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Fairness Opinions: How Fair?

New SEC regulations don't solve any problems.

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On October 17, 2007, the Securities and Exchange Commission published Rule 2290 involving fairness opinions, the document that boards of directors routinely rely on to determine whether shareholders are receiving appropriate compensation in merger and acquisition ("M&A") transactions. The new ruling does not require a board to obtain a fairness opinion. It simply provides minimum standards of disclosure if a fairness opinion is to be relied upon in M&A transactions. The rule was first proposed in 2004 and, after much controversy and numerous re-drafts, it has finally worked its way into securities regulation. After these years of effort, an opinion letter now states only that a transaction is "fair from a financial point of view." The original concerns still exist.

SCOPE & PURPOSE

Faced with an offer to buy the business they advise, board members have a fiduciary duty of care that requires them to be reasonably informed when making decisions that affect public shareholders or minority investors who are not active participants in the decision. Since most boards are not made up of M&A and valuation experts, they often seek financial advice to assist with that decision-making. A formal opinion, most often referred to as a "fairness opinion," serves as "evidence" that the board conducted a process that was sufficient to satisfy its fiduciary obligations.

Although not required, fairness opinions have become standard practice in corporate transactions, after a Delaware court ruled in 1985 that a corporate board breached its fiduciary obligation to carry out its "duty of care" by approving a merger without adequate information. In that case, *Smith v. Van Gorkum*, even though the purchase offer represented a 50% premium over the pre-deal trading price, the court held that the board acted with gross negligence and imposed personal liability on its directors. In response to that ruling, boards have routinely sought fairness opinions to demonstrate that they have thoroughly considered the transaction terms and, thus, have satisfied their fiduciary duties. Courts have found that relying in good faith on fairness opinions is one way that a board can demonstrate that it met its duty of care.

Rule 2290 was originally stimulated by the controversy that has raged over the process of rendering, and the content of, fairness opinions. The criticism is that fairness opinions can be deeply flawed because they are prepared utilizing methodologies that allow considerable subjectivity. Surprisingly, there is no standard for "fairness" and, given the huge fees that investment banks stand to gain if their transactions are successful, they are rife with conflicts of interest. In addition, fairness opinions are of virtually no value as "insurance policies" to provide restitution for shareholders who may be damaged as a result of the board relying on a faulty opinion. Although the new rule set out to alleviate these criticisms, the rule that has been promulgated has been watered down to be virtually meaningless.

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THE RISK TRANSFER PROBLEM

Fairness opinions are generally two- or three-page letters that set forth the transaction terms as well as the qualifications and assumptions underlying the issuer's determination of fairness. If you read the text of a typical fairness opinion, it seems that the letter's primary purpose is to manage and restrict the investment bank's liability for rendering the opinion. The bulk of the text is taken up with a laundry list of qualifications and assumptions. It is only at the letter's end, in one sentence, that an opinion is actually given that the transaction is "fair from a financial point of view."

Engagement letters for fairness opinions routinely incorporate indemnification provisions that absolve the investment bank of all risk or liability (outside of gross negligence). There is no history of an investment bank paying for damages resulting from a flawed opinion.

THE CONFLICT OF INTEREST PROBLEM

Fairness opinions are routinely written by the same investment banking firm that represents the seller in an M&A transaction.While the fees paid for the fairness opinion are not contingent upon completion of a transaction, the considerably greater M&A advisory fees are. This creates an inherent conflict of interest. Many wonder, is the deal best for the shareholders, or is it best for the investment banker?

A more subtle conflict is the relationship between an investment bank and management. Bankers often have relationships that span more than one transaction and thereby may be influenced to find a particular deal fair to avoid alienating management, which stands to benefit from it. And, perhaps the most egregious conflict is where an investment bank participates on both sides of a transaction, by advising the seller on value and also arranging financing on behalf of the acquirer.

THE VALUATION PROBLEM

A fairness opinion is not an appraisal. The opinion does not specify a set value or presume to be a determination of price. Rather, the opinion offers only that a specified transaction is within a range of values encompassing financial fairness. A specific definition of fairness is almost never provided.

The worth of a fairness opinion ultimately lies in the reliability and accuracy of the underlying valuation analysis. This is a realm of finance where there remains considerable controversy. There are many elements of subjectivity, both in the choice and application of the valuation methods. There are no uniform, specific, objective guidelines to arrive at fairness, and this variability makes it difficult to rely on or compare the conclusions, unless disclosure is made of the various inputs to the valuation analysis. Substantial discretion and lack of guidelines or standards make the process vulnerable to manipulation to arrive at

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the "right" answer.

The concept of fairness has inherent limitations. As readers of this publication understand, value is in the eye of the beholder and, because the investment bank does not have access to the mindset and information upon which an acquirer is acting, value to the buyer can never be known. Only the intrinsic value of a corporation to the current stockholders can be analyzed with any objectivity.

A REMEDY

So, with all these problems, why use fairness opinions at all? We find that a compelling question. It seems reasonable that a fairness opinion should not be necessary or considered relevant in the exercise of the duty of care by the board of a seller if the process followed is correctly structured to produce a market price—that is, an auction.

There is, however, a role for fairness opinions in situations where auctions are not possible or when the disclosures that accompany an auction may damage the company. We do not argue that an investment bank that stands to earn a contingent success fee should be disqualified from proffering fairness opinions, as long as there is full disclosure of the type and nature of the conflicts. However, directors and shareholders should have access to the entire valuation analysis (its methodologies and assumptions), as well as its conclusions. It would be reasonable that the opinion's conclusions incorporate a range of values that represent what the business could be worth to prospective buyers, minus the potential costs (monetary and otherwise) of selling the business in an auction. Absent these disclosures and consideration of the rationale that leads to the valuation conclusions, an oblique statement of fairness should not absolve the board of its obligations. ❖