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Fairness opinions in the context of recent Delaware Chancery Court decisions: Q&A with Professor David Denis

The March 7 Delaware Court of Chancery decision on *Rural/Metro* underscored a new reality of heightened liability risk to financial advisors.[1] Damages risk was also stressed by its associated $75.8 million ruling on October 10, which exceeded those in *Del Monte* and *El Paso*, where the Court also focused on financial advisors' alleged conflicts of interest.[2]

In *Rural/Metro*, the Court found a financial advisor liable for aiding and abetting Rural/Metro's board of directors in breaching its fiduciary duties. This financial advisor allegedly did so in two ways. One, it allegedly did not disclose a potential conflict of interest concerning its intent to secure a buy-side financing role in the concurrent sale of a Rural/Metro competitor. Two, it allegedly submitted a valuation analysis in its fairness opinion that undervalued Rural/Metro in order to make the deal seem more attractive, approximately an hour before the board's deadline to approve the merger.

In this Q&A, we speak with Professor David Denis, who researched the empirical data on fairness opinions and published "Information Production by Investment Banks: Evidence from Fairness Opinions" last year in the *Journal of Law and Economics*.[3] This article directly examines whether financial advisors' fairness opinions tend to under- or over-value the acquisition target and, if so, by how much.

Q: Because fairness opinion providers are often compensated contingent upon the successful completion of the merger, fairness opinions are sometimes criticized for being biased towards getting the deal approved. How does your research inform this critique?

A: There is little statistical evidence that fairness opinion valuations are driven by conflicts of interest. Consistent with the deal completion hypothesis, the evidence shows, on average, that acquirer-side opinion providers value the target 20% above the offer price in the deal. Evidence of any bias on the

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1 *In re Rural/Metro Corporation Stockholders Litigation*, 88 A.3d 54 (Del. Ch. 2014).

2 *In re Del Monte Foods Co. Shareholders Litigation*, 25 A.3d 813 (Del. Ch. 2011) and *In re El Paso Corp. Shareholder Litigation*, 41 A.3d 432 (Del. Ch. 2012).

3 Cain, Matthew D. and Denis, David J. (2013) "Information Production by Investment Banks: Evidence from Fairness Opinions," *Journal of Law and Economics*: Vol. 56: Iss. 1, Article 8. Available at http://chicagounbound.uchicago.edu/jle/vol56/iss1/8.

target side is considerably weaker, however: median valuations are below offer prices whereas average valuations are not.

More importantly, no evidence was found that opinion providers deliver less accurate valuations when they are paid contingent fees. Further, top-tier investment banks produce opinions with significantly lower valuation errors, i.e., their estimate is much closer to the target's realized value.

Q: How variable is the premium observed in acquirers' fairness opinions?

A: There is a huge variation in the premium of the acquirer's fairness opinion over the merger offer price. Although the average premium is 20%, the standard deviation of the individual acquirer-side fairness opinion valuation premiums is more than 50%. As a result, most individual advisors' valuation premiums are not statistically different from either the norm or zero.

Q: Do fairness opinions provide incremental information about the value of the target company?

A: If fairness opinions are informative to shareholders, one would expect the public announcement of the opinion to have an impact on the acquirer's stock returns. If the fairness opinion contains useful information to investors, then one would expect, for example, the acquirer's stock price to go up when the target's own fairness opinion suggests a relatively high value.

The evidence indeed shows that the acquirer's stock price around proxy mailing dates – when the fairness opinions are first made public – is positively related to the amount by which fairness opinion valuations of target firms exceed offer prices. In other words, despite possible biases, fairness opinions contain information not previously available to market participants. In this sense, fairness opinions are analogous to reports issued by sell-side stock analysts. Even with possible biases in these reports' opinions, they produce new and useful information as evidenced by their stock price reactions.

Q: In recent Delaware Chancery Court opinions, contingent advisory fees have been front and center. Do these fees influence the valuations produced in fairness opinions?

A: Overall, there is little evidence that fairness opinion valuation errors are associated with either contingent advisory fees or specific advisory relationships. The evidence shows that valuation errors are actually lower, though not statistically so, when advisors are paid fees contingent on completion of the merger or when the advisor has a prior business relationship with the target or the acquirer. The only exception noted is that target advisors produce significantly more negative valuation errors for clients with whom they have prior business experience.

These conclusions do, of course, rely on data provided in proxy mailings, so the underlying assumption in the analysis is that the proxy disclosure is accurate and complete.

Q: In *Rural/Metro*, it was alleged that the time between the fairness opinion and the board meeting was too short, at just over an hour. Is that unusual?

A: A fairness opinion is typically presented to the board shortly after completion of the merger negotiations, but before the deal is finalized and announced to the public. For example, the median time between presentation of the fairness opinion and public announcement of the merger was just one day.

About Professor David Denis

Professor Denis is the Roger S. Ahlbrandt, Sr. Chair and Professor of Finance at the University of Pittsburgh and the author of over 45 published articles in leading peer-reviewed journals on topics related to valuation, corporate governance, corporate financial policies, organizational structure, and entrepreneurial finance.

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