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COURT REFUSES FTC REQUEST FOR INJUNCTIVE RELIEF AGAINST A NON-CONTROLLING PRIVATE EQUITY INVESTOR

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A federal district court dismissed[1] private equity firm Welsh, Carson, Anderson & Stowe from a Federal Trade Commission ("FTC") lawsuit[2] seeking to enjoin the firm and its portfolio company, U.S. Anesthesia Partners ("USAP"), from making future "roll-up" acquisitions of anesthesia practices and abusing USAP's alleged dominant market position.[3] The court found that the FTC had not adequately alleged that Welsh Carson was engaged in an ongoing antitrust violation or was in a position to imminently commit future antitrust violations, given that Welsh Carson was only a minority investor and accounted for just two of 14 board seats in USAP.

While this decision confirms a major limitation on the FTC's ability to add private equity firms with minority investments as defendants in suits seeking injunctive relief, scrutinizing and challenging roll-up strategies will remain a focus for the FTC and the Department of Justice, as evidenced by the agencies' recent announcement that they are seeking information from the public about roll-up transactions that may have harmed competition.[4]

Background

The FTC brought a lawsuit in federal district court in Texas alleging that Welsh Carson and several physician partners formed USAP and, through a series of at least 15 non-HSR reportable acquisitions, rolled-up anesthesiology practices to accumulate dominant positions in multiple geographies across Texas. The FTC sought to enjoin both USAP and Welsh Carson from making future roll-up acquisitions and leveraging USAP's alleged dominant market position, arguing that an injunction was needed because the firms would likely continue to engage in this anticompetitive conduct.[5]

Welsh Carson was included in the lawsuit because, according to the FTC, it was the private equity firm that created and implemented USAP's alleged anticompetitive strategy, financed the acquisitions, and hired USAP executives that led the business. Importantly, Welsh Carson sold its controlling interest in USAP in 2017, reducing its

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FAIRNESS OPINIONS IN CROSS-BORDER PUBLIC M&A: CANADA'S DEAL-SPECIFIC LANDSCAPE

By Jean-Pierre Chamberland, Samuel Li, Jason Giborski, Shanlee von Vegesack, Brad Moore and Paul Blyschak

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As public M&A lawyers know well, fairness opinions are an integral part of the deal process in friendly acquisitions. What U.S. cross-border lawyers may not know, however, is that Canadian market practice regarding fairness opinions recently experienced an evolution. Specifically, whereas the Canadian approach to fairness opinions was previously more standardized, a series of critical court rulings in 2016-2017 has since resulted in more varied approaches to fairness opinions based on situation-specific considerations, including transaction value, cost sensitivity, the potential for a shareholder challenge, and the federal, provincial or territorial corporations statute governing the transaction. Given that Canada is routinely the leading destination for U.S. outbound M&A by deal volume, we explore the Canadian fairness opinion landscape for the benefit of U.S. dealmakers.[1]

Fairness Opinion Market Practice Pre-*InterOil*

For a considerable period of time, market practice regarding fairness opinions in Canadian public M&A was fairly standardized. The financial advisor running the target's sale process—being well-placed to do so—would also prepare a fairness opinion regarding the transaction. The financial advisor would disclose their fulsome financial analysis to the target's board in delivering and discussing the fairness opinion. Shareholders would typically only receive a short-form financial opinion providing the conclusion of the analysis. The financial advisor's fee was typically largely success-based (as opposed to fixed) and the amount of the fee was typically not disclosed. Fixed-fee fairness opinions sometimes occurred, but in a small minority of instances.

The general rationale underlying this approach was that fairness opinions were primarily prepared to assist target directors in their decision-making and in discharging their fiduciary duties amid the public M&A process. The fact that a short form of the fairness opinion was also subsequently shared with shareholders and provided to the court during the approval of the transaction were both generally seen as secondary to this main purpose. A couple of criticisms by securities regulators and an Ontario court in 2009[2] and 2014[3] questioned this logic. However, subsequent judicial comments[4] generally affirmed the traditional market approach as well as its underlying rationale such that market practice did not materially change.

The *InterOil* Decisions in Brief

The turning point was a series of related decisions in 2016 and 2017 arising from ExxonMobil's acquisition of InterOil Corporation, a NYSE-listed energy exploration company incorporated in the Yukon.[5] As with almost all Canadian friendly public M&A deals, the transaction was structured as a statutory arrangement, a procedure that requires (and in most cases receives) court approval. The transaction also featured a market standard fairness opinion from a leading global investment bank with a largely success-based fee.

In reviewing the arrangement's compliance with statutory requirements, the Yukon Supreme Court identified certain deficiencies, including (1) the failure of the fairness opinion to address a potential contingent resource payment comprising part of the purchase price, and (2) a perceived conflict of interest among InterOil's management. Nonetheless, leaning heavily on the fact over 80% of the votes cast by shareholders supported the transaction, the court approved the arrangement.[6] Shareholders holding approximately 10% of InterOil's shares

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exercised dissent rights, however, and a shareholder also appealed the ruling.

In a surprise to Canadian public M&A lawyers, the Yukon Court of Appeal (consisting of three judges from the British Columbia Court of Appeal) overturned the lower court's approval of the deal.[7] The crux of the appellate court's reasoning was that, having identified the various "red flags" that it did, the lower court erred to rely so significantly on the 80% shareholder vote. However, in arriving at this conclusion the Court of Appeal also indicated that "best practice corporate governance" requires an "independent flat fee" fairness opinion to "assist shareholders and the court." The Court of Appeal additionally indicated that a fairness opinion prepared on a success fee "does not assist directors . . . in complying with their fiduciary duties."

The courts' comments did not end there. When InterOil submitted an amended arrangement for approval, it included a "long form" fairness opinion that (1) detailed the valuation methodologies used, (2) was on an independent, fixed-fee basis, and (3) disclosed the amount of the fee. Notwithstanding the particular facts of the deal (*i.e.*, "red flags") that had contributed to the Court of Appeal's decision, the Yukon Supreme Court said such a fairness opinion was a "useful template" and "minimum standard" going forward in Canadian public M&A generally.[8]

Questions Raised by the *InterOil* Decisions

Because the *InterOil* decisions are rulings of the Yukon courts, they are technically not binding in most of the rest of Canada,[9] including such prominent jurisdictions as Ontario, Quebec, and Alberta. Regardless, their impact on Canadian public M&A practice regarding fairness opinions has been significant nationwide. Such impact has not, however, been uniform.[10]

Unlike the previously mentioned hiccups that had temporarily confused Canadian deal lawyers in 2009 and 2014, the *InterOil* rulings were lengthy, generally aligned, and anchored by the authority of an appellate court. That said, they also lacked clear and consistent guidance. On the one hand, they criticized numerous aspects of traditional market practice regarding fairness opinions in Canadian public M&A. On the other hand, it is difficult to disentangle much of this criticism from the courts' perceived and *deal-specific* "red flags." Finally, and as mentioned above, the appellate court's decision was fundamentally rooted not in its dissatisfaction with the original fairness opinion, but rather with the lower court's effective abdication of its duty of review in relying so heavily on the 80% shareholder vote.

Canadian public M&A lawyers therefore faced a question: should market practice regarding fairness opinions change and where, when and how? Numerous potential alternative approaches emerged. Should the fairness opinion provided to shareholders and the court be "long-form" or otherwise include more disclosure of the financial analysis conducted? Should the fairness opinion be prepared on a fixed-fee basis rather than a success-fee basis? Should the target disclose the amount of the success fee? Should the target consider a second fairness opinion on an independent, fixed-fee basis to accompany a success-based opinion?

Fairness Opinion Market Practice Post-*InterOil*: A Deal-Specific Analysis

Perhaps unsurprisingly, given the uncertainty left by the *InterOil* decisions, the market's reaction has been mixed. Whereas Canadian public M&A previously enjoyed a more standardized approach to fairness opinions, a firmly deal-specific approach and analysis has taken its place.

- More considerations are taken into account—and are given more weight—and an overarching question is balancing the value of additional disclosure and fixed-fee opinions against their attendant burdens. Those considerations being more judiciously assessed include:

- The value of the transaction.

- The target's jurisdiction of incorporation and the business corporations statute, fairness opinion caselaw, and securities law specific to that jurisdiction.[11]

- The robustness of the sales process and board pro-

cess conducted in connection with the transaction, including the formation and role of a special committee of directors.

- The potential for any perceived conflicts of interests among target management or the target board related to the transaction.

- Any potential or anticipated shareholder challenge of the transaction, including as the procedure for statutory arrangements provides a ready forum for such challenges.[12]

- The potential for a competing, interloper offer.

- Whether a formal valuation of the target has been obtained in connection with the transaction, as may be required depending on the target's jurisdiction of incorporation in certain conflict of interest transactions (*e.g.*, insider bids).[13]

- The requirements of the IDPC Rules, which impose disclosure obligations on investment dealers in connection with fairness opinions, including regarding the financial terms of their retainer.[14]

The result of this deal-specific analysis has been a greater variety of approaches to fairness opinions in Canadian public M&A in the seven years since *InterOil*. Examples include:

- The fairness opinion including more disclosure of the valuation methodologies employed, although not necessarily the fulsome financial analysis that resulted.

- More frequent disclosure of the nature of the fee, *i.e.*, whether it is on a fixed-fee or success-fee basis, but not necessarily disclosure of the amount of the fee.

- The greater regularity of the target obtaining a second fairness opinion on an independent, fixed-fee basis, typically in higher value transactions (*e.g.*, over C$500 million) or where opposition to the deal is anticipated from one or more shareholders.

- The greater regularity of a bifurcated approach to a financial advisor's fees, *i.e.,* a success-based fee relating to the transaction overall and a separate fixed-fee in respect of the fairness opinion.

Overall, the prudence of the different potential approaches is weighed in the particular circumstances and implemented accordingly. For example, if a bifurcated approach to a financial advisor's fees is adopted, the size of the fees (*i.e.*, success fee versus fixed fee) should not be so disproportionate so as to potentially undermine the court's confidence in the objectivity of the fairness opinion. Moreover, short form fairness opinions may still be accepted from the target board's financial advisor where a second and long form opinion is provided by an independent financial advisor compensated on a fixed-fee basis.

Summary Comments

Fairness opinions are not mandated by law in Canadian public M&A. They are, however, obtained in almost all friendly Canadian public M&A deals. Target boards obtain them to assist in demonstrating compliance with their fiduciary duties in connection with the transaction. Target boards also obtain them to help secure court approval of the transaction as "fair and reasonable" as part of the statutory arrangement process. Whereas prior to 2017, a more standardized approach to fairness opinions characterized Canadian public M&A, with short form versions dominating the landscape, the *InterOil* decisions have led to a much more deal-specific approach and analysis that requires careful attention and discussion with counsel from the inception of the deal process. This has resulted in a shift toward more detailed disclosure of the valuation methodologies informing fairness opinions as well as greater scrutiny of the compensation structure awarded to financial advisors.

ENDNOTES:

[1]Note that this is a high level, introductory overview of fairness opinions in Canadian public M&A and is not exhaustive of all the issues fairness opinions raise in the Canadian public M&A context. By way of example, numerous additional considerations and securities law matters relating to fairness opinions are raised by conflict-

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of-interest transactions (*e.g.*, insider bids, issuer bids, business combinations, and related party transactions) captured by *Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions*.

[2]*See Hudbay Minerals Inc.*, 2009 ONSEC 15 (CanLII) at paras. 263-264.

[3]*See Champion Iron Mines Limited (Re)*, 2014 ONSC 1988 (CanLII) at paras. 17-19.

[4]*See Bear Lake Gold Ltd. (Re)*, 2014 ONSC 3428 (CanLII) at paras. 12-16 and *Re Patents Royal Host Inc.*, 2014 ONSC 3323 (CanLII) at paras. 7-9.

[5]The Yukon is one of Canada's three territories, which, like Canada's provinces, are sub-federal political subdivisions. The key difference between a province and territory in Canada is that provinces receive their authority from Canada's Constitution whereas territories' authority is delegated to them by Canada's federal parliament.

[6]See *Re InterOil Corporation*, 2016 YKSC 54 (CanLII) at paras. 62-70.

[7]*See InterOil Corporation v. Mulacek*, 2016 YKCA 14 (CanLII).

[8]See *Re: InterOil Corporation*, 2017 YKSC 16 (CanLII).

[9]Because the Yukon Court of Appeal is comprised of judges from the British Columbia Court of Appeal, decisions of the Yukon Court of Appeal are persuasive authority in British Columbia. There is conflicting precedent regarding whether such decisions should be considered binding. Compare *R. v. Romanchych*, 2018 BCCA 26 (CanLII) at paras. 9-11 and *Core Gold Inc. (Re)*, 2019 BCSC 1267 (CanLII) at para. 5.

[10]*See* CBV Institute, Journal of Business Valuation—2018 Edition, Fairness Opinions: The New Best Practices (https://cbvinstitute.com/wp-content/uploads/2019/07/2018-Journal-of-Business-Valuation_Digital-File.pdf), at pages 25-29 where the authors' review of market practice in the 18 months following *InterOil* finds that, during this period, the decisions had a stronger impact on market practice in B.C. and the Yukon than elsewhere.

[11]In some Canadian jurisdictions, justices responsible for issuing orders in the arrangement context have signalled to practitioners their expectations as to the level of fairness opinion disclosure required for an arrangement to proceed. Note that Canada does not have a national securities regulators similar to the SEC and that Canadian securities law is a matter of provincial, and not federal, authority.

[12]Statutory arrangements in Canada typically involve two court hearings. The first is held on an *ex parte* basis and is for the purpose of the court issuing an interim order that establishes the procedural rules for the arrangement. The second is held toward the end of the arrangement process and is for the purpose of satisfying the court that the terms of the interim order have been complied with and that the arrangement is "fair and reasonable." It is at the second hearing that any dissident shareholders have standing to challenge the deal, including for any alleged deficiencies regarding the fairness opinion.

[13]*See Multilateral Instrument 61-101 Protection of Minority Security Holders in Special Transactions*, which has been adopted by provincial securities regulators in Ontario, Québec, Alberta, Manitoba, and New Brunswick. *See also Multilateral CSA Staff Notice 61-302, Staff Review and Commentary on Multilateral Instrument 61-101*.

[14]*See* 4270-4276 of the *Investment Dealer and Partially Consolidated Rules* issued by the Canadian Investment Regulatory Organization.

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