Grand Court confirms that dissent rights are available to minority shareholders in short-form mergers

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In a comprehensive ruling handed down today, the Grand Court of the Cayman Islands (**Grand Court**) confirmed that shareholders of companies that undertake a 'short-form' merger are entitled to dissent from the merger and to be paid fair value for their shares. The ruling, delivered by the Hon. Chief Justice Anthony Smellie QC, in *Changyou.com Limited*[1], has clarified a contentious issue of Cayman Islands law and has wide-ranging implications for the jurisdiction.

Collas Crill acted on behalf of the successful petitioners.

In this article, Rocco Cecere provides an overview of the Changyou ruling, and discuss the impact that the ruling will have on Cayman Islands law.

Long-form mergers versus short-form mergers

The Companies Act (2021 Revision) (Act) sets out a regime by which Cayman Islands companies can be merged by the compulsory acquisition of shares from minority shareholders. A minority shareholder may dissent from the merger if they believe the price the company is offering is not fair value, and that dissenting shareholder has a right to be paid fair value for their shares, as determined by the Grand Court pursuant to section 238 of the Act.

The Act describes the procedural steps the company and a shareholder must take in order for the shareholder to enforce their dissent rights and for the commencement of proceedings in the Grand Court for the determination of fair value. In a typical 'long-form' merger, the merger must be approved by a special majority of two-thirds of shareholders. The relevant statutory process is as follows:

1. A shareholder who wishes to dissent from a merger must, prior to the shareholder vote, give the company written notice of the shareholder's objection (s.238(2)).

2. Within 20 days of the date on which the merger was authorised by shareholder vote, the company must give written notice of the authorisation to all objecting shareholders (s.238(4)).

3. Within 20 days of receiving an authorisation notice, the objecting shareholder must give the company a formal dissent notice (s.238(5)), at which point the shareholder ceases to have any shareholder rights except the right to be paid fair value for their shares, as determined by the Grand Court (s.238(7)).

However, where a parent merges with its direct subsidiary, and the parent holds at least 90% of the voting power in the subsidiary, the subsidiary is not required to have a shareholder vote to authorise the merger (s.233(7)). Instead, the subsidiary must give a copy of the plan of merger to each shareholder. This has been referred to as a 'short-form' merger.

A number of Cayman Islands companies, including Changyou.com Limited (**Changyou**), have completed short-form mergers in the last several years without giving their shareholders dissent rights, contending that dissent rights were not available under the Act. Until now, that contention had not been tested by the Grand Court.

Changyou's merger

Changyou is a leading online game developer and operator in China which, prior to its short-form merger, was listed on the NASDAQ. In January 2020, Changyou announced that it had entered into a short-form merger with its parent company, which owned 95.20% of the total voting power in Changyou's shares. In its merger documents and announcements filed with the United States Securities and Exchange Commission, Changyou asserted that no dissent rights would be available to shareholders because Changyou was undertaking a short-form merger.

The petitioners, including entities managed by FourWorld Capital Management and Athos Capital (**Petitioners**), were shareholders in Changyou, and disagreed with Changyou's interpretation of the Act. They wrote to Changyou objecting to, and dissenting from, the merger. Following the completion of the merger, the Petitioners filed a petition seeking a determination of the fair value of their shares pursuant to s.238 of the Act. The parties agreed that the question of whether dissent rights applied to short-form mergers would be dealt with by way of preliminary issue.

The Grand Court's ruling

The question before the Grand Court was one of statutory interpretation. Changyou argued that the right to fair value did not apply to short-form mergers because there was no shareholder vote. That is:

1. a shareholder cannot object to the short-form merger (as contemplated by s.238(2)) because there is no shareholder vote;

2. therefore, a shareholder cannot dissent from the short-form merger because a dissent is conditional upon the shareholder objecting to the merger prior to the vote; and

3. because a shareholder cannot dissent, they did not have the right to be paid fair value as that right was conditional upon the shareholder dissenting from the merger.

The Chief Justice disagreed, holding that Changyou's interpretation elevated the mechanical provisions dealing with how dissent rights were exercised, to substantive law. His Lordship noted that the right to payment of fair value set out in s.238(1) did not expressly exclude short-form mergers. The Chief Justice agreed with the Petitioners that Changyou's construction would lead to the absurd result that minority shareholders would be deprived of dissent rights simply because that shareholder was not permitted to vote on the merger. Changyou had failed to identify any reason why a minority shareholder in a short-form merger was any less deserving of protection against the compulsory acquisition of its shares, than a shareholder in a long form merger. The Grand Court also agreed with the Petitioners that:

- To exclude shareholders dissenting from short-form mergers from the appraisal rights conferred by s.238(1) would produce inconsistencies with other provisions within the merger regime itself, and also with other regimes in the Act whereby shareholders can be forced to sell their shares. As to these latter regimes, the Grand Court noted that pursuant to both a scheme of arrangement (ss.86 to 87) and a squeeze out (ss.88), minority shareholders were afforded significant protections.

- Pursuant to s.25 of Bill of Rights, Freedoms, and Responsibilities set out in the Cayman Islands Constitution, the statutory dissent regime must be construed in a way that is compatible with the rights guaranteed by the Constitution, including the right to peaceful enjoyment of any person's property. Changyou's construction was inconsistent with such rights.

- Depriving minority shareholders of dissent rights in short-form mergers would render the Cayman Islands legislation an outlier among the other comparable legislative regimes (including those in Bermuda, the British Virgin Islands and Delaware), and it would be surprising if this was the legislature's intention.

- The Grand Court rejected Changyou's contention that minority shareholders in short-form mergers had other sufficient legal remedies against a company or its directors to vindicate the true value of the minority shareholder's shares.

The Grand Court held that, properly construed, s.238 provided a freestanding right of dissent in a short-form merger. Section 238(1) should be read as permitting a shareholder to give a notice of dissent in the absence of a shareholder vote. Such notice must be given within 20 days of the company providing a copy of the plan of merger to the shareholder. The Chief Justice held that the Petitioners had validly exercised their dissent rights, and are free to prosecute their fair value petition against Changyou.

Impact of the ruling

This decision will have a significant impact on Cayman Islands merger and acquisitions law and practice. As has been widely reported, a significant number of Cayman Islands companies with business operations in the People's Republic of China and listings on United States stock exchanges, have utilised the statutory merger provisions to compulsorily acquire minority shareholders' shares and to privatise the company.

Most of these mergers have been long form mergers. However, since the introduction of the statutory merger regime, at least seven short-form mergers have been completed. Only two of those mergers have offered dissent rights to shareholders.

Some acquirers have structured their take-private mergers to avoid dissent rights. One method of achieving this is for a parent, holding less than 90% of voting power in its subsidiary, to make a tender offer to acquire more shares, with such offer conditional upon the parent increasing its voting power in the subsidiary to at least 90%. Once that threshold is reached, the parent undertakes a short-form merger, without offering dissent rights. Under this ruling in *Changyou*, companies will not be able to deprive their shareholders of dissent rights by undertaking short-form mergers, however structured.

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] (Unreported 28 January 2021, FSD 120 OF 2020 (ASCJ))

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For more information please contact:

Rocco Cecere

Partner // Cayman

t:+1 345 914 9630 // *e:*rocco.cecere@collascrill.com

Natascha Steiner-Smith

Counsel // Cayman

t:+1 345 914 9661 // *e:*natascha.steiner-smith@collascrill.com

Zachary Hoskin

Partner // Cayman

t:+1 345 914 9663 // *e:*zachary.hoskin@collascrill.com