INTEROIL/EXXON PLAN OF ARRANGEMENT: THIRD TIME'S A CHARM

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On February 20, 2017, InterOil Corporation ("**InterOil**") obtained approval from the Yukon Supreme Court for an updated plan of arrangement with ExxonMobil Corporation ("**Exxon**"). This was InterOil's third court application for approval of a plan of arrangement in connection with Exxon's acquisition of InterOil, as described in an amended and restated arrangement agreement dated December 15, 2016 (the "**Updated Arrangement**"). Pursuant to the court-approved plan of arrangement, Exxon acquired all of the issued and outstanding common shares of InterOil on February 22, 2017.

Judicial History

On InterOil's first application, its original plan of arrangement involving Exxon, as described in the original arrangement agreement with Exxon dated July 21, 2016 (the "**Original Arrangement**"), was approved by the Yukon Supreme Court on October 19, 2016, notwithstanding disclosure and corporate governance deficiencies noted by the application judge. Unsurprisingly, the 5.5% InterOil shareholder that opposed the Original Arrangement, Phil Mulacek ("**Mulacek**"), appealed this decision, and it was subsequently overturned by a unanimous ruling of the Yukon Court of Appeal (comprised of members of the British Columbia Court of Appeal) for reasons which we previously discussed in our Capital Markets & M&A securities law bulletin Court of Appeal Overturns Approval of US$2.3 Billion Merger Between InterOil and ExxonMobil.

An overarching theme in the Court of Appeal decision was the lack of proper disclosure to shareholders. Even though over 80% of InterOil shareholders had voted in favour of the Original Arrangement, the Court of Appeal held that InterOil had not provided shareholders with adequate disclosure as to the value they would be giving up and the value they would be receiving under the Original Arrangement. Without sufficient disclosure, the Court of Appeal concluded that shareholders of InterOil did not have the ability to make an informed decision in voting to approve the Original Arrangement. Accordingly, the Court of Appeal was not able to use the results of the shareholder vote as a proxy in its evaluation of the 'fair and reasonable' part of the test to approve a plan of arrangement (as set forth in *BCE v. 1976 Debentureholders*, 2008 SCC 69). [1] According to the widely accepted test from *BCE*, an application for a plan of arrangement must: (i) comply with all statutory and court-mandated requirements; (ii) be brought in good faith; and (iii) be fair and reasonable.

The fairness opinion that InterOil had obtained with respect to the Original Arrangement was prepared by Morgan Stanley, whose compensation was in large part tied to the success of the transaction. This fee arrangement, which was not disclosed in the management information circular, along with the fact that the opinion failed to value a material asset of InterOil, cast doubt on the legitimacy of the report's conclusions as to the fairness of the proposed transaction. Coupled with the uninformed shareholder approval, these "red flags," led the Court of Appeal to overturn the application judge's decision and block the Original Arrangement from proceeding. Other issues of concern at both levels of court were repeated failures of InterOil to respond to Mulacek's concerns (both in and out of court) and the fact that the Chief Executive Officer of InterOil was heavily involved in the negotiation of the Original Arrangement while facing a potential conflict of interest, in that he stood to gain over $34 million dollars upon its closing, $32 million of which were payable due to the acceleration of his restricted share units under InterOil's management incentive plan. The transaction committee that had been struck with respect to the Original Arrangement was found to be 'passive' and under the influence of the CEO.

Following the Court of Appeal decision, InterOil applied to the Yukon Supreme Court for approval of the Updated Arrangement, which approval was granted.

Key Findings

In issuing its final order approving the Updated Arrangement, the Yukon Supreme Court made the following key findings:

- **Fairness Opinion**: In connection with the Updated Arrangement, InterOil hired an independent financial advisor, BMO Capital Markets (**"BMO"**), that provided a fairness opinion on the proposed transaction on a fixed-fee basis. The application judge felt that the BMO fairness opinion provided a useful template for future fairness opinions in terms of the level of detail and analysis that ought to be provided to shareholders and to the court in transactions conducted by way a plan of arrangement. The BMO fairness opinion clearly set out the materials reviewed and assumptions made, provided a comprehensive explanation of the valuation methodologies used, and analyzed the consideration InterOil shareholders were to receive under the Updated Arrangement. This stood in contrast to the Morgan Stanley fairness opinion which, in the words of the Yukon Supreme Court, "provided no reliable opinion at all." Perhaps unhelpfully, the Yukon Supreme Court also noted that "[i]t is not acceptable to proceed on the basis of a Fairness Opinion which is in any way tied to the success of the arrangement" (*emphasis added*).
- **Improved Corporate Governance Process**: Apart from the new independent fairness opinion, the corporate governance processes of InterOil had significantly improved with the creation of a transaction

committee comprised of four independent members of the board of directors of InterOil (the "**Transaction Committee**"). The Transaction Committee had its own legal counsel, which explained to the Transaction Committee its role and its mandate to consider the Original Arrangement, the Updated Arrangement, and alternatives to an arrangement transaction. After this deliberative process, the Transaction Committee provided a report to the Board of InterOil, which formed the basis of the Board's recommendation that InterOil shareholders vote in favour of the Updated Arrangement. The Board recommendation was accompanied by a management information circular that contained full and complete disclosure of the nature and details of the Updated Arrangement, which enabled shareholders to make an informed decision when voting on the Updated Arrangement.

- **Increased Shareholder Support**: 80% of shareholders voted in favour of the Original Arrangement (with dissent rights being exercised by approximately 10% of shareholders), as compared to over 91% of the shareholders who voted in favour of the Updated Arrangement (with dissent rights being exercised by only 0.5% of shareholders).

Market Practice & Conclusion

A court's assessment of what is 'fair and reasonable' may not include an uninformed shareholder vote approving a plan of arrangement. In contested transactions that may be challenged by a shareholder, it would be prudent for an issuer to obtain a fairness opinion by a financial advisor on a fixed-fee basis. Perhaps most importantly, disclosure in the management information circular will be reviewed by both a court and the securities regulatory authorities.

Accordingly, the market should not panic. The basic concept remains that a shareholder must understand what it is giving up and what it is receiving when it is voting to approve a proposed transaction by way of a plan of arrangement. No one item alone will determine whether a plan of arrangement is fair and reasonable. Like most things, it is a process. The fact situation of each proposed transaction must be reviewed to determine what makes sense in the particular context. At the same time, as a result of the Yukon decisions with respect to *InterOil*, it would be prudent to be more cautious in advising issuers on how to prepare disclosure in the management information circular. It remains unclear, however, whether all jurisdictions will impose higher standards or market practice will change as a result of *InterOil*.

As an aside, since the proceeding before the OSC with respect to *HudBay Minerals*, [2]there has been a noted move toward obtaining a second fixed-fee independent fairness opinion where the financial advisor providing the original fairness opinion receives, as part of its compensation, a success fee. Due to the increased focus on fairness opinions as a result of Hudbay and judicial commentary in the applications involved in InterOil, the Ontario Securities Commission is expected to release a Staff Notice on Multilateral 61-101 – *Protection of*

Minority Security Holders in Special Transactions in the spring which will deal, in part, with fairness opinions. Though it is not required under securities laws to obtain fairness opinions and such opinions are not formal valuations, it is customary in Canada for issuers to obtain them as evidence of satisfying their fiduciary duties and acting independently and objectively in forming their decision to recommend a proposed transaction to shareholders. Such transactions include certain related party transactions, going private transactions and mergers and acquisitions conducted by way of a plan of arrangement. As a result of the increased focus on fairness opinions and their common use, the Ontario Securities Commission is expected to provide guidance on fairness opinions, including the terms under which they are entered into, their use by boards and/or special committees and the breadth of the OSC's disclosure expectations in the management information circular with respect thereto. Once the Ontario Securities Commission provides some clarity on these issues, market practice may be impacted in a more meaningful way.

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[1] https://scc-csc.lexum.com/scc-csc/scc-csc/en/item/6238/index.do

[2] http://www.osc.gov.on.ca/documents/en/Proceedings-RAD/rad_20090428_hudbay.pdf

A Cautionary Note