Going private: How to obtain fair value under the Cayman statutory mergers

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You already know that a ‘going private’ transaction is one that results in a publicly traded company ceases to be publicly traded.

Did you know that a large number of the public companies listed on stock exchanges around the world are incorporated in the Cayman Islands, even if their primary headquarters and operations are not?

Companies choose to go private for a whole host of reasons, including to save on legal, accounting and compliance costs; to realize the full value of the company (eg, if it is perceived to be trading at an undervalued price); to give the management of the company the opportunity to re-focus on long-term goals rather than market expectations; and to give them greater flexibility outside the confines of the relevant listing rules.

Deal structure

Broadly, a going private transaction is typically structured as a merger, a scheme of arrangement or a tender offer. The structure used is determined by factors such as how widely the shares of the company are held (eg, if the bidder has a controlling interest, it is likely a merger will be the preferred route), market practices and regulatory and listing rule requirements.

The transactions involving Cayman companies listed on US exchanges that our firm has advised on have all been structured as ‘reverse triangular mergers’ using the statutory merger regime under the Cayman Islands Companies Law (the Law). In this structure, the bidder incorporates a new Cayman company for the sole purpose of merging with and being subsumed by the listed company, which survives the process and de-lists.

There are several advantages to structuring the deal in this way, including speed of execution (as the merger subsidiary only has one shareholder, ie, the bidder) and the fact that contracts or other assets of the target do not need to be transferred or assigned. In addition, the fact that the target will essentially become a subsidiary of the bidder on completion means that potential liabilities of the target company are ring-fenced from the assets of the bidder.

Dissenting shareholders

One of the key features of the statutory merger regime is that it affords a certainty of outcome to bidders who are confident of their ability to reach the required shareholder approval threshold to effect the merger. This resonates with the examples we have seen in the context of merging Chinese companies, where there is often a large controlling (usually founding) shareholder.

The corollary of this is that options available to minority shareholders in such circumstances are somewhat limited. Essentially, minority shareholders can seek to frustrate the merger process by mustering sufficient votes to prevent its approval, by looking for procedural or other defects in the way the merger process has been conducted, or they can rely on the appraisal rights given to them under the Law. The latter provides
that if shareholders dissent, their rights as shareholders shall cease and shall be converted into a right to be paid 'fair value' for their shares. The Law provides a mechanism for this to be determined by the court if the shareholders and the company cannot agree.

Integra: a milestone ruling

On August 28, the Grand Court of the Cayman Islands released its decision in In The Matter Of Integra Group. This case was the first time the Cayman Islands Court ruled on what constitutes 'fair value' in the context of a statutory merger under the Law.

By way of background, Integra was an oil field services provider which was incorporated in the Cayman Islands and listed on the London Stock Exchange. In December 2013, the management team presented an offer to purchase all of its outstanding shares for US$10 per share. The board resolved to establish a committee of independent directors empowered to accept or reject the offer. The independent committee engaged Deutsche Bank AG to produce a fairness opinion and they subsequently opined that the offer price was fair. It represented a premium of approximately 45 per cent over the average market price on the London Stock Exchange during the previous 30 days.

The deal was structured as a statutory merger. Three investment funds managed by the same investment manager holding, in aggregate, approximately 17 per cent of the issued shares dissented and, ultimately, the Grand Court in the Cayman Islands was required to determine what constituted 'fair value' for the dissenting shareholders' shares.

The Court ruled in favour of the dissenting shareholders and held that the 'fair value' was, in fact, US$11.70 per share.

The judgment goes to great lengths to point out that assessing fair value is a fact-based exercise in each case, which requires an important element of judgment by the Court.

What 'fair value' really means

The Court held that fair value was a shareholder’s pro-rata share of the value of the company’s business as a going concern at the date of the extraordinary general meeting to approve the merger. Importantly, this amount should be without reference to any minority discount or any premium for the forcible taking of shares.

The Court stated that no value adjustment should be made for results attributable to the transaction from which dissenting shareholders have dissented, whether positive or negative.

In the context of a going private transaction, the Court found that 'the cost saving of going private is an inherent result of the transaction from which the [dissenting shareholder] has dissented .... [D]issenting shareholders should not benefit from any enhancement in the value of their shareholding attributable directly to the transaction from which they have dissented.'

How the Court determined the valuation

The Law does not dictate any particular approach. The Cayman Court cited Canadian and Delaware jurisprudence, which establishes that fair value should be proved by any techniques or methods which are generally considered acceptable in the financial community and are otherwise admissible in court.

In Integra, experts appointed by each of the parties opined on what they considered to be fair value and came to different conclusions. Ultimately, based on the facts, the Court preferred the dissenters' expert's methodology.

In regards to using trading prices to determine fair value, interestingly, the Court ruled that the fact that a company’s shares are listed on a major stock exchange will not lead the Court to determine that a valuation methodology based upon its publicly traded price is necessarily the most reliable approach. Whether this valuation methodology is appropriate will depend on the facts, including whether there is a well-informed and liquid market with a large, widely held fee float.

What this means
The Integra case should not be seen as something that will necessarily open the floodgates to a wave of dissenting shareholder petitions. The Court, citing a Canadian authority, made the point that ‘dissenting shareholders are not entitled to a better value than other shareholders simply because they are dissenting.’

However, the approach taken by the Court should provide market participants, especially, minority shareholders, with significant comfort that the Cayman Islands Court will approach the appraisal process in a robust and sensible way.

In addition, boards of directors of companies involved in similar transactions should be on notice of the requirement to obtain (and be seen to be obtaining) fair value to protect against claims. To this end, it is likely that the processes they adopt, such as the establishment of independent committees to consider the merger and obtaining third party professional fair value opinions, will come under greater scrutiny.

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