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GLOBAL GUIDE 2018
PUBLIC MERGERS AND ACQUISITIONS

Dissenting shareholders in public M&A in Cayman Islands: recent developments

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INTRODUCTION

The Cayman Islands has been the leading offshore jurisdiction for M&A activity over the last few years, with a steady flow of over US$77billion in combined value of target companies for 2016 and 2017, and a peak of over US$115 billion in 2015. By way of comparison, in 2017, the combined value of transactions targeting companies incorporated in the British Virgin Islands (BVI) and Hong Kong was US$37 billion and US$40 billion respectively (*Global M&A Review 2017 report published by Bureau van Dijk*).

A significant portion of the M&A activity was related to merger take-privates (that is, transactions involving a group of investors purchasing all outstanding shares of a company's stock and returning it to a privately held company) of Cayman-incorporated companies listed on the US stock exchanges, which were achieved through the Cayman Islands statutory merger regime (Cayman Merger Law). The related transactions also generated a high volume of litigation in the Cayman Islands, as any shareholder who is unhappy with the consideration offered as part of a merger can dissent and is entitled to payment of fair value of its shares under section 238 of the Cayman Islands Companies Law (2018 Revision) (Companies Law). The fair value, if not agreed between the parties, is determined by the Grand Court of the Cayman Islands.

This article aims to review some of the major case law developments in 2017 in the context of the Cayman Merger Law and its use in merger take-private transactions of Cayman companies from international stock exchanges (for example, NYSE, NASDAQ, HKSE) as well as how these developments will affect the approach taken by dissenting shareholders in future merger take-private transactions for Cayman companies.

ABILITY OF DISSENTING SHAREHOLDERS TO SEEK INTERIM PAYMENTS

Under the Grand Court Rules, interim payments can be requested by dissenting shareholders and granted by the Grand Court during the judicial proceedings initiated to determine the "fair value" of the dissenters' shares under Section 238 of the Cayman Merger Law (*Blackwell Partners LLC et al v Qihoo 360 Technology Co Ltd, interim judgement of 26 January 2017*). This decision brought a significant development for minority shareholders in their quest to obtain the "fair value" for their shares in the context of a merger take-private.

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 which announces the receipt of an offer by the board of directors and the formation of a special committee of independent directors (Special Committee) to review the offer and negotiate on behalf of the company. At this point several strategies become available:

- **Activism and raising concerns.** Minority shareholders may look towards activist shareholders or take a more active role themselves, either writing to the board of the company and/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. These may include (among others):
  - the merger not being in the best interest of the company;
  - the consideration being below the company's intrinsic value taking account of the company's market share;
  - the company's market position;
  - specialist technologies;
  - the accumulated cash position; or
  - the holding of trading licences relating to certain specialist areas or assets.
- Ideally, these concerns should be raised sufficiently early before any determination by the board of the company regarding the approval of the offer and recommendation to company'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 obtain:
  - in-depth information about the valuation of company and the proposed financing and structuring of the merger, that may lead to an increase of the merger consideration negotiated by the Special Committee for the benefit of all shareholders; and/or
  - additional protections to benefit minority shareholders, such as "majority of minority" provisions in the merger agreement 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.
- **Looking for alternatives.** If the target company 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 the following factors:
  - if the buyout group, including the management team of the target company (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 team of the target company, and the third party purchaser may invest significant time and money in the proposal with very limited chances of success); and

- the Special Committee will not be able to pursue an alternative offer which lacks substance (that is, merger terms, financing, legal documentation, and so on) other than as a simple manifestation of interest.

- **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 the target company 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 will 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 company and/or the buyout group.

- **Exercising dissenters' rights.** Minority shareholders may choose to dissent to the merger under section 238 of the Companies Law, knowing that the target company must negotiate first and must file a petition with the court for judicial determination of the "fair value" amount to be paid (in the absence of an agreement with the dissenting shareholders as to the "fair value" of the shares). In some cases, the merger agreement may include a condition, as one of the conditions to the closing of the merger, that dissenting shareholders do not own more than a certain percentage (usually in the range of 1% to 5%) of the shares of the target company. When coupled with activism by dissenting shareholders, these clauses may put significant pressure on the buyout group and the management team of the target company.

Information can also be disclosed during court proceedings for a judicial determination of the "fair value" that could later lead to a securities class action in a US court or other jurisdiction where the target company was listed.

SIGNIFICANCE OF THE RULING IN *BLACKWELL PARTNERS V QIHOO*

The interim judgement issued *in Blackwell Partners LLC et al v Qihoo 360 Technology Co Ltd* became very significant in the context of minority shareholders deciding whether to exercise their dissenting rights under section 238 of the Companies Law.

New interim payment relief

The judgment in the *Blackwell Partners v Qihoo* 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 could potentially change the balance of power to some extent in the negotiations between the target company and the dissenting shareholders, possibly encouraging settlement earlier in the process or for higher amounts.

Agreement on security deposit

The security payment made to the court by the target company in the *Blackwell Partners v Qihoo* case was over 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, it is possible that the absence of an agreement as to a security deposit paid into court would not prevent the court from granting interim payments.

The Grand Court Rules clearly state that the court retains full discretion with respect to interim payments and can order the defendant to make an interim payment of any amount the court thinks just, after considering any set-off, cross-claim or counterclaim on which the defendant may be entitled to rely (*O 29, r 12, Grand Court Rules*).

Amount of interim payments

It seems unlikely that any interim payments ordered as part of Section 238 proceedings will exceed the merger consideration approved as part of the merger agreement. However, *Blackwell Partners v Qihoo* does not expressly preclude the possibility of relying on expert evidence to determine that the "just" amount for an interim payment should exceed the merger consideration.

Overall, it is still too early to tell the extent to which *Blackwell Partners v Qihoo* has or will 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.

BUILDING BLOCKS OF THE DISSENTERS' RIGHTS TO INTERIM RELIEF

The ruling in *Qunar Cayman Islands Ltd* builds on the reasoning previously adopted by the court in the *Blackwell Partners v Qihoo* case and provides further guidance on interim relief available as part of proceedings initiated under Section 238 of the Cayman Merger Law.

The availability of interim relief is confirmed. The ruling in the *Qunar Cayman Islands Ltd* case followed the ruling in the *Blackwell Partners v Qihoo* case and confirmed that requests for interim payment can be made by dissenting shareholders as part of the section 238 proceedings, and that the court has jurisdiction to grant such payments, in an amount determined to be "just". In the matter of *Qunar Cayman Islands Ltd,* the "just" payment was deemed to be equal to the amount of the merger consideration which had been offered generally to the shareholders by the company.

At this 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, especially if, as was the case in *Qunar Cayman Islands Ltd*, the request for interim relief had been made before any expert report was submitted on valuation issues. For the purposes of interim relief, however, the court appears willing and able to rely entirely on the company's affirmations that the merger price represented the fair value of shares, without requiring dissenters to present any additional "fair value" evidence.

In *Qunar Cayman Islands Ltd*, and taking account that interim payments in the context of judicial proceedings initiated under section 238 of the Cayman Merger Law are a new development, the court decided not to grant the dissenters' request that the company bear the costs of the application. However, in the future, it cannot be excluded that such request for costs may be granted by the court.

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