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Canadian Court Awards Significant Premium to Negotiated Deal Price in Determining "Fair Value"

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Note: On March 18, 2019, ExxonMobil filed a notice of appeal to the Yukon Court of Appeal. We will be watching the progress of the appeal and will report on the decision once it is released.

The 2017 acquisition of InterOil by ExxonMobil continues to generate cases of interest to M&A participants and practitioners despite the transaction having closed more than two years ago. In *Carlock v ExxonMobil Canada Holdings ULC*, the Yukon Supreme Court sided with dissenting shareholders in determining that the fair value of an InterOil share at the time of closing was US$71.46, representing a premium of over 40% to the actual negotiated transaction value. Although the transaction was itself the result of an unsolicited topping bid made by ExxonMobil, the Court determined, among other things, that the transaction price was "established in a flawed corporate governance process" and, accordingly, "the transaction price, borne of a flawed process, cannot be resurrected as the 'fair value' as defined by the experts." Whether one agrees with manner in which the Court determined fair value in this instance, the case serves as yet another reminder that concerns over the process leading to a public M&A transaction can have significant and substantive economic consequences.

Key Details of the InterOil–ExxonMobil Transaction

Prior to its sale to ExxonMobil, InterOil was listed on the New York Stock Exchange and had no revenue-generating assets, with its principal asset being a 36.5% interest in a petroleum retention licence covering the Elk and Antelope gas fields in Papua New Guinea (PRL 15). In mid-2015, InterOil commenced a process in which it sought to sell minority interests in certain of its assets, with 36 parties being contacted and a number of them conducting due diligence. Some months later, this process led to a narrower, confidential process in which InterOil received bids for the whole company from three parties: Oil Search, ExxonMobil and Total.

After initially reaching an agreement to be acquired by Oil Search, InterOil subsequently exercised its "fiduciary out" to terminate that agreement when, five weeks after announcement of the Oil Search transaction, InterOil received an unsolicited superior topping bid from ExxonMobil. On July 21, 2016, InterOil entered into an agreement with ExxonMobil providing for the acquisition of all of the InterOil shares in a plan of arrangement transaction for US$45 per share, to be satisfied in ExxonMobil shares, together with a contingent value right. The arrangement ultimately failed to win court approval, with the court citing numerous concerns about the process that led to the transaction, including concerns about the independence of the financial adviser, board and management conflicts and the fairness opinion analysis. The parties subsequently amended the transaction to increase the potential value of the contingent value right and addressed the court's process concerns by, among other things, engaging additional independent counsel and securing an independent fairness opinion. The revised transaction received over 90% support from shareholders at the meeting to approve the transaction.

Meaning of Fair Value

A shareholder's right to dissent serves an important function in a corporate transaction in which a shareholder's equity interest is effectively being expropriated. Consistent with other Canadian business corporation statutes, the Yukon *Business Corporations Act* provides that a shareholder has the right to dissent from certain corporate transactions and be paid "the fair value of the shares in respect of which the shareholder dissents." In the case of the InterOil plan of arrangement, the effective date for the determination of fair value was February 22, 2017, the closing date of the transaction.

The term "fair value" is not necessarily synonymous with "fair market value"; however, the Court adopted the customary formulation of fair market value in its analysis, as did the parties to the litigation, being "the highest price available in an open and unrestricted market between informed and prudent parties, acting at arm's length and under no compulsion to act."

The Court reviewed the general principles to determine fair value, including the various methods of valuation generally accepted by the courts: (i) the quoted market price on the stock exchange; (ii) the valuation of the net assets of the company at fair value; (iii) the capitalization of maintainable earnings; (iv) the discounted cash flow method taking into account a capitalization of future profits; and (v) some combination of the foregoing. The Court also noted that "the deal arranged between the parties is not presumed to be fair value, [but] it may well be fair value after 'further careful consideration.'"

Court Rejects the Transaction Price Due to Process Concerns

The Court concluded that the transaction price could not be relied upon as fair value and cited a number of concerns, which can be grouped into two broad categories, to support its conclusion: concerns about the process leading to the original transaction with ExxonMobil and concerns about the process that followed once the transaction was resurrected.

Concerns with the Initial Sale Process

- While the strategic process commenced by InterOil in 2015 ultimately led to three credible bids for the whole company, "[n]one of these approaches had been solicited by InterOil as whole company transactions." In fact, the Court distinguished the "bidding and negotiations process" that took place with these parties from an "auction," later noting there had been "no planned sale process in which InterOil attempted to solicit the highest possible market price for a whole company transaction."
- The Court also cited the fact that once the Oil Search transaction was announced, "the non-solicitation clause prevented InterOil from soliciting or seeking out other bidders for a whole company transaction." An assessment of this criticism of the Court appears to show that the non-solicit clause was viewed as problematic since the initial process leading to the agreement was not the result of an open auction process.
- The process followed by the InterOil board in arriving at the original Exxon Mobil transaction "had been roundly criticized by the Yukon Court of Appeal."

Concerns with Process After Initial Court Rejection

- After the Yukon Court of Appeal rejected the original ExxonMobil transaction, the Court concluded that "there was never even consideration of commencing a fresh process."
- While InterOil's response to the court's decision rejecting the original ExxonMobil transaction was to implement a number of "corporate governance enhancements," the Court viewed those enhancements as "by no means conclusive as they followed rather than preceded the establishment of the transaction price."
- The Court noted that the transaction value remained the same, subject only to an increase in the potential value of the contingent payment.

The Court determined that these concerns outweighed the factors that would typically weigh in favour of accepting the transaction price – namely, that the InterOil shares traded on the NYSE; that the interested parties were all "major players" who knew the industry in Papua New Guinea and included insiders with specific knowledge of the project; that InterOil's presence "on the market" was "no secret"; and that the transaction price increased through the bidding process from $34 to $45.

Court Endorses the Use of a Discounted Cash Flow Analysis

In evaluating the various valuation methods, the Court settled on the use of a discounted cash flow (DCF) analysis. Not only was a DCF analysis considered by all parties during the negotiation and sale process, each party's expert had applied a DCF analysis as well. The

Court also acknowledged potential shortcomings with a DCF analysis, referring to both the apparent mathematical certainty such an analysis can yield and the potentially significant impact of even minor variations in the underlying assumptions used.

For the Court, the "crux" of the fair value dispute was the competing DCF analyses prepared by the parties' respective experts. The dissenting shareholders' expert concluded that the fair value was US$71.46, whereas ExxonMobil's expert concluded that the fair value was US$49.98, which equalled the $45 per share price plus the $4.98 that was ultimately realized on the contingent value right.

The Court noted three principal differences in the key inputs to the analysis which drove the differing values:

- The discount rate applied by ExxonMobil's expert was 1% higher at 11% compared with 10%.
- Exxon Mobil's expert applied a 3.5% country risk premium, whereas the dissenters' expert applied no such premium.
- Exxon Mobil's LNG slope assumption was 12.6% compared with 14%.

Having dismissed the transaction price as a reliable indicator of fair value, the Court did not undertake an independent analysis of its own and ultimately adopted the conclusion of the dissenter's expert. In doing so, the Court noted that no country risk was applied in the analysis by InterOil's independent fairness opinion provider nor was any evidence led on whether there was country risk. The Court also noted that the dissenter's expert had reflected the increase in the oil price between March 2016 and February 2017, which was not considered in the analysis of InterOil's independent fairness opinion provider or the ExxonMobil expert.

Key Takeaways

One could be tempted to dismiss the finding in this case as the product of a unique set of facts and circumstances, including that an earlier iteration of the transaction had been criticized and rejected by the Yukon Court of Appeal. In that regard, notwithstanding the Court's concerns that InterOil did not conduct a fully public and unfettered auction process, the Court acknowledged that there was wide industry knowledge that InterOil was seeking a sale transaction and approached the most logical and credible purchasers, and the bid process had yielded an increased price. Accordingly, absent the process criticisms of the Yukon Court of Appeal, the Court could have come to a different conclusion. Therefore, whether one agrees with the weight ascribed to the process criticisms in this particular case in rejecting the transaction price as evidence of fair value, one of the key takeaways that may be lost in the uproar is that process matters in public M&A transactions. The InterOil decisions, together with the increasing scrutiny by securities regulators on material conflict of interest transactions (see Multilateral CSA Staff Notice 61-302), make clear that all parties involved in a public M&A transaction should have a shared interest in ensuring a sale process that is, to the extent practicable, rigorous, independent and arm's length.

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