COURT OF APPEAL OF YUKON

Citation: *InterOil Corporation v. Mulacek*,
2016 YKCA 14

Date: 20161104
Docket: 16-YU795

Between:

InterOil Corporation

Respondent
(Petitioner)

And

Philippe E. Mulacek

Appellant
(Respondent)

And

Exxon Mobil Corporation

Respondent
(Respondent)

Before: The Honourable Madam Justice Newbury
The Honourable Madam Justice Saunders
The Honourable Mr. Justice Groberman

On appeal from: An order of the Supreme Court of Yukon, dated October 7, 2016 (*Re: Interoil Corporation*, 2016 YKSC 54, Whitehorse Registry No. 16-A0082)

Oral Reasons for Judgment

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<tr><td>Place and Date of Hearing:</td><td>Vancouver, British Columbia
October 31, 2016</td></tr>
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November 4, 2016</td></tr>
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Summary:

Appeal from a ruling under s. 195 of Yukon Business Corporations Act that proposed "arrangement" (acquisition of company by share exchange) was fair and reasonable. <u>Appeal allowed</u>. The court below had erred in principle in setting aside various deficiencies in information provided to shareholders, and other 'red flags' as irrelevant to whether the arrangement was fair and reasonable, and instead relied mainly on the fact a majority of shareholders had voted to approve it. Considering the correct factors, court could not be satisfied the arrangement was fair and reasonable.

[1] **NEWBURY J.A.**: By reasons for judgment dated October 7 of this year, a chambers judge of the Yukon Supreme Court granted an application under s. 195 of the *Business Corporations Act*, R.S.Y. 2002, c. 20 for the approval of an "arrangement" (as defined by s. 195(1)(f)) whereby all the shares of InterOil Corporation ("InterOil") would be exchanged for shares of Exxon Mobil Corporation ("Exxon") valued at $45 per share, plus a capped "contingent resource payment" ("CRP"). InterOil is a Yukon corporation the shares of which are traded on the NYSE. Its primary asset is a 36.5% joint venture interest in an oil and gas field ("PRL15" or the Elk-Antelope fields) in Papua New Guinea that is still in the development stage. As counsel noted in this court, the proposed arrangement is "transformational" in that it will require shareholders to surrender their shares and will result in InterOil's becoming a wholly-owned subsidiary of Exxon.

[2] Yukon's Act, which has counterparts in the corporate legislation of most of the provinces of Canada, contemplates in s. 195(9) that the Supreme Court shall hear applications for approval of an arrangement and may in its discretion:

> (a) approve the arrangement as proposed by the applicant or as amended by the Supreme Court; or
>
> (b) refuse to approve the arrangement, and make any further order it thinks fit.

A copy of the order of the Supreme Court approving the arrangement is one of the documents required to be filed with the Registrar, who is then required by s. 195(11) of the Act to issue a certificate giving effect to the arrangement.

[3] In Canada, the leading case dealing with the approval of corporate arrangements is *BCE Inc. v. 1976 Debentureholders*, 2008 SCC 69. As the chambers judge noted, *BCE* formulated three “tests” for approval. The first two – that the statutory requirements and any court-mandated requirements have been complied with, and that the application has been put forward in good faith – were met in this case; the third is that the court be satisfied the proposed arrangement is “fair and reasonable”. (This phrase does not appear in the Act but may be traced back at least to the decision of Romer L.J. in *Re Alabama*, *New Orleans, Texas and Pacific Junction Ry. Co*. [1891] 1 Ch. 231 (C.A.).)

[4] The chambers judge ruled that the arrangement in this case was fair and reasonable. His ruling is challenged by the appellant Mr. Mulacek, a founder and former chairman and director of InterOil. He holds a 5.5% interest in the company. He has extensive experience in petroleum and related exploration and development. He dissented from the shareholders’ resolution adopting the arrangement, but as the chambers judge stated at the end of his reasons, Mr. Mulacek “failed to persuade the 80%” who voted in favour. If the arrangement proceeds, Mr. Mulacek will be required to surrender his shares in return for their “fair value” as determined in accordance with s. 193 of the Act.

[5] At paras. 6–19 of his reasons, the chambers judge set forth the “background” of Exxon’s offer, beginning with the fact that a previous offer had been made by a company called Oil Search in May 2016. In fact, InterOil had been exploring the possible sale of *some* assets, and then a “Whole Company Transaction” since mid-2015. Immediately before the Oil Search offer was announced on May 20, InterOil’s shares were trading at $31.65 U.S. per share. InterOil first agreed to enter into an arrangement, also structured as a share exchange, with Oil Search that valued InterOil’s equity at about $2.1 billion or $40.25 per share, plus a “Contingent Value Right” (“CVR”) tied to the volume of PRL15. As the chambers judge stated:

> The CVR would have delivered a contingent cash payment of approximately $6.044 for each 1 tcfe (1 trillion cubic feet equivalent) of PRL15 2C Resources above 6.2 tcfe without a cap. All figures are in US dollars. (At para. 9.)

[6] This arrangement was to be voted on at a special meeting of securityholders on July 28, but on June 30, Exxon made an unsolicited offer to buy all the shares of InterOil for *$45* per share plus a contingent payment ("CRP") of approximately "$7.07 for each one tcfe of PRL15 2C Resources above 6.2 tcfe, <u>up to a maximum of 10.0 tcfe</u>". (My emphasis.) Exxon paid the "break fee" of $60 million required under the Oil Search agreement so that InterOil could proceed with the Exxon deal.

[7] The chambers judge described the implications of the capped CRP and the financial implications of the deal for InterOil's CEO and directors in the following terms:

> … the Exxon Arrangement provides an additional $5 per Interoil share and an increased CRP relative to the CVR in the Oil Search Arrangement, but capped at 10 tcfe. It is also important to note that certain Restricted Share Units ("RSU") were granted pursuant to Company Incentive Plans. As of August 2016, the directors of Interoil owned an aggregate of 404,302 RSUs representing 51.9% of the issued and outstanding RSUs. <u>The CEO owns 329,825 of these RSUs. It is estimated that the CEO stands to earn approximately $35 million if the Exxon Arrangement proceeds</u>. The RSUs are accelerated, thereby not required to satisfy certain performance metrics normally necessary for the issuance of common shares to the RSU holders. Each director has entered into a Voting Agreement requiring him or her to vote the common shares issued pursuant to the RSUs in favour of the Exxon Arrangement.
>
> If all CRP payments were made up to the cap of 10 tcfe, the value of the Exxon Arrangement is approximately $72 per Interoil share. The Oil Search Arrangement would have provided a similar value at 11.5 tcfe. Interoil indicates it is possible that the CRP could be 0, although Mr. Mulacek would disagree. <u>He expresses the opinion that the CRP could account for up to 37% of the compensation to shareholders under the Exxon Arrangement. I make no finding of fact in that regard</u>. [At paras. 13–14.]

[8] Once it had become clear that Oil Search would not be revising its bid, the Board met with Morgan Stanley (which had already prepared an opinion in respect of the Oil Search bid) and requested that it prepare a fairness opinion for the Exxon arrangement. Morgan Stanley is to receive a fee for providing the opinion, which fee is largely contingent on the arrangement taking place. The amount of the fee has not been disclosed. A general meeting to approve the arrangement was called for September 21, 2016 in New York City.

[9] Management's Information Circular sent to shareholders in connection with the general meeting summarized the Oil Search and Exxon arrangements respectively, and the reasons for the Board's determination that the new proposal was in the best interests of InterOil, and that the consideration to be received by shareholders was fair to them. The chambers judge summarized these reasons at para. 19:

1. The Exxon Arrangement valued the equity of Interoil at $45 per share which represents a premium of 42.2% on the closing share price of Interoil on May 19. 2016, without considering the potential value of the CRP.
2. It provided Shareholders the ability to participate in the potential upside of the resource volume of the PRL15 Fields. If the CRP is paid, the aggregate consideration for a common share is approximately $72.
3. The Exxon shares provide immediate liquidity to those shareholders who wish to sell them.
4. The Exxon Arrangement provides certainty of value at $45 per common share.
5. Exxon agreed to pay the Oil Search termination fee of $60 million.
6. Under the heading "Review of Strategic Alternatives" the Board said that it "considered and actively pursued a wide range of potential strategic alternatives available to Interoil, including the potential shareholder value as assessed by Interoil and its financial advisors that could be expected to be generated by remaining an independent company, as well as potential benefits, risks and uncertainties associated with such alternatives". No details were given.
7. Under the heading "Probe of Strategic Alternatives" the Board directed management to contact third parties to gauge their interest in a variety of different transactions involving Interoil and its assets. No details were given.
8. The Board also cited the benefits of participation in Exxon shares and their future growth.
9. The Board also found support in the Interior Resource Certification ("IRC") for the CRP to ensure that the PLR15 2C Resource Antelope well 7 would be drilled and tested before the IRC. However, this recommendation was tempered by the risk that the CRP payout, if any, will not be known for some time.
10. The Board relied on the Fairness Opinion and stated that "it did not constitute a recommendation as to how any Shareholder should

vote" but nevertheless stated "Shareholders are urged to read the Fairness Opinion carefully and in its entirety".

11. The Rights of Dissent were carefully set out.
12. The interests of certain directors and officers were set out in their entirety and specifically the value of the CEO's RSUs at $32,252,855 and his termination payment of $2,646,000.
13. The Circular also set out a variety of risks that could influence the market value of shares and the risk that the $67 million termination fee would discourage other bids.

[10] I note that the Circular informed shareholders resident in the U.S. that under s. 3(a)(10) of the U.S. Securities Act, the exchange of their shares for Exxon shares would be exempt from registration, provided that *inter alia* the terms and conditions of the exchange were approved after a fairness hearing before a court or other competent authority at which all recipients of Exxon shares would be entitled to appear. Accordingly, the final order of the Yukon Court would "constitute a basis for the exemption from the registration requirements of the U.S. Securities Act with respect to the Exxon… shares issued in accordance with the arrangement."

[11] The Circular was accompanied by Morgan Stanley's fairness opinion dated July 21, 2016 addressed to the Board. A copy of that letter will be attached to these reasons. Its contents were summarized by the chambers judge at para. 21 of his reasons. He also noted that the Board had consulted other financial experts in addition to Morgan Stanley, but that none of them had provided opinions on fairness. (At para. 24.)

[12] The special meeting was duly held on September 21, 2016. The statutory voting thresholds required by s. 195 of the Act were met by shareholders, security holders, and shareholders of InterOil other than those required to be excluded under MI 61-101, respectively. Mr. Mulacek and others holding approximately 10% of the common outstanding shares voted against the resolution.

[13] In the court below, Mr. Mulacek submitted that the fairness opinion was seriously deficient. In support, he adduced opinion evidence of Mr. Peter Dey, the chairman of an independent investment dealer and a person qualified as an expert

on corporate governance issues. In addition to his legal practice in the securities area, Mr. Dey was Chair of the Ontario Securities Commission between 1993 and 1995 and author of the *Dey Report on Corporate Governance* prepared for the TSE. He is also a former chairman of Morgan Stanley.

[14] For reasons summarized by the chambers judge at para. 26, Mr. Dey opined that the "process undertaken by this board in considering and recommending the Transaction … was deficient, and failed to meet current governance best practice and to ensure adequate safeguards of shareholder interests." (At para. 27.) He contrasted the fairness opinion of Morgan Stanley with three others with which he was familiar, each of which provided a great deal more information – and one might say, substance – than the opinion in this case.

[15] In addition, Mr. Mulacek filed an affidavit of a Mr. Booth, of the investment banking department of Paradigm Capital, opining as to the adequacy of the consideration to be received by InterOil shareholders. Mr. Booth was found to be an expert in the "valuation of reserves and resource estimates for the oil and gas industry." His report is summarized at para. 30 of the chambers judge's reasons, which I will not recount here, except to note his conclusion that the consideration contemplated by the arrangement was "<u>inadequate, from a financial point of view</u>, to the shareholders of InterOil." (My emphasis.) No contrary opinions were adduced into evidence, directly or indirectly, by InterOil or Exxon.

[16] The chambers judge reviewed the law applicable to corporate arrangements of this kind. He noted *Magna International Inc. (Re)* 2010 ONSC 4123, where the Court had approved an arrangement under which certain "super-voting" shares representing control of the company were bought back at a huge premium in comparison to the value of non-voting shares. The chambers judge observed that the Court in *Magna* had "placed significance on the shareholder vote" and he quoted from the Court's reasons:

> ….the position of the Opposing Shareholders disregards entirely the significance of the shareholder vote from the perspective of the implicit contract among shareholders of a public corporation. <u>It is an</u>

> important principle of corporate democracy that a shareholder is bound by an informed vote of all shareholders. It is relevant that, in acquiring shares in a public corporation, a shareholder must expect that the majority vote will prevail, except in circumstances of oppressive behavior by shareholder groups. Moreover, ratification of actions of directors by a vote of the affected shareholders is a recognized means of addressing controversial transactions. [At para. 38; emphasis added.]

[17] The chambers judge summarized the parties' respective positions at paras. 39–46 and many of those arguments have been advanced before us on this appeal. Under the heading "Analysis", he then proceeded to address two questions – first, whether the board of InterOil had provided "improper corporate governance and deficient disclosure", and second, whether the Exxon arrangement was fair and reasonable.

[18] In connection with the first issue, the judge agreed with Mr. Dey that the process undertaken by the InterOil's board in connection with the Exxon arrangement had demonstrated "deficient corporate governance and inadequate disclosure." In particular, the judge wrote:

> The Fairness Opinion obtained by the Board was deficient and indicative of a failure to discharge its fiduciary obligations in the following ways:
>
> 1. it failed to address the value of the Elk-Antelope asset and the impact of the cap on the CRP so that shareholders could consider whether the Exxon Arrangement reflected that value;
> 2. it failed to disclose the details of Morgan Stanley's success compensation so that shareholders could evaluate whether the Fairness Opinion is influenced by the terms of the compensation;
> 3. it failed to provide the shareholders with an independent financial fairness opinion on a flat fee basis, particularly in the situation where the CEO had a financial incentive for the Exxon Arrangement to proceed.
>
> The Fairness Opinion was also remarkably deficient in the following ways:
>
> 1. it contained no reference to the specific documents that it reviewed;
> 2. it contained no facts or information to indicate what the opinion was based on; and

> 3. it contained no analysis of the facts or information so that a shareholder could fairly consider the merits of the Exxon Arrangement. [At paras. 50–51.]

[19] The judge described the Morgan Stanley fairness letter as "devoid of facts or analysis" and contrasted it with examples provided from other cases by counsel for Mr. Mulacek. Those opinions had, he noted, provided "offer facts and figures, analysis and comparative data" not found in this instance. In fact, the judge noted, the Morgan Stanley opinion provided "less information than a residential real estate appraisal commonly filed in this Court." (At para. 53.)

[20] In the chambers judge's analysis, however, the "real question" was whether fairness opinions should be regarded as independent opinions or "simply comfort letters that a board of directors enlists to support their decision." He referred to *Royal Host Inc. (Re)* 2014 ONSC 3323, which was decided after the well-known case of *Champion Iron Mines Ltd. (Re)* (2014) 119 O.R. (3d) 339. In *Champion*, the company seeking court approval had not been permitted to put its fairness opinion into evidence as an expert report because the applicant had not complied with the Court's rules governing the adducing of expert opinions into evidence. (The transaction was approved on the basis of "ample other admissible evidence" that supported it.) Relying on *Champion*, the Court in *Royal Host* commented that:

> The purpose of a fairness opinion is a commercial one. <u>It is an opinion to be considered by the board of directors and the shareholders in a commercial context. It is not an expert report in a litigation context. I</u>f the board or the shareholders are not satisfied with the report, they can vote with their feet and not proceed with or approve the arrangement. [At para. 8; emphasis added.]

The chambers judge agreed that a "third party financial advisor does not need to meet the requirements of an expert pursuant to the *Rules of Court",* although he acknowledged that the question of whether a fairness report should meet the standard of an expert report under the *Rules of Court* had not been argued before him.

[21] More importantly, the judge expressed the view that there should be an independent "flat fee Fairness Opinion to assist shareholders and the court <u>if [the Board] wishes to comply with best practice corporate governance".</u> (My emphasis.) Thus, he said, an opinion that "simply follows the direction of the Board and is based on a success fee does not meet the standard of good corporate governance." (See also *HudBay Minerals Inc. (Re)* 2009 CarswellOnt 2219 at para. 264, cited at para. 60.)

[22] The point, the chambers judge said, is that although a fairness opinion is only one indicator of fairness, it should be "robust, rigorous and independent", prepared by "reputable experts" and intended to help discharge the fiduciary duty of special committees of independent boards and to assist the shareholders in their evaluation of the fairness of a proposed arrangement. Thus an opinion obtained from an <u>independent</u> financial advisor "retained on a flat fee" is an important factor in assisting the court to scrutinize the arrangement before it. (At para. 61.)

[23] Turning, however, to the second question – whether the proposed arrangement had been shown to be fair and reasonable – the chambers judge found the deficiencies he had identified to be less important – or perhaps unimportant – in comparison to the fact that a substantial majority of the shareholders of InterOil had voted in favour of the arrangement. (The purpose of the arrangement was said to be to "sell the assets of InterOil for the highest price available rather than continue to be involved in the long game in the Elk–Antelope gas fields.")

[24] The material portions of the judge's analysis of the "fair and reasonable" issue was as follows:

> Mr. Mulacek had his opportunity to persuade shareholders that the $45 plus the potential of $7.07 for each 1 tcfe of PRL15 2C Resources above 6.2 tcfe to a maximum of 10 tcfe, was not a reasonable or fair price for Interoil shares. He failed to persuade the 80% who voted in favour of the Exxon Arrangement.
>
> This Court should speak freely and independently about matters of corporate governance but at the end of the day <u>it is the shareholders that have spoken in favour of the Exxon Arrangement. Judges are not business people and are not in a good position to judge these investments</u>....

> …
>
> Any shareholder reading the Circular can discern the lack of detail regarding valuations and analysis as well as the interest of the CEO in voting for the Arrangement.
>
> While that may draw criticism from this Court in terms of corporate governance, it should not prevent shareholders from realizing substantive increases in value.
>
> From the shareholders' perspective, they can realize their gain and Mr. Mulacek can pursue his Dissent Rights.
>
> Further, the Exxon Arrangement has clear advantages in receiving Exxon shares with immediate liquidity at $45 per share value.
>
> The CRP provides a higher rate of return than the Oil Search Arrangement but is capped. While the Board did not provide detail on the value of Interoil's Elk-Antelope field nor the strategic alternatives, it reduced the speculative nature of the Interoil shares and provided a solid return.
>
> For these reasons, I approve the Exxon Arrangement as fair and reasonable. [At paras. 62–63 and 65–70; emphasis added.]

In the result, the arrangement was approved.

[25] On October 19, 2016, Mr. Justice Frankel of this court stayed the order of the chambers judge pending the hearing of this appeal by Mr. Mulacek. At the end of the hearing we extended the stay until the disposition of the appeal.

On Appeal

[26] The appellant raises the following grounds of appeal:

> a) The Application Judge erred in relying on the shareholder vote as proxy for the determination of the fairness of the Exxon Arrangement. This is an error because the Application Judge failed to consider the reliability of the vote given the deficiencies in information provided to shareholders and the Application Judge failed to give appropriate consideration to other indicia of unfairness;
>
> b) The Application Judge failed to properly consider the following factors in his fairness analysis: (i) the lack of a robust fairness opinion; (ii) the evidence of the negative impact of the Exxon Arrangement on shareholders; (iii) the lack of any detailed information or analysis from InterOil as to the value of the Elk-Antelope Fields and the financial impact of the structure and terms of the Exxon Arrangement; (iv) the absence of an independent committee of directors' approval of the transaction; and (v) the compromised endorsement of the Exxon Arrangement by the CEO and Morgan Stanley;

c) The Application Judge erred in deferring to the business judgment of the Board instead of scrutinizing the Exxon Arrangement as required under the BCA and the BCE test;

d) The Application Judge erred in considering the reasonableness of the consideration offered by Exxon as an indicator of fairness when there is no evidence to support these factors;

e) The Application Judge erred by reversing the onus in the test for approval of the Exxon Arrangement and holding that it was Mr. Mulacek who had the obligation to convince shareholders that the Exxon Arrangement was unfair; and

f) The Application Judge erred in holding that the Appellant's dissent rights were sufficient.

[27] The respondents take issue with all of these grounds and emphasize the deference that is to be given to a court's exercise of statutory discretion. In this regard, counsel referred us to *Dhillon v. Pannu* 2008 BCCA 514 at paras. 26–8, where it was noted that the standard of review for discretionary decisions has been expressed in "slightly varying ways" in recent years. The leading cases on this point were said to be *Friends of the Oldman River Society v. Canada (Minister of Transport)* [1992] 1 S.C.R. 3 and *Named Person v. Vancouver Sun* 2007 SCC 43. They instruct that an appellate court should not interfere unless the court below misdirected itself, gave no weight or insufficient weight to a relevant consideration, or made an error in principle.

[28] Turning to the substantive law, counsel are in agreement that the leading authority is *BCE, supra*. That case of course involved a group of debentureholders of a corporation in fairly dire straits. Their debt instruments were likely to be adversely affected, in terms of *value*, by the proposed transaction, but the *legal* rights attached to the debentures would remain unchanged. Thus the Court emphasized that a judge faced with an application under s. 192 of the *Canada Business Corporations Act* (the equivalent of s. 195 of the *Yukon Business Corporations Act*) must be satisfied the arrangement achieves a "fair balancing" of conflicting interests – in *BCE*, those of the debentureholders as opposed to those of the shareholders.

[29] The case at bar does not involve competing classes of shares or securities; but the Court in *BCE* also gave some general guidance as to a judge's task in

considering an arrangement. The following comments are most relevant to the case at bar:

a) The court should consider whether the arrangement, objectively viewed, is fair and reasonable and "looks primarily to the interests of the parties whose legal rights are being arranged". (Para. 119);

b) The court should focus on the "terms and impact of the arrangement itself, rather than on the process by which it was reached. What is required is that the arrangement itself, viewed substantively and objectively, be suitable for approval." (Para. 136);

c) The "business judgment test" – whether an intelligent and honest business person, as a member of the voting class concerned and acting in his or her own interest would reasonably approve the arrangement – does *not* constitute "a useful or complete statement of what must be considered". (Para. 139);

d) The reviewing judge must "delve beyond whether a reasonable business person would approve of [the] plan." (Para. 141);

e) There must be a "positive value to the corporation to offset the fact that rights are being altered". In other words, the court must be satisfied the "burden imposed by the arrangement on security holders is justified by the interests of the corporation… as an ongoing concern." (Para. 145);

f) The "valid purpose inquiry" is fact-specific. One important factor is the "necessity" of the arrangement to the continued operation of the corporation. Indicia of necessity include the existence of alternatives and market reaction to the plan. (Para. 146);

g) If the arrangement is not mandated by the corporation's financial or commercial situation, courts will be more cautious and strive to ensure that it is not in the sole interest of a particular stakeholder. (Para. 146);

h) Generally, the arrangement must strike a “fair balance, having regard to the ongoing interests of the corporation and the circumstances of the case. Often this will involve complex balancing, whereby courts determine whether appropriate accommodations and protections have been afforded to the concerned parties.” (Para. 148);

i) Other indicia include whether a majority of securityholders have voted to approve the arrangement; whether an intelligent businessperson might reasonably approve of the plan; the “proportionality of the compromise” between various security holders; the securityholders’ positions before and after the arrangement; whether the plan was approved by a special committee of independent directors; the presence of a fairness opinion from a reputable expert; and the access of shareholders to dissent and appraisal remedies. (Para. 152);

j) The foregoing list is not exhaustive and the court should not insist on a “perfect arrangement.” As stated at para. 155:

> The court on a s. 192 application should refrain from substituting their views of what they consider the “best” arrangement. At the same time, the court should not surrender their duty to scrutinize the arrangement. Because s. 192 facilitates the alteration of legal rights, the Court must conduct a careful review of the proposed transactions. As Lax J. stated in *UPM-Kymmene Corp. v. UPM-Kymmene Miramichi Inc.* (2002), 214 D.L.R. (4th) 496 (Ont. S.C.J.), at para. 153: “<u>Although Board decisions are not subject to microscopic examination with the perfect vision of hindsight, they are subject to examination.”</u>
> [Emphasis added.]

[30] As mentioned, the case at bar does not involve a conflict between different classes of securityholders or the ‘balancing’ of conflicting legal rights. Rather, it involves conflicting views as to the financial situation and prospects of InterOil and the degree of risk to which shareholders wish their investments to be subject going forward. (One assumes the shares were acquired with the understanding they were “speculative” in the first place.) On the one hand, Mr. Mulacek sees the company as “well-positioned” to develop its share in the Elk-Antelope fields with its joint venture partners. He deposed:

> The project development timeline anticipates completion of appraisal drilling in 2016, resource confirmation in 2017, and commercial production in 2022.
>
> The terms and structure of the ExxonMobil Transaction unfairly and inappropriately deny Interoil shareholders any reasonable retained participation in, or compensation for, the vast upside of potential value of the resource. This is particularly egregious given the fact that I believe a development decision on this gas field asset is imminent, which will materially de-risk the project and unlock additional value. In my view, the terms and structure of the ExxonMobil Transaction fail to provide fair consideration to Interoil shareholders.
>
> Under the … Transaction, Interoil shareholders will receive for each common share of Interoil (a) a fixed component comprised of ExxonMobil shares worth $45; and (b) a capped contingent component based on a one-time interim resource estimate. <u>The absence of any subsequent contingent payments tied to future growth in resource estimates based on recertification after production is underway unfairly denies Interoil's shareholders any participation in the value upside created through commercialization of this key gas resource asset. This Transaction structure effectively shifts the entire upside potential value of this gas resource to ExxonMobil after the initial recertification payment.</u>
>
> In addition, the … Transaction fails to ensure that the interim resource certification process for the contingent payment calculation is fair, transparent, and focused on accurately assessing the potential resource. Among other things, <u>ExxonMobil will run the interim resource certification process without the participation of Interoil's long-time independent resource appraiser and with no effective oversight or involvement of any Interoil shareholder nominee.</u> The structure and terms of the Transaction in respect of the interim resource certification for the contingent payment unfairly favours ExxonMobil, who is incentivized to achieve a low contingent payment.
>
> [Emphasis added.]

[31] Mr. Mulacek takes the view that InterOil failed to provide sufficient information to its shareholders to make a "fully informed decision" in determining whether to approve or reject the bid and in particular that it:

> … failed to provide any meaningful disclosure of the potential value of the gas field asset, the financial impact of the cap on the contingent payment, the range of value of the gas field asset shareholders will forego in the event the resource certification exceeded the cap, and the risk factors associated with the determination of the contingent payment.

[32] On the other hand, InterOil's directors are of the view that it is in the interests of shareholders to reap the advantages of "certainty of value" with *some* participation in the 'upside" of the development of the PRL15 gasfields. Thus the Board set forth

in the Information Circular various reasons for its recommendation of the arrangement, including:

- **Significant Premium to Shareholders.** The Arrangement values the equity of InterOil at approximately $2.3 billion or $45.00 per Common Share, plus the potential value of the CRP. Without giving effect to the potential value of the CRP, this represents a premium of approximately 42.2% to the closing price of the Common Shares on the NYSE on May 19, 2016 (Eastern time), the last trading day prior to the public announcement by InterOil and Oil Search of the Oil Search Arrangement.
- **Shareholder Participation in Future Potential of the PRL 15 Fields.** The CRPs and the transactions contemplated in the CRP Agreement provide Shareholders the ability to participate in potential upside of the resource volume of the PRL 15 Fields under the Total Sale Agreement. This upside will also include the results and information gained from the drilling of the Antelope 7 appraisal well which is expected to spud in September 2016.
- **Liquidity of the ExxonMobil Shares.** The ExxonMobil Shares have historically been, and are expected to be at the Effective Time, highly liquid securities. The consideration to be paid to Shareholders pursuant to the Arrangement is comprised in part of ExxonMobil Shares, which should provide immediate liquidity to Shareholders should they wish to sell the ExxonMobil Shares they receive.
- **Certainty of Value.** The portion of the consideration comprised of ExxonMobil Shares to be paid to Shareholders pursuant to the Arrangement is fixed at $45.00 per Common Share and will be satisfied by issuing, in exchange for each Common Share, a number of ExxonMobil Shares equal to (i) $45.00, divided by (ii) the volume weighted average price of the ExxonMobil shares on the NYSE for the 10 consecutive trading days ending on (and including) the second trading date immediately prior to the Effective Date. The fixed value (or floating exchange) nature of the consideration to be issued pursuant to the Arrangement provides certainty of value to the Shareholders.

  …

- **Review of Strategic Alternatives.** The Board considered and actively pursued a wide range of potential strategic alternatives available to InterOil, including the potential shareholder value as assessed by InterOil and its financial advisors that could be expected to be generated by remaining an independent company, as well as the potential benefits, risks and uncertainties associated with such alternatives. As an independent standalone entity and depending on the size of further payments under the Total Sale Agreement, InterOil may have been required to raise additional funds through the capital markets in order to fund its share of project development costs in respect of the PRL 15 Fields – a step that is no longer expected to be necessary under ExxonMobil ownership. See "The Arrangement – Background to the Arrangement".

- **Participation in ExxonMobil Base.** Shareholders who retain the ExxonMobil Shares they receive in connection with the Arrangement will have the opportunity to participate in ExxonMobil's diverse asset base and operations. ExxonMobil's asset base includes an operating interest in the world-class PNG LNG Project.

  …

- **Participation by Shareholders in Future Growth**. Shareholders who retain the ExxonMobil Shares they receive in connection with the Arrangement will have the opportunity to participate in any future increase in the value of ExxonMobil.

- **Participation in ExxonMobil's Dividend.** Shareholders who retain the ExxonMobil Shares they receive in connection with the Arrangement will have the opportunity to participate in any future ExxonMobil dividends.

- **Terms of the Arrangement Agreement are Reasonable.** The Arrangement Agreement is a result of arm's-length negotiations between InterOil and ExxonMobil. The Board believes that the terms and conditions of the Arrangement Agreement, including the fact that InterOil's and ExxonMobil's representations, warranties and covenants and the conditions to completion of the Arrangement are, after consultation with InterOil's legal advisors, reasonable in light of all applicable circumstances.

- **Negotiations with ExxonMobil**. Based on the fact that the negotiations between InterOil and ExxonMobil were extensive, lasted for several months (see "The Arrangement – Background to the Arrangement"), and resulted in a significant increase from ExxonMobil's previous offers and from the consideration contemplated by the Oil Search Agreement, the Board believes that the Arrangement represents ExxonMobil's highest price and the highest price reasonably attainable for the Shareholders in the near future.

- **InterOil's Financial Condition and Prospects.** The Board reviewed InterOil's current and historical financial condition, results of operations, business, competitive position and prospects as well as InterOil's future business and potential long-term value taking into account its future prospects and risks if it were to remain an independent company.

- **Fairness Opinion of Morgan Stanley**. In the opinion of Morgan Stanley, as of June 21, 2016, and based upon and subject to the assumptions, limitations, qualifications and other matters contained therein, the consideration to be received by Shareholders under the Arrangement was fair, from a financial point of view, to such Shareholders. See "The Arrangement – Fairness Opinion" and Schedule C.

…

- **Court Approval is Required.** The Arrangement must be approved by the Court, which will consider, among other things, the fairness, procedurally and substantively, of the Arrangement to Shareholders.
- **Dissent Rights.** The availability of Dissent Rights to the registered Shareholders with respect to the Arrangement.

[33] It is of course for the shareholders, not the court, to decide between the conflicting views of the prospects of InterOil and its joint venture interest in the Elk-Antelope gasfields. It *is* the court's task to decide whether the proposed arrangement has been shown to be fair and reasonable. In the circumstances of this case, that requires, in my respectful view, that the court be satisfied the shareholders were in a position to make an *informed choice*, both as to the value they would be giving up, and the value they would be receiving. It is in connection with the values of the PRL 15 gas fields – the primary asset of the company – and the capped CRP that, in my opinion, difficulties arise in this case.

[34] Most obviously, there is the fact that the Morgan Stanley opinion expressly stated that it had not attributed any "specific value to the CRP for purposes of arriving at the conclusion expressed in this letter." This fact, together with the contingent nature of Morgan Stanley's fee, clearly undermines the utility of the opinion to the directors, the shareholders and the Court. It is difficult to disagree with Mr. Dey's observation that:

> The Board did not obtain advice on the value of the CRP. The Board seems to have concluded that by including the CRP in the consideration to be received for the sale of the company, it had satisfactorily addressed the need for the company to be compensated for the Elk-Antelope asset without actually obtaining advice as to the value of the asset. <u>In my view, a board engaged in a proper and robust review and consideration of a proposed transformative transaction should have obtained independent advice on the value of the CRP, the Elk-Antelope asset, and the 101 CFE's impact on the CRP</u>. Moreover, those estimates of value should have been disclosed to shareholders so that shareholders could decide whether the US$45 plus the capped CRP adequately reflected the value of the company. In the absence of this guidance, shareholders would not know the value of the Elk-Antelope asset, what they gave up by agreeing to capped the CRP at 101 CFE, and whether the terms of the Transaction fairly reflected the value of the Elk-Antelope asset.

> In circumstances where a financial expert's compensation depends in part on the success or failure of a transaction, shareholders must be in a position to evaluate whether the advice is influenced by these terms of payment. In the circumstances of this transaction, it is my view that the Board should have disclosed the details of the compensation payable to Morgan Stanley. <u>It should also have engaged a second financial advisor whose compensation would not be dependent upon the success or failure of the transaction</u>….
>
> [Emphasis added.]

[35] There is another reason why the Board should have engaged a second financial advisor on a 'flat fee' basis, i.e., for a fee not dependent upon the success or failure of the transaction. Although the Board constituted a committee to oversee the negotiation of the transaction, the committee appears to have been fairly passive, merely receiving reports from management who led the negotiations. As we have seen, if the transaction proceeded, the CEO stood to realize significant compensation through the change of control provision in his employment contract and through the acceleration of his RSU's (restricted share units). Other members of the Board also stood to reap significant benefits.

[36] In these circumstances, it was incumbent on the Board to ensure that the arrangement negotiated by management did indeed reflect the fair value of the company (and of course its assets) and its issued shares. For this purpose, the Board should have sought independent advice as to the financial fairness of the transaction.

[37] As we have seen, however, the only independent opinion in evidence on this point was provided by Mr. Booth of Paradigm Capital, who found in part that:

> When examining the resource estimates summarized in the Company's AIFs from 2008 to 2015, it is evident that there has been a history of positive estimate revisions, with GLJ consistently increasing its 1C, 2C and 3C volumes. Indeed, from 2008 to 2015, the 2C volumes were increased from 631 mmboe gross (3.79 Tcfe) to 1,663 mmboe gross (9.98 Tcfe). In our opinion, this indicates an increasing confidence in the resource estimate due to a lack of negative revisions over time. It reflected new developments and information, such as the availability of seismic data and the completion of five Antelope wells and three Elk wells. Based on this historical trend, it is reasonable to expect further positive estimate revisions with the scheduled completion of two new Antelope wells and the resulting test data.

His conclusion was that the “Consideration pursuant to the Transaction [was] inadequate, from a financial point of view, to the shareholders of InterOil.” (My emphasis.) Again, InterOil did not respond to or provide expert opinions that were contrary to those of either Mr. Dey or Mr. Booth.

[38] The chambers judge in his discussion of “best practice corporate governance” agreed that a board in the position of InterOil’s board “must ensure that there will be an independent flat fee Fairness Opinion to assist shareholders and the Court” and that “a fairness opinion prepared by a financial advisor who is being paid a signing fee or success fee does not assist directors comprising a special committee of independent directors in demonstrating the due care they have taken in complying with their fiduciary duties in approving a transaction.” (At paras. 59–60.)

[39] The judge seemed to take the view, however, that the deficiencies in the fairness opinion and disclosure generally were nevertheless not relevant to the question of whether the arrangement was fair and reasonable. I repeat here the crucial part of his reasoning:

> This Court should speak freely and independently about matters of corporate governance but at the end of the day it is the shareholders that have spoken in favour of the Exxon Arrangement. Judges are not business people and are not in a good position to judge these investments. See Edward Iacobucci, “Making Sense of Magna”, (2011) 49 Osgoode Hall L.J. 237-275 at para. 47.
>
> The shareholders of Interoil saw their share price increase at a premium of 42.2% after the Oil Search Arrangement, and, considering the price increase to $45 per share from Exxon, plus a CRP potential for a total value of $72 per share, they are entitled to make the decision approving the Exxon Arrangement.
>
> Any shareholder reading the Circular can discern the lack of detail regarding valuations and analysis as well as the interest of the CEO in voting for the Arrangement.
>
> While that may draw criticism from this Court in terms of corporate governance, it should not prevent shareholders from realizing substantive increases in value. (At paras. 63-66)

[40] With respect, it seems to me that the chambers judge erred in principle in setting aside the identified deficiencies when he came to consider the fairness and reasonableness of the proposed arrangement. Instead of ‘delving into’ the question

of value (see *BCE* at para. 141), he relied on the truism that the shareholders were "entitled to make the decision". Clearly, it *was* the shareholders' decision to make, but court approval was *also* required by the Act to ensure the decision was fair and reasonable in the sense of being based on information and advice that was adequate, objective and not undermined by conflicts of interest. Given the 'red flags' in this case – the absence of a fairness opinion from an independent expert, the failure of Morgan Stanley to assess the value of the CRP as compared with the value of the PRL prospects (again, the company's primary asset); the deficiencies pointed out by Mr. Dey; the unchallenged report of Mr. Booth; the fact the CEO was in a position of conflict; the probability the "independent" special committee was not independent of management; and the lack of "necessity" for the deal – the Court was required to do more than accept the vote of the majority as a "proxy" for fairness, or the cash amount of Exxon's offer as a proxy for reasonableness. As I say, this was an error of principle, if not law, in the sense that the correct 'legal test' was not brought to bear.

[41] The respondents acknowledged that the onus was on InterOil to satisfy the Court that the transaction was fair and reasonable. Counsel urged this court not to substitute its own opinion for that of the chambers judge under the "guise" that he failed to give sufficient weight to one or more relevant factors. Counsel also emphasized the Supreme Court's comment in *BCE* that courts should focus on the terms and impact of the arrangement itself rather than the process by which it was reached. (At para. 136.)

[42] More particularly, Mr. Friedland submitted that Exxon's offer had been the result of a "competitive bidding process." He invited us to review the Oil Search bid (to which Exxon's bid was of course "superior"), and to consider the various negative possibilities or "risks" which may face InterOil in the future as it becomes necessary to contribute its share of funds required for the development of the Elk-Antelope fields. He submitted that past assessments of the project disclosed in various information circulars and financial statements of InterOil have been "all over the map". In his submission, the recent increase in the trading price of InterOil shares is

an indicator that the arrangement is regarded by the market as a ‘good deal’ for shareholders. In the end, the respondents contend the chambers judge recognized that the best alternative for shareholders was to “sell the assets of InterOil for the highest price available rather than continue to be involved in the long game in the Elk-Antelope gas fields.” (At para. 62.)

[43] Again, I acknowledge that (adequately informed) shareholders are perfectly entitled to make a decision to “de-risk” their investments. I also acknowledge that in general, “judges are not business people” and may not be in the best position to assess investments like the InterOil shares. Nevertheless, 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. It will almost always be the case in applications under s. 195 that the arrangement in question has been approved by a substantial majority of shareholders, who are obviously voting in what they see to be their own interests. The Court must be satisfied, however, that the arrangement is objectively fair and reasonable in a more general sense. The evidence before the judge contained many deficiencies that were not answered by the fact that the arrangement was approved by a majority or that Mr. Mulacek had dissent rights available to him.

[44] In all the circumstances, we are not able to say that the arrangement has been shown to be fair and reasonable.

[45] It follows that I would allow the appeal, set aside the chambers judge’s order, and dismiss the application under s. 195 of the *Business Corporations Act*.

[46] We are indebted to counsel for their able arguments.

[47] **SAUNDERS J.A.**: I agree.

[48] **GROBERMAN J.A.**: I agree.

[49] **NEWBURY J.A.**: The appeal is allowed.

"The Honourable Madam Justice Newbury"