Fair value in short-form mergers: a pearl of clarification in the Cayman Islands s.238 saga

Briefing Summary: In recent years, where there has been a merger involving a Cayman Islands incorporated company, it has been a popular trend for shareholders of those companies to apply to the Cayman Islands Grand Court (the "Court") to award them a judicially fair value for their shares instead of accepting the merger consideration which is being offered by the merging company. Under section 238 of the Cayman Islands Companies Act (the "Act"), shareholders have the statutory right to dissent from the merger of a Cayman Islands incorporated company and to ask the Court to determine the value of the shares rather than accept the value of the shares being offered as part of the merger.

Service Area: Dispute Resolution and Litigation

Location: Cayman Islands

Created Date: 25 February 2021

Changyou.com Limited FSD 120 of 2020

In the recent decision of *Changyou.com Limited* FSD 120 of 2020, the Court considered the provisions of ss. 233(7) and 238 of the Act and confirmed a specific but significant point, which is that shareholders are entitled to dissent from and be paid fair value for their shares in relation to a "short-form" merger.

A "short-form" merger is where a parent company holding at least 90% of the voting rights of its subsidiary merges with the subsidiary (s.233(7) of the Act). It is called a "short-form" merger because no vote of members by special resolution is required, as is the usual process under s.233(6) of the Act.

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In this case, Changyou.com Limited ("**Changyou**") was a Cayman Islands incorporated company operating in the People's Republic of China in the technology sector, and was an indirect wholly-owned subsidiary of Sohu.com Limited ("**Sohu**"). A merger plan was announced and implemented by an agreement between Sohu.com (Game) Limited ("**Sohu Game**"), an indirectly wholly-owned subsidiary of Sohu; and Changyou Merger Co. Limited ("**Changyou Merger Co.**"), a directly wholly-owned subsidiary of Sohu Game, and Changyou. Pursuant to the merger agreement, Changyou Merger Co. merged with and into Changyou with effect from 17 April 2020, with Changyou (hereinafter, the "**Company**") becoming the surviving company. As a result of the corporate shareholdings described above, Changyou Merger Co., already owned 95.2% of the voting power represented by all issued and outstanding shares of the Company. This meant that the merger was not subject to a vote of shareholders of the Company, but proceeded with a "short-form" merger under s.233(7) of the Act.

The Company's argument for opposing the minority shareholder's petition to the Court for a determination of fair value under s.238 of the Act was that given that it was undertaking a short-form merger, the shareholders did not vote, and therefore had no right to dissent. Since s.238 requires the shareholder to dissent to the merger, the minority shareholders could not ask the Court for a fair value determination of the value of the shares. The petitioners, who were the minority shareholders holding the remaining 4.8% of the voting shares of the Company, disagreed. They filed a petition for a determination of the fair value of their shares in accordance with s.238 of the Act, and the question of whether the minority shareholders in a short-form merger are entitled to have the Court determine the fair value of their shares was put to the Court.

The Court held that s.238 of the Act did confer the right to be paid fair value on any shareholder dissenting from a merger. It also indicated the procedure by which a member may apply to the Court for the appraisal of fair value when dealing with short-form mergers. The reason for the Court's decision was because the Court considered it to be an absurd conclusion if a shareholder was denied its dissenting rights simply because it was not allowed to vote as part of the procedural process.

The Court was of the opinion that the appraisal process in a short-form merger can operate without a vote under s.233(6) authorising a plan of merger. There are various ways of doing this – for example, allowing a notice of dissent to be given although there is no need for a vote. In that event, the dissent would not be from the merger itself but only insofar as it would result in the acquisition of the shares of the minority for the stipulated merger price. The notice of dissent could be given within 20 days of receiving the copy of the merger plan by the shareholders.

The Court noted that if the Company's argument were accepted, that would make the Cayman statutory regime an outlier. For example, under English law, although there is no direct equivalent of a short-form merger, English law would not allow squeeze-out provisions to be used to enable a 90% majority to deprive a minority of their shares at will and on whatever terms they see fit. Similarly, in each of Bermuda, the British Virgin Islands and Delaware, there are comparable merger regimes and in none of them is a dissenting minority able to be deprived of the right to be paid fair value for their shares. As such, the Court held that it would be very surprising if the legislators had intended, without expressly saying so, that the Cayman Islands be an international outlier in which a shareholder which obtains a 90% majority of shares in another company could do so without the minority having the right of appraisal of the fair value of its shares.

The Court further explained that whilst the compulsory acquisition of a minority's shares under a short-form merger is allowed because it is expedient for promoting the economic well-being of the community, this is only possible if certain conditions are met – such as provision in the law for the prompt payment of adequate compensation and ensuring that the minority shareholder has the right to access the Court to determine the amount of compensation for its shares.

Ultimately, the Court held that it was quite clear that the intended purpose of Act and the short-form merger provision in question was to confer the right to be paid fair value on all dissenting shareholders. To the extent that by inadvertence the draftsman or legislature produced a procedure or mechanism which overlooked one class of dissenters (namely those dissenting from a short-form merger), appropriate language to give effect to that intention *may* and *should* be read into those provisions to carry that purpose into effect.

Key takeaway points

The decision in this case provides a clear example of the Court's pragmatic and commercial approach. Particularly against the backdrop of the recent popularity of s.238 cases being heard and decided in the Cayman Islands, having this pearl of clarity with respect to short-form mergers is beneficial.

The Court's decision allows for fairness to minority shareholders, and also ensures consistency of approach between the short-form merger mechanism and other commonly used tools, such as a squeeze-out, as well as consistency with other jurisdictions such as England, the BVI and Bermuda.

In light of this, this decision is a welcome one for shareholders seeking clarity on what rights they can exercise, and for maintaining the practical and reasonable approach that the Court has sought to adopt.