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UPDATE

Trina Solar Limited and the meaning of 'fair value' in s.238 fair value appraisal cases

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This is the first case to consider the decision of the Privy Council in *Shanda Games*. The Court held that it is not bound to determine value based only on a hypothetical sale on the open market, but rather must assess all relevant facts and matters and can adopt any relevant valuation methodologies. In doing so, the Court must ensure that the sum selected properly reflects the true monetary worth to the shareholder of what he has lost. In this case, it was found that a blended approach to the valuation methodologies was appropriate but the Court has yet to determine whether fair value exceeds the merger price.

Background

Trina Solar Limited (the **Company**) was listed on the NYSE and manufactures and sells solar photovoltaic modules (solar panels). On 12 December 2015 the Buyer Group, which included the Company's CEO, presented a proposal to acquire the Company at a price of US$11.60 per ADS or US$0.232 per ordinary share (the **Merger Price**). On 16 December 2016 (the **Valuation Date**), the Company's shareholders approved the merger. Two shareholders exercised their rights to dissent (the **Dissenters**).

The proposed valuation methodologies

The Company argued that the Court should look only to the adjusted market price (**Adjusted Market Price**), (namely the price at which the shares would have been bought and sold as at the Valuation Date in the absence of any proposed merger) or in the alternative, the negotiated merger price. The Dissenters argued for complete reliance on the DCF valuation because *inter alia*, it is a direct measure of intrinsic value. The Company submitted that the DCF methodology was wholly unreliable not least due to the significant divergence between the experts as to the appropriate DCF inputs and the hugely varying outputs[1].

Shanda Games and the meaning of fair value

The Company relied on the *Shanda* Decision in the Privy Council (the **Shanda Decision**) as authority for the proposition that the Court was required to determine the price at which the shares would be exchanged *between a willing buyer and a willing seller in an arms-length transaction based on publicly available information* (the **Hypothetical Transaction Approach**). In doing so, the Company contended that market price reigned supreme.

The Court rejected this submission, partly on the basis that it would negate the purpose of section 238. The Court found that the Shanda Decision did not require it to adopt the Hypothetical Transaction Approach or any

[1] *The Dissenters' (pre-minority discount) DCF valuation produced an output of US$197.13 per ADS, as compared to the Company's proposed (pre-minority discount) DCF valuation of US$9.48 per ADS.*

other valuation approach. In ascertaining fair value, the Court must assess, taking into consideration all relevant facts and matters, the true monetary worth of the dissenting shareholders' shares. This sum must be undistorted by the limitations and flaws of particular valuation methodologies *fairly balancing, where appropriate, the competing, reasonably reliable alternative approaches to valuation relied on by the parties*.

The Decision

Having concluded that all valuation methodologies were available, the Court embarked on an exhaustive analysis before accepting the approach of the Company's expert in almost all regards. The Court concluded that fair value should be calculated with reference to 30% to the Adjusted Market Price, 45% to the Merger Price, and 25% to the DCF analysis. This may lead to a share price below merger price, given that the Adjusted Market Price yields a value per share of less than the Merger Price and the DCF is almost exclusively based on the Company's expert's analysis.

Adjusted Market Price (30%)

The Court found that where there was sufficient evidence to demonstrate that the market was semi-strong efficient it is, in principle, appropriate to give some weight to the market price.

The Court concluded that in this case, there was sufficient evidence to demonstrate that the requirements for *a semi-strong version of the efficient market hypothesis* were met. This conclusion was reached despite the fact that the Company's expert did not conduct an event study and relied instead on a 'trend based analysis'. However, the weight given to market price was reduced as a result of this omission and as a result of a concession that the market price might be understated by as much as 20%. A further reduction was made on the basis that the Buyer Group had been privy to certain financial information which was not available to the market. No reduction in weight was made for the 'China Effect' which was, once again, found to be based on flimsy evidence.

Merger Price (45%)

The Court held that the merger price can be evidence of fair value where the transaction process was properly conducted. The Court must be satisfied that the market was adequately tested and that there is sufficient evidence that market conditions were such as to facilitate an arm's length transaction with all potentially interested parties. The Court must be persuaded that *there is sufficient evidence of market efficiency, fair play, low barriers to entry, outreach to all logical buyers and a well-designed sales process*. However, the Court held that it could take into account the Merger Price even though it considered that there were flaws in the process, which should be balanced against aspects of the process which were considered reasonable.

The Court found that the test had to some extent been met and gave some weight to Merger Price because (i) the Buyer Group was not in a position to force through the merger with only 5.6% shareholding in the Company; (ii) over 97% of the Company's shareholders approved the merger; (iii) the market in the Company's shares was liquid; (iv) the timing of the acquisition (which was not unfavourable to the Company); and (v) there was no opposition from large and independent institutional investors.

However the weight ascribed to the Merger Price was reduced because of concerns surrounding the governance and effectiveness of the merger process and the deficiencies relating to the market check and scrutiny of the management projections.

One interesting area of the Merger Price discussion was the reliability of a Fairness Opinion prepared by Citi. The Dissenters argued that if the Fairness Opinion was flawed then it must follow that the Special Committee was misled into concluding that the merger price was adequate and into recommending the merger. The Court rejected the attack on the Fairness Opinion concluding, *inter alia*, that it was not possible to safely challenge and criticize Citi’s valuations without having access to Citi’s underlying model. Implicitly the Court must have thought that the Dissenters should have obtained such evidence.

DCF Analysis (25%)

In opposition to the Dissenters (and at odds with its own expert) the Company submitted that no reliance should be placed on a DCF, arguing it to be wholly unreliable. The Company argued that US decisions have suggested caution in relation to the flexibility and potential subjectivity inherent in the use of a DCF methodology. The Court accepted that there were real risks in a DCF, but did not consider that the risks are sufficient to justify a refusal to consider it and give, in an appropriate case, appropriate weight to a DCF valuation.

Much of the DCF discussion was fact specific and in almost all respects the Company's expert's evidence was preferred, however a number of interesting issues arose:

Management Projections:

The Court found that the starting point for determining the reasonableness and reliability of management's projections is to ask whether the projections were prepared in good faith by a competent management team which understands the business and is capable of making informed judgments about its future performance. In the absence of some contemporaneous evidence showing some serious failure in management's general approach to the preparation of the projections, the Court must consider whether they are obviously wrong, careless or tainted by an improper purpose before excluding them. This was termed the *general reliability test*.

The Court would be slow to allow expert witnesses to substitute their judgement for the judgements of those with intimate inside business knowledge; however, the level of caution will vary depending on the outcome of the general reliability test.

In the present case, the Court was concerned that the Special Committee failed to shield the preparation of the management projections from the influence of a senior stakeholder on the buyer-side and failed to adduce evidence to support the projections. Accordingly, the Court refused to give the management projections weight where the experts disputed the inputs and would instead decide those disputes.

Industry Experts:

Industry experts were relied upon to provide input for use by the valuation experts on matters which required special solar energy industry expertise. However it transpired during the course of the litigation that they had instead produced Company level/specific forecasts, which trespassed on the valuers' territory and led to multiple forecasts being in circulation. The Court expressed its disappointment, noting that proper parameters should have been agreed by the experts, and that the valuation evidence should take primacy to the extent there was a conflict.

CAPM Model:

The Court was asked to determine a number of issues with respect to the CAPM:

(i) Market Risk Premium: The Company's expert advocated for a historical risk premium representing an arithmetic average, and the Dissenters' expert a historical average calculated on a geometric basis. The Court saw the strength in both arguments and split the difference between the two calculations. A similar approach was taken in respect of the Risk Free Rate where the experts disagreed over 10 year or 20-year US Treasury yield.

(ii) Country Risk Premium: The Court was somewhat sympathetic to the Dissenters, but rejected their argument that this should be halved on the basis that most of the Company's sales were to the low-risk markets of the US, Japan and Europe. It was found that as presented, the argument was somewhat *crude and unsupportable*. It ultimately decided on the average risk rating for China as set out in Professor Damodaran's 31 January 2017 text.

(iii) Size Premium: Despite vigorous objection from the Dissenters that there was extensive academic literature criticising the application of a size premium, the Court applied a premium of 2.04% and followed the decision of Parker J in *Qunar*, accepting that a size premium represented widespread industry practice.

(iv) Beta: The Court rejected the Dissenters' arguments that a Blume or Vasicek adjustment should be made, finding there was no factual basis for such an adjustment and rejected the argument that Beta should have been based exclusively on the two year beta as opposed to an average of the two year weekly beta and the five year monthly beta as advocated by the Company.

Weighting of valuation methodologies

Having dealt with all of the relevant metrics, the Court returned to issue of weighting. The Company primarily sought a 100% reliance on Adjusted Market Price, and the Dissenters 100% reliance on the DCF. It was only the Company's expert who advocated for weighting each of the methodologies. The Court again supported the Company's expert and found no conceptual difficulty with weighting in this case, stating that *it is appropriate to adopt a blended approach to valuation and the competing methodologies, given that each methodology is subject to sufficiently serious uncertainty or [problems] to justify some level of discounting*.

Minority Discount

The parties agreed that a minority discount should be applied in this case. However, their respective experts were at odds as to what level of discount should be applied. The Company's expert contended for a rate of 10%, and the Dissenters' expert 2%. The Court accepted the Dissenters' expert's proposed discount of 2%, and in doing so noted that the Company's expert's approach of selecting the highest figure from her judgment-based range was impressionistic and difficult to justify.

Notwithstanding the above, and whilst the Court noted that the expert evidence in this case on minority discount was more substantial than in prior Cayman cases, it noted that it was not fully satiated with the evidence and that *the minority discount issue may well merit a more thorough and detailed explanation by experts in the future*.

Conclusion

It is clear that the Dissenters' expert's contention for a fair value of almost 17 times that of the Merger Price was not made out and the Dissenters' expert evidence rejected. However, this decision is not a loss for the s.238 jurisdiction. It confirms that the Court will not be hamstrung by any particular valuation methodology and will instead use whichever methodology it deems most appropriate. It is also serves as a warning that the Court will not allow the decision on minority discounts in *Shanda Games* to restrict the general scope of a fair value appraisal.

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