

COVER STORY | BY SONIA KALSI

Fairness opinions in US M&A

Continuing controversy surrounding the soundness of fairness opinions in evaluating the price offered in a merger or takeover has finally resulted in action by US regulators. The objectivity and value of fairness opinions has come under fire as critics argue that opinions rendered by investment bankers entitled to a substantial portion of their fee upon consummation of the deal have an incentive to render an opinion in order to collect that fee rather than provide objective advice to aid company boards in evaluating the transaction. In addition, in management buyouts, certain directors and members of senior management may have an interest in the proposed outcome that is adverse to those of other shareholders. These conflicting interests have resulted in numerous shareholder lawsuits with several key precedents being set last year. In response to the controversy, the Financial Industry Regulatory Authority (formerly the National Association of Securities Dealers) proposed Rule 2290 requiring new disclosures regarding fairness opinions by its members to minimise abuses. The rule, approved by the Securities and Exchange Commission (SEC), was effective from 8 December 2007 and aims to increase transparency of fairness opinions issued by member firms and reduce concerns about their objectivity and value in US M&A.

Conflicts of interest may exist if the opinion provider renders an opinion in an effort to collect a contingent fee or in order to please management so that it will get referrals or more business. In contrast to an investment bank acting as the primary financial adviser on a deal, an independent adviser will market itself as a conflict free provider of advice to boards whose fee is not contingent on the outcome of the transaction. Although research conducted by Thomson Financial in December last year suggests that shareholders on both sides of the deal aware of the conflict of interest facing financial advisers entitled to contingent fees rationally discount deals where such advisers provide fairness opinions, hiring a conflict free adviser is rarely practiced. Nearly 73 percent of corporate executives surveyed by Thomson Financial said they would consider hiring an independent adviser but only 12.4 percent of deals that had a fairness opinion involved an independent adviser. The reasons given by companies for failing to hire an independent adviser focused on concerns that an independent adviser would not reach the required level of understanding and give little value to the board of directors.

In their role as financial advisers, firms help target companies find potential buyers and assist them in negotiating the deal, particularly its financial terms. It is fair to say, on the one hand, that such advisers are in a better position to provide advice regarding the merger premium through a fairness opinion due to their familiarity with the company and their intimacy with the deal's terms. However, it is also conceivable that such advisers may issue an inappropriate fairness opinion to please a board seeking legal cover against shareholders in order to preserve the continuity of the financial adviser's business relationship or to secure contingent fees on deal completion. Of late, financial advisers and company boards have come under increased scrutiny by shareholders, according to Dr

Stanley Jay Feldman, chairman at Axiom Valuation Solutions. "Having investment banking firms underwrite a deal and providing a fairness opinion on it has always been viewed with far less scepticism than is the case now. In the audit world, the standard of practice is that an audit firm cannot audit its own work. This standard should be applied here. Shareholders have become much more sensitive to conflict of interest issues and as a result, board decisions are subject to more scrutiny."

Staple financing, contingency fees, referral business and future business are some of the conflicts of interests most often cited in relation to fairness opinions. Staple financing has been around for a while but recently received attention in the Home Depot deal in August 2007, where the investment bank advising Home Depot on the sale of a significant subsidiary was also offering to provide financing to potential buyers – thus serving interests on both sides of the transaction. A conflict of interest would exist if the financial adviser attempts to convince the target company board to accept a lower range of target prices so that the acquirer will be in a better position to repay the debt borrowed from the financial adviser. With regards to contingency fees, in many cases an investment bank will not be paid for its services, bar the fairness opinion, unless the merger is completed. As a result, investors fear that financial advisers will be more willing to render a fairness opinion as a necessary step to collecting the bulk of their fee when in actual fact that transaction may not be in the best interest of its client's shareholders. "The fear has always been that management and shareholder objectives may not be properly aligned and an acquisition strategy in this context may simply emerge from management desire to achieve personal objectives," says Dr Feldman. Although independent advisers are considered to be more objective, conflicts of interest can still arise if they have hopes of future and referral business from their client or its management. The problem is compounded if the independent adviser provides a second opinion based on the findings of the investment bank advising on the deal rather than performing its own independent analysis.

Due to the growing concerns over conflicts of interest and additional pressures of regulatory compliance, 2008 could see a rise in litigation surpassing the number of cases in 2007, says Ben Buettell, managing director and co-head of the fairness opinion practice at Houlihan Lokey Howard & Zukin. "Whether it's disclosure issues relating to compensation arrangements or some other issue, litigation may be on the rise as the M&A markets have cooled off recently and transactions face more shareholder scrutiny. Additionally, financial advisers may also face increased regulatory scrutiny to the extent that any litigation uncovers the fact that they did not comply with all of the requirements under Rule 2290." Going forward, company boards and financial advisers should take heed of cases that occurred in 2007. In a number of cases last year, the Delaware Chancery Court emphasised the importance of disclosure regarding the analyses underlying fairness opinions, including full details on compensation arrangements and other relationships that may present potential conflicts of interest. The cases, Netsmart Technolo- ▶▶

gies (March 2007), Caremark (February 2007) and Ortsman (February 2007) highlighted the judicial emphasis Delaware courts have placed on ensuring that information on the compensation arrangements of financial advisers is formally communicated to shareholders through more fulsome disclosure in proxy statements.

Under FINRA Rule 2290, member firms must include disclosures required by the new rule in fairness opinions and must adopt required written procedures for how they evaluate and approve the issuance of a fairness opinion in a transaction. The disclosure requirements under the rule are meant to inform shareholders about potential conflicts of interest and apply to any fairness opinion that is expected to be communicated to company shareholders. In general, the rule has been welcomed. "For the most part, Rule 2290 has been well received. That may, in part, be due to the fact that it will not require a significant change to existing practices of most financial advisers, although now the disclosure is required in the opinion itself rather than pursuant to SEC rules, in the proxy statement sent to shareholders in connection with seeking their approval for the transaction," says Mr Buettell. Most of the disclosures required by Rule 2290 are already routinely made in fairness opinions and proxy statements, but there are a few requirements that will lead to the modification of content within such opinions.

In line with general practice but made mandatory under Rule 2290, shareholders must be informed whether or not any compensation that member firms will receive is contingent on the successful completion of the transaction. A description of all material relationships that existed during the past two years or are contemplated between the member and any party to the transaction is subject to disclosure in the fairness opinion as well. On this point, interestingly, the SEC and FINRA have

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differing requirements over specific disclosure principles in relation to material relationships. Under the FINRA Rule, a company only has to disclose relationships between itself and its client and its client's counterparty but doesn't have to disclose relationships involving its affiliates or its client's affiliates or its client's counterparty's affiliates. In contrast, SEC rules require disclosure regarding relationships involving the opinion provider's affiliates and its client's affiliates, but do not require disclosure regarding relationships involving the client's counterparty or its affiliates. Independent verification also appears as a disclosure requirement under the FINRA Rule and details must be included on whether or not any information that formed a substantial basis for the fairness opinion that was supplied to the member by the client has been independently verified by the member. However, the general practice that has evolved is for advisers to state that nothing was independently verified and thus avoid detailed disclosure regarding the specific information verified. Proponents of this approach argue that it is impossible to independently verify projections, which usually form the basis of a substantial portion of the financial adviser's analysis underlying fairness opinions.

Requirements that will most certainly lead to the modification of current fairness opinions include disclosure on whether the fairness opinion was approved or issued by a fairness committee of the member firm and whether the member firm has taken into account the amount and nature of compensation flowing to certain insiders relative to the benefits to other shareholders in reaching a fairness determination. Such additional compensation could include potential change-of-control, parachute or other severance payments, non-compete agreements, special retention bonuses, etc. The original requirement caused much fuss in financial and legal circles and as a result was modified, points out Kevin Miller, a partner at Alston + Bird. "The original version of Rule 2290 required that member firms have procedures addressing the process to evaluate the degree as to which the compensation from the transaction underlying the fairness opinion benefits any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, is a factor in reaching a fairness determination. This proposed procedural rule was criticised for implying that financial advisers were capable of evaluating compensation arrangements, whether or not in connection with an M&A transaction. Rule 2290 was amended to transform the proposed procedural rule into a disclosure obligation." This obligation will most likely have little effect as the common assumption is that advisers will take the view that this does not fall under their remit and if companies or boards want advice or an opinion on such payments, a professional with expertise in this field should be hired by the compensation committee before such agreements are made.

In addition to requiring that member firms provide information on whether the fairness opinion was approved or issued by a fairness committee, Rule 2290 requires that a member issuing a fairness opinion must have written procedures for approval of its fairness opinions, including the method of selecting fairness committee members and the types of transactions which will be reviewed by a fairness committee. In addition, safeguards must be in place to promote a balanced review by the committee, which must include review and approval by persons not on the deal team of the actual transaction. Under Rule 2290, fair- ▶▶

ness opinion committees make the vetting of the fairness process far more robust than in the past, says Dr Feldman. "Rule 2290 effectively requires individuals from various parts of the firm to opine on the analysis underlying the transaction decision, reviewing the data used to reach a valuation conclusion, and helping to ensure that one person or even group is not in a position to dominate the review process. This differs from traditional practice in that the committees were established to be the contact point for the analyst carrying out the fairness opinion. The group traditionally was narrowly defined which is inconsistent with the process-based foundation set down in Rule 2290." The member firm's procedures must also include the process to determine whether the valuation analyses used in the fairness opinion are appropriate.

Due to the rule's mandatory requirements on disclosure, member firms will need to ensure that appropriate resources are allocated to the task within the set timeframe. In addition, the rule increases accountability of the member firm. In contrast to Rule 2290, the SEC disclosure obligations which place responsibility for disclosure on the company whose proxy statement or prospectus is being filed with the SEC, violations of Rule 2290 are subject to FINRA discipline. Mr Miller points out that although there are a few legal ambiguities in the rule, the objective of the rule is transparent. "As a rule subject to legal interpretation, Rule 2290 does contain some shortcomings and ambiguities in the provisions it sets out and the specific language it uses but as a principle-based approach to regulating fairness opinions, it seems clear. FINRA is unlikely to chase technical violations resulting from those ambiguities, but will focus more on compliance with the spirit of the rule."

Although both the SEC and FINRA have disclosure rules governing fairness opinions, "it is very difficult to accurately and appropriately regulate the dispensing of an opinion" says Mr Buettell. "Fairness opin-

ions are inherently subjective and the valuation methodologies and other financial analyses required by any given transaction or situation must be tailored to the specific facts and circumstances presented. There is no cookie cutter formula." Ultimately the decision on whether such disclosure and procedural rules are a success rests with the investor. Informed investors will make judgments about the quality of disclosure and if not satisfied will view the transaction with appropriate scepticism. Belief is mounting that additional regulation is not the answer as more observers have begun to recognise the limited benefits of attempting regulatory fixes to subjective judgments and the additional costs they can impose. However, litigation is a different matter, says Mr Miller. "Unfortunately, we live in a litigious society – at least in the US. As long as shareholders can bring colourable claims that a board inappropriately relied on the advice or opinion of an allegedly conflicted financial adviser, fairness opinions will continue to be the subject of litigation."

Fairness opinions can be a useful tool in the evaluation of the financial terms of a transaction based on an analysis of relevant financial information with a focus on the best interests of the company and its shareholders. The safest option may be to obtain the unconflicted advice of an independent adviser, but they may not have sufficient knowledge regarding the transaction, the company or the markets in which it operates. Ultimately, the company board is accountable for its recommendation as to whether a transaction is in the best interests of shareholders and bears responsibility for the selection of its advisers and the terms, including the financial terms, of their engagement. The soundness of fairness opinions will continue to come under fire as conflicts of interest remain, but with the new FINRA Rule 2290 improving transparency, such conflicts should be minimised due to increased regulatory scrutiny in addition to the mounting threat of shareholder litigation. ■



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