Fairness Opinions Under Fire

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A renewed market for mergers and acquisitions (and growing value of the deals) is focusing fresh attention on the fairness opinions boards seek before approval. In our post-scandal business environment, the problems with fairness opinions, including conflicts of interest and potential manipulation, have drawn new criticism. How can boards assure the "fairness" of their fairness opinions.

As the value of transactions requiring fairness opinions has surged, they have come under increased scrutiny because of systemic problems that undermine their credibility. The perception among many in the investment community is that fairness opinions are of dubious value as an independent assessment of whether a transaction is fair. Their only real purpose, it seems, is to protect fiduciaries in the event of a lawsuit. Concerns over fairness opinions have attracted the attention of regulatory bodies such as the NASD, the Securities and Exchange Commission and New York Attorney General Eliot Spitzer.

The potential conflict of provider "success fees" is only one problem with fairness opinions. In truth, there are no coherent guidelines used by fairness opinion providers.

Foremost on the regulators' list of concerns is the obvious conflict of interest that exists when the firm issuing the fairness opinion stands to earn a "success fee" upon consummation of the transaction. However, such conflicts are only one of the factors undermining fairness opinions. The most basic problem is that there is no coherent set of guidelines for fairness opinion providers to follow in assessing and demonstrating the financial fairness of a transaction. It is largely left to the provider to set the parameters that will determine its fairness. While overshadowed by the attention being given to success fees, this absence of structure, more than anything else, renders a large number of fairness opinions virtually meaningless.

A fairness opinion is a written, affirmative determination by the provider that a transaction is fair to a particular stakeholder. The most visible transactions involve public shareholders. However, fairness opinions are also sought on behalf of minority stockholders in private companies, preferred stockholders, warrant or option holders, limited partners, creditors, employee stock ownership plans, charitable foundations, and trusts.

Fairness opinions are not required in most transactions (a notable exception being Section 1203 of the California Corporations Code covering tender offers made by certain insiders). Nonetheless, they are sought by fiduciaries in a variety of transactions, particularly those in which there are concerns about self-dealing.

Fairness opinions have been routinely obtained in corporate control transactions since the landmark 1985 case of *Smith v. Van Gorkom* wherein the Delaware Supreme Court strongly criticized the board for its failure to obtain an independent fairness opinion.

The market for fairness opinions is huge and growing. While the following chart represents the majority of the dollar value of transactions involving fairness opinions, it is only a fraction of the number of public and private transactions in which they were sought. Nonetheless, these statistics give a clear indication that the market for fairness opinions rebounded strongly in 2004 in connection with an overall surge in merger and acquisition activity. Thus, despite the well -publicized concerns over fairness opinions, they continue to be an integral part of a suddenly vibrant M&A market.

A Bull Market in Fairness		
Top Ten Providers Of Fairness Opinions		
Year	**Number of Opinion**	**Deal Value *($bil)***
2004	357	$966.8
2003	199	$250.2
2002	188	$390.8
2001	243	$426.9
2000	405	$1,829.9
1999	438	$1,440.3
Source: Mergers & Acquisitions *magazine*		

The 1983 case of *Weinberger v. UOP* introduced the "entire fairness" doctrine to corporate transactions. While it technically applies only to certain "interested party" transactions, the doctrine is a model for the prudent approach to all transactions in which fairness concerns are present.

To establish the "entire fairness" of a corporate transaction, the board must satisfy that the transaction is both *procedurally* fair and *substantively* fair. Procedural fairness addresses whether the board followed proper procedures in initiating, negotiating, structuring, approving and consummating the transaction. Substantive fairness considers the transaction's economic substance.

The act of obtaining an independent fairness opinion helps the board satisfy its obligation to exercise sound business judgment.

A fairness opinion encompasses substantive fairness, or fairness "from a financial point of view" to a particular stakeholder. However, in corporate transactions the act of obtaining an independent fairness opinion will help the board satisfy its obligation to exercise sound business judgment and is an element of procedural fairness.

While case law provides useful guidance on the proper steps to follow to establish procedural fairness, there is insufficient authority on substantive fairness. This has caused some fiduciaries and their advisors to overemphasize the following of proper procedures at the expense of a thorough scrutiny of the economic substance of the transaction.

The lack of guidelines also creates the opportunity for abuse and contributes to the common feeling in the financial community that fairness opinions are merely a "rubber stamp." One example is the provider's use of overly broad valuation ranges. These are based on a wide range of multiples from comparative companies, without any attempt to synthesize the data into meaningful value indications. These can justify any conceivable proposed purchase price.

The most important fairness opinion reform measure would be the development and adoption of a set of guidelines that would make opinions more meaningful and provide fiduciaries, stakeholders, regulators and courts a basis for evaluating them. However, the regulatory agencies are for the most part ignoring this fundamental issue.

The NASD is considering new rules regarding the identification and disclosure of potential conflicts of interest, including both success fees and any financial stake that company executives have in the transaction that could bias them. While the NASD is also said to be looking at the valuation procedures employed, developing a comprehensive set of guidelines for establishing and demonstrating that a transaction is financially fair has not been a prominent discussion point.

No doubt the inherent subjectivity involved in analyzing fairness across the many transactions in which fairness opinions are sought complicates any attempt to regulate the process. This is the justification some providers use to counter the argument for guidelines.

However, the appraisal community has successfully introduced standards in other contexts in which financial opinions are required. For example, the American Society of Appraisers has adopted Business Valuation Standards that have succeeded in adding clarity to valuation opinions without placing undue restraints on the provider's exercise of judgment. The goal of any guidelines should be to enhance the consistency and meaning of fairness opinions. The following discussion points are at the heart of the development of any such guidelines.

Should there be an objective standard for what constitutes "financial fairness" or "fairness from a financial point of view"?

At present, there is no basis against which to judge whether a transaction is substantively fair. This leads to vastly different interpretations of the proper threshold for a determination.

Most would agree that a minimum threshold for financial fairness is that the consideration received by the stakeholder is at least equivalent in value to the consideration tendered (that the stakeholder is financially no worse off as a result of his or her participation in the transaction). However, there is no consensus on whether a higher standard of relative fairness should apply.

Proponents of relative fairness believe that fairness to a stakeholder must be viewed relative to other parties involved in the transaction. To illustrate the point, I was involved in a case in which the majority shareholder negotiated the sale of a company that had minority shareholders. A large portion of the total sale consideration was comprised of extremely generous, and substantially above-market, consulting and non-compete payments that went to the majority shareholder.

The minority shareholders did not participate in these payments. The majority shareholder contended that the transaction was fair to the minority holders since the price they received for their shares was no less than their fair value. We took the position that any consulting and non-compete payments that could not be economically justified should have been allocated to the shareholders on the basis of ownership.

Our position would have been stronger if there was a definitive standard upon which we could have relied. Indeed, another provider acting in good faith might have interpreted the situation differently, concluded that there was no basis for such an assertion, and supported the fairness of the transaction. Having a defined standard would provide the conceptual framework determining fairness and clear up much confusion.

There are no clear guidelines for comparing an all-cash offer to one with less cash, but which also includes non-cash considerations.

Should there be guidelines regarding the evaluation of competing offers or strategic alternatives?

In cases such as *Revlon Inc. v. MacAndrews* and *Paramount v. QVC*, the Delaware Supreme Court has taken the position that once the decision is made to solicit sale offers, the board's duty is to get the maximum value and that it should not give favorable treatment to any suitor.

However, this leaves many issues unresolved in evaluating competing offers. For example, there are no clear guidelines for comparing an all-cash offer to one with less cash, but having non-cash and/or contingent consideration. It seems reasonable that there should be a guideline requiring fairness opinion providers to place a value on all non-cash and contingent consideration so that competing offers can be quantitatively compared.

Another issue is whether consideration should be given to the expected timing and likelihood of completion of competing offers. I have been involved cases in which we judged a sale offer to be fair despite a higher-price competing offer because it was deemed to have a better chance of success. However, there is no clear guideline indicating whether it is appropriate for the opinion provider to consider these factors.

There are also no guidelines indicating whether, in the absence of any competing offers, the provider must consider viable strategic alternatives to the proposed transaction that could bring greater value to shareholders.

What is an acceptable variance between the high and the low end of the valuation range used to affirm the fairness of a transaction price?

A primary criticism of fairness opinions is that providers use overly broad ranges of value to justify unreasonable prices. In a shareholder challenge to the TimeWarner merger, the judge ridiculed the fairness opinion that "provided a range of values that even a Texan would feel at home on."

In its notice to members requesting comment on proposed fairness rules, the NASD said "the multiplicity of valuation methodologies employed, the sensitivity of the results to small changes in the underlying assumptions, and a perceived tendency to make judgment calls that support the company managers' preferred outcome have been the subject of criticism."

Yet, because the magnitude of a reasonable range of value will vary depending on the nature of the company, no specific percentage variance requirement would be applicable to all situations. Nonetheless, a guideline which states that the individual valuation approaches used by the provider should be synthesized into an overall range of value that is narrow enough to be *meaningful* would compel providers to justify valuation ranges as reasonable and might curtail some of the abuse.

Regulations on the selection and use of valuation approaches could do more harm than good. Any guidelines should still be general in nature and provide discretion.

Should guidelines be adopted regarding the specific valuation approaches to be used by fairness opinion providers?

In its notice to members regarding proposed rules for fairness opinions, the NASD suggests a "process to determine whether the valuation analyses used are appropriate for the type of transaction and the type of companies that propose to participate in the transaction."

However, attempting to regulate the selection and use of valuation approaches runs the risk of doing more harm than good. Therefore, any guidelines concerning valuation approaches would have to be general in nature and give the provider the discretion to use the valuation approaches it deems appropriate under the circumstances.

Should there be guidelines on the documentation of fairness opinions?

Typically, a fairness opinion is a two- or three-page letter that is long on caveats and short on discussion of the analysis underlying the opinion. Often, but not always, the opinion is supplemented by a presentation to fiduciaries. If the transaction is subject to SEC scrutiny, a summary of the analysis is generally contained in the proxy statement.

In most transactions, the fairness opinion and supporting materials, if any, are not sufficient for a full understanding of the provider's analysis by fiduciaries and stakeholders. Moreover, the completeness of the provider's internal file is also a major area of concern. In court testimony on M&F Worldwide Corp.'s failed attempt to acquire Panavision, Inc. a few years back (both companies were controlled by billionaire Ronald Perelman), it emerged that the fairness opinion provider destroyed notes of due diligence discussions as part of its normal procedure.

This is the approach that many (if not most) investment banks take towards internal documentation of fairness opinions. Notes of due diligence discussions and other supporting documentation are not kept for fear that they could later be damaging.

At a minimum, guidelines regarding documentation should require the provider to maintain a work file sufficient to document its reasoning and all important assumptions that support its opinion. In addition, content requirements for the opinion itself would allow fiduciaries and stakeholders to better understand the reasoning behind the opinion, and should also figure prominently in any discussion of fairness opinion reform.

Should the fairness opinion provider be required to scrutinize the financial projections upon which the deal price is based?

Fairness opinions have been successfully challenged in the past on grounds that the provider blindly relied on management-prepared projections to support its determination. For example, a New York Stock Exchange arbitration panel criticized the investment banker providing the fairness opinion in the 1992 merger of Medical Care International and Critical CareAmerica for relying on overly optimistic projections.

Concern over the provider's reliance on projections is heightened when management has a vested interest in the outcome of the transaction. Our firm takes the position that it is incumbent upon us to exercise independent judgment regarding the projections.

Projections that are regarded as either overly optimistic or overly conservative are handled in one of three ways. Specific adjustments are made to the revenue and margin assumptions upon which the projections are based; an adjustment is made to the discount rate to nullify the perceived bias in the projections; or (in extreme cases) we disregard the projections altogether. Likewise, a guideline should be adopted that places the onus on the fairness opinion provider to analyze the assumptions underlying the projections and make appropriate adjustments to its analysis.

How should caveats and disclaimers in the fairness opinion be dealt with?

Skeptics often cite a large number of caveats and disclaimers that water down fairness opinions. The typical opinion contains numerous limiting factors, including the presumed accuracy of historical financial statements, interpretations of legal, tax and regulatory matters, and reliance on certain management-provided information.

While some degree of reliance by providers is unavoidable, should they not be required to make independent assessments of matters that are within their presumed area of expertise? In the MCI/CCA merger previously discussed, the provider was criticized for failing to perform enough due diligence on the company's business prospects, or investigating its financial statements, including "CCA's history of large accounts receivable write-offs following acquisitions of other companies."

This case hints at mandatory due diligence requirements, including, among other things, a thorough investigation of -the company's business prospects, the condition of its industry, and a rigorous analysis of its financial results and condition. A corollary to these requirements would be guidelines to limit disclaimers where the provider is presumed to be capable of making an independent assessment. *Should there be credential requirements for fairness opinion providers?*

At present, no credentials are required for opinion providers. Most fairness opinions are issued either by investment banks or business valuation advisors (with the very largest transactions handled almost exclusively by investment banks). These two types of firm differ fundamentally in their approach to fairness opinions. While accreditation would not eliminate these differences nor guarantee competence, it would (coupled with the adoption of standards) foster greater consistency in the providers' approach.

Fairness opinion providers strive to make good faith determinations using their judgment, skill and experience. The lack of standards makes this more difficult.

While fairness opinions appear to finally be getting the serious attention of regulators, most of that attention has focused on the inherent conflict of interest posed by success fees. Yet success fees are only one (albeit the most obvious) of the reasons that fairness opinions are held in such low regard by many in the investment community.

Largely overlooked is the basic problem that the fairness opinion market, despite its huge size, lacks structure and consistency. In spite of this, many providers strive to make good faith determinations of fairness and manage to add value to transactions using their judgment, skill and experience.

However, the lack of standards makes this much more difficult for them. It also encourages less scrupulous providers to issue fairness opinions in marginal transactions because there is little basis for challenging them. Thus, mandatory disclosure, if not outright prohibition, of success fees is a good first step. Also needed is greater clarity on what it takes to affirm "fairness from a financial point of view."

Until such guidance is promulgated, boards should be aware that these factors might undermine a fairness opinion and take steps to mitigate their effects by taking an active and informed role in the process.