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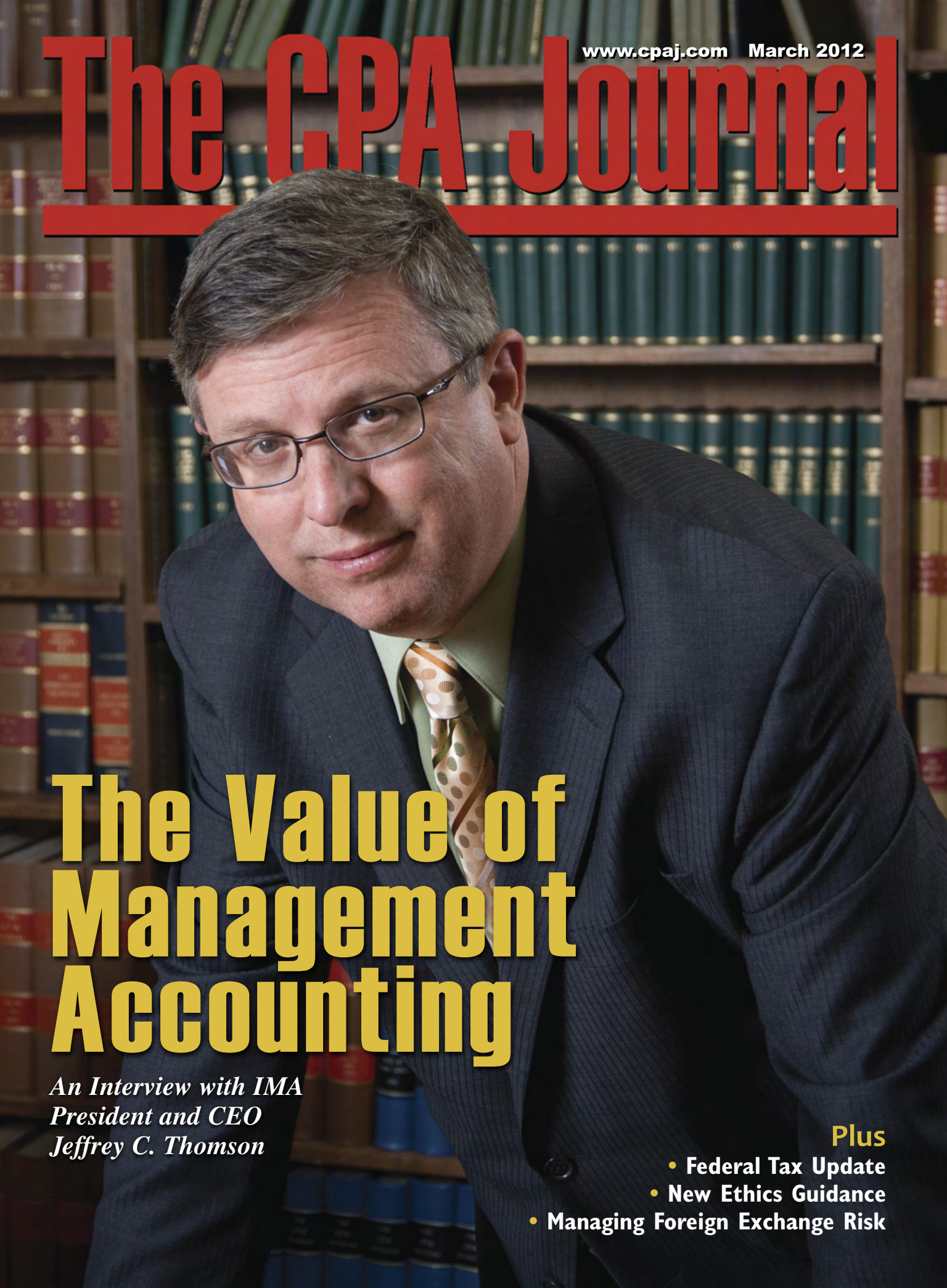

The Value of Management Accounting

An Interview with IMA President and CEO Jeffrey C. Thomson

Plus

- Federal Tax Update
- New Ethics Guidance
- Managing Foreign Exchange Risk

Using Fairness Opinions to Manage Risk in Middle-Market Transactions

By Brian A. Sullivan and Andrew C. Smith

Since the 2008 financial meltdown and the earlier enactment of the Sarbanes-Oxley Act of 2002 (SOX), there has been an ever-increasing outcry from the public for greater corporate transparency, accountability, and fairness. But this heightened awareness and perceived lack of trust in the markets has created a dangerous environment for boards of directors; they must now demonstrate that they acted prudently and fairly, and considered shareholders' opposing interests, whatever their stock—preferred, common, or convertible—when evaluating acquisition and divestiture opportunities. Failure to make this effort may cause a board to face costly litigation and even potential personal liability from an unhappy shareholder who feels slighted during the process.

Transaction fairness is an issue that affects more than just public companies. Traditionally, privately held middle-market companies have had little use for fairness opinions because such companies often have few shareholders or are owned by one group of family members. But as middle-market companies require more sophisticated capital structures to fund growth and expand into new markets, obtaining a fairness opinion may be worth the effort. Given the current litigious business environment, there is a growing demand for fairness opinions in the middle market, in part for the following reasons:

- Fast-growing companies often have a large number of shareholders, which is needed to raise capital but also increases risk and exposure.
- Down rounds of investment increase the scrutiny and potential acceptance of a transaction by minority shareholders.
- Growing private equity groups often find themselves with potential conflicts of interest, which a fairness opinion can help mitigate.
- Not-for-profit organizations may be divesting or acquiring a line of business that may create unintended consequence and unfavorable tax issues.

Effectively using fairness opinions created by outside advisors will ease the strain on board members to demonstrate their careful consideration of different shareholder groups' varying points of view. In addition, understanding fairness opinions and the legal precedent that applies to them can aid CPAs who advise CEOs, CFOs, and boards of directors on managing risk in proposed business transactions.

The Role of Fairness Opinions

A fairness opinion is an opinion from a financial advisor stating that a proposed business transaction is "fair from a financial point of view" as of a specific date.

The advisor usually issues the opinion to shareholders or to those with governance responsibility and fiduciary duties owed to the shareholders. It is viewed as both a necessity and a routine piece of information that a competent board of directors should consider when evaluating an offer to acquire a company.

A well-written and well-reasoned fairness opinion can assist in evaluating the merits of a proposal to buy or sell an asset, division, or company. It also acts as exculpatory evidence that a board followed a reasoned, deliberative process; thus, it can help defend board members against potential legal challenges from stakeholders for a breach of fiduciary duty and care.

The Value of Fairness Opinions

Corporations are separate legal entities held accountable to their stockholders. To meet this obligation, a corporation generally forms a board of directors to act as the interface between the corporate entity and the shareholders it serves. Board members have certain fiduciary duties—such as care, loyalty, and obedience—and can be held liable for breaching these duties if it is later determined that the board did not act with proper authority or care in meeting its charge to the various stakeholders. This can be a difficult area to negotiate because, in meeting this charge, the board must consider the merits of an acquisition mandate or a takeover bid from the perspectives of all classes of shareholders—and those different shareholder classes may have countervailing motivations. Thus, boards must be able to demonstrate careful deliberation when evaluating any potential acquisition opportunity or takeover bid.

Fiduciary Doctrines and a Board's Responsibilities

In order for a board of directors and its advisors to best understand a fairness opinion, they should familiarize themselves with established doctrine and precedent, as discussed below. A board should always keep its responsibilities in mind when evaluating fairness opinions.

Corporate fiduciary doctrine. Established corporate fiduciary doctrine applies two standards of review in this context: the business judgment rule and the entire fairness standard. The business judgment rule presumes that, in contemplation of any business decision, "the directors … acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" (*Aronson v. Lewis*, 473 A.2d 805, 812, Del. 1984). The entire fairness standard is limited to controlling takeover bids where a board or company's management may find themselves accused of acting in their own self-interest at the expense of other stakeholders. In this situation, the board has the burden of demonstrating that its conduct was entirely fair to the corporation and its shareholders, with regard to both process and price (*Weinberger v. UOP Inc.*, 457 A.2d 701, 711, Del. 1983). This doctrine requires the board to set forth a formal policy and procedure when evaluating a controlling takeover bid and considering its merits with respect to the benefit of all shareholder classes.

Generally speaking, if a disgruntled stakeholder can demonstrate that the board lacked independence when making a decision in this context, some courts (for example, the Delaware court) will apply the so-called entire fairness test. This takes away the business judgment rule's presumptions and shifts the burden onto the board (fiduciary) to prove that the process followed was fair (so-called fair dealing) and that the price achieved was fair. Typically, fairness opinions do not address the fair dealing element of the entire fairness test and instead concentrate on a fair price.

The fair dealing perspective of the entire fairness test looks at the various procedural elements of the transaction, including the following:

- Whether the transaction's timing benefited the proponents of the transaction to the detriment of the company or its minority shareholders (i.e., who initiated negotiations and why)
- Whether the transaction's structure favored insiders to the detriment of the company or its minority shareholders
- Whether the transaction's negotiations were conducted, controlled, or overseen by competent and independent individuals free of conflicts of interest
- Whether a competitive bidding process was implemented to maximize shareholder value
- Whether the directors were fully informed and provided with all relevant information
- Where shareholder approval was required, whether the shareholders were fully informed and provided with all relevant information.

The fair price component of the entire fairness test takes into consideration all of the economic and financial aspects of the transaction, including—

- market value of the company's shares,
- earnings (discounted cash flow analysis),
- underlying asset values,
- future prospects,
- potential synergies related to the transaction, and
- other elements that affect the proposed transaction's intrinsic value.

Precedent court cases. One of the fundamental court cases in addressing the need for a fairness opinion was *Smith v. Van Gorkom* (488 A.2d 858, Del. 1985). This

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case did not focus on the intentions or other motivations of the board, but rather on whether the board properly considered and informed itself of all reasonable information needed to make a proper decision. In this case, the board did not seek an independent advisor's perspective on the fairness of the proposed transaction, and the court determined that this failure to do so contributed to the board's breach of its duty of care.

The Delaware Supreme Court has provided further guidance regarding the fiduciary duty of a board and the standards of review, especially pertaining to defensive conduct in response to hostile takeovers. Privately held companies are rarely party to a hostile takeover; but as capital structures become more complex and create disparate shareholder classes, it may become more relevant and worthwhile for them to understand the basic conceptual precedents the court will consider in evaluating the board's conduct.

These new standards—known as "intermediate standards"—were developed between 1985 and 1988. Three legal precedents were established in the following landmark decisions:

- The *Unocal v. Mesa Petroleum Co.* (493 A.2d 953-54, Del. 1985) standard applies to cases where the board adopts a defense intended to preserve the company's independence.
- The *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (506 A.2d 173, Del. 1985) standard controls situations where the board, in response to a hostile bid, decides to sell the company or commit it to a change of control transaction.
- The *Blasius Industries v. Atlas Corp.* (564 A.2d 651, 662-663, Del. Ch. 1988) standard directs the board when it is engaged in defensive conduct that intentionally interferes with shareholders' voting rights—in particular, their right to elect a different board.

Unocal represents a landmark shift in the court's understanding of the paradox of a board faced with the possibility of a hostile takeover. This type of situation contemplates the board acting in a competing and contradictory way, looking to protect its own interest rather than the interest of the corporation and its shareholders. To deal with this issue, the court established an intermediate standard of reasonableness: A board must demonstrate that its defensive actions were objectively reasonable and, therefore, qualify for treatment under the business judgment rule. To meet this charge, the board must prove that a hostile takeover was reasonably understood as a threat to corporate value and policy, and that the board's selected actions and responses were not disproportionate to the threat.

Revlon deals with another wrinkle that a board may face when defending against a hostile takeover attempt—in particular, a situation where the board has initiated one course of action in an effort to dismantle corporate ownership structure, but later changes that strategy to sell the company to another party. The ruling in *Revlon* holds that, in this situation, the board's fiduciary duty is to sell the company to the highest bidder without losing sight of this primary overriding objective.

Blasius deals with the use of "poison pills" as an antitakeover defense. Poison pills are options designed to massively dilute the bidder's target stock ownership percentage at exercise and thereby denigrate the economic underpinning of a takeover attempt. Initially, the poison pill defense was very effective in defeating hostile takeovers. As time went on, however, an effective counterstrategy developed that called for the proxy contest to be resurrected and combined with a hostile tender offer. Conducting a proxy solicitation to remove incumbent target directors and replace them with board candidates sympathetic to the bidder's cause would assure the bidder that the poison pill would be redeemed and thus would not dilute the offer. To disrupt this strategy, a countermeasure would be developed whereby the board would amend the organization's bylaws to increase the size of the board. By filling the new positions with management-friendly designees, the incumbent board would maintain command and control.

Reviewing fairness opinions. A board should not simply file a fairness opinion upon receipt. As part of a board's efforts in exercising its fiduciary duty, it has an obligation to review and discuss a fairness opinion that it receives. It is not uncommon for a board or a designated board member to review the details of a fairness opinion, paragraph by paragraph, with its preparer.

Typically, the board engages experienced investment bankers or business valuation professionals familiar with the industry to render an official opinion as to whether the contemplated transaction is fair from a financial point of view. The fairness opinion itself is typically presented to the board in a detailed written analysis that includes ranges of values for recent transactions in the industry, current multiples, industry trends, and a discounted cash flow analysis. Ideally, the results of the individual valuation approaches should be consistent with the overall valuation range for the transaction.

In reviewing any fairness opinion, it is common for the report to include multiple valuation approaches and analyses to support the conclusion about a transaction's fairness. Different valuation professionals can choose different approaches. Thus, boards should understand why the opinion includes certain approaches and analyses while ignoring others.

Beware conflicts of interest. For many years, it was standard practice for an entity to prepare a fairness opinion even though it was also acting as the investment banker for the transaction. Boards should also consid-

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er the inherent conflict of interest in situations where the entity that provides a fairness opinion also acts as financial advisor to the transaction and is compensated based on the successful closing of the transaction.

This type of conflict of interest has drawn the attention of regulators. In 2007, the Financial Industry Regulatory Authority (FINRA) drafted Rule 2290, Fairness Opinions, which requires FINRA members to expand disclosure requirements about potential conflicts and impose internal and procedural review requirements on the entity providing an opinion. With this in mind, boards may wish to obtain a fully independent fairness opinion to mitigate any potential hint of conflict and avoid this issue from surfacing on a later date.

The Limitations of Fairness Opinions

A fairness opinion is not a judgment that the process leading up to a proposed transaction was necessarily fair. It does not comment on the fairness of the transaction's legal merits, nor does it serve as a recommendation to accept the proposal. A fairness opinion focuses on the proposed fairness of the transaction from a financial point of view only.

It is also important to recognize that a fairness opinion focuses on analyzing whether the transaction is within a range of fairness and not whether the transaction represents the best price and terms in the market. Rendering an opinion on the fairness of a transaction from a financial point of view does not include an opinion on whether to consummate the transaction or whether it is legally sound. It is the responsibility of the board of directors to decide whether completing the transaction is the appropriate business decision, and it is the responsibility of the company's legal counsel to advise on legal matters.

Implications

Fairness opinions can serve as effective tools for evaluating the fairness of acquisition or divestiture opportunities and can assist a board of directors in demonstrating that it acted prudently for the benefit of all of the various shareholder classes and interests. In this environment, it is important for any board to be able to document its process in evaluating the merits of any significant corporate action. Prior knowledge of fairness opinions helps CPAs provide guidance to management when faced with a proposed business transaction. ❑

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