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UPDATE

Demystifying the de-listing process: guidance on section 238 fair valuation

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According to the Financial Times and Dealogic, in the past two years, there were 37 de-listings of Chinese companies in the US with a total deal value of more than US$33 billion. By and large, the company is de-listed from a prominent US exchange and subsequently re-listed in China at a far higher price to take advantage of investor confidence in the company's pedigree. These de-listings are colloquially referred to as 'take-privates'. On any view, this is an enormous market and one that has caused a flurry of activity in the Cayman Islands, where a significant proportion of these companies are domiciled.

Given the significant sums at stake, two recent decisions of Mr Justice Segal in In the Matter of Shanda Games Limited have provided much needed clarity and further guidance on the correct determination of fair value under section 238 of the Companies Law. These decisions follow the only other judicial determination of fair value pursuant to section 238, handed down last year by Mr Justice Jones QC in Re Integra Group (our update on that decision can be found here). In both cases, by challenging the original valuation, the dissenting shareholders benefited from a substantial uplift. The section 238 regime is designed to afford disgruntled shareholders an opportunity to obtain a ruling on the fair value of the company as at the date of the meeting to approve the 'take-private' transaction. We discuss the forensic analysis and reasoning in Shanda Games below.

Shanda Games Limited (**Shanda**) is a Cayman Islands company listed on the NASDAQ. Shanda Group was founded by a husband and wife duo and, according to its website, began life as a small online games company with an initial investment of US$50,000. By 2004, it was reportedly the largest internet-based company in China by market capitalisation.

Between listing its American Depositary Shares (**ADS**) in 2009 and late December 2013, Shanda's offering price per share fell from US$12.50 to approximately US$5.50. The following month, Shanda put forward a 'take-private' offer of US$6.90 per share. This led to a drawn out negotiation involving a number of interested parties, including: management; advisers; and shareholders. Following the conclusion of the negotiations, Shanda increased the offer price to US$7.10 per share and, at an extraordinary general meeting (**EGM**) in November 2015, the merger was approved by 99.3 per cent of those who voted. However, certain minority shareholders were dissatisfied and exercised their rights under section 238 to object to the merger, triggering the fair valuation procedure. On the basis that the EGM offer price had already been approved by an independent adviser, Shanda made an interim payment of US$7.10 per share prior to the Court's determination of fair value.[1] Based on expert reports and live evidence, the valuation parameters were set by the respective experts at trial between US$10.84 and US$27.16 per ADS.

Last month, Segal J handed down his fair valuation findings and confirmed the principles to be applied when reaching a determination in this area. Having received final calculations from the respective experts,

[1] Our March 2017 article discussing the Grand Court's decision in *Qihoo 360 Technology Co. Ltd* and the Court's jurisdiction to order a company to make interim payments to section 238 dissenters can be found here.

following his substantive judgment, he has now held that the fair value is US$16.68, ie more than double the initial offering.

Shanda Games considers a range of valuation issues but provides helpful guidance on two questions in particular: should minority discounts be applied in section 238 fair value determinations and should the dissenting shareholders' entitlement to a proportionate share fixed at the valuation date, be diluted as a result of unvested stock options?

Based on final judgments in *Shanda Games* and *Integra*, applying well-established principles of Canadian and Delaware law, it appears that the position in Cayman is now settled as follows:

1. there should be no minority discount applied to dissenters' shares. This point was agreed between the parties in Integra but disputed in Shanda Games. Segal J dismissed arguments raised by Shanda in relation to minority discount on the basis that the valuation relates to dissenters' interests in the entire company, not a particular voting block or portion of shares. Fair value, as contemplated by section 238, means determining the correct proportionate share of the capital and value of the company treated as a going concern;[2] and
2. where stock options are given as a result of a particular transaction and are conditional upon that transaction being approved, dissenting shareholders should not bear any diminution in the value of their investment directly attributable to the transaction from which they were entitled to dissent[3] and, although it was not necessary for him to decide the point, Segal J stated that if '... the right to have the shares issued was conditional on and could only take effect upon the closing of the merger ... then the Dissenting Shareholders should not be affected by a change in their interest in Shanda which came about in consequence of the merger'.[4]

It is important to be aware that, in respect of stock options, the analysis is likely to be very fact-sensitive and will largely depend on the terms of restricted stock units or employee stock options. Segal J was not taken to the terms of the employee stock options in the *Shanda Games* trial and therefore could not determine whether such options were conditional upon the merger going ahead. Although he did not make a finding on that point, he did state that:

> ... if employees and holders had the rights to subscribe for and to the issue of shares in Shanda which were exercisable as at the Valuation Date without reference to or reliance on the merger (so that such rights were not conditional or dependent on the merger) then the Dissenting Shareholders' interest in Shanda was always subject to the issue of further shares and at risk of being diluted by shares issued to the holders and employees.

Therefore, in future cases, if employees are able to exercise stock options as at the relevant valuation date, irrespective of the outcome of the merger or transaction, then dissenting shareholders may be at risk of losing value due to the dilution of the pool.

One point that remains unclear is how the costs incurred as a result of the merger or any other transaction, particularly in resolving fair valuation issues, should be treated in each case. In *Shanda Games*, Segal J ordered that all merger costs incurred prior to the relevant valuation date be deducted from the equity value of Shanda. However, as he was not taken to authorities from other jurisdictions on this point, Segal J declined to decide whether costs associated with dissenter applications should be deducted from the equity value or incurred for the dissenting shareholders' account. We understand that the dissenting shareholders will seek an order for costs in due course.

At the conclusion of trial, Segal J directed that further evidence and submissions be filed in respect of the appropriate calculation of interest. In a separate judgment handed down on 17 May 2017, Segal J dealt with the fair rate of interest to be applied to the shares of the dissenting shareholders. In reaching his conclusion on interest, Segal J formed the view that it was necessary to balance the rate that the surviving company would pay to borrow the amount of the judgment sum (the **Borrowing Rate**) as against the rate that a prudent investor would have earned on the sum (the **Prudent Investor Rate**).

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[2] Paragraph 93 *In the Matter of Shanda Games Limited*.

[3] Paragraph 70 in *Re Integra Group* [2016] 1 CILR 192.

[4] Paragraph 179(d) *In the Matter of Shanda Games Limited*.

In relation to the Borrower Rate, it was held that, because Shanda is debt-free and has ample revenue, it was appropriate to treat Shanda as a prime borrower. If treated in that way, Segal J was convinced that the prime rate of 3.5 per cent was the correct Borrowing Rate. Determining the Prudent Investor Rate, similar to assessing loss of investment opportunity in any litigation damages context, is a more complex task. The Court was presented with evidence that the index for investment grade corporate bonds was a relatively low risk and sensible investment. Such bonds produced a rate of 5.09 per cent and, although the Court accepted that a prudent investor would be likely to diversify its portfolio, the Court accepted that as the Prudent Investor Rate.

On that basis, it was concluded that the fair rate of interest in *Shanda* was 4.295 per cent. That figure represents the mid-point between 3.5 per cent, the Borrowing Rate, and 5.09 per cent, the Prudent Investor Rate. Jones J applied a similar logic in relation to the fair rate of interest in *Integra*. He also decided to adopt the mid-point approach, which effectively struck a balance between the benefit derived by the company as a result of being able to use the judgment sum; and the loss suffered by the dissenting shareholders by losing the opportunity to invest the judgment sum elsewhere.

Although the core legal principles remain intact, it is clear from the judgments in *Integra* and *Shanda Games* that, when determining fair value pursuant to section 238, much will depend on the expert evidence and the underlying facts. The centrality of the role of the experts was underlined by Mangatal J in her recent interlocutory decision in *Homeinns Hotel Group* regarding the scope of disclosure to be provided to experts (see link to our recent article in relation to that decision here). Jones J also made it clear in *Integra* that the respective valuation experts must be provided with all the material they require to prepare their valuations reports. The Court will be conscious that the company has far more control over the documentation than the dissenting shareholders and, for that reason, has been willing to draw negative inferences from a company's failure to comply with their disclosure obligation.

There are still a number of ongoing disputes in this area and dissenting shareholders will be encouraged by recent developments. However, it is clear that each valuation will depend on the particular facts and methodologies preferred in *Shanda Games* may not be appropriate in every instance. Judges and experts are looking at the entire factual matrix in each case including, for example, revenue streams and market reputation. Although the basic principles may be slightly clearer, we anticipate more activity in this space as advisers, shareholders and management come to grips with the section 238 regime.

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