SUPREME COURT OF YUKON

Citation: *Carlock v. ExxonMobil Canada Holdings ULC*, 2019 YKSC 10

Date: 20190218
S.C. No. 16-A0193
Registry: Whitehorse

BETWEEN

CHARLES A. CARLOCK

PETITIONER

AND

EXXONMOBIL CANADA HOLDINGS ULC and dissenting shareholders as defined in paragraph one of the Order of June 20, 2017

RESPONDENT

Before Chief Justice R.S. Veale

Appearances:

Peter Griffin
Dena Varah and
Megan Hannam
Counsel for Petitioner and Dissenting Shareholders

David Tupper
Michael Dixon and
Tom Wagner
Counsel for Exxonmobil Canada Holding ULC

REASONS FOR JUDGMENT

INTRODUCTION

[1] Charles A. Carlock and other dissenting shareholders ("the dissenting shareholders") apply to have the court set "the fair value" of the shares they held in InterOil Corporation ("InterOil") as of February 22, 2017 ("the valuation date"). The

application is brought pursuant to s. 193(3) of the Yukon *Business Corporation Act*, R.S.Y. 2002, c. 20 (the "*YBCA*"). In the Plan of Arrangement, ExxonMobil Canada Holdings ULC ("Exxon") agreed to purchase the shares of InterOil.

[2] On July 21, 2016, Exxon agreed to pay $45 USD per InterOil share paid in Exxon shares plus a contingent resource payment ("CRP") estimated at $7.07 per share. The result of the approval of the arrangement was that InterOil shares were exchanged for Exxon shares and InterOil became a wholly owned subsidiary of Exxon.

[3] The dissenting shareholders say that a fair value of an InterOil share is $71.46 USD based upon a discounted cash flow analysis. They submit that the sale process was flawed because a whole company sales process was never properly pursued and that a discounted cash flow analysis is the most suitable method to establish fair value.

[4] Exxon submits that the $45 per share plus the actual CRP of $4.98 making a total price of $49.98 is the fair value. Exxon submits that the discounted cash flow analysis is not a suitable methodology to evaluate InterOil's shares.

[5] The most significant and most developed asset of InterOil was its 36.5% ownership interest in Petroleum Retention License 15 ("PRL15") in Papua New Guinea. PRL 15 was the significant asset in a joint venture to build a liquefied natural gas ("LNG") plant to export natural gas from Papua New Guinea in 2023.

COURT HISTORY

[6] This Court approved the first Arrangement Agreement with Exxon dated July 21, 2016, on the application of InterOil (2016 YKSC 54).

[7] On November 4, 2016, the Court of Appeal in *InterOil Corporation v. Mulacek*, 2016 YKCA 14, set aside that approval order concluding that the arrangement had not been shown to be "fair and reasonable" as required in s. 195 of the *YBCA*.

[8] The Court of Appeal summarized its decision in the following succinct paragraph:

> [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.

[9] The focus in *InterOil Corporation v. Mulacek* was on the information provided to shareholders, among other things, and the fairness and reasonableness of the proposed arrangement. The focus in the case at bar is on the process followed by the Board of Directors of InterOil in negotiating the sale of its assets and what is "the fair value" of InterOil shares. As a result of the approval of the Arrangement Agreement following the decision of the Court of Appeal, Exxon is now defending the Arrangement

Agreement based upon the improved corporate governance of InterOil and its negotiations for the sale of its assets. Exxon has declined to provide details of its negotiating information.

THE LAW OF FAIR VALUE IN CANADA

[10] The shareholder's right to dissent is set out in s. 193(3) of the *YBCA* as follows:

> 193(3) … a shareholder entitled to dissent under this section and who complies with this section is entitled to be paid by the corporation the fair value of the shares in respect of which the shareholder dissents, determined as of the close of business on the last business day before the day on which the resolution from which the shareholder dissents was adopted. (my emphasis)

[11] There are a number of general principles that are well established to determine fair value:

1. Neither party bears the burden of proof and the court itself must value the shares of the dissenting shareholders. In other words, the dissenting shareholders do not have to prove that the transaction price is too low, nor does the corporation have to prove that the transaction price is the fair value. See *Cyprus Anvil Mining Corp. v. Dickson*, [1986] 33 D.L.R. (4t) 641 (B.C.C.A.), at paras 102 – 103 (*"Cyprus Anvil*") and *Ford Motor Co. of Canada Ltd. v. Ontario Municipal Employees Retirement Board* (1997), 36 O.R. (3d) 384 (O.N.C.A.), at para. 19;
2. Any party that asserts a proposition for a value must prove it by a preponderance of evidence on a balance of probabilities;
3. There are five methods of valuation generally accepted by the courts:
    a) The quoted market price on the stock exchange;

b) The valuation of the net assets of the company at fair value;

c) The capitalization of maintainable earnings;

d) The discounted cash flow method taking into account a capitalization of future profits; and

e) Some combination of these approaches.

See *Robinson v. Realm Energy International Corp.*, 2015 BCSC 1437, at para. 120 ("*Realm Energy*").

4. The one true value 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; see *Cyprus Anvil*, at para. 51.

5. "While the starting point for a consideration of what is fair value is the deal that was struck, the deal is not determinative of the question. If it was, there would be no need for legislation." However, while the deal arranged between the parties is not presumed to be fair value, it may well be fair value after "further careful consideration". See *Realm Energy* at para. 108.

[12] There is no doubt that where the court is dealing with undeveloped assets, the negotiated price must be considered with some caution. This was particularly so in a somewhat unique example of *Cyprus Anvil* where the ore body in question was located near the existing mine resulting in only one prospective purchaser. See *Cyprus Anvil*, at paras. 65 and 66.

[13] Nevertheless, reliance on the discounted cash flow method "with the illusion of mathematical certainly" (*Cyprus Anvil*, at para. 50) has its own challenges, particularly

when dealing with the volatility of the energy markets. See *Deer Creek Energy Ltd. v. Paulson & Co. Inc.*, 2008 ABQB 326 ("*Deer Creek*"), at para. 549 – 550.

[14] Both *Cyprus Anvil* (para. 73) and *Deer Creek* (at para. 555) concluded that the discounted cash flow method must be approached with care, where there is no historical cash flow, since even minor variations in assumptions "become magnified through the calculation into a gross distortion of the fair value".

[15] At the same time, it must be recognized that the discounted cash flow method was considered by all parties in the case at bar during the negotiation and sale process.

PETROLEUM RETENTION LICENSE 15

[16] InterOil was an integrated oil and gas company prior to June 2014, when it sold its refinery in Port Moresby and its wholesale and retail sales business of refined petroleum products. From that point on, it had no revenue generating assets and focussed on its six gas licences in Papua New Guinea.

[17] Four of the licences were Petroleum Prospecting Licences, which grants the right to conduct exploration activities in a particular geographic area. Two of the licences were Petroleum Retention Licences which grant the licensee rights to the raw gas in the geographical area prior to commercial production. It did not hold any Petroleum Development Licenses, which grant the licensee the exclusive right to explore, produce and sell petroleum products within the license area.

[18] InterOil's primary and most developed asset was PRL15 covering the Elk and Antelope gas fields in Papua New Guinea. PRL15 is a pre-commercial development raw gas asset. The estimates of raw gas from independent resource evaluators from 2014 to 2016 vary dramatically from a low of 6.90 tcfe to a high of 12.3 tcfe.

[19] As of April 2014, the ownership interests in PRL15 were:

Total S.A.	40.1%
InterOil	36.5%
Oil Search	22.8%
Other Investors	0.5 %

[20] Total had purchased its interest from InterOil in March 2014 and by agreement would be the operator of the proposed Papua LNG Project. Each party to the joint venture would be responsible for its proportional share of the development costs which were projected to be $14.5 to $20 billion with 65% to be debt financed.

THE SALE TO EXXON

[21] Although it was entitled to certain fixed and contingent payments in excess of a billion dollars (the Interim Resource Payment), the InterOil Board of Directors became concerned about InterOil's ability to fund its share of the capital costs for the Papua LNG Project.

[22] The completed final investment decision was scheduled for 2019 with commercial production in 2023.

[23] The joint venture development would have the following interests:

Total	31.1%
Oil Search	17.7%
InterOil	28.3%
Government of Papua New Guinea and Landowners Back-In	22.5%

[24] As a result of delays in the Interim Resource Payment in October 2014, InterOil began to consider potential sales of some of its smaller assets other than its PRL15 interest. By March 2015, the Board of Directors instructed management, with the advice of InterOil advisors, to identify parties for potential commercial level transactions that were not whole company transactions. In the next 14 months, InterOil identified and engaged 36 potential parties for commercial level transactions that did not attract suitable bids. In early 2016, InterOil received bids from three different parties for smaller stakes in PRL15. The bids did not have sufficient implied share values and might possibly have downgraded the share value of InterOil.

[25] It should be noted that InterOil shares were listed and actively traded on the New York Stock Exchange ("NYSE").

[26] Although InterOil had an active defence program to repel takeover bids, in November 2015, Total, Exxon, Oil Search and Woodside Petroleum accessed and conducted due diligence in the InterOil data rooms.

[27] I find that the Board of Directors of InterOil focussed on commercial level transactions at meetings on November 10, 2015, and January 19, 2016.

[28] Exxon, Total and Oil Search already had significant LNG investments in Papua New Guinea. At the same time, Total had provided notice that it would not acquire an additional 3.4% stake in PRL15 and, in November 2015, neither Exxon nor Oil Search had expressed any interest in a whole company transaction.

[29] In March 2016, InterOil finalized a new credit facility for $400 million.

[30] It was not until March 2016 that InterOil received three different proposals for a whole company transaction:

a. On March 3, 2016, Exxon approached InterOil with a bid of $35 per share to be paid in Exxon shares and made on a "debt-free, cash-free basis" ("First Exxon Offer"). This bid represented a 27.1% premium above InterOil's one-month volume-weighted average share price at the time;

b. On March 11, 2016, Total made a proposal of approximately $38 - $40 per share to be paid in cash. Total's bid represented a 40% premium above InterOil's one-month volume-weighted average share prices at the time; and

c. On March 14, 2016, Oil Search made a proposal of approximately $34 in cash and Oil Search stock plus a contingent value right ("CVR") allowing InterOil to share in the IRC Payment ("First Oil Search Offer"). The $34 share value of Oil Search's bid represented a 23.4% premium above InterOil's one-month volume-weighted average share price at the time, plus the value of the CVR.

[31] None of these approaches had been solicited by InterOil as whole company transactions.

[32] At the March 15 – 16, 2016 Board of Directors meeting, a Transaction Committee of four non-executive directors independent of management was formed. Three of those directors remained on the Transaction Committee until the close of the Exxon transaction on February 22, 2017.

[33] After the March 15 – 16, 2016 Board meeting, a second round of bidding occurred:

a. On April 29, 2016, Oil Search submitted a revised proposal of $40.25 per share, to be paid in Oil Search stock, plus an improved CVR (the “Second Oil Search Offer”). This offer reflected an increase of $6.24 per share as compared to the share value of the First Oil Search Offer, and a 33% increase in value assuming a 2C resource size of 7.5 tcfe; and

b. On May 6, 2016, Exxon submitted a revised bid worth $38.50 per share to be paid in Exxon stock (“Second Exxon Offer”).

[34] At this point, Total was no longer a bidder because it had entered into an agreement with Oil Search premised on the successful acquisition of InterOil by Oil Search.

[35] On May 20, 2016, based on advice from the Transaction Committee, the Board of Directors voted to accept the Second Oil Search Offer and entered into an arrangement agreement. It was the first time that there was public disclosure of a whole company transaction. The reaction of the stock market was positive and InterOil’s share price increased 38% from $31.65 to $43.57 on the day of the announcement.

[36] The arrangement agreement with Oil Search included a “break fee” of $60 million if InterOil backed out of the transaction. InterOil also agreed to a non-solicitation clause that prohibited InterOil from pursuing other acquisition proposals unless they were “superior proposals”, i.e. they would pay the “break fee” and improve the Oil Search offer. However, the non-solicitation clause prevented InterOil from soliciting or seeking out other bidders for a whole company transaction.

[37] On June 23, 2016, Exxon presented an unsolicited proposal for $45 per share payable in Exxon shares plus a maximum $7.07 per share for each tcfe of 2C resources

identified during the interim resource certification process up to 10 tcfe. Upon receiving a binding offer from Exxon on July 15, 2016, the Board of Directors of InterOil determined that it was a "superior proposal". Oil Search declined to match the Exxon offer and InterOil proceeded with the arrangement agreement with Exxon. In the subsequent court ordered process, over 80% of the voted shares of InterOil supported the transaction and 19.4% voted against.

[38] On October 7, 2016, as stated previously, this Court approved the transaction with reservations and the Court of Appeal of Yukon found the arrangement was not fair and reasonable in *InterOil Corporation v. Mulacek.*

[39] Despite the Court of Appeal rejecting the transaction, InterOil remained committed to the Exxon transaction. InterOil never pursued a public auction for a whole company transaction.

[40] I add that on December 15, 2016, the Board of Directors of InterOil approved a revised offer from Exxon that increased the cap on the contingent resource payment.

INTEROIL'S RESPONSE TO THE DECISION OF THE COURT OF APPEAL

[41] The Board of Directors responded to the Court of Appeal's decision to not approve the Arrangement Agreement with Exxon by implementing the following corporate governance enhancements:

a. Retaining BMO on a fixed fee basis as independent financial advisors for the Transaction Committee;

b. Instructing BMO to complete a new, long form fairness opinion that considered the value of the CRP;

c. Retaining a law firm as an independent advisor to the Transaction Committee;

d. Having a different law firm representing the Board of Directors;

e. Obtaining an updated resource assessment for PRL15;

f. Removing Dr. Hession, the conflicted CEO, from the voting of the Board of Directors and reducing his compensation;

g. Providing disclosure of all relevant details in an approximately 300-page Management Information Circular;

[42] I note that the engagement agreement between InterOil and BMO was not produced by InterOil as BMO would not consent to it being produced.

[43] On February 14, 2017, the shareholders of InterOil approved the Exxon arrangement with 91.24% of the voted shares cast in favour of the Exxon arrangement, including InterOil's former CEO, Mr. Mulacek, who previously opposed it.

[44] The Exxon arrangement had the same $45 InterOil share price and an improved CRP payment as well as a $100 million "break fee" with a "fiduciary out".

THE DISCOUNTED CASH FLOW EXPERTS

[45] Both parties acknowledge that the corporate governance procedures were enhanced as a result of InterOil addressing the deficiencies identified by the Court of Appeal. While the corporate governance enhancements may be considered to be a factor on the road to establishing "fair value", they are by no means conclusive as they followed rather than preceded the establishment of the transaction price.

[46] The crux of this "fair value" dispute is the different conclusion reached by Mr. West for the dissenting shareholders and Mr. Doran for Exxon. Both experts

employed the discounted cash flow methodology. Mr. West arrived at a share price of $71.46 and Mr. Doran concluded that the existing transaction price of $49.98 was the fair value. The value of $49.98 includes the actual CRP calculation which should be included as it is the actual share value rather than an estimate of the CRP. The qualifications of each expert were not challenged.

The West Report

[47] Mr. West is a Certified Valuation Analyst and specializes in the valuation of oil and gas related businesses and assets.

[48] He utilized the generally accepted definition of fair value as "the highest price available in an open and unrestricted market between informed and prudent parties, acting as arm's length and under no compulsion to act." Mr. West concluded that the fair value of InterOil shares at valuation date was $3.65 billion or $71.46 per share. He describes PRL15 as one of Asia's largest undeveloped gas fields.

[49] Mr. West selected the discounted cash flow method to value the expected production and cash flow of PRL15. He then discounted the shares to their present value. He used InterOil's internally prepared evaluation model. There are a number of inputs that are discretionary or speculative. Mr. West chose, among other inputs, the following:

1. A discount rate of 10%;
2. A country risk premium of 0.0%; and
3. A 14% LNG slope assumption, i.e. the LNG price based on a percentage of the Brent Crude price.

[50] I have highlighted the above assumptions made by Mr. West because they are challenged by Mr. Doran on behalf of Exxon.

[51] It is fair to say that Mr. West takes an optimistic view of the future of global demand and pricing for LNG. He quotes InterOil's own statement as follows:

> 58. The Company stated to its public investors that "[f]irst and most importantly, PNG is the lowest-cost developer of LNG for the Asian market. With the world's largest LNG market within 7 days sailing, PNG also enjoys low transportation costs. From an economic standpoint, many industry watchers expect the gap between LNG demand and contracted supply to widen in the early 2020s. This is due to current and existing contracts expiring, while high-cost LNG projects face investment delays. This works perfectly for Papua LNG, which we expect to start production just as this gap starts to widen."

[52] Mr. West also relied upon the January and February 2017 market valuations which reflected the significant rise in oil prices from January 2016 to January 2017.

The Doran Report

[53] Mr. Doran determined that a market approach was the most appropriate method to decide the fair value of InterOil shares. He considered the value implied in the $45 share price plus the contingent resource payment and the InterOil adjusted trading price. He then considered an asset approach and a discounted cash flow approach analysis to determine a fair value of $49.98 per share, the exact amount of the transaction price of $45 per share plus the calculated CRP of $4.98.

[54] In contrast to Mr. West's optimistic view of future LNG prices, Mr. Doran was decidedly pessimistic:

> In my view, Mr. West provides an optimistic description of the LNG market as it existed at the Valuation Date. His discussion emphasizes recent and expected long-term growth in LNG demand and implies favorable supply

> conditions. In reality, market conditions at the Valuation Date were not favorable. As outlined earlier in my report, LNG prices have fallen dramatically since 2014. New LNG contracts were not being signed. Financing for LNG projects had become very difficult. New LNG supply was entering the market. New LNG projects were being cancelled. (reference in report)

[55] In Mr. Doran's discounted cash flow analysis, he applied to the following values, among others, corresponding to Mr. West's above:

1. A discount rate of 11%;
2. A country risk premium of 3.5%;
3. A 12.6% LNG slope assumption.

[56] West and Doran have a significant disagreement on their evaluation of a country risk premium for Papua New Guinea. While acknowledging that "the country is generally stable, incidents of potential unrest and other violence can occur". Mr. Doran included a 3.5% country risk premium despite the fact that the BMO report, retained by InterOil, did not include a premium for country risk. After reviewing further submissions of counsel on the country risk issue, I have concluded that Mr. West has already built in a country risk factor in his discount rate and a further country risk premium is not appropriate for Papua New Guinea.

DISCUSSION

[57] Both parties agree on the definition of fair value as follows:

> … 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. …

[58] There are many factors to take into consideration in approaching the question of fair value in this case, which has a somewhat unique situation where corporate

governance was heavily criticized by this Court and the Court of Appeal prior to November 4, 2016. After that date, best practices were incorporated into the process but by that time, the purchase price per share of $45 was already concluded and did not change but for the post valuation date calculation of the CRP, the most speculative aspect of the transaction. The effect then of the best practices was to better inform the InterOil shareholders reviewing the Information Circular for the second vote of approval. It is therefore a positive factor, albeit not conclusive, that the shareholder approval rose from 80% to approximately 90%. The fact that Philippe Mulacek, a very knowledgeable shareholder, first objected but then approved, is also important.

[59] In my view, 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.

[60] There are factors that support the proposition that the transaction price is fair value:

1. InterOil shares were known to individual and institutional investors and traded on the NYSE;
2. There were many interested parties in partial transactions and three major players (Total, Exxon and Oil Search) who knew the Papua New Guinea gasfield scene;
3. It was no secret that InterOil and its significant asset, PRL15, were on the market based on the parties expressing interest to partial or whole company transactions;

4. Although there was not an auction, there was a bidding and negotiations process that moved the InterOil share price from $34 to $45; and
5. The bidders included insiders like Oil Search and Total as well as Exxon.

[61] Nevertheless there were other factors at play that must be taken into consideration:

1. There had been no planned sales process in which InterOil attempted to solicit the highest possible market price for a whole company transaction. In fact, InterOil had been subject to non-solicitation agreements since May 19, 2016;
2. Oil Search's decision to not match Exxon's unsolicited bid is not evidence of an auction or the value of the Exxon bid;
3. The base price offered by Exxon had not changed since the initial binding offer of June 23, 2016. This is despite substantial changes to the state of the LNG market over this period; and
4. The Board process leading to the approval of the first proposed Exxon Transaction had been roundly criticized by the Yukon Court of Appeal. Although the Board of Directors had addressed and remedied the specific deficiencies identified by the Court, there was never even consideration of commencing a fresh process.

CONCLUSION

[62] I conclude that the transaction price was established in a flawed corporate governance process. The fact that the corporate governance process to establish a fair and reasonable arrangement was enhanced does not change the findings of the Court

of Appeal on the original arrangement. These findings included a CEO in a position of conflict, an “independent” special committee that was not independent of management and the lack of necessity for the deal. In my view, the transaction price, borne of a flawed process, cannot be resurrected as the “fair value” as defined by the experts.

[63] I conclude that the West Report is consistent with InterOil’s own BMO Fairness Opinion in not adding a country risk premium. It is also significant that Exxon did not lead evidence on whether there was a country risk.

[64] I accept the fact that the discounted cash flow method is dependent upon the factors and values that are assumed. Nevertheless, the West Report reflects the oil price increase that Doran and BMO neglected to consider.

[65] I therefore order that the dissenting shareholders are entitled to be paid $71.46 USD for each InterOil share together with a reasonable rate of interest to be paid no later than 30 days from the date of this judgment.

[66] Counsel may speak to costs in Case Management, if necessary.

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VEALE C.J.