COURT OF APPEAL OVERTURNS APPROVAL OF US$2.3 BILLION MERGER BETWEEN INTEROIL AND EXXONMOBIL

Posted on December 3, 2016

Categories: Insights, Publications

On November 4, 2016, the Court of Appeal of Yukon (comprised of three justices of the British Columbia Court of Appeal) unanimously overturned a lower court decision that had approved the proposed acquisition of InterOil Corporation ("**InterOil**") by ExxonMobil Corporation ("Exxon") by way of a plan of arrangement (the "**Plan of Arrangement**"). Under the Plan of Arrangement, Exxon would acquire all of the issued and outstanding common shares of InterOil for US$2.3 billion.

Although a significant majority of shareholders voted in favour of the Plan of Arrangement, it was opposed by Philippe E. Mulacek, the founder and former Chairman and CEO of InterOil. Mr. Mulacek opposed the Plan of Arrangement on the basis that it was not fair and reasonable, that InterOil's corporate governance process was deficient, and that the disclosure to InterOil shareholders was inadequate.

Key Findings

In striking down the lower court's decision, the Court of Appeal applied the three-part test for approval of a plan of arrangement as set out in *BCE Inc. v. 1976 Debentureholders,* 2008 SCC 69: 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 Court of Appeal held that the first two requirements were satisfied on the facts of this case, but the third requirement was not. In so holding, the Court of Appeal clarified the role of the court in arrangement transactions and made the following key findings:

- **The Impact of Inadequate Disclosure on the Shareholder Vote:** In order to accept that shareholder approval is an indicia of a plan of arrangement being fair and reasonable, the court must be satisfied that shareholders were in a position to make an "informed choice." In this case, InterOil did not provide sufficient disclosure to its shareholders "both as to the value they would be giving up and the value they would be receiving." Since the shareholders had "no real assistance in evaluating the [Plan of Arrangement] prior to their vote," the Court of Appeal did not show deference to the vote.
- **The Corporate Process and the Role of Independent Advice:** InterOil established a transaction committee comprised of directors independent of management, but the Plan of Arrangement was only

considered and approved by the full board of InterOil, which included two members (including the CEO) who stood to gain personally if the Plan of Arrangement was approved. Further, the negotiation of the transaction was led by management and the committee charged with overseeing the process was "fairly passive." In these circumstances, it was incumbent on the Board to ensure that the agreement negotiated by management reflected the fair value of the company and its shares. The Court of Appeal concluded that the Board should have obtained independent advice as to the financial fairness of the Plan of Arrangement, holding that the Board's process in considering and recommending the Plan of Arrangement was deficient.

- **The Fairness Opinion:** The fairness opinion, which was prepared by Morgan Stanley & Co. LLC, became the subject of much scrutiny. The Court of Appeal noted that the Morgan Stanley opinion was very limited in scope and did not contain any analysis to support the conclusion that the Plan of Arrangement was financially fair to shareholders. Another troubling fact was that Morgan Stanley's fee for providing the opinion was largely contingent on the Plan of Arrangement taking place. As a result, the Court of Appeal concluded that the Morgan Stanley fairness opinion was inadequate and that the board of InterOil should have engaged a second financial advisor on a flat-fee basis (i.e., for a fee not dependent on the success or failure of the transaction). None of the Board, the shareholders, or the Court could rely on the Morgan Stanley opinion.
- **The Role of Courts in Approving Arrangement Transactions:** Even though a significant majority of shareholders voted in favour of the Plan of Arrangement, a court must be satisfied that a proposed arrangement is objectively fair and reasonable in a more general sense. In this case, there were several "red flags" that the Court of Appeal believed could not be ignored: the absence of a fairness opinion from an independent expert, the conflicted position of members of the board of directors (who stood to gain personally from the Plan of Arrangement), and the lack of "necessity" for the deal. The lower court held that, despite these deficiencies, the shareholders were entitled to make their own decision. The Court of Appeal disagreed, stating that, in light of these red flags, "the Court was required to do more than accept the vote of the majority as a 'proxy' for fairness."

Conclusion

This decision illustrates the need for strong corporate governance practices for companies involved in public M&A transactions generally and in arrangement transactions in particular. It is important to have procedures in place to address actual or perceived conflicts of interest and to ensure that a proposed transaction is subject to independent review (and independent advice, where necessary). Ultimately, if a court believes that a company's corporate governance practices were flawed, it may lead to a finding that the arrangement is not fair and reasonable, notwithstanding a shareholder vote in support of the arrangement. In the same vein, it is crucial that shareholders be provided with full and complete disclosure so that they can make a fully informed decision. However, as emphasized by the Court of Appeal, shareholder approval is not a proxy for fairness. Even where a majority of shareholders and the board have voted in favour of a proposed arrangement, the court retains a supervisory role and has the ultimate say in determining whether an arrangement is in fact "fair and reasonable."

As a practice note, it appears that the principal cause of the failure of the Plan of Arrangement to receive court approval may have been the reliance by InterOil's Board on a fairness opinion which, in this court's view, was provided by a financial advisor whose conclusions could have been tainted by the receipt of an undisclosed success fee. As noted by the Court of Appeal, "an opinion obtained from an independent financial advisor 'retained on a flat fee' is an important factor in assisting the court to scrutinize the arrangement before it."

Since the obiter of the Ontario Securities Commission ("**OSC**") in the *HudBay Minerals case* (where the OSC held that success fees create an incentive for advisors to facilitate a transaction, and opinions prepared in this context do not assist directors in demonstrating compliance with their fiduciary duties), there has been a movement towards retaining a second financial advisor to provide a fairness opinion on a flat fee basis in significant transactions. This decision will undoubtedly cause issuers involved in M&A transactions – particularly if they are contested – to carefully consider whether it is appropriate to proceed without such a second opinion. In smaller transactions, this will be a more difficult decision as issuers will have to consider the costs associated with engaging two financial advisors.

by Paul Davis, Laura Fraser

A Cautionary Note