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QUASI-APPRAISAL IN THE CAYMAN ISLANDS

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The Cayman Islands have recently seen a sharp increase in the use of their statutory merger regime to complete management buyouts (take-privates) of U.S.-listed Cayman companies whose businesses operate in mainland China. Because the merger regime permits a merger to be approved by, normally, a two-thirds majority of the shareholders, and the management of these companies usually hold at least that many shares and cast affirmative votes, the completion of such take-privates is often assured. The only choice with which a minority shareholder, or ADS holder, is typically left is whether to accept the price per share which management has offered, or to exercise its statutory right to dissent from the merger and demand to be paid fair value for its shares, which generally leads to an appraisal action.

A relatively large number of these take-private deals have led to appraisal rights actions, particularly since the Grand Court made its first determination of fair value in Re Integra Group in August 2015. The very recent fair value judgment in Re Shanda Games Limited, an appraisal action which arose out of such a take-private involving Shanda Games, is indicative of just how unfairly the target company's management may be treating the minority shareholders in these deals. The Grand Court in that case determined fair value to be somewhat more than twice the merger price.

Notwithstanding this, it continues to be the case that the minority shareholders, who actually do dissent from a merger and only account for a rather small fraction of the minority, most simply accept the price which the management has offered, ostensibly in reliance on the information and advice provided in the proxy statements which they should have received. This potentially raises some quite serious questions, particularly:

(a) whether (and, if so, why) the proxy statements have failed to sufficiently inform and fairly advise minority shareholders of facts and matters which are material to their decision whether to accept the merger price or dissent, or have misinformed or misled them into accepting it, and

(b) what relief a minority shareholder may be able to obtain and from whom under Cayman law in the event of such transgressions, principally in a so-called quasi-appraisal action?

The authors will discuss and offer their views on each of these issues in this article.

The duty to disclose and advise

It is trite law that directors of companies owe an equitable duty to sufficiently inform and advise shareholders regarding the matters on which they are being asked to vote in shareholder meetings. As Hoffman J said in Re a Company, a case where two competing bids had been made to acquire the shares of a private company, the lower of which had been made by a company set up by the directors of the target company for that purpose, directors are required to:

"…give the shareholders sufficient information and advice to enable them to reach a properly informed decision and to refrain from giving misleading advice or exercising their fiduciary powers in a way which would prevent or inhibit shareholders from choosing to take the better price."

Sharp v Blank confirmed more recently that this includes a duty not to mislead the shareholders or conceal material information from them, as well as a duty to provide them with any advice and information in clear and readily comprehensible terms.

The concept of sufficient information is necessarily broad, because the duty applies generally to the various matters on which shareholders may be asked to vote. As the Supreme Court of South Australia explained in Residues Treatment & Trading Co Ltd v Southern Resources Ltd:

"Sufficiency of information is a matter of fact and degree. […] The essence of the duty is the requirement of reasonableness or fairness in the circumstances, having regard to the interests of the company as a whole. A surfeit of information may well obscure the purpose of the resolution. A lack of information may constitute misrepresentation by omission. It is a matter of sensible judgment by the directors in each case and ultimately by the court if complaint is made to it" (per White J); and

"the sufficiency of the notice of meeting has to be judged according to its terms and without regard to a shareholder's possible supplementing of the information by making his own inquiries whether from the company or anyone else" (per Cox J).

Who must discharge the duty in a take-private transaction?

Management who are seeking to cash out minority shareholders and take their companies private are in the clearest position of fiduciary conflict: their interests in acquiring the minority shares for the lowest possible price and their fiduciary duties to those same shareholders are of course diametrically opposed. The boards of the target companies thus appoint special committees of purportedly independent directors to evaluate and negotiate the proposed take-private transactions in the best interests of the unaffiliated minority shareholders, and then to decide whether the board should be advised to approve the transaction and recommend to shareholders that they cast affirmative votes. By reason of the function which the special committees are asked to perform, they would therefore appear to be obliged to ensure that shareholders are sufficiently informed and advised on the proposed transaction, where it will be put to a vote at a shareholder meeting, to enable the shareholders to reach a properly informed decision on the question of its approval at the meeting.

Sufficiency and fairness of the information and advice provided

The information and advice which special committees provide to the shareholders, which is of course principally directed to the minority shareholders who are being cashed out, will be laid out in a voluminous proxy statement, which ostensibly complies with the requirements of U.S. securities law (as it must) since the target companies are U.S.-listed.

While it is understood that such proxy statements are intended by U.S. securities law to address concerns regarding self-dealing in such take-private transactions, it is submitted that they fail to provide the minority shareholders with all of the material facts which they would need in order to reach their own properly informed views as to the fair value of their shares. In circumstances where, as mentioned above, the only real decision that the minority shareholders are able to make with respect to the proposed transaction is whether to accept the merger price or to dissent and seek fair value, it is submitted that, notwithstanding the apparent compliance with U.S. law requirements, this omission may, in and of itself, fall foul of the equitable duty to sufficiently inform and advise.

In the same vein, it is fair to observe that minority shareholders are invariably informed that the special committee has reached its view that the merger price is fair having regard to inter alia: (a) the size of the premium which the merger price represents above the recent closing prices of the ADSs and the low probability that the ADSs will trade at the merger price any time soon; and (b) the fairness opinion which the special committee received, to the effect that the merger price is fair. However, they typically are not informed of the meaning of fair value under the statute, which of course refers to the intrinsic value of the business rather than the trading price of its shares; nor are they usually told up front of any reasons to doubt the reliability of the fairness opinion, notwithstanding that these opinions are invariably very heavily-qualified and are frequently based upon financial projections prepared by the self-interested management in anticipation of the transaction. It would therefore also seem arguable that the information and advice which the minority shareholders have been given was liable to mislead, and in any event was not provided in clear and readily comprehensible terms as the duty requires.

For the avoidance of doubt, the authors submit that it should be no justification for the directors, including the special committee, to say that the matter to be decided by the shareholders at the meeting is whether or not the merger should be approved, since, for the minority shareholders who are being cashed out, the fairness of the merger price and the question whether to approve the merger are of course inextricably linked. One may safely presume that a minority shareholder would think twice about approving a merger, if given good reasons to doubt the fairness of the merger price which it would be due to receive.

The availability of relief

Where minority shareholders have been insufficiently informed and advised, or misinformed and misled, into accepting the merger price, and thus abandoning their rights to dissent from the merger and to demand fair value for their shares, there can be little doubt that they should be entitled personally to sue the person(s) responsible for their losses, being the difference between the merger price and fair value. This is what is known as a quasi-appraisal action, and, although such an action has not been pursued in the Cayman Islands to date, the authors consider that the court is likely to regard such relief as being available in principle. In addition to the matters previously discussed, it is clear that the merger regime itself does not preclude any such action from being pursued by a shareholder who has not exercised its right to dissent.

It is also noted that, if inadequacies in the information and advice given to shareholders were to be discovered prior to the vote being taken on the merger, it might be possible for minority shareholders additionally to obtain injunctive relief to restrain the vote on the merger being taken pending the provision of sufficient information and proper advice. But requiring such disclosure might potentially stop such a take-private transaction altogether if management cannot bear the risk of paying fair value to the entire minority. Recent

experience suggests that the appraisal action which the minority shareholder might instead have pursued should have been the considerably more attractive option.

One potential impediment to obtaining either form of relief from a breach of the relevant duties however arises from the fact that the minority shareholders in these companies hold their interests in the form of ADSs. All such holdings must be converted into registered shares in the company before any entitlement to assert shareholder rights will be recognized by the Cayman courts, i.e. pending conversion, as a matter of Cayman Islands law, such persons are not actually considered shareholders of the company at all. This is likely to preclude most of the minority shareholders of the companies which have recently been taken private from pursuing any claim for quasi-appraisal relief, since it is unlikely that they will have converted their ADSs to registered shares without having intended to exercise dissent rights and pursue payment of fair value.

Finally, although minority shareholders may convert their ADSs to registered shares effectively to reserve the right to pursue a quasi-appraisal action, where their companies are proposing but have yet to complete a take-private and they are not certain whether they wish to dissent, because success in the quasi-appraisal action would be dependent on inter alia establishing breaches of the relevant duties, it would inherently carry much greater uncertainty than the standard appraisal action, in which the main issue to be decided is simply what is fair value. Additionally, if the quasi-appraisal action were to succeed, the shareholder might still encounter enforcement difficulties depending on the whereabouts of the individual defendants and the location of their assets, whereas judgment in an appraisal action would fall to be enforced against the Cayman company itself, assuming that the surviving entity is not foreign, if necessary, with further assistance from the Cayman courts.

The duty of directors to sufficiently inform and advise shareholders regarding the matters on which they are asked to vote is well-established, and it is doubtful whether the proxy statements which are being provided to shareholders when they are asked to approve take-private transactions of U.S.-listed Cayman companies satisfy the requirements of that duty.

Subject to the need to convert their ADSs to registered shares, where minority shareholders have been misinformed or misled into accepting a merger price which is well beneath fair value and giving up their rights to dissent, they may accordingly be able to obtain compensation from those responsible for their loss in a quasi-appraisal action. However, the considerably better course for a minority shareholder who is in any doubt as to the fairness of the merger price remains, again, subject to converting its ADSs to registered shares, to exercise its right to dissent from the merger and to demand to be paid fair value for its shares.

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ENDNOTES

1. N.b. proposals to make the transactions conditional upon majority of the minority approval are almost invariably rejected by the management on the basis that this is not required under Cayman Islands law.
2. [2016] 1 CILR 192
3. (unrep. 25 Apr. 2017, Segal J)
4. It seems unlikely that most minority shareholders will have been discouraged by the costs of an appraisal action, since a company cannot obtain a default judgment on the question of fair value; the company must prove its case on fair value with expert evidence and the Court must make a determination, even if the dissenting shareholders do not actively participate in the appraisal action: see Re Integra Group (unrep. 10 Sept. 2015, Jones J), p.3. It is also not expected that most are failing to convert their ADSs into registered shares in their companies for the purpose of dissenting, or failing to comply with the statutory notice procedure and perfect their rights to dissent, in light of the information which they should have received on each of these requirements sufficiently in advance of the shareholder meeting.
5. [1986] BCLC 382
6. [2015] EWHC 3220 (Ch)
7. (1988) 14 ACLR 375; considered in Re RAC Motoring Services Ltd [2000] 1 BCLC 307 (Neuberger J)
8. See Anabtawi, Predatory Management Buyouts, 49 UC Davis Law Review 1285 (2016), at pp.1312 and 1318-1319
9. Even though this would not disentitle the shareholder from exercising its dissent rights.

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