

## CURRENT CONTROVERSIES RELATED TO FAIRNESS OPINIONS AND "INDEPENDENT" FINANCIAL ADVISORY FIRMS

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*Fairness opinions opine on the fairness of a proposed transaction from a financial perspective. A fairness analysis is always performed from the perspective of a particular party or transaction participant. This perspective allows the financial adviser to answer the question: fairness to whom? Companies involved in a bankruptcy proceeding are particularly sensitive to obtaining fairness opinions before pursuing capital market transactions. Historically, fairness opinions were often provided by the deal investment banker—or by another professional services firm with an ongoing relationship with the opinion recipient. Recently, however, commentators have questioned the independence of such fairness opinion providers. This discussion summarizes the current issues related to transactional fairness opinions, including the need for "independent" independent financial advisers.*

### INTRODUCTION

Fairness opinions are the opinion of a financial adviser that the price of a prospective transaction is fair from a financial point of view. The objectivity of transactional fairness opinions is an issue that has recently received a good deal of attention in the financial press. This issue of fairness opinion objectivity has received attention for several reasons.

A fairness opinion is typically performed on behalf of either the buyer or seller in a merger, acquisition, divestiture, recapitalization, or reorganization transaction. The fairness opinion solely reflects the fairness of the proposed transaction to that specific party.

A fairness opinion does not opine as to whether the proposed transaction is fair to any other party—other than to the party to whom it is addressed. A fairness opinion provides the opinion recipient with the financial advisor's yes/no judgment with regard to the proposed transaction.

A fairness opinion relates to the price and structure of the proposed transaction from a financial perspective. That is, the fairness opinion does not opine on the transaction terms and conditions, including the legal aspects of the transaction.

The current controversy regarding fairness opinions involves concerns with regard to apparent conflicts of interest between:

1. the providers of fairness opinions and
2. the principal parties involved in the proposed transactions.

There has also been discussion in the financial press as to whether "unbiased" fairness opinions actually provide any meaningful information.

### RELEVANCE OF A FAIRNESS OPINION IN A TRANSACTION ANALYSIS

The issues addressed by a fairness opinion are particularly relevant for both:

1. companies in financial distress and
2. the asset managers of companies in bankruptcy.

This relevancy is due to the greater financial/operational uncertainty related to these companies and to their operating assets.

In situations involving distressed companies, it is particularly important for parties to a potential transaction to rely on the independent advice provided by issuers of fairness opinions.

The utility of fairness opinions is also obvious to anyone involved in: (1) the sale of a company, (2) the sale of a division of a company, or (3) the sale of substantially all of a company's assets.

One reason that corporate board members and other fiduciaries obtain transactional fairness opinions is to demonstrate that they have used reasonable business judgment in approving a proposed transaction. This demonstration of reasonable business judgment is premised on the fact that the fairness opinion is provided by a competent—as well as an independent—financial adviser.

The reliability of transactional fairness opinions is of critical importance to the transaction principals. This is because it is difficult for any party not intimately involved in the proposed transaction to:

1. be sufficiently informed of the facts regarding the proposed transaction and
2. understand the financial complexities of the deal to the extent necessary to make an informed decision on the proposed transaction.

Therefore, managers, fiduciaries, and deal participant stakeholders often rely on fairness opinions in voting for the proposed transaction. And, corporate directors and other fiduciaries often rely on fairness opinions in recommending the proposed transaction.

## RECENT CRITICISM OF FAIRNESS OPINIONS

Fairness opinions were of paramount importance in the recent litigation related to the completed merger between the New York Stock Exchange (NYSE) and Archipelago Holdings, Inc.

In the recent litigation, various NYSE seatholders challenged the terms of the proposed merger. These NYSE seatholders claimed that they should have received a larger portion of the value/equity of the merged company.

In the interest of full disclosure, we should note that Willamette Management Associates analyzed the investment banking documents and fairness opinions, and advised the client and counsel to certain seatholders on the fairness of the NYSE/Archipelago merger.

The judge in the NYSE/Archipelago litigation stated that fairness opinions “have become watered down and toothless.” He also stated that, “Conflicts between the board and financial experts who issue fairness opinions have become the norm instead of the exception.”

In one sense, the controversy surrounding fairness opinions is part of the larger picture of why shareholders have become skeptical of management. For example, there is evidence that acquisitions are often not in the best interests of the buyer corporation shareholders.

It is important for shareholders to ascertain whether the proposed transaction is truly in their best interests, or if the deal merely serves the interests of:

1. management (who may have their own reasons to promote a deal) and
2. management's advisers (who often earn substantial fees upon completion of the transaction).

A “rubber stamp” fairness opinion may cause shareholders to approve a proposed transaction that they would not approve if they were more accurately informed of all relevant issues related to the deal pricing.

## CONFLICT OF INTEREST RELATED TO FAIRNESS OPINION PROVIDERS

The issue of conflict of interest with regard to the issuance of fairness opinions can arise in several ways. This is because there may be numerous parties involved on each side of a proposed transaction. These parties may include one or more groups of owners, managers, independent directors, one or more investment banking firms, and the company's auditors.

Historically, fairness opinions have often been performed on behalf of a company by that company's investment bank and/or accounting firm. For the reasons discussed below, these firms may be unable to provide objective, unbiased information regarding a prospective transaction.

## COMPANY STOCKHOLDERS AND OTHER TRANSACTION PARTICIPANTS

A fairness opinion ultimately opines on whether a proposed transaction is fair to the party to whom the fairness opinion is addressed. One potential conflict of interest in the issuance of fairness opinions relates to the conflict between (1) the company owners and (2) other parties to the proposed transaction.

Conflicts of interest can also arise between the different classes of owners of the company, depending on:

1. the capital structure of the subject company and
2. the terms of the potential transaction, including conflicts of interest that also arise between the varying owners of the company.

## Company Stockholders and Company Managers

It is important to understand that company stockholders and company managers often have conflicting economic

interests. For example, a manager who owns stock options may have an incentive to focus on the company's short-term growth and profitability.

The objective of this short-term focus is to boost the company's current stock price. This short-term focus may be applied at the expense of the company's long-term growth and profitability.

Corporate shareholders who are not employees may be more concerned with the company's long-term growth. Therefore, the economic interests of company management and the economic interests of the company shareholders can diverge. And, this divergence may motivate a company manager to consummate an acquisition at a transaction price that is higher than the fair price the company should pay.

There are other, nonquantitative areas in which the economic interests of company stockholders and company managers may diverge. One such area involves the fact that managers have an incentive to consummate acquisitions.

This incentive is due to the fact that those acquisitions create visibility, attract attention, convey the perception of status, and give the impression that management is being "active," as opposed to being "passive" and not taking big steps to improve the company.

Acquirer company managers may also be motivated by the philosophy that "bigger is better."

Company managers may also be influenced by the advice and pressures from investment bankers. These investment bankers may have worked with the company in the past, or they may be simply contacting company management in order to determine if there is an opportunity to put a transaction together.

## Company Stockholders and Investment Bankers

Fairness opinions are often issued by the investment banker representing either the buyer or seller in a proposed transaction. From one perspective, there is logic to having the "deal" investment banker prepare the subject transaction fairness opinion.

This logic relates to the fact that the investment banking firm may be familiar with many aspects of the target company, including: results of operations, financial projections, industry prospects, and target management capabilities.

However, none of the above-mentioned factors negate the fact that company shareholders and investment bankers have an inherent conflict of interest. This is because the investment banking firm typically receives a substantial fee only upon the successful completion of the merger/acquisition transaction.

Therefore, the investment banking firm has a strong incentive to "close the deal" regardless of whether the proposed merger/acquisition transaction is really in the best interest of the company shareholders.

## Company Stockholders and Company Auditors

Corporate acquirers have sometimes relied on fairness opinions issued by the company's public accounting firm. The public accounting firm has an incentive to agree with management's proposed transaction. This is because company management has a large voice in hiring the public accounting firm.

Even an accounting firm that is not currently auditing the acquirer company has the incentive to make the acquirer management happy. This is because the public accountants hope to get future auditing or consulting work from the acquirer company.

In any of the above-described cases, the important factor is that the company issuing the proposed transaction fairness opinion (i.e., the investment banker or the public accountant) has every incentive to agree with interests of the acquirer management (over the interests of the acquirer stockholders).

These potential conflicts should be completely disclosed to all interested parties to the proposed transaction. The National Association of Securities Dealers (NASD), the private-sector regulator of the U.S. securities industry, has taken this transparency issue further by proposing Rule 2290. Rule 2290 is currently being reviewed by the Securities and Exchange Commission.

This new Rule 2290 would provide investors with a disclosure regarding the actual and potential conflicts of interest between: (1) the valuation agent rendering the fairness opinion and (2) the company seeking the opinion.

Rule 2290 would also require valuation agents to examine their fairness opinion process in order to identify such conflicts of interest.

## THE VALIDITY OF "INDEPENDENT" FAIRNESS OPINIONS

Even when there are no obvious conflicts of interest, there are still some reasons why an "independent" fairness opinion may not truly serve the interests of the company stockholders.

Let's assume an investment banking firm is retained to perform a fairness opinion for an acquirer company with which it has no other business relationship. In this case, there is still an incentive for the investment banking company to issue a positive fairness opinion.

Investment banking firms have an incentive to issue a positive fairness opinion because the investment banking firms have an incentive to promote a high level of merger and acquisition activity. This is because these firms ultimately expect to earn other transactional fees from the increased merger and acquisition activity.

There are also economic incentives for investment banking firms to help one another. Let's consider the presumption of "you scratch my back, and I'll scratch yours." This implies that one investment banking firm expects to receive reciprocal business (or additional business) from the other investment banking firm.

There are many ways that investment banking firms can "help" each other, including:

1. asking the deal investment banking firm to perform a fairness opinion for a transaction in which it is performing the investment banker role and
2. allowing other investment banking firms to participate in lucrative initial public offerings (IPOs) and other capital market transactions.

### Data Used in the Fairness Opinion Analysis

Another reason that even "independent" fairness opinions may not provide meaningful information is the fact that any fairness opinion is only as good as the underlying data. A fairness opinion may be prepared with the best of intentions. However, it may rely on flawed data.

Such a flawed (or "defective") fairness opinion can result in company stockholders and acquirer managers making a decision without having appropriate professional guidance from the firm that issued the fairness opinion.

There are many ways in which company financial information can result on a misleading valuation or transaction price information. That is, a company's historical financial statements may not reflect the value inherent in the company's operations going forward for several reasons.

First, the historical financial statements may include revenue and/or expense items that are not expected to recur. In such instances, the financial statements used by the fairness opinion provider will have to be properly normalized to reflect the recurring levels of revenue and expense.

Second, the subject company and/or the subject industry may be undergoing substantial change. That is, historical company/industry results of operations are simply not indicative of prospective company/industry results of operations.

Financial projections can similarly provide misleading information as to the value of the subject company. For example, the financial projections may incorporate unrealistically optimistic or pessimistic growth and profitability assumptions. And, the financial projections may be "missing a piece of the puzzle."

That is, the projections may not contemplate other areas of business that the subject company may enter,

either as a stand-alone company or in combination with a prospective buyer or seller.

### Financial Adviser Due Diligence Procedures

It is important to understand that the providers of fairness opinions typically do not participate in the preparation of the subject company financial projections. It is the responsibility of the independent financial adviser to:

1. understand management's competitive/strategic financial statements and
2. properly assess the level of risk inherent in management's financial statements.

A good independent financial adviser (or other fairness opinion provider) will perform a sufficient amount of due diligence and quantitative/qualitative analysis with regard to management's financial projections. Such due diligence procedures are necessary to properly estimate the value of the subject company and/or the price of the subject proposed transaction.

### RELATIVE FAIRNESS VERSUS ABSOLUTE FAIRNESS

An additional concern in some transactions is that there are differing groups of stockholders in the target company. It is possible for a deal to be fair in the aggregate (i.e., the total price is fair to all owners) but still be unfair to certain owners.

One example of this is when certain owners have restrictions on securities that they will receive in a transaction that are different from otherwise similar securities that will be received by other owners.

If the terms of the deal do not properly account for these differences, it is possible that the deal may not be fair to some owners of the selling company but not to other owners. It is important to note that disclosing these differences is not the same thing as accounting for these differences.

### WHAT A FAIRNESS OPINION IS NOT

A fairness opinion is not a valuation analysis. More importantly, a fairness opinion does not indicate a conclusion that the subject transaction price is the only price at which the transaction could be considered fair from a financial point of view.

When analyzing transaction prices and transactional fairness opinions, it is important to understand the different standards (or definitions) of value. In the business valuation profession, the following two standards of value are relevant to this discussion:

1. fair market value, which is typically defined as the price “between a willing seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts,” and
2. investment value, which is typically defined as the price to a specific investor or owner.

Investment value typically includes the value of synergies between the actual buyer and the actual seller.

From one perspective, these two definitions of value form the upper and lower boundaries of the price of a potential transaction. A transaction normally should not be consummated at a price that is below fair market value.

In an efficient market, there should always be a buyer prepared to pay at least fair market value for an acquisition target. And, the highest price an acquirer would normally offer is the investment value of the target company to that acquirer.

The price at which a transaction actually occurs may reflect a number of factors, including:

1. the competitive environment for target companies in the particular industry and
2. the needs of individual acquirers.

For example, for a target company that is for sale (but for which there is a small number of potential buyers), the actual price may be at or slightly above the fair market value of the target. Alternatively, if there are a large number of potential acquirers, the actual price would reflect the investment value of the target company to the successful bidder.

Another consideration with regard to the actual transaction price of a merger or acquisition is the relative negotiating ability of the respective parties.

## FAIRNESS OPINION PROVIDERS

The current controversy with respect to fairness opinion independence issues may mean a change in the landscape of fairness opinion providers. There is clearly an increased role for independent financial advisers. This is because fairness opinion analysis is based on generally accepted valuation approaches and methods.

The issue of fairness opinion independence is particularly relevant to providers of fairness opinions that are also involved in investment banking, audit, or other consulting work that may affect their objectivity.

If investment bankers and public accounting firms limit the number of fairness opinions they issue due to potential or real conflicts of interest, this limitation will affect the composition of the firms that do provide fairness opinions.

There is evidence that corporate fiduciaries increasingly seek independent financial advice on proposed mergers and acquisitions. Many independent directors contact independent financial advisers and/or other fairness opinion providers for objective advice even before they receive a formal offer.

The above-mentioned NYSE transaction initially involved two independent financial advisory firms issuing fairness opinions. In addition, a third fairness opinion was issued in settlement of the litigation regarding the NYSE transaction.

It is a safe assumption that future transaction participants will increasingly rely on independent fairness opinion provided by independent financial advisory firms.

## SUMMARY AND CONCLUSION

In today’s litigation-prone investment environment, it is more important than ever for parties involved in mergers and acquisitions to obtain independent and unbiased financial advice. Such independent financial advice will encompass the valuation-related aspects of the proposed transaction.

This reliance on an independent financial adviser is particularly relevant in proposed transactions involving the sale of business interests or of assets of companies that are in financial distress or bankruptcy. This reliance is due to the difficulty related to estimating the value of the business interests or assets of troubled companies.

Therefore, it is important for parties in interest to a bankruptcy to be knowledgeable of the independence issues related to fairness opinions.

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