Cayman Court makes landmark decision in section 238 fair value dissenting merger/take-private case in Re Changyou.com Limited

October 2022

Introduction

The Court of Appeal of the Cayman Islands has delivered a landmark judgment which has provided clarification of and, arguably, amendments to, Section 238 of the Cayman Islands' Companies Act (the "**Act**").

The Court had to consider whether there was an error in or an omission from Section 238 of the Act and whether it was possible to interpret the law in a manner that gives effect to the original intention of the Cayman Islands' Parliament.

Legislative background

For those who might not be familiar with this part of the Act, Section 238 affords important protection to minority shareholders who dissent to a merger or consolidation involving the Cayman company in which they are a shareholder. Section 238(1) of the Act states that a shareholder of a company is "*entitled to payment of the fair value of that person's shares upon dissenting from a merger or consolidation*" and the remainder of Section 238 sets out the steps by which such '*fair value'* is achieved. The process begins with the dissenting shareholders serving notice of their objection on the relevant company[1] and in the absence of agreement on '*fair value*', culminates in an application being made to the Court for '*fair value*' to be determined there.[2]

Crucially, section 238 of the Act is drafted on the assumption that the shareholders of the relevant company will be able to vote on the proposed merger or consolidation. However, such a vote is not always required. If the proposed merger or consolidation is between a parent company and a subsidiary company both of which are incorporated in the Cayman Islands, the requirement for such a vote can be dispensed with provided that a copy of the plan of merger is provided to all shareholders.[3]

[1] Section 238(2) of the Act.
[2] Section 238(9) of the Act.
[3] Section 233(7) of the Act.

As a matter of terminology, mergers or consolidations where a vote is required are known as '**long-form mergers**' and those where no vote is required are known as '**short-form mergers**'.

The question to be answered by the Court in this case was therefore whether minority shareholders in a subsidiary company (which it was proposed would merge with a parent company by way of a short-form merger) could benefit from the protection provided by Section 238 of the Act.

Is the wording of Section 238 'wrong'?

Section 238(1) of the Act establishes the "fair value" principle for the benefit of dissenting shareholders and it reads as follows:

"*(1) A member of a constituent company incorporated under this Act shall be entitled to payment of the fair value of that person's shares upon dissenting from a merger or consolidation*."

Section 238 of the Act therefore does not, on its face, distinguish between long-form mergers or short-form mergers. The same cannot be said of the remaining sub-sections, however, and the Court noted that "*it is plain that subsections (2) to (16) of section 238 apply only to long-form mergers. This is evident from the fact that the opportunity to object and the opportunity to dissent depend upon the existence of a shareholder vote, and the timing of the matters set out in subsequent subsections depends upon the existence of such a vote*."[4]

The Court held that subsection (1) of Section 238 is a 'free-standing provision' and so is capable of applying to both long-form mergers and short-form mergers whilst noting that the remainder of Section 238 of the Act is "*not apt to apply to short-form mergers*".[5]

The Court considered further that "*this is not what the legislature intended*"[6] with the Judge observing that "*the sensible and commercially justifiable decision to dispense with a shareholder vote in a short-form merger has had the unintended and hitherto unrecognised effect of depriving minority shareholders in a short-form merger of appraisal rights which the legislature intended them to have.*"[7]

Is a different interpretation of Section 238 of the Act possible?

Regardless of the Court's view that Section 238 of the Act had been incorrectly drafted, the Judge did not consider it to be within the Court's powers to interpret Section 238 so as to give effect to Parliament's original intentions by using ordinary means of construction. The reason for this was because there was no ambiguity in the drafting of Section 238 as it clearly excluded short-form mergers from its ambit because so many of the subsections were predicated on the requirement for a vote of shareholders on the proposed merger or consolidation in every such case.

The Court therefore gave consideration to the principles of construction mandated by the Constitution of the Cayman Islands to see if they produced a different result. In particular, the Court considered section 15 of the Bill of Rights of the Cayman Islands which affords the right of peaceful enjoyment of property with protection against dispossession of such property, save in certain limited circumstances prescribed by law.

---

[4] CICA (Civil) Appeal 6 of 2021 – In the matter of Changyou.Com Limited – Judgment (FSD 120 of 202) (ASCJ)) at para. 44.
[5] *Ibid.*
[6] *Op cit. at para. 44.*
[7] *Op cit. at para. 52.*

The Court found that section 15 of the Bill of Rights is precise as to the provision that must be made by applicable law in circumstances where personal property is interfered with. Such provision must require the "*prompt payment of adequate compensation and for securing a right of access to the Grand Court for the determination of the amount of any compensation*".[8]

As the Court had concluded that there were no other remedies available to protect the interests of minority shareholders in cases of short-form mergers, the Court considered it to be necessary to consider how that would affect its interpretation of Section 238 of the Act. It was noted as part of this consideration that section 25 of the Bill of Rights required all legislation to be interpreted in a manner that is compatible with the Bill of Rights.

In light of this, the Court concluded that "*the effect of section 25 of the Bill of Rights is to give the court a greater degree of interpretative latitude than is available under the ordinary rules of construction*".[9]

Section 238 'as amended' by the Court's judgment

In exercising such 'interpretative latitude', the Court set out in paragraph 79 of the judgment a mark-up of Section 238 of the Act to more visually demonstrate its interpretation of that section for the benefit of dissenting shareholders in short-form mergers. It is as follows (with amendments shown in red by us):

Section 238

(1) A member of a constituent company incorporated under this Act shall be entitled to payment of the fair value of that person's shares upon dissenting from a merger or consolidation.

(2) A member who desires to exercise that person's entitlement under subsection (1) shall give to the constituent company, before the vote on the merger or consolidation ***(if any such vote is to be held) or (if no such vote is to be held) immediately after the date on which the plan of merger is given to the member pursuant to section 233(7)****, written objection to the action.*

(3) An objection under subsection (2) shall include a statement that the member proposes to demand payment for that person's shares if the merger or consolidation is authorised ~~***by the vote***~~ ***or approved****.*

(4) Within twenty days immediately following the date on which the vote of members giving authorisation for the merger or consolidation is made, ***or (if no such vote is to be held) within twenty days immediately following the date on which the plan of merger or consolidation is filed with the Registrar pursuant to section 233(9),*** *the constituent company shall give written notice of the authorisation* ***or filing*** *to each member who made a written objection.*

(5) A member who elects to dissent shall, within twenty days immediately following the date on which the notice referred to in subsection (4) is given, give to the constituent company a written notice of that person's decision to dissent, stating-

(a) that person's name and address;

---

[8] *Op cit. at para. 65.*
[9] *Op cit. at para. 78.*

(b) *the number and classes of shares in respect of which that person dissents; and*

(c) *a demand for payment of the fair value of that person's share.*

Conclusion

Mergers and consolidations can be contentious and highly emotive processes, especially for minority shareholders who consider that the initial price they are being offered for their shares is below '*fair value*'. Whilst shareholder dissent from such processes is already a well-trodden path in the Cayman Islands, the conclusions reached by the Court in this case are surely correct whilst the clarification that has been provided in the context of short-form mergers is very much welcome. However, what will undoubtedly raise a few eyebrows is the willingness of the Court to essentially re-write statutory provisions.

This publication is not intended to be a substitute for specific legal advice or a legal opinion. For specific advice on value dissenting merger/take-private in Cayman Islands, please contact your usual Loeb Smith attorney or:

Robert Farrell

E: robert.farrell@loebsmith.com

T: +1 345 749 7499

About Loeb Smith Attorneys

Loeb Smith is an offshore corporate law firm, with offices in the British Virgin Islands, the Cayman Islands, and Hong Kong, whose Attorneys have an outstanding record of advising on the Cayman Islands' law aspects and BVI law aspects of international corporate, investment, and finance transactions. Our team delivers high quality Partner-led professional legal services at competitive rates and has an excellent track record of advising investment fund managers, in-house counsels, financial institutions, onshore counsels, banks, companies, and private clients to find successful outcomes and solutions to their day-to-day issues and complex, strategic matters