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Use fairness opinions to manage conflicts of interest

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By 2011 kicked off the next huge demographic shift in the U.S. - Baby Boomers entering retirement age. Over the next 19 years - 10,000 Americans per day will be retiring for a total of more than 69 million people. This dramatic shift is increasing ownership transition activities among architecture, engineering, and environmental consulting firms. As firms explore ways to buy out retiring shareholders, care must be given to the process of executing a transaction, whether it's with a third party, select employees, and/or an ESOP.

Whatever approach your company takes to monetize the ownership interests of its shareholders, the board of directors and senior management acting on behalf of minority shareholders must take great care to avoid or mitigate conflicts of interests. Since most, if not all A/E firms are owned by employees, the appearance of conflicts of interest or self-dealing can be difficult to avoid. The use of fairness opinions can reduce your risk of minority shareholder litigation.

In 1985, in the case of Smith v Van Gorkum, the board of directors was held personally liable for breaching their fiduciary duty of care by approving a merger - even though the premium received in the transaction was substantial. In this instance, the board of directors of Trans Union approved the sale of the company to Jay Pritzker, a corporate takeover specialist, at $55 per share by relying upon the opinions and the transaction process being carried out by a few senior managers - namely the CEO and CFO. In its ruling, the Court set a precedent that board members should protect themselves by obtaining a fairness opinion from a qualified, third-party valuation expert.

Fairness opinions are designed to assist directors in making reasonable business judgments that require the board to: (a) exercise due care in the process of making that decision; (b) act independently and objectively; (c) act in good faith; and (d) exercise full discretion in making their decision. Fairness opinions do not express an opinion value or even a range of values, and should not be confused with a valuation report or appraisal. A fairness opinion is an opinion as to whether a proposed transaction is fair from a financial point of view. It examines the value of the interests to be received in a transaction (cash, notes, earn-outs, employment bonuses, etc.) compared to the value of the interests given up. Fairness opinions are usually issued on behalf of either the buyer or the seller in a proposed transaction and do not make a recommendation as to whether or not to pursue the deal.

In evaluating the fairness of a transaction, appraisal experts take into account the broader concept of fairness involving potential conflicts of interest. Thus, the test for fairness requires the consideration of procedural fairness and substantive fairness.

Procedural Fairness requires that no one individual or group of individuals can use their management influence to direct the outcome of a transaction such that the benefits of the transaction inure to select individual(s) without regard for the rights of minority shareholder(s). Courts have ruled that fair dealing includes matters such as how the transaction is timed, initiated, structured, negotiated, and disclosed to directors as well as how the approval of the transaction is obtained from shareholders. In a transaction, questionable dealings include, but are not limited to, overreaching, hurried transaction, lack of arm's length negotiation, fraud, and withholding of pertinent information. In some states, in a transaction that has an appearance of a conflict of interest, the burden of proof will initially rest on the party with the conflict.

Substantive Fairness considers the economics of a proposed transaction, including, but not limited to the types of economic considerations such as employment agreements, earn-outs, seller financing, retention compensation, rental agreements on seller-principal owned buildings, among other factors. Substantive fairness does not consider whether a higher price or more favorable structure could be achieved.

Since fair dealing and fair price are examined as a whole, your financial expert should be informed of all material facts and circumstances of the transaction, even if the opinion does not directly address the aspect of fair dealing.

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