

discussion at the full Committee meeting. The agenda for the full Committee meeting will also include some observations by Vice Chancellor Strine on remedies in mergers and acquisitions litigation (recorded earlier this year at the Annual Securities Regulation Institute in San Diego), a presentation on “sandbagging” provisions (or as I like to refer to them when representing a buyer, “benefit of the bargain” provisions) by the M&A Market Trends Subcommittee, and a discussion of some interesting aspects of the JPMorgan Chase – Bear Stearns transaction. We will also have a Delaware law update and a presentation by the Annual Survey Working Group of the M&A Jurisprudence Subcommittee on the *Genesco* and *United Rentals* decisions (those cases are described in the M&A Jurisprudence Subcommittee report beginning on page 18 of this issue of *Deal Points*).

The Business Law Section will hold its first Global Business Law Conference on Thursday, May 29, 2008 and Friday May 30, 2008, at the Westin Grand hotel in Frankfurt, Germany. It is not practical to have our normal full agenda of meetings in Frankfurt, but we will be well represented, presenting two programs, co-sponsoring a third and holding a few subcommittee meetings. I encourage you to consider attending the conference.

The 2008 Annual Meeting of the American Bar Association will be held in New York City from August 7, 2008 through August 12, 2008. The Business Law Section meetings will be from Friday, August 8, 2008 through Monday, August 11, 2008 at the Grand Hyatt Hotel (42nd Street, just to the east of Grand Central Station). The meetings of our Committee and its subcommittees, task forces and working groups will be held from Friday, August 8 through Sunday, August 10, 2008.

I look forward to seeing you in Dallas.

FEATURE ARTICLES

New Fairness Opinion Rule Now in Effect

Jeffrey S. Tarbell¹

“We believe there is inherent bias when a contingent fee structure is used in rendering any opinion. There is a very large incentive for an investment bank to find that a transaction is fair, regardless of the circumstances, when the bank will receive the bulk of its fee only if the transaction is successful.”

-- CalPERS comment letter on NASD proposed rule 2290

“We are totally conflicted — get used to it.”

-- Robert Kindler, vice chairman of investment banking at Morgan Stanley

Introduction

On October 11, 2007, the SEC approved FINRA’s proposed fairness opinion rule, which sets forth new procedural and disclosure requirements by FINRA members issuing fairness opinions that will be provided or described to public shareholders. The new rule became effective December 8, 2007, following three years of proposals, revisions, and abundant commentary.² The primary goal of Rule 2290 is to provide public shareholders

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² Securities and Exchange Commission (Release No. 34-56645), October 11, 2007.

with additional information about the potential conflicts of interest between fairness opinion providers and recipient companies. Rule 2290 is intended to complement existing SEC disclosure rules relating to fairness opinions.

FINRA (Financial Industry Regulatory Authority), formed in 2007 by the merger of the National Association of Securities Dealers (NASD) and some regulatory functions of the New York Stock Exchange, is a self regulatory organization for its member investment banking firms. Rule 2290 requires certain disclosures in fairness opinions when a member firm knows, or has reason to know, at the time a fairness opinion is issued, that the opinion will be provided or described to the client's public shareholders. FINRA's regulatory authority does not extend to nonmember firms, and the new disclosure obligations do not apply to fairness opinions that will not be provided or described to the client's public shareholders.

A Primer on Fairness Opinions

A fairness opinion is a statement of a financial advisor's opinion as to the fairness, from a financial point of view, of the consideration paid or received in a corporate transaction. While not formally required by rule or statute, fairness opinions have become a standard element of public corporate control transactions since 1985, when the Delaware Supreme Court held that a board of directors breached its duty of care by approving a merger without adequate information on the transaction, referring specifically to the board's failure to obtain a fairness opinion, among other things.³ From the perspective of boards of directors and other corporate fiduciaries, fairness opinions serve a number of useful purposes.

From a procedural standpoint, a fairness opinion provides evidence that the board sought

³ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

professional advice regarding the financial aspects of a proposed transaction. From a legal standpoint, a fairness opinion provides evidence that the board gathered all reasonably available information and exercised reasonable business judgment in its evaluation of a proposed transaction. Under the business judgment rule, courts generally will not second-guess the decisions of a board of directors (or find liability for honest mistakes) provided that such directors have acted (i) on an informed basis, (ii) in good faith, (iii) in a manner they reasonably believe to be in the best interest of the company, and (iv) without fraud or self-dealing.⁴

Background of the Rule

Rule 2290's origins can be traced to the Spring of 2003. Wall Street was still reeling from major corporate and accounting scandals, and the Sarbanes-Oxley Act was focusing corporate America's attention on conflicts of interest. Following his investigation into the integrity of equity research analysts, then-New York Attorney General Elliott Spitzer suggested that the target of his next inquiry might be Wall Street's fairness opinion practices. His premise was that a fairness opinion might not be reliable if issued by an investment bank that stood to receive a large success fee upon completion of the deal.⁵ Spitzer's attention to fairness opinions was soon preempted by the emerging mutual fund timing scandal. However, over the following 12 months, the issue garnered traction in the press and, ultimately, spurred the NASD into action.

In June 2004, the NASD reportedly sent letters of inquiry to several investment banks requesting information on the firms' fairness

⁴ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

⁵ Leddy, Patrick J., and Walters, Randall M., "Put the 'Fair' in Fairness Opinions," *Directors & Boards*, Spring 2005.

opinion practices for the prior three years. Not surprisingly, the requests apparently focused on services rendered, fee structures, and any legal actions regarding transactions with respect to which fairness opinions were rendered. The NASD reportedly requested additional information in September 2004, focusing on transactions where the member firm issued a fairness opinion *and* provided financing to any party to the transaction. Finally, in November 2004, the NASD issued a notice to member firms, and request for comments, regarding a potential new rule on fairness opinions. In its notice, the NASD identified the following concerns:

- investment banks rendering a fairness opinion may be inclined to opine favorably if a transaction is endorsed by company management;
- the potential for conflict is strong when the financial advisor will receive financial advisory fees upon successful completion of the transaction; and
- proxy disclosures may not be sufficient to inform investors about the subjective nature of fairness opinions and the potential biases.

The NASD received comments from several interested parties, including academics, bar associations, institutional investors, and investment banks. Not surprisingly, the institutional investors demanded more disclosure, tougher rules, and elimination of conflicts of interest. At the other end of the spectrum, firms in the financial services industry generally embraced enhanced disclosure, but resisted efforts to define a “conflict.”⁶

⁶ Securities and Exchange Commission (Release No. 34-56645), October 11, 2007.

In June 2005, the NASD filed its initial proposed rule with the SEC. Several amendments were filed during the following two years, with the SEC granting accelerated effectiveness to the fourth amendment in October 2007.

New Disclosure Requirements

Rule 2290(a) requires the member firm to disclose the following information within the fairness opinion.⁷

Disclosure Regarding Contingent Compensation. Rule 2290(a)(1) requires the member firm to disclose whether the firm has acted as a financial advisor to any party to the transaction that is the subject of the fairness opinion, and, if applicable, that it will receive compensation that is contingent upon the successful completion of the transaction, for rendering the fairness opinion, and/or serving as an advisor. Disclosure regarding contingent compensation is not required to be quantitative. Only descriptive information is required. In addition, FINRA explained that it does not believe a conflict exists simply because of the existence of a contingent fee arrangement. Rather, disclosure of the fee arrangement will enable shareholders to reach their own conclusion regarding the existence of a conflict.

Disclosure of Other Compensation. Rule 2290(a)(2) requires the member firm to disclose whether it will receive any other significant payment or compensation contingent upon the successful completion of the transaction. This rule is essentially a “catch-all” designed to prevent circumvention of Rule 2290(a)(1). This requirement would require disclosure of significant payments or compensation from related transactions (*e.g.*, financings) if such fees are contingent upon the completion of the transaction for which the

⁷ FINRA Regulatory Notice 07-54, “Fairness Opinions,” November 2007.

fairness opinion was issued. FINRA does not define “significant,” but it states that such payment or contingent compensation is one that a reasonable person would have an interest in knowing about in order to assess whether the member firm issuing the fairness opinion has a potential conflict of interest.

Disclosure of Material Relationships.

Rule 2290(a)(3) requires the member firm to disclose any material relationships that existed during the past two years (or that are mutually understood to be contemplated) in which any compensation was received (or is intended to be received) as a result of the relationship between the member firm and any party to the transaction that is the subject of the fairness opinion. This disclosure requirement pertains not just to material relationships between the member firm and its client, but to such relationships between the member firm and *all* parties to the transaction. For example, in the case of a takeover, a member issuing a fairness opinion to the target’s board of directors would also have to disclose any material relationships it had with the acquiror. However, Rule 2290 does not require disclosure of such relationships with affiliates of the member firm’s client or other parties to the transaction, or between the member firm and affiliates of its client or of other parties to the transaction.

Disclosure Regarding Verification of Information.

Rule 2290(a)(4) requires the member firm to disclose whether it has independently verified any of the information that was provided to it by its client and formed a substantial basis for the fairness opinion. When no such information has been verified, a blanket statement to that effect is sufficient. However, information provided by the member firm’s client that was independently verified must be described in the fairness opinion. Historically, issuers of fairness opinions have disclaimed any responsibility for independently verifying any information, and blanket

statements to this effect are expected to continue to be the norm in fairness opinions subject to Rule 2290.

Disclosure of Fairness Committee.

Rule 2290(a)(5) requires the member firm to disclose whether the fairness opinion was approved or issued by a fairness committee. While many, if not most, financial advisors—particularly larger firms—have historically required that all fairness opinions be approved by such a committee, specific policies and practices vary from firm to firm, and disclosure about the use of such committees was rare. The rule does not require the use of a fairness committee—which might be an issue for some very small firms with insufficient personnel—it merely requires disclosure as to whether the fairness opinion was approved by such a committee.

Disclosure of Insider Compensation.

Rule 2290(a)(6) requires the member firm to disclose whether the fairness opinion expresses an opinion about the fairness of the amount or nature of the compensation to insiders, relative to the compensation to the client’s public shareholders. Transaction-related compensation to insiders, such as severance, noncompete payments, and retention bonuses, are not uncommon and, in some cases, may lead to claims that such additional compensation diverts funds that should be paid to the public shareholders. Historically, fairness opinion providers have treated decisions about the appropriateness of such payments as outside of their core competencies and more properly within the purview of compensation consultants. Consequently fairness opinion providers have treated such payments as existing liabilities of the transaction participants rather than the proper subject of a fairness opinion. As a consequence, it is expected that most, if not all, member firms will disclose in their fairness opinions that the opinion does not address such payment.

New Procedural Requirements

NASD Rule 2290(b) requires that any member firm issuing a fairness opinion must have written procedures for approval of a fairness opinion. These procedures must address, among other things, the types of transactions and the circumstances in which the firm will use a fairness committee to approve or issue a fairness opinion. In those transactions in which the member uses a fairness committee, the firm must have procedures for (i) selecting personnel to be on the fairness committee, (ii) determining the necessary qualifications of persons serving on the fairness committee, and (iii) promoting a balanced review by the fairness committee, which shall include the review and approval by people who do not serve on the deal team. FINRA notes that whether a person is considered part of a deal team will depend on the nature and substance of that person's contacts and the advice rendered to the issuer.

Firms are also required to have a process to determine whether the valuation analyses used in the fairness opinion are appropriate. Rule 2290 does not go so far as to mandate the use of specific valuation analyses or methodologies (although, as hereinafter discussed, some commentators called for such requirements).

Too Watered Down?

The final approved version of Rule 2290 is less burdensome to member firms than the originally proposed rule. Some commentators have complained that the final rule largely overlaps the SEC's current disclosure rules regarding fairness opinions. For example, in its initial Notice to Members, the NASD proposed a requirement that fairness opinions contain "clear and complete descriptions of any significant conflicts of interest in issuing the

opinion."⁸ By contrast, the final rule requires firms to disclose only any "material relationships" with its client and other transaction participants.

Also, the original rule proposal filed with the SEC required member firms to have procedures to evaluate how the amount and nature of the compensation from the transaction underlying the fairness opinion benefit any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, are factors in reaching a fairness determination. By contrast, rather than have procedures, the final rule requires only that member firms *disclose* whether the fairness opinion expresses any opinion about the fairness of insider compensation relative to the public shareholders' compensation.⁹

The following were some of the other rules proposed by commentators or listed in the initial rule proposal filed with the SEC that were not ultimately adopted in the final rule:

- a requirement for independent fairness opinions from firms not otherwise involved in the transaction;
- specifically prescribed procedures, including mandated valuation methodologies;
- for each category of data provided by the issuer with respect to transaction participants, disclosure of whether the member firm has independently verified the data provided by the issuer; and
- mandated disclosure of the fairness opinion fee payable to the member firm.

⁸ NASD Notice to Members 04-83, November 2004.

⁹ Kalsi, Sonia, "Fairness Opinions in US M&A", *Financier Worldwide*, February 2008.

Impact of Rule 2290

As readers may have surmised by now, the disclosures required by Rule 2290 are largely redundant with the disclosures already required of issuers by SEC Regulation M-A, among others. There are, however, important differences. For example, under Rule 2290, member firms must ensure that the required disclosures are included in fairness opinions when issued, while the SEC rules require that the issuer or other filing party include the required disclosures in the proxy statement or other similar filing made with the SEC, often several weeks after the delivery of the fairness opinion. This represents a shift of responsibility and the regulatory agency responsible for the enforcement of the relevant rules.

Perhaps the most significant difference between the two rules relates to the material relationships required to be disclosed. While Rule 2290 requires disclosure of material relationships directly between the member firm and its client and other transaction participants (but not their respective affiliates), the SEC disclosure rules require disclosure of material relationships between the member firm, its client, *and their respective affiliates* (but not other transaction participants or their affiliates).

Additional disclosure will be needed with regard to whether the fairness opinion expresses an opinion about the fairness of the compensation accruing to insiders relative to the compensation to the company's public shareholders. The requirement that fairness opinions disclose whether the opinion was approved or issued by a fairness committee of the member firm is also a novel disclosure requirement.

In terms of its impact on the board's deliberation process, Rule 2290 should provide boards with some additional visibility into the relationships between their company and/or any other party to the transaction and the member

firm issuing the fairness opinion. Although, as a matter of good business practice, most financial advisors try to identify such relationships at the beginning of an engagement to avoid awkward surprises, the prospect of disclosures regarding these relationships in the fairness opinion itself may cause some boards to focus greater attention on this potential issue and consider the propriety of seeking a second opinion from an independent fairness opinion provider.

In terms of its impact on public shareholders, it is important to note that neither FINRA nor SEC rules require that a fairness opinion include sufficient information for the public shareholder to "recreate" the underlying financial analysis. This issue was recently addressed by the Delaware Court of Chancery, where the court held that "disclosure that does not include all financial data needed to make an independent determination of fair value is not *per se* misleading or omitting a material fact."¹⁰

In addition to the benefits accruing to boards and shareholders, another potential beneficiary of Rule 2290 is the plaintiff's bar. Armed with more information about the fairness opinion process, as well as a sort of "compliance checklist" in the form of the new rule, litigators are likely to challenge the propriety of analysis and disclosure in fairness opinions. 2007 saw no shortage of cases involving challenges to fairness opinion disclosure, including *Ortsman*,¹¹ *Caremark*,¹²

¹⁰ *Globis Partners, L.P. v. Plumtree Software, Inc., et al.*, 2007 WL 4292024, at *12, Parsons, V.C. (Del. Ch. Nov. 20, 2007). See also *Skeen v Jo-Ann Stores, Inc., et al.*, 750 A.2d 1170 (Del. 2000).

¹¹ *Ortsman v. Green, et al.*, 2007 WL 702475, Lamb, V.C. (Del. Ch. Feb. 28, 2007).

¹² *Louisiana Municipal Police Employees' Retirement System, et al. v. Crawford et al.*, 918 A.2d 1172 (Del. Ch. Feb. 23, 2007).

and *Netsmart*.¹³ While each of these cases focused on adequacy of disclosure regarding fairness opinions under Delaware law, the next round of such cases may attempt to leverage new claims from the disclosure requirements imposed on the member firms under Rule 2290.

With regard to transaction attorneys, it is important for counsel to be familiar with the disclosure and procedural requirements of Rule 2290. Even though the accountability for compliance falls on the member firm, the issuer will be poorly served if a fairness opinion provided or described to its public shareholders does not comply with Rule 2290.

Summary and Conclusion

Rule 2290 will provide increased transparency into fairness opinion practices and relationships between fairness opinion providers and transaction participants. Complying with the new rule should not be particularly burdensome to member firms. Critics continue to argue for standardizing the fairness opinion process. Calls for reform range from requiring the opinion to state whether a materially better price could have been obtained to establishing a standards-setting body that would dictate the valuation methods used in fairness opinions.¹⁴ However, fairness opinion providers continue to resist efforts to establish required standards and methodologies. The underlying analyses are tailored to the facts and circumstances of each particular transaction, and judgment is necessary to select appropriate companies and transactions for comparative purposes and to select appropriate discount rates and terminal multiple or growth rates when performing a discounted cash-flow

¹³ *In re Netsmart Technologies, Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007).

¹⁴ Davidoff, Steven M., "Fairness Opinions", Wayne State University Law School Legal Studies Research Paper Series No. 07-07, 2006.

analysis. As a consequence, subjectivity is unavoidable and, perhaps, even beneficial to the fairness opinion process. Issuers choose legal counsel from among hundreds of seemingly qualified law firms based on the perceived quality of the advice they will receive. A board of directors selecting a fairness opinion provider faces an analogous situation. The perceived quality of the provider's analysis and advice should be critical to the choice.

The Disclosure of Projections Under Delaware Law

By Michael B. Tumas and Michael K. Reilly¹

Over the past year, the Delaware Court of Chancery issued three decisions and one bench ruling that have fueled the debate concerning whether certain "soft information," particularly financial projections, must be disclosed as a matter of Delaware law when a corporation is seeking stockholder approval of a merger transaction.² Those decisions indicate

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² See *In re Netsmart Technologies, Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007); *In re CheckFree Corp. S'holders Litig.*, 2007 WL 3262188, Chandler, C. (Del. Ch. Nov. 1, 2007); *Globis Partners, L.P. v. Plumtree Software, Inc.*, 2007 WL 4292024, Parsons, V.C. (Del. Ch. Nov. 30, 2007); *In re BEA Systems, Inc. Shareholder Litig.*, C.A. 3298, Lamb, V.C. (Del. Ch. Mar. 26, 2008) (Transcript).