Fair Value as Windfall: A Tale of Dissent

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As intrepid readers of our blogs will recall, we previously discussed the tale of ExxonMobil Canada's ("ExxonMobil") acquisition of InterOil Corporation here and here. To refresh: ExxonMobil had sought to acquire by plan of arrangement under the Yukon *Business Corporations Act* (YBCA) all of the shares of InterOil for shares of ExxonMobil, plus a capped contingent payment (the "Arrangement"). Although the arrangement had been approved by over 80% of voting InterOil shareholders and Mr. Justice R. S. Veale of the Supreme Court of Yukon granted the final order approving the arrangement, a number of governance concerns were raised, including most notably deficiencies in the disclosure regarding valuation and analysis, conflicting interests and the success fee basis of the financial advisor's compensation in relation to the delivery of its fairness opinion. On appeal, the Yukon Court of Appeal agreed with the governance concerns and viewed them as so fundamental to the question before shareholders that it set aside the final order.

What followed was a painful and costly do-over by ExxonMobil and InterOil involving a second shareholder meeting and a refreshed proxy circular based on a more robust governance process and reflecting fixed fee financial advisory services from an additional financial advisor. Notably, the terms of the arrangement, including the price of US$45 per share plus a contingent value payment offered for the InterOil securities, remained materially unchanged,

Shareholders overwhelmingly approved of the arrangement…again…with over 91% in favour. The Supreme Court of Yukon issued a final order in respect of the arrangement thereafter and the transaction closed.

The Saga Continues…

While not statutorily required, it is fairly common practice for issuers negotiating arrangements in Canada to provide for a dissent right consistent with the statutory provisions and as may be modified by the interim order in respect of the arrangement, which dissent right entitles a shareholder to receive the "fair value" for their shares as of the business day preceding the date on which the arrangement is approved. Such a right was afforded to shareholders under the Arrangement and, as luck would have it, certain shareholders determined to exercise it.

Interestingly, Chief Justice R.S. Veale of the Supreme Court of Yukon, the same judge who was so deeply troubled by the governance deficiencies in the original application for the final order for the Arrangement, presided over the determination of "fair value". The decision, *Carlock v. ExxonMobil Canada Holdings ULC*, can be found here.

Notwithstanding that ExxonMobil's successful offer of US$45 was approved by over 91% of shareholders and represented at the time an approximately 30% premium to the market price and that the Arrangement followed a protracted bidding process involving three bidders (ExxonMobil, Total and Oil Search), the dissenting shareholders asserted that the "fair value" ought to be US$71.46, a premium of some US$26.46 (59%) above Exxon's successful offer. For reasons which are challenging to reconcile, the Court ultimately agreed with the dissenting shareholders, ordering ExxonMobil to pay US$71.46 per share as fair value. Given the substantial disconnect between the Arrangement price and the "fair value" determination of the Court and its potential implication for future acquisition processes, the analysis bears review.

While "fair market value", being the highest price obtainable in an open and unrestricted market between willing parties dealing at arm's length, is often used to determine "fair value" the two are not synonymous. [1] Judicially accepted alternatives to "fair market value" include:

- the valuation of the net assets of the company at fair value;
- the capitalization of maintainable earnings;
- the discounted cash flow method, taking into account a capitalization of future profits; and
- some combination of the above.[2]

In determining the fair value of the dissenting shareholders' shares, Chief Justice Veale accepted the discounted cash flow methodology despite its dependency on assumed factors such as the lack of historical cash flow of InterOil since 2014, the undeveloped nature of InterOil's main asset (a 36.5% ownership interest in a Papua New Guinea Petroleum Retention License to be used in an LNG joint venture) and the volatility of energy commodity prices. It appears this discounted cash flow methodology was adopted because it was considered by InterOil and Exxon in the negotiation and sale process and of the two options before the Court, it wasn't tainted in the way the Court viewed the transaction price methodology.[3]

That is, the Court focused closely on why the transaction price in the circumstances was not representative of fair value. Ultimately, while the Court recognized that multiple parties with knowledge of the assets of InterOil (including insiders) were involved in a bidding and negotiation process that led to an escalation of the offer price from $35 to $45 dollars, it determined that the process leading to the approval of the transaction by InterOil was so flawed that the transaction price was tainted beyond utility for purposes of the fair value determination.

The subsequent improvements made to InterOil's corporate governance process, including an additional long form fairness opinion, following the Court of Appeal's rejection of the Arrangement, were not sufficient to justify Exxon's valuation.

As the Chief Justice stated:

In my view, the transaction price, borne of a flawed process, cannot be resurrected as the "fair value" as defined by the experts.[4]

It is likely that Exxon was prejudiced in these unique circumstances by the rescheduling of the Meeting occasioned by the protracted court approval of the Arrangement, allowing market changes like commodity price movements to impact the Court's assessment of "fair value". Indeed, positive oil price changes between the initial meeting date of September 21, 2016 and the rescheduled meeting date of February 14, 2017 were material. As a result, absent significant changes in the underlying assets, industry or business of a target with value implications between the date on which a transaction price is agreed and the shareholder meeting to approve it, it is unlikely such a significant disparity between transaction price and "fair value" would again arise.

However, more disconcerting was the Court’s heavy emphasis on the articulated governance flaws as justifying an inability to rely on “fair market value” as a concept; that governance failures so seriously prejudiced a negotiation and the reliability of the transaction price as to render it an invalid proxy for fair value. With respect, such emphasis inflates the relevance of the governance deficiencies to the clearing price and the manner in which it was achieved and implies a breakdown of the duties of the directors to achieve the highest value for shareholders in a transaction of this nature. If followed, it creates the possibility that courts in future dissent proceedings might similarly be tempted to engage in an evaluation of the conduct of the target board; potentially substituting the court’s judgment for the board’s in determining to reject the negotiated value.

Conclusion

Whether this decision will stand as guidance to future fairness hearings, notably on the relevance of the corporate governance associated with a transaction in rejecting fair market value as a fair value proxy remains to be seen. To date the decision has not been appealed.

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[1] *Brant investments Ltd. v KeepRite* 1987, 60 OR (2d) 737, aff’d 1991 CanLii 2705 (ONCA).

[2] *Robinson v Realm Energy International Corp*.,2015 BCSC 1437, at para. 120.

[3] *Carlock v ExxonMobil Canada Holdings ULC*, 2019 YKSC 10 at paras 15, 62-64.

[4] *Ibid* at para. 62.