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2

FAIRNESS OPINIONS IN AFFILIATED PARTY TRANSACTIONS

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I. INTRODUCTION

This article discusses fairness opinions in affiliated party transactions and focuses on the following topics: what fairness opinions address, what "fairness" means, criticism of fairness opinions, Delaware law's impact on their content and use, FINRA and SEC requirements, and valuation methods employed.

Our recommendations and comments are italicized and placed in a paragraph under the relevant text.

Affiliated party transactions, also known as related party transactions and non-arm's-length transactions, include the following:

- going-private transactions through a negotiated merger (one-step freezeouts),
- going-private transactions through a two-step transaction (two-step freezeouts – a tender offer followed by a short-form merger),
- going private through a reverse stock split,
- leveraged buyouts with management participation,
- recapitalizations,
- material sales of particular parts of a business to insiders,
- transactions in which high-vote shares receive greater consideration than low-vote shares, and
- transactions in which insiders receive different consideration from other shareholders.

A. What Do Fairness Opinions Address?

A fairness opinion is a letter report that states whether or not a transaction, or the consideration paid in a transaction, is fair from a financial point of view to a group of constituents as of a specific date. It is addressed to the fiduciaries responsible for determining whether the proposed transaction should be recommended on behalf of these constituents. Fairness opinions are normally prepared by a knowledgeable financial advisory firm, generally an investing banking firm or a

valuation firm. An opinion of fairness from a financial point of view expresses the financial advisor's conclusion, supported by its analyses that the financial terms of a proposed transaction fall within a range to which the parties might reasonably agree. The opinion letter sets forth the assumptions, limitations and procedures relevant to the conclusion.

B. What is Financial "Fairness?"

A determination of financial fairness weighs what is being given up against what is being received in a particular transaction. The financial advisor determines a range of values based on various valuation approaches, giving consideration to current financial data and expected future results. Unlike a valuation, a fairness opinion does not determine a specific dollar value of a company, but instead determines whether the proposed transaction is financially fair based on the terms of the transaction and on market conditions at the date of the opinion.

It is important to note that even if a proposed transaction is deemed fair, it does not mean that the proposal must be accepted. Directors may exercise their business judgment to reject a proposed transaction even if the consideration offered is fair. Furthermore, a fairness opinion is not a recommendation that the parties enter into a transaction; it merely provides a basis for decision-making and is only one of the factors the decision-makers should consider.

C. The Widespread Criticism of Fairness Opinions

There have been extensive criticisms of fairness opinions in affiliated party transactions in the financial press,[1] in academic articles,[2] and in the courts. The fact that fairness opinions are necessarily subjective can lead to different views, and the quality of the analyses has often been questioned. The criticisms, however, go deeper. The principal criticisms address:

- opinions that are conflicted because a major portion of the fee is contingent on closing,
- perceived bias because of past and potential future relations between the opinion-giver and the acquiror,
- an appearance that analyses are manipulated to achieve a pre-determined result, and
- the extensive use of disclaimers in the opinion letter.

D. Fairness Opinions in Affiliated Party Transactions

By their nature, going-private and other affiliated party transactions may be subject to controller opportunism. In these transactions, a public company's board of directors usually appoints an independent committee that engages an independent firm to render a fairness opinion.[3] The opinion report with its financial analyses evidences that the fiduciaries' approval is based on consideration of the transaction's benefit for the minority shareholders. A fairness opinion provides decision-makers with information which may affect their decision, and it confirms in litigation that they used reasonable business judgment in approving the transaction. In addition, summaries of the financial analyses underlying the opinion are provided to minority shareholders in the proxy statement or tender offer to assist in their decisions.

1 See, *e.g.*, Andrew R. Sorkin, "Mergers: Fair Should Be Fair," N.Y. Times, Mar. 25, 2005.
2 See, *e.g.*, Steven M. Davidoff, "Fairness Opinions," 55 Am. U. L. Rev. 1557 (2006).
3 There is one exception: Delaware exempts short-form mergers from a fairness requirement (*Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2000)). Under Delaware law, a controller who owns at least 90% of each class of stock may consummate a "short-form" merger without a shareholder vote. The shareholder's only remedy is appraisal.

II. DELAWARE'S INFLUENCE ON FAIRNESS OPINIONS IN AFFILIATED PARTY TRANSACTIONS

The Delaware courts have effectively set the standards for reviewing fairness of corporate affiliated party disputes. Delaware corporate law is widely accepted and a majority of listed companies are incorporated in Delaware.

A. Delaware Requires Financial Advisors for Freezeouts

Delaware requires that when a freezeout is proposed, the independent committee must be given the ability to hire their own independent financial and legal advisors and be given sufficient time to react. Moreover, the shareholders must be given adequate summaries of the advisor's analyses to enable the shareholders to make an informed judgment.[4] Although a 2000 Delaware decision held that "fairness opinions … are not generally essential as a matter of law, to support an informed business judgment,"[5] later decisions began to call for them.[6] A 2010 decision on this issue, *CNX Gas*, not only effectively mandated fairness opinions in freezeouts but spelled out as well that unless the independent committee affirmatively recommends the transaction based on its financial advisor's opinion, the Court will subject the transaction to a strict standard of scrutiny ("entire fairness" review) rather than the more lenient "business judgment" review.[7]

The fairness opinion requirement, along with the necessity of the independent committee's positive recommendation to the minority shareholders based on it, arose from freezeout transactions. Although these decisions address freezeouts, we believe that the reasoning which requires an independent financial valuation as well as a positive recommendation could be expanded in the future to other types of affiliated party transactions.

B. Delaware Disclosure Requirements

The general rule in Delaware today is based on the Court's insistence that shareholders receive information that enables them to understand the basis of the independent committee's recommendation so that they can decide on their course of action. Directors have "a fiduciary duty to disclose fully and fairly all **material** information within the board's control."[8]

The key determinant as to information that must be disclosed is whether that information is **material** to the minority shareholder. If the Court has decided that a certain type of information, such as financial analyses, is material in the subject case, disclosure is required. The U.S. Supreme Court in 1976 set forth the "materiality" standard that is still in force:

> An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[9]

4 *In re Pure Resources, Inc. Shareholder Litigation*, 808 A.2d 421, 445 (Del. Ch. 2002).

5 *Crescent/Mach I Partners v. Turner*, 846 A.2d 963, 984 (Del. Ch. 2000), citing *Smith v. Van Gorkom*, 488 A.2d 858, 876 (Del. 1985).

6 See *Pure Resources* at 445, *In re Cox Communications, Inc. Shareholder Litigation,* 879 A.2d 604, 624 (Del. Ch. 2005).

7 *In re CNX Gas Corporation Shareholder Litigation*, 4 A.3d 397, 412-3 (Del. Ch. 2010). The Court also ruled that the committee be empowered to elect to take appropriate defensive measures, such as a "poison pill." *Id.* at 414-5.

8 *Gantler v. Stevens*, 965 A.2d 695, 710 (Del. 2009), citing *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992).

9 *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

Vice Chancellor Leo Strine stated in *Pure Resources* (2002) that the general legal standards that govern plaintiffs' claims for disclosure of financial information are settled:

> [S]tockholders are entitled to disclosure of all **material** [emphasis added] facts pertinent to the decisions they are being asked to make. . . . [They] rely on those documents to provide the substantive information on which stockholders will be asked to base their decision whether to accept the merger consideration or to seek appraisal.
>
> As a result, it is the information that is **material** [emphasis added] to these various choices that must be disclosed. In other words, the S-4 and the 14D-9 must contain the information that "a reasonable investor would consider important in tendering his stock," including the information necessary to make a reasoned decision whether to seek appraisal.[10]

1. Delaware Does Not Require Disclosure of Data Sufficient for Independent Determination of Fair Value

Although the Courts agree that minority shareholders must have a basis for understanding how the Board came to its decision, Delaware does **not** require disclosure of all the extensive and detailed information necessary for minority shareholders or their advisors to conduct an independent valuation. Indeed, "Delaware law does not require stockholders be 'given all the financial data they would need if they were making an independent determination of fair value'."[11] The Court has said, "A disclosure that does not include all financial data needed to make an independent determination of fair value is not, however, per se misleading or omitting a material fact. The fact that the financial advisors may have considered certain non-disclosed information does not alter this analysis."[12] It observes that a minority shareholder who believes the transaction is unfair and wishes to conduct an independent valuation can undertake an appraisal action.[13]

2. Delaware Does Requires Summaries of Advisor's Financial Analyses

The Delaware Courts recognize the materiality of substantiated valuations and the necessity of disclosure to minority shareholders of the important information in the financial advisor's analyses.[14] Delaware requires that a detailed summary of the analyses underlying a fairness opinion be included in the documents sent to shareholders. The *Pure Resources* decision stated:

> [C]ourts must be candid in acknowledging that the disclosure of the banker's "fairness opinion" alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability.
>
> The real informative value of the banker's work is not in its bottom-line conclusion, but in the valuation analysis that buttresses that result. . . . [A] minority stockholder engaging in the before-the-fact decision whether to tender would find it material to know the basic valuation exercises that [the investment banker] undertook, the key assumptions that they used in performing them, and the range of values that were thereby generated.[15]

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10 *Pure Resources* at 448-9, citing *Zirn v. VLI Corp.,* 621 A.2d 773, 779 (Del. 1993).

11 *Globis Partners, L.P. v. Plumtree Software, Inc.,* 2007 Del. Ch. LEXIS 169 (Nov. 30, 2007) at *45, citing *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1174 (Del. 2000).

12 *In re General Motors (Hughes) Shareholder Litigation*, 2005 Del. Ch. LEXIS 65 (May 4, 2005) at *65.

13 Recent cases in which the Court deemed the disclosures adequate and pointed out the appraisal option are *In re 3Com Shareholders Litigation*, 2009 Del. Ch. LEXIS 215 (Dec. 19, 2009) at *21 and *In re Cogent, Inc., Shareholder Litigation*, 7 A.3d 487, 516 (Del. Ch. 2010).

14 As discussed below, the SEC also requires a summary of the fairness opinion analyses in going-private transactions.

15 *Pure Resources* at 449.

A 2010 decision similarly held, "[S]tockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice their board relied in reaching their recommendation."[16]

Although the summary must cover the various methods used by the financial advisor, it does not have to disclose whether or why the advisor's analyses deviated from accepted practices or from the Delaware standards for determining fair value.[17] In addition, if the financial advisor has performed its DCF analysis based on its own projections, there is no requirement to disclose these projections.[18]

In practice, these summaries of investment banker analyses are often of limited value to shareholders. The summaries give limited data such as ranges of value and the names of selected guideline companies and guideline transactions without presenting data for these companies. The summaries of DCF analyses give a range of value, discount rates, and the method of calculating terminal value but often give no other data. It is our belief that these summaries are therefore of limited value to shareholders. The Court should consider requiring that the valuation section of the advisor's presentation to the independent committee (which has to be filed with the SEC) be attached as an exhibit to the document sent to shareholders.

3. Summary of Management Projections Provided to Advisor Is Required

Delaware has ruled that a proxy statement should "give the stockholders the best estimate of the company's future cash flows as of the time the board approved the [transaction]."[19] The Court said:

> [S]tockholders must measure the relative attractiveness of retaining their shares versus receiving a cash payment, a calculus heavily dependent on the stockholders' assessment of the company's future cash flows. . . .
>
> It would therefore seem to be a genuinely foolish . . . inconsistency to hold that the best estimate of the company's future returns, as generated by management and the Special Committee's investment bank, need not be disclosed when stockholders are being advised to cash out. . . . Indeed, projections of this sort are probably among the most highly-prized disclosures by investors. What [investors] cannot hope to do is replicate management's inside view of the company's prospects.[20]

Nonetheless, even though a valuation analysis is heavily dependent upon the projections utilized, the Delaware Courts permit summaries and do not require detailed management projections to be disclosed.

When the disclosed management projections included no more than revenues, gross margin, operating profit, and EPS, the Court determined that "full disclosure of the projections would [not] alter the total mix of available information."[21] More recently, however, the Court in *Maric Capital* ordered that projected free cash flow be included in the summarized projections,[22] ruling that "management's best estimate of the future cash flow . . . is clearly material information."[23] In a situation

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16 *Cogent* at 511; see *Pure Resources* at 450.
17 *3Com* at *21.
18 *Id.* at *23.
19 *David P. Simonetti Rollover IRA v. Margolis*, 2008 Del. Ch. LEXIS 78 (June 27, 2008) at *30, citing *In re Netsmart Technologies, Inc. Shareholders Litigation*, 924 A.2d 171, 203 (Del. Ch. 2007).
20 *Netsmart* at 203.
21 *3Com* at *7, fn. 11 and *10.
22 *Maric Capital Master Fund, Ltd. v. Plato Learning, Inc.*, 2010 Del. Ch. LEXIS 115 (May 13, 2010) at *9.
23 *Id*. at *11.

where a company disclosed projections that the financial advisor had not used, the Court required that the projections relied on by the advisor also be disclosed.[24]

When projections were stale, the Court understandably ruled that no disclosure was required.[25] Similarly, the Court also did not require disclosure of projections that it deemed incomplete because they did not reflect known risks.[26]

In practice, the determination of what is material to the investor and important to the "total mix of information" varies within the Court of Chancery. The recent Maric Capital *decision (discussed above) requiring the disclosure of projected free cash flow is a positive step for investors.*

In our view, given the emphasis that the Delaware Courts have placed on DCF analyses in valuation cases,[27] *more detailed management projections should be disclosed.*

C. Delaware Requires that Financial Advisor's Conflicts Be Disclosed

"[C]onflicts of interest must be disclosed [whether or not] there is evidence that the financial advisor's opinion was actually affected by the conflict."[28] When an advisor had previously worked for the buyer, the Court criticized a proxy statement because it did not disclose "how much [the investment bank] was paid, whether it would have received the same payment even if it was unable to render a fairness opinion . . . or how much [it] has earned in recent periods from . . . members of the buyer group."[29] In a situation where the investment bank rendering a fairness opinion benefited from its ownership of securities, the Court ruled that the bank's entire benefit, including benefits as a debtholder and warrantholder, must be disclosed.[30]

The Court recognizes the conflict raised by contingent fees, stating that "the contingent nature of an investment banker's fee can be material and have actual significance to a shareholder relying on the banker's stated opinion."[31]

The Court also recognizes that projections prepared by a party with an interest in the transaction may be biased. It rejected a valuation based on projections prepared by an officer who bought a business from a company.[32]

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24 *Netsmart* at 200.

25 *In Re PNB Holding Co. Shareholders Litigation*, 2006 Del. Ch. LEXIS 158 (Aug. 18, 2006) at *69-70. "[O]ur law has refused to deem projections material unless the circumstances of their preparation support the conclusion that they are reliable enough to aid the stockholders in making an informed judgment." *Id.* at *60.

26 *In re CheckFree Corporation Shareholders Litigation*, 2007 Del. Ch. LEXIS 148 (Nov. 1, 2007) at *10-11.

27 See*, e.g., Grimes v. Vitalink Comm. Corp.,* 1997 Del. Ch. LEXIS 124 (Aug. 26, 1997) at *3 ("[The] discounted cash flow model [is] increasingly the model of choice for valuations in this Court."); *Gholl v. eMachines, Inc.,* 2004 Del. Ch. LEXIS 171 (July 7, 2004) at *20 ("This [DCF] method is widely accepted in the financial community and has frequently been relied upon by this Court in appraisal actions.").

28 *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 Del. Ch. LEXIS 174 (Oct. 2, 2009) at *56.

29 *Ortsman v. Green*, 2007 Del. Ch. LEXIS 29 (Feb. 28, 2007) at *4-5.

30 *Simonetti* at *26.

31 *Louisiana Municipal Police Employees Retirement System v. Crawford*, 918 A.2d 1172, 1191 (Del. Ch. 2007).

32 *McPadden v. Sidhu,* 964 A.2d 1262,1272 (Del. Ch. 2008).

D. Delaware Requires Independent Opinions in Affiliated Party Transactions

Recent Delaware decisions have been critical of independent directors who engaged firms that had recently advised the control shareholder or were otherwise conflicted.[33] The Court has stated that independent committees should hire their own advisors, holding that where an independent committee employed an advisor who had previously worked for the control party, the "conflict of interest robs [the] fairness opinion of its value as an indicator of fairness."[34]

Since the committee is responsible for negotiations with the control party, and the opinion-giver may function as the committee's de facto financial advisor in connection with these negotiations, the independence of the financial advisor is particularly vital.

1. Advisor Should Structure Its Fee to Maintain Independence

Fairness opinion fees are often about 25% of the customary M&A advisory fee for a transaction of the same size; however, most firms have a minimum fairness opinion fee. Assignments for independent committees sometimes include advisory work and assistance in negotiations.

Furthermore, the committee may contract to pay an incremental fee contingent on the advisor negotiating a higher price. This fee structure rewards the advisor for increasing the consideration paid to minority shareholders. This structure is unlikely to be judicially criticized.

The credibility of an opinion is harmed if the advisor's fee is substantially contingent on closing. Moreover, the fee structure should not give the appearance of favoring a positive opinion. The advisor's engagement letter should provide that the fee is payable whether or not its opinion favors the proposed transaction.[35]

E. Additional Criticisms by the Delaware Courts

The Court criticized opinions that are hastily rendered. In *Weinberger*, the seminal Delaware valuation case, the Delaware Supreme Court discussed the "cursory preparation of the [investment bank's] fairness opinion" in five days, but attributed the problem to the defendants, stating that "the rush imposed on Lehman Brothers by Signal's timetable contributed to the difficulties under which this investment banking firm attempted to perform its responsibilities."[36] More recently, when a fairness opinion was produced in a week, the Court derided the opinion as "pure window dressing intended by defendants to justify the preordained result."[37]

Also, the Court has faulted some opinions that considered what shareholders were receiving but did not weigh what insiders were getting. When high-vote shares received a substantial premium over low-vote shares, the advisor was faulted for failing to opine upon the relative consideration to be received by shareholders in each class.[38] In another case, the Court criticized the directors'

33 *Finkelstein v. Liberty Digital, Inc.,* 2005 Del. Ch. LEXIS 53 (Apr. 25, 2005) at *64, fn. 39; *Gesoff v. IIC Industries Inc.,* 902 A. 2d. 1130, 1150-1 (Del. Ch. 2006); *In re Tele-Communications, Inc. Shareholders Litigation*, 2005 Del. Ch LEXIS 2006 (Oct. 11, 2006) at *41.

34 *Gesoff* at 1150.

35 To demonstrate that the fee is not contingent on a favorable opinion, the engagement letter should contain language such as "The fee for our opinion is $XXX,000, of which 50% shall be paid upon execution of this letter and 50% shall be paid at the time we inform you that we are prepared to render our opinion."

36 *Weinberger v. UOP, Inc*., 457 A.2d 701, 712 (Del. 1983).

37 *In re Sunbelt Beverage Corp. Shareholder Litigation*, 2010 Del Ch. LEXIS 1 (Jan. 5, 2010) at *19.

38 *Tele-Communications* at *55. See also *Levco Alternative Fund Ltd. v. Reader's Digest Association, Inc*., 803 A.2d 428 (Del. 2002).

reliance on a fairness opinion regarding sale of a company that did not consider the concurrent sale of a subsidiary to a major shareholder.[39]

Opinions normally address only the fairness of the consideration to be paid in a given transaction. A transaction can be structurally unfair if certain inside shareholders are receiving materially different consideration than the outside shareholders[40] *or if a class of securities is receiving unjustifiably disproportionate consideration.*[41] *An opinion that the consideration is fair is misleading if the advisor has reason to believe that the transaction taken as a whole is not fair.*

III. GOVERNMENTAL AND PROFESSIONAL REQUIREMENTS FOR FAIRNESS OPINIONS

A. FINRA Rule 5150

The Financial Industry Regulatory Authority, Inc. ("FINRA"), the successor to the National Association of Securities Dealers, Inc. ("NASD"), is a non-governmental self-regulatory organization that has regulatory oversight over all securities firms that do business with the public. It regulates its members through the adoption and enforcement of rules and regulations governing business conduct of member firms.

FINRA Rule 5150 (formerly Rule 2290) became effective in 2007. It set forth disclosure and procedure standards applicable to all FINRA members who render fairness opinions. Although these standards are not explicitly applicable to non-member firms, all practitioners would be well advised to conform to them.

Rule 5150 requires that FINRA member firms have written procedures for approval of a fairness opinion, as well as procedures for internal approval of a fairness opinion. When an internal committee is used, the firm must have written procedures as to the process for selecting committee members, the qualifications for persons on the internal committee, and provisions for review and approval by persons not on the deal team. The committee can include someone on the deal team, but the committee must have a "balanced review."

Rule 5150 also sets forth specific required disclosures that must be made when fairness opinions are included in documents sent to public shareholders. The chart below shows the required disclosures and the customary responses to these requirements.

Disclosures required by Rule 5150	Customary disclosures in practice
1. Whether the member has acted as advisor to any party to the transaction.	1. Past engagements disclosed; hedged as to future engagements.
2. Whether compensation is contingent upon closing. (Amount does not necessarily have to be disclosed.)	2. Whether compensation is contingent is disclosed; compensation amount is often (but not always) disclosed.

39 *Alidina v. Internet.com Corp.*, 2002 Del Ch. LEXIS 156 (Nov. 6, 2002) at *25.
40 *Hammons* at *55-56.
41 See *Tele-Communications* and *Levco*.

3. Any material relationships between the member and any party to the transaction (i) during the preceding two years or (ii) mutually understood to be contemplated	3. Past relationships are disclosed; no disclosure as to future relationships.
4. Whether an internal committee approved fairness opinion.	4. Disclosed.
5. Whether the member has independently verified any company-supplied information that formed substantial basis for its opinion. If so, describe the information verified. (When no information is verified, a blanket statement is sufficient.)	5. Blanket statement that no company-supplied information has been verified by the advisor.
6. Whether the opinion expresses a view as to the fairness of any compensation to officers and directors relative to the payment to public shareholders.	6. No opinion is expressed as to the fairness of compensation to any officers or directors.

B. SEC Rule 13e-3 Fairness Opinion Disclosure Requirements

The SEC has established rules with respect to disclosure in going-private transactions.[42] The actual opinion letter and a summary of the fairness opinion analyses must be included in the proxy statement or tender offer document (Form 14D-9) for the transaction. A description of the substance of written and oral reports and opinions by the advisor must be included as well.

The summary of the analyses must include a discussion of each methodology used. Data such as multiples used in guideline company and guideline transaction analyses and discount rates used in DCF analyses are included. Any limitation imposed on the scope of the investigation must be disclosed. In its comment letters to the company, the SEC often requests supplemental information and may ask for additional disclosure.

Written reports supporting the opinion must be filed as exhibits and must made available at the company's principal office for inspection or copying by a shareholder's designated representative. Companies sometimes make the advisor's final report publicly available.

Any material relationship between the advisor and the company and/or its affiliates must be disclosed. The SEC's requirements are limited to disclosure; it does not require that the advisor be independent.

42 For purposes of Rule 13e-3, going private transactions include any transaction which would cause a class of equity securities to be delisted or to become eligible for termination of registration, or would cause the reporting obligations with respect to such class to become eligible for termination. Other types of affiliated party transactions are not subject to Rule 13e-3.

IV. FAIRNESS OPINIONS IN PRACTICE

A. Methods for Determining Fairness

As any valuation professional would expect, most fairness opinions are based on three methods: discounted cash flow, guideline companies, and guideline transactions (including control premiums). These approaches are normally used unless relevant information, such as reasonable projections or relevant guideline transactions, is not available.

Other approaches occasionally used include asset value, liquidation value, present value of a projected future price, a leveraged buyout model, value available in a recapitalization, target prices published by security analysts, a regression model, and industry-accepted rules of thumb (such as value per ton of steel or per cable subscriber).

The frequently stated Delaware preference for discounted cash flow as a valuation methodology makes the use of DCF mandatory whenever adequate projections are available. But DCF should not be used as the sole approach; other methods should be used to corroborate the conclusion.[43]

About half of the published fairness opinions use a "premiums paid" analysis, which compares the premium over market to be paid in the subject transaction to average premiums paid in other transactions.

The use of average premiums as a standard of fairness is conceptually wrong and statistically flawed. Historical premiums are a biased sample: they include only acquisitions of companies that buyers view as undervalued and exclude companies viewed as overpriced. The premium paid is a result, not a cause: each premium depends on specific facts. Depending on a company's value, a small premium could be fair or a large premium could be unfair.

1. Price Less Than the Highest Bid Can Be Fair

Directors may choose, in their business judgment, to accept an offer whose value is certain rather than a facially higher offer whose value is uncertain or conditional. For example, they may choose to accept (i) a cash bid rather than a higher bid that is subject to anti-trust or other regulatory approval and therefore has a risk of not closing; (ii) a cash bid rather than a bid in stock or debt with a greater current market value; or (iii) a lower bid because of a perceived risk in the higher bid's financing.

The financial advisor is justified in providing a fairness opinion that the selected proposal is fair after giving consideration to the facts and circumstances of the transaction.

2. The Need for Heightened Due Diligence in Affiliated Party Transactions

The due diligence for preparing a fairness opinion in an affiliated party transaction has to be conducted with skepticism. The valuator should recognize that management may have an incentive to prepare overly conservative projections. It is essential to review forecasts that had been made

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43 *In re Hanover Direct, Inc. Shareholders Litigation*, 2010 Del. Ch. LEXIS 201 (Sept. 24, 2010) at *5-6. ("[T]here are commonly accepted methodologies that a prudent expert should use in coordination with one another to demonstrate the reliability of its valuation. If a discounted cash flow analysis reveals a valuation similar to a comparable companies or comparable transactions analysis, I have more confidence that both analyses are accurately valuing a company.")

prior to the gestation of the proposal. The valuator should also review information provided to parties asked to assist in financing, since projections given to financing sources are less likely to be low-balled.

B. Appraisal Standards Set a Floor for Fairness

In Delaware, all frozen-out shareholders are entitled to receive at least the "fair value" of their stock, whether or not the structure of the transaction permits shareholders to use the appraisal remedy.[44] In Delaware and in a majority of other states, minority discounts, discounts for lack of marketability, and control premiums may not be considered when valuing shares in appraisal actions.

In arriving at a fairness opinion, the opinion-giver should consider the value of the minority shares under the appraisal standard, because appraisal value in the relevant jurisdiction represents a floor value for fairness. A cash or cash-equivalent transaction should not be considered fair if the consideration is below the price which the opinion-giver believes would likely be awarded in an appraisal action.

C. The Lack of Industry Standards for Fairness Opinions

No professional investment banking or valuation organization has yet proposed standards for fairness opinions. The SEC and FINRA rules do not address any standard that should be considered in determining the fairness of a transaction.

In practice, it is highly unlikely that any investment banking group would propose standards without prodding from the SEC. Members of the academic community have made "ivory tower" proposals involving such concepts as setting the methodology for determining discount rates and prescribing the weighting to be given to different valuation methods. These proposals appear to be impractical.

As the courts review and critique fairness opinions, they contribute toward the evolution of standards. Areas that the courts might conceivably address in the future include, among others, the impact of disclaimers on the credibility of an opinion, improved descriptions of the financial advisor's analyses, financial advisors' liability for questionable opinions, the impact on fairness of factors in addition to the consideration paid, and whether opinions need to be updated.

About the Authors

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Dr. Patterson is a consultant to Sutter Securities. She was an associate in litigation with Gibson, Dunn & Crutcher, taught law-related courses at Brandeis University, University of California at Santa Barbara, Mills College, and is a retired professor at San Francisco State University.

44 *Metropolitan Life Insurance Co. v. Aramark Corp.*, 1998 Del. Ch. LEXIS 70 (Feb. 5, 1998) at *6.