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InterOil Decision – Implications for Fairness Opinions, Disclosure and Corporate Governance in Sale Transactions

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In a decision [PDF] with potentially significant implications for current market practice with respect to fairness opinions, disclosure and corporate governance in public company sale transactions, the Yukon Court of Appeal blocked Exxon Mobil's proposed US$2.3 billion acquisition of InterOil. Despite the fact that the proposed plan of arrangement transaction was a topping bid approved by over 80% of the votes cast by InterOil's shareholders and the InterOil board of directors (Board) received a market standard form of fairness opinion from a leading global investment bank, the Court found that the arrangement was not fair and reasonable.

The potential implications for market practice include:

- Whether the financial analysis typically provided by a financial advisor to the target board of directors should also be provided to the target shareholders either in the fairness opinion itself or in the information circular provided to shareholders;
- Whether the specific amount of the fee payable to a financial advisor rendering a fairness opinion should be disclosed;
- Whether in circumstances where the financial advisor to the target company is entitled to a fee that is contingent on the completion of the transaction – a "success fee" – it should be incumbent on the target board of directors to obtain a second fairness opinion from an advisor entitled only to a fixed fee that is not contingent on completion of the transaction; and
- Whether independent committees of directors should be constituted in sale transactions and what role they should play where the only potential conflict of interest arises from the impact of the transaction on management's equity-based compensation awards or other executive compensation arrangements.

Background

The Final Order Hearing

InterOil originally entered into an arrangement agreement with Oil Search Limited on May 20, 2016 under which InterOil shareholders would receive, at their election, either Oil Search stock or cash (subject to proration if cash elections exceeded US$770 million) worth US$40.25 per InterOil share and a contingent value right that would have delivered a contingent cash payment of approximately US$6.04 for each trillion cubic feet equivalent (tcfe) of resources

above a certain threshold that was tied to the value of InterOil's primary asset, a 36.5% joint venture interest in a development stage oil and gas field in Papua New Guinea (PRL 15).

Exxon Mobil subsequently made a superior proposal under which it offered US$45 per share in Exxon stock, plus a contingent resource payment (CRP) of US$7.07 for each tcfe of PRL 15 resources above the same threshold as in the Oil Search transaction, subject to a cap. If all CRP payments were subsequently made, the value of the consideration payable to shareholders under the arrangement was approximately US$72 per InterOil share.

The Exxon Mobil transaction represented a 42.2% premium to InterOil's share price prior to the public announcement of the Oil Search transaction, based purely on the stock component of the consideration, i.e. without ascribing any value to the CRP. On July 21, 2016, Exxon Mobil and InterOil entered into an arrangement agreement and Exxon Mobil financed the US$60 million break fee payable to Oil Search.

InterOil's financial advisor provided the Board with a fairness opinion to the effect that the consideration to be received by InterOil shareholders under the arrangement was fair from a financial point of view. The financial advisor was entitled to a fee for its services, a substantial portion of which was contingent on completion of the arrangement. As is customary in Canada, the amount of the financial advisor's fee was not disclosed in the InterOil information circular.

In addition, the financial advisor noted in its opinion that "While we have considered the potential value of the CRP under different possible resource certification outcomes, with the permission of the Board of Directors, we have not attributed a specific value to the CRP for purposes of arriving at the conclusion expressed in this letter." Rather, the financial advisor was able to reach its conclusion that the consideration was fair based solely on the value of the stock consideration to be received by shareholders in the arrangement, without regard to the value of the additional CRP component. It should be noted that the information circular included disclosure of the variable amounts payable to shareholders under the CRP based on various volumes of resources.

The arrangement was approved by 80.57% of the votes cast by shareholders on September 21, 2016. Phillippe Mulacek, the founder and former chairman of InterOil, who owned 5.5% of the shares, exercised dissent rights to be paid the fair value of his shares. In total, shareholders holding approximately 10% of the outstanding common shares exercised dissent rights. Mr. Mulacek also challenged the arrangement at the final order hearing following the shareholder vote on the grounds that the arrangement was not "fair and reasonable" as an arrangement is required to be under applicable law.

Mr. Mulacek argued that InterOil failed to provide sufficient information to its shareholders to make a fully informed decision on the arrangement by failing to disclose the potential value of the PRL 15 gas fields and the value of the CRP. In support of his position, he retained a non-bank-owned Canadian investment dealer to submit affidavit evidence as to deficiencies in the process undertaken by the Board, as well as an opinion that the arrangement was inadequate, from a financial point of view, to shareholders.

One of these affidavits stated that in circumstances such as these, where the financial advisor is entitled to a success fee, the Board should have disclosed details of that fee to shareholders and engaged a second financial advisor whose compensation would not be contingent on the completion of the transaction. The affidavit also expressed the view that the CEO had a strong financial incentive for the transaction to proceed in light of the change of control provisions in his employment contract and the acceleration and waiver of performance conditions attached to his restricted share units, providing another reason for engaging a second financial advisor whose compensation would not be contingent on the

completion of the transaction.

The application judge found [PDF] that there was "deficient corporate governance and inadequate disclosure." He was critical of the fairness opinion, on the grounds that it did not address the value of PRL 15 and the value of the CRP. He was also critical of the lack of disclosure regarding the details of the financial advisor's success compensation, which would have enabled shareholders to evaluate the extent to which the fairness opinion may have been influenced by the terms of the financial advisor's compensation. He stated that the fairness opinion contained no valuation analysis so that a shareholder could fairly consider the merits of the arrangement, noting that he was not saying that the financial advisor did not provide that information to the Board but simply that shareholders did not receive the benefit of the analyses referred to in the fairness opinion and, as a result, had no real assistance in evaluating the arrangement.

In addition, the judge also expressed the view that there should be an independent "flat fee fairness opinion to assist shareholders and the court if [the Board] wishes to comply with best practice corporate governance," adding that an opinion that "simply follows the direction of the Board and is based on a success fee does not meet the standard of good corporate governance."

Nevertheless, the judge approved the arrangement as fair and reasonable, attaching significant weight to the shareholder approval. He observed that any shareholder could discern the lack of detail regarding valuations and analysis as well as the financial interest of the CEO, in voting for the arrangement. He noted that the CRP provided a higher rate of return than the Oil Search arrangement, although acknowledged that it was capped. While the Board did not provide detail on the value of PRL 15 or the strategic alternatives to the arrangement considered by the Board, the judge found that the arrangement reduced the speculative nature of the InterOil shares and provided a solid return. Mr. Mulacek subsequently appealed the approval of the arrangement by the application judge to the Yukon Court of Appeal.

The Court of Appeal Decision

The Yukon Court of Appeal (which is constituted by judges from the British Columbia Court of Appeal) agreed with the application judge's findings on disclosure and governance deficiencies and indicated that these deficiencies called into question whether the shareholders of InterOil had been adequately informed regarding the value of their shares and the consideration to be received from Exxon. Accordingly, despite the approval of shareholders and the availability of dissent rights for Mr. Mulacek, the Court did not find sufficient evidence to meet the required legal standard for approval of an arrangement that the arrangement is fair and reasonable.

The Court was troubled by the fact that the fairness opinion did not attribute a specific value to the CRP or to the PRL 15 gas fields. From a governance perspective, the Court noted that "although the Board constituted a committee to oversee the negotiation of the transaction, the committee appears to have been fairly passive, merely receiving reports from management who led the negotiations." The Court also stated that the CEO was conflicted, as he stood to realize significant compensation from the acceleration of his restricted share units and the change of control provision in his employment contract. It also found that "[O]ther members of the Board also stood to reap significant benefits." In these circumstances, the Court found that "the Board should have sought independent advice as to the financial fairness of the transaction" and should have obtained an independent opinion for a fixed fee.

Implications for Market Practice

It remains to be seen whether the decision will affect future Canadian market practice in sale transactions.

There is no legal requirement in Canada for a board of directors in a sale transaction to obtain a fairness opinion or to disclose it in an information circular, although the overwhelming market practice is to do so. Canadian fairness opinions do not as a matter of course include detailed financial analysis, nor is that analysis typically disclosed in the accompanying management information circular, unless there is a related party transaction where a valuation is required under Multilateral Instrument 61-101 – *Protection of Minority Security Holders in Special Transactions* (M1 61-101), where the valuation or a detailed summary must be disclosed. Financial advisors typically provide more detailed information and analysis to the board of directors in a separate bankers' "board book" that accompanies the fairness opinion. This information is taken into account by the directors in considering whether to approve a transaction, but is typically not reproduced or summarized in the information circular. The fairness opinion delivers the conclusion of the financial advisor's work, without showing the detailed analysis used to arrive at that conclusion.

There has been limited judicial consideration of what disclosure is required in fairness opinions. In *Re Champion Iron Mines Limited*, an Ontario court held that a fairness opinion was not admissible at a final order hearing to approve an arrangement because it did not meet the requirements of an expert report, due to the fact the opinion did not disclose detailed financial analysis. The court nevertheless approved the arrangement due in part to the overwhelming shareholder vote in favour of the arrangement. In two subsequent Ontario decisions in respect of arrangements rendered shortly thereafter, the courts found that in sale transactions a fairness opinion is admissible both as evidence that the plan of arrangement is being put forward in good faith, as well as evidence of the fairness and reasonableness of the proposed transaction. Market practice in respect of fairness opinions did not change.

It is also accepted practice in Canada that there is no need *per se* for a second, fixed fee "independent" fairness opinion where the financial advisor providing the fairness opinion also receives a success fee. A previous decision of the Ontario Securities Commission in *HudBay* included a statement, which was cited with approval by the application judge and the Court, to the effect that a fairness opinion rendered by a financial advisor receiving a success fee was of no benefit to directors in demonstrating that they discharged their fiduciary duties. This statement by the Commission was the subject of considerable attention and criticism. The Vice-Chair of the Commission who wrote the decision subsequently made public remarks qualifying his comments in the decision, and market practice did not change.

The Yukon Court of Appeal's decision suggests that in the future more detailed valuation disclosure should be included in fairness opinions or elsewhere in a circular in an increased range of circumstances, and that the financial advisor's compensation should be disclosed as well. It also suggests that independent fairness opinions provided by advisors on a fixed fee basis (i.e. in which the fees are not contingent on completion of the transaction) should be obtained as a corporate governance best practice, particularly where members of management may have a financial conflict of interest.

The enhanced disclosure obligations suggested by the Court would bring Canadian practice more in line with practice in the United States. Under U.S. practice, where a fairness opinion is included in an information circular, detailed financial analysis as well as the amount of the advisor's fee is typically disclosed. In addition, where a company is sold for cash, the company includes management's standalone projections (if they exist).
However, it is not the practice in the United States to require fixed fee "independent" fairness

opinions where payment of the fee is not contingent on the outcome of the transaction, absent a specifically identified conflict of interest on the part of the financial advisor. It is also not clear that the purported benefits of such a requirement would exceed the costs. Fairness opinions are not legally required in Canada, and to the extent that a fairness opinion is disclosed in an information circular, the fact that the opinion giver is entitled to be paid a success fee is presumably a factor that shareholders can take into account when deciding how much weight to place upon the opinion. Perhaps more importantly, the financial advisor that is running the sale process and entitled to a success fee is typically best positioned to deliver a meaningful fairness opinion, as opposed to a second advisor that may be brought in later in the process and that may not have the same familiarity with the assets, the industry, or the sale process.

Finally, given the widespread use and typical terms of both equity compensation awards and change of control protections in executive employment agreements, the Court's findings of a conflict of interest on the part of management and the resulting consequences have potentially broad implications.

The typical management conflict that has preoccupied courts and regulators in the past has been, on the contrary, the perceived risk of entrenchment, due to the fact that management will likely be replaced following a sale and may seek to oppose or undermine a sale of the company in order to preserve their positions. Equity-based compensation, including the acceleration of awards on a change of control, have been designed in part to address this conflict so that the risk of management entrenchment is lessened or eliminated, and the incentives between management and shareholders aligned. In this case, due to the significant compensation that the CEO stood to realize, the Court expressed the view that it was incumbent on the Board to ensure that the arrangement negotiated by management did indeed reflect the fair value of the company – the concern appears to be that the arrangements initially adopted to align the incentives of management and shareholders have now potentially over-incentivized management in some circumstances to seek a sale of the company in a manner that is no longer aligned with shareholders.

While management incentives need to be carefully considered, it should be noted that in this case they were clearly disclosed and could therefore be assessed by shareholders, and that separate approval of shareholders other than the CEO was obtained pursuant to the applicable provisions of MI 61-101. A board of directors is also arguably perfectly capable of dealing with potential conflicts of this nature without the need for a special committee (e.g., by having in camera sessions where these matters are discussed, or by providing appropriate instructions to and oversight of management).

While surprising in various respects, this decision serves as a reminder of the required "fair and reasonable" determination by a court for a proposed plan of arrangement. Approval from shareholders is an important factor in this determination and, in our experience, a high level of approval from shareholders is afforded great weight in most circumstances. However, shareholder approval may not be sufficient, particularly if, as the Court found in this case, the shareholders are not provided with sufficient information to make an informed decision.

We will continue to monitor how Courts deal with future arrangements and whether this decision results in any changes to market practice.

Osler was engaged by InterOil's financial advisor in connection with the arrangement. Osler was not involved in the proceedings before the application judge or the Court of Appeal.