Article

HARNEYS

Recent developments in Cayman Islands merger appraisal litigation

Section 238 of the Cayman Islands' Companies Act is a relatively new jurisdiction, having been introduced only in 2009. It provides a mechanism for shareholders of a company to dissent from the statutory merger process under part XVI of the Act and demand payment of the 'fair value' of their shares. Over the past few years, the number of section 238 cases has grown substantially, mainly due to increasing numbers of take-private transactions involving United States-listed Chinese companies. The case law in this area continues to develop rapidly, and this is illustrated by recent decisions of the Grand Court relating to three different aspects of the section 238 regime.

Short form mergers

The statutory merger process under part XVI of the Act must ordinarily be authorised by a special resolution of the company, which typically requires the consent of a two-thirds majority of the shareholders. The vast majority of take-private mergers that have taken place since 2009 have been approved in this way. The timing of the steps to be taken by a dissenting shareholder under section 238 is calculated by reference to the extraordinary general meeting (***EGM***) vote: dissenters must first file a notice of objection prior to the vote, followed by a formal notice of dissent after the company gives notice that the merger was authorised at the EGM.

However, section 233(7) allows for an exception, namely that a merger between a parent company and its subsidiary does not require authorisation by special resolution. Parent company in this context refers to a company that holds at least 90 per cent voting power in general meetings of the subsidiary. For a long time, this was understood to provide a loophole whereby companies that were able to meet the 90 per cent threshold could avoid the section 238 dissenter rights regime altogether, there being no EGM vote in relation to which a shareholder might serve the requisite notices. Mergers of this kind were commonly referred to as 'short-form' or 'vertical' mergers, and several of these took place successfully under the assumption that appraisal rights did not apply.

This understanding has been upended following the Grand Court's decision in Changyou.com Limited. Changyou is a leading operator of online games in the PRC. It underwent a take-private transaction by way of short-form merger, and the schedule 13E-3 statement it filed with the Securities and Exchange Commission (***SEC***) prior to the deal stated definitively that appraisal rights were not available to its shareholders. Nonetheless, a number of shareholders purported to dissent from the merger, and the question of whether they did so validly was determined by the court as a preliminary issue.

In his judgment, Chief Justice Smellie QC acknowledged the ambiguity in the drafting of part XVI of the Act but held that it would be 'absurd' to deny the protections afforded to shareholders by section 238 for the merely procedural reason that no vote takes place in a short-form merger. He went on to suggest a pragmatic solution to the issue of how and when a shareholder should give notice to dissent, namely that the circulation of the plan of merger to shareholders required for a short-form merger could be treated as equivalent to the notice of authorisation in a long-form merger. Shareholders would accordingly have 20 days from receipt of the plan of merger to serve a notice of dissent.

The Chief Justice's suggestions were adopted for the subsequent take-private short-form merger of Ruhnn Holding Limited, whose schedule 13E-3 statement acknowledged the existence of dissenter rights and followed the timing suggested in Changyou. It is interesting to note that this approach effectively dispenses with the requirement for dissenters to serve a notice of objection, which in the case of a long-form merger must be served prior to the EGM. However, this does not in any way detract from the most important effect of the court's ruling in Changyou, which is to provide certainty as to the existence of dissenter rights in short-form mergers and how they are to be exercised.

Fair rate of interest

In addition to determining the fair value of the dissenting shareholders' shares, section 238 also requires the court to decide a fair rate of interest (if any) to be paid by the company on the amount determined to be the fair value. The Act is silent as to how the rate is to be derived, whether the rate should be calculated on a simple or compound basis and the exact period for which interest should accrue.

In the first two reported section 238 decisions, Integra Group and Shanda Games, the Grand Court adopted a "mid-point approach", following the Delaware case of Cede & Co Inc v MedPointe Healthcare Inc. This involved calculating the average of the company's cost of borrowing with the rate of return of a 'prudent investor' (representing the dissenting shareholders) on a simple interest basis over the relevant period (albeit the court in Integra used the company's return on cash in place of this component, as no evidence was available regarding the prudent investor rate).

The mid-point approach was endorsed by the Court of Appeal in Shanda Games in 2018 on the basis that it achieved a balance between the 'financial advantage' enjoyed by the company and the disadvantage to the dissenters of being out of their money. A further appeal to the Privy Council by the company in Shanda Games was dismissed essentially on a technicality, namely that the arguments advanced by the company had not been raised at first instance and accordingly could not be deployed on appeal.

This year, the Grand Court in Qunar Cayman Islands revisited the issue of the fair rate of interest in two separate judgments, which will likely have important consequences for future section 238 cases.

There were three main takeaway points from Justice Parker's first judgment, which was handed down in March 2021. First, the court reaffirmed the use of the mid-point approach, which had been challenged by the company but was held to be "consistent with the nature and purpose of the statutory jurisdiction and language". Second, the court rejected the dissenters' argument that interest should be calculated on a compound, rather than simple, basis. Third, the court clarified that the relevant period over which interest would accrue began with the company's fair value offer under section 238(8) and would end upon the earlier of the dissenters receiving payment of fair value or the court giving judgment on the issue of interest.

The court's second judgment in Qunar related to the issue of simple versus compound interest, on which the parties had been unable to reach agreement. The court had explicitly rejected a compound rate of interest, but the dissenters maintained that the prudent investor rate should nonetheless include an implicit compound element, on the basis that investments are inherently compounding. Justice Parker agreed with the dissenters' submissions in this regard and held that the Court's simple interest calculation should "equal or approximate amounts that would arise under a compound interest award".

In Qunar, the overall impact of the court's decision to award sums equivalent to compound interest was relatively small in dollar terms, but it may turn out to be significant for future cases. It will be concerning for companies that the seemingly benign 'fair rate' of interest has morphed into de facto compound interest, which Einstein famously described as the "eighth wonder of the world". Whether this will be the subject of a future appeal remains to be seen.

Foreign third-party discovery

As with many types of litigation, discovery of documents is one of the most important and costly elements of section 238 appraisal proceedings. Appraisal proceedings are, however, slightly unusual in that the discovery exercise is largely a one-sided affair, as the experts will be valuing the company from an inside perspective, with access to the company's internal documents and financial data. The Court of Appeal's 2018 decision in Qunar Cayman Islands restored balance somewhat by requiring dissenting shareholders to give discovery also, but the reality remains that the vast majority of discoverable documents in section 238 proceedings will be held by the company.

In recent section 238 cases, there has emerged a trend for dissenting shareholders to seek the assistance of foreign courts to extend the scope of discovery that they can seek from third parties who may hold relevant documents. Two recent decisions of the Grand Court illustrate this, one involving a request to a court in Hong Kong and the other taking advantage of the relatively generous discovery provisions in section 1782 in the US.

In an April 2021 decision in Xiaodu Life Technology Ltd, Justice Kawaley granted the dissenters' application for the issuance of a letter of request to the Hong Kong Court for the discovery of documents held by a Hong Kong-incorporated affiliate of the company. Letters of request (also known as letters rogatory) are a common law procedure whereby a judge in one jurisdiction formally writes to a judge in another common law jurisdiction to ask for discovery assistance in relation to a person located in the other jurisdiction. The documents sought in Xiaodu included relevant emails and documents stored on servers that were outside the company's control. The principles applied by Justice Kawaley in granting the application included that the request must not be a fishing expedition and that the documents sought must be directly material to matters in issue in the proceedings.

The use of section 1782 of title 28 of the United States Code has featured in multiple section 238 cases to date, and its use was the subject of judicial comment, also by Justice Kawaley, in Nord Anglia Education Inc. Section 1782 of title 28 of the United States Code allows parties to litigation outside the United States to obtain evidence, in the form of documents or a deposition, from a person or entity incorporated or located in the US for use in the non-US proceedings. However, in Nord Anglia Justice Kawaley was very critical of the dissenting shareholders' conduct in relation to their use of Section 1782. In particular, the dissenters had failed to keep the Cayman Islands Court involved or informed of their US application, which he described as a "frolic". In future directions orders in section 238 cases, one can expect to see explicit provisions accommodating foreign applications of this kind, which was Justice Kawaley's suggested approach for handling the cross-border element.

This article was first published by Commercial Dispute Resolution.

Paula Kay
+852 5806 7879
paula.kay@harneys.com
Hong Kong

James Granby
+852 5806 7829
james.granby@harneys.com
Hong Kong

For more information and key contacts please visit **harneys.com**