INDEPENDENT FINANCIAL ADVISERS AND THE CONSTRUCTION COMPANY M&A TRANSACTION

When determining if decision-makers have fulfilled their fiduciary obligations, various judicial decisions indicate that judges give weight to the contemporaneous transaction advice that was provided by an independent financial adviser.

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Construction industry merger and acquisition (M&A), restructuring, reorganization, and refinancing transactions continue to become more complex. Executives responsible for making the decision whether or not to consummate such a complex business transaction sometimes request that a construction company business valuation be performed. Alternatively, the construction company decision-maker may seek the advice of a valuation analyst who will act as the independent financial adviser to that decision-maker. That independent financial adviser may conduct an analysis that is consistent with generally accepted business valuation standards and principles. However, such a financial advisory analysis will focus on the specific transaction-related information needs of the construction company decision-maker.

Construction industry executives are often asked to decide, either for themselves or on behalf of others (e.g., nonemployee stockholders), whether or not to enter into a complex corporate transaction. In such transactions, the construction company could be the buyer or the seller, the debtor or the creditor, the licensor or the licensee, the contract party or the contract counterparty, etc. On many occasions, these executive decision-makers may ask that a construction company business valuation be performed to help them make the important strategic decision. These executives want to be comfortable that they are making the appropriate decision, particularly when

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the decision is going to affect other parties (creditors, minority stockholders, joint venturers, etc.).

A valuation analyst can provide important information to help inform the executive's strategic decision. However, a business valuation may not be (or may not be all of) the information that the executive decision-maker needs. He or she may need different information: transaction planning and structuring advice from an independent financial adviser. Valuation analysts often provide that transaction-related independent financial advice to construction company executives and/or owners.

The M&A transaction economic conflict

Of course, the corporate buyer wants to minimize the consideration he or she pays in the proposed M&A transaction, and the corporate seller wants to maximize sale proceeds. Hence, there is an inherent economic conflict between the buyer and the seller in a construction company M&A transaction. The final transaction purchase price is typically the result of informed (and intense) negotiations between sophisticated (or at least well-advised) transaction participants. During these informed purchase/sale negotiations, each party seeks to achieve its maximum economic self-interest.

When a corporate executive or controlling stockholder is making a financial/investment decision on behalf of others, that individual may have a fiduciary duty to those other parties. A fiduciary has a duty of loyalty to the beneficiary of his or her financial/investment decisions and should not put personal interests before that duty.

A fiduciary should function as an agent of the beneficiary. The fiduciary can be, for instance, an individual executive, the company's controlling stockholder, a trustee, or a member of the construction company's board of directors. It seems as though the interpretation of fiduciary duties is ever-changing, based on the continued guidance of statute, judicial precedent, regulations, and regulators.

Typically, the fiduciary duties do not pass through to the advisers (including financial advisers) engaged by the fiduciary. The financial adviser's client is the fiduciary (and not the beneficiary of the fiduciary's duty). The financial adviser takes instructions from — and works for the benefit of — the fiduciary. Normally, the financial adviser does not have a fiduciary duty to the parties to whom the fiduciary has such a duty.

In the typical construction industry M&A transaction, the independent financial adviser may perform several functions; such financial advisory functions include the following:

1. conducting the financial analysis of the construction company that is the target of the proposed transaction;
2. assisting the executive or shareholder decision-maker in the negotiation of the M&A transaction price (including the price payment terms);
3. assisting the transaction decision-maker and his or her legal counsel, if any, in the optimal structuring of the M&A transaction;
4. advising and counseling the transaction decision-maker on any of the proposed M&A transaction details; and
5. rendering a financial opinion to the transaction decision-maker stating (typically) that the price of the transaction is fair from a financial point of view.

An independent financial adviser's opinion is typically a short letter issued by the financial adviser to the fiduciary stating that a proposed transaction is fair (or that the proposed consideration is adequate), from a financial point of view, to a specific constituent. That specific constituent may be the subject construction company buyer or seller or a particular group of company shareholders.

Such a financial opinion can be relevant in a variety of transactions involving both public and private construction companies. Affected transactions may involve negotiated mergers, friendly or hostile tender offers, management buyouts (leveraged or otherwise), transactions

THERE IS AN INHERENT ECONOMIC CONFLICT BETWEEN THE BUYER AND THE SELLER IN A CONSTRUCTION COMPANY M&A TRANSACTION.

involving an employee stock ownership plan (ESOP), public company going private transactions, recapitalization or restructuring transactions, non-employee leveraged buyouts, and transactions involving the appearance of a conflict of interest (e.g., a controlling shareholder buying out a minority shareholder).

The members of the company's board of directors may obtain independent financial advice primarily to satisfy their obligation to ensure that either (1) in the interests of the sellers, the selling shareholders receive a fair price for the sale of their stock or (2) in the case of the buyer, the acquiring company isn't paying too much. Particularly when the proposed corporate transaction involves a change of control, the target company's directors may obtain a fairness opinion; this opinion is intended to demonstrate that the directors have not breached their duty of care (to the company shareholders).

THERE ARE MANY TRANSACTIONAL SITUATIONS IN WHICH THE ADVICE OF AN INDEPENDENT FINANCIAL ADVISER WOULD ASSIST THE DECISION-MAKER, EVEN WHEN THE RISK OF BEING SUED IS MINIMAL.

There are no federal or state laws mandating that an independent fairness opinion be considered when decision-makers conclude whether or not to complete a proposed M&A or similar transaction. When determining if decision-makers have fulfilled their fiduciary obligations, various judicial decisions indicate that judges give weight to the contemporaneous transaction advice that was provided by an independent financial adviser.

The contemporaneous advice of the independent financial adviser helps the decision-maker scrutinize a potential M&A transaction. Such independent financial advice also serves to provide other parties involved in the potential M&A transaction with assurance regarding the financial soundness of the deal.

The other parties involved in the potential M&A transaction may not be privy to the detailed efforts being put forth by the financial adviser to the decision-maker. However, merely knowing that the decision-maker is getting advice from an independent financial adviser may provide comfort to those parties.

If there is a risk that the corporate decision-maker may be sued for allegedly accepting the "wrong" price when entering into an M&A transaction, then the decision-maker will want to make sure he or she has directors/officers insurance. Of course, the insurance carrier will expect the corporate decision-maker to have followed customary procedures during such transaction negotiations and deliberations. One such customary procedure may be the obtaining of independent financial advice.

The company board's rationale for obtaining financial opinion is that the advice of an independent financial adviser provides comfort to the directors in potential change-of-control transactions. Of course, that kind of advice should provide comfort to the board in other transactional situations as well.

There are many transactional situations in which the advice of an independent financial adviser would assist the decision-maker, even when the risk of being sued is minimal. For example, these transactional situations include when a proposed transaction:

1. involves different classes of stock that have different rights and attributes; for example, a transaction structure that is fair to one class of stockholders may not be fair to another class;
2. changes the way the construction company does business;
3. exchanges corporate debt for equity;
4. redeems only some of the construction company's outstanding shares;
5. is an acquisition of a going-concern business or of significant operating assets, as even a relatively small acquisition may cause dilution to the shareholders of the corporate acquirer;
6. is one in which one company shareholder is deliberately given special treatment (e.g., greenmail) or special consideration (e.g., a signing bonus, premium employment agreement, agreement not to compete, earn-out, or royalty based on future performance);
7. is one in which one party to the M&A transaction (e.g., the company shares owned by the employee retirement plan) has special access

to confidential information that, if it were available to other parties, may lead to a different decision to buy, hold, or sell; and/or
8. involves the company's controlling shareholder who proposes an action:
- that may affect the capital structure of the construction company;
- that may be considered to be an "insider" transaction;
- to acquire an entire tranche of preferred stock not offered to any other stakeholder; or
- that requires special consideration to be paid to the controlling shareholder in order to accept a transaction that is presented as if it provides a benefit to the other shareholders.

Different classes of securities may have privileges for which holders of those classes expect to receive a price premium (or other special consideration); the buyer of the target construction company for a single overall price is not overly concerned with how that overall price is to be allocated to the selling shareholders. In many situations, allocation of the purchase price to the various claims on that purchase price may cause controversy between selling shareholder constituents.

The decision-maker needs to understand the substance of the advice from the independent financial adviser so that reliance is not misplaced. In some circumstances, a second financial opinion may be prudent. For example, this may occur when the first advisor puts the pending transaction together (and will receive a commission success fee if the pending deal closes).

The advice provided by the independent financial adviser typically describes (1) the intended audience for the advice, (2) the scope of the analysis, (3) the work that was completed, and (4) the assumptions that underlie the analysis. The independent financial adviser should be clear that the transactional advice about financial fairness:
1. is not a recommendation regarding whether or not to enter into the proposed M&A transaction and
2. is not an affirmation that the proposed deal consideration is the best price that is achievable.

The decision-maker should be on the alert if nonstandard assumptions are identified in the text of the financial opinion rendered by the independent financial adviser. Nonstandard assumptions (1) may signal the limitations of the opinion and (2) may limit the usefulness of the opinion to the decision-maker.

Business judgment

The so-called "business judgment rule" was developed by the courts to avoid unnecessary scrutiny of corporate director actions, as long as the corporate directors act in good faith on an informed basis, without fraud or self-dealing, and in a manner that the directors believe to be in the best interest of the company shareholders.

The business judgment rule is meant to preclude a court from imposing its own judgment on the business and affairs of any company. The "rule" is a legal presumption that provides that the strategic decisions made are not subject to challenge as long as the corporate decision-maker:
- is disinterested;
- has acted on an informed basis; and
- has acted with an honest belief that the action taken was in the best interests of the beneficiaries, as a whole.

Decision-makers are typically not considered to be disinterested if (1) they stand on both sides of a transaction or (2) they expect to derive a personal financial benefit from the proposed transaction. In other words, if the decision-maker is engaged in self-dealing, then he or she cannot claim the benefit of the business judgment rule as a defense to claims of breach of fiduciary duty. However, self-interest alone is not sufficient to base a claim against a decision-maker. A claim against a corporate decision-maker may be based on either of the following:
1. disloyalty to the beneficiary or
2. the receipt of (or the potential to have received) a material or significant benefit.

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The mere fact that, in hindsight, a decision-maker made a bad decision or a mistake is not sufficient to (1) challenge that decision or (2) allege breach of duty or other mismanagement claims. While it may be apparent in hindsight that the financial/investment decision was wrong, that decision should withstand an attack if it was made in good faith, on an informed basis, by a disinterested person.

In some circumstances, the stakeholders in a construction company are considered to be the individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities. Such constituencies are, therefore, the company's potential beneficiaries and/or risk bearers. The argument is that creditors, employees, and suppliers also make contributions and take risks in creating a successful construction company.

The construction company board of directors may consider if the transaction is fair to the company from points of view other than merely the financial. By attempting to consider the needs and wants of many different constituents, ranging from the local population and customers to the company's own employees and owners, the board can prevent damage to the image of the company and its brand, prevent losing large amounts of sales and irritating customers, and prevent costly legal expenses. When it is deliberating about whether or not to execute a particular proposed M&A transaction, in addition to the fairness from a financial point of view, these other points of view may also be considered by the company's board of directors.

IN SOME CIRCUMSTANCES, THE STAKEHOLDERS IN A CONSTRUCTION COMPANY ARE CONSIDERED TO BE THE INDIVIDUALS AND CONSTITUENCIES THAT CONTRIBUTE, EITHER VOLUNTARILY OR INVOLUNTARILY, TO ITS WEALTH-CREATING CAPACITY AND ACTIVITIES.

To analyze the fairness of the proposed M&A transaction from a financial point of view, the financial adviser may analyze information such as financial projections prepared by company management, the financial performance of guideline publicly traded construction companies, pricing evidence derived from M&A transactions of guideline construction companies, pricing evidence derived from prior transactions involving the subject construction company, and the value implications of breakup/liquidation scenarios.

In conjunction with these analyses, the independent financial adviser may conduct an analysis of the sensitivity of the company value/deal price of various transaction structure assumptions. These analyses are consistent with generally accepted business valuation procedures. However, the work product of these analyses may be a financial opinion rather than a narrative business valuation report.

In addition to a fairness opinion, the fiduciary decision-maker will typically receive a more detailed presentation from the financial adviser that summarizes the entire process undertaken by that financial adviser. This presentation helps the fiduciary decision-maker become familiar with important factors from a financial point of view; these factors may affect the fiduciary's decision regarding the proposed M&A transaction. The presentation assists in making the transactional decision and provides support for the fiduciary's business judgment rule defense that the financial/investment decision was "informed."

Selection of the independent financial adviser

The criteria decision-makers typically consider during the selection process for an independent financial adviser include the following:

1. the professional qualifications of the financial advisory firm;
2. the professional qualifications of the firm's financial adviser principal analyst(s); and
3. any independence issues regarding the financial advisory firm.

The advice provided to the decision-maker by the independent financial adviser involves more than business valuation and other quantitative information. The financial advice ultimately comes down to whether or not a proposed transaction is fair to a particular party to that pricing transaction.

Being proficient in the application of generally accepted business valuation approaches and methods is one skill set that the independent financial adviser should demonstrate. Therefore, valuation analysts are often the appropriate providers of independent financial advisory services. Some of the business valuation professional credentials that the decision-maker may consider during the selection of the independent financial adviser include the following:

1. the Accredited Senior Appraiser (ASA) designation of the American Society of Appraisers (ASA);
2. the Certified Business Appraiser (CBA) designation of the Institute of Business Appraisers (IBA);
3. the Accredited in Business Valuation (ABV) designation of the American Institute of Certified Public Accountants (AICPA); and/or
4. the Certified Valuation Analyst (CVA) credential of the National Association of Certified Valuators and Analysts (NACVA).

Conflicts of interest, or the appearance of conflicts of interest, can damage the purpose of the advice and render it meaningless. Many parties to a proposed M&A transaction have adverse interests. Therefore, if the financial adviser is acting or has acted on behalf of any party with any interest whatsoever in the M&A transaction, the financial adviser's independence may be suspect.

In some situations, an "independent" financial adviser may not be viewed as serving the interests of the decision-maker. Regardless of the interests of the decision-maker, some financial advisers have an incentive to render advice in order to:

- protect an investment in, or perpetuate a relationship with, the management of the construction company or the other advisers in the proposed M&A transaction;
- promote a high level of merger and acquisition activity in the particular construction industry sector; and/or

- reciprocate to other financial advisers in the pending transaction for access to fees in other situations.

The financial adviser may not be perceived to be independent if, for example, that financial adviser:

- has given advice on strategy in an existing or prior assignment, or has attended discussions whereby the strategy and merits of the contemplated M&A transaction have been developed;
- has accepted data and analysis from the commissioning party or other interested parties without critical review;
- has entered into a fee agreement in which the fee payment or the fee amount depends on the outcome of the proposed M&A transaction;
- has discussed future business relationships with the commissioning party or any other interested party before issuing the final financial opinion;
- has changed his or her opinion following a factual review of a draft of the fairness opinion by the commissioning party for a reason other than a change in the facts on which it was based; or
- has changed his or her opinion at the suggestion of the commissioning party or any other interested party without due inquiry and analysis by the fairness opinion provider.

The financial adviser should be trusted to explain the following to the decision-maker:

1. both the seller's and the buyer's perspectives of the proposed M&A transaction;
2. alternatives to entering into the M&A transaction;
3. the financial aspects of the proposed M&A transaction to the beneficiaries of the decision; and
4. an analysis of the assumptions on which the transactional decision is most sensitive.

ESPECIALLY IN AN M&A TRANSACTION THAT INVOLVES MULTIPLE CLASSES OF SECURITIES, THE FINANCIAL ADVICE SHOULD BE CAREFULLY SCRUTINIZED.

Fair to whom?

An M&A transaction may be fair in the aggregate (i.e., the total price is fair to the target construction company) but still be unfair to certain non-controlling shareholders (e.g., preferred stockholders, ESOP participants, or nonvoting LLC members).

If certain parties to the M&A transaction will receive special consideration (e.g., an ownership interest in the surviving company, payment for an agreement not to compete with the company, or a lucrative employment contract), then the relative fairness of the proposed transaction may be of concern to the decision-maker who is not being offered that special consideration. The terms of the proposed transaction that are offered to the decision-maker may not properly account for these differences. Disclosing these differences is not the same as accounting for these differences.

Especially in an M&A transaction that involves multiple classes of securities, the financial advice should be carefully scrutinized. A proposed M&A transaction that is fair to one constituent may not be fair to another.

The following section presents an example of financial advice that, upon close scrutiny, should not be relied on by all parties to the proposed M&A transaction. The advice may not be pertinent to many decision-makers who represent other beneficiaries. This financial advice does not support a decision for all parties to the proposed transaction as to whether they should enter into the subject transaction.

> You have asked for our opinion as to whether the consideration to be received by the holders of the Alpha Construction Company ("Alpha") common shares pursuant to the merger agreement is fair from a financial point of view to such holders.

> We were engaged by the trustees of the trust holding stock of Alpha under the 401(k) plan to act as an independent financial adviser to the trustees (solely in their capacity as such) to provide an opinion as to whether the consideration to be received by the plan in the offer and merger is not less than adequate consideration, as defined by Section 3(18) of the Employee Retirement Income Security Act of 1974, as amended, and is fair to the plan from a financial point of view.

> We have not been asked to pass upon, and we express no opinion with respect to, any mat-

ter other than the fairness to the holders of the Alpha common stock, from a financial point of view, of the cash consideration as of the date hereof. We do not express any view on, and our opinion does not address, the fairness of the proposed transaction or any other matter with respect to, or any consideration received in connection therewith by, the holders of any other securities, creditors, or other constituencies of Alpha, nor as to the fairness of the amount or nature of any compensation to be paid or payable to any of the officers, directors, or employees of Alpha, or any class of such persons, whether relative to the cash consideration or otherwise.

Unless the assignment conducted by the financial adviser specifically states otherwise, a fairness opinion is not:

- an opinion or any form of assurance that the highest and best possible deal price is being obtained or received in the proposed M&A transaction;
- an assessment or evaluation of the sale or negotiation process leading to the pending M&A transaction or consideration to be paid/received therein;
- an affirmation of the strategic merit of the contemplated M&A transaction;
- a recommendation to any individual company security holders as to how to vote;
- an analysis of, or opinion on, other aspects of a given M&A transaction such as lockups, termination fees, severance agreements, and so on; or
- a confirmation of, or any form of opinion or assurance (audit, review, or compilation) on, historical or prospective financial or any other information provided by or on behalf of the client or obtained publicly.

The independent financial adviser typically does not participate in the preparation of the data considered by the corporate decision-maker regarding the ownership interest that is the subject of the M&A transaction. The independent financial adviser should perform a sufficient amount of due diligence and quantitative/qualitative analysis with regard to the significant components of the proposed M&A transaction, especially with respect to the expected financial performance of the subject ownership interest.

Even in the rare situation when the deal price offered to the selling shareholders is higher than all indications of value for that ownership interest, it may not be prudent for sellers to enter into the transaction. When the transaction price seems too good to be true, it probably is. In this situation, the financial adviser may be asked by the selling shareholders to consider if the buyer has the financing capacity to enter into the proposed M&A transaction. If it is likely that the M&A transaction would render the buyer insolvent, then the sellers may be accused of fraudulently conveying the property to the buyer. Accordingly, the decision-maker may ask the financial adviser to conduct a solvency analysis.

The "as of" date

It is important that the decision-maker provides enough time for the financial adviser to conduct reasonable and responsible due diligence. The amount of time required to conduct the due diligence varies from one transaction to the next for the following reasons:

1. the complexity of the proposed M&A transaction and
2. the consequences potentially associated with making the wrong decision.

The decision-maker should allow the financial adviser to begin the analysis as early as possible. The financial adviser will provide the decision-maker with a description of the information being considered in the analysis and the steps undertaken toward understanding the financial aspects of the proposed transaction.

The work product provided by the financial adviser typically includes a presentation to the decision-maker regarding the history and financial merits of the proposed M&A transaction. This presentation should take place early enough, prior to the date the final decision is required, that the decision-maker can ask questions and fully consider the advice being provided.

THE DECISION-MAKER SHOULD ALLOW THE FINANCIAL ADVISER TO BEGIN THE ANALYSIS AS EARLY AS POSSIBLE.

Often, M&A transactions are delayed through no fault of the decision-maker or the financial adviser. In most of these situations, the decision-maker should ask the financial adviser to update the presentation and the financial advice so that the advice is relevant as of the date on which the irrevocable decision is to be made.

Summary

When a decision-maker is asked to decide, for him or herself or on behalf of others, whether or not to enter into a proposed M&A transaction, that person may seek independent financial advice. There are also many types of acquisitive, financing, restructuring, and reorganization transactions for which the decision-maker may seek independent financial advice.

The independent financial advice that the decision-maker may seek is different from, and in many situations broader than, a construction company business valuation. The decision-maker may engage the independent financial adviser for objective transactional advice even before the subject construction company receives a firm offer. It is more important than ever for construction company executives and shareholders involved in potentially controversial transactions to obtain timely, independent financial advice. This discussion presented some of the types of potentially controversial transactions with which a construction company decision-maker may be confronted.

It is prudent for the decision-maker, especially one who is acting for the benefit of other parties, to obtain his or her own independent financial advice. These instances include (and may especially include) a pending M&A transaction in which the other transaction participants have already engaged their own financial adviser. ■