



FAIRNESS OPINIONS REVISITED: LESSONS FOR THE BOARD

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Fairness opinions are largely accepted as forming an essential component of the board's review of a major business transaction. They are typically obtained from a financial adviser for the purpose of analysing the consideration that is being received or paid, in order to determine whether the transaction meets the requisite standards of fairness. In this respect, the fairness opinion can assist in demonstrating that the board has fulfilled its duties in considering a transaction, and provide objective evidence of its fairness. A fairness opinion often supports a board's recommendation to the shareholders when a transaction requires the affirmative vote of the shareholders in order to proceed. Issues relating to fairness opinions and the proper board process surrounding such opinions have surfaced recently on a few occasions in Canada, the most recent being the high-profile dual class share declassification of Magna International Inc, a transaction where, ironically, no fairness opinion was given. What follows from the Magna transaction is a clear affirmation that the facts will be paramount in determining whether a fairness opinion fulfils its objectives. These facts include not only the nature of the transaction and consideration involved, but also the process followed by the board in retaining and working with its financial advisers.

FACTS OF THE MAGNA TRANSACTION

Magna International Inc (Magna or the Company) had, since 1978, a dual class share structure where the subordinate voting shares carried one vote (class A shares), in contrast to the 300 votes attached to the multiple voting shares (class B shares). The class B shares were held by the Stronach Family Trust, a family trust set up by the Company's

founder, Frank Stronach. It was generally accepted that the class A shares had historically suffered from a trading discount on account of the dual class structure. This was exacerbated in the Magna situation because the class A shares did not have the protection of any "coat-tails" (that would have otherwise restricted the sale of class B shares without involving class A's), nor were the

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class B shares subject to a sunset or expiry provision. The Stronach Family Trust was thus free to sell its control position at any time. The Company's management sought to remedy the situation through a plan of arrangement under Ontario corporate law, that would see the class B shares being cancelled in exchange for the issuance of nine million class A shares, representing approximately 7 per cent of the outstanding class A shares and dilution of just over 11 per cent for the class A

shareholders. Additional consideration included the payment of US\$300 million in cash, a consulting agreement that would give Frank Stronach a percentage of the Company's before-tax profits (starting at 2.75 per cent in the first year and decreasing at a rate of 0.25 per cent each year), and a 26.67 per cent interest in an "e-car" partnership with the Company. As a plan of arrangement, the transaction was subject to both shareholder and court approval. Being challenged by a group of opposing shareholders, it was also reviewed by the Ontario Securities Commission (OSC).

The facts before the courts and the OSC were largely as follows: the Executive management of the Company worked with the Stronach Family Trust and brought a proposal to the board. The board struck a special committee to be comprised of independent directors. The Special Committee engaged CIBC as its financial adviser. While the proposal's announcement was followed by a positive response from securities analysts and a rise in Magna's share price, a group of mainly institutional shareholders opposed the transaction. The central issue was whether the benefits of the proposed arrangement outweighed the costs to class A shareholders. On the flip side, it was widely acknowledged that the primary benefit to the class A shareholders would be the eventual increase in the trading multiple of the class A shares. A benefit that became arguably the key distinguishing feature in this case and one that the financial adviser stated it could not value. CIBC's reports to the special committee did, however, review comparable transactions and advise, among other things, that the average dilution in comparable transactions ranged from between 0.89

per cent and 1.28 per cent, in contrast to the estimated 11.4 per cent here. The special committee, having no fairness opinion in hand, recommended that the transaction be put to a shareholder vote but made no recommendation as to how shareholders should vote. The proxy advisory firm, ISS, also reluctantly recommended that shareholders vote in favour of the transaction. ISS relied heavily on positive market reaction in making this recommendation, voicing its discontent with a number of elements of the transaction, including the board approval process. In an interesting subsequent development, ISS took the opportunity to rebuke members of the Special Committee by opposing their re-election at the Company's annual meeting. In its report dated 19 April 2011, ISS noted that given the size and importance of the transaction and the responsibility of the Special Committee to safeguard the shareholders' interests, the decision not to advise shareholders as to fairness was unacceptable.

Notwithstanding the unprecedented nature of the transaction on many fronts and despite its opposition, the plan was ultimately approved by both shareholders and the court. The OSC also, while expressing a number of reservations about the approval process and ordering the Company to augment its disclosure, did not find grounds to restrain the transaction or cease trading the shares.

COURT AND OSC REVIEW

In coming to its conclusion, the Ontario Superior Court of Justice cited the Supreme Court of Canada's decision in *BCE Inc v 1976 Debentureholders* (BCE) for the proposition that three conditions must be satisfied by a corporation seeking an arrangement:

- that statutory procedures have been met;
- that the application has been put forward in good faith; and
- that the arrangement is fair and reasonable.

This case centred primarily on the last condition. On this point, the court cited BCE as requiring that the arrangement have a valid business purpose and the

objections of those whose legal rights are being arranged are being resolved in a fair and balanced way. The court, relying heavily on the shareholder vote, concluded that the arrangement was fair and reasonable. It also highlighted the positive market reaction as excluding the possibility of a determination that the proposed arrangement was inherently unfair and unreasonable, there being some belief among market participants that there was at least a reasonable possibility of achieving the benefits upon which the transaction was premised.

The primary economic rationale for the transaction was the benefit to the class A shareholders from the increase in the trading multiple of their shares. The way that CIBC saw it, any fairness opinion on the transaction would therefore need to cover the future trading multiples and future trading prices of the class A shares. According to CIBC, however, it was not customary practice in giving fairness opinions to express an opinion on likely future trading prices. In contrast, Morgan Stanley, the financial adviser retained by counsel to the opposing shareholders, noted that all precedent transactions from 1994 to present had been the subject of a fairness opinion and concluded that the consideration paid was not fair from a financial point of view. It did not, however, address the likely trading prices of the class A shares or the impact on their future trading multiples.

Faced with these divergent views, the court concluded that the correct exercise in the circumstances was the one that the special committee attempted to undertake: a balancing of the cost-benefit analysis in a manner that addresses the benefits to both parties. This analysis could be satisfied in the court's view notwithstanding the unprecedented price being paid if the benefits to the class A shareholders reasonably approximated or exceeded such price. The opposing shareholders argued, as one would expect, that the lack of both a fairness opinion and a recommendation reflected the fact that the transaction was not objectively and substantively fair. While the court agreed that many traditional indicia of fairness and reasonableness were absent, it was not able to draw an adverse

inference from the absence of a fairness opinion, noting that CIBC's position on the general practice regarding fairness opinions in Canada was not challenged. The court further stated that given the absence of a fairness opinion, the special committee "could not responsibly make a recommendation based on its personal assessment of the likely direction of the trading multiples pertaining to the class A shares."

The Divisional Court dismissed the case on appeal, noting that it may find a plan of arrangement to be fair and reasonable in the circumstances even if it cannot make an exact determination of the relative financial costs and benefits. It was sufficient, according to the court, that there is "credible evidence that shareholders could reasonably conclude that the perceived benefits equal or outweigh the costs."

Before the OSC, commission staff argued that no vote should be put to shareholders because the disclosure was deficient and the process followed by the board was inadequate. The opposing shareholders asked the OSC to enjoin the transaction altogether on grounds that it was abusive to shareholders. The OSC ordered the Company to amend its disclosure to include a "full and accurate" description and a "meaningful discussion and analysis" of certain prescribed information. This information included:

- how the management and the board arrived at the consideration to be paid and the potential economic benefits to shareholders;
- a detailed review of the approval process adopted by the special committee; and
- the advice given by CIBC, including details on how CBCA assessed the transaction and why it could not provide a fairness opinion.

It should be noted however that proxy circulars are not generally subject to review or approval by securities regulators in Canada. In this case, a formal valuation was also not required (of what was otherwise a "related party transaction" which would be subject to formal valuation) because of a statutory exemption relating to the value of

the transaction relevant to the market capitalisation of the Company.

The OSC was also particularly critical of the process followed by the board and the special committee. It took issue with the level of management participation, which the OSC saw as being “fundamentally conflicted,” and that management essentially had negotiated and presented a “done deal” to the board. A deal that was negotiated without management having any benefit of independent financial advice, including advice on comparable historical transactions. The negotiation process, according to the OSC, was as a key aspect of the overall process that should have been conducted by the special committee. The OSC also took issue with the special committee’s mandate, which it saw as being too narrow in that the special committee was:

- limited to reviewing and considering the proposal developed by management;
- not authorised to negotiate; and
- asked only to determine whether the transaction should be submitted to a shareholder vote.

Regulatory guidance (namely, the Companion Policy to Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions) made it clear, according to the OSC, that the board and special committee should address the desirability and the fairness of the transaction. Moreover, and in contrast to the Superior Court’s view on this point, the absence of a fairness opinion was no reason why the special committee could not conclude on the fairness of the transaction. Ultimately, while the OSC considered intervening due to inadequacies in the process, it did not have sufficient evidence regarding the process to come to that conclusion. However, the OSC did note that to obtain the benefit of a special committee review of a related party

transaction, the process must appropriately manage all conflicts of interest and the mandate must be broad enough to allow key issues to be addressed.

Prior to Magna, the OSC also noted concerns surrounding retention of financial advisers and fairness opinions in its reasons for decision in the matter of Hudbay Minerals Inc (Hudbay). That transaction involved a review by the OSC of the TSX’s decision not to impose acquirer shareholder approval for what would have been a highly dilutive transaction for acquirer shareholders (and predated implementation of TSX rules that now require acquirer shareholder approval for transactions that result in greater than 25 per cent dilution). Determining that acquirer shareholder approval was required, in its obiter statements the OSC stated that “a fairness opinion prepared by a financial adviser who is being paid a signing fee or a success fee does not assist directors comprising a special committee of independent directors in demonstrating the due care they have taken in complying with their fiduciary duties in approving a transaction.” These comments caused quite a stir in Canada, given the generally accepted practice of paying success fees to financial advisers. In subsequent public comments, one member of the panel that was involved in the decision attempted to clarify this statement on the distinguishing fact that the fairness opinion in that case was given in respect of the interests of the shareholders of the acquirer, noting that where a target is looking to maximise value, a success fee would not likely give rise to the same type of concern. He further noted that, “...any issue of alignment or misalignment of the financial incentives to an opinion giver, relative to the interests of shareholders, is one for consideration by the board of directors in the particular circumstances of the

relevant transaction.” Simply obtaining the fairness opinion, in other words, does not allow the board to “check a box” in its due process “to do” list. As demonstrated by Magna, the facts of each case will be paramount in determining the process required in the circumstances.

This is a sentiment recently echoed by the Delaware courts in *Re Del Monte Foods*, where Vice Chancellor Laster noted that not only have Delaware Courts required full disclosure of investment banker compensation and potential conflicts, but have also examined banker conflicts closely to determine whether they taint the directors’ process. What follows from cases like these is that it is incumbent upon the board to be fully engaged and actively supervise the process, which includes asking for full disclosure about, and objectively reviewing, any potential conflicts with financial advisers. Notably, financial advisers who are subject to the rules of the Investment Industry Regulatory Organization of Canada are required to disclose past, present, or anticipated relationships that may be relevant to their independence for the purposes of rendering a fairness opinion. While the circumstances of each case will ultimately dictate whether the board’s process was sufficient, what stems from these developments are a number of factors to consider when assessing how much weight can be placed on a fairness opinion and whether obtaining the opinion enhances or taints the board’s process. These factors include the mandate given to the financial adviser, the scope and subject matter of the fairness opinion, the process followed by the board or the special committee in retaining the financial adviser and obtaining the opinion and the independence (or lack thereof) of the financial adviser.