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"Take-private" transactions: a review of the Cayman Islands merger regime, "fair value" and dissenting shareholder rights

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With the recent establishment of Carey Olsen's offices in Hong Kong and Singapore, we have prepared this article reviewing the Cayman Islands merger regime, "fair value" and dissenting shareholder rights for the information of our Asia-based clients. As the law in this emerging field develops, we will continue to provide regular updates.

Introduction

Mainland PRC businesses owned by holding companies listed on overseas stock exchanges, commonly in New York or London, have increasingly been utilizing the Cayman Islands company merger laws to take the listed company into private hands and de-list, with a view to re-listing the business on a PRC stock exchange.[1]

A principal commercial driver for these transactions is the significant increase in share price often attainable on a PRC stock exchange for the same business. Financial commentators suggest that this phenomenon may be attributable to: (i) Chinese money being forced to stay in the PRC; (ii) relatively few attractive investment alternatives in the PRC; (iii) an incomplete understanding of PRC businesses by Western investors; and (iv) increased costs and regulatory requirements associated with listings on major overseas stock exchanges.

That this is a prevalent and expanding practice is born out by the figures: there were 37 such de-listings in the US alone in 2015 and 2016, with a combined deal value in excess of US$33 billion.[2] 2017 has seen a continuation of this trend.

Merger regime: overview of the legal framework

The favoured method of taking listed Cayman Islands holding companies private is by invoking the Cayman Islands statutory merger regime[3] in Part XVI of the Companies Law (as revised) (the "Law").

In summary, a new Cayman Islands company is established[4] to merge with the listed Cayman target company.[5] The terms of the merger are embodied in a formal plan of merger. The board (or a special committee of the board) will consider the plan and engage a financial expert to advise them on the "fairness" of the offer price for the shares. Following board approval, two-thirds of the shareholders of the company[6] must vote in favour of the merger.

Listed companies seeking to go-private are attracted by the two-thirds shareholder approval threshold under the merger regime. Take-privates may also be achieved by way of a takeover and "squeeze out" process or implementation of a scheme or arrangement, but these avenues involve higher shareholder support thresholds and/or involvement of the Court.

1 Cayman Islands companies are commonly used as the listing vehicle in such structures.
2 Financial Times, China Business & Finance, 28 February 2017, Henry Sender.
3 These provisions apply also to the "consolidation" of companies. In this article we will refer exclusively to mergers.
4 Usually an SPV incorporated for this sole purpose.
5 For simplicity, in this article we refer to the existing listed company and the new company together as "the company".
6 Or such higher number as the Articles of Association may prescribe.

Keys requirements for a successful take-private merger include the following:

- Development of a merger plan in consultation with appropriate advisors.
- Appointment of a financial expert to advise the board (or a special committee of the board) as to the appropriate offer price.
- The directors of the company must approve a written plan of merger.
- The plan must be approved by a special resolution of the shareholders of the company (requiring a two-thirds majority).[7]
- The consent of holders of fixed or floating security interests granted by the company must be obtained.
- The directors of the company must make a declaration that (among other things) it is solvent, the post-merger company will be solvent and the merger is *bona fide* not intended to defraud unsecured creditors.

Upon obtaining all necessary authorisations and consents, the plan may be filed with the Registrar of Companies and will become effective.

Rights of dissenting shareholders

Shareholders of take-private target companies opposed to a planned merger are afforded certain rights under the Law. First, they may apply to the Court for relief on the ground that the merger is void or unlawful. This ground rarely arises in practice, but in effect, the merger may be stopped if the parties supporting the merger do not comply with applicable legal requirements.

Secondly, if certain preconditions are met, they may invoke a process which at its core alleges that the offer price for their shares is at an undervalue. Unless the company and the shareholders subsequently agree upon the “fair value” of the shares, the Court will be called upon to make that determination.

The “dissenting shareholder” / “fair value” provisions

The “dissenting shareholder” / “fair value” provisions are contained in section 238 of the Law and are supplemented by a growing body of case law. The gateway to activating section 238 - one which transforms an unhappy shareholder in a proposed take-private transaction into a “dissenting shareholder” entitled to payment of “fair value” for his shares – is the requirement that the shareholder properly notify the company of his objection to the merger before the merger vote. Once this is done, the shareholder qualifies as a dissenting shareholder under section 238.

The statutory procedure may be summarised as follows:

- The dissenting shareholder must lodge an objection in writing prior to the vote on the proposed merger stating that he will demand payment for his shares if the merger is authorised by the vote.
- Within 20 days of the vote (if approved), the company must give notice to dissenting shareholders of the approval.
- The dissenting shareholder then has 20 days within which to give notice to the company of his decision to dissent and of the particulars of his shareholding, together with a demand for payment of the fair value of his shares.
- The company must then, within 7 days, make a written offer to purchase the shares at a specified price.
- If the dissenting shareholder and the company do not agree upon the price to be paid within the following 30 days, the company must (and the shareholder may) file a petition under section 238 of the Law to have the fair value of the shares determined by the Court.

The costs to a shareholder of activating the fair value determination process (points 1 to 4 above) are relatively modest in the early stages, but will increase once formal Court proceedings are initiated (point 5 above).

Determination of “fair value” by the Court

There have been two fair value trials in the Cayman Islands.[8] The judgments in these cases, together with a number of important interlocutory judgments in cases which did not proceed to trial or are currently before the Court, have established in quite some detail, the legal framework, principles and procedures applicable to fair value cases.

The Cayman Islands regime follows similar legislation to that in Canada and Delaware. For this reason, the considerable body of case law available in those jurisdictions assists where appropriate in the development of Cayman Islands jurisprudence in fair value cases.

An in-depth account of Cayman Islands fair value case law will be addressed in a succeeding Carey Olsen article. However, for the purposes of this overview, it is worth mentioning the following major principles:

- Fair value is a shareholder’s proportionate share of the value of the company’s business as a going concern as at the date of the shareholder’s meeting approving the merger.
- The appropriate valuation methodology will depend upon the circumstances of the particular company having regard to generally accepted valuation techniques.
- No discount should be applied because the shares of a minority are being valued and no premium should be applied by reason that the shares are being compulsorily acquired.

7 Or such higher number as the Articles of Association may prescribe.
8 In the Matter of Integra Group (Jones J, 20 August 2015); In the Matter of Shanda Games Limited (Segal J, 25 April 2017).

Continued

- The company and dissenting shareholder will adduce their own expert evidence as to fair value. In addition, the experts may prepare a joint report and they may be cross-examined on their evidence.
- The company must provide discovery of sufficient information to enable the experts to opine on value.
- The dissenting shareholder may be entitled to pre-payment by the company of the merger offer price and interest in some cases.

Notably, in both fair value cases that proceeded to trial, the dissenting shareholders enjoyed a significant increase in the price paid for their shares. In our own experience, a number of other fair value cases have been resolved by mutual consent after the commencement of legal proceedings, following the exchange of expert reports, but prior to trial. It stands to reason that with the benefit of detailed information provided to the shareholder by the company and consideration of each other's expert reports, parties are often able to find common ground as to fair value without the need for a formal determination by the Court.

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