), currently under appeal to the Delaware Supreme Court, the Delaware Court has maintained the proposition that the final merger consideration can be the best evidence of fair value provided that the transaction has resulted from a competitive process and fair auction involving a rigorous sales process involving the wide dissemination of confidential information to a large group of prospective buyers.

In *In re Appraisal of DFC Global Corp.*, C.A. No. 10107-CB (Del. Ch., July 8, 2016), also on appeal, the issue in the appeal is whether in appraisal actions, the Delaware Court should defer to the final merger consideration that was reached as a result of an arm's length auction process. Given that the Court in *Shanda* placed heavy weight on both *Dell and DFC Global* to determine how valuation issues in appraisal actions can be disposed of, it is likely that the Delaware Supreme Court's decisions in both cases will influence how the Court determines future section 238 proceedings in the Cayman Islands.

Ultimately, the burden of establishing the reliability and persuasiveness of a particular methodology in any given case will be for the party seeking to rely on it.

In this case, there were two principal issues before the Court concerning valuation methodology:

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The Minority Discount Point

A central issue when determining the fair value of a company's business as a going concern is whether the court should (a) value the dissenting shareholders' shares or (b) value the company as a whole with the pro-rata share of the value awarded to the dissenting shareholders. In *Integra*, Jones J had regard to the principles established by Delaware and Canadian law and agreed with the proposition that when determining fair value, it is not appropriate or permissible to apply a minority discount.[5]

In *Shanda*, the Company nevertheless sought to argue that a minority discount should apply to the Dissenting Shareholders' interest in the Company on the basis that the Cayman Court should first and foremost have regard to a line of English judicial authorities dealing with unfair prejudice under the English Companies Act. Under that Act, the English courts have ordered members, against whom a finding of unfair prejudice has been made, to buy the petitioner's shares but to be valued with a minority interest.

Disagreeing with the Company, the Court distinguished appraisal cases from unfair prejudice cases on the basis that the statutory language in the English Companies Act was different from the language used in section 238 of the Law and because the Dissent Regime imposes a fairness requirement. Accordingly, Segal J. determined that a minority discount would not apply to the Dissenting Shareholders' shares; and affirming the approach in *Integra* , the approach to be taken by the Courts is to value a dissenting shareholders' minority interest in a company as a whole rather than their block of shares.

The DCF Methodology

In *Integra*, the appropriateness of the valuation approach was the subject of argument between the parties. The Court favoured a 75% / 25% weighting to the DCF method / the Market Approach respectively.   However, in *Shanda* the experts agreed that the DCF methodology was the only valid applicable methodology to value the Company the differences.

The DCF methodology involves three basic components: (1) the cash flow projections; (2) a discount rate and (3) the terminal value. In this case, the experts disagreed on each of these components – the projections to use for future cash flows, the discount rate and the terminal value. The Company's expert concluded that the Company's fair value as at the Effective Date was US$9.56 per ADS (being US$2.46 per ADS more than the Final Merger Consideration) whilst the Dissenter's expert valued the company at US$27.03 per ADS (being 19.93 per ADS more than the Final Merger Consideration).

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The Company's expert used the Company's projections in his DCF model whilst the Dissenting Shareholders' expert, having identified numerous inconsistencies and errors in the Company's management projections, replaced them with his own.The Court determined that the Company's management had been given the opportunity but had failed to clarify or provide a suitable explanation to resolve the apparent errors and inconsistencies and to demonstrate that their model and projections were reasonable.Accordingly, the Court inferred and concluded that there were errors and that the management forecasts were unreliable.

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One of the underlying components for calculating the discount rate is the cost of equity; defined as the rate of return required by a company's common stockholders. Cost of equity models have three components in common: risk-free rate, beta and equity risk premium.

In *Shanda*, the significant issue in dispute between the parties' experts was in relation to the appropriate beta to be used for valuing the Company.Beta is a measure of volatility: the covariance of the return on an individual stock against the return on the market; small variances in beta will have the largest effect on the outcome of the DCF valuation.

The Company's expert sought to apply a directly measured beta (the Company's own beta) on the basis that doing so is the customary practice and the preferred approach when dealing with publically traded stocks in efficient trading markets.He adopted a beta of 1.78.The Dissenting Shareholders' expert, however, estimated the Company's beta by reference to the betas of two peer companies and adopted a beta of 1.00, concluding that it was impossible to use the Company's measured beta for two principal reasons:

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<u>The Staleness Point</u>

The Dissenting Shareholders' expert opined, and the Court agreed, that the pre-deal announcement data used by the Company's expert raised a serious doubt as to its reliability.However, the Court also agreed with the Company's expert that the Company's beta was unlikely to have changed in the two year period between the announcement date and the Effective Date.

<u>The China Effect</u>

Perhaps of more interest is the so called 'China Effect'.The Court was referred to various studies demonstrating that events of 2010 and 2011 affected market appraisals of Chinese companies in the US when “*a good number of Chinese companies were discovered engaging in fraudulent accounting practices. These practices affected the US market views of Chinese companies in general regardless of whether a particular company was fraudulent or not*".

The Court was alive to the fact that the research on which the studies were based represented, to some degree, works in progress; limited data sampling and that none of the papers had been published in peer-reviewed publications.Nevertheless, it noted that the papers appear to show a clear consensus among experts in the field and that there was a significant adverse impact on the value of the all Chinese companies listed in the US and that many shares were undervalued.

Although the papers had not been published the Court determined that there was sufficient evidence of the problem identified by the Dissenting Shareholders’ expert "*to raise material concerns that the data derived during the relevant period has been subject to exceptional and distorting effects such that it might be unreliable and result in an error in the beta estimate*"[6].

Ultimately, the Court considered that both experts’ methodologies were consistent with accepted practice but that there were risks of error associated with both approaches.Accordingly, it concluded that in such circumstances, the correct approach was for the Court to use and rely on both estimates and adopted the average of the experts' betas: 1.39.In taking this approach, the Court noted that the Delaware courts[7] had used the average of the experts’ estimates of beta as well as a blend of direct and indirectly measured betas.

The Court's approach to competing valuation opinions

Given the different approaches taken by the experts in their respective valuations, the Court made clear that the proper approach to the resolution of disputes between the experts is for each of them to establish, on a balance of probabilities, that their valuations are reasonable and reliable and that (a) if only one is reasonable and reliable, the Court should follow and apply that approach; (b) if both appear reasonable and reliable, the Court must decide which is to be preferred; and (c) if neither is reasonable and reliable, the Court must make its own determination of fair value.

Availability of a Chinese Listing

In *Shanda* the Dissenting Shareholder’s expert referred to the upside of, and value to be derived from, a Chinese listing as a way of checking that his own valuation was not unrealistic but made clear that the reference to a Chinese listing and the valuations based on Chinese trading multiples did not form part his valuation. Accordingly, the Court concluded that the question of whether it would be permissible to rely on the availability of a Chinese listing for the purpose of a section 238 fair value did no arise in in the proceedings[8].

Given the prevalance of Cayman Islands companies with operations in the PRC whose intention is or has been to 'go-private' and to later relist in China's A-Share IPO market, this particular feature of the merger is likely to be the subject for the Court's determination in the near future.

The Fair Rate of Interest

The Court also determined that the fair rate of interest to be paid by the Company on the judgment sum of US$73,575,995 is 4.295% per annum, payable from 4 January 2016, being the date that Shanda made a written offer to each of the Dissenting Shareholders as required by section 238 (8) of the Law.

Referring to Jones J.'s conclusion in *Integra* that the fair rate of interest was the mid-rate between a company's assumed return on cash and the rate at which it could borrow (the "**Mid-point Approach**"), Segal J. noted that in that case, the Court was not offered any evidence by the dissenting shareholders in relation to the rate of interest they could have earned on the sums payable to them or what an objectively ascertained investor could have earned on such sums as a prudent investor.

Applying the approach outlined by the Delaware Court in *Cede & Co., Inc. v. Medpoint Healthcare, Inc.* (revised opinion dated 10 September 2004), the Court noted that the statutory language in appraisal actions is designed to protect the dissenting shareholder from the effects of a forced merger and to compensate them for being out of their money for the relevant period.

Accordingly, like *Integra*, the Court was of the view that the Mid-point Approach is consistent with the statutory mandate to establish a fair rate of interest, an exercise which it considered is comparable when awarding interest in a judgment on a debt or damages claim under the Judicature Law (2013 Revision). In that respect, Segal J. commented that the Court may have regard to the prescribed rate (that is the statutory rate of interest payable on judgment debts which is 2.375% as a reference point but not one on which much weight is to be placed).

The Court noted that when determining the fair rate of interest to be paid, it relies on the parties' assistance to provide it with reliable evidence in the form of a financial expert's opinion. In this case, there was no expert opinion making it impossible for the Court to form a view as to which indices a prudent investor would use, in what combination and with what weighing.

The Court concluded that as regards:

Accordingly, the Court determined that the fair rate of interest to be paid by the Company is the mid-point between 3.5% and 5.09%, i.e. 4.295%[9].

Conclusions

In any given case, there is a need for the Court to consider all evidence that may be helpful in its determination of company's fair value and the recent decisions discussed above serve as a reminder that a company's failure to engage with the proceedings and comply with its disclosure obligations may give rise to adverse inferences being drawn against the company in the proceedings and in more serious cases may debar the company from adducing evidence on fair value all together.

The key point in *Shanda* is that the Court has shown that the reliability of the parties' and their experts' evidence is central to the Court's process for determining fair value in appraisal actions. It is now settled law that the parties' experts are the 'best judge' of what information is relevant and are therefore given a wide latitude of discretion when assessing the relevance of a company's books and records for the purpose determining a company's fair value. Consequently, valuation experts can expect to be subjected to rigorous examination of their valuations and companies which are undergoing or are considering a going private transaction would be well advised to ensure that their evidence will stand up to such scrutiny.

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[1] The appeal is expected to be heard on 4 September 2017.

[2] In *In the Matter of Bona Film Group Limited*, Unreported, 13 March 2017 (McMillan J), the petitioning company was debarred from adducing evidence on fair value on the basis that "*there appear[ed] to be serious defaults in [Bona Film's] documentary discovery process and ultimately a failure to put forward any expert evidence*" (Bona at p. 4 para. 12).

[3] Merion Capital L.P and Merion Capital II LP –v- BMC Software, Inc. C.A No. 8900-VGC.

[4] *Integra*, paras. 29 - 32 at pp. 13-15.

[5] *Integra* at p.11

[6] Shanda at p.82 para. 150(f)

[7] *In re Appraisal of Dell, Inc.* (Del. Ch. May 2016) at 45.

[8] Notably, in Dell Inc., the Delaware Court held that the value arising from the accomplishment or expectation of the merger must be excluded from its determination of a company's fair value.

[9] It was argued by the Company that the Court could only award simple and not compound interest. That point was not in dispute and was accepted by the Dissenting Shareholders.

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