

CAN THE QUALITY OF FAIRNESS OPINIONS BE IMPROVED?



by Joel F. Johnson

Last fall, NASD requested comment on a proposed rule related to fairness opinions. Comments came in through the winter. The proposed rule and the comments received in response provide an insight into the current state of the art in fairness opinions.

As readers of *M&A Today* know, a fairness opinion is prepared by a financial expert in situations where the corporate client is contemplating a major transaction, such as an acquisition. The expert is asked to opine, from a financial point of view, on the fairness of the transaction to the shareholders of the corporation. Because of the litigation risk associated with fairness opinions, the price of obtaining a fairness opinion may be much higher than the price of a simple valuation opinion, although the analyses are similar.

The rule under consideration by the NASD would require members to:

1. Disclose in any fairness opinion appearing in any proxy statement any significant conflicts of interest, including, if applicable, that the member has served as an adviser on the transaction in question, and the nature of compensation that the member will receive upon the successful completion of the transaction.
2. Require specific procedures that members must follow to identify and disclose potential conflicts of interest in rendering fairness opinions.



NASD acknowledged that the Securities & Exchange Commission (SEC) already has rules in place for fairness opinions that are included in proxy statements. In the proxy statement, the SEC requires a summary of the opinion, a description of the procedures followed, a summary of findings and recommendations, a description of the methods used to arrive at these findings, and other information.

NASD may require an expansion of the disclosure requirements, and it may dictate the procedures to be followed by its member firms. According to the NASD notice, "NASD is concerned that these disclosures [required by the SEC] may not sufficiently inform investors about the subjective nature of some opinions or their potential biases. In addition, the multiplicity of valuation methodologies employed, the sensitivity of results to small changes in the underlying assumptions, and the perceived tendency to make judgment calls that support the company managers' preferred outcome have been the subject of criticism. Finally, when the transaction will result in one group of shareholders receiving a benefit that is materially different than that received by the unaffiliated shareholders, this result may create biases in favor of the transaction if the people receiving the benefits were involved in hiring the investment bank ..."

The rule change would require NASD members to adopt procedures that would help in identifying and disclosing potential conflicts of interest. These procedures would address the internal approval process for fairness opinions, the process for determining whether the valuation analyses are appropriate and the process for evaluating the degree to which compensation from the transaction is a factor in reaching the fairness determination.

POTENTIAL CONFLICTS OF INTEREST

Perhaps the most frequently-sited conflict is one where the firm delivering the fairness opinion is entitled to a larger fee contingent upon the closing of the transaction. For example, a *Wall Street Journal* article notes that, "When Bank of America Corp. agreed to acquire FleetBoston Financial Corp. for more than \$40 billion last fall, Bank of America agreed to pay adviser Goldman Sachs Group Inc. \$3 million as a retainer, \$5 million for its fairness opinion, and

\$17 million upon completion of the merger, according to a proxy statement filed on the deal." The NASD rule change is not intended to eliminate such conflicts. Instead, the goal is to improve the process for identifying and disclosing potential conflicts.

Some respondents argue that merely disclosing the conflict does not go far enough. One recommends "requiring fairness opinions... to be issued by independent investment banks that do not receive a fee that is contingent upon the closing of the transaction." A state pension fund manager writes, "Ideally, fairness opinions should consist of an independent legal appraisal by outside experts, who are not connected to the transaction, to ensure that the valuation is fair to the shareholders." On the other hand, many investment bankers would argue that they are not going to recommend a transaction if they believe it is unfair to the client. In this view, by providing a fairness opinion, the investment banker is confirming in legal terms what it has already represented to the client. In fact, one could argue that advisers should be *required* to issue fairness opinions! Ultimately, this is not an issue that requires new rules from NASD or a change in investment banking practices. The issue goes away if a board of directors simply elects to hire an independent firm to provide the fairness opinion.

Another potential conflict of interest is associated with management compensation. If senior management is in-line for large bonuses when the company is sold, and management engages an investment banker to deliver a fairness opinion, the investment banker may be subject "biases in favor of the transaction." Some respondents to the NASD expressed an opinion that these types of conflict are beyond the purview of the fairness opinion. According to this view, the firm has been engaged as an expert in valuation, not compensation, and should not stray beyond its area of expertise. These respondents argue that the board of directors is responsible for considering compensation conflicts, not the provider of the fairness opinion.

Yet another conflict exists when the opinion relies on data supplied by management. NASD is considering requiring a member to disclose the extent to which the member relied on key information supplied by a company or its

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management, or whether it independently verified certain information. The data may take various forms, but the most obvious example is a forecast. Typically, a discounted cash flow analysis is one of the methods employed in arriving at a fairness opinion. If the opinion is delivered on behalf of the buyer, a "high" price may seem "fair" as long as management provides a forecast that is sufficiently rosy. In the view of some respondents, this is a conflict that cannot be avoided. Most often, management is in a better position to assess a company's prospects than an outsider. Therefore, management's forecast represents the most fully informed point of view.

One conflict NASD did not address is simply a symptom of human nature. Charles M. Elson makes note of it in an article published in the *Ohio State Law Journal*: "Personal considerations inherent in the banker/manager relationship militate against objectivity. Despite the fact that, legally, the bank is employed by and is expected to advance the best interests of the corporation, bankers must work with managers. As most banking relationships become long standing, personal relationships between the banker and manager develop that naturally impact on the advice rendered."

VALUATION METHODOLOGIES

NASD has accurately noted that valuation opinions are subjective judgments, sensitive to the assumptions made and methodologies employed. Neither the SEC nor NASD requires that the expert define what "fair" means. When preparing a fairness opinion, the expert is undertaking a quantitative analysis to deliver a qualitative opinion. Some transactions are clearly fair and others are not, but when so many transactions are the result of hard-fought negotiations between competent contenders, it should not be surprising that prices often fall into a gray area, possibly fair and possibly not.

Daily movements in the stock market provide ample evidence that opinions of value are constantly changing. While there is a consensus that certain methodologies are the correct ones to employ when valuing a company, no two investment bankers, analysts, investors or appraisers seem to employ the exact same procedures. Furthermore, deal structures differ. Is a cash price that is fair still fair if it is delivered as stock instead of cash? Factors unique to the companies involved and the transaction structure may influence the valuation methodologies and assumptions that are appropriate. As one respondent notes, "Promulgation of a set of specific procedures or factors is unlikely to be universally effective. The alternative is that any such procedures or factors will be too general to provide useful direction to the Member or useful disclosure to the shareholders."

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Start with Results

"To create value, management needs to set goals for superior results to make them happen," said Mickelson. "The best way to do this is to have a well-articulated strategy that you've been implementing for a period of time and a track record of accomplishing superior business results. If you don't have this in place, it's going to be a struggle to sell the business because it will be harder for buyers to rely on future projections."

Build a Solid Foundation

According to Mickelson, management can also establish credibility with potential buyers early in the process with a solid foundation. Too many businesses are disorganized, have poor business practices in place and react to problems as they come up. Having documents, facilities, infrastructure and people in proper order will help give the buyer confidence in the quality of the business.

Creating Value with a Solid Foundation	
Process	How to maximize value
Creating value	A comprehensive, long-term strategy supports future projections and opportunities.
Developing a solid foundation	By having documents, facilities, infrastructure and people in order, the seller gives the buyer confidence in the company's quality and creates credibility.
Establishing solid business connections	Business connections can help the seller identify a winning advisor team that has experience buying and selling.

Connections, Connections, Connections

Selling a business is not the time to rely on instincts or advice from friends. "If you don't have excellent business contacts, this is where an investment banker's experience with buying and selling businesses can bring value to the seller," Mickelson said. "When we sold our businesses, our investment bankers walked us through the sales process. Their expertise and contacts helped us to get a higher price for our businesses."

These principles are universal and apply to all businesses – from small shops on Main Street to giant corporations in the Fortune 500 – as well as to subsidiaries, divisions and product lines.

This article was written by Linda Mertz, managing director at Mertz Associates, an investment bank focused exclusively on middle-market mergers and acquisitions. Peter Sommerhauser from Godfrey & Kahn and Lee Riordon from Deloitte and Touche also made contributions. If you have questions or would like additional information, call Linda Mertz at (414) 258-2288.

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CONCLUSION

Fairness opinions are receiving increasing scrutiny from regulatory bodies, such as NASD and the SEC, from enforcement officers, such as New York Attorney General Eliot Spitzer, and from elected representatives, such as Edward Markey of Massachusetts. Suggestions for improving the quality of fairness opinions include increasing the disclosure requirements, separating the providers of the opinion from the advisers in the transaction, and dictating new procedures for identifying conflicts.

It is unlikely that these measures will wipe out conflicts of interest or eliminate subjectivity from fairness opinions. However, they may encourage beneficial changes. First, they may continue to expand the field of candidates considered when a fairness opinion is required. Recognition is growing that appraisal firms are qualified to deliver fairness opinions and may have fewer conflicts than investment bankers in some situations. Second, to the extent that increased disclosure makes it clear that a fairness opinion is a judgment call, it may eliminate a false sense of complacency in the minds of board members and shareholders. Finally, by simply scrutinizing the process, regulatory agencies may bring about improvements in the practices of firms that deliver these opinions.

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M & A
UPDATE

ACQUIRING IN CHINA

Recently, *M&A International* sponsored an open conference call with expert panelists discussing various aspects of doing deals in China. While everyone knows that China has the fastest growing economy, the political risks are real for a country that is not a democracy. The Chinese are receptive to U.S. investors particularly if it is a joint venture, but the relationship has to be spelled out in detail as to what is to take place, who is in charge,

how issues are to be resolved, etc. The personal relationships are extremely important in conducting business in China so communication face to face is imperative in order to solidify the right chemistry. The initial meeting should be spent philosophizing and strategizing about their businesses knowing that it might take a year and half to complete a transaction. Inviting the Chinese counterpart to visit you in the U.S. is advisable.

Because there is so much interest in acquiring a company in China, it is not as easy to find the right opportunity as the early 1990s. As the expression goes: "An opportunity is an opportunity until everyone has seen it." The greatest M&A activity in China has been in the auto industry, usually as a joint venture. However, there are huge industry sectors open for investment. To cite one example, in the healthcare industry there is \$5,000 spent per capita in the U.S. compared to \$100 per capita in China. The Asians want to westernize their businesses and particularly want to align themselves with worldwide brands.

Heretofore, most of the investing in Chinese mainland companies has been through a Hong Kong holding company since half of the Hong Kong companies are Chinese. The trend nowadays is for foreigners to invest directly. Hong Kong is the financial capital of Asia, and it is relatively easy to fund acquisitions there, albeit, the equity portion is considerably more difficult. Chinese middle market companies are receptive to U.S. private equity investors although strategic acquirers are preferred. It should be noted that earn-outs are an anathema, and during the due diligence process there is a complete lack of accounting transparency.

Acquisitions in China are not for the inexperienced dealmakers in that country.

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