Valuation methods in Cayman Section 238 fair value proceedings

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Perhaps the most important decision for a Court when determining the fair value of a company's shares, pursuant to Section 238 of the Companies Law (2018 Revision) (Law), is the valuation methodology to apply. There are, in broad terms, two main options:

1. the discounted cash flow (DCF) method which values shares based on the company's projected cash flows; and

2. market-based methods, which assume that the financial markets are the best indicators of fair value, and which are highly deferential to the merger or "deal" price paid by the buyer, and the price at which the company (and comparable companies) were trading at the time of the merger.

Shareholders who have dissented from a merger pursuant to Section 238 of the Law have done so on the basis that the merger price was below fair value and therefore generally argue that a DCF valuation should be used. Companies, on the other hand, have previously approved and finalised the merger on the basis that the merger price constituted fair value to its shareholders, and invariably argue for a market-based methodology.

In the two reported Cayman decisions, the Grand Court has applied a DCF analysis (in Shanda[1], by agreement between the parties) and a 75% DCF / 25% market-based analysis (in Integra[2]).

This article argues that, despite the Delaware courts' apparent movement towards market-based approaches, there are certain characteristics of Cayman mergers that make it likely DCF valuations will continue to be preferred in the Cayman Islands.

The Position in Delaware

Delaware's appraisal law is in a state of flux. In both DFC[3] and Dell[4], the Supreme Court reversed earlier Court of Chancery decisions to give the deal price no weight (Dell, where the Court of Chancery applied a 100% DCF analysis) or just one-third weight (DFC, where one-third weight was given to each of the deal price, a DCF analysis, and a comparable companies analysis).

In Dell, the Supreme Court stressed that the deal price should be given significant, if not complete, weight where the merger was conducted at an arm's length with a robust sale process (i.e. where the merger was "Dell complaint"). The Supreme Court also suggested that a DCF analysis was inherently unreliable and should not be preferred over market-based approaches.

In both Dell and DFC, the Supreme Court reinforced the importance of the efficient market hypothesis, which posits that that a market is efficient if the prices of assets sold in that market fully reflect all available information about those assets. The Supreme Court held that, where the market for shares is efficient, market-based prices (i.e. the deal price and trading price) will be good indicators of fair value[5]. Features of an efficient market in shares include high trading volumes, a diverse range of shareholders, and good information flow to the market.

Following Dell and DFC, a series of decisions (SWS Group[6], Clearwire[7], Solera Holdings[8], AOL[9], and Aruba[10]) have determined fair value to be equal to the deal price or below. A factor that appears to be driving these decisions is the Delaware courts'

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increased willingness to adjust valuations (whether determined by reference to deal price, or a DCF analysis) down to account for "merger synergies"[11]. In any event, these recent decisions are likely to have a chilling effect on Delaware appraisal activity, if they have not already.

The most notable of these post-Dell cases is perhaps Aruba. In that case, the Court of Chancery held that the sale process was "Dell compliant" but eschewed the deal price in favour of Aruba's 30-day unaffected market price (i.e. Aruba's average trading price in the 30 days preceding its merger announcement). This was the first time that unaffected share price had been applied in Delaware appraisal litigation, and it drove the fair value to over 30% below deal price. Aruba, which has been highly controversial in Delaware, is on appeal and argument has been listed for hearing before the Supreme Court on 27 March 2019.

The Position in Cayman

Irrespective of the outcome in Aruba, some commentators have speculated that the Cayman Islands Court of Appeal's decision in Shanda[12] may signal a broader move by the Cayman courts away from Delaware jurisprudence. In that case, the Court of Appeal overturned the Grand Court's refusal (consistent with a long line of Delaware authorities) to apply a minority discount. In doing so, the Court of Appeal noted that the policy considerations underpinning the Delaware decisions were inconsistent with those underpinning the mechanisms available under English law (and replicated in Cayman law) to acquire the shares of a dissenting minority[13]. The Court of Appeal also drew support from the dissent regimes in the British Virgin Islands and Bermuda, both jurisdictions based on English common law. Shanda has been appealed and is listed for hearing before the Privy Council[14] on 12 March 2019.

Even if the Cayman courts follow Delaware's emphasis on the efficient market hypothesis and deal process, it remains to be seen whether the Cayman jurisprudence will also develop towards market-based methodologies. First, the Supreme Court's decisions in DFC and Dell have been controversial and some argue that the court misunderstood or misapplied basic corporate finance theory. For example, it has been suggested that the Supreme Court's application of the efficient market hypothesis was flawed because it conflated informational efficiency with the more controversial theory of value (or fundamental) efficiency. It has also been suggested that, in Dell, the Supreme Court applied the wrong legal standard when determining what constitutes an arm's length and robust sale process in the context of appraisal litigation[15].

Second, there are a number of characteristics of a typical Cayman take-private merger which make it less likely that the Cayman Courts will consider deal price and market price as reliable indicators of fair value.

Efficient market hypothesis

Under Dell and DCF, deal price will be a good indicator of fair value if three is an efficient market for the company's shares. However, Cayman companies which have been taken private often lack a number of the important indicia of efficient)or semi-strong efficient) markets. For example, they often include a controlling shareholder, and their stocks are often illiquid and thinly traded In Integra, the illiquidity of the company's shares was the primary basis the Grand Court rejected of the company's argument that a market-based approach should be used, and preferred the dissenters' expert's suggestion of a 75% DCF / 25% market price weighting.

The absence of an efficient or semi-strong efficient market would also appear to make it less likely that a Cayman court would apply the unaffected share price (assuming, of course that Aruba is not overturned by the Supreme Court) given that, in Aruba, the Court of Chancery said it felt compelled to apply unaffected share price because of the Supreme Court's emphasis on efficient market hypothesis in Dell and DFC.

Dell compliance

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The Cayman courts have yet to undertake a detailed consideration of the robustness of the merger process, and whether the process can be considered "Dell compliant". However, many Cayman mergers are management buy-outs, which the Delaware courts have held to be a factor militating against Dell compliance. Moreover, in Cayman take-privates, buyer groups often have the two-thirds majority required to vote their own deal through, and invariably the one-third majority required to veto competing bids. Dissenters may argue that such voting power undermines the integrity and soundness of the merger process, such that the deal price cannot be considered a reliable indicator of value[16].

Conclusion

A handful of Cayman appraisal cases are expected to come to trial in 2019 (Qunar[17] commenced a two week hearing on 24 February 2019), and further guidance on valuation methodology will no doubt be forthcoming. We will keep you informed of developments in these and all related proceedings.

Led by Partner Rocco Cecere, Collas Crill's highly experienced section 238 practice is a sought-after, market-leading presence in merger appraisal cases in the Cayman Islands. Please contact Rocco for more information.

[1] Re Shanda Games Limited (FSD 14 of 2016, unreported, 25 April 2017)
[2] Re Integra Group (FSD 92 of 2014, unreported, 28 August 2015)
[3] DFC Global Corp. v. Muirfield Value Partners LP, 172 A.3d 346 (Del. 2017)
[4] Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd, 177 A.3d 1 (Del. 2017)
[5] The Dell court stated, at [17], the price produced by an efficient market is generally a more reliable assessment of fair value than the view of a single analyst, especially an expert witness who caters her valuation to the litigation imperatives of a well-heeled client
[6] SWS Group, Inc., C.A. No. 10554-VCG (Del. Ch. May 30, 2017) (Glasscock, V.C.) (7.8% below deal price, applying a DCF analysis less synergies)
[7]In re Appraisal of; ACP Master, Ltd. v. Sprint Corp., C.A. No. 8508-VCL (Del. Ch. July 21, 2017) (Laster, V.C.) & ACP Master, Ltd. v. Clearwire Corp., C.A. No. 9042-VCL (Del. Ch. July 21, 2017) (Laster, V.C.) (57.4% below deal price, applying a DCF analysis less synergies. The Delaware Supreme Court upheld the Chancery Court's determination without discussion.
[8] In re Appraisal of Solera Holdings, Inc., Consolidated C.A. No. 12080-CB (Del. Ch. July 30, 2018) (Bouchard, C.) (3.4% below deal price, applying deal price less synergies)
[9] In re Appraisal of AOL Inc., C.A. No. 11204-VCG (Del. Ch. Feb. 23, 2018 and Aug. 15, 2018) (2.6% below merger price, applying a DCF analysis less merger synergies)
[10] Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., C.A. No. 11448-VCL (Del. Ch. Feb. 15, 2018) (Laster, V.C.) (30.6% below deal price, applying 30-day unaffected share price analysis)
[11] Section 262(h) of the Delaware General Corporations Law provides that the "fair value" of the shares is to be determined "exclusive of any element of value arising from the accomplishment or expectation of the merger"
[12] Re Shanda Games (CICA 12 of 2017, unreported 6 March 2018)
[13] Namely, a "squeeze-out" under Chapter 3 of Part 28 of the Companies Act 2006 (the Cayman equivalent is contained in s.88 of the Law); and a scheme of arrangement under Part 26 of the Companies Act 2006 (ss.86 and 87 of the Law)
[14] The Judicial Committee of the Privy Council, which sits in London, is the final court of appeal in the Cayman Islands' legal system
[15] See, for example, Charles Korsmo and Minor Myers, The Flawed Corporate Finance of Dell and DFC Global, Emory Law Journal, Vol. 68:221; and Guhan Subramanian, Appraisal After Dell, in The Corporate Contract in Changing Times: Is The Law Keeping Up? (Steven Solomon and Randall Thomas eds) University of Chicago Press 2019
[16] In SWS Group Inc., the existence of a veto power was the primary reason that the Court of Chancery held that deal price was not a reliable indicator of fair value
[17] Qunar Cayman Islands Limited (formerly NASDAQ: QUNR) is China's leading mobile and online travel platform and delisted from the NASDAQ in March 2017 with a take private value of approximately US$4.4 billion

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