Reappraising section 238 "fair value" proceedings: an update on recent developments

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Section 238 of the Cayman Islands Companies Act (2022 Revision) (the **Act**), provides a mechanism by which shareholders in Cayman Islands companies are able to dissent from mergers and consolidations, and have the "fair value" of their shares determined by the Grand Court of the Cayman Islands.

As we begin 2022, it is helpful to take stock of the current appraisal landscape in this relatively new, but rapidly evolving, area of law. In particular, there have been a number of interesting developments since our initial overview was published in 2020. This article provides an update on these advancements and considers what the future may hold.

Recent outcomes

Soon after the overview was published, the Grand Court (**Court**) delivered its substantive judgment in *Nord Anglia*. [1] In ordering a 16% uplift on the merger price, the Court applied a blended 60% weighting to the deal price and 40% to a discounted cash flow (**DCF**) analysis. Importantly, no weight was given to the trading price, primarily due to material non-public information not being available to market participants.

The Court then gave judgment in *Trina Solar* in September 2020. [2] Again, the Court determined fair value using a blended valuation methodology. However, unlike previous decisions [3] where two methodologies were given weight, this decision was the first to blend three different valuation methodologies - applying 45% to the deal price, 30% to the adjusted trading price and 25% to a DCF valuation. Upon applying these weightings, and a 2% minority discount to both the deal price and DCF components, the Court ultimately determined fair value to be 1% above the merger price.

A number of other section 238 proceedings have also recently settled, including *eHi Car* [4] and *KongZhong*. [5] However, the terms of these settlements are confidential and any uplifts on the merger price cannot be publicly disclosed.

Extension of appraisal rights to "short-form" mergers

In *Changyou.com*, [6] the Court confirmed that shareholders of companies that effect "short-form" mergers [7] are entitled to be paid the fair value of their shares on dissenting, even though no shareholder vote is required to authorise the merger.

In determining that the right to payment of fair value for shareholdings upon dissenting from a merger was an absolute right, the Chief Justice took a purposive approach to interpreting section 238. This right was found to not be fettered by the apparent "mismatch" between the mechanical provisions of the legislation [8] and the substantive right to receive fair value. The Chief Justice held that, properly construed, the provisions of section 238 should be read so as to allow the appraisal process to also operate in respect of short-form mergers. For a more detailed analysis of this decision, see Short-form mergers: Changyou judgment confirms appraisal rights in the Cayman Islands.

An appeal against the Chief Justice's decision was heard by the Cayman Islands Court of Appeal (**CICA**) in November 2021 and judgment on this appeal remains pending at the time of writing.

Differing procedures for dissenting from long and short-form mergers

As explained in the earlier overview, certain statutory steps must be taken within prescribed timeframes in order for dissenters to avail themselves of their entitlement to be paid fair value for their former shareholdings under section 238. Following the extension of appraisal rights to short-form mergers in *Changyou.com*, the timeframes in which some of these steps must be taken are triggered by different events, depending on whether the merger is in long or short-form.

The steps and the relevant time periods for compliance for both long and short-form mergers are summarised in this timeline.

Other developing areas

Amongst the many recent developments in section 238 jurisprudence were a number of important interlocutory decisions on disclosure, management meetings, interest and costs.

Dissenter disclosure

Disputes have continued to arise as to the scope of disclosure to be provided by dissenting shareholders.

In *FGL Holdings*, [9] the Court refused the company's invitation to broaden the scope of dissenter disclosure to categories beyond those first ordered by the CICA in *Qunar*, [10] and applied in subsequent cases (as discussed in the overview). The Court in *FGL* reaffirmed that dissenting shareholders were not obliged to disclose documents relating to their characteristics, motivations, or commercial positions. Furthermore, documents that are only relevant to the dissenting

shareholders' "rationale" or expectations were found to not be useful to the assessment of fair value and of no assistance to the Court. Similarly, the particular motives, commercial positions or subjective views of the dissenters, brokers or counter-parties were also held to be irrelevant to the Court's fair value determination.

Inadvertent disclosure

In *eHi Car*, [11] the Court was required to determine whether without prejudice communications with third parties mistakenly disclosed by the company could be relied on by the dissenting shareholders' valuation expert.

In dismissing the dissenting shareholders' application, the Court held that that a shareholder's standard entitlement to privileged communications of the company did not extend to without prejudice settlement negotiations between the company and a third party and that the joint privilege between the company and the third party was not capable of being waived by inadvertent disclosure. None of the established exceptions to the rule against disclosure of without prejudice communications applied, nor was the disputed correspondence sufficiently important or probative to justify making any further principled or discretionary exception on the merits. The Court consequently refused to order disclosure of the without prejudice communications.

Specific disclosure

In *Xiaodu*, [12] the company omitted to give discovery of certain categories of documents which the dissenters' expert considered were relevant and considered likely to be or have been in the company's possession, custody, power or control. The Court held that the company's explanation for why the documents were not capable of being disclosed was inadequate and unconvincing. Accordingly, the Court directed the company to serve an affidavit verifying the whereabouts of certain categories of documents, when and why any of the documents sought were no longer in the company's possession, custody or power, and details pertaining to the steps taken to recover the documents from any third party.

Management meetings

In *eHi Car*, [13] the company refused to convene a management meeting prior to receiving a list of intended questions from the dissenters' valuation expert or any evidence as to why a management meeting was required by him. Despite the company's protestations that it was not reasonable, proportionate or necessary to convene the meeting, and notwithstanding that the time for holding such meetings had since passed, the Court ruled that there was no principled reason to dispense with it. The Court confirmed that management meetings are a tried and tested procedural step in achieving a fair outcome in section 238 cases and an integral part of the information exchange process – echoing the Chief Justice's earlier finding in *JA Solar* [14] that such meetings are "crucial". For more detail on this decision, see Snapshot: management meetings confirmed as being integral in section 238 proceedings.

Further guidance on the procedure for reviewing and correcting the transcripts of management meetings was given in *FGL*, [15] where the Court acceded to the company's request to be permitted to review and correct any errors in the transcript before circulating it to the dissenters. After this, the experts must identify any oral statements or passages from the transcript that they may wish to rely on in their reports (without needing to indicate the basis or purpose of their reliance) and give the company an opportunity to clarify, correct or comment on the relevant statement or passage. This procedure has subsequently been adopted by consent in other 238 proceedings. [16]

Interest

Section 238(11) of the Act requires the Court to determine the "fair rate of interest, if any, to be paid by the company upon the amount determined to be the fair value". However, there is no further statutory guidance on what a "fair rate" is or the period of time to which interest should apply.

In *Qunar*, [17] the Court confirmed that, as a matter of principle, it was right to follow the midpoint approach previously adopted in *Integra* [18] and *Shanda Games*. [19] This requires the Court to determine the midpoint between the rate which prudent investors in the position of the dissenting shareholders could have obtained if they had the money to invest and the rate at which the company could have borrowed the amount representing the fair value of the dissenters' shares. Although this blended rate is to be applied on a simple interest basis, the Court held in a subsequent supplemental decision [20] that an element of compounding must be applied when calculating the prudent investor rate (in order to take account of the compounding nature of investment returns during the time that the dissenters were kept out of their funds).

Interest was found to run from the date that the company makes its written fair value offer to dissenting shareholders (ie 30-50 days prior to commencing proceedings), until the earlier of either when any judgment is given as the interest payable or when the dissenters are actually paid for their former shareholdings in the company (taking into account any interim payment made). After any judgment is made on interest, further interest then continues to run at the statutory judgment interest rate. [21] For more detailed analysis on these decisions in *Qunar*, see Approach to interest and costs in section 238 proceedings confirmed in the Cayman Islands and Snapshot: fair rate of interest in section 238 proceedings to include a compounding element.

The midpoint approach in determining a fair rate of interest was then reconfirmed last month by the Court in *Trina*. [22] The Court rejected the company's argument that the rate which prudent investors in the dissenters' position could have obtained if they had the money to invest should be based on an entirely risk-free strategy and clarified that the prudent investor rate can be determined by reference to the ordinary asset allocation of the particular dissenting shareholders - provided that a prudent investor in their position would have also been likely to have apportioned its investment in this way for the time that the dissenters were actually kept out of their funds. For more information on this decision, see Interest and costs in section 238 proceedings revisited.

Costs

The Court in both *Qunar* [23] and *Trina* [24] was also required to determine how adverse costs should be approached in the section 238 context.

In *Qunar*, the dissenters had contended that an uplift of 415% on the merger price should be awarded. However, the Court ultimately ordered an uplift of just 2%. In these circumstances, the Court considered that this was a case where "a more nuanced approach should apply than merely to look at 'who writes the cheque'". Given that the real issue for the Court was the vast delta between the parties' respective expert valuations, and since the Court's determination was significantly closer to what the company's expert had opined was fair value, the Court held that the common sense view was that the company had succeeded at trial, and that it would be unfair to order the company to pay the dissenters' costs (even though the dissenters had achieved a modest uplift on the merger price). The company then argued that the dissenters should themselves be ordered to pay the company's costs from the time that they refused a "without prejudice save as to costs" offer to settle the proceedings for a 20% uplift on the merger price, made two weeks before the trial commenced. However, the Court held it would not be fair to make such an award against the dissenters due to uncertainty in the wording of the company's settlement offer, which was made on a "subject to contract" basis and, even if the offer was capable of acceptance, the dissenters having not conducted themselves unreasonably in their response to it. Accordingly, the Court made no order as to costs, the result being that the parties each bore their own costs of the proceedings. A more detailed analysis of this decision can be found here.

Continuing this trend, no order for costs was again made in *Trina* [25] where the dissenters had been awarded an uplift of just 1.29% on the merger price. This uplift equated to nearly US$8 million more than the Company had argued should be payable to the dissenters at trial, although was far less than the 1,565% (US$181 million) uplift contended for by the dissenters. In these circumstances, the Court found the dissenting shareholders to have been the "successful" parties, but since the company had been successful on a number of discrete issues arising out of the expert valuation evidence, the Court found the equitable (fair) result was that each of parties should bear their own costs. Similarly to *Qunar*, this outcome was not affected by the dissenters' refusal to accept an earlier settlement offer made by the company. The seven day period for acceptance did not provide the dissenters with a reasonable period in which to consider the offer and they were held to have acted reasonably in not accepting it. A further analysis of this decision is available here.

Future developments

In addition to the awaited appeal decision in *Changyou.com* on short-form mergers (foreshadowed above), it is anticipated that a number of section 238 proceedings will go to trial in 2022 and that the jurisprudence in this area will continue to evolve.

It is also predicted that, amid the mounting pressure from both Chinese and United States regulators, more US-listed companies with operations in Asia will delist from US stock exchanges. With nearly 250 such companies presently listed in New York, most of which are incorporated in the Cayman Islands, it is expected that this will give rise to further section 238 appraisal opportunities, as shareholders seek to challenge the amounts they are offered for the cancellation of their shares upon delisting.

Ogier presently acts for dissenting shareholders in many ongoing section 238 matters and our cross-border team of appraisal rights specialists are well placed to meet any increase in demand for legal advice and representation in fair value proceedings in the Cayman Islands.

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[1] *In the matter of Nord Anglia Education, Inc* (unreported judgment dated 17 March 2020, Kawaley J)

[2] *In the matter of Trina Solar Limited* (unreported judgment dated 23 September 2020, Segal J)

[3] *In the matter of Integra Group* [2016 1 CILR 272]; *In the matter of Qunar Cayman Islands Limited* [2019 (1) CILR 611]; *In the matter of Nord Anglia Education, Inc* (unreported judgment dated 17 March 2020, Kawaley J)

[4] *In the matter of eHi Car Services Limited* (FSD 115 of 2019 (RPJ))

[5] *In the matter of Kongzhong Corporation* (FSD 112 of 2017 (RPJ))

[6] *In the matter of Changyou.com Limited* (unreported judgment dated 28 January 2021, Smellie CJ). Note this decision is subject to an appeal to the Cayman Islands Court of Appeal at the time of publication.

[7] Where a parent merges with a subsidiary in which the parent already holds 90% of the voting power and where a special resolution of shareholders is not required (section 233(7)).

[8] Section 238(2) to 238(16) of the Act

[9] *In the matter of FGL Holdings* (unreported judgment dated 18 December 2020, Parker J)

[10] *In the matter of Qunar Islands Limited* [2018 (1) CILR 199]

[11] *In the matter of eHi Car Services Limited* (unreported judgment dated 2 August 2021, Parker J)

[12] *In the matter of Xiaodu Life Technology Ltd* (unreported judgment dated 28 April 2021, Kawaley J)

[13] *In the matter of eHi Car Services Limited* (unreported judgment dated 22 June 2021, Parker J)

[14] *In the matter of JA Solar Holdings Co., Ltd.* (unreported judgment dated 18 July 2019, Smellie CJ)

[15] *In the matter of FGL Holdings* (unreported judgment dated 18 December 2020, Parker J)

[16] *In the matter of JA Solar Holdings Co., Ltd.* (unreported judgment dated 18 July 2019, Smellie CJ); *In the matter of iKang Healthcare Group, Inc* [FSD 32 of 2019 (NSJ)]; *In the matter of 58.com* (FSD 275 of 2020 (MRHJ))

[17] *In the matter of Qunar Cayman Islands Limited* (unreported judgment dated 29 March 2021, Parker J)

[18] *In the matter of Integra Group* [2016 (1) CILR 192]

[19] *In the matter of Shanda Games Limited* (unreported judgment dated 25 April 2017, Segal J); *In the matter of Shanda Games Limited* [2018 (1) CILR 352]

[20] *In the matter of Qunar Cayman Islands Limited* (unreported judgment dated 16 June 2021, Parker J)

[21] Presently set at 2⅜% per annum

[22] *In the matter of Trina Solar Limited* (unreported judgment dated 8 December 2021, Segal J)

[23] *In the Matter of Qunar Cayman Islands Limited* (unreported judgment dated 29 March 2021, Parker J)

[24] *In the matter of Trina Solar Limited* (unreported judgment dated 8 December 2021, Segal J)

[25] *In the matter of Trina Solar Limited* (unreported judgment dated 8 December 2021, Segal J)

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