Thought Leadership

Guide to Transaction Opinions Provided by Independent Financial Advisers

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Transaction opinions from independent financial advisers are commonly relied on in today's litigation-prone transaction environment. Such opinions are relied on by the directors of transaction participant companies and by other parties with fiduciary responsibilities. This discussion provides an overview of two common types of transaction opinions provided by independent financial advisers: fairness opinions and solvency opinions. This discussion summarizes the purposes of these transaction opinions, the circumstances when such transaction opinions are appropriate, and the analyses performed by the independent financial adviser in the preparation of such a transaction opinion.

Introduction

Corporate transactions are often high risk events that involve a number of parties to complete. For purposes of this discussion, corporate transactions include mergers, acquisitions, divestitures, financings, restructurings, reorganizations, and leveraged dividend distributions.

The parties executing the corporate transaction (including controlling shareholders, boards of directors, company management, and lenders) and the transaction advisers (especially investment bankers) often have conflicts of interest when approaching a proposed transaction. Transaction opinions provided by independent financial advisers may assist the deal process by providing an unbiased analysis of the proposed transaction. Such an analysis, prepared from a financial perspective only, may provide the decision makers and the corporate fiduciaries with the support needed for any business judgments related to the proposed transactions.

Transaction opinions provided by independent financial advisers often take the form of fairness opinions and solvency opinions. This discussion summarizes the purposes of fairness opinions and solvency opinions, the situations when fairness opinions and solvency opinions are appropriate, and the general analyses performed by the independent financial adviser in the preparation of a fairness opinion or a solvency opinion.

Fairness Opinions

Overview

A fairness opinion expresses the financial adviser's opinion as to whether a proposed transaction is fair from a financial point of view. Fairness opinions are generally provided to assist individual directors, board committees, trustees, or other parties who have fiduciary duties in the transaction decision-making process.

The role of the fiduciary is to serve as an agent of the beneficiary. In a corporate transaction setting, the fiduciary may be the board of directors, a special committee of the board of directors, an individual director, or a trustee. The extent of the fiduciary duties are based on the legal guidance provided by statutory authority, judicial precedent, or administrative regulations and regulators.

Such fiduciary duties may vary based on the relevant legal jurisdiction. However, it is generally understood that the fiduciary's duty is to uphold the business judgment rule.

In the corporate transaction analysis, the fiduciary typically is the client of the financial adviser. And, the financial adviser typically performs the fairness opinion for the benefit of the fiduciary. The financial adviser does not have a fiduciary duty to the parties to whom the fiduciary has a duty.

> "The issue of relative fairness comes into play when certain transaction parties will receive special consideration. . . ."

Obtaining a fairness opinion is one way that the fiduciary party is able to demonstrate that he or she has upheld the business judgment rule standard with regard to the proposed corporate transaction.

What Does "Fairness" Imply?

The phrase "fair from a financial point of view" is somewhat ambiguous. There is no statutory guidance, judicial precedent, or administrative ruling that provides a specific definition of the phrase "fair from a financial point of view." However, financial advisers typically have a practical understanding of what the phrase means.

The concept of fairness covers both legal and financial issues. It follows that the qualifier "from a financial point of view" limits the fairness opinion to the financial aspects of a proposed transaction.

The legal aspects of the proposed transaction should be addressed in a legal opinion that is separate from the fairness opinion.

In determining fairness, the financial adviser may consider both aggregate fairness and relative fairness.

Aggregate fairness is concluded based on the amount of the entire compensation to be received in the transaction. For example, the financial adviser may compare the price per share to be received in a merger or acquisition transaction to the concluded range of value per share estimated by the financial adviser.

The issue of relative fairness comes into play when certain transaction parties will receive special consideration (e.g., an ownership interest in the surviving company, payment for an agreement not to compete with the surviving company, or a lucrative employment contract).

In determining relative fairness, the financial adviser may consider:

1. the relative investment risk accepted by each party in a transaction and
2. the expected investment return associated with that risk.

It is noteworthy that the allocation of equity, debt, and other securities to the various parties in a corporate transaction may affect the investment internal rate of return (IRR) earned by each of the transaction participant categories.

What Is the Purpose of a Fairness Opinion?

The product of a fairness analysis is an indication as to whether a transaction is fair to shareholders, particularly the beneficiaries that the fiduciary has a duty to (typically noncontrolling or nonvoting shareholders). The fairness opinion and the fairness analysis often provide useful tools with multiple applications for the fiduciary.

First, a fairness opinion is a procedural tool, as it provides a fiduciary with financial information regarding the pending transaction.

Second, a fairness opinion may be a legal tool. Fairness opinions may provide evidence that the fiduciary used reasonable business judgment in evaluating and assessing the pending transaction.

Under the legal concept of business judgment, courts typically do not second guess the decisions of the fiduciary, provided that the fiduciary acted:

1. with an informed basis,
2. in good faith,
3. in a manner that the fiduciary believed to be in the best interest of all beneficiaries, and
4. without fraud or self-dealing.

Third, a fairness opinion is a practical tool. A fairness opinion from an independent financial adviser may provide a level of reassurance for other parties to the transaction. The fairness opinion is not an explicit endorsement of the transaction. However, the fairness opinion may persuade other parties to approve the transaction.

It is important to make a distinction between the fairness opinion and other forms of business valuation or financial consulting arrangements.

A fairness opinion is not:

1. an opinion or any other form of assurance that the highest and best possible price is being obtained or received for a given transaction;
2. an assessment or evaluation of the negotiation process leading to the proposed transaction;
3. an evaluation of the business rationale regarding the proposed transaction;
4. an opinion of the legal fairness of the proposed transaction;
5. a recommendation to the fiduciary on how to vote; or

6. a confirmation of, or any form of opinion or assurance (whether audit, review, or compilation) on, historical or prospective financial statements or any other information provided by or on behalf of the client or obtained publicly.

When Is a Fairness Opinion Appropriate?

There are no federal or state laws mandating that the fiduciary obtain a fairness opinion from an independent financial adviser when considering a transaction. However, courts have indicated that they give weight to the fairness opinion when analyzing whether the fiduciary has fulfilled his or her obligation to beneficiaries.

The fairness opinion may be a consideration in transactions where there is a potential conflict of interest. Fairness opinions may be relevant in a variety of transactions involving both privately held and publicly traded companies. Such transactions may involve a negotiated merger, friendly or hostile tender offer, management buyout, transaction involving an employee stock ownership plan (ESOP), going-private transaction, recapitalization or restructuring transaction, leveraged buyout, and so on.

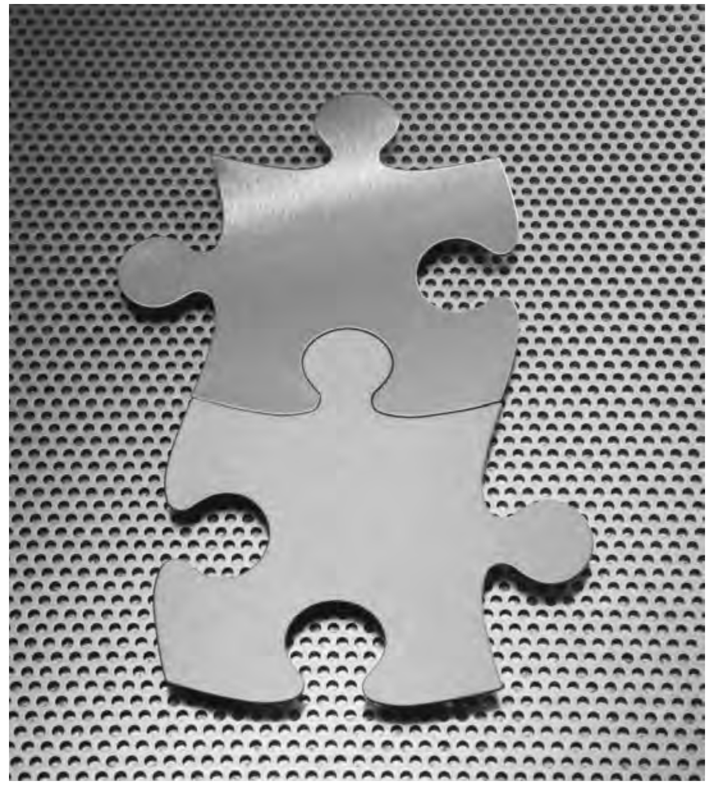
In a merger or acquisition transaction, the fiduciaries representing each of the buying and the selling stakeholders may benefit from obtaining separate fairness opinions.

Fairness opinions are customary components of transactions involving publicly traded companies due to the liability of fiduciaries (usually the boards of directors) acting on behalf of the noncontrolling stockholders.

Fairness opinions have become increasingly common in private company transactions. They are also becoming common for transactions involving a change in control, an ESOP, or a company with few or no external directors on its board.

A recent study[1] by FTI Capital Advisors of 50 major domestic transactions that involved controlling interest transactions among publicly traded companies indicated that 46 percent of the transactions involved one fairness opinion, 28 percent involved two fairness opinions, and 26 percent involved three or four fairness opinions.

Altogether, according to the FTI Capital Advisors study, 95 fairness opinions were provided for the 50 transactions, and 71 percent of the fairness opinions were provided to sell-side boards of directors.



What Is the Work Product?

The work product of a fairness opinion analysis is typically delivered to the client in the form of a letter. The content of the fairness opinion letter generally contains the following elements:

1. The purpose and objective of the fairness opinion
2. A description of the proposed transaction
3. A list of the documents and agreements that were relied on and any additional due diligence performed by the financial adviser such as a site visit or management interviews
4. Appropriate caveats regarding significant assumptions or conditions
5. A statement on significant limitations on use
6. A statement conclusion as to whether the proposed transaction is fair from a financial point of view

Notably, the standard fairness opinion letter does not include a detailed description of the financial and valuation analysis performed by the independent financial adviser. This information is often presented to the client in a separate oral or written presentation. For publicly traded companies, the valuation analysis and presentation may be summarized and publicly disclosed with the Securities and Exchange Commission.

The fairness opinion is:

1. specific to a particular party or transaction participant,
2. specific to the terms and structure of the proposed transaction, and
3. valid only as of the specified valuation date (typically, the date issued).

Fairness Opinion Analysis

A fairness opinion analysis is more broad in scope than a typical business valuation. Nonetheless, the business valuation process does play a role in the fairness analysis. Typically, the target company is valued as a going-concern business, using the generally accepted valuation methods of the income approach, market approach, and/or asset-based approach.

The business value for the target company is typically based on a highest and best use analysis. And, the target company value is typically estimated by using income approach valuation methods (usually the discounted cash flow method) and market approach valuation methods (usually the guideline publicly traded company method and the guideline merged and acquired company method).

The financial adviser typically uses a combination of these generally accepted business valuation methods to estimate a range of value for the target company equity. The concluded range of value can then be compared to the proposed transaction consideration to be received by the selling shareholders. The range of value may be specific to a particular interest in the company (i.e., a noncontrolling ownership interest) depending on the interest held by the client and the facts and circumstances of the transaction.

One component in estimating a range of value per share is the specified standard of value. Unfortunately, the phrase "fair from a financial point of view" provides little guidance as to the appropriate standard of value to apply in the fairness analysis.

In most states, the statutory standard of value for dissenting shareholder appraisal rights considerations is "fair value." This fact has led some financial advisers to believe that fair value is the appropriate standard of value to be considered in a fairness opinion. Other financial advisers believe that economic synergies may be considered in determining the target company fair value range.

In the case of a fairness opinion, there is no statutory standard (or definition) of value by which to perform the valuation analysis. Rather, the fairness of the transaction consideration should be evaluated based on the facts and circumstances of the particular proposed transaction.

In addition to a business valuation, the fairness opinion analysis may include an analysis of the terms of the proposed transaction financing.

Fairness opinion analyses for publicly traded companies may include an analysis of historical stock price, trading volume, and volatility. This type of stock price analysis may be helpful for:

1. determining the relative liquidity of the securities and
2. assuming the reasonableness of the proposed transaction acquisition price premium.

For transactions involving multiple classes of equity, relative fairness may be brought in to question. In order to determine relative fairness, the financial adviser may estimate and compare the expected rates of return earned by the selling shareholders with the inherent risk of the consideration received by the selling shareholders.

Solvency Opinions

Overview

A solvency opinion is a tool that may be used to support a leveraged corporate transaction. The very nature of a leveraged corporate transaction raises issues related to the consideration of a fraudulent conveyance. Solvency opinions are often performed either:

1. contemporaneously, as part of a proposed, leveraged transaction or
2. in hindsight, such as in bankruptcy or prebankruptcy cases that have fraudulent conveyance or preference payment implications.

This discussion focuses on solvency opinions that are provided as part of a proposed leveraged transaction.

A solvency opinion is intended to provide positive assurance that a proposed leveraged transaction will not result in undue financial stress to the debtor company and to its creditors.

A leveraged corporate transaction should not be considered a fraudulent conveyance if, after giving effect to the proposed transaction, it is determined that the:

1. fair value of the debtor company assets exceed its debts (the balance sheet test),
2. the debtor company is expected to meet its debt obligations (the cash flow test), and
3. the debtor company has a reasonable amount of capital going forward (the capital adequacy test).

What Is the Purpose of a Solvency Opinion?

The solvency opinion is a procedural tool that communicates that a particular transaction would not, in the normal course of business, render the debtor company insolvent. By obtaining a solvency opinion, the board of directors (and other parties to the transaction) has taken a step to protect itself against fraudulent conveyance claims relating to the transaction, should the debtor company ultimately become insolvent.

The issue of fraudulent conveyance may be relevant to many parties involved in a corporate transaction. A judicial determination of fraudulent conveyance can result in the following considerations:

1. The unwinding of the subject corporate transaction may be required.
2. A breach of fiduciary duty from directors and controlling shareholders to creditors may be found; directors and controlling shareholders may be held personally liable.
3. Selling shareholders risk the return of proceeds from the transaction.
4. Secured creditors risk the revocation of their liens and the subordination of their claims to other creditors.
5. Professional advisers may be required to return fees related to the corporate transaction.

The solvency opinion analysis examines three conditions to determine whether the proposed corporate transaction will result in the debtor company solvency. The three conditions provide the basis for a claim that a fraudulent transfer occurred at the time of the proposed transaction. These three conditions are defined in the U.S. Bankruptcy Code (Section 548), the Uniform Fraudulent Transfer Act, and the Uniform Fraudulent Conveyance Act.

A solvency opinion addresses the three conditions of a fraudulent transfer through the balance sheet test, the capital adequacy test, and the cash flow test as follows:

1. The balance sheet test seeks to answer the question: does the recorded amount of the debtor company liabilities (specifically including the proposed financing) exceed the fair value of the debtor company assets?
2. The capital adequacy test seeks to answer the question: does the debtor company have an unreasonably small amount of capital to run its business operations (after the proposed transaction)?
3. The cash flow test seeks to answer the question: does the debtor company have adequate cash flow to service all of its liabilities (specifically including the proposed financing) as those liabilities come due?

The solvency opinion and underlying solvency analyses may be an important tool for deal participants that have to consider transactional risk. The solvency opinion and analysis may be helpful to such parties for the following reasons:

1. The results of the solvency analysis may assist stakeholders in assessing the risk of whether the transaction may be characterized as a fraudulent conveyance in the event of a bankruptcy or other proceeding.
2. The existence of a solvency analysis and the documentation of associated stakeholder reliance may reduce the scope and risk of fraudulent conveyance litigation.
3. The existence of a solvency opinion provides evidence that the stakeholders took the necessary effort to avoid perpetrating the alleged fraud.
4. The existence of a solvency opinion demonstrates that the fiduciary exercised due care when deciding to enter the proposed transaction.

When Is a Solvency Opinion Appropriate?

Solvency opinions may be appropriate for any leveraged corporate transaction. Solvency opinions are provided for leveraged dividend recapitalizations, stock buybacks, asset sales or transfers, debt refinancings, intercompany restructurings, divestiture spin-offs and split-offs, leveraged buyouts, leveraged payment of an expense/liability/large capital expenditure, and so forth.

The issue of fraudulent conveyance is impartial as to whether the debtor company is a closely held company or a publicly traded corporation. That is, solvency opinions are appropriate for both publicly traded and privately held companies that are entering a highly leveraged corporate transaction.

Who Is the Client?

Independent financial advisers may provide solvency opinions to the debtor company board of directors, private equity sponsors, chief executive or chief financial officers (to support officer solvency certificates), and/or secured lenders.

In the case of merger and acquisition transactions, both the buy-side and the sell-side boards of directors may seek a solvency opinion.

Solvency Analysis

As stated previously, the three financial tests for identifying a fraudulent conveyance are:

1. the balance sheet test,
2. the cash flow test, and
3. the capital adequacy test.

Each of the fraudulent conveyance tests results in a "pass" or "fail" indication. In order for the corporate transaction to not be considered a fraudulent transfer, all three tests should be "passed."

Balance Sheet Test

The balance sheet test is applied to determine whether, after considering the effects of the proposed transaction, the total fair value of the debtor company assets is greater than the total amount of its liabilities. The balance sheet test measures solvency as of the transaction date.

The first procedure in the balance sheet test is for the financial adviser to consider the highest and best use of the debtor company assets. The highest and best use analysis indicates the appropriate premise of value for the valuation aspects of the solvency analysis. A common premise of value is value in continued use, as part of a going concern business enterprise.

Second, the financial adviser estimates the fair value of the debtor company assets. The fair value of all tangible and intangible assets should be measured. Typically, the financial adviser will conduct a valuation analysis of the debtor company to estimate the fair value of the debtor company operating assets. The financial adviser may consider the income approach, the market approach, and the cost approach in the valuation of the debtor company assets.

Third, the financial adviser determines the amount of the debtor company liabilities, including all current, long-term, and contingent liabilities. The proposed transaction financing is included in the estimate of liabilities.

Fourth, the financial adviser subtracts the amount of the company total liabilities from the fair value of the company total assets.

The balance sheet test is "passed" if the fair value of the debtor company assets is greater than the amount of the debtor company total liabilities.

Cash Flow Test

The cash flow test analyzes the debtor company's ability to meet its debt obligations as these obligations come due.

The first procedure in the cash flow test is to project the debtor company expected cash flow over the repayment period for the proposed financing. The cash flow projection includes both principal and interest payments on the proposed financing and any other transaction-related expenditures.

The next procedure in the cash flow test is to estimate the cash flow available to meet the debt service obligations. This procedure typically involves an analysis of:

1. projected cash flow from operations throughout the projected period,
2. any excess cash available on the transaction date, and
3. the availability of any unused credit commitments.

The financial adviser should be aware of the covenants of the proposed financing and should compare the specified coverage ratios in the financing agreement to the projected debtor company covenants.

The cash flow test is "passed" if the debtor company can (1) pay its projected debt obligations from any of the three aforementioned sources of cash and (2) remain in compliance with all of its debt covenants.

As part of the cash flow test, the financial adviser typically performs a sensitivity analysis to "stress test" the cash flow projection. The sensitivity analysis is performed by altering various cash flow projection variables (i.e., projected revenue and profit margin) to determine whether the debtor company can meet its debt obligations under a variety of alternative operating conditions.

The Capital Adequacy Test

The capital adequacy test measures whether the debtor company is engaged in a business or a transaction for which it has an adequate amount of capital. The capital adequacy test determines whether the debtor company has adequate capital to meet its:

1. operating expenses,
2. capital expenditure requirements, and
3. debt repayment obligations.

The goal of the capital adequacy test is to evaluate the likelihood that the debtor company will survive potential business fluctuations over several quarters following the transaction date.

The capital adequacy test involves an analysis of short-term sources and uses of funds, typically for the four fiscal quarters after the transaction date. The financial adviser typically considers various operating scenarios, in addition to debtor company management's projected operating performance.

The capital adequacy test is "passed" if the debtor company is expected to have sufficient cash on hand to pay its (1) operating expenses, (2) capital expenditure requirements, and (3) debt repayment obligations.

How Are Transaction Opinions Priced?

The professional fee structure for transaction opinions is primarily related to the level of risk associated with the opinion. Transaction opinions that are issued to multiple parties and relied on by multiple parties will have greater risk and higher fees than transaction opinions that are issued and relied on by one party.

Furthermore, the level of risk associated with a transaction opinion increases based on the transaction opinion's level of disclosure. An opinion that is issued publicly will have greater risk and higher fees than an opinion that is not publicly disclosed.

Transaction Opinion Provider Independence

Transaction opinions may serve as tools for fiduciaries in the process of assessing pending transactions. While transaction opinions may be provided by parties to the deal (i.e., investment bankers or company management), courts have consistently favored transaction opinions provided by independent financial advisers.

In a recent survey[2] conducted by FTI Capital Advisors, 76.5 percent of respondents indicated that fairness opinions provided by independent financial advisers were "very effective" at defending the decisions of boards of directors, whereas only 9.8 percent of respondents found fairness opinions provided by an investment bank involved in the transaction to be "very effective."

". . . the level of risk associated with a transaction opinion increases based on the transaction opinion's level of disclosure."

Despite these survey results, a data sample of recent transactions suggests that only 9 percent of boards used fairness opinions from independent financial advisers.[3]

Summary

In today's litigation-prone transaction environment, a transaction opinion provided by an independent financial adviser may be an effective procedure to defend a fiduciary's decision making regarding a proposed corporate transaction.

Some of the criteria for selecting a financial adviser to perform a transaction opinion include that the financial adviser (1) is independent; (2) has experience in performing valuation analyses, specifically with respect to providing transactional opinions; and (3) has experience performing analyses in the subject industry.

Because the ultimate audience for transaction opinions may be a court of law, it may be helpful that the financial adviser has the appropriate experience and expertise to convince a judicial finder of fact that he or she is professionally qualified to perform the transactional analysis.

Notes:

1. "FTICA Fairness Opinion Landscape," FTI Capital Advisors (February 2014).
2. "State of Transaction Opinions—Optimizing Opinion Defensibility," FTI Capital Advisors (September 2014).
3. "FTICA Fairness Opinion Landscape," FTI Capital Advisors (February 2014).

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