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Yukon Appeal Court's InterOil Decision Based on Cold, Hard and Questionable Facts

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Background

A recent court decision from the Yukon has grabbed the attention of financial advisers and mergers and acquisition practitioners, raising questions about established market practices in M&A transactions, particularly with respect to fairness opinions. In a decision rendered on November 4, 2016, the Yukon Court of Appeal blocked ExxonMobil Corporation's proposed $2-billion takeover of InterOil Corporation that was structured as a statutory plan of arrangement. Although the transaction was itself a topping bid to a previously proposed transaction and was approved by over 80% of InterOil's shareholders, the Court cited a number of "red flags" that prevented it from concluding that the proposed arrangement was objectively "fair and reasonable" as required by the corporate statute. The red flags cited by the Court included the following:

- There were deficiencies in the fairness opinion received by InterOil's board – for example,
  - the financial adviser providing the fairness opinion, Morgan Stanley, was paid a fee that was contingent on the success of the transaction;
  - InterOil's financial adviser failed to assess the value of capped Contingent Value Rights (CVRs) payable by ExxonMobil relative to the value of InterOil's unexplored petroleum prospects on which the CVRs were based;
  - the fairness opinion was not accompanied by facts, information or analysis to indicate the basis for the opinion.
- The board failed to engage a second financial adviser on a flat-fee basis.
- The committee constituted by the board to oversee negotiation of the transaction was found to be fairly passive and merely received reports from management.
- The CEO who led the negotiations stood to receive $2.6 million in termination payments and $32 million under share awards and was therefore incentivized to approve the deal.

The Court ultimately held that, in light of these governance, disclosure and procedural deficiencies, the trial judge was incorrect in finding that the shareholder vote was a reliable proxy for the arrangement's fairness.

In our view, the deficiencies cited by the Court of Appeal regarding the fairness opinion and the suggestion that a flat-fee fairness opinion from an independent financial adviser is the "best-practice" standard were conclusions that are not consistent with established Canadian market practice. This inconsistency occurred because the trial judge made factual findings based on the uncontroverted expert evidence filed by the InterOil shareholder who was opposing the transaction, rather than on a full and complete evidentiary record. In particular, InterOil did not file countervailing expert evidence or cross-examine the opposing shareholder's expert witness in order to challenge the assertions that best practices require obtaining an independent flat-fee fairness opinion and that fairness opinions contain or are accompanied by disclosure of the information and analysis on which their conclusions are based. Nonetheless, the statements of the trial judge and the Court of Appeal, particularly with respect to the use and nature of fairness opinions, raise key issues for Canadian M&A practice that need to be considered.

Key Takeaways

1. CEO conflicts can be caused by incentives to transact

The Court's criticism of the prominent role of management in the negotiations with ExxonMobil is a cautionary reminder to independent directors to watch for and actively manage conflicts of interest. The CEO of InterOil stood to receive almost $35 million from a successful transaction, yet played a key role in the negotiation of the transaction. Transaction-based payments are designed to counter management's tendency toward entrenchment and are usually designed to align management's interests with the interests of shareholders; however, when the choice is between a sale of the company and the status quo, a transaction-based payment may give rise to a conflict of interest. While it may be appropriate for management to be involved in the negotiations of the sale price, the board or special committee should appropriately supervise the negotiations and ensure that it is not influenced by those entitled to significant payments. Holding *in camera* sessions that exclude board members who are entitled to transaction payments or those whose continued employment is jeopardized by the transaction can mitigate the influence of these interests. Board minutes should record the procedural steps taken to manage these conflicts.

2. Arrangement hearings are a difficult forum for complex determinations of corporate governance, adequate process and disclosure

The expert evidence asserting deficiencies in the InterOil transaction, which was relied on by the trial judge and which formed the foundation for the Court of Appeal's decision, was filed just days before the arrangement hearing. Rather than delay the hearing and file responding or contradictory evidence – whether by filing responding expert affidavits or through cross-examination – InterOil chose to proceed on the basis of the existing factual record. It did so presumably because it was under intense deal-execution pressure to proceed with the hearing and it was confident that the 80% approval by its shareholders would be sufficient to persuade the Court that the transaction was fair and reasonable. Although the lower court judge did approve the transaction largely on the strength of shareholder approval, his findings of fact concerning InterOil's corporate governance and procedural deficiencies – which were based on an incomplete record – laid the factual foundation for the Court of Appeal's ultimate rejection of the transaction.

The case is an important reminder of the significance of court procedures in a plan of arrangement and the risks of proceeding in the absence of a full factual record. Although plan of arrangement hearings are conducted in real time, with transactions placed on hold pending the outcome of hearings, proponents of plans of arrangement must carefully assess and weigh the benefits and costs of proceeding without delay against the risks of not fully or robustly challenging any evidence filed in opposition.

3. Transaction proponents must be clear about the purpose of fairness opinions

Although the fairness opinion received by the InterOil board was typical of those found in Canadian M&A transactions, the Court found that this opinion was deficient in failing to include any substantive analysis and failing to disclose the amount of Morgan Stanley's fee. Although it might be possible to distinguish the *InterOil* case on its facts and the uncontroverted evidence of best practices presented by the opposing shareholder at the trial, the comments of both the trial judge and the Court of Appeal suggest that courts are seeking objective evidence regarding the fairness and reasonableness of a plan of arrangement and that a standard form Canadian-style fairness opinion on its own will not generally be considered very persuasive. A similar conclusion was reached by the Ontario Superior Court in *Champion Iron Mines Ltd.* In this case, the judge ruled that a typical fairness opinion cannot be accepted as expert evidence.

Historically, the purpose of a fairness opinion has been to demonstrate that the board, in approving a transaction, has taken due care by receiving expert financial advice with respect to the fairness of a transaction from a financial point of view. This is a different purpose from using a fairness opinion to prove to a third party, such as a court or the shareholders, that the proposed transaction is fair from a financial point of view to the company's shareholders. Despite these differences in purpose, in proxy circulars for arrangements and in plan of arrangement hearings, proponents commonly rely upon fairness opinions as evidence of the fairness of the proposed transaction as opposed to merely evidence that the board made its recommendation on the basis of expert advice. The experiences of Champion Iron Mines and InterOil (as well as a prior case involving Royal Host) demonstrate that overplaying the purpose and significance of a fairness opinion can in fact be counterproductive, particularly if supporting financial analysis backing up the conclusion is not independently filed as evidence with the court.

4. A transaction can be structured as a bid or an amalgamation

Plans of arrangement have generally been a preferred form of transaction structure for the acquisition of a public company, particularly in more complex transactions or when securities are being offered to target shareholders and use of a plan of arrangement affords access to the exemption under U.S. securities laws for securities being issued to U.S. residents. However, the *InterOil* decision underscores the risks inherent in a transaction structure that requires court approval. Although any transaction (whether structured as a plan of arrangement, takeover bid or amalgamation) can be challenged in court, including under the oppression remedy provisions of Canadian corporate statutes, the plan of arrangement process presents opposing shareholders with a ready-made forum to make their case. In addition, in contrast to an oppression proceeding, at an arrangement hearing the proponent bears the burden of establishing that the transaction is fair and reasonable. This has been held by courts to be a higher standard than that required to defend a shareholder's claim that the transaction is oppressive to the company's shareholders.

In the vast majority of arrangement cases, court approval is obtained in a straightforward way, particularly if shareholder support for the transaction is strong. While M&A advisers have always weighed the incremental risks of a successful challenge inherent in a plan of arrangement structure, we anticipate that greater weight will be given to this consideration in future transaction planning, with alternative structures (such as takeover bids or amalgamations) becoming preferred structures when the flexibility afforded by a plan of arrangement structure is not a significant consideration.

5. There is greater emphasis on full disclosure

In overturning the trial judge's acceptance of the shareholder vote as evidence of the fairness of the transaction, the Court of Appeal noted the lack of information disclosed to shareholders regarding the value of the company's assets as well as the lack of information regarding the financial adviser's conclusion that the consideration offered to shareholders was fair. The Court stated that, in approving an arrangement, the Court must be satisfied that shareholders were in a position to make an informed decision. While the importance of a properly informed shareholder vote is not a novel principle and is a common basis for challenging a transaction that has received shareholder support, the *InterOil* decision seems to raise the bar on the nature and extent of the disclosure required. It will be interesting to see whether as a result of the decision, Canadian practice migrates to the U.S. standard whereby fairness opinions are accompanied by detailed disclosure in a proxy circular of the analysis underlying the fairness opinion and by disclosure of the amount of the financial adviser's fee.

6. Will flat-fee fairness opinions become the future standard?

As discussed above, the trial judge accepted uncontroverted evidence that best practices required the hiring of a second independent financial adviser compensated on a flat-fee basis, given the contingent success fees that was to be paid to Morgan Stanley. Some commentators have suggested that the decision stands for the proposition that a flat-fee fairness opinion will be required for all plans of arrangement. We do not believe that the decision goes that far and we note that, although the trial judge made a number of findings regarding the deficiencies in the fairness opinion, the Court of Appeal identified these deficiencies as part of a list of red flags in the transaction and not as the sole basis for its conclusion.

Unfortunately, neither the trial judge nor the Court of Appeal provided any analysis on why a flat fee is superior to a customary success fee arrangement or why a fairness opinion is a better determinant of value than a price established in an arm's length competitive bidding situation. As a result, boards and special committees will need to continue to consult with legal advisers to determine appropriate compensation arrangements for financial advisers, as well as how those arrangements and underlying analyses should be disclosed.

If you have any questions regarding the foregoing, please contact Patricia L. Olasker (416.863.5551), James W. E. Doris (416.367.6919) or J. Alexander Moore (416.863.5570) in our Toronto office; or Franziska Ruf (514.841.6480) in our Montréal office.