Cassels

Fair Value of Shares in Dissent Proceedings – Market Value and the "One True Rule"

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The concept of fair value in dissent and appraisal proceedings in public M&A transactions was recently considered by the Quebec Court of Appeal in its decision *in Fibrek Holding Inc. et al. v. 1600013 Ontario Ltd.* et al. The Court reinforced the importance of market evidence in determining fair value, emphasizing that market value is the strongest indication of fair value in dissent and appraisal proceedings.

The case involved a bid by Resolute Forest Products Inc. (Resolute), the appellant in the appeal, for the common shares of Fibrek Inc. Resolute acquired the majority of the common shares pursuant to an unsolicited take-over bid at an initial price equivalent to $1.00 per Fibrek share (the Resolute Offer). However, prior to the Resolute Offer being completed, Fibrek and a new bidder, Mercer International Inc. (Mercer) announced a board-supported take-over bid by Mercer to acquire Fibrek at a price of $1.30 per share, payable in cash, in Mercer shares or in a combination of cash and shares. Mercer later increased its offer by $0.10 per share. Nonetheless, Resolute was still able to acquire 46.8% of the shares, which included shares that had been agreed to be tendered to the Resolute Offer pursuant to lock-up agreements. Mercer allowed its bid to expire and Resolute was able to increase the number of shares it took up to 74.56%.

Resolute then effected a “second-step” plan of arrangement to acquire the balance of the outstanding Fibrek shares for the same consideration. The respondent shareholders in the appeal, who held approximately 12% of the outstanding Fibrek shares, dissented and were therefore entitled to be paid the *fair value* of their shares under the *Canada Business Corporations Act* (the “CBCA”) as of the date prior to the date the resolution was passed to approve the second-step arrangement, being July 22, 2012 (the Valuation Date). Resolute offered the respondents $0.8773 per share. When the respondents refused that offer, Resolute filed a motion for a court to fix the fair value of the shares. The Quebec Superior Court, Commercial Division, fixed the fair value of the Fibrek shares as of the Valuation Date, at $1.99 per share. Resolute appealed and asked to fix the fair value at $0.8773 per share.

General Principle - Market Value is Central and to be Emphasized

In considering how fair value should be determined, the Court of Appeal reviewed appellate caselaw from Ontario and the Yukon. The Court noted the five potential approaches to valuation set out by the Yukon Court of Appeal in *Carlock v. ExxonMobil Canada Holdings ULC*, being: the quoted market price on the stock exchange (a market value approach); the valuation of the net assets of the company at fair value (an

assets approach); the capitalization of future maintainable earnings (an income approach); discounted cash flow (an income approach); and a combination of approaches.

The Yukon Court of Appeal stressed that the market value approach was “likely the best and most objective” because “[i]t is rooted in reality and not based on assumptions, theory and predictions.”

The Court agreed with the analysis in Carlock, that courts should review the full evidence using the various approaches and decide which result is most fair and equitable, with emphasis on the market value. This is the “one true rule” in valuation – “to consider all the evidence that might be helpful, and to consider the particular factors in the particular case, and to exercise the best judgment that can be brought to bear on all the evidence and all the factors.”

The Court thus determined that fair value starts with a value established by the market, adjusted for "elements the market had not considered."

Date of Market Value

The Court then turned to whether what market price should be used. In its view, there were four indicators of the market value of the Fibrek shares:

- the trading price of the shares on the TSX,
- the Resolute Offer, and
- the two Mercer Offers.

In this case, the relevant valuation date was approximately eight months after the initial bid.

The Court found that the trading price of Fibrek shares on the TSX at that time was of limited value in determining the fair value of the shares on the Valuation Date as it was affected not just by the initial offer, but by the subsequent offers from Mercer. The evidence also showed many arbitrageurs purchased shares based, not on the fair value of Fibrek, but on the offers by Resolute and Mercer, and their assessment of the potential success of those offers. Most of the Respondents were arbitrageurs and acquired their Fibrek shares during this period.

Instead, the Court found that the trading price of the Fibrek shares before the Resolute offer was announced was a good indication of the market value of the individual shares. The Court noted that the lower court emphasizes that the price of the shares in November 2011 was at a “historic low,” but also noted that is the nature of markets: “Prices rise and fall, and buyers want to buy when the price is low. The price on the stock market remains an accurate indication of the value of the shares at particular times.”

The Resolute Offer of $1.00 on November 28, 2011, included a premium of approximately 39% over the closing price of Fibrek's shares on the TSX on the date that Resolute announced its bid, and a premium of approximately 31% over the volume weighted average trading price of the shares on the TSX for the 20 trading days ending on that date. This suggests that the Resolute Offer of $1.00 on November 28, 2011, was consistent with the price at which the shares were trading on the TSX prior to the offer.

Third party entities must be assumed to be acting rationally and in their self-interest. Fairfax, Pabrai and Oakmont believed $1.00 to be a reasonable price for their shares. The Court noted with approval the statement of Justice Harris in Carlock:

Commonly, the determination of fair value in the reported cases occurs where there is no broadly based open market transaction because, for example, the transaction might not involve a disposition of shares or is not arms?length. In those kinds of circumstances, it is often necessary to resort to a theoretical search for value that attempts to estimate the value that would be the product of a hypothetical market. Where, however, there is an open market for shares or other evidence indicative of arms?length conduct of numerous market participants acting in their own self?interest and settling on a price, such evidence is particularly reliable as an indicator of fair value, as I have already explained. Objective market evidence, in the absence of evidence of market failure, is more reliable than theoretical analysis that attempts to derive a value based on assumptions about what a real market would disclose, if there were one. The behaviour of a real market is better evidence of value than a theoretical market.

At trial, the second Mercer Offer of $1.40 per share was used. The Court had reservations about the trial judge's decision to use it as his starting point. The most significant issue was that no one from Mercer testified at trial and there were no documents describing how Mercer arrived at its prices. It was therefore impossible to the extent Mercer included, for example, synergies or the value of the Hydro-Québec contract in the prices that it offered, and it was challenging to compare them to the Resolute Offer or to make adjustments to them. The Court further noted that the Mercer Offers were made at a time when Resolute had already locked up 46.3% of the shares and these offers were conditional on being accepted by a majority of the shareholders. The Court thus determined there was never any practical prospect of that happening and as a result, they should be given less weight than the Resolute Offer.

The Court thus found that the judge made a palpable and overriding error in excluding the Resolute Offer from his assessment of fair value and should have started with the $1.00 Resolute Offer as indicative of the fair value of the Fibrek shares.

Adjustments to Market Value

The Court explained that the Resolute Offer required updating on two fronts. First, because the First Offer was partly payable in cash and partly payable in the Buyer's shares, to reflect the value of the Buyer's

shares on the Valuation Date. And then also to account for “facts that affect value that were not known or considered” when the Resolute Offer was made.

Changes in Values as of the Valuation Date

The market value was determined to be $0.8773 per share, which was the cash equivalent of the “Cash and Share Option” under the original Resolute Offer ($0.55 in cash and 0.0284 Resolute share), using the value of the Resolute shares as of the close of business on the Valuation Date. This was lower than the value on the date of the Resolute Offer.

Control Premium: Add?

The Court noted that fair value is based on an “en bloc” value for all of the shares, and so adding a premium to the market trading price to compensate for the minority discount inherent in the price on the stock market may be appropriate. This is not directly addressed by the Court, which immediately begins a discussion of synergies and thus may be (incorrectly) considered as being the same.

Synergies: No Adjustment

While the trial court’s valuation involved adding value for synergies that would be experienced by Mercer, the Court saw no reason to make a similar adjustment in respect of Resolute. It clarified that “[i]n principle, synergies have no place in the market value approach” for the simple reason that “the market value approach includes synergies.” The Court assumed that part of the 31% premium of the Resolute Offer was attributable to synergies anticipated by Resolute (although the Court of Appeal would not speculate as to what portion).

The Court notes that a judge’s mandate is to fix the fair value. It stated:

The judge should use the objective evidence of what parties actually bid for the shares and make necessary adjustments to those bids to take into account objective elements that were not considered. He should not be trying to guess how high the parties might have bid if there had been an unrestricted auction.

Unknown Assets - Hydro-Quebec Contract: Add

The other factor adding value to Fibrek was the 33 MW Power Purchase Agreement concluded with Hydro-Québec on May 4, 2012, which added as much as $16 million per year to Fibrek’s EBITDA.

Regarding the former, the Contract was a 25-year energy supply agreement which the Court of Appeal characterized as “clearly very valuable.” The trial court fixed its value to the Target at $0.80 per share and that value was not challenged on appeal. As Resolute did not know about the Contract, its value could not

have been considered when Resolute made its offer. The Court therefore added $0.80 to the Resolute Offer as part of its fair value calculation.

Unknown Liabilities – Environmental: Deduct

The Court agreed with the trial decision and deducted $0.08 per share for contingent environmental liabilities of Fibrek only discovered after Resolute took control of the business in May 2012. This was the figure calculated by the trial court, and also was not challenged on appeal.

Key Points

- Dissenting shareholders may be entitled to a premium over the deal price if the market value is higher.
- Facts that affect value that were not known or considered will adjust market values in determining fair value.
- A determination of fair value is fact specific. Market values should be emphasized in appraisal proceedings.
- Objective market evidence, in the absence of evidence of market failure, is more reliable than theoretical analysis that attempts to derive a value based on assumptions about what a real market would disclose, if there were one. The behaviour of a real market is better evidence of value than a theoretical market.
- The concept of legitimate expectations, relied upon in the context of oppression remedies, should not be imported into valuation proceedings.
- “Legitimate expectations” is relevant in oppression cases and should not be considered in setting fair value.
- The judge should use the objective evidence of what parties actually bid for the shares and make necessary adjustments to those bids to take into account objective elements that were not considered. He should not be trying to guess how high the parties might have bid if there had been an unrestricted auction.

Other Takeaways

- There is nothing illegal nor improper about lock-up agreements, even hard lock-up agreements, which are a common and accepted tool in the context of take-over bids.
- Shareholders do not owe any fiduciary duty to other fellow shareholders. The only people who owed fiduciary duties to the shareholders are directors. exercise that fiduciary duty by recommending or rejecting an offer, obtaining an independent valuation or fairness opinion, and seeking out higher bids.

- A bidder is under no obligation to offer fair value when offering to purchaser shares. The obligation to pay fair value only arises in the context of dissent rights.
- To the contrary, it is in a bidder's interest to pay as low a price as possible. However, in the context of a hostile take-over, if a bidder wants its offer to succeed, it needed to offer a price that the market would accept, and a price acceptable to the market is a good indication of the fair value of the shares.

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