Cassels

Court of Appeal Confirms Importance of Proper Corporate Process and Disclosure in M&A Transactions; Overturns Approval of US$2.3 Billion Merger Between InterOil and ExxonMobil

Gordon R. Chambers, Lara Jackson

November 9, 2016

On November 4, 2016, the Court of Appeal of Yukon overturned the decision of the Supreme Court of Yukon approving the proposed US$2.3 billion acquisition of InterOil Corporation (InterOil) by ExxonMobil Corporation (Exxon) by way of a plan of arrangement (the Exxon Arrangement). Philippe E. Mulacek, the founder and the former Chairman and CEO of InterOil, objected to the proposed acquisition on the basis that, among other things, the process undertaken by InterOil demonstrated deficient corporate governance and inadequate shareholder disclosure and the proposed acquisition was not substantively or objectively fair and reasonable.

Cassels Brock & Blackwell LLP represented Mr. Mulacek both in the Supreme Court of Yukon and in the Court of Appeal of Yukon.

Key Findings

The Court of Appeal refused to approve the Exxon Arrangement principally due to failures in InterOil's corporate governance and deficiencies in the information provided to its shareholders. The Court of Appeal confirmed and clarified the importance of the role of the court in connection with arrangement transactions - a statutory mechanism which permits transformative changes while ensuring that all those whose rights may be affected are treated fairly – and the importance of a rigorous application of the *BCE* test for court approval of transactions as fair and reasonable. In particular:

- **Shareholder vote** – Although the shareholder vote is an indicia of fairness, the Court must be satisfied that shareholders were in a position to make an informed choice. In this case, InterOil failed to provide sufficient meaningful information to shareholders on the financial impact of the terms of the proposed acquisition, and the value of its oil and gas assets – "the value they would be giving up and the value they would be receiving" - and given these disclosure deficiencies the court could not rely on the shareholder vote.
- **Court role** – Notwithstanding the shareholder vote, it is "the Court's task to decide whether the purposed arrangement has been shown to be fair and reasonable." An auction process with a

second superior bid does not relieve the Court of its duty to examine all of the circumstances and engage in the complex weighing necessary to determine whether the arrangement is fair and reasonable.

- **Corporate process** – The failure to follow a robust corporate governance process is a factor in a fairness hearing. A compromised corporate process for review and approval of the transaction will impact the Court's reliance on a board's recommendation as an indicia of fairness. In this case the lack of an independent review and consideration of the proposed arrangement, including retention of independent advisors and obtaining an independent financial fairness opinion, were all "red flags" that required the Court to do more than accept the shareholder vote as a "proxy" for fairness.
- **Financial Fairness** – A fairness opinion by a financial advisor with a substantial success fee and a restricted review is of little assistance in assessing financial fairness. A fairness opinion that is devoid of facts or analysis will not suffice on its own to establish financial fairness.

In all of the circumstances of this proposed acquisition, discussed further below, the Court of Appeal found that it could not pay deference to the business judgment of the Board, the verdict of the market or to the shareholder vote. The Court itself had to be satisfied that the arrangement was objectively fair and reasonable.

The decision of the Yukon Supreme Court in the fairness hearing can be found here. The decision of the Court of Appeal in Chambers granting a stay of the fairness approval pending the appeal can be found here. The decision of the Court of Appeal overturning the fairness approval can be found here.

Background

While incorporated in the Yukon Territory, InterOil's principal assets are its interests in oil and gas properties in Papua New Guinea that are at the exploration and development stage. InterOil is listed on the New York Stock Exchange and the Port Moresby Stock Exchange in Papua New Guinea.

In May 2016, during an ongoing review of ordinary course funding initiatives and an asset sale process, InterOil receiving an unsolicited bid from Oil Search Limited (Oil Search) and ultimately entered into an agreement whereby Oil Search would acquire InterOil by way of a plan of arrangement for consideration of US$40.25 per share plus a contingent value right providing for a cash payment linked to the interim certified contingent resources volume on InterOil's main oil and gas property. The contingent value right was not capped in any way.

On June 30, 2016, before InterOil's shareholders could vote on the approval of the Oil Search transaction, InterOil received an unsolicited "topping" bid from Exxon. After Oil Search declined to match the Exxon bid (and after Exxon paid to Oil Search a US$60 million break fee on behalf of InterOil), InterOil and Exxon entered into an agreement whereby Exxon would acquire InterOil by way of plan of arrangement for consideration of US$45 per share plus a contingent resource payment (CRP). Significantly, while Exxon's

CRP provided for a cash payment based on the same interim certified contingent resources volume as Oil Search's contingent value right, the CRP was capped at a volume of 10 trillion cubic feet equivalent (tcfe). The payment to be made by Exxon in respect of the CRP was also at a greater rate per tcfe than Oil Search had agreed to pay.

The maximum CRP amount payable up to the cap would amount to approximately US$27 per share, thus bringing the potential total compensation to US$72 per share for the InterOil shares.

On September 21, 2016, shareholders holding approximately 72% of InterOil's issued and outstanding shares voted at a shareholder meeting to approve the acquisition, and approval was given by approximately 80.2% of the shares voted (representing approximately 58.2% of the issued and outstanding shares). Mr. Mulacek voted against approval of the arrangement and he, and other shareholders, dissented from the transaction. All told, holders of approximately 10% of the issued and outstanding shares dissented.

The "fairness hearing" to approve the plan of arrangement was held in Whitehorse, Yukon Territory, on September 27, 2016, before the Yukon Supreme Court. Judgment was released on October 7, 2016, and the Yukon Supreme Court approved the Exxon Arrangement as fair and reasonable.

On October 19, 2016, Mr. Mulacek applied to the Yukon Court of Appeal for a stay of the decision of the Yukon Supreme Court and an expedited appeal. The motion for a stay order was opposed by InterOil and ExxonMobil. The Court of Appeal granted the stay and ordered an expedited hearing of the appeal to be held on October 31, 2016.

After hearing the argument of the appeal in Vancouver on October 31, 2016, the Court of Appeal reserved judgment. On November 4, 2016, the Court of Appeal allowed the appeal on the basis that it had not been established that the plan of arrangement was fair and reasonable. The Court therefore denied the necessary approval of the plan of arrangement.

The Decisions of the Yukon Supreme Court and the Court of Appeal of Yukon

In both Courts, the corporate governance process followed by InterOil in approving the Exxon Arrangement was reviewed in detail, as was the sufficiency of the information provided to shareholders in connection with the shareholder approval. Both were found wanting.

Board Process

InterOil established a transaction committee comprised of directors independent of management to review the Oil Search arrangement. That committee did not meet separately, conduct any separate review or consideration, or make any recommendation, in respect of the Exxon Arrangement. Rather, the Exxon Arrangement was considered and approved only by the full Board. This occurred even though two

management directors stood to gain significant financial benefits as part of their employment arrangements, which would be triggered by completion of a change of control transaction.

In particular, the Court of Appeal found that in the circumstances of this matter, the Board should have obtained independent advice as to financial fairness as it was incumbent on the Board to ensure that the arrangement negotiated by management reflected the fair value of the company. They accepted the expert opinion of Mr. Peter Dey, a former Chairman of the Ontario Securities Commission and the author of the *Dey Report* on corporate governance in Canada, that "the process undertaken by this board in considering and recommending the [ExxonMobil] Transaction in these circumstances was deficient, and failed to meet current governance best practice and to ensure adequate safeguards of shareholder interests."

Fairness Opinion

InterOil engaged three financial advisors to assist it, including Morgan Stanley & Co. LLC (Morgan Stanley). Of those three financial advisors, only Morgan Stanley provided the Board with a written fairness opinion. InterOil, in turn, provided that fairness opinion to its shareholders in its meeting materials. The fairness opinion became the subject of extensive comment by both Courts.

The Morgan Stanley fairness opinion provided a one sentence conclusion that "the Consideration to be received by the holders of the Company Common Shares pursuant to the Arrangement [with ExxonMobil] is fair from a financial point of view to the holders of the Company Common Shares" but contained no information as to the analyses, factors, considerations or results of such analyses that underlay its conclusion as to financial fairness. In addition, Morgan Stanley's opinion disclosed that "a substantial portion of [its fee] is contingent upon the closing of the Arrangement" but InterOil did not disclose the amount of this success fee or its terms. Finally, the Morgan Stanley fairness opinion expressly stated that "with the permission of the Board of Directors [of InterOil], we have not attributed any specific value to the CRP for the purposes of arriving at the conclusion expressed in this letter."

Both the lower Court and the Court of Appeal found that the fairness opinion of Morgan Stanley was deficient. The lower Court went so far as to say that it was "indicative of a failure [by the Board] to discharge its fiduciary obligations." The Court of Appeal found that the exclusion of value for the CRP together with the contingent success fee "undermined the utility of the fairness opinion to the directors, the shareholders and the Court." The following points were of particular concern to the Courts:

- The fairness opinion failed to address the impact of the cap on the CRP so that shareholders could consider whether the proposed arrangement reflected the value of InterOil's assets;
- The fairness opinion failed to disclose the details of Morgan Stanley's success compensation so that shareholders could evaluate whether the fairness opinion was influenced by that compensation;
- The fairness opinion was deficient ("remarkably deficient" in the words of the Yukon Supreme Court) in that;• it contained no reference to the specific documents reviewed,• it contained no facts

or information to indicate what the opinion was based on, and• it contained no analysis of the facts or information so that a shareholder could fairly consider the merits of the Exxon Arrangement; and
- Shareholders had not been provided with an independent financial fairness opinion on a flat fee basis, particularly where, as here, the CEO had a significant financial incentive for the Exxon Arrangement to proceed.

The Courts contrasted the opinion of Morgan Stanley with an opinion on financial fairness from Paradigm Capital Inc. (Paradigm) that was filed by Mr. Mulacek. Paradigm detailed its approach and the results of its considerations, including the multiple valuation methodologies and analyses undertaken. Paradigm concluded that the consideration pursuant to the Exxon Arrangement "is inadequate from a financial point of view, to the shareholders of InterOil." The Court of Appeal explicitly noted that the Paradigm fairness opinion was the only independent opinion as to financial fairness.

Shareholder Approval

Notwithstanding clear findings of deficiencies in the corporate process for the review and approval of the Exxon Arrangement and inadequate disclosure such that shareholders had "no real assistance in evaluating the Exxon Arrangement" prior to their vote, the lower Court deferred to the shareholder vote and approved the transaction, stating that the Court should "speak freely and independently about matters of corporate governance but at the end of the day it is the shareholders that have spoken in favour of the Exxon Arrangement. Judges are not business people and are not in a good position to judge these investments."

The Court of Appeal found that the application judge erred in principle in setting aside these deficiencies in the corporate process and disclosure to shareholders. The Court of Appeal held that the Court must be satisfied that shareholders were able to make an informed choice and cannot defer to a shareholder vote or market verdict in circumstances were such vote is unreliable. The Court is required to ensure that the shareholder vote was informed "in the sense of being based on information and advice that was adequate, objective and not undermined by conflicts of interest." Given the deficiencies in corporate process and in the disclosure to shareholders the Court of Appeal concluded that the fairness of the arrangement had not been established and it therefore set aside the order approving the arrangement.

Lessons Learned

This case once again stresses the importance of a robust corporate governance process in reviewing and approving a transformative transaction and the necessity for adequate disclosure to shareholders to make a fully informed vote. In particular:

- Court approval is an important procedural safeguard for shareholders whose rights are being arranged through an arrangement. The shareholder vote is not a proxy for fairness. Court approval is also required and it is the Court's task to decide whether the proposed arrangement has been

shown to be fair and reasonable in all the circumstances.

- An independent process for review and consideration of a transformative transaction of this nature should be implemented to properly address inherent conflicts of interest, including the establishment of an independent committee of directors with carriage of the review and oversight over the conduct of negotiations, with its own independent legal and financial advisors where appropriate.
- If a fairness opinion is not robust, rigorous and independent, the court may not give any weight to it in assessing the fairness of the transaction.
- A Board in circumstances similar to that of the InterOil Board should retain at least one financial advisor on a “flat fee” engagement to provide a fairness opinion.

If a company take these steps, the Court may properly show deference to the business judgment of the Board and the will of the shareholders provided there are no other circumstances which militate against approval of the transaction as fair and reasonable. Canadian courts have a meaningful and important role in scrutinizing arrangement transactions which should not be approached as a mere “rubber stamp” function.

Mr. Mulacek was represented in the Yukon Supreme Court and the Yukon Court of Appeal by Cassels Brock lawyers Wendy Berman and Lara Jackson with the assistance of Bill Burden, Gordon Chambers, John Christian, Jeffrey Roy, Derek Ronde, Carly Cohen and David Kelman. Local counsel to Mr. Mulacek in the Yukon was provided by Meagan Hannam and Graham Lang of Lamarche & Lang.
