

Fairness Opinions in Affiliated Party Transactions

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I. OVERVIEW: AFFILIATED PARTY TRANSACTIONS AND FAIRNESS OPINIONS



What we will discuss (1)

- Affiliated party transactions (related party transactions, non-arms' length transactions, etc.) which include:
 - ◆ going private,
 - ◆ two-step freeze-outs (a tender offer followed by a short-form merger),
 - ◆ management buyouts,
 - ◆ sale of certain parts of a business to insiders,
 - ◆ high-vote shares receiving greater consideration than low-vote shares, and
 - ◆ insiders receiving different consideration than other shareholders.



What we will discuss (2)

- Affiliated party fairness opinion considerations:
 - ◆ Valuation methods used in fairness opinions.
 - Same for affiliated and non-affiliated.
 - ◆ Regulatory requirements:
 - FINRA Rule 5150 (formerly Rule 2290).
 - SEC Rule 13e-3.
 - ◆ Delaware decisions.
 - ◆ Lack of industry standards.



Fairness opinions routinely used since *Van Gorkom*

- Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) ruled that directors were grossly negligent in not seeking a valuation study of company's value.
- Although transaction price was substantially over market, directors were held liable to plaintiffs for damages.
- The Court did not hold that directors must always obtain outside valuation study.
- However, fairness opinion would have helped the directors demonstrate that they had made an informed business decision.
- In practice, since *Van Gorkom*, Boards have routinely requested fairness opinions.



Affiliated party transactions should have fairness opinions

- Although there is no regulatory or legal requirement that directors must obtain a fairness opinion, in practice, fairness opinions are almost always obtained in affiliated party transactions.
 - ◆ Special Committees must explain why they support an affiliated party transaction and whether they obtained a fairness opinion.
 - ◆ Well-supported fairness opinions often assist defendants.
 - ◆ Judges are critical of opinions that are conflicted or not well-reasoned.



Purpose of fairness opinions

- Committees of independent directors usually request fairness opinions to show they are acting for target shareholders' benefit.
- Two purposes:
 - ◆ provide decision-makers with information supporting their decisions, and
 - ◆ serve as evidence in litigation demonstrating that decision-makers used reasonable business judgment.



What does “fairness” mean in a fairness opinion?

- No court has yet defined it.
- Neither the SEC nor FINRA has defined it.
- The investment banking industry has established no “fairness” standards.
- Neither the ASA nor any other valuation industry group has established “fairness” standards.



Minimum requirements for fairness

- My two minimum requirements :
 - ◆ the investor should be at least as well off after the transaction as before it; and
 - ◆ if there is a valid superior alternative, the transaction is not fair.



Fairness opinions have been widely criticized

- Financial press, academia and courts have frequently criticized fairness opinions
- Principal criticisms of opinion-givers:
 - ♦ conflicted because a major portion of their fee is predominantly contingent on closing,
 - ♦ biased because of past and potential future relations with the acquiror,
 - ♦ their analyses are manipulated to achieve a pre-determined result, and
 - ♦ extensive use of disclaimers.
- Valuation analysis is subjective.
- Even in non-conflicted opinions, the quality of the analyses has often been questioned.



II. INDEPENDENCE OF THE ADVISOR



Affiliated party transactions should have independent opinions

- Based on recent cases, Special Committees are effectively required to engage independent opinion-givers in public company transactions.
 - ◆ An exception: Delaware exempts short-form mergers from a fairness requirement.
- Delaware courts are critical of independent directors who engage firms that have recently advised the control shareholder.



The independent advisor's role

- Affiliated party transactions may be subject to controller opportunism or other conflicts.
- Thus, Special Committee should engage independent firm to render fairness opinion.
- Opinion-giver must:
 - ◆ conduct due diligence with skepticism,
 - ◆ beware of overly conservative management projections,
 - ◆ review forecasts prior to proposal, and
 - ◆ review any information provided to lenders.
- Opinion-giver also may be asked to:
 - ◆ act as Special Committee's advisor for its negotiations with acquiror, and
 - ◆ consider possible alternatives.



Advisor should structure fee to maintain independence

- Fairness opinion's credibility is harmed if advisor's fee is substantially contingent on closing.
 - ◆ Engagement letter should provide that fee is payable whether or not opinion is positive.
- Fairness opinion fees are often about 25% of customary M&A advisory fee for same-size transaction; however, most firms have minimum fairness opinion fee.
- When advisory services are provided, a higher fee may be paid.
 - ◆ A Special Committee may contract to pay incremental fee contingent on increased price.
 - ◆ Since this incremental fee structure rewards advisor for increased price, it is unlikely to be judicially criticized.



III. VALUATION METHODS



Principal valuation methods for determining fairness

- Predictably, most fairness opinions for affiliated and non-affiliated transactions are based on:
 - ♦ discounted cash flow,
 - ♦ guideline companies, and
 - ♦ guideline transactions.
- These methods are widely accepted.
- DCF is the method of choice for the Delaware Courts.



Methods occasionally used

- ◆ Asset value
- ◆ Liquidation value
- ◆ Present value of projected future price
- ◆ Leveraged buyout model
- ◆ Value available in recapitalization
- ◆ Target prices of security analysts
- ◆ Regression model
- ◆ Rule of thumb (*e.g.*, value per ton of steel)



Average premiums: a flawed method

- “Premiums paid” analysis compares premium over market offered in subject transaction to average premiums paid in other transactions.
 - ◆ Used in about half of published fairness opinions.
- Method is conceptually wrong and statistically flawed.
 - ◆ Historical premiums are biased sample: they include only acquisitions of companies that buyers view as undervalued and exclude companies viewed as overpriced.
 - ◆ The premium paid in any transaction is a result, not a cause: each premium depends on specific facts.
 - In some cases, a small premium could be fair; in others, a large premium could be unfair.



IV. AGENCY REGULATORY REQUIREMENTS



New procedure and disclosure standards: FINRA Rule 5150

- FINRA Rule 2290 became effective in 2007 and was renamed Rule 5150 in 2008.
- Applicable to all fairness opinions for public companies issued by FINRA members.
- Not explicitly applicable to non-member firms, but all practitioners should endeavor to conform to these standards.



Rule 5150: required procedures

- Written procedures for approval of a fairness opinion.
- Procedures as to when internal committee must approve fairness opinion.
- When internal committee is used:
 - ◆ process for selecting committee members,
 - ◆ qualifications for persons on committee, and
 - ◆ review and approval by persons not on deal team.
 - committee can include someone on deal team, but committee must have “balanced review.”



Rule 5150: required disclosure to public shareholders (1)

What is required

1. Whether member has acted as financial advisor to any party to transaction.
2. Whether compensation is contingent upon closing.
 - ◆ Amount does not necessarily have to be disclosed.
3. Any material relationships between member and any party to the transaction (i) during preceding two years or (ii) mutually understood to be contemplated.

Customary disclosure

1. Past relations disclosed; indefinite on future engagements.
2. Disclosed; amount of compensation is often disclosed.
3. Past relations disclosed; indefinite on future engagements.



Rule 5150: required disclosure to public shareholders (2)

What is required

4. Whether internal committee approved fairness opinion.
5. Whether member has independently verified any company-supplied information that formed substantial basis for its opinion.
 - ♦ If so, describe information verified.
 - ♦ When no information verified, blanket statement sufficient.
6. Whether opinion expresses view as to fairness of any compensation to officers and directors relative to payment to public shareholders.

Customary disclosure

4. Disclosed.
5. No company-supplied information verified by advisor.
6. No opinion as to the fairness of compensation to any officers or directors.



SEC Rule 13e-3: affiliated party transaction fairness opinion disclosure requirements

- Opinion letter and summary must be in proxy statement or tender offer document (Form 14D9).
- Disclosure of advisor's written and oral reports and opinions.
- Detailed description of the methods used:
 - ◆ discussion of each methodology used, and
 - ◆ data such as multiples, discount rates, etc.
- Any limitation on the scope of the investigation.
- SEC comment letters often request additional disclosure.
 - ◆ Underlying written report given to directors made available at company's principal office for inspection or copying by a shareholder.
 - ◆ Report sometimes filed as exhibit to SEC filing.
- No SEC requirement that advisor be independent.
 - ◆ Any material relationship between advisor and issuer and/or its affiliates must be disclosed.



V. JUDICIAL REQUIREMENTS AND GUIDANCE – DELAWARE



The Delaware Courts recognize the importance of substantiated valuations

"The financial advisor's opinion of financial fairness for a proposed transaction is one of the most important process-based underpinnings of a board's recommendation of a transaction to its stockholders and, in turn, for the stockholders' decisions on the appropriateness of the transaction. Thus, it is imperative for the stockholders to be able to understand what factors might influence the financial advisor's analytical efforts."¹

"The real informative value of the banker's work is not in its bottom-line conclusion [of fairness], but in the valuation analysis that buttresses that result."²

"Shareholders are entitled to a fair summary of the substantive work performed by the investment banks."³



The Delaware Courts: conflicts must be disclosed

"[C]onflicts of interest must be disclosed" whether or not "there is evidence that the financial advisor's opinion was actually affected by the conflict ."⁴

Conflicts concerning benefits and fees must be disclosed:

Investment banker's entire benefit, including benefits as a debtholder and warrant holder, must be disclosed.⁵

"The contingent nature of an investment banker's fee can be material and have actual significance to a shareholder relying on the banker's stated opinion."⁶

The Court has stated that Special Committees must hire their own advisors, holding that, in a case where a Special Committee employed an advisor who had worked for the control party, the "conflict of interest robs [the] fairness opinion of its value as an indicator of fairness."⁷

The court rejected a valuation based on projections prepared by an officer who bought a business from a company.⁸



The Delaware Courts: no requirement of full disclosure of financial data

"Delaware law does not require stockholders be given all the financial data they would need if they were making an independent determination of fair value."⁹

"A disclosure that does not include all financial data needed to make an independent determination of fair value is not per se misleading or omitting a material fact," even if the financial advisor had "considered certain non-disclosed information."¹⁰



The Delaware Courts: decisions requiring inclusion of projections

"[S]tockholders must measure the relative attractiveness of retaining their shares versus receiving a cash payment, a calculus heavily dependent on the stockholders' assessment of the company's future cash flows" and it would be wrong "to hold that the best estimate of the company's future returns, as generated by management and the Special Committee's investment bank, need not be disclosed when stockholders are being advised to cash out. . . . What [investors] cannot hope to do is replicate management's inside view of the company's prospects."¹¹

The key assumptions made by a banker in formulating his opinion are of paramount importance to the stockholders because any valuation analysis is heavily dependent upon the projections utilized. A proxy statement should "give the stockholders the best estimate of the company's future cash flows as of the time the board approved the [transaction]."¹²

The court has required the inclusion of projections relied on by the financial advisor when other projections have been disclosed.¹³



The Delaware Courts: decision holding the inclusion of projections not to be required

The Court has declined to require the disclosure of projections that it did not deem to be material information.¹⁴

My view:

- It is difficult to understand why management projections should not be a required disclosure, given the emphasis that the Delaware courts have placed on DCF analyses in valuation cases, and their belief that a “fair summary of the substantive work performed by the investment banks” be made available to shareholders so that they may make an informed view.



The Delaware courts: some other criticisms of opinions

- The court derided a fairness opinion produced in a week as "pure window dressing intended by defendants to justify the preordained result."¹⁵
- When high-vote shares received a substantial premium over low-vote shares, the advisor was faulted for providing only separate analyses of the fairness of the respective exchange ratios to each class, and failing to opine upon the relative consideration.¹⁶



Impact of appraisal standards on fairness

- In Delaware, cashed-out shareholders are entitled to receive at least the “fair value” of their stock, whether or not the structure of the transaction permits use of the appraisal remedy.
 - ◆ Thus, a cash or cash-equivalent transaction should not be considered fair if the consideration is below the price which likely would be awarded in an appraisal action.
- In Delaware (and in a majority of other states), minority discounts, and discounts for lack of marketability may not be considered when valuing shares in appraisal actions.
- Control premiums are generally not applicable in appraisals, but they are relevant in determining fairness.
 - ◆ Appraisal value is a floor for fairness.



VI. THE LACK OF STANDARDS



Lack of industry standards for fairness opinions

- Neither the SEC nor FINRA has proposed standards for fairness opinions.
- No professional investment banking or valuation organization has proposed standards for fairness opinions.
 - ◆ It is unlikely that any investment banking group would propose standards without prodding from the SEC.
- Members of the academic community have made "ivory tower" proposals including such concepts as setting the methodology for determining discount rates and prescribing the weighting to be given to different valuation methods.
- As the courts review and critique fairness opinions, they contribute toward the evolution of standards.
- Areas that the courts might address in the future include, among others:
 - ◆ the impact of disclaimers on the credibility of an opinion,
 - ◆ improved descriptions of the financial advisor's analyses,
 - ◆ financial advisor's liability for questionable opinions,
 - ◆ the impact on fairness of factors other than consideration paid, and
 - ◆ the need to update opinions.



Impact on fairness of factors other than consideration paid

- Opinions normally address the fairness of the consideration to be paid in a given transaction.
- There are instances in which the consideration itself is fair to non-control shareholders, but the transaction is structurally unfair for other financial reasons, *e.g.*, when certain inside shareholders are receiving materially different consideration than the outside shareholders.
- For example, Delaware courts have been critical of transactions in which holders of high-vote shares received greater consideration than holders of low-vote shares.¹⁷
- An opinion that the consideration is fair is misleading if the advisor has reason to believe that the transaction taken as a whole is not fair.



Opinions in affiliated party transactions should be updated

- No regulation or judicial decision has yet directly addressed the issue of a fairness opinion that has become unfair due to subsequent events prior to closing.
- Special Committees would be better protected, and shareholders would be better informed, if a fairness opinion was updated shortly prior to mailing of a proxy statement.
- The Delaware court has stated:

The financial advisor's opinion of financial fairness for a proposed transaction is one of the most important process-based underpinnings of a board's recommendation of a transaction to its stockholders and, in turn, for the stockholders' decisions on the appropriateness of the transaction.¹⁸
- If a fairness opinion is no longer valid, the proxy statement becomes misleading.
- If a material change in market conditions or in factors intrinsic to the target company take place after a fairness opinion has been rendered, the issuer of the opinion should consider whether or not its opinion is still valid and, if appropriate, withdraw its opinion.



Footnotes

- ¹ *David P Simonetti Rollover IRA v. Margolis*, 2008 Del. Ch. LEXIS 78 (June 27, 2008) at *25.
- ² *Id.* at *30, citing *In re Pure Resources, Inc. Shareholders Litigation*, 808 A.2d 421, 449 (Del. Ch. 2002).
- ³ *In re CheckFree Corporation Shareholders Litigation*, 2007 Del. Ch. LEXIS 148 (Nov. 1, 2007) at *29-30, citing *In re Pure Resources* at 449.
- ⁴ *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 Del. Ch. LEXIS 174 (Oct. 2, 2009) at *56.
- ⁵ *Simonetti* at *26.
- ⁶ *Louisiana Municipal Police Employees Retirement System v. Crawford*, 918 A.2d 1172, 1191 (Del. Ch. 2007).
- ⁷ *Gesoff v. IIC Industries Inc.*, 902 A. 2d. 1130, 1150 (Del. Ch. 2006).
- ⁸ *McPadden v. Sidhu*, 964 A.2d 1262,1272 (Del. Ch. 2008).
- ⁹ *Globis Partners, L.P. v. Plumtree Software, Inc.*, 2007 Del. Ch. LEXIS 169 (Nov. 30, 2007) at *45, citing *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1174 (Del. 2000).
- ¹⁰ *CheckFree* at *8, citing *In re General Motors (Hughes) Shareholder Litigation*, 2005 Del. Ch. LEXIS 65 (May 4, 2005) at *65.
- ¹¹ *E.g.*, *In re Netsmart Technologies, Inc. Shareholders Litigation*, 924 A.2d 171, 203 (Del. Ch. 2007).
- ¹² *Simonetti* at *30, citing *Netsmart* at 203.
- ¹³ *Netsmart* at 200.
- ¹⁴ *E.g.*, *Checkfree* at *11.
- ¹⁵ *In re Sunbelt Beverage Corp. Shareholder Litigation*, 2010 Del Ch. LEXIS 1 (Jan. 5, 2010) at *19.
- ¹⁶ *In re Tele-Communications, Inc. Shareholders Litigation*, 2005 Del. Ch LEXIS 2006 (Oct. 11, 2006) at *55. See also *Levco Alternative Fund Ltd. v. Reader's Digest Association, Inc.*, 803 A.2d 428 (Del. 2002).
- ¹⁷ See *Hammons*, *Tele-Communications* and *Levco*.
- ¹⁸ *Simonetti* at *25.