Yukon Court Awards Premium in Fair Value Determination - A Comment on *Carlock v. ExxonMobil Canada Holdings ULC*

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In a surprising recent decision with potential implications for public M&A transactions in Canada, the Supreme Court of Yukon determined that the "fair value" of the shares of InterOil Corporation ("**Interoil**") acquired by Exxon Canada Holdings ULC ("**Exxon**") in 2017 was significantly higher than the negotiated deal price.

The Acquisition of Interoil

The acquisition of InterOil by Exxon had already followed a somewhat tortuous path by the time the transaction closed in 2017. InterOil had conducted a strategic review, contacted numerous potential bidders, received three proposals, entered into an agreement with a bidder and finally accepted a topping bid from Exxon, for which it received a fairness opinion from its financial advisor. None of this was extraordinary in the context of a public M&A transaction. However, the acquisition by Exxon, which was proposed to be completed by a plan of arrangement (a court-approved acquisition process available under the *Business Corporations Act* (Yukon), as well as the other main corporate statutes in Canada), was challenged in court, with InterOil's former CEO alleging numerous corporate governance failures.

Though initially approved by the Supreme Court of Yukon (the "**Court**"), largely on the basis that in spite of the governance deficiencies found by the Court, the arrangement had been approved by a significant majority of the shareholders, the arrangement was struck down by the Yukon Court of Appeal, which found that the transaction was not "fair and reasonable" - the required test for approval of a plan of arrangement. The Court of Appeal emphasized the inadequacy of the fairness opinion, due to the financial advisor being entitled to a success fee, and the lack of disclosure of the analysis underlying the advisor's conclusion. In addition, the Court of Appeal pointedly disagreed with the chambers judge on the weight given to shareholder approval in the test of "fairness and reasonableness," noting that while adequately informed shareholders are entitled to sell their shares at any given price, "it was not open to the Court to set to one side the deficiencies it had identified, and simply accept the verdict of the market or the majority shareholders."[1]

Ultimately, the transaction closed, with InterOil obtaining a new fairness opinion (on a fixed fee basis), a new shareholder vote based on revised disclosure, in which over 90% of the shareholders approved the transaction, including the shareholder who had challenged the initial deal, and approval by the Court. Nonetheless, a number of shareholders dissented under the terms of the arrangement, which largely imported Section 193 of the *Business Corporations Act* (Yukon) (the "**Act**"). Much like the corresponding provisions in other Canadian corporate statutes, Section 193 of the Act entitled dissenting shareholders to receive the "fair value" of the shares acquired by Exxon, as determined by the Court. The result was the Court's surprising decision in *Carlock v. ExxonMobil Canada Holdings ULC*[2] ("***Carlock***"), where the Court agreed with the dissenters' expert and set the "fair value" of the shares at US$71.46, a significantly higher value than the US$49.98 per share paid by Exxon in the transaction.

A "Starting Point" for Fair Value

Determinations of fair value under the various *Business Corporations Acts* in Canada are often challenging for courts. They are highly fact-specific, outside of most judges' expertise and normally informed by expert evidence that generates vastly different valuations for the same shares. Nonetheless, recognizing that "valuation is not an exact science,"[3] Canadian courts have established principles designed to generate results that are as fair and predictable as possible.

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1 *InterOil Corp. v. Mulacek*, 2016 YKCA 14 at para. 43.

2 2019 YKSC 10 ("***Carlock***").

3 *Brant Investments Ltd. v. KeepRite Inc.*, 1987 CarswellOnt 135 at para. 134.

In *Carlock*, the Court identified some of those principles, including paraphrasing the guiding statement that the "one true [rule] is to consider all the evidence that might be helpful, and to consider the particular factors of the case, and to exercise the best judgment that can be brought to bear on all the evidence and all the factors."[4] Doing so generally requires consideration of the various acceptable methods of valuation and then an exercise of judgment on which method is appropriate and how it is to be properly applied, including in relation to the underlying assumptions and the final result.[5]

It is important to note that the Canadian authorities on fair value, like their counterparts in the United States, have been clear that expert testimony is not determinative. One of the key principles mentioned above is that while the court may be guided by expert evidence, it is not bound by it.[6] Similarly, the Delaware Court of Chancery has cautioned that it "should be chary about imposing the hazards that always come when a law-trained judge is forced to make a point estimate of fair value based on widely divergent partisan expert testimony."[7]

The authorities in Canada are also clear that absent mitigating factors that undermine its reliability (such as a meaningful conflict of interest or a barrier to any competing bids), the deal price is an appropriate "starting point" for a fair value determination.[8] Leading Canadian cases give significant weight to the negotiated price between arm's length parties as a "starting point" for a determination of value, including in a case in which the target did not hold a formal auction but nonetheless engineered a competitive bidding process.[9] In an influential article on fair value in Canada, which has been cited and relied upon in court, the authors state that "in circumstances where the price was negotiated in an appropriate and effective manner, both Canadian and American jurisprudence has demonstrated a willingness to rely on negotiated transaction prices… Provided the process undertaken was adequate, the negotiated transaction price provides an objective and realistic assessment of the fair value."[10]

For a public company, where the shares are valued constantly on a stock exchange by sophisticated parties (and absent mitigating factors, such as a thin public float or low trading volume), it is difficult to conceive how a negotiated deal price above the current trading price would not be a reliable indicator of fairness. As the Delaware Court of Chancery noted in the *Aruba* decision, "in a scenario where the underlying market price is reliable, competition and negotiation become secondary. Under these circumstances, an arm's-length deal at a premium over the market is non-exploitive. By definition, it gives stockholders 'what would fairly be given to them in an arm's-length transaction.'"[11]

In short, the authorities on the determination of fair value are generally clear that absent mitigating factors of some severity, the deal price is the appropriate starting point for a determination of fair value, with a discounted cash flow analysis or other approach always still available as a check. While the severity of those mitigating factors, and the weight accorded to them, are questions for the court to decide in each instance, it stands

4 *Carlock, supra* note 2 at para. 11, paraphrasing *Cyprus, infra* note 5 at para. 53.

5 *Cyprus Anvil Mining Corporation v. Dickson et al.*, 1986 CarswellBC 362 ("***Cyprus***") at para. 54.

6 *Domglas Inc. v. Jarislowsky, Fraser & Co.*, [1980] Q.J. No. 89. See also *Brant Investments Ltd. v. KeepRite Inc.*, 1991 CarswellOnt 133 at para. 112: "[t]he Court is to be guided by the evidence given by the experts but is not bound by their opinions."

7 *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 177 A (3d) 1 at 26 (Del. 2017) ("***Dell***").

8 *Cyprus*, *supra* note 5 at paras 62-63. See also *Deer Creek Energy Limited v. Paulson & Co. Inc.*, 2008 ABQB 326 (Alta. Q.B.). In Delaware, see for example *Dell*, *supra* note 7, *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A (3d) 346 (Del. 2017), and *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.* No. 11448-VCL, 2018 WL 922139 (Del. Ch. Feb. 15, 2018) ("***Aruba***").

9 *Deer Creek Energy Ltd. v. Paulson & Co.,* 2009 CarswellAlta 1285 (Alta. CA).

10 Clarke Hunter, Q.C. and Clarissa Pearce, "'Fair Value'—A Common Issue with Surprisingly Sparse Canadian Authority" (2011) Ann Rev of Civ Lit, cited in *Glass v. 618717 Ontario Inc.*, [2012] O.J. No. 225 and *Robinson v. Realm Energy International Corp.*, 2015 BCSC 1437.

11 *Aruba*, supra note 8 at 95.

to reason that where a deal price has been negotiated at arm's length, multiple parties have submitted bids (including a topping bid that constitutes a "superior proposal" under an already binding deal), more than 90% of shareholders are willing to vote in favour of the deal after receiving a fairness opinion and corrective disclosure recommended by an appellate court, and where the court itself has approved the arrangement as "fair and reasonable", it is plausible to suggest that those mitigating factors ought to be quite devastating in order to displace a market value approach.

"Fair Value" for InterOil Shares

The positions of the parties in the InterOil "fair value" hearing were typical, in the sense that Exxon's expert valued the shares at the deal price of US$49.98 and the dissenters' expert valued the shares much higher, at US$71.46, based on a discounted cash flow analysis. The decision, however, contains at least two unusual elements: first, the dismissal of the market value approach even as a starting point for the analysis; and second, the selection of one expert's valuation wholesale once the discounted cash flow method had been identified as more appropriate.

The Valuation Approach

After providing an overview of the history of the transaction and a summary of the law of fair value, the Court summarized the positions of the two experts, noting that "the crux of this 'fair value' dispute is the different conclusion reached" by the two experts, where "both experts employed the discounted cash flow methodology."[12]

While both experts may have employed a discounted cash flow approach, the expert for Exxon in fact relied on and strongly favoured a market value approach, as might be expected in this type of situation, presumably using the discounted cash flow approach only as a check. Further, the Court analyzed the factors militating in favour or against the deal price only after calling the experts' differing conclusions on the discounted cash flow the "crux" of the matter , and only in the context of an initial statement that "considerable attention must be paid to the sales process prior to the Court of Appeal decision and the commercial or partial sale process which was followed by the whole company transaction."[13] It therefore appears that the "starting point" of the Court's analysis may have been the experts' discounted cash flow analyses, and that the market value approach was summarily rejected on the basis that the governance issues relevant to the "fairness and reasonableness" of the first arrangement were severe enough to undermine the market price not only as a "starting point", but as a reliable indicator of value.

Keeping in mind the importance of the factual matrix and the Court's discretion in making a judgment as to fair value, it is worth putting the governance deficiencies that originally affected the InterOil arrangement in context. They were undeniably a factor in determining the appropriateness of the arrangement as a matter of the Act's arrangement provisions: the Court of Appeal had found that because of those deficiencies, the transaction did not meet the Act's test of "fair and reasonable". However, the Court of Appeal's suggestion that the willingness of the shareholders to accept the deal price could not vitiate the Court's mandate to apply the "fair and reasonable" test does not necessarily mean that the willingness of the shareholders - in fact, an even more overwhelming majority of them, now more fully informed - to accept the deal price should not play a completely different role, and be given a completely different weight, under a determination of "fair value." In other words, particularly given the numerous other factors that would normally bring the market value approach to bear, such as the number of parties contacted, the multiple bids, the superior proposal with non-abnormal

12 *Carlock, supra* note 2 at para. 46.

13 *Ibid*. at para. 59.

deal protections and the fixed fee fairness opinion, it should not necessarily follow that the same governance deficiencies allowed the InterOil board to negotiate a deal price that did not represent "fair value".[14]

Adoption of Expert Evidence and the Discounted Cash Flow Approach

Further, even if the governance deficiencies did suppress a higher deal price, it does not follow that a dissenter's expert's discounted cash flow analysis is the only other option before the court. As noted, a fair value determination involves judgment in choosing a valuation method, in applying that method and in the final result,[15] and a court is not bound by, and should in fact be wary of, partisan expert evidence.[16]

Further, Canadian courts have recognized the difficulties in applying a discounted cash flow analysis, noting that "the discounted cash flow approach to valuation is highly sensitive to the assumptions relied upon"[17] and that "the discounted net cash flow method must always be viewed with care where there is no historical cash flow to use as the basis of the calculation."[18] Recent decisions by the Delaware Court that have rejected the deal price have used their own discounted cash flow analyses to generate fair values below the deal price, taking into account synergies generated by the deal.[19]

In other words, absent more detailed reasons, and in light of the Canadian and other authorities and the many factors militating in favour of the deal price as a more appropriate starting point, it is difficult to explain the Court's reasoning in adopting one expert's valuation wholesale.

Possible Implications

While the ultimate impact of the InterOil saga on the M&A landscape is not yet fully clear, this fair value decision, if not appealed, may have an impact at least in Western and Northern Canada. The Yukon Court of Appeal's decision to strike down the arrangement appears to have had a more profound effect on Yukon and British Columbia transactions - particularly in relation to their use of fairness opinions - than elsewhere in Canada.[20] Nonetheless, market participants across the country should consider the implications of a Canadian court awarding such a significant premium to the deal price. Investors, including those with "appraisal arbitrage" strategies, may be encouraged by a decision from a Canadian court awarding such a significant premium to dissent in corporate transactions. Arrangement agreements may see increased thresholds in the condition precedent based on the number of dissenters. More generally, targets should consider whether the well-established processes in Canadian public M&A transactions, which have evolved to satisfy the requirements of corporate and securities laws, need to be considered more closely through the lens of "fair value".

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14 It is worth noting that the Court emphasized on numerous occasions that InterOil had not solicited "whole company" transactions, including adding a qualifying statement, after listing the three proposals received by InterOil to buy the whole company, that "none of these approaches had been solicited by InterOil as whole company transactions." In addition, the Court noted that there had been no disclosure of a "whole company transaction" until the Company entered into the first arrangement agreement, and that InterOil "never pursued a public auction for a whole company transaction." A formal auction would be a positive factor militating in favour of a market value approach, but is not a necessary element of that disposition. In this case, there were three offers for the whole company and a topping bid by Exxon for the whole company. Further, the Court noted that the non-solicitation provision in the arrangement agreement with the first bidder, prior to Exxon's bid, "prevented InterOil from soliciting or seeking out other bidders for a whole company transaction." While customary non-solicitation provisions prevent the target from "shopping" itself to other bidders, it should not - and in this case did not - prevent InterOil from accepting a superior proposal.

15 *Cyprus*, *supra* note 5.

16 See *supra* at notes 6 and 7.

17 *Paulson & Co. Ltd. v. Deer Creek Energy Ltd.*, 2008 ABQB 326 (Alta. Q.B.).

18 *Cyprus*, *supra* note 5 at para. 75.

19 See for example, *Aruba*, supra note 8 and *In re: Appraisal of AOL Inc.*, C.A. No. 11204-VCG, 2018 WL 1037450 (Del. Ch. Feb. 23, 2018).

20 Jamie van Diepen, "Fixed Fee Fairness Opinions - A One-Year Retrospective on *InterOil*" Goodmans LLP Update (3 April 2018) online: <www.goodmans.ca>.