

HOW CAN FAIRNESS OPINIONS PROVIDE VALUE TO SHAREHOLDERS?

4th OIV International Business Valuation Conference

30 November 2015

Milan, Italy

Jay E. Fishman, FASA

Jfishman@finresearch.com



WHAT IS A FAIRNESS OPINION?

- A fairness opinion is a letter opining whether a transaction is fair from a financial point of view
- The letter may discuss the fairness of the:
 - Terms of a transaction
 - Consideration transferred
- Typically prepared by a knowledgeable financial advisory firm – usually an investment bank or financial firm specializing in business valuation

WHY GET A FAIRNESS OPINION?

1. Seller

- In the sale of a company for cash and/or securities
- In the sale or spin-off of material assets, divisions, or subsidiaries

2. Purchaser

- In the acquisition of a company (if material)
- In the acquisition of material assets, divisions, or subsidiaries
- In the buyback of outstanding securities

WHY GET A FAIRNESS OPINION?

3. Other

- Independent directors or fiduciaries in related party transactions
- Limited partners when contributing or selling assets
- Trustees in acquisition or divestiture by a nonprofit organization
- Bond trustees as required by indenture
- Regulatory agencies when converting nonprofit organizations to for-profit stock corporations

WHO OBTAINS THE FAIRNESS OPINION?

- Fiduciaries are charged with the oversight of an organization, in hopes of safeguarding the assets of a company and the interests of shareholders (or another third party)
- Fiduciaries are required to act in good faith and have duties of Care and Loyalty

FIDUCIARY'S DUTIES

- Duty of Care
 - Places a burden on the fiduciary to take an active role in the decision making process
- Fiduciary Must:
 - Consider relevant and adequate information
 - Exercise the care that an ordinary prudent person would exercise under the same circumstances
 - Act on an informative basis after careful deliberation
 - Act in a diligent and reasonable fashion

FIDUCIARY'S DUTIES

- Duty of Loyalty
 - Prohibits unfaithfulness and self-dealing
- A fiduciary is **preferably** independent and disinterested
 - Focus is on impartiality and objectivity
- Fiduciary Must:
 - Act in a manner believed to be in the best interest of the corporation
 - Not appear on both sides of a transaction
 - Not expect to received personal financial benefit from a transaction of self-dealing

DUTIES OF DIRECTORS:

SMITH v. VAN GORKOM

- In hopes of taking advantage of tax credits and accelerated depreciation, the CFO of Trans Union *suggested* to the CEO that the company monetize these benefits by undergoing a leveraged buy-out to a company that could utilize these tax benefits
- In his suggestion CFO indicated that a range of \$50 - \$60 per share was acceptable (shares were currently valued at a high of \$39.50)
- CEO, Van Gorkom, pursued this idea with a take-over specialist (without further discussion with CFO, consulting the Board of Directors, most of senior management, or a financial advisor) and set up an agreement to sell the company for \$55 per share

DUTIES OF DIRECTORS:

SMITH v. VAN GORKOM

- CEO presented the idea to the Board without distributing any materials or support– the President (who was privy to talks with the take-over specialist) recommended the transaction giving the Board his word and an attorney warned the Board that they may be sued if they attempted to stop the transaction
- The Board agreed to a leveraged buy-out and two plaintiffs brought a class action suit against the corporation and the CEO, Van Gorkom

DUTIES OF DIRECTORS: *SMITH v. VAN GORKOM*

- Decision – Delaware Supreme Court (1985)
 - Court decided that even though the Board acted in good faith, they had been grossly negligent in recommending a merger offer, even though it had provided shareholders with a premium, because they had not made an informed decision
 - Through this decision, the Court created the obligation of the Board of Directors, when evaluating a takeover proposal, to inform themselves of **all** reasonably available and relevant information to making the decision
 - **In the decision, the Court suggested that obtaining a fairness opinion would shield the Board from liability for an alleged breach of the duty of care**

THE FIDUCIARY'S USE OF FAIRNESS OPINIONS

- Delegation is necessary in order for a fiduciary to fulfill their obligation to protect the corporate assets, safeguard the interest of the company's constituents, and actively promote the constituent's interests
- Obtaining a fairness opinion is one way that a fiduciary is able to discharge a portion of his or her duties in consideration of a potential transaction

WHAT IS FAIR?

- The Delaware Supreme Court has stated that “fairness” has two components:
 - “Fair Dealing”
 - Centered around procedural matters related to the timing of the transaction and how it was initiated
 - “Fair Price”
 - Looks at all economic and financial matters in a transaction
- The test of fairness is not bifurcated between fair dealing and fair price, but instead requires that all aspects of the transaction be considered in order to determine entire fairness



BUSINESS JUDGMENT RULE AND FAIRNESS OPINIONS

- In suits alleging a corporate director violated his duty of care to the company, courts will evaluate the case based on the business judgment rule
- Under this standard, a court will not second-guess the decisions of a director as long as they are made
 - in good faith,
 - with the care that a reasonably prudent person would use, and
 - with the reasonable belief that they are acting in the best interests of the corporation

DEFINITION OF FAIRNESS

- Any fairness opinion must address whether the transaction is “fair from a financial point of view”
- There is no single test to assess the fairness of a transaction
- Fair could be:
 - Highest attainable price
 - Price which reasonably informed, unrelated parties would agree upon
 - A threshold below which the transaction would be unfair
 - A combination of the above concepts, or other concepts not listed



DEFINITION OF FAIRNESS

- Consider:
 - Whether there is one bidder or many bidders
 - Whether the bidder is an insider or an outsider
 - Whether the bidder has voting control in the target company
 - Whether the transaction is hostile or friendly
- There is a general consensus that fairness is not identified by a point, but instead a range of prices

WHAT IS INCLUDED IN A FAIRNESS OPINION?

Although fairness opinions almost always involves an assessment of the value of a company, there is no specific guidance regarding what the opinion should contain or when a fairness opinion must be obtained

WHAT A FAIRNESS OPINION IS “NOT”

- **NOT** a recommendation to undertake a particular deal or transaction
 - The Board of Directors is responsible for determining whether the transaction is an appropriate undertaking for the corporation
- **NOT** an opinion of the legality of a transaction
 - The Board of Directors is responsible for seeking the legal advice of counsel regarding the undertaking of a transaction

CRITICISM OF FAIRNESS OPINIONS

- A fairness opinion's worth ultimately lies in the reliability and accuracy of its underlying valuation analyses
- It is not a **search for metaphysical certainty in valuation practice**
- A fairness opinion aids the board in satisfying its duty of care

CRITICISM OF FAIRNESS OPINIONS

Criticisms can be viewed as falling into two basic categories:

- The problem of discretion
- The problem of conflicts of interest

CRITICISM OF FAIRNESS OPINIONS

The Problem of Discretion: What is the Definition of Fair?

- Providers of fairness opinions possess substantial discretion in determining what prices are “fair” to the shareholders
- This can result in widely differing estimates of “fair price,” due to varying interpretation of the definition of “fair” which is undefined
- What is meant by a “fair price”?
 - Could refer to the value of the company as an independent entity
 - Value the shareholders would receive if their company was auctioned off to the highest bidder
 - Could be the value that a bilateral, arm’s length bargaining would yield

CRITICISM OF FAIRNESS OPINIONS: CONFLICTS

The Problem of Conflict of Interest

- Fee Structure
 - Contingent Fees
 - Success or Execution Fees
- Desire to Attract and Retain Clients
 - Investment banks generally do more than write the fairness opinion; the same bank often controls other financial aspects of the transaction
 - Incentive to write opinions that attract future clients
 - Many extol their ranking as an investment advisor
- Psychological and Social Factors
 - The M&A world is self contained
 - Many of the bankers personally know the managers who hired them
 - Often establish continuing relationships



CRITICISM OF FAIRNESS OPINIONS: MEASUREMENT

The Problem of Discretion: The Measurement Problem

- Analysis depends on the accuracy of company supplied information
- Based on this information, the analyst makes assumptions (or, after review, accepts management's assumptions) about revenue, expenses, capital expenditures, growth and working capital needs
- Many of these assumptions depend on variables such as future inflation rates, new product development, market competition, tax rates, and the general and economic political climate
- If using a DCF, it is necessary to derive
 - A discount rate which is based on several assumptions, such as future risk free rates, and market risk premiums
 - A terminal value, which is based on several assumptions, such as growth rate and/or appropriate multiple at end of projection period

CRITICISM OF FAIRNESS OPINIONS

Summary

- “Fair” is undefined and prone to a large amount of discretion
- A fairness opinion does not indicate whether the offer price is the best price a target could fetch or the lowest price an acquirer could accomplish in a competitive auction
- Conflicts and definitional issues aside, providers have a lot of discretion in selecting the methods and variables used and their application during this process

PROPER APPROACHES TO FAIRNESS OPINIONS

Limiting the Problem of Conflict of Interest

- Disclosure based solutions including full disclosure of all material elements in the determination of the consideration offered
- Hire an independent firm to provide a fairness opinion and give the firm the same compensation regardless of whether the opinion is positive or the deal completed
- Obtain a second fairness opinion from an independent bank that does not have a stake in the success of the transaction other than the fee for the fairness opinion
- Have an effective internal review by the investment bank's Fairness Committee



PROPER APPROACHES TO FAIRNESS OPINIONS

The Problem of Discretion: The Measurement Problem

- Valuation analysis should be conducted with rigor and discipline in accordance with best practices
- Recognition that a valuation analysis can inform as to value but it is not a prediction of price: price offered is within a reasonable range in a corporate control transaction
- Valuations always contain subjective elements but these should be well grounded and based on as much analysis as possible
- Look to best practices currently being developed in connection with fair value measurements
- Understand that it is a well reasoned opinion and not a guarantee



HOW CAN FAIRNESS OPINIONS PROVIDE VALUE TO SHAREHOLDERS?

Are Fairness Opinions merely insurance to protect the Board of Directors from liability?

- **Yes, if no supporting data or inadequate data is given to shareholders**

Do they provide stakeholders, including shareholders and other market participants, with additional information to properly evaluate the offer.

- **Yes, if adequate information is given to shareholders; no, if ranges of value provided to shareholders are not useful**

Can they be used to further the negotiation process and result perhaps in a change in the offer?

- **It is hard to use fairness opinions to renegotiate an arms'-length transaction but they are often very helpful to a Special Committee negotiating with a control shareholder**

HOW CAN FAIRNESS OPINIONS PROVIDE VALUE TO SHAREHOLDERS?

- Cain and Denis performed an event study and analyzed a sample of 582 negotiated public transactions from 1998 through 2005
- Event study included completed transactions (95%) and withdrawn (5%) transactions
- For procedural reasons they excluded tender offers
- Their sample included 67 matched transactions in which they had valuation information from the fairness opinions from the acquirer advisors and the target advisors
- They found that targets disclosed receiving a fairness opinion in 96 percent of the transactions and acquirers in 28 percent of the transactions

HOW CAN FAIRNESS OPINIONS PROVIDE VALUE TO SHAREHOLDERS?

- In addition to the bottom line opinions, fairness opinions presented to corporate boards typically also includes a “board book” that provides details of the valuation analyses conducted by the opinion provider in arriving at an overall opinion of the financial fairness
- Cain and Denis attempted to measure the impact of the information provided in fairness opinions by conducting the event study as of two dates:
 - First Date: Date of merger announcement
 - Second Date: Mailing date

HOW CAN FAIRNESS OPINIONS PROVIDE VALUE TO SHAREHOLDERS?

- Fairness opinion valuations provided by target advisors are significantly related to the stock price reaction to the merger announcement
- Target side mean valuations do not differ significantly from the offer price
- Cain and Denis conclude that, although fairness opinion valuations cannot necessarily be taken at face value, they nonetheless appear to contain information that is useful to both directors and shareholders

HOW CAN FAIRNESS OPINIONS PROVIDE VALUE TO SHAREHOLDERS?

- Fairness opinions provide useful inputs to the acquisition process because fairness opinion providers enjoy access to higher quality information including financial forecasts and synergy estimates
- Accordingly this results in an ability to generate incrementally new private information acquired during the due diligence process
- This information is communicated to the board and investors through the detailed financial analysis contained in the fairness opinion's "board book"

HOW CAN FAIRNESS OPINIONS PROVIDE VALUE TO SHAREHOLDERS?

As Vice Chancellor Strine indicated in his opinion in *Pure Resources* (808 A. 2d 449, Del Ch. 2002):

- “Courts must be candid in acknowledging that the disclosure of the bankers “fairness opinion“ alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability. The real informative value of the banker’s opinion is not in the bottom line conclusion. But in the evaluation analysis that buttresses that result.”

HOW CAN FAIRNESS OPINIONS PROVIDE VALUE TO SHAREHOLDERS?

- Although fairness opinions cannot necessarily be taken at face value, they nonetheless appear to contain information that is useful both to directors and investors
- Fairness opinions provide value when they provide certain information not previously available to market participants, including shareholders
- Fairness opinions provide value when they provide useful analyses that relate to the fairness of the consideration
- Findings indicate that target-side advisors produce fairness opinion valuations that are informative to market participants
- Fairness opinions by independent advisors are more credible than fairness opinions tainted by contingent fees

JAY E. FISHMAN, FASA

Jay E. Fishman, FASA, is a Managing Director of Financial Research Associates and has been actively engaged in the appraisal profession since 1974. He specializes in the valuations of business enterprises and their intangible assets. Mr. Fishman has co-authored several books, including the highly acclaimed Guide to Business Valuations (with Shannon Pratt and James Hitchner), and Standards of Value (with Shannon Pratt and William Morrison). He has also written numerous articles on business valuations as well as qualifying as an expert witness and providing testimony in twelve states. He has taught courses on business valuation to the Internal Revenue Service, the National Judicial College, the Hong Kong Society of Accountants and on behalf of the World Bank in St. Petersburg, Russia. He recently taught courses in Moscow, Russia for Kwinto Management and for the Slovenian Institute of Auditors in Ljubljana, Slovenia.

He holds a bachelor's and master's degree from Temple University as well as an M.B.A. from LaSalle University. Mr. Fishman is a Fellow of the American Society of Appraisers, a Fellow of the Royal Institution of Chartered Surveyors, a former Chairman of the Business Valuation Committee of the American Society of Appraisers, Editor of the Business Valuation Review, Chair of ASA's Government Relations Committee, a former Trustee of the Appraisal Foundation and member of the Appraisal Standards Board of the Appraisal Foundation. He is currently a member of the Appraisal Practice Board of the Appraisal Foundation. He recently was awarded the Chairman's Public Service Award from The Appraisal Foundation. The award was established in 2005 to recognize individuals who have worked with the Foundation for the benefit of the appraisal profession and who, in the process, have gone above and beyond the call of duty.



QUESTIONS?



THANKS

Thank you to

- Kyle Garcia
- Stefanie Jedra

Selected Bibliography

- Bebchuk, Lucian A. & Marcel Kahan, “Fairness Opinions: How Fair Are They and What Can Be Done about It?” 1989 Duke L. J. 27 (1989)
- Cain, Matthew D. & David J. Denis, “Information Production by Investment Banks: Evidence from Fairness Opinions,” 56 J. Law & Econ. 245 (2013)
- Clements, Philip J. & Philip W. Wisler, *The Standard & Poor’s Guide to Fairness Opinions* (McGraw Hill, 2005)
- Cleveland, Steven J., “An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions,” 58 Ala. L. Rev. 299 (2006)
- Davidoff, Steven M., “Fairness Opinions,” 55 Amer. U. L. Rev. 1557 (2006)
- Elson, Charles. M., Arthur H. Rosenbloom & Drew D.L. Chapman, “Fairness Opinions – Can They Be Made Useful?” Sec. Reg. and L. Rep., Vol. 35, No. 46 (November 2004)
- Foulds, Christopher, “My Banker’s Conflicted and I Couldn’t Be Happier: The Curious Durability of Staple Financing,” 34 Del. J. Corp. L. 519 (2009)
- Frye, Melissa B. & Weishen Wang, “Boards, Uncertainty, and the Use of Fairness Opinions” (2009), available at: <http://ssrn.com/abstract=1468380>
- Kisgen, Darren J., Jun Qian & Weihong Song, “Are fairness opinions fair? The case of mergers and acquisitions,” 81 J. of Fin. Econ. 171 (2009)
- Leddy, Patrick J.; Walters, Randall M. (2005). “The Growing Storm Over Fairness Opinions”, *M. and A. J.*, Vol. 40 Issue 3, pp. 35-40.
- Lee, M. Mark & Gilbert E. Matthews, “Fairness Opinions,” in *The Handbook of Advanced Business Valuation*, Robert F. Reilly and Robert P. Schweihs, eds. (McGraw Hill, 2000)
- Manning, Jeffrey R., “The Current State of the Fairness Opinion,” 24-7 Amer. Bankr. Inst. J. 14 (2005)
- Rizik, Jr., Michael B. & Matthew M. Wirgau, “Fairness Opinions: No Longer a Laughing Matter,” 25 T.M. Cooley L. Rev. 233 (2008)
- Sorkin, Andrew R., “Fair Should Be Fair,” N.Y Times, March 20, 2005

