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Fairness In Financial Transactions

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Officers, directors and majority shareholders of a corporation owe a fiduciary responsibility to minority shareholders. When such fiduciaries participate, either through equity in or employment agreements, with a potential buyer, the transaction may very well be the subject of intense scrutiny under continually developing "fairness" standards. Dissident minority shareholders may seek injunctive relief, rescission, damages or a statutory appraisal, and may allege the transaction involves inadequate disclosure, breach of duty or even fraud. Obviously, inadequate preparation to defend against dissident shareholder actions may be perilously costly.

A "fairness opinion" is a statement from a financial expert that a transaction is "fair from a financial point of view" to certain parties at interest. In theory, such opinions should protect minority shareholders who are diffuse and cannot have a direct voice in transactions. Fairness opinions serve two purposes: 1) to assist and justify the decision making of directors and 2) to persuade shareholders to tender shares or to agree to approve the terms of a merger.

The issue of fairness and the need for fairness opinions generally arise where actual or potential conflicts of interest exist among parties involved in a transaction. A fairness opinion attempts to provide a posture maintaining arm's length standards where they do not otherwise exist.

The Business Judgment Rule

Fairness opinions are generally not required, but have evolved from state corporate laws requiring boards of directors to approve transactions affecting shareholders and express their views on fairness. An independent opinion will help the board satisfy its obligation to exercise sound business judgment in approving transactions.

With the power to oversee the business and affairs of a corporation, granted by state law and corporate charter, come the duties of care and loyalty to the corporation (as well as shareholders). In other words, the board must act in a prudent manner and avoid, where possible, conflicts of interest. The touchstone for judging director behavior is the "Business Judgment Rule" which presumes that directors have acted responsibly as long as they act: i) on an informed basis, ii) in good faith, iii) in a manner they believe to be in the best interest of shareholders, and iv) without fraud or self dealing. In transactions where management may have a significant self-interest, there is a heightened duty of care. An expert valuation opinion is one factor considered in determining whether directors have acted on an informed basis and have critically examined relevant information.

In *Smith v. Van Gorkam*, it was held that the directors of Trans Union Corporation breached their fiduciary duty of care by approving a merger without adequate information on the fairness of the offered price. The court suggested that, although fairness opinions were not required by law, the directors could have exercised an informed business judgment by obtaining such an opinion. Likewise, in *Hanson Trust PLC v. SCM Corporation*, the court was openly critical of the failure to obtain a written fairness opinion and to explore the "range of fair values" for the assets in question.

In contrast, a friendly sale of stock in *Treadway v. Care Corp.* was upheld, where the board received a written fairness opinion and report detailing the transaction.

Entire Fairness

As stated in *Sterling v. Mayflower Hotel Corp.*, when controlling stockholders stand on both sides of a transaction, they must "bear the burden of establishing its entire fairness, and the transaction must pass the test of careful scrutiny by the courts." The concept of "entire fairness," initially highlighted in *Singer v. Magnavox Company* and discussed at length in *Weinberger v. UOP, Inc.*, encompasses two tests: 1) fair dealing or procedural fairness and 2) fair price or substantive fairness.

Procedural fairness requires that the majority not use their control of the corporate machinery to effect a transaction without regard for the rights of the minority. In *Weinberger*, the court indicated that fair dealing "embraces the questions of when the transaction was timed, how it was initiated, structured, negotiated and disclosed to the directors, and how the approvals of directors and stockholders were obtained." Unfair dealing includes fraud, overreaching, hurried transactions that deny directors an opportunity for careful deliberations, lack of arm's length negotiation, and nondisclosure of pertinent information.

Substantive fairness encompasses the economic and financial aspects of a proposed transaction. While a fairness opinion issued by a financial expert only addresses the issue of fair price, obtaining a fairness opinion provides an indication of procedural fairness. The determination of fair price remains an elusive concept. In an effort to simplify the field of security valuation, the Delaware courts had developed an approach, adopted in most other states, known as the "Delaware Block Rule" in determining fair value. The approach was somewhat mechanical and consisted of developing and weighting three prescribed indications of value based on those elements considered to be common to all valuations. In 1983, *Weinberger* found the Delaware Block Rule to be outmoded and determined that a "more liberal approach must include proof of value by any technique or methods which are generally considered acceptable in the financial community." Thus, in addition to the three approaches of the Delaware Block Rule, other factors that influence or provide an indication of value, including discounted cash flow, should be considered.

Since fair dealing and fair price are examined as a whole, the financial expert should also be informed of all material facts and circumstances of the transaction, though the opinion does not directly address the aspect of fair dealing.

Weight Accorded Fairness Opinions of Financial Experts

An expert's opinion is not conclusive on the issue of fairness. Important issues to be considered in determining the weight that a fairness opinion may be given in court include the due diligence of, the information and length of time provided to, and the independence of the valuation expert providing the opinion.

In both *Weinberger* and *Joseph v Shell Oil Company*, the validity of the fairness opinion was rejected due to time limitations and inadequacy of disclosure to the provider of the opinion. It is clear that the business judgment rule will not protect directors against charges of breach of fiduciary duty based on reliance on a hastily prepared and uninformed opinion.

Fairness opinions are often provided by the very same investment bankers who also structure deals and whose compensation is mostly contingent on the deal's success. Thus, if a financial advisor both structures a deal and prepares a fairness opinion, the investment bank itself faces a serious conflict of interest, which can compromise the importance of a fairness opinion. This conflict may lead advisors to craft opinions in a misleading way or to follow valuation techniques that predispose results.