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GUIDE

What you need to know about the Cayman Islands statutory merger

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The Cayman Islands introduced mergers and consolidations in 2009 under Part XVI of the Companies Act (as amended) (the **Act**). The law has since been amended. There has been a surge in the use of statutory mergers as the most common method of takeover and privatisation of companies listed on the New York Stock Exchange or Nasdaq Stock Market.

This guide seeks to outline the process of a Cayman Islands statutory merger and consider the advantages and disadvantages of using this as a mechanism for effecting take-private transactions, and also explores the right of dissenting shareholders to obtain fair value for their shares. It is worth noting though that statutory mergers and in particular short form mergers may also be used in private acquisitions as well as for the rationalisation of structures.

The Cayman Islands statutory merger

What is it?

A Cayman Islands statutory merger is the process by which two or more companies (each, a **constituent company**) merge into one of the constituent companies (the **surviving company**) and the legal existence of each constituent company other than the surviving company ceases. The Act defines a merger as 'the merging of two or more constituent companies and the vesting of their undertaking, property and liabilities in one of such companies as the surviving company.' As such, the legal effect of a merger is that the surviving company assumes all of the undertakings, property, assets, rights, obligations and liabilities of every non-surviving entity.

What are the key steps and requirements?

The Act allows two or more companies (at least one Cayman Islands company limited by shares) to merge. Investors (usually comprising a combination of the founders or managers of the listed company, its parent and potentially private equity investors) intending to use a statutory merger to take a listed company private will as an initial step typically form a new company in the Cayman Islands (**Bidco**) which can be used as the offeror vehicle and recipient of finance and ultimately merge with the target company. In order to implement a statutory merger, the following key steps must be taken:

(a) The directors of each constituent company must approve a written plan of merger, which includes certain specific information regarding each constituent company, the terms of the merger and other information as prescribed under the Act (the **Plan of Merger**).

(b) The Plan of Merger must be approved by:
- a special resolution of members of each constituent company, being at least a two-thirds majority of shareholders who have the right to receive notice of, attend and vote at the general shareholders' meeting, voting as one class or such higher threshold as may be specified in its articles of association (and it should be noted that there may also be other shareholder consent threshold imposed by the relevant listing rules or takeover codes); and
- such other authorisation, if any, specified in the constituent company's articles of association. The Plan of Merger can be pre-cleared with the Cayman Islands Registrar of Companies (the **Registrar**).

(c) The consent of each holder of fixed or floating security interests of a constituent company must be obtained.

(d) The Plan of Merger (accompanied by other required documentation, including, amongst other things, written director's declarations of each constituent company in respect of the company's solvency, that the merger is *bona fide* and not intended to defraud unsecured creditors, and there is no outstanding petition for winding up, etc.) must then be filed with the Registrar for approval and upon payment of the applicable fee and, assuming that the Registrar is satisfied that the requirements of the Act (including any change in name of the surviving company) relating to the merger have been met, the Registrar will:

- register the Plan of Merger and any amendment to the memorandum or articles of association of the surviving company;
- issue a certificate of merger within 24 to 48 hours, on an express filing basis, or, around five working days on a normal filing basis; and
- strike-off each constituent company other than the surviving company once the merger becomes effective.

The merger is effective on either: (a) the date the Plan of Merger is registered by the Registrar (the **Registration Date**); or (b) such date or the occurrence of an event subsequent to the Registration Date as specified in the Plan of Merger (which must not be more than 90 days after the Registration Date).

A shareholder of a constituent Cayman Islands company who dissents from a merger is entitled to be paid fair value for his shares pursuant to section 238 of the Act (see 'Rights of dissenting shareholders' below for more details).

There is a short form method of merger. If a parent company seeks to merge with one or more of its subsidiaries (in which the parent company holds shares that represent at least 90% of the votes of a general meeting of the company), a special resolution of the shareholders will not be required (but a copy of the Plan of Merger will need to be given to each shareholder of the subsidiary unless that shareholder agrees otherwise).

As most take-private transactions are initiated with the involvement of the management of the target company, the merger process typically will have an independent financial expert appointed and an independent special committee formed to review and negotiate the take-private offer on behalf of the target company to mitigate litigation risks, in particular, to ensure the board's fiduciary duties owed to the target company are observed. Cayman Islands law on this aspect of the process is not as rigid as Delaware although the process (or similar) in Delaware may be used as a point of guidance.

Financing a take-private transaction

A take-private transaction by statutory merger may often be financed by a loan which is advanced to the Bidco, one of the constituent companies, or a newly incorporated parent of Bidco, in each case a Cayman Islands company incorporated by the sponsors of the take-private. There will usually be a robust security package, including share security over Bidco and post-merger target, debentures and guarantees at various levels up the bidder group structure and, post-merger, from the target. The loan proceeds, together with equity injected from the investors, are usually used to meet the costs of buying-out the existing shareholders of the target and to funding the working capital requirements of the business post its de-listing. The debt obligations of the constituent companies will be assumed, upon merger, by the target if it is the surviving entity, along with all other rights and liabilities of the constituent companies.

Pros and cons of the Cayman Islands statutory merger

Advantages – why use it?

The statutory merger process has a number of advantages over a typical scheme of arrangement and/or a general offer followed by a 'squeeze-out' (which are usually used for the privatisation of companies listed on the Hong Kong Stock Exchange), including the following:

(a) Cost and speed:

- it provides a straightforward and relatively inexpensive mechanism by which two or more companies can merge, with all rights and property of each of the merging companies vesting in a surviving company that also assumes all of their obligations. This can also involve a capital reorganisation so that some or all of the shares (of the same or different classes) may be converted into, or exchanged for, different types of property (such as shares or other securities in the surviving company or money, or a combination of these); and

- it does not involve a court process which forms an integral part of a scheme of arrangement and therefore benefits from substantial time and cost savings.

(b) Shareholder approval threshold:

- it typically enjoys a clearer shareholder approval threshold, being at least a two-thirds majority (subject to the articles of association of the constituent company which may specify a higher threshold), compared to the shareholder approval thresholds required under the Act for a scheme (being the majority in number of shareholders who vote (the headcount test) that collectively represent at least three-fourths of the value of the shares voted). Notwithstanding the above, the applicable listing rules or takeover codes in respect of the target company may require other shareholder approval thresholds;
- it also avoids the need to grapple with the uncertainty and practical difficulties which have historically plagued the approval process for schemes of arrangement owing to the fact that the majority of shareholders of listed companies hold shares through a nominee; and
- it entitles all shareholders of a constituent company to vote on the proposed transaction, including a controlling shareholder who is proposing to acquire overall control of the target, who is sometimes excluded from a vote to approve a scheme (pursuant to applicable listing rules or takeover code) or discounted from the 'disinterested' acceptances required to effect a 'squeeze-out' following a general offer.

Disadvantages – why not?

The potential disadvantage of using a statutory merger over a scheme of arrangement is the ability of any dissenting minorities to object to the merger and demand fair value for their shares where they believe that this ought to be more than what was offered to them. This is a right afforded to shareholders of a Cayman Islands company at law, although it is worth noting that their dissent does not affect the merger taking effect. As such, this is effectively a separate process which runs post-merger which is examined in further detail under 'Rights of dissenting shareholders' below.

For companies or investors evaluating the cost-benefit of a privatisation, the possibility of dissenting shareholders can be a significant concern where the success of even one or two dissenting shareholders can impact the financial viability of the deal. In contrast, a scheme of arrangement, once sanctioned and approved by the Cayman Islands court, binds all shareholders (including any dissenting minority) and therefore provides the offeror with certainty.

Rights of dissenting shareholders

Shareholders of Cayman Islands companies which have voted to merge are entitled, pursuant to section 238 of the Act, to dissent from the merger and receive payment of fair value for their shares. Whilst such dissenting member will not necessarily impact on the timing and effect of a merger, it is prudent to identify dissenting members as early as possible as this may impact on the economics of the merger.

Fair value can be determined by agreement of the parties. Where parties are not able to agree the value to be attributed to the shares, within a certain prescribed timeframe, either party may petition the court for a determination of the fair value of the company's shares. The right to dissent under the Act is restricted and will not apply to members who receive in exchange for their shares:

(a) shares of a surviving company (or depositary receipts in respect thereof);

(b) shares of any other company (or depositary receipt in respect thereof) that are either listed on a national securities exchange or designated as a national market system security on a recognised interdealer quotation system or held of record by more than two thousand holders; or

(c) cash in lieu of fractional shares or fractional depository receipts as described above.

Upon giving formal notice of dissent in accordance with the procedure set out under the Act, a dissenting shareholder shall cease to have any of the rights of a member except the right to be paid fair value, the right to petition the court where an agreement as to fair value cannot be reached, and the right to institute proceedings to obtain relief on the ground that the merger is void or unlawful.

In line with the increasing use of statutory mergers as the favoured mechanism for take-privates, claims by dissenting shareholders demanding fair value for their shares are no longer a rarity as they were a few years ago when the landmark ruling of *Integra* in 2015 made headlines for its important guidance on how the 'fair value' of a dissenting shareholder's shares is to be determined.

Indeed, there now exists a rapidly evolving area of jurisprudence in the Cayman Islands concerning the dissent process, and the rights afforded to shareholders who seek the payment of fair value for their shares, including with respect to interim payments to dissenting shareholders. Given the continued use of the statutory merger process by Chinese (and other) businesses to effect take-private transactions, and the perception among some investors that those transactions are being undertaken at prices which are undervalued, it is expected that this body of case law will continue to expand.

Conclusion

Investors and private equity sponsors are increasingly eyeing taking listed companies private which they deem are undervalued amid current volatile markets. While the Cayman Islands statutory merger regime is extensively used in achieving these take-private transactions, there is a lot of judicial activity particularly on fair value dissent which is moving very quickly and hence needs to be carefully considered. Financing and a robust security package need to be carefully planned by the lenders, especially on the timing of taking security and at what level in the group structure debt should be provided and security be taken.

Contacts

A full list of contacts specialising in Cayman Islands law can be found here.

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