Cayman appeal court applies Minority Discount in appraisal cases under section 238

Insights - 23/04/2018

Two recent Cayman Islands Court of Appeal decisions will impact the position of Dissenting Shareholders in fair value appraisal cases coming before the Cayman courts.

Following the first of these decisions, *Re Shanda Games Limited* (6 March 2018), dissenting shareholders will need to take into account the commercial impact of a minority discount on the value of their shares in a company subject to a merger, consolidation or take-private transaction under section 238 of the Companies Law.

Section 238 of the Cayman Islands Companies Law entitles a member of a company to "*payment of the fair value of his shares*" upon dissenting in a merger or consolidation. Until now, the practice of the Cayman Court to determine the "*fair value of* [a dissenter's] *shares*" has been to calculate the value of the company and award the dissenting shareholder an amount representing their proportionate share of that value, with limited adjustments. However, the Cayman Islands Court of Appeal has now reversed this approach and made clear that it can be appropriate for a minority discount to be applied in determining the fair value of a dissenter's shares in a statutory appraisal case under section 238 of the Companies Law.

In order to quantify the consequences of this decision for the dissenters in the *Shanda Games* case itself, the minority discount was 23%. This figure was agreed by the experts and resulted in a reduction in the value of the dissenters' shares to the tune of US$16.9 million. However, even with the minority discount applied, as a result of the appraisal proceedings the Dissenter's received a share value over 80% higher than the original price offered by the Company.

The First Instance Decision

The Honourable Mr Justice Segal had followed the earlier decision of Jones J in *Re Integra Group* [2016] 1 CILR 192 (though it is important to note that the minority discount question was not argued before Jones J in *Integra*) and rejected the suggestion of a minority discount at first instance on the basis that, inter alia:

1. The Cayman Islands' statutory appraisal regime was based on the Delaware statute and in that jurisdiction, no minority discount is applied (nor is it applied in Canada which also has a statutory appraisal regime). Rather it is the practice in those jurisdictions to value a dissenting shareholders' holdings as a proportion of the value of the company. Thus, the Courts have rejected a market value approach to appraisal in Delaware.

2. The purpose of the s238 regime is to protect the interests of minority shareholders and applying a minority discount to the assessment of the value of their shares is inconsistent with this purpose.

3. The full value of a dissenting shareholder's interest includes a right to distribution of their share of the company's assets following a sale of the company's business, which is inconsistent with the application of a minority discount.

While Segal J reviewed comparable provisions and cases in England and Bermuda, he considered that they were distinguishable from the s238 cases that come before the Cayman Islands Court and that having regard to the origins of s238, it was more appropriate to follow the Delaware court.

The Court of Appeal's reasoning

In forming its view that a minority discount is appropriate and expressly rejecting the findings of Segal J in *Shanda Games* and Jones J in *Integra*:

1. The Court of Appeal looked to the English authorities on share valuation in the context of compulsory acquisition of shares by way of scheme of arrangement, "squeeze-outs" and unfair prejudice claims. The Court of Appeal considered that it would be "*unlikely in the extreme*" that the simplified merger and consolidation regime in section 238 was intended to depart from the approach adopted to squeeze outs and schemes of arrangement and opined that "*it is to be presumed that the three mechanisms, contained in the same piece of legislation and capable of serving the same purpose in different ways, are to be construed from the same standpoint".*

2. The Court formed the view that the Delaware jurisprudence should no longer be followed on this point in the Cayman Islands. In this regard the Court of Appeal pointed to Delaware public policy considerations which do not apply in the Cayman Islands and also pointed to the linguistic differences in the Cayman Islands and Delaware legislation. In Delaware, a dissenting shareholder is entitled to the fair value of their "shares of stock", being their proportionate share of the company's value. In contrast, section 238 entitles a dissenter to "the fair value of his shares" which instead focuses the appraisal exercise on the personal shares of the dissenting shareholder and any attendant rights and liabilities of those shares. The Court concluded that "*there is nothing in the wording of the section that suggests that the focus is to be on the value of the company rather than on the value of the shares*".

3. The Court of Appeal rejected the suggestion that the reference to Delaware law during the second reading speech in the Legislative Assembly, which introduced section 238 to the Cayman Islands Companies Law, indicated an intention that section 238 was intended to implement or follow the Delaware model in particular. In adopting this view, the Court had regard to the fact that that Delaware law was just one of numerous jurisdictions reviewed prior to the introduction of the statutory appraisal regime and observed that "*the appraisal regime to which section 238 bears most similarity is that of Canada, but its legislation is not said to have been reviewed*." The Court of Appeal accepted that Delaware jurisprudence can be of assistance to the Cayman Court but noted that it should not be determinative.

The dissenting shareholders tried to argue on appeal that the Court should follow the Privy Council decision in *CVC/Opportunity Equity Partners Ltd v Demarco Almeida* [2002] 2 BCLC 108 in which the Court assessed the appropriateness of a share buy-out offer in the context of an unfair prejudice petition. The Board determined that the minority shareholder was entitled to an offer that reflected his interest in the business as a going concern and was not subject to a minority discount. However, the Court of Appeal expressly rejected this submission on the basis that the cases in England and the Cayman Islands where the Court has not applied a minority discount (including in *CVC/Opportunity*) all involve circumstances where there is a relationship of trust and confidence, such as quasi-partnerships.

Cayman Appeal court orders Minority Shareholder disclosure in s238 cases

The three disclosure issues considered by the Court of Appeal were:

(a) the inclusion in the Order of Mr Justice Parker of a catch-all disclosure provision ("**the catch-all disclosure clause**") under which the Company was required to give general disclosure of all relevant documents, beyond those set out in an agreed Schedule to the Order. The Company argued on appeal that there was no case for any such general disclosure.

(b) the inclusion in the Order of a clause, (the "**further disclosure clause**") requiring the Company to provide such further disclosure/information as the experts might require after they have assimilated the first rounds of disclosure. The Company argued that there was no need for such further disclosure, nor, separately, for the right to obtain further information from the Company as this would be an inappropriate delegation of power to the experts.

(c) the failure of the Judge to order the Dissenting Shareholders to provide any disclosure. The Company argued that Parker J was wrong to rule that any such disclosure was irrelevant.

The Court of Appeal's reasoning and rulings were as follows:

(a) In respect to the catch all disclosure paragraph, the Court of Appeal noted that GCR Order 24 r3 applies in petition proceedings as it does in writ actions and allows the court to make an order for general discovery. Moreover, Sir Bernard Rix, JA observed *"In section 238 fair value*

proceedings, such an attitude to the Company's disclosure obligations is entirely understandable. It is for the Company itself which has put forward a price for the merger buy-outs of its shares, and it has done that on the basis of its own internal assessment of its business and its prospects. For these purposes it knows better than anyone else the documentary material which is relevant to its assessment." In the circumstances, the appeal with respect to the catch-all paragraph was dismissed.

(b) In respect to the further disclosure paragraph, the Company effectively withdrew its appeal on this point during submissions and the Court of Appeal stated that the Company could not in any event successfully appeal against the concept of expert engagement in the process of disclosure.

(c) The Court of Appeal recognised that the issue of Dissenting Shareholder disclosure is of substantial importance in section 238 proceedings and this was the first time it had been considered on appeal. Finding that the Honourable Judge had erred fundamentally and in principle by creating a unique field for one-sided disclosure and had wrongly considered himself to be following a line of established authority in the form of Honourable Madame Justice Mangatal in *Homeinns*, the Court of Appeal held that Dissenting Shareholders should give relevant disclosure.

The appellate court considered that one-way disclosure was not appropriate on the central issue in s238 cases, namely the fair value issue. Recognising that the Dissenting Shareholders were professional, sophisticated investors who had taken the decision to invest in the company whose value was in issue, the Court ruled that the third party valuations in the Dissenter's possession, were just as relevant as the third party valuations in the possession of the company. Rix JA stated that it is unhealthy in the context of applications such as those before the court, and litigation generally, to form *a priori* assumptions about relevance. The normal rule is that disclosure is a mutual obligation and *"mutuality in this respect is equity and fairness"*. Rix JA commented that "*it is a strong thing indeed in the face of a general regime, to rule at an interlocutory hearing that documents that an expert says that he would find useful in the preparation of his report would not be permitted to him."*

Impact of the Judgments

As a result of these decisions, it should be assumed that the court will be more likely to apply a minority discount to s238 matters in future and will look to mutuality in respect to disclosure of material relevant to the determination of fair value. Both of these rulings are likely to have an impact on the legal landscape for Dissenting Shareholders seeking fair value determinations.

In particular, the impact of the minority discount on the likely amount which dissenting minority shareholders will be able to recoup will need to be an important commercial consideration for those inclined to dissent on the merger price. However, the quantification of the minority discount was not addressed in the Court of Appeal's judgment (as the discount to be applied, if

applicable, had been agreed by the experts), nor was it addressed in Segal J's judgment, nor by Jones J in *Integra* before him. Similarly, the English line of authority (including *Irvine v Irvine (No 2)* [2007] 1 BCLC 445) leaves the calculation of the minority discount to the valuers.

This is not to say, however, that there is no room for legal argument on how and when the minority discount may be applied going forwards. There is, for instance, a suggestion in the English authorities that there may be circumstances outside of the quasi-partnership scenario in which application of a minority discount would be contrary to the interests of fairness. In addition, there may well be circumstances in which valuers consider that a minority discount of 0% is appropriate. This is therefore likely to be an area in which the jurisprudence will continue to develop in the near future on appeal and in other matters.

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