

Short-form mergers – appraisal rights confirmed in the Cayman Islands in Changyou judgment

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The Cayman Islands Grand Court (**Court**) has confirmed that shareholders of companies that effect a "short-form" merger pursuant to section 233(7) of Part XVI of the Companies Act (2021 Revision) (**Act**) are entitled to be paid the fair value of their shares on dissenting from the merger under section 238 of the Act.

The eagerly awaited judgment in *Changyou.com* [1] (please contact us for a copy) clarifies an issue, which had previously been the subject of extensive debate and provides welcome certainty to minority shareholders of Cayman Islands companies.

Long-form and short-form mergers under the Act

A typical "long-form merger" must ordinarily be approved by a special majority of its members. [2] A member who wishes to dissent from a long-form merger must object to it in writing before the shareholder vote. [3] If the merger is subsequently approved, the company must then give a notice of authorisation to each member who provided a written objection. [4] Any member who objected to the merger may then elect to give a notice of dissent. [5] Upon dissenting from the merger, the member ceases to have rights as a shareholder but becomes entitled to payment of the fair value of its shares, which is required to be determined by the Court under section 238 of the Act. [6]

However, in a "short-form merger", where a parent merges with a subsidiary in which the parent already holds 90% of the voting power, a special resolution of its members is not required. [7] In the absence of there being a shareholder vote, it had previously been unclear if the consequential statutory process described above (in respect of long-form mergers) could apply – and consequently, if shareholder appraisal rights were available to members in short-form mergers.

Background to Petition

Changyou.com Limited (**Changyou**) is a Cayman Islands incorporated company, and a developer and operator of online and mobile games. It operates in China and was formerly listed on the NASDAQ stock exchange. Prior to the merger, over 90% of Changyou's voting power was held by its parent company. In merger documents and filings with the US Securities and Exchange Commission Changyou proposed to merge with its parent and de-list from the NASDAQ (thereby effectively forcing out the minority independent shareholders under a short-form merger). Changyou asserted that dissent rights under section 238 did not apply in these circumstances. Certain shareholders (**Petitioners**) disagreed with Changyou's interpretation of the relevant provisions of the Act and purported to formally dissent from the merger in accordance with the terms of the Act.

Changyou contended that appraisal rights can only be exercised by shareholders who dissent from a merger in which there is a shareholder vote (a long-form merger). It argued that as no vote is required for a short-form merger, no appraisal rights were available.

Accordingly, the Court was asked to adjudicate whether members of a subsidiary company in a short-form merger are entitled to payment of the fair value of their shares, and, if so, what steps (if any) are required to be taken in order for such members to dissent.

Decision

The Hon. Chief Justice Smellie QC disagreed with Changyou's interpretation of the Act, which he found "effectively elevated the procedural or mechanical provisions contained in subsections 238(2) to 238(16), for the access to and conduct of an appraisal, to the status of the substantive right to fair value appraisal conferred by subsection 238(1)". [8]

The Chief Justice held that the Petitioners should not be precluded from accessing the rights afforded by section 238 because of a mismatch between the mechanical provisions of that section and the substantive right to fair value conferred by section 238(1). The Chief Justice found that this would result in absurdity and was not what the legislature had intended. The Court determined that, properly construed, the provisions of section 238 should be read so as to allow the appraisal process to operate in the absence of any vote authorising the merger.

The Chief Justice agreed with the Petitioners that:

- i. by reading down the provisions of section 238 in this way, the appraisal regime can be construed in a way which is consistent with the rights guaranteed by the Cayman Islands Constitution, [9] including the right to peaceful enjoyment of property
- ii. the exclusion of short-form mergers from section 238 would be anomalous to, and

inconsistent with, other sections of the Act, which provide for protection of minorities [10]

- iii. such exclusion in short-form mergers would effectively mean that the Act was an outlier among comparable statutory regimes in other jurisdictions
- iv. the alternative legal remedies which Changyou contended were otherwise available to shareholders who wished to challenge a short-form merger were not adequate alternatives to the statutory right to be paid fair value

The Court therefore determined that the right to payment of fair value for shareholdings upon dissenting from a merger was an absolute right, which could be exercised in a short-form merger by giving a notice of dissent to the company within 20 days of the plan of merger being provided. The Petitioners were held to have validly exercised that right.

Subject to any appeal, the Petitioners' shareholder appraisal action will now be tried in the usual way.

Discussion

While the majority of mergers effected under Part XVI of the Act to date have been long-form mergers, there have been several short-form mergers, the majority of which have denied shareholders the right to dissent and be paid fair value.

Until now, an acquirer who wished to take a publicly held company private, but held less than 90% of the target company's voting power, could seek to acquire more shares in order to cross the 90% threshold in order to try to effect a short-form merger and not recognise shareholder appraisal rights. However, any former perception that this strategy precluded minority shareholders having appraisal rights has now been dispelled by the ruling in *Changyou*.

Ogier is one of the leading shareholder appraisal firms in the Cayman Islands. For more information contact your usual Ogier contact or one of the authors of this article.

[1] In the matter of Changyou.com Limited (unreported judgment dated 28 January 2021, Smellie CJ)

[2] Section 233(6)(a)

[3] Section 238(2)

[4] Section 238(4)

[5] Section 238(5)

[6] Sections 238(1), 238(7) and 238(11)

[7] Section 233(7)

[8] Ibid at footnote 1, paragraph [127]

[9] Section 25 of the Bill of Rights, Freedoms and Responsibilities, Cayman Islands Constitution 2009

[10] Schemes of arrangements (sections 86 and 87), "squeeze outs" (section 88), and mergers or acquisition by an overseas company (section 237(10))

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