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Are your directors relying on a strong, defensible fairness opinion?

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Merger-and-acquisition deal activity has significantly increased. Corporate acquirers are complementing organic growth through strategic acquisitions, and private equity firms are seeking to invest billions in capital. Increased competition for acquisition targets has led to heightened pressure on boards of directors to ensure that they are not approving overpayment for new acquisitions. In addition, board members of selling corporations are under increased pressure to receive fair consideration, or perhaps even more.

As a result, boards of directors and their legal counsel may be tasked with obtaining and reviewing fairness opinions in connection with the consummation of mergers-and acquisitions transactions. How do board members and their counsel know they have received a strong fairness opinion? What factors should apply when assessing the opinion's strength? When should they make more in-depth inquiries of their opinion provider?

This commentary will examine the importance of securing a strong fairness opinion. It will also discuss Delaware court rulings that found boards of directors relied on weak fairness opinions. These include *Koehler v. NetSpend Holdings Inc.*, No. 8373, 2013 WL 2181518 (Del. Ch. May 21, 2013), in which the Delaware Chancery Court discussed a relied-upon fairness opinion that was viewed as "weak."

FAIRNESS OPINIONS

A fairness opinion is one provided by a third party (an independent valuation firm or investment bank) as to whether a transaction is fair from a financial standpoint to a particular party. A fairness opinion opines on whether one receives "substantial equivalent in value" consideration. *Sterling v. Mayflower Hotel Corp.*, 93 A. 2d 107 (Del. 1952).

In the 1980s fairness opinions became much more commonplace after the Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), indicated that a board had breached its duty of care because of the lack of a fairness opinion or other reliable valuation in a corporate control transaction.

Delaware Stat. tit. 8, § 141(e)'s protective safe harbors for directors who reasonably rely on third-party fairness opinions further increased the importance of the opinions. This section of the Delaware Code states directors are "fully protected in relying in good faith … upon such information, or statements presented to the corporation by any of the corporation's officers or employees … or by any other person as to matters the officers or employees … or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence."

WEAK VS. STRONG OPINIONS

Although Section 141(e) provides boards of directors certain protections when they reasonably rely on third-party fairness opinions (even weak opinions) in good faith, it is important for directors to be aware of factual circumstances that make such opinions weak in the view of the Delaware Chancery Court.

NETSPEND CASE SUMMARY

NetSpend was a public company that provided prepaid debit cards to millions of people who did not have traditional bank accounts. In 2012 NetSpend and Total System Services engaged in negotiations for an all-cash acquisition transaction.

The final terms consisted of a price of $16 per share in cash, a no-shop provision, a 3.9 percent termination fee amounting to about $53 million and a 1.9 percent security breach threshold. On the last trading day prior to its receipt of TSS' first indication of interest at $14.50 cash, NetSpend's final trading price was $11.65.

In the litigation, the plaintiff shareholders asked the court to enjoin the acquisition of TSS because the transaction's "lack of a pre-agreement market canvas, negotiation with a single potential purchaser, reliance on a weak fairness opinion, agreement to forgo a post-agreement market check and agreement to deal-protection devices including, most significantly, a don't-ask, don't waive provision." The plaintiffs said the deal "was not designed to produce the best price for the stockholders."

Although the transaction process was procedurally flawed on many fronts, this commentary will focus on the fairness opinion and insight that the case can provide boards of directors and their counsel in determining whether they have an adequate fairness opinion.

The court identified several factors it said made the fairness opinion "weak," even though the opinion was provided by a bulge bracket investment banking firm. Specifically, the court said:

- The stock price was not a good indicator of the company's value.
- The comparable companies were dissimilar and did not have good utility in estimating the value of the company.
- The precedent transactions were old.
- The discounted cash-flow analysis indicated that the TSS offer was grossly inadequate and was based on financial projections that were outside the range of management's customary projections.

With respect to the first factor, the $16-pershare merger price was considered 20 percent below the bottom range of values implied by the discounted cash flow. The presence of the anomalous valuation made the fairness opinion a less reliable substitute for a market check. In fact, the defendants were reduced to arguing that the valuation was unreliable because NetSpend management typically prepared projections no further than three years out, making the fairness opinion's five-year analysis speculative.

ASSESSMENT AND RECOMMENDATIONS

- Ensure that multiple valuation techniques are used and that they accurately provide a real indication of the subject company's valuation.
- Heighten the level of diligence to confirm that comparable companies and comparable transactions used are truly comparable to the company being valued.
- Heighten the level of diligence if the acquisition price falls outside the valuation range for any valuation technique.

SO, WHAT'S A BOARD TO DO?

Dicta in the NetSpend ruling provides insight; the court said the board relied on a weak fairness opinion that was provided by a major Wall Street investment bank.

Boards of directors and their counsel can improve the likelihood of receiving a more defendable fairness opinion by making specific inquiries of their opinion provider and management as to whether:

- The valuation techniques that are used accurately provide a real indication of the subject company's valuation.
- The comparable companies and comparable transactions used are truly comparable to the company being valued.
- The acquisition price is outside the valuation range for any valuation technique.

RELIABILITY AND CONSISTENCY

Comparable companies and comparable transactions When working with an outside financial adviser on the development and delivery of a fairness opinion, boards, fiduciaries and/or corporate counsel should ask the following:

- Are the comparable companies truly comparable to the subject company?
- Are these the same companies that the subject company has been compared to in the past?
- What are the differences between the selected comparable companies and the subject company?
- Is the subject company affected by the same macro factors as the comparable companies?
- Do comparable companies have the same customers and end markets?
- Has the subject company's financial performance differed from the performance of the comparable companies?
- Should the comparable companies be placed into separate classes?
- What are the time frames of the comparable transactions data?

Valuation ranges

- Is the acquisition price within the indicated valuation ranges for each of the techniques? If not, with that indication are we receiving less than or more than fair consideration by that valuation range?
- Are there other non-standard valuation methodologies that it may be reasonable to consider?

Projections

- Were the projections developed similarly as they have been in the past? If so, please explain the differences.
- Are the projections conservative, moderate or aggressive?
- Are there factors that the board should consider that may not be reflected in the projections?
- How are these projections as compared to previous projections that may have been prepared?

CONCLUSION

Scrutiny of corporate-deal activity is not likely to decrease. If M&A activity climbs to its expected levels, dependable fairness opinions will become more and more important to boards of directors.

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