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Cayman Court Relies on Market Value in Merger Appraisal

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In a recent decision of the Financial Services Division of the Grand Court of the Cayman Islands, *Qunar Cayman Islands Limited* (10 May 2019) ("Qunar"), Parker J rejected the central hypothesis of the dissenting shareholders' expert that there was a systematic undervaluation of Chinese companies on US exchanges which meant that their publicly traded share price was not a reliable indicator of the fair value of such companies. Having rejected this theory, he attributed a 50% weighting to the market value of the shares following the approach of the Company's expert. Save in two minor respects, he also rejected the dissenting shareholders' expert's DCF calculation in excess of 4x the market price which was not credible unless there was a systematic undervaluation of Chinese companies on US exchanges.

Qunar is only the third[1] reported merger appraisal case in the Cayman Islands, and is the first to be decided after the Court of Appeal's decision in *Shanda Games*[2] holding that the focus of attention in such cases should be on the value of the dissenters shares themselves, rather than on seeing the entitlement of the dissenting shareholders as being to a proportionate share in the value of the business as a going concern, as is the case in Delaware, and as had been accepted by the Court previously in *Integra* and in *Shanda Games* at first instance. Parker J expressly stated that *"the exercise is to value <u>the shares</u> as at the valuation date."*[3]

The value which was to be found was the "fair value" which Parker J held[4] to add the concepts of just and equitable treatment and flexibility to "value". Neither the motivation and conduct of the company in effecting the merger on the one hand, nor the character and motivation of the dissenting shareholders on the other, are relevant considerations. In order to arrive at a fair value, the Court should look at all the information relevant to fair value and should not confine itself to information which would be relevant to market participants at the relevant time. He said that *"the imbalance of control and information between the Company and the dissenters is corrected by a full enquiry into the relevant commercial reality from which to assess fair value."* He thus recognised and confirmed the need for extensive discovery to be given by the company in an appraisal case.

[1] The others being *Integra* [2016] 1 CILR 192 and *Shanda Games* unrep. 25 April 2017
[2] [2018] 1 CILR 352
[3] Paragraph 52
[4] Paragraph 62

The use of the trading price of the shares on NASDAQ, both as a direct evidence of fair value (as to 50%) and as a "real-world" cross-check to the DCF calculation is a unique and novel feature of the decision in *Qunar*.

In *Integra*, although Jones J had said that a market based approach would be preferable where the shares being valued are listed on a major stock exchange and there is a well-informed, liquid market with a widely held free float, the shares in *Integra* were in fact illiquid, and his use of a market based approach as to 25% of the valuation in that case[5] was based upon comparable companies and not the share price of the company itself.

In *Shanda Games* the company's expert did not suggest that the trading price of the shares was relevant, probably because there had been a delay of 22 months between the last unaffected trading price and the valuation date. Both experts agreed that 100% DCF valuation was appropriate in that case.

[5] 75% weight being given to a DCF calculation

In *Qunar*, there was no dispute that the shares were liquid, and the company's expert conducted an event-study to confirm the reliability of *Qunar's* share price, as well as a portfolio study of trading multiples of comparable companies which also supported the market valuation. The dissenting shareholders' expert did not dispute the liquidity of the shares, and did not carry out any kind of market efficiency test. He relied upon the fact that 94% of the shares were controlled by Ctrip, whose strategic partner was effecting the take-private transaction. However, the Judge held that, absent evidence of the controlling shareholder exercising control so as to benefit itself at the expense of the company, this factor alone would not undermine the reliability of the trading price.

The main argument of the dissenting shareholders' expert was that the trading price could not be relied upon because of a systematic undervaluation of Chinese companies by US markets.

There were two limbs to this argument. The first was a series of studies which demonstrated stigmatisation of *all* Chinese companies as a result of certain well-known accounting scandals which had affected *some* Chinese companies in 2010-2011. However, the Judge held that there was no evidence that such an effect persisted up to the time of this transaction in early 2017. The second was the fact that a significant number of Chinese companies had delisted from US stock markets and subsequently re-listed in China or in Hong Kong, or had been the subject of trade sales, all at values representing many multiples of their previous US market capitalisation. The Judge rejected such examples in the absence of proof that there had been no substantial changes to the business of these companies in the intervening period. He was also not convinced that it had been demonstrated that the Chinese markets were efficient and the US markets inefficient.

The final piece of evidence upon which the Judge relied to reject the dissenting shareholders' expert's theory was the views of analysts who had followed *Qunar*, and produced numerous reports on the company since it had been listed, none of whom had suggested any significant undervaluation of the company.

Having rejected the theory underpinning the dissenting shareholders' expert's justification of the very high value resulting from his DCF calculation, the Judge relied instead upon the company's expert's DCF calculation, subject to two minor adjustments relating to the terminal growth rate and the future cost to the company of its share based compensation scheme.

The final aspect which the Judge considered was the amount of the minority discount which he was required to apply in accordance with the decision of the Court of Appeal in *Shanda Games*[6]. On the facts, the Judge found that the applicable minority discount was in fact nil. This was a publicly traded liquid security in a well-run company without any risk of minority disadvantage regarding management control or the payment of dividends, and so a nil value was appropriate.

This is a significant decision in the context of appraisal litigation under Section 238 of the Cayman Islands Companies Law, being the first case to rely upon the publicly traded share price as evidence of fair value.

Notably, what is not explored in the judgment is the reliability of a pre-announcement market price as a measure of fair value as at the valuation date many months later, when macro-economic circumstances may have changed, and there may be industry or firm specific events or developments which, by definition, will not have been reflected in the pre-announcement trading price many months before. There is also the potential for non-public information which would not be reflected in the share price, and this may be particularly so when the bidder is a 94% controlling shareholder.

In the latest decision from the Delaware Supreme Court, in *Veriton Partners Master Fund -v- Aruba Networks,*[7] published only one month prior to the decision in *Qunar*, a first-instance valuation based upon the 30 day average pre-announcement trading price was rejected in favour of the merger price less an estimate of deal synergies. The Court noted that the unaffected market price "was a measurement from three to four months prior to the valuation date," during which it was possible for new, material information regarding the company's future earnings to emerge, and the bidder had a greater incentive to evaluate the company more closely than an ordinary trader of small blocks of the company's shares.

The other aspect which may affect the reliability of the publicly traded share price as a proxy for fair value will be the decision of the Privy Council in *Shanda Games* which is currently awaited. Parker J appears to have been influenced significantly by the approach of the Court of Appeal in *Shanda Games* to minority discount and their rejection of the Delaware approach of looking at a proportionate share of the company as a going concern. If the Privy Council reaches a different conclusion then its reasoning may impact the extent to which direct reliance should be placed upon the traded value of a company's shares as evidence of fair value.

[6] Currently awaiting the outcome of an appeal to the Privy Council
[7] C.A. No. 11-448-VCL (Del. 2019)

The focus of the recent Delaware Supreme Court decisions[8] on the deal price is based upon there having been a “robust sale process involving willing buyers with thorough information and the time to make a bid”, which are features significantly absent from the Cayman Islands cases to date. This has resulted in the deal price being ignored in the Cayman cases and an emphasis on a DCF valuation methodology in the cases prior to *Qunar*.

It is not known at this time whether any of the dissenters will appeal the decision in *Qunar* or what impact the decision will have on other appraisal cases before the Cayman Court.

[8] In addition to *Aruba Networks* see the earlier decisions in *DFC Global Corp. -v- Muirfield Value Partners*, L.P., 172 A.3 346 (Del. 2017) and *Dell, Inc. -v- Magnetar Global Event Driven Master Fund Ltd.*, 177 A.3d 1 (Del. 2017).

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