Raising the bar for fairness opinions

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It has been 28 years since the Chancery Court of Delaware established that public company boards of directors are obligated to do their own level of diligence surrounding proposed transactions. Although the court still does not require seeking a third-party opinion on a transaction's fairness from a financial point of view, the day it cited a board's failure to obtain a fairness opinion as a breach of director duty of care made the practice an almost essential part of every public transaction. In the intervening years, increased corporate and shareholder scrutiny and litigation all contributed to a higher demand for fairness opinions. Recently, not only have we seen a greater level of requests for them, we have also noted a focus on decoupling the transaction advice provider from the fairness opinion provider, thereby eliminating the potential for a conflict of interest. In addition, fairness opinions are demanded more by the seller's board of directors, who have a heightened level of concern about disputes and challenges. Increasing value and reducing liability through this corporate governance tool is a powerful motivator that isn't going away any time soon.

What is a fairness opinion?

Rather than providing a valuation or a recommendation of a specific price to transact, the fairness opinion evaluates whether the transaction price is within an observable range of potential transactions. A fairness opinion is not meant to tell buyers or sellers whether they are getting the highest or best consideration in a transaction; instead, it states whether a deal is fair given a specific set of assumptions at the time. When third parties provide an opinion as to whether a transaction price is fair from a financial point of view, it indicates that the consideration meets or exceeds a certain threshold.

Obtaining a second independent fairness opinion is not as expensive as it might seem. Because the cost of an original fairness opinion is baked into the transaction adviser's total fee, unless the transaction doesn't close, only the second opinion would be an incremental cost. Some of the specific functions of a fairness opinion are to aid in decision-making, mitigate risk and enhance communication. The cost of a lawsuit would most likely exceed the second opinion significantly.

Who needs fairness opinions?

Traditionally, public company boards on both sides of a merger where shareholder approval is required often will obtain a fairness opinion. They have a duty of care and loyalty, which calls for them in their role as fiduciaries to show that a transaction meets the requirement of entire fairness. An acquirer might also seek a fairness opinion if the transaction is subject to shareholder approval or the transaction is deemed financially onerous or dilutive to the acquirer's shareholders. On the other hand, boards of public company sellers will almost always seek a fairness opinion to fulfill their fiduciary duty.

A fiduciary should seek a fairness opinion in their review of:

- M&As
- Tender offers, particularly those involving the buyout of minority shareholders
- Private placements
- Management buyouts
- Corporate restructuring, including going private or delisting
- Loan covenant requirements
- Down round capital raises
- Related-party transactions
- Sale of a portfolio company owned by a private equity fund to another affiliated fund

Some board members engaging in transactions that are not subject to shareholder approval might also seek fairness opinions. The following thresholds will help these buyers determine whether or not a fairness opinion is recommended.

- If a public company buyer is so much larger than its target company, then the transaction might be deemed immaterial to the buyer and the need for shareholder approval is mitigated; the board may not seek a fairness opinion. However, larger and more material transactions present potential dilution to the shareholders or might place the buyer at risk of failing to meet ongoing obligations due to the amount of cash required. In these cases, the board would probably be advised to seek a fairness opinion.
- Related-party transactions, such as a transaction between a company and one of its major shareholders or another affiliated party, might also prompt a request for a fairness opinion to help fulfill the controlling shareholder's fiduciary obligation to maximize shareholder value in the face of potential conflicts of interest. For example, an individual might control 60% of Company A and 80% of Company B and need to look after the minority shareholders of each company.
- Inter-fund transactions — where a private equity fund sells a portfolio company to a sister fund within the private equity families of funds — might also trigger the need for a fairness opinion, to indicate to the board and the limited partners that the related-party transaction was fair.

Help for global entities

As countries around the world seek to reduce costs and raise revenue in the face of the ongoing debt crisis, higher tax rates will drive some global public companies to revisit where they want to be headquartered or have a significant presence. Such reorganization of an existing organization's legal structures and how it operates globally to increase cash flows may require fairness opinions.

Even in the best of times, boards and management of global entities might seek fairness opinions as they embark on the following activities:

- Re-evaluating where they want to place significant operations and intangible assets to maximize their cash flow. That might mean moving intangible assets into jurisdictions that are more favorable to that type of operation or asset.
- Reorganizing ownership structures to consolidate operations to gain certain levels of improved performance and centers of excellence to maximize the future potential cash flow.
- Selling a subsidiary to another subsidiary to effect change in the organizational structure with consequences to minority shareholders. For example, local management might have an equity interest in a subsidiary, so it might be only an 80%-owned subsidiary. Management might own 20% or share it with creditors that are considered stakeholders in that business. Moving to a different structure could result in dilution or losing some control over the collateral value of assets for a lender. The challenge is to make sure that you are receiving fair compensation for transferring the asset or operations to another corporate structure.

When debt is at the door

Protecting the interest of all stakeholders may call for attention not only to common stock and equity holders, but also to other stakeholders, including lenders and other creditors. Any business with stakeholders that is winding down, selling off assets and giving up control of the business is strongly recommended to obtain a fairness opinion to help meet the fiduciary obligation for getting a fair price for all stakeholders. It is important to remember that a fairness opinion does not mean the best deal possible; it just means a fair deal.

When companies do not have the cash on hand to pay down debt that is coming due, management is faced with alternatives, which for better or worse, are all going to have an impact on stakeholders. A fairness opinion may be advised when raising capital in order to pay down the debt with another debt issuance, which might have favorable or unfavorable terms compared to the debt that is coming due.

When a plan of reorganization under Chapter 11 is contemplated, it might seem counterintuitive to pay for a fairness opinion, but the protection it provides from further problems, such as creditor's claims including fraudulent conveyance, could be priceless. Many fairness opinions are sought around private investment and public equity (PIPE) deals, in which common and preferred stock or convertible security is sold to private investors. Such transactions typically involve some kind of debt issuance that may be convertible and has warrants and other equity kickers as return enhancements to the investors of the PIPE.

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Occasionally, the analysis performed by financial advisers will not support a specific consideration to be fair. This indicates management, the board, counsel and the financial adviser have integrity as top of mind. This is an opportunity for the financial adviser to provide insight to the board on how to change key deal terms to make the transaction fair.

Perhaps the silver lining in the clouds of recent shocking corporate collapses and economic uncertainty is the illumination of more effective corporate governance practices and, hopefully, their contribution to future success. Raising the bar for those who have been entrusted with fiduciary obligations, such as boards of directors, is an important step toward greater transparency and protection of stakeholder interests, as well as minimizing future litigation liabilities.

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About Grant Thornton Financial Advisors LLC

We provide fairness opinions based on objective, independent analysis. Our professionals are highly skilled and credentialed and have extensive training in valuation, accounting and auditing, taxation, finance, economics, and investment banking. They are further equipped with technical training in finance, M&As, statistics, and economics, with extensive experience providing high-quality work involving confidential information with time-sensitive challenges.

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