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Playing Fair in a Post-*InterOil* World: Market Practice in Fairness Opinions

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The provision of fairness opinions in M&A transactions remains an area of evolving practice in Canada following the Yukon Court of Appeal's 2016 decision in *InterOil Corporation v Mulacek*. In that decision, the Yukon Court of Appeal blocked ExxonMobil's acquisition of InterOil Corporation under a plan of arrangement on the basis that the arrangement was not fair and reasonable to the parties whose interests were being arranged, partly due to deficiencies in the fairness opinion obtained by InterOil's board of directors. The Yukon Supreme Court subsequently approved ExxonMobil's second attempt to acquire InterOil through a plan of arrangement after InterOil's board of directors had obtained a more robust, "long-form" fairness opinion. Despite considerable discussion of the potential impact of the *InterOil* decision, the implications of the decision are not fully clear almost two years later. As a result, issuers and their financial advisers continue to need to balance the value of providing a comprehensive fairness opinion to shareholders with the costs of enhanced disclosure in the particular circumstances of each transaction.

The Canadian Approach

Fairness opinions are not legally required to be provided in Canadian acquisition transactions, but are a regular feature of almost all board-supported transactions in Canada. Boards customarily obtain fairness opinions from a financial adviser to help demonstrate that they have satisfied their fiduciary duties in approving a transaction.

In contrast to the approach taken in the United States, where issuers typically provide detailed disclosure of the financial analysis underlying the fairness opinion, market practice in Canada prior to *InterOil* had been to obtain only a "short-form" opinion, with no disclosure of the underlying financial analysis. Further, the financial adviser providing the opinion has generally been compensated through a success-fee arrangement. Disclosure of the underlying financial analysis has only been included in the context of transactions subject to Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions* (MI 61-101), which mandates the requirement to obtain a formal valuation from an independent valuator in certain circumstances and certain related disclosure.

Judicial and regulatory consideration of market practice relating to fairness opinions predated the decision in *InterOil*. In its 2009 ruling in respect of the proposed transaction between Hudbay Minerals Inc. and Lundin Mining Corporation, the Ontario Securities Commission (OSC) concluded that a fairness opinion prepared by a financial adviser compensated on a success-fee basis did not assist directors in demonstrating compliance with their fiduciary duties.[1]

A year later, the OSC intervened in the reorganization of the capital of Magna International Inc. (Magna) in circumstances in which, among other things, no fairness opinion was obtained by the issuer. The OSC required Magna to provide enhanced disclosure to its shareholders, including additional disclosure concerning the financial analysis of the underlying transaction provided by the issuer's financial advisers.[2]

In 2014, the Ontario Superior Court questioned the prevailing practice with respect to fairness opinions by refusing to admit as evidence the fairness opinion filed by Champion Iron Mines Limited on the basis that it did not disclose any meaningful financial analysis.[3] However, in two subsequently released decisions, *Re Bear Lake Gold Ltd.* and *Re Patents Royal Host Inc.*, the Ontario courts concluded that there was no reason to depart from the existing disclosure practice in the context of non-contested transactions.[4]

The *InterOil* Standard

In 2016, ExxonMobil agreed to acquire InterOil under a Yukon plan of arrangement. In approving the transaction, the InterOil board obtained a market standard short-form fairness opinion from a leading investment bank that was to be compensated with a success-based fee.

Despite the arrangement receiving the support of over 80% of shareholders, the Yukon Court of Appeal (comprising judges from the B.C. Court of Appeal) held that the arrangement was not fair and reasonable, in part due to deficiencies in the fairness opinion relied upon by the InterOil board. Among other "red flags" in the board-approval process, the Court objected to the success fee of the financial adviser providing the fairness opinion, the failure to disclose the specific amount of the fee, and the fairness opinion included in the circular not providing the financial adviser's underlying financial analysis.

InterOil continued to pursue the transaction and, ultimately, paid US$4 million for an independent, fixed-fee, long-form fairness opinion. The circular for the second attempt at the transaction contained detailed disclosure about the valuation of InterOil and the consideration payable to shareholders under the arrangement, including the financial adviser's methodologies and a value analysis. The Yukon Supreme Court approved the revised transaction and endorsed a new minimum standard for plans of arrangement to be supported by a long-form fairness opinion obtained on a fixed-fee basis.

Staff Notice 61-302

On July 27, 2017, staff at five of the Canadian provincial securities regulatory authorities issued Multilateral CSA Staff Notice 61-302 (Notice),[5] which clarified staff's expectations regarding the role of special committees in "material conflict of interest transactions" and discussed the standard of disclosure for fairness opinions in these transactions.

The Notice confirms the discretion of the board and the special committee in determining whether or not to obtain a fairness opinion and in determining the compensation arrangements for the financial adviser providing the opinion. However, where a fairness opinion is obtained, the Notice sets out that the circular should disclose the following:

- the compensation arrangement of the financial adviser and its consideration by the board or special committee;
- any other relationship or arrangement between the financial adviser and the issuer or an interested party that may bear on the independence of the opinion;
- a summary of the methodology, information and analysis underlying the opinion; and
- the relevance of the fairness opinion to the board and special committee.

In contrast with the guidance provided by the Yukon courts in the *InterOil* decisions, the Notice did not mandate fixed-fee compensation for the financial adviser providing the fairness opinion, nor that the specific amount of the fee must be disclosed.

Market Trends Post-*InterOil*

While the *InterOil* series of decisions do not reflect the law on fairness opinions in Canadian jurisdictions other than Yukon and B.C., market practice across Canada is trending toward enhanced disclosure of the financial analysis underlying fairness opinions. Financial advisers should, at a minimum, be prepared to deliver a fairness opinion that includes details regarding valuation methodology in any transaction in which a fairness opinion is used.

In addition, since *InterOil*, there has been a subtle market shift toward fixed-fee compensation arrangements, with a majority of arrangement transactions valued at over $100 million including at least one fairness opinion provided on a fixed-fee basis. A significant majority of issuers continue to elect not to disclose the amount of the fee paid to financial advisers.

In transactions in which a formal valuation under MI 61-101 was not required, but a fairness opinion was nonetheless provided, the trend is toward fairness opinions containing additional analysis of the financial adviser's methodology. These long-form fairness opinions were obtained in the majority of the transactions surveyed.

There are several examples of issuers moving away from the *InterOil* standard of disclosure in fairness opinions toward a "hybrid" form of disclosure including the financial adviser's valuation methodology, while omitting the detailed financial analysis underlying the opinion. For example, in PayPal's 2017 acquisition of TIO Networks, the fairness opinion obtained by TIO Networks contained a detailed discussion of the methodologies employed by the financial adviser, but did not include an *InterOil*-style value analysis. A similar approach was taken in the 2018 acquisitions of Klondex Mines Ltd. by Hecla Mining Company and of Primero Mining Corp. by First Majestic Silver Corp. Given the incremental costs of comprehensive disclosure and second fairness opinions, we expect that many issuers will opt for this more moderate standard of disclosure in non-contested transactions.

Need to Know

The optimal level of disclosure in a fairness opinion and the appropriate compensation structure continue to depend on the circumstances of each transaction, including the perceived existence of conflict in a particular transaction, the robustness of the board approval process, the governing jurisdiction of the particular issuer and the likelihood of a shareholder challenge or interloper offer.

In non-conflicted transactions, it may not be necessary to obtain a long-form fairness opinion from an independent financial adviser that is compensated on a fixed-fee basis. Transparency regarding the financial adviser's compensation structure (but not necessarily the compensation amount) is generally recommended. In each case, the relevant inquiry is whether the disclosure provided to shareholders is fair and appropriate so as to enable an informed shareholder vote.

[1] *Re Hudbay Minerals Inc.*, 32 OSCB. 1082, para 264.

[2] *Re Magna International Inc.* (OSC reasons); *Re Magna International Inc.*, 2010 ONSC 4123.

[3] *Re Champion Iron Mines Limited*, 2014 ONSC 1988, para 17.

[4] *Re Bear Lake Gold Ltd.*, 2014 ONSC 3428, para 16; *Re Patents Royal Host Inc.*, 2014 ONSC 3323.

[5] Multilateral CSA Staff Notice 61-302, Staff Review and Commentary on Multilateral Instrument 61-101, *Protection of Minority Security Holders in Special Transactions*. See the subheadings "Financial advisors and fairness opinions" and "Fairness opinions." The Notice was issued by staffs at the security regulators in each of Ontario, Québec, Alberta, Manitoba and New Brunswick.

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