

Fairness Opinions: The Value of Independence By Helen Bowers, Ph.D. and Tara Stephenson

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The year 2000 marked the 15th anniversary of *Smith v. Van Gorkom*, the landmark Delaware Supreme Court case. In its ruling, the Court created new, rigorous standards for boards of directors considering mergers or acquisitions, specifically requiring boards to perform detailed, thorough and independent analyses of proposed transactions' fairness to shareholders, from a financial perspective.

Since *Smith v. Van Gorkom*, other rulings have supported the need for reliable, thorough and independent assessments of the financial fairness of corporate transactions, known as fairness opinions. As a result, though fairness opinions are not required as a matter of law, most public company boards of directors rely on fairness opinions when considering transactions such as mergers, acquisitions, going-private transactions, tender offers, management buyouts and divestitures.

In the following pages, we answer three questions: What is a fairness opinion? When is it necessary? What protection does it provide? Our answers show that merely obtaining a fairness opinion may not be sufficient to protect directors from liability; courts are increasingly requiring evidence that opinions that are thoroughly, analytically, and *independently* prepared by qualified financial advisors.

What is a Fairness Opinion?

Fairness opinions are a judgment regarding the fairness of the consideration to be received by the stockholder – relative to industry and market conditions in a corporate transaction. To be acceptable and useful, a fairness opinion must be reliable, meaning that it must include careful and relevant analyses of a proposed transaction's value.¹ In addition, for an opinion to have the greatest degree of credibility, it must be prepared by advisors without any actual or perceived conflict of interest.

Courts pose the following questions when assessing the reliability of a fairness opinion:

- Did the opinion provider use appropriate, up-to-date methodologies to analyze the transaction(s)? Did the opinion provider have adequate transaction, valuation and industry experience?
- Were the analyses thorough and complete?
- Was the opinion really independent or was the provider dominated or influenced by management or a controlling shareholder? Was compensation for the opinion provider *de facto* linked to or affected by a particular outcome?
- Did the provider have processes in place to ensure that the opinion was prepared in a manner that ensured an impartial conclusion?

A fairness opinion must incorporate the most up-to-date and relevant valuation methodologies. Furthermore, it must be prepared and reviewed by senior, experienced professionals who address and explain anomalies in the analyses. Companies should not rely on boilerplate language or a well-recognized firm name in place of thorough analyses and reasoned explanations.

Most corporate transactions involve unique circumstances, assets, and/or consideration, all of which a fairness opinion must address. For example, the opinion providers might explain why similar or competing companies were sold at prices in excess of values indicated by the current transaction, or why and how the value of intellectual property was assessed included in the analyses.

In addition, fairness opinions must be independently prepared; the provider cannot have any real or perceived conflict of interest. The independence of a fairness opinion may be called into question if, for example, the advisor issuing the opinion is paid a contingent fee, predicated on a successful closing of the transaction analyzed in the opinion.

When is a Fairness Opinion Necessary?

Fairness opinions help corporate boards fulfill their obligations to make carefully considered judgments. Fairness opinions can provide evidence that the board of directors made a decision in an informed, objective, fair and rational manner.

An independent fairness opinion is especially crucial when:

- Management, members of the board or a controlling shareholder benefit from the proposed transaction;
- Minority shareholders are being bought out;
- The company's capital structure will significantly change following the proposed transaction;
- A tender offer, sale or merger transaction is conducted without an auction; or
- A fiduciary wants an independent advisor to support its actions.

Do Fairness Opinions Provide Liability Protection?

Delaware courts, as well as courts in other states, view the existence of fairness opinions as instrumental in judging whether the directors have satisfied their fiduciary duties of due care and, therefore, are protected under the business judgment rule.ⁱⁱ

Under the business judgment rule, directors are protected from liability when considering corporate transactions *unless* shareholders can prove that the corporate board:

- Did not make an informed judgment, by obtaining and reviewing all reasonably available information on the transaction;
- Failed to act in good faith; or
- Had a conflict of interest with respect to the transaction (*i.e.*, a potential breach of the directors' "duty of loyalty" occurred).

A fairness opinion provides evidence that directors conducted a careful, thorough review of a given transaction, as well as market and industry conditions. However, obtaining a fairness opinion does not provide *automatic* liability protection. Courts scrutinize the thoroughness of fairness opinions and have repeatedly denied protection under the business judgment rule when the fairness opinion has been deemed unreliable. Reliability, as outlined above, refers to the methodology and thoroughness of analysis, but also emphasizes the independence of the financial advisors providing the fairness opinion.

For example, in *Mills Acquisition Co. v. MacMillan*ⁱⁱⁱ³, the Delaware Supreme Court questioned whether the provider, an investment bank, could render an independent analysis of a proposed management buyout because, prior to its appointment as financial advisor to an independent committee of the board, the investment bank had worked with management for over 500 hours on the transaction. In addition, members of management who had a strong financial interest in the outcome of the transaction selected the investment bank as the fairness opinion provider.

Furthermore, in *Joseph v. Shell Oil Co.*, the Delaware Chancery Court enjoined a tender offer, in part, because of deficiencies in the fairness opinion included in the tender offer materials. In this case, the court found Royal Dutch, which was the majority shareholder of Shell and was making a tender offer for the minority shares, did not make available sufficient information to allow rendering of a meaningful opinion. Such conduct was found to constitute a breach of the fiduciary duty owed by Royal Dutch to Shell's minority shareholders.

Conclusion

"Boards relying on an investment bank's valuation analysis are well advised to make every effort to ensure the independence of their financial advisors, particularly where management is interested in the outcome of the transaction."^{iv} Any board considering use of a fairness opinion should address two critical factors when retaining a financial advisor to provide the opinion: (i) is the financial advisor truly independent and not being paid any fees contingent on successful completion of the transaction;

and (ii) are the analytical capabilities, experience and academic credentials of the advisor the best available for the assignment?

About the Authors

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The Woodward Group, a “boutique” investment banking firm, advises on mergers and acquisitions and financings and regularly provides valuations and fairness opinions for corporate transactions involving asset purchases, stock purchases and the determination of corporate security values, including preferred stock, options, stock appreciation rights, and convertible securities.

The Woodward Group’s offices are located at 6 and 8 South Plum Street in the first US designated free trade town of Media, Pennsylvania. Additional information via the Woodward Group web site: www.woodwardgroup.com.

ⁱ See *The Art of Due Diligence* by Alexandra Reed Louis, Editor of Directors Monthly, the official newsletter of the National Association of Corporate Directors and former editor of *Mergers and Acquisitions* magazine and Charles M. Elson, Edgar S. Woolord Jr. Professor of Corporate Governance and the Director of the Center for Corporate Governance and Of Counsel, Holland & Knight, LLP.

ⁱⁱ The business judgment rule is a judicial doctrine applied in cases where shareholders have sued directors for violating their fiduciary duty of care in making a particular business decision.

ⁱⁱⁱ See *Mills Acquisition Co. v. MacMillan*, 559 A.2d 1261 (Del. 1988).

^{iv} Dennis J. Block & Jonathon M. Hoff, *Reliance on Fairness Opinions*, N.Y. L. J. (June 16, 1994).