Financial Adviser Insights

The Role of the Independent Financial Adviser in M&A Fairness Opinions

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Corporation boards of directors (and not-for-profit institution trustees, securities lawyers, and other parties) often rely on fairness opinions when evaluating merger and acquisition (M&A) transactions. In many instances, these fairness opinions are issued by the same investment banker/financial intermediary that structured and priced the pending M&A transaction. This discussion summarizes the typical content and intent of fairness opinions in M&A transactions. And, this discussion contrasts the role of the deal financial intermediary with the role of the independent financial adviser with respect to the probity and objectivity of the M&A transaction fairness opinion.

Introduction

Fairness opinions are an important tool that may be used as proof of the due diligence process being conducted in relation to a potential merger and acquisition (M&A) transaction. These fairness opinions are often prepared by the financial intermediary that structured the pending M&A transaction.

Many commentators have asked: Can corporate directors (or not-for-profit entity trustees) rely on a fairness opinion prepared by an investment banker (IB) that is not independent of the subject transaction?

In addition, many commentators have asked: Isn't such board reliance on the transaction financial intermediary's fairness opinion similar to relying on the internal corporate accountant to audit the company's own financial statements?

Many commentators believe that just like no accountant can objectively audit his or her own accounts, no financial intermediary can objectively opine on the fairness of his or her own transaction. Many commentators believe that client representation financial intermediaries and independent financial advisers both have important—but separate—roles to play in M&A transactions.

However, these two transaction adviser roles are distinctly different. And, corporation directors (and other parties with fiduciary duties) who rely on an IB financial intermediary with an economic interest in the subject deal should not necessarily expect to receive independent financial advice.

This discussion will summarize the following issues related to fairness opinions:

1. the content and intent of a fairness opinion
2. why the fairness opinion needs to be prepared by an independent financial adviser
3. the role of the transaction financial intermediary versus the role of the independent financial adviser
4. a list of factors for corporate directors to consider regarding financial intermediary fairness opinions

Fairness Opinion Content

A fairness opinion is an expression of a financial adviser's opinion as to the fairness, from a financial point of view, of the financial terms of a corporate transaction.

In many circumstances, the fairness opinion will only address the fairness of the consideration to be received by the selling shareholders. In other circumstances, the fairness opinion will also address the fairness of the transaction as a whole.

A fairness opinion is typically delivered in the form of a brief letter addressed to:

1. a company's board of directors or
2. a special sub-committee of disinterested directors formed to consider the proposed transaction.

With respect to content, fairness opinions tend to conform to a fairly straightforward outline, an example of which follows:

1. a description of the proposed transaction
2. a summary of the financial adviser's due diligence investigations
3. a statement of any significant assumptions or conditions
4. a statement of any significant limitations on use
5. a statement of conclusion (e.g., that the proposed transaction consideration is fair, from a financial point of view)

Notably absent from the standard fairness opinion is any meaningful description of the financial and valuation analyses upon which the fairness opinion is based. Normally, this information is presented separately to the fairness opinion recipient in an oral—and sometimes written—presentation.

In the case of publicly traded companies, the financial analysis/valuation presentation will be summarized and disclosed in (1) the proxy statement or (2) other transaction filings with the Securities and Exchange Commission (SEC).

In the particular case of a going-private transaction, SEC Regulation M-A requires that the financial analysis/valuation presentation itself be included as an exhibit to the Schedule 13E-3 or proxy statement filing.

The fairness opinion should also have language addressing that the conclusions reached regarding the pending transaction were arrived at in an objective manner. If a fairness opinion is conducted by an interested/related party, then the objectivity of the opinion may come into question.

Why a Fairness Opinion Needs to Be Independent and Objective

In general, a fairness opinion needs to be independent and objective for several reasons. Some of these reasons include the following:

1. to avoid conflicts of interest
2. to avoid reputational damage (board member or financial adviser)
3. to avoid negative (legal) publicity in the case of a failed transaction.

Conflicts of Interest

In many corporate control transactions, it is typical for the board of directors to seek a fairness opinion from the investment bank that is involved in sourcing, structuring, and negotiating the proposed transaction. Normally, this investment bank is working under an engagement letter that provides for a (perhaps significant) fee that is contingent upon the successful completion of the corporate control transaction.

This relationship has caused many commentators to ask whether the investment banker is sufficiently "disinterested" to render an independent opinion on the fairness of the proposed transaction to the selling shareholders.

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These apparent conflicts of interest occur quite frequently on Wall Street. For example, when Bank of America Corp. agreed to acquire FleetBoston Financial Corp. for more than $40 billion, 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. FleetBoston agreed to pay adviser Morgan Stanley as much as $25 million for the same set of financial advisory services.

An independently prepared fairness opinion can avoid this appearance of a conflict of interest.

Professional Reputation

Since investment banks are compensated primarily for services other than rendering fairness opinions, they have incentives to render "pro-management" opinions—even in situations involving noncontingent fees. This is because such opinions will typically generate more work than "opposition" opinions.

Issuing a fairness opinion that is not in line with management's wishes can cause the termination of the business arrangement between the company and the investment banker. And, it may significantly impact the fees receivable by the IB. Therefore, the investment banker may appear to subjugate the objectivity of the fairness opinion in order to secure more work.

This, in turn, can damage the reputation of the company management or the board of directors that relies on such an opinion. An independently issued fairness opinion can remove any issues that may be damaging to the reputation of company management, the board, or the professional financial adviser.

Legal Issues

In the following cases, the courts have examined the so-called independence of the investment banks that issued the fairness opinions on their own deals.

- *Doris I. Sandberg, et al. v. Virginia Bankshares, Inc., et al.*,[1] where the U.S. Court of Appeals for the Fourth Circuit held that it was a triable question of fact as to whether the characterization of an investment bank's fairness analysis as "independent" in a proxy statement was a material misrepresentation.

  In this case, the investment bank was to receive a fee contingent on the consummation of a merger.
- *Radol, et al. v. Thomas, et al.*,[2] where the U.S. District Court stated that a contingent fee arrangement between a target company and its investment banker could have the potential to taint the fairness opinion of the investment banker.

  The District Court concluded that the reasonable shareholder would consider information regarding a contingent fee arrangement of obvious importance in deciding how to vote on a merger proposal.
- *Smith v. Shell Petroleum, Inc.*,[3] where the Court of Chancery of the State of Delaware found that the plaintiffs failed to show by a preponderance of the evidence that the investment bankers deliberately skewed its analysis due to the fee arrangement.

  However, the Chancery Court also found that: (1) the existence a conflict of interest was obvious and (2) the conflict of interest diminished the validity of the investment banker's opinion.

In these cases, the terms "material misrepresentation," "deliberately skewed its analysis," and "diminished the validity of the investment banker's opinion" are all extremely damaging terminology to the professionals that issue the fairness opinion, and also to the company that relied on the fairness opinion.

The legal costs and the negative publicity for the professional adviser are immense in these cases. An independently issued fairness opinion may hold up much better to judicial scrutiny in a litigation setting than a fairness opinion that is issued by a related/interested party.

The Role of the Transaction Financial Intermediary Versus the Role of the Independent Financial Adviser

Our firm Willamette Capital provides performance-based investment banking services to substantial privately owned companies. And, Willamette Management Associates provides independent financial advisory services (e.g., transactional fairness and solvency opinions) to both publicly traded and closely held corporations.

However, seldom is it appropriate for any one firm to perform both types of services for the same client on the same deal.

Willamette Capital provides the typical client-representation investment banking services. These performance-fee-based IB services include the following:

1. capital formation (including the private placement of debt and equity securities)
2. business brokerage (including M&A transaction negotiations)
3. financial restructuring (including debt/equity reorganization, equity recapitalization, and troubled debt restructuring)

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And, Willamette Management Associates provides the typical independent financial advisory services. However, these services are not performance-fee based. These services include debt/equity security design and transactional opinions such as:

1. fairness opinions,
2. solvency opinions,
3. adequate consideration opinions, and
4. fair market valuations.

These independent financial adviser transaction opinions relate to:

1. corporate M&A transactions,
2. ESOP formation and acquisition,
3. joint venture formation and dissolution,
4. not-for-profit institution excess benefit and private inurement avoidance, and
5. secured lender (e.g., fraudulent conveyance avoidance) transactions.

Financial intermediaries typically perform IB services on a performance fee/commission basis. In these situations, the financial intermediary is not compensated if the transaction is not consummated. Accordingly, the IB financial intermediary has an economic incentive to structure a deal that will close—and not necessarily a deal that is theoretically fair from a financial perspective to any particular investor constituency.

Most importantly, some observers may conclude that the IB financial intermediary is not independent of the subject transaction. The IB is an agent of one of the M&A transaction principals. And, the IB has a duty to that party only.

Independent financial adviser firms typically perform fairness opinion and other transaction-related services on a fee-for-service basis. Accordingly, the independent financial adviser is not compensated based on a percentage of the transaction price.

In addition, the independent financial adviser is compensated for professional advice whether or not the subject transaction closes. Therefore, the independent financial adviser has no economic incentive to give a biased opinion—even if it means that opinion derails an "unfair" pending transaction.

In addition, the independent financial adviser has a duty to whomever the transaction opinion is addressed. The independent financial adviser analyzes the pending transaction from the perspective of the stated opinion audience—and not solely from the perspective of a particular transaction principal.

"Top 10" Factors to Consider Regarding Financial Intermediary Fairness Opinions

The following "top 10" list indicates factors that investors, corporate directors, institutional trustees, securities lawyers, securities industry regulators, and other interested parties should consider when relying on a fairness opinion issued by the IB financial intermediary that structured the subject M&A transaction.

This list of factors is not intended to be comprehensive. And, this list of factors is not presented in any particular order of importance.

Factor Number 1

Under the Sarbanes-Oxley Act, a certified public accounting (CPA) firm can no longer provide certain services (e.g., certain appraisals and valuations) to its audit clients. This is because those services would involve the CPA firm auditing its own work, which may impair the independence of the CPA firm.

In another area of corporate governance, how can the financial intermediary IB "audit" (i.e., opine on the fairness of) its own M&A transaction pricing and structuring work? Some observers would argue that such a service may impair the independence of the IB firm.

Factor Number 2

When a financial intermediary has the transaction performance fee (i.e., commission) at risk, some commentators may ask: Can corporate directors or investors expect the IB to be totally objective and unbiased—to the extent of derailing the pending transaction by not issuing a favorable fairness opinion?

Factor Number 3

Let's ignore the economic influence associated with the pending transaction performance fees. The IB financial intermediary still has that firm's professional pride and reputation invested in the particular transaction price/structure.

Can corporate directors or investors expect the IB to be impartial enough to not issue a favorable fairness opinion on his or her own transaction price/structure?

". . . the independent financial adviser is compensated for professional advice whether or not the subject transaction closes."

Factor Number 4

In the post-Sarbanes-Oxley (SOX) era more than ever, independent corporate directors (and institutional trustees) want—and need—independent advice. Post-SOX, independent corporate directors regularly retain independent legal counsel and independent forensic accountants.

Clearly, the financial intermediary that structured the pending transaction cannot also serve as an "independent" financial adviser to independent corporate directors.

Factor Number 5

Let's ignore the IB financial intermediary independence issues regarding performance compensation and personal vested interest. An independent financial adviser can bring a fresh and different perspective to the assessment of the pending transaction.

This professional "fresh pair of eyes" should be welcome by all parties (and certainly by all principals) to the pending M&A transaction.

Factor Number 6

An independent financial adviser will likely use different deal valuation variables—for example, guideline publicly traded companies, guideline M&A transactions, income projections, and discount/capitalization rates—in his or her analysis of the pending transaction than the deal valuation

variables used by the financial intermediary that put the transaction together.

If the pending M&A transaction is financially sound, then this independent financial analysis should provide independent confirmation of the financial intermediary's selection of deal valuation variables.

Factor Number 7

An independent financial adviser will likely use different valuation approaches and methods in his or her analysis of the pending transaction. If the pending M&A transaction is financially sound, then the use of additional valuation approaches and methods should also provide an independent confirmation of the financial intermediary's transaction price/structure conclusions.

Factor Number 8

An independent financial adviser will have a different "master" than the IB financial intermediary that sponsored the pending transaction. Although all fairness opinions are typically addressed to the subject corporation board of directors, the financial intermediary is typically retained by the company management.

And, the IB financial intermediary has worked closely with the CEO, director of M&A, and other corporate executives who have a vested (financial or professional) interest in closing the pending transaction.

In contrast, an independent financial adviser typically retained by the corporation board would only serve the interests of the directors (and, through the directors, the interests of the stockholders).

"As a rule of thumb, an IB typically allocates about 20 percent of the total transaction fees to the preparation of a fairness opinion."

Factor Number 9

The total deal transaction costs may actually be lower if (1) the IB financial intermediary structures the deal and (2) an independent financial adviser issues the fairness opinion. As a rule of thumb, an IB typically allocates about 20 percent of the total transaction fees to the preparation of a fairness opinion.

In contrast, independent financial advisers issue fairness opinions on a fixed fee basis (and not on a percent of the transaction price basis). Often, this fixed fee for the independent financial adviser's transaction opinion is less than 20 percent of the total IB fee (i.e., the fee amount that the corporation would not have to pay to the IB if the IB did not issue a fairness opinion).

Factor Number 10

Ultimately, corporate directors should ask themselves: How would I explain this decision to rely on the IB financial intermediary in a shareholder lawsuit deposition or trial cross examination? If the corporate directors are comfortable explaining why they relied on the performance fee compensated IB financial intermediary to opine on the subject transaction fairness, then they should elect that fairness option.

On the other hand, if the corporate directors would be more comfortable explaining that they relied on a totally independent financial adviser to opine on the subject M&A transaction price/structure fairness, then they should elect that fairness option.

Summary and Conclusion

Fairness opinions are an important tool that may be used as proof of the due diligence process being conducted in relation to a pending M&A transaction. Just like no accountant can objectively audit his or her own accounts, many commentators believe that no financial intermediary can objectively opine on the fairness of his or her own transaction.

Many commentators believe that client representation financial intermediaries and independent financial advisers both have important—but separate—roles to play in M&A transactions. However, these two transaction adviser roles are often distinctly different.

And, corporation directors (and other parties with fiduciary duties) who rely solely on an IB financial intermediary with an economic interest in the subject deal should not necessarily expect to receive independent financial advice.

Notes:

1. *Doris I. Sandberg, et al. v. Virginia Bankshares, Inc., et al.*, 979 F.2d 32 (4th Cir. 1992).
2. *Radol, et al. v. Thomas, et al.*, 556 F.Supp. 586 (S.D. Ohio 1983), *aff'd* 772 F.2d. 244 (6th Cir. 1985).
3. *Smith v. Shell Petroleum, Inc.*, No. 8395, 1990 Del. Ch. LEXIS 82 (June 19, 1990), *aff'd* 606 A.2d 112 (Del. 1992).

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