December 09, 2016

ARTICLE

Canadian Courts take a Second Look at Fairness to Shareholders in Plans of Arrangement

Acquisitions of public companies in Canada are, by a wide margin, completed by way of a statutory plan of arrangement. There are many reasons for this, including the procedure's flexibility in allowing for tax planning or to provide for the acquisition of multiple classes of securities, as well as the ability to achieve 100% ownership in a single closing. A recurring concern with the approval process for a plan of arrangement is the requirement for court approval of the arrangement. Recently, the risks around this have been highlighted by the *Marquee Energy* decision at first instance which was overturned on appeal (discussed in our recent Alert) and the decision in *InterOil Corporation v. Mulacek*[1] ("*InterOil*"). In both cases, courts have scrutinized transactions notwithstanding a favourable shareholder vote and, in the *InterOil* case, refused to grant approval.

InterOil Background

In *InterOil,* the Yukon Court of Appeal (made up of judges from the British Columbia Court of Appeal) reversed a successful application for approval of an arrangement pursuant to the Yukon *Business Corporations Act*. Under the proposed arrangement, shareholders of InterOil would receive, in exchange for their InterOil shares, shares of Exxon Mobil Inc. ("Exxon") plus a capped "contingent resource payment" ("CRP"). Total consideration exceeded $2 billion. InterOil's primary asset was a 36.5% joint venture interest in an oil and gas field in Papua New Guinea. The Exxon transaction was the result of a superior proposal made by Exxon following the announcement by InterOil of its agreement to an acquisition proposed by a third party (but prior to shareholder approval of such acquisition). Exxon had paid a $60 million break fee on behalf of InterOil in order to allow InterOil to terminate the prior transaction and accept the Exxon deal.

InterOil's Board bid retained Morgan Stanley to prepare a fairness opinion for the Exxon arrangement. Morgan Stanley was to receive a fee for providing the opinion, which was largely contingent on the arrangement taking place. While it is not clear from the Court of Appeal's reasons, it appears that Morgan Stanley may have been involved for some time. The decision states that Morgan Stanley had already given a fairness opinion regarding the prior transaction, but also indicates that InterOil had been exploring a sale of the company since mid-2015. The proxy circular sent to shareholders in connection with the arrangement indicates that Morgan Stanley was engaged as financial advisor (and not just to provide the fairness opinion). As will be seen, the Court of Appeal made much of the contingent nature of Morgan Stanley's fee in evaluating Morgan Stanley's fairness opinion, but the full nature of the engagement is not explored.

A special meeting of shareholders was held and the resolution to enter into the arrangement with Exxon passed with 80% approval. Philippe E. Mulacek ("Mulacek"), holder of 10% of the outstanding InterOil shares and also the founder and former chairman/director of InterOil, voted against the resolution. Mulacek also opposed the application to have the Yukon Court approve the arrangement.

Yukon Supreme Court

At first instance, the chambers judge granted the application and approved the arrangement. Mulacek argued that the fairness opinion was seriously deficient and adduced two expert opinions (including an "unfairness" opinion from Paradigm Capital) to rebut the Morgan Stanley fairness opinion. One opinion claimed that the process undertaken by the board recommending the transaction was deficient and failed to meet current governance best practice to ensure adequate safeguards of shareholder interests. The Paradigm opinion concluded that, from a financial point of view, the consideration contemplated by the arrangement was inadequate to the shareholders of InterOil. With respect to whether the arrangement was fair and reasonable, although the chambers judge accepted that there may have been deficiencies in the Morgan Stanley opinion and the process, he decided to approve the arrangement relying primarily on the fact that 80% of the shareholders of InterOil had voted in its favour.

Yukon Court of Appeal

The Court of Appeal overturned the Yukon Supreme Court and found that, while it is for the shareholders to decide between conflicting views of the prospects of InterOil, it is the court's task to decide whether the proposed arrangement has been shown to be fair and reasonable. The Court of Appeal stated, "Clearly, it *was* the shareholders' decision to make, but court approval was *also* required by the Act to ensure the decision was fair and reasonable in the sense of being based on information and advice that was adequate, objective and not undermined by conflicts of interest".

In rejecting the arrangement, the Court held that the Morgan Stanley opinion was deficient in its substantive analysis of the transaction. Specifically, the report failed to value the CRP, which, together with the contingent nature of Morgan Stanley's fee, meant that the opinion was of limited utility to the directors and shareholders and the court. The Court agreed with Mulcaek's expert who stated that that board should have obtained independent advice on the value of the CRP and the gas field asset.

The Court also found other reasons why there should have been another fairness opinion. In its view, the fact that management would realize significant compensation from the transaction meant that it was incumbent on the Board to ensure the deal reflected fair value — by seeking another "independent" opinion. The Court did not examine whether the compensation arrangements in fact incentivized management to get the best price possible. It also expressed the view that the special committee had not done enough to act independently of management in the course of negotiations.

The Court of Appeal found that these and other "red flags" required the chambers judge to do more than simply accept the majority vote as a "proxy" for fairness or the cash amount of Exxon's offer as a proxy for reasonableness.

Other Cases

If nothing else, the *InterOil* decision shows how unpredictable outcomes for plans of arrangements can be once they are before the courts. In a 2010 decision, notwithstanding widespread criticism and opposition from several large institutional shareholders, the Ontario Divisional Court upheld a lower court ruling approving a plan of arrangement involving Magna International Inc.[2] where shareholders had voted 75% in favour.

With regard to fairness opinions, two 2014 Ontario cases provided diverging commentary that appeared to have the net result of leaving practice the same. In *Champion Iron Mines Limited*[3] the Court rejected a fairness opinion as being inadmissible and commented that companies should tender strong, robust fairness opinions when applying to the Court with a plan of arrangement. Despite this commentary, the plan was approved on the basis that there was a high level of shareholder approval (over 99%) and the Board and Special Committee had determined that the Arrangement was in the best interests of Champion Iron and its shareholders. On the other hand, in *Bear Lake Gold Ltd. (Re)*[4] the Court held that a fairness opinion in respect of a plan of arrangement is not intended to be expert evidence akin to that tendered at trial but rather is to be used by the court as a factor in determining whether the plan of arrangement is fair and reasonable to the shareholders. Notably, the arrangement was passed by 97.9% of the votes cast at the shareholders meeting called to consider the arrangement. The Court approved the arrangement.

In a 2009 decision of the Ontario Securities Commission, *Re HudBay*, the Vice Chair of the OSC had expressed concern in respect of fairness opinions contingent on transaction fees by noting that they will not establish that a director has discharged their fiduciary duties. Following significant concern being voiced by the M&A community, the Vice Chair in remarks at a Conference Board of Canada conference, stated that the *HudBay* decision depended on its own facts and that it was not the intention of the OSC to send a message to directors not to get a fairness opinion or that success fees could not be paid to the person giving a fairness opinion. As a result, practice in this area, including payment of success fees to financial advisors who also gave fairness opinions, did not change.

As the *InterOil* case demonstrates, however, once things get into court, the rules change. The Yukon Court of Appeal made the point that the "only independent opinion in evidence" was the opinion of Mulacek's expert and the Court did not place much weight on the Morgan Stanley opinion. Since the purpose of a fairness opinion is to help the directors discharge their fiduciary duties, this is not necessarily inappropriate. However, it does demonstrate that in a contested hearing on fairness, it may be necessary for the company that is the subject to a plan of arrangement to introduce evidence beyond the fairness opinion itself.

Conclusion

It is difficult to know what the impact of the *InterOil* decision will be. Certainly, it reinforces what has always been the case — if a transaction is implemented by way of a plan of arrangement, then one must be prepared for disgruntled securityholders to use the platform it provides to oppose the transaction. With regard to fairness opinions, it would not seem inappropriate for boards of directors to themselves determine, knowing the relevant fee arrangements of their advisors, whether a further independent opinion is necessary in the particular circumstances. Nevertheless, boards may decide in some circumstances, to seek fairness opinions from a financial advisor whose compensation is not tied to the outcome of the transaction.

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[1] 2016 YKCA 14

[2] 2010 ONSC 4685

[3] 2014 ONSC 1988

[4] 2014 ONSC 3428

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