

## Parsing M&A Liquidity And Fair Value In Del. And Caymans

By **Erik Himan and Carlos Penikis** (May 3, 2022, 5:36 PM EDT)

In certain jurisdictions, investors in companies that are acquired may dissent from selling their shares at the offered consideration, and instead opt for judicial appraisal of the value of their shares. In Delaware and in the Cayman Islands, the court will award what it assesses to be the fair value of such shares.

However, fair value is a legal concept with a definition that varies by jurisdiction. While that definition is largely settled in Delaware, it is not completely determined in the Cayman Islands.

Delaware appraisal defines fair value as the — relatively — straightforward calculation of the value of the dissenter's pro rata ownership in the value of a company.[1] Therefore,

the Court of Chancery's task in an appraisal case is to value what has been taken from the shareholder: "'viz. his proportionate interest in a going concern.'"[2]

According to this definition of fair value, this valuation will

[take] into account all relevant factors, including the "operative reality" of the company as of the time of the merger.[3]

The Delaware Court of Chancery does not consider premia or discounts related to control, synergies from potential transactions or other factors unrelated to the company and its independent operations.

In contrast, Cayman Islands appraisal aims to provide dissenting shareholders the fair value of their shares, which may include the valuation effect of features inherent to the shares but not inherent to the company as a whole.[4][5]

As the Court of Appeal of the Cayman Islands explained:

If [the dissenter] holds shares to which particular rights or liabilities attach, the shares are to be valued as subject to those rights or liabilities.[6]

An example of such a liability attached to a dissenter's shares is the minority status of those shares,



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which provides the logic for the application of a minority discount — if applicable — to those shares in Cayman Island appraisal.[7]

This article investigates the concept of liquidity as it relates to fair value and how it may potentially be applied in determining fair value in Delaware and the Cayman Islands. We discuss the ways that dissenters and the companies subject to appraisal have used and may potentially use arguments about the liquidity of a company's shares to argue for a higher or lower fair value.

### **The Concept of Liquidity**

Liquidity refers to the ability of an asset to be "converted into cash quickly and cheaply." [8] It is well-known that, all else equal, less liquid assets may have a lower value relative to more liquid assets. [9] While estimates of illiquidity discounts vary widely, and while these discounts can depend on the specific characteristics of the security being valued, analysts can and do assign illiquidity discounts greater than 25% or sometimes even greater than 50%.

Companies whose stocks trade on major exchanges such as the New York Stock Exchange, Nasdaq Stock Market and London Stock Exchange are commonly understood to enjoy greater liquidity than stocks that do not trade on a major exchange, however, even on such exchanges, the degree of liquidity varies across companies and over time.

For example, in the appraisal of Nasdaq-listed Nord Anglia Education Inc., the Grand Court of the Cayman Islands found that:

While the Shares were to some extent actively traded, the free float was not a large one (some 33% of the total shares) and so the market was not so liquid. [10]

Similarly, in the appraisal of Integra, the Grand Court of the Cayman Islands found that LSE-listed Integra Group was "an illiquid stock from 2012 onwards and the trend was towards increasing illiquidity during this period." [11]

### **Liquidity Arguments That Have Been Used by Dissenters**

A liquid market for a stock can be an indicator that the stock trades in an efficient market, and an illiquid market for that stock can be an indicator that the stock trades in an inefficient market. [12]

In both Delaware and the Cayman Islands, dissenters have argued that the illiquidity of shares is a reason that the price of publicly traded shares is not an indicator of their fair value. This approach has seen success in both Delaware and the Cayman Islands.

For example, in the appraisal of Norcraft Cos., the Delaware Chancery assigned no weight to Norcraft's unaffected market price because "[w]hat trading did occur following the IPO was relatively limited, an unsurprising phenomenon." [13]

Similarly, in the appraisals of both Nord Anglia and Integra in the Cayman Islands, the Grand Court assigned no weight to the unaffected market prices due to their lack of liquidity. [14]

Because M&A transactions typically occur at a premium to a company's unaffected market price, an appraisal valuation based on the unaffected stock price is generally favorable to the company rather

than the dissenters. Dissenters therefore frequently argue that the illiquidity of shares is a reason to disregard a company's unaffected market price as an indicator of value.

One undiscussed assumption of this argument, however, is that the illiquidity of a company's shares is not an inherent feature of those shares requiring an adjustment to fair value.

### **Implications If Liquidity Is an Inherent Feature of Appraised Shares in Caymans Grand Court**

In Delaware, the lack of liquidity should not be an issue in the calculation of fair value because liquidity does not have a relationship to the pro rata share of a company's value. In Cayman Islands appraisal, on the other hand, lack of liquidity could be argued to be an inherent feature of the shares in question.

To the best of our knowledge, the Grand Court of the Cayman Islands has not addressed whether the lack of liquidity, which may be inherent in appraised shares, necessitates a downward adjustment in price when determining the fair value of those shares. Until the Grand Court of the Cayman Islands clarifies that issue, however, dissenters who own relatively illiquid securities run a risk that a liquidity discount will reduce the value of their shares compared to their pro rata share in the value of a company.[15]

For example, suppose the Grand Court of the Cayman Islands valued a company with a discounted cash flow, or DCF, valuation and concluded the value of a share was \$20, but the Grand Court of the Cayman Islands additionally concluded that illiquidity is an inherent feature of a company's share.

The Cayman Islands Grand Court would then be compelled to apply a liquidity discount to that \$20 per share value, because that DCF valuation would not incorporate the impact of limited liquidity in that company's shares. If the appropriate liquidity discount was determined to be, for example, 25%, dissenting shareholders would receive only \$15 per share[16] rather than the \$20 per share calculated via a DCF valuation.

### **Conclusion**

In Delaware appraisal actions, liquidity is not considered to be an inherent feature of appraised securities. As a result, the illiquidity of appraised securities provides dissenting shareholders with the argument that market price is not a reliable indicator of fair value, but it does not run the risk for the dissenting shareholders that the determination of the fair value of the shares will include an illiquidity discount.

What does illiquidity mean for the concept of fair value in the Cayman Islands? The answer is still undecided, but illiquidity has features that can help both dissenters and the appraised company.

On one hand, dissenters can argue — and have successfully argued — that illiquidity means that a company's publicly traded share price is not an indicator of fair value. On the other hand, the appraised company may be able to argue that illiquidity is an inherent feature of the appraised shares, and therefore the fair value of those shares should therefore be adjusted by an illiquidity discount.

Going forward, both dissenters and companies subject to appraisal in the Cayman Islands should be cognizant of the ways in which liquidity may affect the fair value of their claims. While claiming that a company's shares are illiquid may be a double-edged sword, when utilized properly, these arguments may have significant impact on the appraisal process.

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[1] *Tri-Cont'l Corp. v. Battye*, 74 A.2d 71, 72 (Del. 1950).

[2] *Verition Partners Master Fund Ltd. and Verition Multi-strategy Master Fund Ltd. v. Aruba Networks, Inc.*, 11448-VCL, (Del. Ch. April 16, 2019) (internal quotation marks removed).

[3] "The corporation is to be valued as a going concern, taking into account all relevant factors, including the 'operative reality' of the company as of the time of the merger. That is, the fair value calculation focuses on the value of the company as a going concern, rather than its value to a third party as an acquisition" *In re Appraisal of SWS Group, Inc.*, C.A. No. 10554—VCG, 2017 WL 2334852 (Del. Ch. May 30, 2017) (internal quotation marks removed).

[4] *Shanda Games Ltd v. Maso Capital Investments Ltd and others* [2020] 1 BCLC 577; *In the matter of Shanda Games Ltd-Judgment*, CICA 12 and 13 of 2017.

[5] Experts and the Courts use similar methodologies to value companies in Delaware and the Cayman Islands including looking to the companies' unaffected stock price, transaction price, and conducting valuations based on discounted cash flows or market multiples.

[6] *Shanda Games Limited v Maso Capital Investments Limited and others*, [2018] 1 CILR 352 (Shanda CICA).

[7] *Shanda Games Limited v Maso Capital Investments Limited and others*, [2018] 1 CILR 352 (Shanda CICA).

[8] Brealey, Richard, Stewart Myers, and Franklin Allen, *Principles of Corporate Finance*, 12th Edition, McGraw Hill Education, p. 746.

[9] "Among publicly traded (i.e., marketable) stocks, the prices of shares with less depth to their markets (less liquidity) often reflect an illiquidity discount" (Pinto, Jerald E. et al, "Reading 24 - Equity Valuation: Applications and Processes," Equity, CFA Institute, p. 30).

[10] *In the Matter of Section 238 of the Companies Law (2016 Revision) and in the Matter of Nord Anglia Education, Inc.*, (Unreported, Grand Court, Kawaley J, 17 March 2020), ¶ 99.

[11] *In the Matter of the Companies Law (2013 Revision) and In the Matter of Integra Group* (Grand Court, Jones J, 28 August 2015).

[12] Note, however, that market price has been rejected as an indicator of value by the Grand Court of the Cayman Islands even when a stock trades in an efficient market if liquidity is sufficiently low. In the appraisal of Nord Anglia, the Grand Court of the Cayman Islands found that "My critical finding on liquidity is that the proportionate size of the public float in the Company's Shares was sufficiently small

to limit the weight that might otherwise be attached to the Market Price alone as reflective of the fair value of the Shares. However, I also find that the volume of Shares traded was not sufficiently small to raise real doubts about whether or not the relevant market was semi-strong form efficient." (In the Matter of Section 238 of the Companies Law (2016 Revision) and in the Matter of Nord Anglia Education, Inc (Unreported, Grand Court, Kawaley J, 17 March 2020).

[13] Blueblade Capital Opportunities LLC v. Norcraft Cos., C.A. No. 11184-VCS (Del. Ch. July 27, 2018).

[14] In the Matter of Section 238 of the Companies Law (2016 Revision) and in the Matter of Nord Anglia Education, Inc (Unreported, Grand Court, Kawaley J, 17 March 2020); In the Matter of the Companies Law (2013 Revision) and In the Matter of Integra Group (Grand Court, Jones J, 28 August 2015).

[15] Even if a company's shares are sufficiently liquid that a liquidity discount may not be appropriate, a blockage discount may still be appropriate. Pratt explains that "the concept of blockage applies primarily to a holding of publicly traded stock, when the block is so large relative to normal trading volume that either an instant sale probably would be at a discounted price compared to the prevailing market or else it would take a long time to sell." Pratt explains that "the concepts of blockage and restricted stock [liquidity] are separate concepts...while restricted stock discounts may easily be over 30 percent, discounts for blockage usually are considerably less, typically under 15 percent, although they have been as high as 25 percent." (Pratt, Shannon, Business Valuation Discounts and Premiums, 2nd Edition, John Wiley & Sons, pp. 118-119). Interestingly, if the Court were to apply blockage discounts in appraisals, a larger blockage discount may be appropriate for larger shareholdings, implying that not every dissenter's shares would have the same fair value. (Note also that, reflecting the diversity of opinions in the valuation literature, some analysts consider blockage discounts a form of liquidity discount.)

[16]  $\$15 = \$20 \times (1 - 25\%)$ .