

# Current Issues in Fairness Opinions

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# Fairness Opinions

- A fairness opinion is...
  - A financial advisor’s opinion that states whether or not the financial terms of a proposed transaction are **within a range of fairness**
  - Expressed from a **financial point of view** to one or more specific parties of the proposed transaction as of a specific date
  
- A fairness opinion is NOT...
  - An opinion that the proposed transaction is fair from a legal point of view
  - A recommendation for the proposed transaction
  - An evaluation of the business rationale to proceed with the proposed transaction

# When Does a Fiduciary Need a Fairness Opinion?

- Fairness opinions are **not required by any statute or regulation**, but they have become a regular feature of corporate transactions since 1985 when the Delaware Supreme Court issued its opinion in *Smith v. Van Gorkum*.
- The Court found that a corporate board **breached its fiduciary duty of care** by **approving a merger without adequate information** on the transaction, including information on the **value of the company** and the **fairness of the offering price**.
- It was not the price itself that was questioned, only that there was **no independent evidence** that the price was fair.

## When Does a Fiduciary Need a Fairness Opinion? (cont'd)

- Corporate boards of directors or trustees frequently obtain an independent opinion to assess the fairness of certain contemplated transactions having a significant impact on shareholders' value.
- Fairness opinions are generally rendered for the following transactions:
  - Mergers and acquisitions
  - Employee Stock Ownership Plans (ESOP)
  - Restructurings
  - Equity private placements
  - Going private transactions
- Issues for which opinions are necessary
  - Management, board members, or controlling holders benefit from the transaction
  - Minority shareholders are being bought out
  - Significant change in capital structure
  - Tender offer, sale or merger is conducted without an auction.
  - A fiduciary wants an independent advisor to support its actions
  - Prospects of dilution
  - Multiple constituencies of shareholders

# What are the Benefits of a Fairness Opinion?

- Fairness opinions serve two main purposes:
  - Provide boards of directors with **information** which **may affect** their **analysis** of the transaction
  - Serve as **evidence** in litigation that the board of directors used **reasonable business judgment** in approving the transaction
- Boards of directors must meet a high standard of due diligence when acting on behalf of their shareholders.
- Fairness opinions:
  - Assist directors and other fiduciaries in fulfilling their duty to their constituencies
  - Afford the directors and other fiduciaries the comfort of knowing the proposed transaction was **diligently investigated**
  - Benefit stakeholders by assuring them that the transaction was **independently reviewed**

# What are the Benefits of a Fairness Opinion?

- Under the concept of **business judgment**, the courts generally look for evidence that directors have acted
  - On an informed basis
  - In good faith
  - In a manner they reasonably believe to be in the best interest of the company's stakeholders
  - Without fraud or self-dealing
- Fairness Opinions can only be utilized by the specified party or parties to a transaction as set forth in the engagement letter.
  - ESOP Trustee
  - Board of Directors
  - Investors
- Independence is the primary issue

# Public vs. Private Company Fairness Opinions

- For public companies that do not provide a fairness opinion, the SEC is likely to question why an opinion was not obtained in connection with the filing of any proxy materials
  - Increased director liability
- Private companies are certainly subject to less scrutiny and potential lawsuits than public companies in connection with a transaction, although there is still potential liability
- Private companies may seek fairness opinions when there is potential for conflicts among shareholders.
  - A large number of shareholders
  - Different classes of security holders (debt, preferred, convertible, common)
  - Outside shareholders (private equity or trusts)

# What is Included in a Fairness Opinion?

- Fairness opinions historically have been delivered in the form of a letter addressed to a:
  - Company’s board of directors
  - Special committee of independent directors formed to consider a proposed transaction
- The opinion is backed by a supporting memorandum detailing the methods used and the analysis leading to the conclusion.
- Fairness opinions include the following:
  - Description of the proposed transaction
  - Summary of the financial advisor’s due diligence investigations
  - Statement of assumptions or conditions
  - Statement of any limitations on use
  - Statement of conclusion (example, that the proposed transaction or consideration received is fair, from a financial point of view)

# What is Disclosed in a Public Filing?

- The **SEC proxy rules** require that when a public company's board of directors obtains a fairness opinion that is referred to in the proxy statement, the opinion must be fairly summarized and describe:
  - The procedures followed
  - Findings and recommendations
  - Bases for and methods of arriving at such findings and recommendations
  - Any instruction received from the subject company concerning the investigations, and
  - Any limitation imposed by the subject company on the scope of the investigation
- For publicly traded companies, a synopsis of the oral or written presentation to the board of directors is always included in the proxy statement.
- The financial advisor should work in conjunction with the legal counsel in preparing the relevant sections of the SEC filings.
  - Requirements under Rule 13E(3)

## NASD Notice to Members 04-83

- In November 2004, the NASD issued a request to member firms for comments as to whether it should propose a rule that would address **procedures**, **disclosure requirements** and **conflicts of interest** when member firms provide fairness opinions.
- Potential conflicts the NASD noted in its request for comments include:
  - Influence by company management
  - Same investment bank issues fairness opinion and acts as advisor on the transaction
  - Success fees
  - Stapled financing
- Of the 20 comment letters received by the NASD, 12 were in favor of the proposed rule change, 7 were opposed, and 1 expressed no opinion.
- NASD filed a proposed rule change to Rule 2290, which requires certain **disclosures** and **procedures** for the issuance of fairness opinions by NASD member firms.

# NASD Rule 2290

- Disclosure Regulations:
  - Compensation contingent upon successful completion of the transaction
  - Material relationships and any compensation received as a result of the relationship
  - Information that formed a substantial basis for the opinion that was provided by management and whether that information was independently verified; and
  - Was the opinion approved or issued by a fairness committee?
  
- Procedural Requirements
  - Types of transactions in which a fairness opinion committee will be used
  - Process to determine if the valuation analyses used are appropriate for the type of companies; and
  - Process to evaluate the degree to which the compensation from the transaction benefits any individual officer, director, or employees relative to the benefits to the shareholders of the company, is a factor in reaching the fairness determination
  
- Fairness Committee
  - Process to select personnel on committee
  - Qualification of persons on committee
  - Process to ensure balanced review and approval by persons who do not serve or advise the “deal team”

# What is Considered in Rendering an Opinion?

- In preparing a fairness opinion, financial advisors must:
  - Utilize proven valuation techniques
  - Implement thorough industry analysis and extensive due diligence
  - Include a rigorous analysis of the **available alternatives** to the proposed transaction
- Key question is “Are the shareholders or beneficiaries better off with or without the proposed transaction?”
- In a cash transaction, an advisor should analyze whether the consideration to be paid falls within the fairness range and what alternatives exist.
- In a stock exchange, an advisor should consider the relative benefits to the selling shareholders of owning the buyer’s securities.
- Not a consideration
  - Finding a better deal
  - Anti-Trust

## What is Considered in Rendering an Opinion? (cont'd)

- All types of consideration must be valued, including management contract fees and contingent payments.
- A financial advisor must analyze:
  - The relative consideration received by various parties
  - Other financial terms of the transactions
  - Any financial alternatives that may be available to the shareholders or beneficiaries
- High level of due diligence
  - History of the transaction
  - Marketing of the deal
  - Projections

# What is the Standard of Value?

- **No formal standard of value** exists for the preparation of fairness opinions.
- Fair value is a **legal standard** governed by **state statute** and **precedent**.
  - **Precedents**
- Some advisors use **fair value** as the standard of value based on the premise that the consideration to be paid in the proposed transaction would not be fair if it was lower than the amount that would be awarded in a shareholder appraisal rights action (which uses a fair value standard).
  - Force-out or simple repurchase
- Other advisors use a standard of value that represents the **highest value** that shareholders would receive if the corporation was sold in a auction to the **highest bidder**.
- Advisors may or may not take into account any **economic synergies** that would be realized in the proposed transaction. (Delaware)
- It is necessary to **consider all the material facts and circumstances** of the proposed transaction when determining the standard of value to be used.

# What is Fair Value?

- **Fair value is not a “one size fits all” concept.** It is a complicated and fact specific determination.
- The meaning of fair value **varies with the type of transaction** and the **specific facts** of each transaction.
  - Defining the standard internally is not uncommon
- There is no clearly recognized consensus about the interpretation of fair value.
  - Value before and after the transaction
  - Relative values
- There is **wide variation** among the states as to the meaning and definition of fair value.

## What is Fair Value? (cont'd)

- The appraiser should seek **guidance from legal counsel** regarding the **appropriate statutes** and **case law** for the jurisdiction of the assignment.
- In states that have adopted the Uniform Business Corporation Act, fair value is generally defined as the value of the shares as of the day immediately preceding the effectuation of the proposed corporate action, **excluding** any appreciation or depreciation in anticipation of the proposed action.
- Even in states that have adopted this definition, there is **no clearly recognized consensus** about the interpretation of fair value in this context.
- Fair value is **vaguely defined** in most statutes, and many states have limited case law which interprets the meaning of fair value as set forth in the state statutes.
- Counsel will usually adopt the standard of a state with significant precedent if none is available.
- Legal definitions need to be provided by counsel.

# Fair Value is NOT Fair Market Value

## Fair Market Value Definition:

“...the price at which the subject of the appraisal would change hands between a [hypothetical] willing buyer and a [hypothetical] willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts”

(Treasury Regulations)

# Valuation Methodology

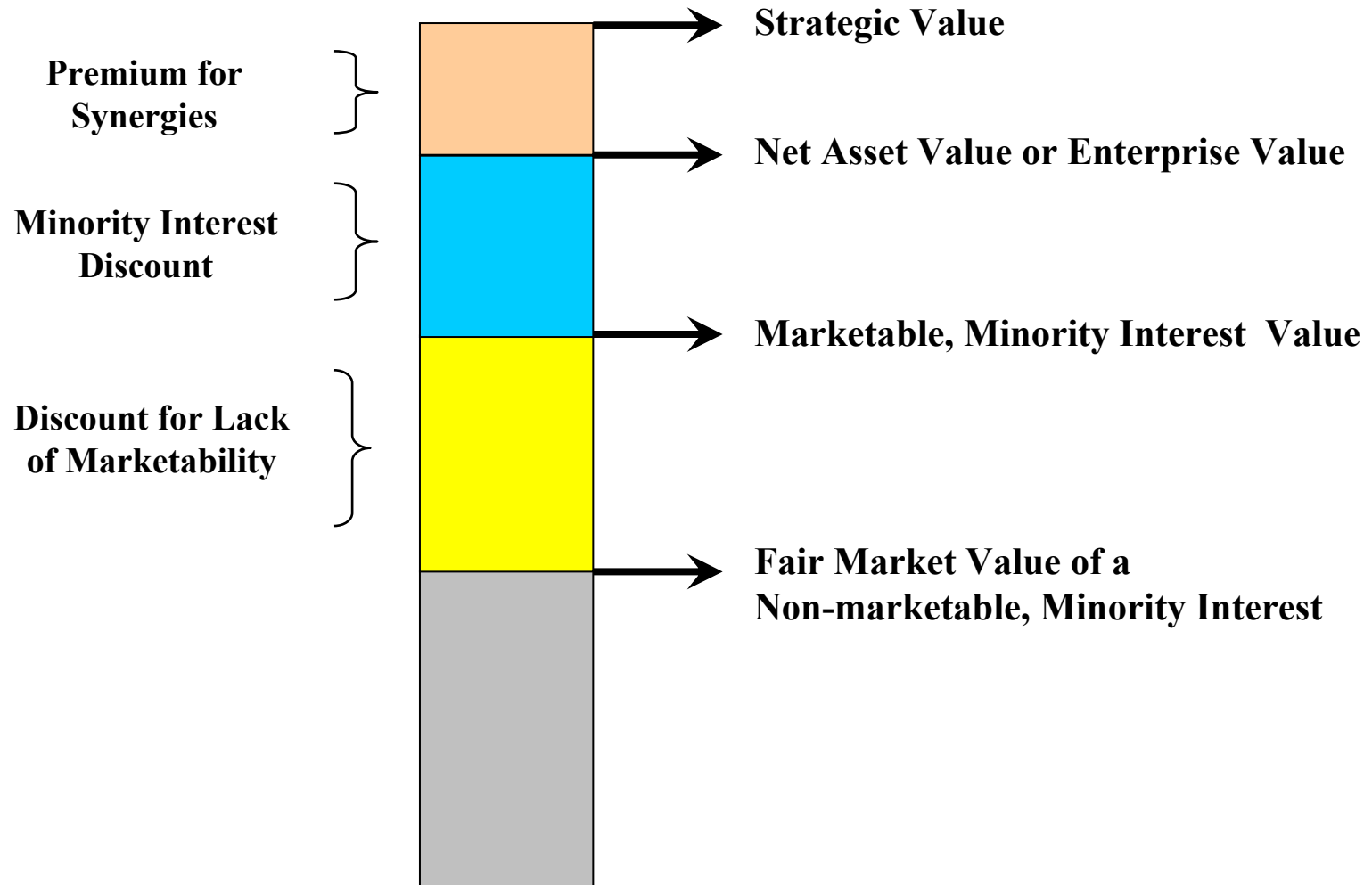
- **Market Approach** – based upon arm’s-length transaction of generally similar entities or securities
  - Comparable Companies
- **Income Approach** – based upon the present value of an income stream
  - Discounted Cash Flow
  - Capitalized Cash Flow
  - LBO Analysis
- **Asset Approach** – based upon the aggregate value of the underlying assets
  - Net Asset Value
  - Liquidation Value

# Fair Value Appraisal Battleground – Discounts!

## To Discount or Not to Discount, That is the Question

- Some states define “fair value” in a way that valuation discounts for minority interest and lack of marketability are often taken.
- Others (most notably) Delaware rarely permit the use of any valuation discounts and prescribe that shareholders be bought out at pro rata enterprise value.
- The type of transaction and the specifics may determine the standard used.
  - “Squeeze-out” transaction
  - Voluntary shareholder “buyout”
- Private company adjustments
  - Reasonable pay
  - Accounting methods

# Levels of Value



# Delaware Valuations

- Many publicly traded American companies are incorporated in the state of Delaware, thus the Delaware courts have ruled on several landmark cases relating to fair value and appraisal rights.
- The Court of Chancery has jurisdiction over all corporate matters in Delaware, and appeals to the Chancery Court go directly to the Delaware Supreme Court.
- While each state has their own laws and courts, other states and courts often look to the decisions of the Delaware court for guidance.

## Weinberger v. UOP, Inc.

- In *Weinberger v. UOP, Inc.* the Delaware Court stated:

“The standard ‘Delaware block’ or weighted average method of valuation, formerly employed in appraisal and other stock valuation cases, shall **no longer exclusively control** such proceedings. We believe that a more liberal approach must include proof of value by **any techniques or methods generally considered acceptable in the financial community** and otherwise admissible in court...Fair price obviously requires **consideration of all relevant factors** involving the value of a company.”

- The *Weinberger* case stressed the tendency in the financial community to use the discounted cash flow (“DCF”) method in valuation.

# Recent Valuations in the Delaware Courts

- As shown in the table below, the DCF method was the primary valuation method used by the Delaware Court of Chancery in the 13 opinions issued by the court in statutory appraisal cases since 2004.

**Methods Used or Rejected by Court of Chancery  
2004-2005 Cases\***

<b>Method</b>	<b>Used</b>	<b>Rejected</b>
Discounted cash flow	11	2
Comparable companies	5	3
Comparable transactions	4	2
Net asset value	1	0

\* Based on 13 case opinions issued by the Delaware Court of Chancery in statutory appraisal cases since 2004.

Source: Gilbert E. Matthews, Delaware Appraisal Cases, 2004-2005

## Recent Valuations in the Delaware Courts (cont'd)

- The DCF method was used by both experts in each of the 13 cases issued since 2004.
- The DCF method was the only valuation method used by the Delaware Court in 5 of the 13 cases.
- The Delaware Court rejected the use of the DCF method in 2 of the 13 cases for the following reasons.
  - Lack of reliable projections
  - Did not accept petitioner's optimistic adjustments to management's projects or WACC
- When the Delaware Court used the comparable company method, it generally gave it a low weighting. However, in one case, the Delaware Court exclusively used the comparable company method for its valuation and rejected the use of the DCF due to the lack of reliable projections.

## Recent Valuations in the Delaware Courts (cont'd)

- The Delaware Court applied a specified control premium (ranging from 15-38%) in 4 of the 5 decisions in which the Court used the comparable company valuation method.
- The use of a control premium in comparable company valuations seemed to be based on the view that publicly traded market prices necessarily include imbedded minority discounts. In one case, the Court applied a 30% premium even though there was no testimony that a control premium should be applied.
- The Delaware Court deducted a control premium for synergies in only 1 of the 4 cases in which the Court used the comparable transactions valuation method.