Shanda Games Limited – Court of Appeal Judgment

Service area / Dispute Resolution and Litigation, Restructuring and Insolvency
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On 6 March 2018, the Cayman Islands Court of Appeal handed down judgment in an appeal brought by Shanda, holding that a "minority discount" should be applied in assessing the fair value of a dissenter's shareholding. The judgment provides welcome certainty in take-private litigation in Cayman with the Court largely affirming the established valuation methodology of the Grand Court in conducting fair value assessments of companies under s.238 of the Companies Law.

Minority discount

In both the first instance judgment of Shanda and a previous judgment in Integra, the Grand Court, having regard to fair value valuation principles in Delaware and Canada, held that a minority discount (the discounted value of the dissenters' shares reflecting the limited influence or control afforded by the minority shareholding) should not be applied in Cayman fair value proceedings under s.238. In Shanda this resulted in a fair value determination of US$8.34 per share (US$16.68 per ADS) as against the merger price of US$3.55 per share (US$7.10 per ADS). The dissenting shareholders' shares were valued at US$73,575,995.

Shanda, in appealing the first instance judgment, contended that the trial judge should not have had regard to Delaware and Canadian jurisprudence, but should instead have looked to the English authorities governing schemes of arrangement and squeeze-out valuations (as well as valuations in the unfair prejudice context). In contrast, the dissenters argued that a "going-concern" value should be adopted as is the case in Delaware and Canada. The English authorities were distinguishable in that English legislation governing schemes of arrangement and squeeze-outs does not expressly require the Court to apply a standard of "fair value", in contrast to Delaware, Canadian and Cayman legislation.

In Shanda, the Court of Appeal held that the dissenters' shares should be subject to a minority discount, following the English authorities. The Court drew parallels to British Virgin Islands and Bermudian authorities which support the application of a minority discount. The Court distinguished the various Cayman and English authorities in the just and equitable winding-up and unfair prejudice contexts (which disallow a minority discount), on the basis that such cases apply in quasi-partnership cases.

The Court of Appeal noted that there are three means of taking a company private: (i) merger, (ii) scheme of arrangement, and (iii) squeeze-out. According to the Court, a minority discount applies to valuations in schemes and squeeze–out cases. Nothing in the Companies Law suggests that a different approach should be taken for mergers. The Court favoured applying a consistent approach to valuation across the three categories.

Valuation methodology

The Court of Appeal rejected the three valuation methodology appeal points made by the dissenters. As has always been the case in Cayman, the Court is entitled to adopt, some, all or none of the expert evidence to assist the court in arriving at a reasoned, fair valuation.

Interest

The Court of Appeal held that the "mid-point" approach adopted by the trial judge (and in earlier Cayman cases) is appropriate. In this case, the rate of interest payable was that falling at the mid-point between a prudent investor's assumed rate of return on investment (the prudent investor rate) and the rate at which the company could borrow capital representing the sum of the fair value of the dissenters' shares (the borrowing rate). Shanda was capable of borrowing at the prime rate of 3.5%. A prudent investor would not be limited to investing in three month fixed deposits in Cayman banks as suggested by Shanda. Instead the Court considered investment grade corporate bonds at 5.09% to be relevant and suitable to use for the prudent investor rate in this particular case. Accordingly, the mid-point was 4.295%.

The important take-aways

The key take-away points are: (i) the existing legal principles governing valuation of dissenters' shares remain exactly the same, (ii) the only exception is that a discount should be applied to the fair value assessment in recognition that dissenters hold a minority interest; and (iii) the calculation of interest in s.238 cases remains unchanged.

Interestingly, during the Court of Appeal hearing Shanda elected not to pursue various additional appeal points concerning valuation methodology that it had formerly raised. Its appeal on valuation was confined to the minority discount issue. The three valuation methodology points raised by the dissenters were rejected. It remains to be seen whether Shanda or the dissenters will appeal to the Privy Council, and if so, whether the appeal will cover valuation methodology generally or will be limited to the minority discount issue. We will keep you up to date with developments as they arise.

Following the Court of Appeal's decision, both Shanda and the dissenters appealed to the Privy Council with the leave of the Court of Appeal[1]. The primary issue brought by the dissenters was whether the Court of Appeal was correct to hold that a minority discount should be applied in the determination of the fair value of the dissenters' shares pursuant to s.238 of the Companies Law. The secondary issue brought by Shanda was whether the requirement to award a fair rate of interest under s.238 requires the court to do so in accordance with the same principles on which it awards interest on an award of debt or damages.

On the primary issue, the Privy Council held that a minority discount should be applied in most circumstances when determining the fair value of the dissenters' shares principally for three reasons:

1. Comparable provisions of the Companies Law, such as those dealing with schemes of arrangement and "squeeze outs", do not provide for pro rata valuation. Further, it would be surprising if the Cayman Islands legislature intended to introduce a fundamentally different approach to share valuation under s.238 as against the approach adopted in England and Wales under analogous provisions;
2. In the absence of some indication to the contrary or special circumstances, the minority shareholder's shares should be valued as a minority shareholding and not on a pro rata basis. This is in line with the general principle of share valuation that the court should value the actual shareholding which the shareholder has to sell and not some hypothetical share; and
3. The similarities between the Delaware appraisal remedy and s.238 do not justify departure from that general principle. While the jurisprudence of Delaware is of great value in this field, there may be different rules in related contexts, as well as different economic and social policy considerations affecting legislation.

It is also worth noting that the Privy Council was careful not to embark on a detailed analysis of how a fair value determination should be made due to the narrow scope of the appeal (as set out above, Shanda's appeal on valuation was confined to the minority discount issue and during the Court of Appeal hearing it elected not to pursue various additional appeal points concerning valuation methodology). Nonetheless, it held that it was incorrect for the Court of Appeal to hold that a minority discount should invariably be applied as a matter of law and that "there might be a case where a minority discount was inappropriate due to the particular valuation exercise under consideration."

On the secondary issue of interest, Shanda argued that the "mid-point" approach was contrary to principles established under English law. This argument was rejected by the Privy Council on the basis that it was not before the first instance judge and there was accordingly no good reason why the exercise of the judge's discretion should be open to challenge on a ground which he was not asked to consider.

The Privy Council's decision is important as it is affirms the Court of Appeal's decision that the Cayman courts will generally apply a minority discount when assessing the fair value of dissenters' shares, albeit not as a "bright-line" rule to be applied in every case. In addition, this decision is of interest as it opines on comparative law and the manner in which Cayman and similar legislation should be interpreted.

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