

## FAIR WARNING

ON THE PRECIPICE OF CHANGE: WILL CONFLICTS OF INTEREST FOREVER CHANGE THE FAIRNESS OPINION LANDSCAPE IN M&A DEALS?

BY HENDRIK JORDAAN AND BRETT SUCHOR

Conflict-of-interest issues that pervade fairness opinions are quickly becoming one of today's thorniest problems for corporate America. The M&A community is abuzz about the conflicts of interest that exist when an investment bank providing advisory services on a deal, generally with significant compensation tied to the deal's closing, also opines that the deal is "fair." As a frequently cited example, in the 2004 **J.P. Morgan Chase & Co.**-Bank One Corp. merger, J.P. Morgan obtained a fairness opinion from one of the "top five financial advisers in the world"—J.P. Morgan. In response to this issue, the NASD is considering regulating fairness opinions, and Congress may ask the Securities and Exchange Commission to step in.

Many view fairness opinion conflicts akin to investment banking conflicts that resulted in a separation between equity research and investment banking departments and accounting conflicts that resulted in a separation between audit and non-audit functions. Others consider fairness opinions to be under the same microscope as executive compensation. Meanwhile, boards of directors are demanding more fairness opinions than ever before.

Simply put, the entire M&A world is waiting for the ball to drop, and the end result could be far-reaching: investment banks divesting fairness

opinion practices, rigid NASD regulation, state regulation or anything in between. While no one can predict how the dust will settle, the result will have a lasting impact on how deals are done and where liability falls.

How did we get here? As the name implies, a fairness opinion expresses a view as to the fairness of the consideration to be paid or received in a transaction. Fairness opinions have a limited scope. They do not speculate on whether the price is the best available or the transaction is optimal. Instead, they simply state that consideration received is "fair from a financial point of view." Their use became prevalent after a 1985 Delaware case, *Smith v. Van Gorkom*, in which the court suggested that fairness opinions could evidence that a board fulfilled its duty of care. As a result, they quickly became status quo in many M&A transactions.

Citing concern about conflicts, the NASD recently entered the fray by seeking comment on a proposed rule that would generally require member firms to disclose fairness opinion conflicts of interest. The NASD proposal does not provide much detail, perhaps reflecting the difficulty of drafting rules that satisfy the concerns of all relevant constituencies. The comment letters are more revealing. For instance, the Securities Industry Association's letter argued that "there is no per se 'conflict' in hiring a member firm merely because that firm has existing or prior relationship with a particular company." On the other end of the spectrum, the AFL-CIO

called for an "outright ban on the most egregious conflicts, notably arrangements in which part of an investment bank's fee for rendering its opinion is contingent upon the transaction closing."

With the future of fairness opinions in the balance, what is a board to do? First, a board should be vigilant in identifying, thoroughly understanding and carefully considering all actual and potential conflicts of interests. This should extend to actual, and potential future, conflicts with the firm providing the fairness opinion, its affiliates, the company's affiliates and other individuals. The board should consider such conflicts against the backdrop of increased litigation and recognize that simply disclosing conflicts may not be enough to avoid a lawsuit. Second, the board should avoid making a fairness opinion contingent on the closing of the transaction.

Fixed-fee pricing, for example, will remove certain conflicts associated with contingent compensation. Third, the board should consider engaging an independent valuation opinion—either as the sole opinion or in addition to the adviser's fairness opinion. It is critical that the board understands the qualifications of the firm providing the independent fairness opinion and not compromise quality for independence.

What does the future hold? Millions of dollars in investment banking and legal fees hinge on the outcome of the fairness opinion debate. While the NASD has recently led the fairness opinion discussion, it appears it is only a matter of time before Congress, the SEC and perhaps

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even state regulatory agencies join the discussion. Additionally, there is little doubt that independent opinions, free of many of the conflicts that plague larger investment banks, are here to stay. Other questions remain: Will investment banks spin off their

fairness opinion practices or bolster their internal control programs? How will state courts respond to potential federal regulation of how boards of directors exercise their fiduciary duties? Regardless, change is in the air, and boards would be well served by

treading cautiously until the landscape becomes clearer. ■

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