A wave of Chinese stocks is poised to exit the US and seek capital back in Shanghai or Hong Kong, following recent fraud allegations of Nasdaq-listed Luckin Co ee and intensifying political tensions. Senior practitioners provide insights into the transactions that are fuelling their return

Cayman privatizations back in vogue

Privatizations of public companies incorporated in the Cayman Islands and listed on a major stock exchange are in vogue again for a variety of reasons, financial and regulatory. In the US, for example, the Holding Foreign Companies Accountable Act will prohibit trading in the shares of a company if the Public Company Accounting Oversight Board is unable to conduct an inspection of the audit papers of the company's foreign auditor for three consecutive years. Chinese companies are a particular target.

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Privatizations can be effected by: (1) a general offer and compulsory acquisition; (2) a scheme of arrangement; or (3) a long-form or short-form merger.

Long-form mergers have been the predominant method of taking a company private in US markets since the merger provisions were introduced in 2009. But a long-form merger, at least a cash squeeze-out merger, carries a high risk of dissentient shareholders applying to the Grand Court to have the fair value of their shares assessed by the court.

A short-form merger can be undertaken by the buying consortium forming a bid vehicle (Bidco), and the Bidco acquiring shares carrying at least 90% of the voting rights exercisable in general meetings of the target company. The Bidco will then become the parent of the target company and can effect a short-form merger, with the target company being the surviving company in the merger.

Under section 238(1) of the Companies Law, shareholders of the target are entitled to payment of the fair value of their shares, but only upon dissenting from a merger.

The advantage of the short-form merger is that shareholder approval is specifically not required (section 233(7) of the Companies Law), and so is not sought, and the statutory procedural requirements are very di erent from a long-form merger. There is no vote or decision from which shareholders can “dissent”, and none of the antecedent conditions that are required to be met to exercise appraisal rights in a long-form merger can be satisfied in the case of a short-form merger.

Appraisal rights do not stand in isolation and cannot be crafted out of thin air. Only a member – i.e., a person who is a shareholder entered in the register of members of the company pursuant to section 38 of the Companies Law – of a constituent company in a merger is entitled to an appraisal right. It does not include the holders of American Depositary Shares (ADS) or the holders of depositary instruments.

The exercise of a statutory right to effect a short-form merger, without appraisal rights, at a 90% threshold (albeit voting rights) is consistent with a compulsory acquisition following a general offer (90% acceptances) and to a scheme of arrangement (majority in number of members holding 75% in nominal value of the scheme shares), neither of which carry appraisal rights.

In a retreat from the dizzy days of an appraisal award being made at 235% of the merger consideration (in the matter of Shanda Games FSD 14 of 2016, 25 April 2017), perhaps some semblance of reality has crept into recent appraisal awards where, in one case, the fair value was found to be a mere 1.2% over the merger consideration (in the matter of Qunar, 2019) and a minority discount might be found to apply (*Maso Capital Investments Ltd & ors v Shanda Games Ltd* [2020]).

However, as the author perpetually stresses, each determination of fair value is highly dependent on its own facts, and upon agreement or disagreement of the valuation models or their components by the valuation experts in each case. Valuation cases do not necessarily form transferable precedents.

From a buy-side perspective, short-form mergers are therefore highly attractive, since they may eliminate the tail-end price risk associated with buying out dissentient minority shareholders at a price which, if applied to the buy-side generally, would potentially make the pricing for the privatization unrealistic.

One example of a short-form merger is the privatization of Jumei International Holding, which was listed on the New York Stock Exchange (NYSE). There have been other public company short-form mergers, but the Jumei transaction is the rst two-step merger in the Cayman Islands.

Jumei had a dual-class share structure with the buying consortium holding class B shares (10 votes per share) representing approximately 44.6% of the issued shares and carrying 88.9% of the votes exercisable in general meetings.

The buying consortium had to acquire further shares so that it held at least 90% of the total voting rights to effect the short-form merger. A general offer (the rst step) was therefore made for all the issued class A shares (one vote per share) of Jumei, with an acceptance condition that required the tender of su cient class A shares to enable the buying consortium to hold at least 90% of the total voting rights exercisable in general meetings.

The offer price represented a premium of 14.7% to the closing price of Jumei’s ADS on the NYSE on the last trading day prior to the announcement of the going-private proposal, and a premium of 29.3% to the closing price of Jumei’s ADS on the last trading day prior to the execution of the merger agreement.

After completion of the offer, the remainder of the shares not tendered to the offer were cancelled in a short-form merger (the second step) for the same price as the offer price. Appraisal rights did not apply. Two-step short-form mergers are here to stay.

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