

Shanda Games, Homeinns Hotel Group and Qihoo: recent case-law concerning the Cayman Islands statutory merger regime

The Grand Court of the Cayman Islands has delivered three decisions concerning the statutory merger regime under section 238 of the Companies Law, which is typically triggered by the taking private of a publically listed Cayman Islands company. S.238 requires the Court to determine the “fair value” of shares compulsorily purchased from a shareholder who dissents from the merger. All three cases involved the same investors as dissenting shareholders.^[1]

Most significantly, the judgment of Segal J in *Shanda Games Limited*^[2] is the second Cayman Islands judgment to arise from a contested trial of a valuation dispute since the merger regime was introduced in 2009. In summary, the Court endorsed the approach taken by Jones J in the *Integra*^[3] case, and Delaware jurisprudence, insofar as “fair value” is to be determined on the basis of the company being a going concern, and without any minority discount. The judgment also addressed many technical issues of valuation methodology that will be of interest to specialists in this field.

The Court has also delivered two interlocutory judgments: *Homeinns Hotel Group*^[4] concerns the parties’ discovery obligations in *fair value* cases; and *Qihoo*^[5] concerns whether the dissenting shareholder is entitled to an interim payment, pending final determination of the price to be paid for its shares.

Shanda Games

Factual background

Shanda Games Limited (“**Shanda**”) is a Cayman Islands company that operates a multi-billion-dollar Chinese online gaming business. Shanda issued ordinary shares and “American Depositary Shares” (“**ADSs**”) that were listed on the NASDAQ. In 2016, Shanda was taken-private by means of a management buy-out which was structured in the form of a merger and subsequent de-listing. The merger was approved by 99.03% of Shanda’s shareholders, at a price of US\$7.10 per ASD. The dissenting shareholders, which together held a 0.07% stake (the “**Dissenters**”), were required to be bought-out at fair value under the s.238 regime. While Shanda made the Dissenters an interim payment at the merger price per share, the fair-value price was disputed.

Litigation

During the year after the date of the merger, Shanda and the Dissenters litigated their dispute about the fair value payable for the compulsory purchase of the Dissenters’ shares. Shanda offered to pay US\$9.56 per ASD (revised to US\$10.84 during trial), whereas the Dissenters claimed a price of US\$27.16 per ADS.

Each party relied upon expert evidence in support of their position; Shanda's expert was a statistics professor, whereas the Dissenters instructed an accountant specialising in valuations. The expert evidence was crucial in a number of respects, as summarised below. Before turning to that evidence, however, the Court was required to address a question of legal principle.

Decision on a question of legal principle: no minority discount

The Court was required to decide whether any minority discount should be applied to the price otherwise payable for the Dissenter's shares. Shanda's position was that a minority discount *should* be applied, despite the Court having taken the contrary approach in *Integra*, consistent with Delaware and Canadian case-law. Shanda argued that (i) in *Integra* the Court had not heard legal submissions about this question because the principle of applying no minority discount had been agreed between the parties and (ii) English authorities dealing with buy-outs and minority prejudice were valued by applying a minority discount. The Court rejected these arguments, and affirmed the principle that no minority discount should be applied. Instead, the Court must simply establish the fair value of the company as a going concern immediately prior to the merger, and then award the Dissenters their proportionate share of that value. In doing so, the Court assesses the fair value afresh, rather than by reference to the merger price.

Decision on questions of valuation methodology

Although s.238 does not dictate any particular valuation methodology, the parties' experts agreed that the valuation of Shanda should be done on the basis of a discounted cash-flow ("**DCF**") model. However, the experts disagreed about many details of how to apply that model. Many of the points of disagreement concerned technical valuation questions, which we summarise briefly, below.

The overarching importance of this decision, however, is to confirm that the Court will conduct a detailed and forensic examination of the expert evidence which will be tested exhaustively via cross-examination and legal submissions. The parties' choice of expert, and the analytical rigour of each expert's analysis, will be critical to their success. In *Shanda*, the Dissenters' expert in general provided a more logical and sustainable analysis, and in several instances Shanda's expert modified his own opinion during the course of the trial. The Dissenters' expert had also made many detailed enquires of Shanda during the litigation, and sometimes received unsatisfactory responses – which led to adverse inferences being drawn by the Court against Shanda at trial.

The main valuation issues considered in *Shanda* were:

- **Depreciation:** Any estimate of depreciation of the company's assets must be based upon realistic and reasonable assumptions that are capable of proper justification. In this case, it was incorrect of Shanda's expert to have correlated the rate of depreciation with the company's anticipated revenues, rather than simply its anticipated capital expenditure and the resulting reduction in value over time.
- **Trading results between the date of the company's internal valuations and the merger valuation date:** it is proper for the valuation to take account of information relating to the company's trading that occurs at any point up until the valuation date. In this case, the Dissenters' expert had rightly taken account of the unexpected success of some of Shanda's products shortly before the valuation date, and after the company

had produced its own more pessimistic financial projections.

- **Two or three valuation stages?** The DCF model takes account of growth forecasts, which will typically decline over time. In some cases, there may be a dispute over whether the forecasts should be based upon two or three stages, and this can have an impact on the valuation. In general, a three-stage model will be required where there would otherwise be a very significant difference between the growth forecasts modelled at stages one and two. That applied in Shanda's case, and so the Court agreed with the Dissenters' expert who had adopted a three-stage model.
- **Beta:** The Court considered various fact-specific matters regarding the calculation of "*beta*", which represents the actual or anticipated performance of the company against the market. However, the Court also considered some questions of general principle: the beta must be calculated using data that is not "*stale*", and peer-group betas should also be relied upon where the circumstances suggest it would be helpful to do so. The Court would need to consider the reliability of the company's own beta, and the comparability of the peer-group, in order to reach a conclusion on this point. In Shanda's case, the Court agreed with the Dissenters' expert who considered that peer-group data was helpful. Further, the Court could "*blend*" the betas suggested by the parties experts, where there was uncertainty about the correctness of either calculation. The Court adopted such an approach in *Shanda*, by holding that Shanda's beta was half-way between each of the experts' figures.

Conclusion

Despite considering the applicable valuation methodology in great detail, the Court did not reach a conclusion about the actual price payable in respect of the Dissenters' shares; certain matters have been referred back to the parties and their experts on the basis that they should now reach an agreement. Overall, though, the Dissenters prevailed and they will expect to receive a very substantial uplift on the merger price.

Homeinns Hotel Group

This case examined the extent of discovery by the parties which is necessary to determine the fair value of the company's shares in a s.238 application.

A petition was filed by Homeinns Hotel Group ("**Homeinns**") as required by s.238(9) of the Companies Law, and Homeinns requested that the Court list the petition for a directions hearing to determine the procedure for discovery and inspection of documents.

The fundamental dispute between the parties was in relation to the process of discovery. Although Homeinns' objections to discovery via an electronic data room had fallen away, it argued that the ordinary principles and practices of discovery should apply, and that it was not the time for the Dissenters to seek discovery of certain documents (amounting to a specific discovery application). The Dissenters argued that, without prejudice to the obligation to disclose all documents relevant to fair value, the order should refer specifically to certain relevant classes of documents required to be uploaded to the data room.

Mangatal J was assisted by the guidance in *Integra* in relation to the relevant principles and issues in s.238 cases, although the directions made in *Integra* could not be regarded as "*precedent*" because assessing the fair value is

very fact based.

The Court found in favour of the Dissenters, such that the discovery order would include certain specific documents that must have been readily accessible by the Petitioner, and held that the experts and the Court are to have regard to all relevant documents and information (not just publicly available information). The Court refused to make a standard order under Order 24 of the Grand Court Rules (the “GCR”) for disclosure by both parties, because it was not in keeping with the purposes of s.238 to require the Dissenters to give discovery.

The Court agreed with the Dissenters’ proposal to upload to the data room any additional documents and information that either expert considered necessary, and requests by the experts for additional information should be on a rolling basis but with a cut-off point. The Court also held that English translations of documents should only be provided when they were available, in keeping with the well-established principle that a party that is compelled to disclose documents should not be obliged to translate each foreign document. It is for the party seeking to rely upon the document to translate it.

Qihoo

This matter considered whether Dissenters could receive an interim payment in s.238 proceedings or whether the provisions of s.238 are a self-contained statutory code which does not permit any discretionary overlap for an interim payment.

Qihoo 360 Technology Co. Ltd. (the “Qihoo”) was a Cayman Islands company which announced that it had entered into a merger with various companies. The Dissenters who held 329,097 shares in Qihoo objected to the merger, and sought orders that Qihoo make interim payments out of the US\$92 million paid by the Petitioner into Court.

The Dissenters applied pursuant to GCR O.29 r.10 for an interim payment “*of such amount as [the Court] thinks just....*”, and their position was that the Court should award an interim payment of the entire US\$92 million.

Qihoo argued that there was nothing in section 238 to permit any interim payment. Instead, the s.238 petition was said to constitute a self-contained statutory code with no scope for any discretionary overlap for interim payments under GCR. O. 29. Further, Qihoo argued that interim payments are only available under GCR O.29, r.10(3)(a) where the claimant is owed a debt or is entitled to damages or some other sum, whereas the Dissenters simply had the right to be paid fair value for their shares (to be agreed or determined via the s.238 procedure).

Quin J disagreed with Qihoo and held that a fair value determination by the Court in s.238 proceedings came within the interpretation of “*interim payment*” pursuant to GCR O.29 r.9 by constituting an “*other sum*” which the petitioner will be liable to pay to the dissenting shareholders together with a “*fair rate of interest...*”. Furthermore, s.238 petitions constituted “*proceedings otherwise than by writ, where one party seeks an order for an interim payment to be made by another*” pursuant to GCR 0.29 r.18 and therefore GCR 0.29 r.9-18 applied to the proceedings.

Quin J held that as Qihoo paid US\$92 million into Court pursuant to GCR 0.22, the Dissenters would obtain “*judgment against [the Petitioner] for a substantial sum of money*” pursuant to GCR 0.29 r.12. The Court

awarded the Dissenters the sum of US\$16,892,549.01, which was the Petitioner’s own stated fair value of the shares, based upon the merger price of US\$51.33 per share.

In reaching his decision, Quin J found “*considerable force*” in the Dissenters’ reliance on the dicta of Jones J in *Integra*, where he noted that the petitioner had had the use of the dissenters’ funds for a considerable amount of time. An interim payment redresses the balance, to some degree.

[1] Blackwell Partners, Crown Managed Accounts and Maso Capital Investments entities.

[2] *In the matter of Shanda Games Limited* (unreported, 25 April 2017).

[3] *In the matter of Integra Group* (unreported, 28 August 2015).

[4] *Homeinns Hotel Group v Maso Capital Investments Limited and others* (unreported, 7 February 2017).

[5] *Blackwell Partners LLC – Series A and others v Qihoo 360 Technology Co. Ltd* (unreported, 26 January 2017).



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