

Nine Myths of Fairness Opinions

By Michael A. Papile

Along with most other activities of public company boards, the utilization of fairness opinions is getting re-examined by regulators, shareholder advocates, investment bankers, and boards themselves. However, unlike many other board activities, the need for a fairness opinion is an uncommon event, typically required as part of a material sale or acquisition transaction that is under consideration. As a result, many board members will find themselves in a reactive mode when duty calls, unprepared to identify and assess the relevant issues surrounding the fairness opinion process. They will rely on their instincts and preconceived notions to determine acceptable practice. This article will attempt to clarify some of the myths surrounding fairness opinions in an effort to better equip these decision makers and their advisors.

Myth # 1: A fairness opinion is expensive and has little substantive value, so find the cheapest one available, paper the file and move on.

This is dangerous thinking.

A fairness opinion can be a very useful analytical and decision-making tool. However, it is only as useful as its audience makes it. It is most useful when the board is fully engaged in the fairness-opinion process. One could argue that in this regulatory environment, the board should be actively involved in the selection of the investment bank, participate in the preparation of the opinion, and fully understand or challenge the analysis that is presented to it. It is also helpful to receive and review the materials ahead of any board meeting and carve out sufficient time for board discussion

Director Summary: Fairness opinions in anticipation of acquisitions are often misunderstood by boards of directors. Although not mandated by law, fairness opinions are a valuable tool, both for their importance in the decision-making process, and because investors expect them as an indicator of due diligence.

and follow-up questions with the investment banker.

Myth #2: The board is legally required to obtain a fairness opinion.

Yes and No.

The fairness opinion has never been legislated into existence. However, there is a well-established body of case law with respect to board responsibilities and fairness opinions that provide significant guidance on accepted standards of practice.

Regardless of the legalities, fairness opinions have become a standard market requirement for a board of directors involved in a material transaction. That is, the investing public has come to expect them. Going forward, both the details of the analysis and the process under which the opinion was obtained will be scrutinized. With increasing disclosure requirements, this task should be much easier for them to accomplish.

Myth #3: The investment banker who has advised the company on a transaction is the most qualified party to deliver the fairness opinion.

Perhaps.

The incumbent investment bank is often well suited to deliver the opinion because of its familiarity with the company, industry, and circumstances leading up to the contemplated transaction. However, one could argue that such a relationship brings a number of conflicts that can impair the integrity of the opinion. Such conflicts include the large success fee payable to the investment banker once the deal closes, the potential for future business from the management team that hired them (and who may personally benefit from the deal), or any financing arranged or provided for the company by the investment bank.

A qualified investment bank relies on its reputation for long-term survival, and will therefore act professionally and go to great lengths to identify and disclose the full extent of its past, present, and future relationship with the company, its management, and its competitors. It will also



vet out internally, through a conflicts or fairness opinion review committee, whether or not its relationship with the company prevents it from delivering unencumbered advice.

Ultimately, it is up to the board to decide if such a relationship detracts from or contributes to the quality of the fairness opinion. The board can choose to have another firm provide the opinion or seek out a second opinion. Both practices are at least being considered more frequently. However, one should be mindful of the additional cost required to get a second opinion, as well as the additional time required for a different investment banker to become familiar with the company and the transaction.

If the board, rather than management, selects the investment banker, it can avoid the conflicts that may arise out of a cozy relationship between the banker and management. The logic and objective is similar to that of having audit committees take responsibility for the retention of the company's outside auditors.

In any event, it is most important when selecting an investment banker to find one that is experienced, both in the industry in which the company operates, and in the type of transaction which the company contemplates.

Myth #4: A fairness opinion represents the investment banker's "blessing" of the deal.

Not exactly.

If you read the opinion letter closely, you will see that most fairness opinions can be quite narrow in scope. They typically look at the fairness of the deal only from a "financial point of view" and do not consider tangential aspects such as management's compensation, impact that the deal will have on employment levels, or other strategic considerations.

The limited scope does not mean the fairness opinion has limited value. In addition to providing the benefit of its wisdom and professional judgment, a good investment bank will conduct a thorough and exhaustive valuation analysis of the company within the context of the deal under consideration and the market conditions prevailing at the time. Because the investment bank will utilize standard valuation methodologies, an experienced board member who has reviewed other fairness opinions should be in a position to easily assess the quality of the analysis and use it to assist the board in its decision-making process.

Myth #5: A fairness opinion confirms the company's projections.

No.

One of the recent criticisms of current fairness opinion practices has been the lack of assurance provided by investment bankers on management projections. Although the analysis contained in the fairness opinion

The board should be actively involved in the selection of the investment bank, participate in the preparation of the opinion, and fully understand or challenge the analysis that is presented to it.

may rely heavily on management projections, most fairness opinions explicitly state that they have not confirmed the viability of projections but have relied on management's representation that the forecasts provided are reasonable. This does not mean that the investment bank, in preparing its opinion, should not push and probe management on the reasonableness of its assumptions. But as a practical matter, this increased diligence has limitations and will never provide ultimate assurance.

The board of directors should be fully engaged in the discussions over the relevance of any management projections used in a fairness opinion. They should be very sensitive to any possible understatement or overstatement of future results or any deviations from the forecasts the board may have previously reviewed in the normal course of business.

Myth #6: The fairness opinion provides implicit approval of management's compensation package.

No.

The investment banker is not an expert on executive compensation. It is the board of directors who must determine the appropriateness of a compensation package and what impact it may have on shareholders.

It is interesting to note that an executive compensation package that is tied to a transaction may be considered egregious, but the transaction value and consideration paid to or received by shareholders may still fall within a range of fairness.

Myth #7: Fairness opinions are only for public companies.

Not necessarily.

A fairness opinion can be a useful tool for a board member of a public or private company or any other fiduciary who is looking to fulfill their duty of care. For example, in privately held companies where there is a relatively large shareholder base, a buyout of one shareholder by another, or where the shareholders are not actively engaged in the operations of the business, a fairness opinion may be quite useful and very appropriate.



As the corporate governance requirements of Sarbanes-Oxley continue to trickle down to privately held companies, the receipt of a fairness opinion may become a standard practice for private company boards and other fiduciaries.

Myth #8: The fairness opinion confirms that this is the “best” deal for shareholders.

Not really.

A fairness opinion will tell you if the financial terms of a particular deal fall within a range of fairness. It is conceivable that there may be a more attractive deal out there or that more than one proposal could be considered “fair.”

It is the board’s responsibility to make sure that the deal in question is superior, considering a number of factors beyond those that are contained in a fairness opinion. These would include: liquidity to shareholders, the process upon which the company embarked to arrive at this proposal, the market conditions prevailing, the present and future competitive environment for the com-

It is the board’s responsibility to make sure that the deal in question is superior, considering a number of factors beyond those that are contained in a fairness opinion.

pany, the intangible strategic benefits of the deal, and a comparison of this proposal to alternative transactions or to doing nothing at all.

Myth #9: When you receive a great premium to the current stock price you don’t need a fairness opinion.

Big mistake.

Current market value and intrinsic value of a business are not always the same. Relying solely on the current trading value as a benchmark is a mistake. A fairness opinion analysis will include a number of valuation methodologies that look at both market value and intrinsic value so that, taken as a whole, one can reasonably determine the range of fairness.

In *Smith v. Van Gorkom*, which is considered a major event in the evolution of fairness opinions, the Delaware Supreme Court ruled that the directors of Trans Union Corp. failed to inform themselves about all material information reasonably available, violating their duty of care as directors. The absence of a fairness opinion in the board’s decision process was noted prominently in the court’s criticism despite the large premium being offered in the deal. (Ed. Note: For a longer discussion of the case, please see Jeffrey Williams article in this issue, on page 15.)

Conclusion

The fairness opinion is but one tool available to a board of directors to assist in evaluating a transaction. While it can be viewed as a requirement to fulfill its duty of care, it does not relieve the board of conducting a thorough and independent evaluation of the transaction. With that in mind, it is essential to remember that the end result of the fairness opinion process will only be as good as the time and effort invested in it by the board of directors and the investment banker retained to assist them in the process. ■

Michael Papile is a managing director of Covington Associates, LLC, a specialty investment banking firm based in Boston. He may be reached at michaelp@covllc.com.

Directions with Mark Goulston

What Do You Stand For?

If you don’t stand for *something*, you’ll fall for *anything*.
—Harry Glazer
Special Counsel, Kelley, Drye & Warren, LLC

Glazer adapted this from Alexander Hamilton’s quote: “Those who don’t stand for anything, will fall for anything.” Glazer, formerly a full-time attorney and now a deal maker and mentor in emerging growth businesses, lived through the dot-com bubble and burst. He has learned first-hand through riding those ups and downs how important standing for something is, and how ambition and drive are okay, but greed is not. How doing the right thing is more important than having to be right. Most importantly, he learned how cutting your losses from greedy people who have to *be* right rather than *do* what’s right is better than waiting for them to change for the better—which they never do. Glazer serves as special counsel at the Vienna, Virginia, office of Kelley, Drye & Warren, LLC, and has served on the boards of the American Electronics Association and Boys and Girls Clubs of Greater Washington, and on the board of advisors for *Internet Law & Regulation*.

Mark Goulston, MD, is an executive coach and advisor to boards, and author of *Get Out of Your Own Way at Work and Help Others Do the Same* (Putnam, 2005). He may be reached at mgoulston@markgoulston.com.