

FAIRNESS OPINIONS

Jeffrey S. Tarbell, ASA, CFA

INTRODUCTION

Fairness opinions have been an integral part of the merger and acquisition (M&A) landscape for more than 20 years. However, a number of recent events have caused renewed focus on the usefulness of fairness opinions in corporate control transactions.

This article provides (1) a historical background and (2) a legal/economic context in which to consider the current controversies surrounding fairness opinions.

WHAT IS A FAIRNESS OPINION?

A fairness opinion is an expression of a financial advisor's opinion as to the fairness, from a financial point of view, of the financial terms of a corporate transaction.¹ In many circumstances, the opinion will only address the fairness of the consideration to be received by the selling shareholders. In other circumstances, the opinion will also address the fairness of the transaction as a whole.

Parties who rely on fairness opinions (including corporate boards of directors) generally agree on what a fairness opinion is. However, the cause of many disagreements is a lack of understanding of what a fairness opinion is not.

A fairness opinion is not:

1. a valuation analysis of the target company,
2. an evaluation of the business rationale to proceed with the proposed transaction,
3. an opinion as to the legal fairness of the proposed transaction, or
4. a recommendation that the board of directors or controlling shareholder of the target company vote to approve the proposed transaction.

FAIRNESS OPINION CONTENT

A fairness opinion is typically delivered in the form of a brief letter addressed to (1) a company's board of directors or (2) a special sub-committee of disinterested directors formed to

consider the proposed transaction. With respect to content, fairness opinions tend to conform to a fairly straightforward outline, an example of which follows:

1. a description of the proposed transaction,
2. a summary of the financial advisor's due diligence investigations,
3. a statement of any significant assumptions or conditions,
4. a statement of any significant limitations on use, and
5. a statement of conclusion (e.g., that the proposed transaction consideration is fair, from a financial point of view).

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RELATED FINANCIAL/VALUATION ANALYSIS

Notably absent from the standard fairness opinion is any meaningful description of the financial and valuation analyses upon which the opinion is based. Normally, this information is presented separately to the fairness opinion recipient in a verbal—and sometimes written—presentation.

In the case of publicly traded companies, the financial analysis/valuation presentation would be summarized and disclosed in (1) the proxy statement or (2) other transaction filings with the Securities and Exchange Commission (SEC). In the particular case of going-private transactions, SEC Regulation M-A requires that the financial analysis/valuation presentation itself be included as an exhibit to the 13E-3 or proxy statement filing.

THE PURPOSES OF FAIRNESS OPINIONS

From the perspective of boards of directors and other corporate fiduciaries, fairness opinions serve a number of useful purposes.

First, the fairness opinion is an important procedural tool. The fairness opinion provides the recipient with important information regarding various financial and valuation aspects of the proposed corporate transaction. Stockholders expect that the opinion recipient(s) would rely on this information,

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among other things, in their evaluation of the relevant aspects of the proposed corporate transaction.

Second, the fairness opinion is an important legal tool. The fairness opinion provides an element of proof that the opinion recipient used reasonable business judgment in the evaluation of the proposed corporate transaction. Under the concept of business judgment, courts will generally not second-guess the decisions of a board of directors (or find liability for honest mistakes) provided that such directors have acted (1) on an informed basis, (2) in good faith, (3) in a manner they reasonably believe to be in the best interest of the company, and (4) without fraud or self-dealing.²

And, third, the fairness opinion is an important practical tool. The fairness opinion (1) provides a certain “endorsement” of the proposed M&A transaction and (2) may help to persuade shareholders to tender their shares or vote to approve the proposed transaction. Why else would a company pay upwards of a million dollars for a “bulge bracket” fairness opinion, when an equivalent analysis could likely be obtained “off Wall Street” for a significantly lower fee? While most fairness opinion providers would claim that this purpose is incidental and unintended, this effect should certainly not be lost on the board or other corporate decision makers.

COMMON CORPORATE TRANSACTIONS CALLING FOR FAIRNESS OPINIONS

Generally, there is no legal requirement that companies or boards of directors seek a fairness opinion in connection with any corporate transaction. However, an abundance of judicial precedent has demonstrated that the absence of such an opinion strongly suggests careless decision making on the part of the target company board.

In a classic example, the Supreme Court of the State of Delaware found in *Smith v. Van Gorkom* that the Trans Union Corp. board of directors did not (1) seek adequate information or (2) take sufficient time when it approved the acquisition of the company. Regardless of the substantial price premium represented by the merger price, the Court specifically criticized the Trans Union Corp. board for its reliance on the company chairman for its evaluation of transaction fairness.³

In the current atmosphere of (1) the Sarbanes-Oxley Act and (2) the associated attention on potential board conflicts of interest, boards of directors are especially concerned with demonstrating good corporate governance. Corporate boards of directors commonly obtain independent fairness opinions in connection with the following types of business transactions:

	<u>Types of Business Transactions Involving Fairness Opinions</u>
<u>Interested Party</u>	
Target Company	Sale, merger, or acquisition of the company Any related-party transaction
Purchasing Company	Acquisition involving the issuance of a material amount of cash or securities Any related-party transaction
Parent Company	Divestiture or spin-off of material corporate assets Repurchase or conversion of outstanding securities
Other Fiduciary	Sale of assets encumbered by a bond indenture
Regulators	Conversion or sale of not-for-profit entities

THE FAIRNESS OPINION PROCESS

No formally promulgated professional standards exist for the preparation of fairness opinions. However, as a matter of generally accepted professional practice, there are probably more similarities than differences in the underlying process and procedures employed by experienced financial advisory firms.

Investors who are familiar with public company transaction proxy statements will surely recognize this.

While the descriptions of the individual procedures may vary, an independent financial advisory firm will undertake some variation of the following procedures in the preparation of a fairness opinion:

1. visit company facilities,
2. conduct discussions with management and certain company advisors,
3. analyze historical and projected financial statements and operating performance information,
4. review transaction documents,
5. analyze the subject company’s stock trading history (if publicly traded),
6. analyze comparable/guideline publicly traded companies,

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7. analyze comparable/guideline M&A transactions, and
8. analyze other relevant information.

COMMON ANALYTICAL METHODS USED IN FAIRNESS OPINION ANALYSES

The financial analyses involved in preparing a fairness opinion are more broad in scope than those involved in a typical business valuation. Nonetheless, valuation does play an integral role in the analysis of the fairness of the proposed transaction consideration.

BUSINESS VALUATION ANALYSES

Financial advisors usually employ the same generally accepted valuation approaches and methods that are used in business valuation analyses:

1. the market approach/guideline publicly traded company method,
2. the market approach/guideline merged and acquired company method, and
3. the income approach/discounted cash flow method.

In a straightforward corporate acquisition scenario, the financial advisor uses these three valuation methods to estimate a range of values for the target company. The concluded range of values can then be compared to the proposed transaction consideration to be received by the selling shareholders. In the context of "fair market value," one way to interpret the range of value indications for the target company is:

1. the low end of the range represents the lowest price that a willing seller would accept, and
2. the high end of the range represents the highest price that a willing buyer would pay.

Logically, if the proposed transaction consideration falls below the range of indicated values for the target company, it would be difficult to render an opinion that the proposed consideration was fair to the target company shareholders.

OTHER TRANSACTION ANALYSES

Aside from the generally accepted valuation methods mentioned above, financial advisors often employ additional analy-

sis to evaluate the fairness of a proposed transaction consideration.

For target companies with publicly traded securities, the financial advisor may examine the historical market prices and historical trading volume of the subject securities. This information can be helpful in determining (1) the relative liquidity of the target company securities as well as (2) the recent stock price trading range. This information can also be helpful in determining whether the recent trading price is indicative of the intrinsic value of the subject business.

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Also for target companies with publicly traded securities, financial advisors may examine the amount, if any, by which the proposed transaction consideration exceeds the historical and current market prices of the securities. This comparison indicates the amount of the proposed transaction price premium. The proposed

transaction price premium can then be compared to price premiums paid in relevant and recent completed acquisitions.

In certain transactions, financial advisors may also conduct an "LBO analysis." An LBO analysis estimates the price that an equity investor may be willing to pay for the target company in a hypothetical leveraged buyout transaction. This LBO analysis is based on numerous analytical assumptions, including:

1. projections of future cash flow,
2. the capital structure of the hypothetical LBO transaction,
3. the equity investors' required rate of return, and
4. the expected terminal value exit multiple.

This LBO analysis yields a range of indicated values that can then be compared to the contemplated transaction consideration.

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NO STANDARD DEFINITION OF "FAIR PRICE"

Despite all the legal precedent concerning fairness in corporate transactions, there is no generally accepted or statutory definition of the phrase "fair from a financial point of view". It is clear that the concept of fairness encompasses both legal and financial issues. It follows, therefore, that the qualifier "financial point of view" is meant to express that the fairness opinion does not address the legal or other aspects of the proposed transaction.

The term “fair,” however, is notoriously ambiguous. Having reviewed literally hundreds of fairness opinions prepared by dozens of financial advisory firms, the author has yet to come across an opinion that provided a specific definition of the term “fair price.”

Some financial advisors take the position that the fairness of a proposed transaction consideration should be evaluated relative to “fair value,” the standard of value applicable in most state dissenting shareholder rights proceedings. This position is based on the premise that the proposed transaction consideration could not be “fair” if it was less than the amount that would be awarded in a shareholder appraisal rights action in the company’s state of incorporation. Some financial advisors subscribe to this position regardless of whether or not the subject company shareholders actually have the statutory right to dissent from the specific proposed transaction.

On the other side of the spectrum, some financial advisors argue that fair price refers to the value of a company as an independent, stand-alone entity. Other financial advisors argue that, for a price to be fair, it must represent the highest value that shareholders would receive if the company was sold in an auction to the highest bidder.

Still other financial advisors argue that prospective transaction economic synergies should be taken into account when evaluating the fairness of proposed transaction consideration.

Fairness of transaction consideration should be evaluated based on the facts and circumstances surrounding the particular proposed transaction. Generally, the form of the proposed transaction will influence the elements of the valuation. However, the context of the proposed transaction could be just as important.

For example, a proposed transaction consideration need not include a significant price premium in order to be fair. Any transaction price premium should be (1) evaluated in light of price premiums paid in similar transactions, and (2) justified by some identifiable excess economic benefit that would accrue to a controlling shareholder.

In another example, many companies are sold after the investment banker conducts a thorough auction process that results in multiple, competing bids. Should such a competitive, market-derived transaction price be deemed “unfair” if it was below the theoretical fair value of the subject shares under state dissenting shareholder rights statutes?

THE HIGHER STANDARD OF “ENTIRE FAIRNESS”

The concept of “entire fairness” arises in conflict transactions, such as (1) going-private transactions or (2) acquisitions of

majority owned subsidiaries. Because of the inherent conflicts of interest, such transactions are not generally subject to the business judgment rule. This is true even when a special committee of disinterested (independent) directors has been formed.

The standard of entire fairness is a stricter standard than the business judgment rule. In addition to the concept of fair price (relating to economic and financial considerations of the proposed transaction), the standard of entire fairness introduces the concept of fair dealing.

FAIR DEALING

The following excerpt explains the concept of fair dealing:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of this issue must be examined as a whole since the question is one of entire fairness.⁴

“Fairness of transaction consideration should be evaluated based on the facts and circumstances surrounding the particular proposed transaction.”

Essentially, fair dealing addresses the conduct of the control shareholders in effectuating the proposed transaction.

ENTIRE FAIRNESS

Under this standard, in a conflict-of-interest transaction, the board carries the burden of proving the entire fairness of the transaction. However, by creating a special committee of independent and disinterested directors—with real authority to negotiate the proposed transaction with the controlling shareholders—the board may shift this burden of proof to the minority shareholders who contest the proposed transaction.

Interestingly, under a fairly recent line of Delaware court cases, controlling shareholders can avoid the entire fairness standard by structuring a going-private transaction as a two-step tender offer. Specifically, a tender offer whereby (1) a first-step tender (or exchange) offer is made and approved by an informed majority of the minority shareholders (unaffiliated

with the control shareholder) is followed by (2) a second-step short-form statutory merger.⁵

A TREND TOWARDS INDEPENDENCE?

As long as fairness opinions have been prevalent in corporate control transactions, both transaction principals and financial intermediaries have understood the conflicts of interest that many investment banks face in issuing fairness opinions. Specifically: when a single firm is hired to both (1) structure/negotiate the deal and (2) issue a fairness opinion, there may be significant financial incentives to find that the proposed consideration is fair. Recently, this inherent conflict of interest has received increased attention from company directors, state attorneys general, regulators, and investment bankers themselves.

Some of the events that have contributed to this realization include:

1. The Sarbanes-Oxley Act of 2002 caused public company (and, to some extent, private company) officers and directors to focus on the avoidance of conflicts of interest.
2. The Sarbanes-Oxley Act also provided increased empowerment to boards and board committees to hire their own independent advisors, rather than to rely on the advice of management's advisors.
3. The exposure of significant instances of financial and corporate mismanagement (e.g., Adelphia, Enron, Worldcom, etc.) resulted in a renewed focus by regulators on ensuring that both corporations and directors (1) fulfill their fiduciary duties and (2) truly act in the best interests of shareholders.
4. Recent court decisions—such as *In re: Emerging Communications Inc., Shareholders Litigation*—reminded corporate directors that failure to uphold their fiduciary duties of loyalty and good faith to shareholders will result in personal liability, both financial and criminal.

Corporate directors appear to be responding to these trends by showing an increased interest in the actual independence of independent fairness opinions: that is, fairness opinions provided by a financial advisor other than the investment banker who has a financial interest in completing the subject transaction. It is unclear whether this development is a result of (1) recent events (such as those mentioned above), (2) conservative advice of legal counsel, or (3) an honest concern for shareholder welfare.

In any case, securities watchdogs such as the NASD and the New York State Attorney General are reportedly investigating the issuance of fairness opinions by investment banks (i.e., financial intermediaries) that earn significant advisory fees contingent on the successful consummation of the proposed transaction.

SUMMARY AND CONCLUSION

“ . . . when a single firm is hired to both (1) structure/negotiate the deal and (2) issue a fairness opinion, there may be significant financial incentives to find that the proposed consideration is fair.”

Fairness opinions serve a number of useful purposes in corporate control transactions. From a procedural standpoint, fairness opinions provide the opinion recipient with important information on various financial and valuation aspects of the proposed transaction. From a legal standpoint, fairness opinions provide evidence that the opinion recipient used reasonable business judgment in its evaluation of the proposed transaction.

And, from a practical standpoint, fairness opinions provide an indirect and informal “endorsement” of the proposed transaction which may increase the propensity of shareholders to approve the proposed transaction.

Recent events have expanded the role of fairness opinions in the defense of corporate board actions. And, in certain circumstances, corporate directors—perhaps at the behest of their legal advisors—increasingly insist that the transaction fairness opinions be provided by independent financial advisors.

This recent interest in financial advisor independence should not be surprising. After all, in the event of shareholder litigation, it may be difficult for the defendant board members to claim reliance on a fairness opinion unless that fairness opinion is free of both real and perceived conflicts of interest.

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Notes:

1. As discussed herein, a fairness opinion may be issued in a broad variety of corporate transactions. However, for purposes of this article, we will refer to the common context of a cash acquisition of a publicly traded company.
2. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
3. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).
4. *Weinberger v. UOP, Inc.*, 457 A.2d 701,711 (Del. 1983).
5. *In re Pure Resources, Inc. Shareholders Litigation*, 808 A.2d 421, 438 (Del. Ch. 2002).

Jeff Tarbell is a principal and national director of financial advisory services of the firm. He can be reached at (503) 243-7501 or jtarbell@willamette.com.

www.willamette.com