Lessons from an Inadequate Fairness Opinion

By Bret A. Tack
Los Angeles Office

A well supported fairness opinion by a qualified independent investment bank or business valuation firm can provide substantial protection against a challenge on the fairness of a transaction. Conversely, a poorly supported fairness opinion may ultimately prove to be worthless against such an attack. The responsibility of fiduciaries (including officers and directors of the company, trustees, majority shareholders, etc.) is to obtain a fairness opinion that will withstand future scrutiny, a task, which is made more difficult by the fact that the language of most fairness opinions generally contains little or no detail regarding the analysis underlying the opinion. While exercising care in selecting the firm to render the opinion can mitigate the risk, as the following 1994 case illustrates, even hiring a top tier investment bank to render a fairness opinion for a seven-figure fee does not guarantee a reliable opinion.

In 1992, Medical Care International (MCI), which ran a number of small surgical centers throughout the country, contemplated a merger with Critical Care America (CCA), which provided at-home drug infusion services. The two companies were to form a new publicly traded company, Medical Care America (MCA). The investment banker was engaged to render an opinion that the proposed exchange ratio of shares was fair to MCI's shareholders. Only weeks after the investment banker rendered its opinion and the transaction was consummated as proposed, the price of MCA's stock fell more than 50 percent on news of much lower than expected results for the CCA division, due mainly to increased price competition which the claimants allege, would have been uncovered if the investment banker had done an appropriate level of due diligence. Subsequently, several of the former shareholders of MCI brought an action against the banker claiming that they had approved the merger based in large part on their reliance upon the banker's opinion which "grossly overvalued" CCA in connection with the merger. In 1994, a New York Stock Exchange arbitration panel ordered the banker to pay a total of approximately $4.5 million to the former shareholders of MCI.

Among the criticisms of the investment banker's opinion were: a) the banker allegedly "rubber stamped" the transaction, failing to perform the requisite amount of due diligence regarding CCA's business prospects which would have uncovered problems at CCA, including falling prices for CCA's services, b) the banker relied upon overly optimistic financial projections for CCA, c) the investment banker failed to investigate CCA's financial statements, including "CCA's history of large accounts receivable write-offs following acquisitions of other companies," and d) since most of the investment banker's $3 million fee for the opinion was contingent upon the deal being consummated, it had a direct conflict of interest with MCI's shareholders.

One of the most important lessons to be learned from this case is that the weight accorded to a fairness opinion in any subsequent challenge to the transaction is likely to be diminished if the fees to the firm issuing the opinion are dependent on the consummation of the transaction. Additionally, fiduciaries should ensure that the independent financial advisor has adequate time and access to information to perform the required level of due diligence.

Fiduciaries must also take the time to understand the analysis and assumptions underlying the opinion. Finally, fiduciaries should examine the text of the opinion carefully and understand any disclaimers or limiting assumptions, which weaken or dilute the opinion. While it is common for the firm issuing the opinion to rely upon the validity of historical financial statements provided without independent verification, this does not absolve it from its responsibility to investigate and analyze such financial statements as they relate to the financial strength of the company. Similarly, while the firm issuing the opinion may include a caveat that it has assumed that financial projections have been properly prepared and represent management's best estimate of future financial performance, the onus remains with the provider to test the reasonableness of the assumptions underlying such projections and to make adjustments in its analysis accordingly. By exercising due care and making informed decisions, fiduciaries substantially reduce the risk of an inadequate fairness opinion.