# A Survey of Recent Judicial Decisions Involving Fairness Opinions

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*Over the years, disclosures related to fairness opinions have become a focus of shareholder claims against the target company, and the target company board, in connection with a proposed merger or acquisition transaction. This discussion summarizes the regime governing disclosures related to fairness opinions. In addition, this discussion identifies and summarizes recent judicial decisions that address fairness opinion issues.*

## Introduction

Investment banks, financial advisers, and other valuation professionals are often called upon to provide fairness opinions to the boards of directors of companies involved in a merger or acquisition ("M&A") transaction.

Frequently, both the buying company and the selling company ( the "target company") retain separate investment banks, advisers, or valuation analysts:

1. to review the terms of the potential transaction and
2. to evaluate whether the terms of the proposed transaction are fair, from a financial point of view, to the parties' shareholders.

While both the buyer company and the target company frequently obtain their own fairness opinions, litigation involving fairness opinions often centers on the fairness opinions offered to the target company's boards of directors.

In part, that is due to the fact that the provision of a fairness opinion to the directors of the target company is often disclosed by the target company to its shareholders as part of the proxy solicitation. This solicitation seeks shareholder approval of the proposed M&A transaction.

The buying company, by contrast, may not be required to seek shareholder approval of the M&A transaction.

The target company's board is not required to obtain a fairness opinion (to the best of our knowledge) under the laws of any jurisdiction. However, obtaining a fairness opinion from an independent third-party adviser frequently gives the board, and the company shareholders, comfort that the terms of the proposed M&A transaction are fair and, thus, the proposed M&A transaction is in the best interests of the shareholders.

Over the years, disclosures related to fairness opinions have become ripe for shareholder claims against the target company, and the target company board, in connection with a proposed M&A transaction.

Among other things, shareholders have brought claims alleging that the target company failed to adequately disclose:

1. the underlying financial data provided to, and reviewed by, the party performing the fairness review;
2. certain conflicts of interest that may have influenced the party performing the fairness review; or

3. certain assumptions or scenarios either considered or not considered by the party performing the fairness review.

Although there appears to have been a downtick in M&A litigation since the Delaware Chancery Court's landmark decision in 2016 in the *In re Trulia, Inc. Stockholder Litigation*[1] ("Trulia")—in which Chancellor Bouchard declined to approve a "disclosure only settlement" and pledged to apply greater scrutiny to such settlements going forward[2]—there has nevertheless been a steady stream of such litigations both in Delaware and in other forums.

This discussion (1) summarizes the regime governing disclosures related to fairness opinions and (2) also identifies and summarizes recent judicial decisions addressing fairness opinions.

This discussion not only summarizes the current legal landscape with respect to fairness opinions, but it is intended to make practitioners, valuation analysts, financial advisers, and other interested parties aware of the potential pitfalls that may arise in the next engagement.

## The Applicable Disclosure Regime

Judicial opinions discussing fairness opinions typically arise in the context of claims brought by stockholders. Such claims allege that the target company issued a proxy statement that was materially false or misleading. The claims allege that the statement failed to disclose material facts, or omitted material facts.

The claims are usually lodged against certain directors and officers of the target company and the target company itself.

Usually, the shareholder will seek to enjoin the pending transaction through a preliminary injunction motion. However, disclosure claims can also be litigated even after an M&A transaction closes.

Historically, these types of disclosure claims were frequently brought as state law breach of fiduciary duty claims under the law of the state in which the target company is incorporated. The stockholder would typically allege that the directors of the target company breached their duties of care, loyalty, and/or candor (if such a duty exists) by issuing a materially false or misleading proxy statement.

Frequently, these claims were either brought in the Delaware Chancery Court and/or governed by Delaware law (as the state of incorporation).

More recently, and particularly in light of the Delaware Chancery Court's opinion in *Trulia*, shareholders appear to be more frequently bringing claims in federal courts around the country. These claims allege that the proxy statements violated provisions of the federal securities laws.

Specifically, Section 14(a) of the Securities Exchange Act of 1934 (the "Exchange Act") grants the Securities and Exchange Commission (the "SEC") the authority to promulgate rules and regulations for soliciting proxies on any registered security and makes it unlawful to solicit any proxy in violation of whatever rules the SEC promulgates.

The SEC promulgated Rule 14a-9 pursuant to this provision of the Exchange Act. Rule 14a-9 prohibits soliciting a proxy through materially false or misleading statements or omissions—including solicitations for shareholder approval of an M&A transaction.[3]

In order to state a claim under Section 14(a) of the Exchange Act and SEC Rule 14a-9, the plaintiff has to show that:

1. a proxy statement contained a material misrepresentation or omission, which
2. caused plaintiff's injury, and
3. the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.[4]

There is some conflicting authority about whether the defendants' state of mind in making the alleged misrepresentation or omission need only be negligent. A showing of recklessness or actual knowledge is not required.[5]

In any event, claims brought under Section 14(a) of the Exchange Act and SEC Rule 14a-9 are subject to the heightened pleading standards of the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), which requires particularized factual allegations in order to survive a motion to dismiss.

The PSLRA does not apply in state court disclosure actions arising under state law. Therefore, stockholders in federal court disclosure actions face an additional hurdle in pleading their claims.

In addition to hearing claims under Section 14(a) and Rule 14a-9, federal courts may exercise their supplemental jurisdiction to hear disclosure-based breach of fiduciary duty claims arising under state law as well.

## Recent Notable Decisions

### In Re Almost Family Inc. Securities Litigation[6]

In *In re Almost Family Inc. Securities Litigation* ("Almost Family"), the plaintiff shareholder brought claims in the United States District Court for the Western District of Kentucky, Louisville Division (the "District Court of Kentucky") under Section 14(a) of the Exchange Act, and SEC Rule 14a-9. The plaintiff alleged that defendant Almost Family's proxy statement was materially false or misleading in certain respects. Almost Family provides home health care services.

The shareholder also brought state law fiduciary duty claims.

Notably, this case was adjudicated on a motion to dismiss, after a motion to enjoin the M&A transaction had previously been denied, and the merger had closed. This appears to be one emerging trend after *Trulia*—since disclosure-only settlements appear to be trending downward, more M&A litigations are being litigated after the proposed transaction has already been approved and consummated.

In *Almost Family*, the proxy referenced and included two fairness opinions—one prepared by an investment bank retained by the acquirer's board and one prepared by an investment bank retained by the target company's board.

The litigation focused on the fairness opinion issued for the target company's board, which the shareholder plaintiff alleged "omitted necessary financial information that would allow stockholders to understand the financial figures and fairness opinion included within the proxy."

In connection with the fairness opinion, the target company's investment bank was provided "unaudited prospective financial information" by the target company's management. The financial information was not "prepared with a view toward compliance with GAAP." These facts were disclosed by the target company in the proxy.

While the full 14-page fairness opinion prepared by the investment bank for the target company was included within the proxy, and some of the unaudited financial opinion was included in the proxy, not "all the financial data and figures which [the investment bank] relied on in preparing the fairness opinion" were included in or attached to the proxy.

The plaintiff shareholder attacked the fairness opinion and related disclosures on two grounds.

First, the plaintiff alleged that the financial projections in the proxy, and relied upon by the target company's investment bank, were misleading because "they were not prepared in accordance with GAAP." Specifically, the plaintiff alleged that SEC Regulation G required the target company to include GAAP-equivalent figures along with the non-GAAP figures prepared by management.

Regulation G states that "whenever a registrant . . . publicly discloses material information that includes a non-GAAP financial measure, the registrant must accompany the non-GAAP financial measure with" either comparable GAAP figures or a reconciliation.[7]

Regulation G, however, includes numerous exceptions, including one cited by the defendants in *Almost Family* which exempts from compliance "a non-GAAP financial measure included in a disclosure relating to a proposed business combination . . . if the disclosure is contained in a communication that is subject to" Item 1015. Item 1015, in turn, requires companies that receive fairness opinions to disclose summaries of those opinions, including "the bases for and methods of arriving at such findings and recommendations."[8]

The District Court of Kentucky agreed with the defendant target company that:

1. the exception to Regulation G applied, and
2. the target company was not required to disclose GAAP-reconciled versions of the financials relied upon by the investment banker in preparing its fairness opinion.

The District Court of Kentucky agreed that the target company disclosed the unaudited financials relied upon by the investment bank in order to comply with Item 1015, and thus there was no requirement to disclose GAAP-reconciled figures.

The court noted approvingly that the target company had disclosed that the unaudited financials "were not prepared with a view toward public disclosure . . . nor were they prepared with a view towards compliance with GAAP," but were included in the proxy "solely to give stockholders access to information that was made available to Almost Family's board of directors and financial adviser."

Therefore, the portion of the plaintiff stockholder's disclosure claim aimed at the unaudited financial statements was dismissed.

Second, plaintiff alleged that the omission of certain financial data and figures relied upon by the target company's investment bank in preparing its fairness opinion deprived shareholders of the ability to fully understand the basis for the fairness opinion.

Specifically, plaintiff alleged that "the omission of [unlevered free cash flow] projections and the line items used to calculate the [unlevered free cash flow] projections" rendered the investment bank's "discounted cash flow analysis incomplete and misleading."

The plaintiff further alleged that omission of this material deprived the target company's stockholders of the ability to "assess the merit" and "determine the weight" of the conclusions reached in the fairness opinion.

The District Court of Kentucky disagreed, noting at the outset that "the law does not require disclosure of every financial input used by a financial adviser so that the shareholders can replicate the advisers' analysis." Rather, "all that is required regarding a fairness opinion is an adequate and fair summary of the work resulting in the opinion. . . . The proxy need not disclose financial inputs sufficient to allow the shareholders to reconstruct the analysis."

The District Court of Kentucky concluded that the omission of the unlevered free cash flow projections was not material because the proxy—which included a full copy of the fairness opinion itself—otherwise fairly summarized the work performed by the investment bank.

Often legal counsel and valuation analysts are provided with unaudited non-GAAP compliant financial projections and other financial data (i.e., internal historical financial statements) as data to rely on. Practitioners should be aware of the Regulation G and Item 1015 requirements when rendering a fairness opinion.

While the decision in the instant case points out that there are no legal requirements to disclose enough information to replicate the valuation analysts work, it is important that the analyst is cognizant to disclose enough information to provide shareholders a fair summary of the analyst's work.

## Baum v. Harman International Industries, Inc.[9]

One area in which companies and their financial advisers should be cognizant when making disclosures is conflicts of interest that may exist for the adviser providing the fairness opinion. In shareholder litigation, plaintiffs frequently question the sufficiency of the disclosure of such conflicts-of-interest (real or potential).

*Baum v. Harman International Industries, Inc.* ("*Baum*") is a case in which such conflicts-of-interest claims survived a motion to dismiss and proceeded to discovery.

In *Baum*, a shareholder of the target company brought suit in the United States District Court for the District of Connecticut (the "District Court of Connecticut") alleging violations of Sections 14(a) and 20(a) (control person liability) of the Exchange Act and SEC Rule 14a-9.

The target company obtained fairness opinions from two separate financial advisers—each of which recommended that the target company accept the offer from the buyer (Samsung) to purchase its shares for $112 in cash. In its proxy statement, the target company disclosed that one of its advisers had provided certain services to Samsung in the "preceding two years," and identified certain of the services that had been provided.

The target company, however, only disclosed services provided to Samsung that had been concluded in the prior two years; it did not disclose ongoing services, including that one of its advisers' affiliates was still providing investment management services for one of the Samsung affiliates.

The plaintiff alleged that this potential conflict of interest should have been disclosed by the target

company. Among other things, the plaintiff noted that the target company's financial adviser had counseled the target company to reject a competing offer in favor of the Samsung offer.

The plaintiff alleged that the financial adviser, in counseling the target company to reject the competing offer, and in providing a fairness opinion in favor of the Samsung offer, could have been conflicted by virtue of its affiliate's relationship with Samsung's affiliate.

The District Court of Connecticut agreed, noting the following:

> The complaint explains that a potential conflict of interest by [the financial adviser] would be material because the [financial adviser] conducted the unsuccessful acquisition with Company A and prepared a fairness opinion recommending that the acquisition by Samsung be approved. The failure to disclose even potential conflicts of interest may be actionable under federal securities laws. The relevant inquiry is not whether an actual conflict of interest existed, but rather whether full disclosure of potential conflicts of interest has been made . . . [B]y only listing engagements that ended before [the financial adviser] issued its fairness opinion in November 2016, the proxy could have led shareholders to incorrectly believe that [the financial adviser] had no ongoing business relationship with Samsung apart from the acquisition. . . . Harman shareholders should have been given the opportunity to assess for themselves whether [the financial adviser's] ongoing relationship with Samsung was material.

The District Court of Connecticut then denied the motion to dismiss and reserved the question of whether the omission was material for summary judgment following discovery.

One important takeaway from *Baum* is that valuation analysts and advisers should review any and all relationships that may be considered a conflict-of interest and err on the side of disclosure. In Baum, there were competing bids from multiple potential buyers and the adviser failed to disclose an ongoing engagement with Samsung, one of the competing buyers.

Whether this affiliate relationship influenced the adviser's decision making or not, it was enough to cause the District Court of Connecticut to question the materiality of the omission.

## Salladay v. Lev[10]

*Salladay v. Lev* ("*Salladay*") involves something of a "musical chairs" among financial advisers and investment banks advising a target company. Salladay addresses the sufficiency of the target company's disclosures related to the rotating cast of advisers.

This case was brought before the Court of Chancery of Delaware (the "Delaware Chancery Court").

For years, the target company had been exploring potential sources of financing and strategic transactions, and retained an investment bank ("Firm 1") to advise it throughout the process. Firm 1 did so, and eventually, a potential acquirer submitted a bid to acquire the target company.

The target company created a special committee to review the acquisition proposal. However, instead of using Firm 1, the special committee hired a different investment bank (Firm 2) to serve as its adviser in connection with an acquisition offer.

As alleged in the complaint, "just days" after Firm 2 was retained, it "abruptly terminated" its relationship with the special committee. Thereafter, the special committee hired a new firm (Firm 3) to serve as its adviser. Within eight days, Firm 3 reviewed the proposed transaction and issued a fairness opinion stating that the proposed consideration was fair, from a financial point of view, to the target company's shareholders.

The plaintiff was a shareholder in the target company and brought a number of state-law-based disclosure claims in connection with the proxy statement issued by the target company in connection with the proposed M&A transaction.

Among other things, the shareholder alleged that the proxy was materially misleading because it did not "disclose the reason why [Firm 2] terminated its engagement" several days after being retained.

The Delaware Chancery Court agreed with the plaintiff shareholder and denied the defendant's motion to dismiss on this issue, finding it "reasonably conceivable that missing information regarding the exit of [Firm 2] would have been material to a reasonable stockholder."

The Delaware Chancery Court explained as follows:

> The compressed timing of this transaction and the fairness opinion associated with it create a context in which information regarding a hired financial adviser that walks away becomes plausibly material . . . Presumably, [Firm 2] reviewed the transac-

> tion in preparation to provide an opinion. It then walked away. An innocent inference is that it declined to participate due to unforeseen conflicts or other logistics that made it impossible to turn a fairness opinion around in a compressed timeframe. The plaintiff's inference is that the financial adviser found it could not approve the transaction as it stood and so it walked away, and the company chose not to disclose its disapproval. Either way, in evaluating the transaction, the board and [Firm 3] would themselves want to know why a well-known financial adviser voluntarily terminated an engagement and walked away from a fully formed transaction. It follows that so would a reasonable stockholder. The fairness opinion is perhaps the most material factor in a 'sell/don't sell' binary decision, and the reasons for going to a second—arguably a third—financial adviser here, in the context of a near-completed deal and a tight schedule, are not trivial. . . . I find it reasonably conceivable that such disclosures, not made here, are material.

It is important for valuation analysts and advisers preparing a fairness opinion to understand the history of the transaction and to be aware of any other analyses or engagements with other advisers or consultants. A rigorous due diligence process typically yields the facts and circumstances of any previous engagements related to a particular transaction.

Valuation analysts and financial advisers can then independently determine whether these facts and circumstances are relevant to the current assignment.

## Diekman v. Regency GP LP[11]

Like *Salladay*, *Diekman v. Regency GP LP* does not involve claims under the federal securities laws. This case was also tried in the Delaware Chancery Court and involves claims for breach of a Delaware partnership agreement arising, in part, out of the general partner's reliance on a fairness opinion obtained in connection with a merger.

The plaintiff was a unit holder of the defendant and target company Regency Energy Partners, LP ("Regency"), a Delaware limited partnership that traded publicly prior to the merger in question.

Regency entered into a merger agreement with another Delaware partnership, Energy Transfer Equity ("ETE"). Indirectly, both Regency and ETE were controlled by the same entity, meaning that the merger was a "conflicted transaction."

As such, prior to approving the merger, Regency established a "Conflicts Committee" to evaluate the merits of the merger and to make a recommendation as to whether it should be approved by Regency's unit holders.

In connection with its work, the Conflicts Committee retained a financial adviser to evaluate the terms of the transaction and render a fairness opinion. The case raises two interesting questions for practitioners and experts:

1. What constitutes "reliance" upon a fairness opinion?
2. Whether a new a fairness opinion should be provided after the terms of a merger change.

### Reliance

On January 22, 2015—three days before it received the fairness opinion—the Conflicts Committee met and determined that the merger was fair to the unit holders. Three days later, after the proposed consideration to be received by the target's unit holders was increased, the financial adviser rendered an oral fairness opinion to the Conflicts Committee, opining that the proposed transaction (and the improved terms) was fair from a financial point of view.

The question before the Delaware Chancery Court was whether under these circumstances—where the Conflicts Committee determined that the less favorable terms were fair prior to even receiving the adviser's fairness opinion—the Conflicts Committee had actually relied upon the fairness opinion in deciding to recommend the proposed transaction to the target entity's unit holders.

The question of reliance was important because, under the target's partnership agreement, reliance on "investment bankers and other advisers" created a conclusive presumption that the general partner (or entities acting at its direction, like the Conflicts Committee) acted "in good faith."

On summary judgment, the Delaware Chancery Court determined that there was a material question of fact for trial about whether the Conflicts Committee had actually relied on the fairness opinion received on January 25, 2015—"given the evidence that the Conflicts Committee already had determined that the inferior January 22 terms were fair."

### Changed Consideration

Additionally, after the financial adviser provided its fairness opinion on January 25, 2015, the compensation to be paid to the target company subsequently changed again. Specifically, in mid-February, the cash component of the consideration was replaced

with additional units in the acquiring company. The financial adviser did not update its fairness opinion to reflect or address this change.

The plaintiff argued that this, too, showed that the Conflicts Committee had not actually relied on the fairness opinion, since the fairness opinion did not actually evaluate the revised terms of the merger agreement.

The Delaware Chancery Court again agreed with the plaintiff and held that the question of whether the change in consideration was material—and thus the fairness opinion should have been updated—was "a fact question appropriate for trial, especially given that the value of the proposal could fluctuate since the exchange ratio did not have a collar."

M&A transactions can be a moving target for valuation analysts and financial advisers. When rendering a fairness opinion, valuation analysts and financial advisers need to be made aware of ongoing changes to the structure of the transaction and incorporate them into the analysis as appropriate.

In addition, during the course of their work, financial advisers and valuation analysts typically perform a thorough review of the target company's articles of incorporation or partnership agreement.

## Summary and Conclusion

Often, litigation involving fairness opinions is related to the fairness opinions prepared for the target company's boards of directors. The judicial precedent summarized in this discussion provides practitioners with a survey of recent judicial decisions related to a target company's fairness opinion decided in both state and federal courts.

As summarized in this discussion, disclosures related to fairness opinions have become the focus of stockholders' claims against target companies, and those companies' boards of directors. The issues brought before either state court or federal court, or both, often relate to adequate disclosure.

An understanding of the judicial decisions in this discussion can assist practitioners to appropriately disclose:

1. the underlying financial data provided,
2. certain conflicts of interest, and
3. certain assumptions or scenarios either considered or not considered.

**"M&A transactions can be a moving target for valuation analysts and financial advisers."**

Notes:

1. 129 A.3d 884 (Del. Ch. 2015).
2. A "disclosure only settlement" is a settlement reached between the stockholder challenging the proposed transaction (purportedly acting on behalf of all stockholders) and the target company (or, in some cases, the buyer), in which the target company agrees to make certain additional disclosures relating to the proposed transaction in order to cure the purported deficiencies in the proxy statement issued by the target company seeking approval of the transaction. In addition to issuing supplemental disclosures, the target company usually also agrees to make a payment of attorneys' fees to counsel representing the plaintiff stockholder. The target company is usually incentivized to reach these settlements given the typical procedural posture of these cases, in which the stockholder brings (or threatens to bring) a preliminary injunction motion to enjoin the pending transaction. In Trulia, Chancellor Bouchard questioned the utility of "disclosure only settlements" and indicated such settlements (which require court approval) would be subject to greater scrutiny in Delaware.
3. 17 C.F.R. § 240.14a-9.
4. Baum v. Harman Int'l Indus., 408 F. Supp. 3d 70 (D. Conn. 2019).
5. See, e.g., In re Almost Family Secs. Litig., 2020 U.S. Dist. LEXIS 23456 (W.D. Ky. Feb. 11, 2020).
6. 2020 U.S. Dist. LEXIS 23456 (W.D. Ky. Feb. 10, 2020).
7. 17 C.F.R. § 244.100.
8. 17 C.F.R. § 229.1015.
9. 408 F. Supp. 3d 70 (D. Conn. 2019).
10. C.A. No. 2019-0048-SG, 2020 Del. Ch. LEXIS 78 (Del. Ch. Feb. 27, 2020).
11. 2019 Del. Ch. LEXIS 1334 (Del. Ch. July 19, 2019).

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