LEGAL INSIGHT

Interim Payment Relief: New Developments Regarding Dissenters' Rights under Cayman Merger Law

Introduction

In our recent publication **Cayman Merger Take-Privates from NYSE and NASDAQ in 2016 – Year in Review**, we discussed some developing trends and lessons that can be learned from merger take-private acquisitions from U.S. stock exchanges completed[1] in 2016 using the Cayman Islands statutory merger regime[2] (the "**Cayman Merger Law**"), including our **Top 5 Lessons for the Buyout Group and for the Minority Shareholders**. In this first issue of our legal insights series regarding the Cayman Merger Law, we take a closer look at the first decision delivered by the Grand Court of the Cayman Islands regarding one of the 2016 merger take-privates[3].

Ability of Dissenting Shareholders to Seek Interim Payments

In an interim judgement issued on 26th January 2017 in the matter of Blackwell Partners LLC et al v. Qihoo 360 Technology Co Ltd., in a lengthy well-reasoned decision, Hon. Mr. Justice Charles Quin Q.C. decided that interim payments pursuant to the Grand Court Rules (G.C.R.)[4] could be requested by dissenting shareholders and granted by the Court during the judicial proceedings initiated to determine the "fair value" of the dissenters' shares under Section 238 of the Cayman Merger Law[5]. This decision brings a new and significant development for minority shareholders in their quest to obtain the "fair value" for their shares in the context of a merger take-private.

Overview of Typical Minority Shareholder Strategies:

Diligent minority shareholders typically learn of a merger take-private offer within days of the first press release by the company ("**Target**") which announces the receipt of an offer by the Board of Directors and the formation of a special committee of independent directors (the "**Special Committee**") to review the offer and negotiate on behalf of the Target. At this point several strategies become available:

1. Activism & Raising Concerns: Minority shareholders may look towards activist shareholders or take a more active role themselves, either writing to the Board of Target, or communicating to the other shareholders through public media. Any concerns that the minority shareholders may have about the proposed merger should be raised at this stage, such as the merger not being in the best interest of Target, the consideration being below Target's intrinsic value taking account of the Target's market share, market position, specialist technologies, accumulated cash position, holding of trading licences relating to certain specialist areas or assets, etc. Ideally, these concerns should be raised sufficiently early before any determination by the Board of Target as to whether or not to approve the offer and recommend it to Target's shareholders and the execution of the Merger Agreement. The aim of this approach is to ensure that the Special Committee will properly review the offer and in so doing request:

(i) in-depth information about the valuation of Target and the proposed financing and structuring of the merger, which may lead to an increase of the merger consideration negotiated by the Special Committee for the benefit of all shareholders; and/or

(ii) additional protections to benefit minority shareholders, such as "majority of minority" provisions in the Merger Agreement[6] in order to secure a better bargaining position for minority shareholders leading to the shareholders' meeting convened to approve the merger and the terms of the Merger Agreement.

2. Looking for Alternatives: If Target received an offer from the management group or a group composed of the management and certain private equity sponsors (the "**Buyout Group**"), activist shareholders may try to look for an alternative buyer, generally inviting third party interest, or associate with other sponsors to initiate a counter-offer. This strategy is based on the assumption that the Special Committee will be bound by its fiduciary duties to take into consideration any additional offers received, which may place upward pressures on the initial merger consideration proposed by the Buyout Group. However, the effectiveness of this strategy is generally limited by two factors:

(i) if the Buyout Group, including management of Target (generally in control of a significant number of votes), in the initial offer, clearly states that they do not intend to sell their shares in any alternative transaction, the interest of any third party buyer is greatly diminished (an alternative offer may be deemed "hostile" by the management of Target, and the third party purchaser may invest significant time and money in the proposal with very limited chances of success); and

(ii) the Special Committee will not be able to pursue an alternative offer which lacks substance (*i.e.* merger terms, financing, legal documentation, etc.) otherwise than as a simple manifestation of interest.

3. Blocking Completion: Minority shareholders may seek to file for an injunction to stay or stop the progress of the merger on the basis that the directors of Target are acting in breach of their fiduciary duties. This strategy is based on the fact that most merger agreements include, as one of the conditions to the closing of the merger, that no final order by a court or other governmental entity shall be in effect that prohibits the consummation of the merger or that makes the consummation of the merger illegal. As such, if minority shareholders are successful in obtaining an injunction and such injunction has not been reversed and is non-appealable, then the merger cannot become effective. In some cases, however, the aim of this strategy is not to block the merger but to engage in settlement discussions with the Target.

4. Exercising Dissenters' Rights: Minority shareholders may choose to dissent to the merger under Section 238 of the Companies Law, knowing that Target is required first to negotiate and, in the absence of an agreement with the dissenting shareholders as to the "fair value" of the shares, to file a petition with the Court for judicial determination of the "fair value" amount to be paid. In some cases, the Merger Agreement may include, as one of the conditions to the closing of the merger, that dissenting shareholders do not own more than a certain percentage (which may be in the range of 1% or 5%) of the shares of Target. When coupled with activism by dissenting shareholders, these clauses may put significant pressure on the Buyout Group and the management of Target.

Significance of the ruling in Blackwell Partners LLC et al v. Qihoo 360 Technology Co Ltd:

It is in the context of minority shareholders deciding whether to exercise their dissenting rights under Section 238 of the Companies Law that the interim judgement issued in Blackwell Partners LLC et al v. Qihoo 360 Technology Co Ltd. becomes most significant.

Qihoo 360 Technology is a leading Internet company in China, that was listed on the New York Stock Exchange (NYSE) and that was taken private using the Cayman Merger Law in 2016 for an aggregate merger offer price in excess of US$9billion. As part of the merger take-private transaction, a fairness opinion on the merger offer price of US$51.33 per share was issued by JP Morgan Asia and the merger was approved the Board of Directors in December 2015 and then by the shareholders in March 2016. However, a number of minority shareholders disagreed with the merger offer price and dissented under Section 238 of the Cayman Merger Law.

Without prejudice to the final determination of "fair value" for their shares, the dissenting shareholders immediately requested payment of an amount of US$16,892,549.01 representing the portion of the merger consideration they were entitled to, based on the US$51.33 merger offer price per share. They also requested security for their claims. They were refused on both counts and, failing agreement, the company had to apply to the Cayman Court to seek a "fair value" determination.

The dissenting shareholders presented as evidence two valuation reports indicating a value per share ranging between approximately US$124.4 and US$290.49 per share (well in excess of the merger offer of US$51.33 per share). While the fair value determination proceedings are still ongoing before the Court, the company agreed to pay into court a security deposit amounting to US$92 million, well in excess of the total value of their shareholdings of approximately US$16,892,549.01. The dissenting shareholders requested an interim payment in respect of their merger consideration because, they argued, whatever the outcome of the fair value determination, they would still be paid a substantial sum in respect of their shares. In an interim judgement issued on 26th January 2017, the Court decided in favour of the dissenting shareholders and ordered an interim payment of US$16,892,549.01, representing the portion of the merger consideration they were offered, based on the US$51.33 merger offer price per share.

1. New Interim Payment Relief: The judgment in this case has opened the door to petitions for interim payment being filed systematically by dissenting shareholders as part of the Section 238 proceedings, at least in the amount of the merger consideration which is offered generally to the shareholders. This will slightly change the balance of power in the negotiations between the Target and the dissenting shareholders, possibly encouraging settlement earlier in the process or for higher amounts.

2. Agreement on Security Deposit: The security payment made into court by the Target in this case had been more than five times the amount previously offered to the dissenting shareholders as "fair value", and likely contributed to the decision of the Court to grant an interim payment to the dissenting shareholders. However, in our view, the absence of an agreement as to a security deposit paid into Court should not prevent the Court from granting interim payments. Further guidance on this matter is expected as dissenting shareholders in other pending cases will likely request interim payments on account of the "fair value" of their shares being at least equal to the

offered merger consideration. As a reminder, O. 29, r. 12 of Grand Court Rules (G.C.R.) clearly state that the Court retains full discretion with respect to such interim payments:

> "*the Court may, if it thinks fit, and without prejudice to any contentions of the parties as to the nature or character of the sum to be paid by the defendant, order the defendant to make an interim payment of such amount as it thinks just, after taking into account any set-off, cross-claim or counterclaim on which the defendant may be entitled to rely*."

3. Amount of Interim Payments: At this early stage, it seems unlikely that any interim payments ordered as part of Section 238 proceedings will exceed the merger consideration as approved as part of the Merger Agreement. However, Blackwell Partners LLC et al v. Qihoo 360 Technology Co Ltd. does not expressly preclude the possibility of relying on expert evidence in order to determine that the "just" amount for an interim payment should exceed the merger consideration. As stated by Hon. Mr. Justice Charles Quin Q.C. in the interim judgement:

> "*75. (…) because of the limited nature of the Dissenters' expert evidence and the absence of expert evidence on behalf of the Petitioner, I do not wish to stray into the jurisdiction of the judge who will be making such a determination.*
>
> *76. It is for the Judge hearing the Petition to come to a determination of the fair value of the shares of all Dissenters after hearing expert evidence from both the petitioner and the Dissenters*."

Also, an argument can be made that if the Target itself, during negotiations with dissenting shareholders, offered an amount in excess of the original merger consideration (and if this fact is not disputed by the parties), the Court may take into account this higher figure.

Overall, even if it is quite early to tell, Blackwell Partners LLC et al v. Qihoo 360 Technology Co Ltd. will certainly impact dissenting shareholder strategies in the context of merger take-privates, and possibly contribute to the rising number of Section 238 petitions in the Cayman Islands.

This is not intended to be a substitute for specific legal advice or a legal opinion.
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[1] The word "complete" is used in this article to designate EGM shareholder approval of the merger and is not referring to the effective date of the merger (which is dependent upon filing) or the effective de-listing of the company.
[2] Part XVI (sections 232 to 239A) of the Cayman Islands Companies Law.

[3] Three other cases are pending (China Ming Yang Wind Power Group Limited, E-House (China) Holdings Limited, and E-Commerce China Dangdang Inc.)
[4] Order for interim payment in respect of sums other than damages (O.29, r.12).
[5] Under the Cayman Merger Law, shareholders who elect to dissent from the merger have the right to receive payment of the "fair value" of their shares if the merger is consummated, but only if they deliver to the company, before the shareholders' vote which approves the merger, a written objection (and then comply with all procedures and requirements of Section 238 of the Cayman Islands Companies Law)
[6] A "majority of minority" provision is a condition precedent to the closing of the merger, that the merger be approved by a majority of the shareholders that are unaffiliated with the Buyout Group.