"It's Just Not Fair" – Heightened Expectations for Fairness Opinions and Update on Recent Developments in Corporate and Securities Law for Business Valuators

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AGENDA

- **Director's Duties and Expert Advice**
- **Basis for Advisor Liability**
  - Canada; U.S.; Recent Developments – Bill 198/Bill 41
- **Fairness Opinions and Valuations; What is the Difference?**
- **Regulation of Significant Transactions Requiring Valuations**
  - OSC Rule 61-501 and Quebec Policy Q-27
- **Engagement Letter Issues**
- **Best practices for Fairness Opinions and Valuations**

INTRODUCTION

- **Governance Developments**
  - S-OX Act
  - SEC
  - NYSE/NASDAQ
  - TSX
  - OSC using new powers given under Bill 198

- **Liability increased for professionals, experts and directors/officers**
  - Bill 198/Bill 41 liability for secondary market disclosure
  - Class action legislation and common law decisions

INTRODUCTION

- **These developments have lead to greater reliance on financial advisors and other experts**
- **Boards protected in good faith reliance on report of an "expert" – a person whose profession lends credibility to their statements**
  - Financial; legal; pension; HR; operations; compensation
- **Greater reliance on experts leads to increased exposure for professionals**
  - Common issue for accountants, debt rating agencies, financial publishers, stock analysts, investment bankers and valuators

INTRODUCTION

Issue for valuators in many types of engagements

- Advisory
- Asset impairment
- Solvency (e.g. LBO)
- Fairness
- Valuation
- Reasonably equivalent value (insolvency context)
- Cheap stock options
- Compensation

INTRODUCTION

- **Circumstances in which claims have been made or analysis disputed**
  - Mergers (share exchange ratio: *Pacifica Papers and Norsk Hydro)*
  - LBO (Dylex)
  - Spin-offs
  - Going private transactions: Emerging Communications; TD Waterhouse; Hayes Dana; LSI Logic; Ford of Canada; Service Corp. International; Motorola-Next Level Comm.
  - Contested takeover bids (Maple Leafs Hockey Club)
  - Recapitalizations (Bell Canada-BCI; private equity down-rounds)
  - Compensation and Related Party Transactions: (Hollinger, Disney, Repap, NYSE, Centrefund Realty)

The Rise of the Institutional Shareholder as Plaintiff

- **Catalyst – Hollinger**
- **Hedge Funds**
- **Teachers re Penn West petroleum trust conversion**
- **Kirk Kerkorian re Daimler-Chrysler litigation**
- **Carl Icahn and Blockbuster (among others)**
- **Cooperative attacks**
  - Magna, Brookfield, Molson-Coors

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Typical Story

- **Forbes Magazine Feb. 14, 2005 story: *"Free Riders"***
  - Study of 564 public M&A transactions 1999 – 2001
  - Litigation over values more likely in larger transactions where minority cashed out
  - Cox Communications example (US$ 7 billion GPT where minority 38% cashed out August 2004)
    - ✓ 6 class action suits launched against transaction by noon on the very day the transaction was announced
    - ✓ Claims that transaction "unfair and coercive" and that directors breached their fiduciary duties
    - ✓ US$32 per share offer ultimately raised to US$34.75 per share
      - ❖ Lawyers sought approval for US$5 million premium
      - ❖ Institutional investors objected – claiming that they were the cause of the better deal

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LITIGATION PROCESS IN A NUTSHELL

- **Numerous potential plaintiffs against the expert**
  - Client (VTech Holdings v. PwC re Lucent consumer telephone business; Enron v. numerous advisors)
  - Board/insurer (subrogation)
  - Client shareholders
  - Target or its shareholders
  - Trustee in bankruptcy
  - Banks and others who provide credit
- **Stages: Try to get out as early as possible**
  - Motion to dismiss for lack of a cause of action
  - Class action certification motion
  - Summary judgment

LESSONS FROM AN INADEQUATE OPINION

- *Medical Care International v. Critical Care America* (1994)
  - Top tier investment bank retained for US$3 million fee
  - Opinion rendered re proposed exchange ratio in formation of joint venture
  - Within weeks stock price fell 50% due to competition within CCA division
  - Suit by MCI shareholders led to US$4.5 million award by NYSE arbitration panel
  - Criticisms: failure to do adequate due diligence on falling margins; relied on overly optimistic CCA projections; failed to investigate CCA history of large A/R write-offs after acquisitions; conflict due to most of fee being contingent

LESSONS FROM AN INADEQUATE OPINION

➢ Cendant (1997 – 1998)

- Lots of press about how valuators retained by HFS Inc. missed fraud at CUC International and whether they were responsible – not primarily liable
- Common to rely on adequacy of financial statements
  - ✓ Not a free pass when it comes to applying professional scepticism and analysis
  - ✓ Must acknowledge risk of "soft accounting"
- Common to assume that financial projections properly prepared and represent management's best estimate of future financial performance
  - ✓ Must still test the reasonableness of the assumptions underlying the projections and make appropriate adjustments

LESSONS FROM AN INADEQUATE OPINION

➢ In Re Emerging Communications, Inc. Shareholders Litigation (Delaware Court of Chancery, June 2004)

- Parallel fiduciary duty class action and appraisal actions brought in response to GPT proposed by CEO who owned controlling shareholder (US law required same substantive review of value)
- Defendant used as financial and legal advisors firms who had advised the target company on a related party transaction abandoned to pursue GPT due to declining share price opportunity
  - ✓ Target Board failed to object
  - ✓ Court found (contrary to testimony from Burton Malkiel) that market was artificially depressed due to lack of transparency from company
- Special Committee located on three continents, separated by 14 hours and never met in person
  - ✓ Meeting at which transaction terms approved attended by only two of three members
- Committee mandate was merely to negotiate best terms possible or decline the GPT, no mandate to pursue other alternatives
- Financial Adviser to Special Committee not asked to testify for defence – adverse inference made by Court

LESSONS FROM AN INADEQUATE OPINION

➢ In Re Emerging Communications, Inc. Shareholders Litigation (Delaware Court of Chancery, June 2004)

- Financial Adviser not provided with updated projections used by proposed GPT lender, financial adviser to Insider and Insider's legal counsel
  - ✓ Lender's implied value used in fixing available financing significantly higher than Fairness Opinion
- Chair of Special Committee used CEO's assistant to distribute confidential materials to committee members
- Committee members received Fairness Opinion one day before telephonic meeting at which 2 of 3 members attended to approve the transaction
- Granular analysis by the Court of:
  - ✓ Appropriate management projections to use, and what modifications
  - ✓ Appropriate discount rate
    - ❖ How to determine cost of debt
    - ❖ How to handle circularity in calculation of WACC re capital structure
    - ❖ How to determine cost of equity
  - ✓ Weight accorded to stock price
  - ✓ Weight to be given to comparative company valuation

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Proper Use of Outside Experts??

- **Pacifica Papers Inc. v. Johnstone (B.C. 2001 S.C. and C.A.)**
  - Application for approval of an arrangement transaction
  - Pacifica had to demonstrate that its planned merger with Norske was “fair and reasonable and one that a person of business would approve”
  - Two fairness opinions obtained (CIBC World Markets and BMO Nesbitt Burns)

PACIFICA PAPERS

- Plaintiffs provided expert evidence of an independent business valuer who challenged certain methodology
  - ✓Ignored synergies and full value of tax losses
  - ✓Questionable and inconsistent exchange rates assumed re U.S. revenue and debt
  - ✓Technical issue with comparable transactions methodology (one of three approaches used)
- No board discussion of methodologies used
- Court influenced by lack of dissent and substantial institutional acceptance of the transaction (Norske's stock price stayed stable)

Fairness Opinions in the News

- **Masonite International acquisition by KKR**
- **Crocus Investment Fund**
- **Goldman Sachs – NYSE – Archipelago**
- **Banks requiring two home appraisals due to concern of real estate bubble**
- **Short vs long-term value**
  - MCI (Verison beat out Qwest)
  - China Oil bid for Unocal
- **J.P. Morgan's US$58 billion acquisition of Bank One (2004) fairness opinion supplied by ….. J.P. Morgan**
- **Massachusetts Secretary of Commonwealth William Galvin investigated the fairness opinions rendered by Goldman Sachs and UBS to Gillette re US$57 billion offer from Procter & Gamble (Goldman was credited in proxy statement with bringing the parties together)**

"Checkup Prompts Search for Second Opinions" (Wall St. Journal, January 24, 2005, p.C1)

- **Practice of working both sides of the deal changing**
  - CSFB changing policy so now asks clients to get a second opinion where it is advising seller but also providing financing to buyer ("stapled financing")
    - ✓ Can earn 3 fees: advisory, fairness opinion, financing
  - IB had liked $$ and deal/relationship control
  - Goldman Sachs had typically declined to issue Fairness Opinion where it did a stapled financing
- **S&P study of large 2004 transactions found that, in cases where the advisers' roles were disclosed, only 7% identified a separate Fairness Opinion provider from the main adviser**
  - But that was up from 3% in 2003

DIRECTORS DUTIES AND EXPERT ADVICE

FIDUCIARY DUTIES OF DIRECTORS AND POTENTIAL LIABILITY

➢ ***CBCA Section 122 / OBCA Section 134*** **– Directors' Duty of Loyalty and Standard of Care**

- Every director (and officer) of a corporation in exercising their powers and discharging their duties shall:
  - ✓Act honestly and in good faith with a view to the best interests of the corporation; and
  - ✓Exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances
- Leading US case of *Smith v. Van Gorkom* (1985) re Trans Union merger found gross negligence in approval process
  - ✓No fairness opinion or market check or valuation discussion
  - ✓While not "required", process flawed and transaction "rubber stamped" (see also, *Re Standard Trustco Ltd. et al OSC 1992)*
- Heightened duty of care (enhanced scrutiny) in certain situations of conflict *(Weinberger v. UOP Inc.* Delaware 1983)
  - ✓MBO; insider-lead refinancing
  - ✓Must exercise duties in a fashion which takes into account – and minimizes, to fullest extent reasonable, conflicts of interest

BUSINESS JUDGMENT RULE

- **In the absence of evidence to the contrary, directors are presumed to be acting on an informed basis, in good faith and with a view to the best interests of the company (*i.e.* the company's shareholders as a whole)**
  - *CBCA s. 122 / OBCA s. 134* encapsulate this principle
  - Directors may exercise their business judgment without fear of being second-guessed by courts acting with the benefit of perfect hindsight
    - ✓Recognized need to encourage risk-taking and deal with business uncertainties
    - ✓Judicial deference as Courts recognize that judgment required and that Board has the advantage of first-hand information
  - Onus of proof resides with the claimant to establish facts to rebut this presumption (*e.g.* an abuse of discretion, self-dealing, absence of a majority of disinterested directors in approving the terms of a financing, etc.)
  - Presumption is not defeated by mere fact of controlling shareholder
  - Historically required a "reasonable decision", not a "perfect decision"

BUSINESS JUDGMENT RULE (Cont'd)

- **If the directors have sufficient information concerning the issue before them, examine the information critically and reflect carefully and fully, courts will not overturn or impose liability for decisions that are debatable or produce bad results**
- **Ont CA (1998) *Schneider*; *CW Shareholdings v. WIC Western*:**
  - A court must be satisfied that the directors have acted reasonably and fairly but will look to see that the directors made a reasonable decision, not a perfect one. So long as a reasonable alternative is selected, deference is to accorded to their decision. Where a conflict of interest is raised, the burden of proof ("enhanced scrutiny") does not shift to the directors if they took reasonable steps to avoid the conflict of interest
  - Where business decisions have been made in good faith and on reasonable grounds, a court will be reluctant to interfere and usurp the board of directors' function in managing the corporation
- ***820099 Ontario Inc. v. Harold Ballard Ltd. (Ont. 1991)***
  - However, the oppression remedy is still available to a plaintiff who can show that the decision is oppressive (fails to protect reasonable expectations of shareholders) or is unfairly prejudicial to or unfairly disregards his interest

BUSINESS JUDGMENT RULE (Cont'd)

- **Challenges are possible and raise issues of director liability and third party's ability to enforce the transaction**
  - Misfeasance (conflict, fraud, bad faith, illegality)
  - Nonfeasance
  - Prolonged failure to supervise
  - Complete failure to act
  - No business purpose
  - Irrational
  - Beyond scope of legal mandate
  - Corporate waste

EXERCISE OF DUTY OF CARE

- **Accepted procedures to deal with potential conflicts include use of independent committees and advisors**
  - ✓ Cannot merely rely on experts and advisors
  - ✓ Informed decision-making requires prior review of relevant documents, reviewing underlying investigations, assumptions and methodology of the expert report and consideration of alternatives not contemplated by the report
  - ✓ Determine the factors the expert considered most important and whether management furnished all facts requested by the expert or otherwise relevant (*Maple Leaf Gardens e.g.)*
  - ✓ Consider whether the expert's conclusion is within their sphere of competence and their reputation
- ***Weinberger* (Delaware 1983) case requires both procedural fairness and substantive fairness where conflicts exist**
  - If procedural fairness substantiated, then burden shifts to Plaintiff re substantive fairness

EXERCISE OF DUTY OF CARE

- **Notwithstanding settled jurisprudence, consider:**
  - Trend to companies avoiding investment bankers' fees by doing M&A work in-house
    - ✓ *BusinessWeek,* June 2, 2003 p. 78
    - ✓ University of Delaware study 2004 re factors influencing acquirer use of fairness opinions
    - ✓ Inconsistent US law regarding use of tender offer and 90% squeeze out merger as not requiring "entire fairness" analysis and therefore financial advice followed by neutral position on transaction
  - Recent Brookfield Properties – BPO Properties going private transaction
    - ✓ 89% - owned subsidiary
    - ✓ Bid at $27.83 per share
    - ✓ Special committee retains RBCDS
      - ❖ Opinion: $32.50 - $38 per share
        - Primarily due to *en bloc basis* as per 61-501
      - ❖ Nonetheless recommends that shareholders tender

Business Judgment Rule and *Repap* Case

➢February 2004 Ontario Court of Appeal:

- Set against very egregious facts, the decision clarifies and extends the nature of the court's review
- The pursuit of procedures to foster independence in form, but not in substance, (special committee, experienced counsel, benefits consultant) is not sufficient where it is demonstrated that the directors have not been "scrupulous in their deliberations and demonstrate diligence" in arriving at their judgment
- Directors relied on recommendation of compensation committee that did not have the time or expertise to review the CEO's contract and the members did not understand key components
- Consultant recommended by management
- Advice not tested
- Benchmarking not questioned

Pending Litigation and Enforcement

- **Webb report on NYSE and Grasso employment contracts and SERP**
  - Spitzer launched action
- **Disney**
  - Ovitz severance agreement and corporate waste arguments
- **Hollinger**
  - Special Committee report: “Corporate Kleptocracy”
- **Nortel**
  - Wilmer Cutler and Huron Consulting report to audit committee on 2000 – 2003 restatement

RELIANCE ON EXPERTS NOT SUFFICIENT

- **Reliance by board on fairness opinion must be in good faith and reasonable in light of relevant circumstances**
- ***Hanson Trust PLC v. ML SCM Acquisition Inc. (U.S. Second Circuit 1986)***
  - *Prima facie* breach of duty even though F.O.
  - Directors methodologies and procedures so restricted in scope, so shallow in execution, or otherwise so *pro forma* or half-hearted that held to be a sham

RELIANCE ON EXPERTS NOT SUFFICIENT

- **Numerous U.S. cases have held that plaintiffs rebutted the Business Judgment Rule arguing:**
  - Directors did not in fact rely on the experts
  - Reliance not in good faith
  - Did not believe/verify expert's competence
  - Faulty advisor selection process or remuneration
  - Material facts reasonably available ignored by Board
    - ✓ Gross negligence trumps expert report
  - Board failed to participate in the diligence, decision-making and negotiation and overly relied on management and expert
  - Examples:
    - ✓ *Hollinger International* report on "Corporate Kleptocracy"
      - ❖ Director Perle added as class action defendant as allegedly "routinely signed written consents without even reading them, let alone discussing them or understanding them"
    - ✓ Interim Motion in *Disney* litigation (2000) regarding reliance on a "presumed expert" who admitted that no scenario analysis done on Ovitz severance contract

RELIANCE ON EXPERTS NOT SUFFICIENT

- **Most recently, Re: The Walt Disney Co. Derivative Litigation (2003):**
  - A board's failure to apply actual thought and judgment to a proposed golden parachute arrangement can lead to liability, notwithstanding the apparently proper "process" that was conducted
  - Allowed case to proceed to trial
- **YBM Magnex (OSC administrative action) and Emerging Communications (class action) hold that directors will be held to differing standards based on extent of involvement and qualifications**
  - In Emerging Communications one director (who was not even on the Special Committee) was not entitled to rely on the Fairness Opinion, due to his investment banking background

Special Committees

- **Substantiating an impartial decision-making practice, procedures must be put in place to deal with actual or perceived conflicts:**
  - Management or significant shareholders with board representation may have initiated transaction
  - Parties may have commercial interest not consistent with shareholder value
- **Special committees consistently held to help establish integrity of board deliberation process**

Special Committees

- **Members must be truly disinterested and "independent" – guidance in OSC Rule 61-501 and *Oracle* (Delaware 2002)**
- **The committee must function independently and manage the process and not be mere "window dressing"**
- **The deliberations must be thoroughly documented**
- **Independent lawyers, investment bankers, accountants and other advisors must be used**

PRACTICAL TIPS FOR DIRECTORS

- Be prepared - Obtain and review all relevant documents before the meeting where they will be discussed
- Take sufficient time to consider the matter; avoid or question haste
  - ✓ Developing practice to not sign agreement fro several days after board presentation and delivery of F.O.
- Use all necessary advisors, reviewing the underlying investigations, assumptions and methodology of the opinion of the expert, without unquestionably relying on them
  - ✓ Developing practice of reviewing the “blue book”
  - ✓ See list of common problems found in business valuation reports
- Review, compare and weigh any alternatives to the proposed action – that may have been beyond the scope of review
- Ask questions and actively participate in discussion and the decision-making process
  - ✓ Competitors not benchmarked? Why? Talked to other side? Where they forthcoming? Projections verified and reasonable? Transaction terms verified? Discounts justified?
- Review advice for basic due diligence, analysis of risks, understanding of deal structure and terms, conflicts, valuation analysis, timeliness

PRACTICAL TIPS FOR DIRECTORS – Questions to Ask

- **What valuation approaches used/not used and why?**
- **Objective criteria used to determine comparative companies/comparative transactions analysis?**
  - What data sets "excluded" from the presentation
- **What growth rates and profit margins used in the company's forecasts?**
- **How was cost of debt and cost of capital determined?**
- **What was the range of values determined?**
- **Were synergistic factors considered?**

Common Problems in Valuation Reports

COMMON PROBLEMS IN BUSINESS VALUATION REPORTS

- **Inadequate depth of analysis:**
  - Scope of review must allow for a proper industry and market analysis, business analysis and an appropriate review of budgets and projections
    - ✓Breadth/depth
    - ✓Internal/external information and interviews
      - ❖Excluded parties (qualification)
  - Industry and market analysis
    - ✓Understand key characteristics and trends
      - ❖Consolidations; IPO's

COMMON PROBLEMS IN BUSINESS VALUATION REPORTS

- **Inadequate depth of analysis:**
  - Business analysis
    - ✓Understand operations and process
    - ✓Identify key economic drivers
    - ✓Thorough assessment of risks & opportunities
    - ✓Analyze the reasons behind the historical results
    - ✓S.W.O.T. analysis
  - Budgets and projections
    - ✓Who/why/when prepared
    - ✓Bias/risk/sensitivity
    - ✓Supporting assumptions/working papers

COMMON PROBLEMS IN BUSINESS VALUATION REPORTS

- **Misapplication of methodology:**
  - key: appropriate methodology properly applied
    - ✓ Avoid a "boilerplate" approach
    - ✓ Avoid undue reliance on "comparable" companies, stock market returns and rules of thumb and technical errors
    - ✓ Consider 61-501 substantive issues
- **Internal inconsistency:**
  - key: consistent application of facts and assumptions throughout the valuation report
    - ✓ Business/industry facts ↔ Report assumptions ↔ ↔Valuation approach ↔ Rate of return selection ↔ ↔Valuation conclusions ↔ Business/industry facts
  - Within projections:
    - ✓ Assumptions used; completeness of costs; capacity constraints; working capital/growth capital requirements
  - Between rate of return & projected cash flow/earnings
    - ✓ Interdependence – risk/return trade-off; inflation rate; growth assumptions

COMMON PROBLEMS IN BUSINESS VALUATION REPORTS

➢Comparable Company Multiple fallacies:

- Public company multiples
  - ✓No two companies are alike
  - ✓Liquidity differences
  - ✓Insider information
  - ✓Ability to lever/de-lever
- Transaction multiples
  - ✓Differing forms of payment
    - ❖Cash; shares; VTB; earn out
  - ✓Difficulty in factoring out synergies anticipated by strategic acquirer
  - ✓Fact specific issues of the transaction:
    - ❖Time offered for sale; negotiating positions and abilities
- What Multiple?
  - ✓EBIT/EBITDA/free cash flow

COMMON PROBLEMS IN BUSINESS VALUATION REPORTS

➢ Comparable Company Multiple fallacies:

- Calculating Enterprise Value:
  - ✓ Market value of equity plus market value of interest-bearing debt (and equivalents)
  - ✓ Definition of “interest-bearing debt (and equivalents)”
  - ✓ Deduct cash on hand against debt?
  - ✓ How to treat redundant (non-operating) assets
- Calculating Earnings/Cash Flow Base
  - ✓ What “unusual or non-recurring” items to adjust for?
  - ✓ Use historical or prospective earnings (cash flows)?
  - ✓ Treatment of synergies where the multiples being calculated relate to an open market transaction?

COMMON PROBLEMS IN BUSINESS VALUATION REPORTS

- **Unreasonable valuation conclusions:**
  - Key: rational balanced assessment of specific facts of the business, appropriate rates of return, information provided
  - Critical evaluation of key assumptions
    - ✓ Reasonableness of budgets & projections
    - ✓ Perpetual growth?
    - ✓ Conclusions of other experts
- **Poor communication with counsel:**
  - Key: counsel must be kept informed throughout the valuation process and understand assumptions and issues that affect valuation conclusions
  - Specific instructions from counsel must be established at the outset
  - Updates as to progress and issues

Common and Uncommon Errors in Company Valuation

- **See definitive papers written by Pablo Fernandez and others**
- **Social Science Research Network**
  - www.ssrn.com
  - Abstracts 545546, 411600, 274973, 496083, 568144

2003/2004 "Soft Accounting" Issues

- **Auditing fair value measurements and disclosures, estimates, judgment**
- **Krispy Kreme investigated for accounting (amortization period) for franchise buy-backs**
- **AT&T restated 2001, 2002 results due to two mid-level employees circumventing controls and incorrectly recording network access charges**
  - Employees and supervisors terminated
- **SEC industry-review of supplier rebates in foodservice industry as a result of Ahold's U.S. Foodservice unit scandal**
  - Minimal disclosure requirements for over U.S.$100 billion industry issue in 2003
  - Recent EITF (FASB) guidance states that generally should deduct rebate from COGS, but in some cases can be booked as revenue, other income or as a reduction of some other cost
  - Determining when to book the rebate is left open – "probable and reasonably estimable" that rebate will be received
- **Travelers merger with St. Paul Insurance highlighted different methodologies used by the two companies for loss reserves – led to increased reserve for St. Paul business post-closing**
- **Alstom US subsidiary significantly understated losses on rail-car contract**

2003/2004 "Soft Accounting" Issues

- **Pensions:**
  - assumed rates of return on assets
  - Discount rates re future cost
  - See, *"Pumped-Up Pension Plays?"*, BusinessWeek, October 25, 2004, p. 92
  - SEC requested details of pension accounting from Ford and GM, October 2004
- **Post retirement healthcare:**
  - Healthcare inflation typically exceeds assumptions
- **Tax rates/deferred taxes**
  - Assumptions re rates and timing of taxes on foreign income (*"Unexploded Ordnance",* Forbes, October 4, 2004
  - Lack of clarity on overall tax rate – Texas Instruments 2004
- **Gaming the "matching" principle:**
  - Delayed recognition of a variety of operating expenses including development costs, acquisition costs for new ventures, stat-up costs, financing costs
- **Revenue games:**
  - Vendor financing, rolling receivables into investments in customers, artificially low allowance for doubtful accounts
- **Abuse of "one time gains"**
  - Asset sales, currency translation, changes in valuations, allowances and reserves

Freddie Mac (2003) and Fannie Mae (2004)

- Among the largest financial institutions in the US; own or guarantee close to half of the U.S.$7.8 trillion residential mortgage debt outstanding
- Regulated by OFHEO and SEC
- Each alleged to have improperly "smoothed" earnings to avoid impact of FAS 133 and other accounting rules and to meet executive bonus targets
- Concerns about corporate cultures, capital adequacy and response of market to their securities, as well as impact on mortgage market
- Investigative reports (http://www.ofheo.gov) charge: departure from GAAP re derivatives transactions and hedging, use of "cookie-jar" reserves, tolerating internal control deficiencies, deferring expenses to achieve compensation targets and "maintaining a corporate culture that emphasized stable earnings at the expense of accurate disclosures"

Nortel 2003

- After an internal investigation, finance officials accused of inappropriately used accruals and provisions to ensure profit in first half of 2003
- Nortel had paid tens of millions of dollars under a “return to profitability” bonus program
- Market looking to pending update on 2003-2004 in late October

LITIGATION AND ENFORCEMENT ISSUES

HISTORICAL CONCERNS RE FAIRNESS OPINIONS

- **Spitzer comments March 2003 about potential investigation based on other IB scandals**
  - IPO laddering; stock analysts; tax shelters; Enron structuring; Telco capacity swaps
  - SEC has not indicated any interest in taking on this project – saying private market remedies sufficient
- **Scope of engagement**
- **Transparency**
- **Conflicts of interest**
  - Goldman Sachs – Jinro
  - Misusing confidential information
    - ✓ ADT v Chase; Weiner v. Lazard Freres
  - Acting for bidders against former client
- **Independence and Qualifications**
  - Note Rule 61-501 and Companion Policy
  - New SEC audit independence rules

LITIGATION CONCERNING FAIRNESS OPINIONS

- **Canadian courts have generally respected significant firms' reports in the corporate context without getting too granular**
  - See also Gazit (1997) Inc. v. Centrefund Realty *Corporation (Ont. 2000)*
- **U.S. courts willing to examine the report and second guess analysis and conclusions**

SOURCES OF LIABILITY FOR ADVISORS

- **Negligent Misrepresentation/Fraudulent Misrepresentation**
  - Duty of care; Standard of care; Reliance; Causation
  - Public policy limitations
  - Problems in pursuing auditors due to SCC decision in Hercules Management (1997) and Ontario CA in Waxman (2004)
  - Issue of duty of care between investment bankers preparing fairness opinions and non-privity shareholders in the context of a merger held unsettled and open to litigation in *Proprietary Industries Inc. v. CIBC World Markets Inc. (2002 B.C.S.C.)*
- **Statutory Liability**
  - Canada:
    - ✓ OSA prospectus and takeover bid rules
    - ✓ Pending statutory secondary market liability
  - U.S.:
    - ✓ Proxy statement and going private form requirements where expert consent
    - ✓ Registration statements where expert consent
    - ✓ Rule 10b5 anti-fraud
      - ❖ Primary vs. secondary liability
      - ❖ Recent Enron litigation

SOURCES OF LIABILITY FOR ADVISORS

➢Fairness "from a financial point of view"

- Must nonetheless take into account business alternatives
- Boards sometimes rely on "soft factors"
  - ✓Perceived risks
  - ✓Operational benefits may be more important than price

➢Fairness to whom?

- *Levco Alternative Fund v. The Readers Digest Association (Delaware 2002)* concerning a recapitalization transaction – zero sum game among different classes

➢Contract vs. Tort: How Does the Engagement Letter and Indemnity Agreement Fit In?

- *Cognos* (SCC 1993) requires express disclaimer of tort liability
- Standard of care limitations *("gross negligence")*
- *Etoys v. Goldman Sachs* (IPO litigation) allowed fiduciary duty and fraud claims to proceed

THE LATEST ON LIABILITY

- ***In re Reliance Securities Litigation* (District Ct. Delaware 2001)**
  - Plaintiffs must show that the adviser's conclusions were both objectively false (incorrect) and subjectively false (advisor did not believe in analysis or was reckless)
- ***In re Enron Corp. Securities Litigation (S.D.Texas Dec. 20, 2002)***
  - *Rule 10b-5 claim against Dealers and law firm and accounting firm survived motion to dismiss*
    - ✓ *Expanded basis for "primary liability" of those who create a misrepresentation alone or with others*
- ***Bre-X***
  - *Canada and the US diverge on whether a class action against advisors is certifiable*
- ***YBM***
  - *Plaintiff successful in resisting motion to dismiss as pleaded actual reliance*
- ***Beaudoin v. Avantage Link (Quebec Superior Ct. 2002)***
  - *Court relied on Article 1457 of Civil Code*

Failure of Gatekeeper Process

- **Failure of deterrence related to:**
  - USSC 1991 decision in *Lampf, Pleva*, which significantly shortened the limitations period for securities fraud
  - USSC 1994 decision in *Central Bank of Denver*, which eliminated private "aiding and abetting" liability in securities fraud cases
  - 1995 PSLRA
  - 1998 SLUSA, abolished state court class actions for securities fraud
  - 1997 Can Supreme Court decision in *Hercules Management* and Ontario CA in *Waxman v. Waxman* (2004)
- **Recent Event: *Enron* decision permitting claims against secondary actors to proceed on basis of participation in "creation" of the misrepresentation**
- **See: *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms",* John C. Coffee presentation to Berkely Program in law & Economics, Working Paper Series, *http://repositories.cdlib.org/blewp/art160***
  - *See related article by Stanley Beck published as part of 1994 Queen's Business Law Symposium*
- **See: Interagency Statement on Sound Practices Concerning Complex Structured Finance Activities**
  - http://www.sec.gov/rules/policy/34-49873.htm

Gatekeepers Actually Aided and Abetted

- **Investment bankers, insurers and others developed sophisticated structures and transactions to assist in revenue booking, earnings management, risk syndication and tax minimization**
  - Note recent enforcement actions re AOL-Homestore, IBM-Dollar General and AIG-Brightpoint and PNC Financial (sold "non-traditional" insurance product designed to assist client's income smoothing and hiding of underperforming loans and VC investments); Lucent - Windstar
  - SEC SOX s.703 report
  - Senate staff report on Enron financing structures
  - GAO report on Bankers, analysts and Enron and Global Crossing
  - Senate Report on Enron banker influence on credit ratings
  - Participation in Enron wash trades
  - Credit derivatives and Ethical walls
  - Forced to defend WorldCom and Enron class actions and regulatory enforcement
  - FT Interactive Data (Dec. 2003) alleged by SEC to have improperly allowed a mutual fund firm to influence its decisions in valuing bonds
  - Citigroup (then called SSB) brokers administering WorldCom (now MCI) stock option plan failed to receive adequate training and many employees exercised and held stock (some on margin) despite varying risk profiles and investment objectives
    - ✓ Morgan Stanley and Microsoft options
  - Mutual Fund scandal
  - Voting of proxies in HP-Compaq merger
  - At the very least ignored "reputation risk"
    - ✓ CIBC Reputational Risk Policy published

Gatekeepers Actually Aided and Abetted

- **Investment bankers, insurers and others developed sophisticated structures and transactions to assist in revenue booking, earnings management, risk syndication and tax minimization**
  - Participation in underwritings without full disclosure
  - Directed brokerage and mutual fund sales
  - Tied selling – Parmalat loans (Parmalat banks and auditors being sued)
  - Anti-trust issues in bond pricing
  - Securities clearing businesses
  - Insider trading (e.g. Yorkton)
  - Breach of money laundering and Patriot Act duties
  - IPO allocation scandal; Spinning and personal loans to executives Securitization and insurance on troubled loans
  - *"Financial Reinsurance Open to Abuse"*, National Post, Oct. 22, 2004 IN3
  - Private placements
  - Off-exchange trading
  - Side letters (CIBC-Livent; Merrill Lynch-Enron; Lucent-Windstar)
  - Credit Lyonnais being sued by Sumitomo (Oct. 2004) for "dishonest assistance" to rogue Sumitomo trader in US$2.6 billion copper trade losses
  - Execution of fraudulent receivables/rebates confirmation letters for Ahold subsidiary
  - See: Senate report attacking structured finance activities http://govt-aff.senate.gov/010203psireport.pdf
  - Sumitomo suing Credit Lyonnais for permitting trader to do extraordinarily large trades
  - SEC report on "soft dollar" practices (1998)

SEC Gets Aggressive with Intermediaries

- **2004 SEC settled aiding and abetting actions against CIBC, JP Morgan Chase & Co., Citigroup Inc. and Merrill Lynch & Co.**
  - Section 20(e) of *Securities Exchange Act*
- **Criteria: at least a general awareness by the intermediary that their actions are part of an overall course of improper conduct together with substantial assistance by the intermediary in the violative conduct**
  - Conduct going beyond this might attract primary liability
- **Requires high level assessment of risk ("how would it look in the New York Times"), together with full understanding of the background facts and good judgment**
- **No similar provisions in the *Securities Act (Ontario)*, but section 77 of the *Provincial Offences Act***

NASD Gets Aggressive

- **Speeches by Mary Schapiro, Vive Chair NASD**
- **Recently addressed top 8 "Myths" about "self-regulation"**
- **Emphasizes financial services industry as a "profession" that stands apart from other commercial endeavours by virtue of the presence of widely accepted and applied ethical principles**
  - References NASD Rule 2110 which compels observance of high standards of commercial honour and just and equitable principles of trade

Valuators as Expert Witnesses

- Must be impartial, not the advocate of the party retaining the valuator
- Overriding duty to court to be objective
- Should be independent; no prior existing relationship or interest in the litigation should exist
- As expert, should be clear, transparent, objective and educational
- Expert Witness Immunity differs between Canada and the US

Valuators as Expert Witnesses

- **Strong statements about work performed that is viewed as "flawed"or "influenced**
  - *Pizza Pizza Ltd. V. 805837 Ontario Inc. (Ont.)*
  - *Debora v. Debora (Ont. Sup. Ct. J. Nov. 2004)*
- **General criteria:**
  - Expert evidence should be seen to be the independent product of the expert uninfluenced as to form or content by the exigencies of litigation
  - An expert should provide independent assistance to the court by objective unbiased opinion
  - An expert should state the facts or assumptions on which the opinion is based
  - An expert should make it clear if a question or issue falls outside their expertise
  - If opinion not properly researched due to insufficient data, this must be stated

BILL 198/Bill 41/Bill 149 AND SECONDARY MARKET LIABILITY

Background to the Legislation

- **December 1995 – Interim Report of TSE "Allen Committee" on Corporate Disclosure**
- **March 1997 – Final Report of Allen Committee**
- **May 1998 and November 2000 – CSA Proposals for Statutory Civil Remedy in the Secondary Market**
- **May 2002 – Draft Report of Five Year Review Committee reviewing the Ontario Securities Act**
- **October 30, 2002 – Ontario Government introduces Bill 198**
- **May 22, 2003 – Ontario Government introduces Bill 41 (technical amendments)**
- **December 16, 2004, the Budget Measures Act (Fall), 2004 (Bill 149) received Royal Assent. Part XXIII.1 of the Securities Act entitled "Civil Liability for Secondary Market Disclosure" and related liability section 126.2 have not yet been proclaimed into force**

What is Secondary Market Liability?

The proposed Securities Act amendments will:

i. **create statutory offences for securities fraud, market manipulation and making misleading or untrue statements**

ii. **introduce a private right of action for breaches of Ontario's continuous disclosure requirements**

iii. **provide tougher penalties for breaches of Ontario's securities laws - increase maximum court fines for general offences to $5 million from $1 million and prison terms to 5 years from 2 years**

iv. **give the OSC authority to impose administrative fines of $1 million for securities law violations and to issue disgorgement orders in respect of profits resulting from those violations**

What is Secondary Market Liability?

v. give the OSC authority to compel issuers to deliver up all relevant documents required to conduct a continuous disclosure review

vi. provide the OSC with rule-making authority in respect of audit committee composition, function and responsibilities, including certification of reports

vii. provide the OSC with rule-making authority in respect of internal control systems and disclosure controls and procedures to be implemented by issuers, including requiring CEO and CFO certification as to such systems, controls and procedures.

New Statutory Offences - Fraud and Market Manipulation

It will be an offence for anyone to "directly or indirectly" engage or participate in any act, practice or course of conduct relating to securities or derivatives of securities that the person or company "knows or reasonably ought to know":

a) **results in or contributes to a misleading appearance of trading activity in or an artificial price for a security or derivative; or**

b) **perpetuates a fraud on any person or company.**

New Statutory Offences (cont.)
Misleading or Untrue Statements

It will be an offence to "make a statement" that the maker of the statement "knows or ought reasonably to know":

a) **in a material respect and at the time and in light of the circumstances under which it was made, is misleading or untrue or does not state a fact required to be stated or necessary to make the statement not misleading; and**

b) **significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of a security.**

Civil Liability for Secondary Market Disclosure

Current Regime

- **Before this legislation, no specific statutory civil remedies under Canadian securities law for untimely or misleading continuous disclosure.**
- **Significant hurdles face an investor bringing an action at common law based on misrepresentations made by an issuer in its public disclosure, including the investor must prove that:**

  i. the issuer owed a duty of care to the investor;

  ii. the investor relied to his detriment on the misrepresentation in making an investment decision; and

  iii. the misrepresentation caused the damage suffered.

- **Also, prohibitively high costs associated with bringing an individual action.**

Requires Leave of Court to Proceed

- **No action can be commenced under the new civil remedy without leave of the Ontario Superior Court of Justice and only where the court is satisfied that:**

  i. **the action is being brought in good faith, and**

  ii. **there is a reasonable possibility that the action will be resolved at trial in the plaintiff's favour.**

- **Anyone granted leave to commence an action under the new remedy must promptly issue a news release disclosing that fact.**

- **The OSC may intervene in any action under the new remedy and in an application for leave.**

Disclosures that will Attract Liability

- **A "misrepresentation" in a <u>public written document</u> (not restricted to Canadian securities filings and including in electronic form).**
- **A "misrepresentation" in a <u>public oral statement</u> by a person with actual, implied or apparent authority to speak on behalf of a responsible issuer.**
- **<u>Failure of an issuer to make required timely disclosure</u> of a "material change".**

Disclosures that will Attract Liability (cont.)

- **A "misrepresentation" is**

  i. an untrue statement of "material fact", or

  ii. an omission to state a material fact that is required to be stated or that is necessary to make a statement not misleading in light of the circumstances in which it was made.

- **A "material fact" is a fact that would reasonably be expected to have a significant effect on the market price or value of the issuer's securities.**

- **A "material change" means**

  i. a change in the business operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the issuer's securities, or

  ii. a decision to implement such a change made by the board of directors or by senior management who believe board confirmation is probable.

Who will have a Cause of Action?

- **Anyone who acquires or disposes of a security of the responsible issuer in a secondary market transaction between the time when the misrepresentation was made and when it was publicly corrected, or in the case of untimely disclosure of a material change, between the time when the disclosure ought to have been made and when it was in fact made.**

- **A person or company has this right of action *without regard to* whether the person or company relied on the misrepresentation.**

Standards of Liability, Burdens of Proof and Defences for Experts

Experts are liable for misrepresentation in a document or public oral statement derived from the expert's report, opinion or statement unless the person can prove he conducted or caused to be conducted a reasonable investigation and had reasonable grounds to believe that there was no misrepresentation

Due Diligence/Gross Misconduct – Factors to be Considered

The court will consider all the relevant circumstances, including:

- the nature of the issuer
- the knowledge, experience and function of the person
- the office held if the person is an officer
- the presence or absence of another relationship with the issuer if the person is a director
- the existence and nature of any system to ensure that the issuer meets its continuous disclosure obligations
- the reasonableness of reliance on the issuer's disclosure compliance system and on the issuer's officers, employees and others whose duties should give knowledge of the relevant facts

Due Diligence/Gross Misconduct – Factors to be Considered

- the time period within which disclosure was required to be made
- the role and responsibility of the person in the preparation and release of the document or in ascertaining the facts contained in the document or public oral statement
- the role and responsibility of the person involved in a decision not to disclose a material change
- the extent to which the person knew or should reasonably have known the content and medium of dissemination of the document or public oral statement
- in respect of a report, opinion or statement of an expert, the professional standards applicable to the expert

Proportionate Liability

Liability of defendants will be proportionate to their respective fault except in the case of a defendant (other than the responsible issuer) found to have authorized, permitted or acquiesced in the making of the misrepresentation or failure to make timely disclosure while *knowing* it was a disclosure violation, in which case such defendant will be jointly and severally liable with each similarly culpable defendant for the aggregate amount of damages awarded.

Where No Limit on Liability

There is no limit on the total liability of a defendant (other than the responsible issuer) if the plaintiff proves that the defendant

i. authorized, permitted or acquiesced in the making of the misrepresentation or failure to make timely disclosure while *knowing* it was a disclosure violation, or

ii. influenced the making of the misrepresentation or failure to make timely disclosure while *knowing* it was a disclosure violation.

Liability Caps - Experts

The damages payable by an expert are limited to the greater of:

i. $1 million; and

ii. the revenue earned by the expert and its affiliates from the responsible issuer and its affiliates during the 12 months preceding the misrepresentation,

less any damages assessed (after appeals) against the expert in all other actions brought under the new remedy and under comparable legislation elsewhere in Canada in respect of the same misrepresentation.

SECURITIES LAW REGULATION OF VALUATIONS

The Fairness Opinion

- **Corporate law was not fully adequate, however, to ensure fair dealing between companies and their shareholders**
  - Fairness opinions became a lucrative line of business for investment dealers notwithstanding lack of standards for output and questions about independence and qualification
  - The rise of the “success-based” fee

The Fairness Opinion

- **Regulatory response:**
  - Securities laws and CSA policies
  - By-laws of self-regulatory organizations and stock exchanges
    - ✓ Modern corporate law and the oppression remedy also imported a "fairness requirement"
  - 1970's marked by rash of issuer bids and squeeze-out transactions
  - Corporate appraisal remedy in the event of fundamental change transactions from which a shareholder dissents
  - Securities regulations imposed as a regulatory response to the informational disadvantages of offered evaluating an issuer bid, insider bid or going private transaction
    - ✓ Informational disadvantage also addressed by requiring approval of majority of the minority in certain circumstances

History of Securities Regulation of Certain Transactions In Ontario

- **Policy 3-37 introduced September 1977 – initially restricted to issuer bids**
  - Offers by an issuer to purchase, redeem or retire their own securities
  - Timely disclosure required in issuer bid circular
  - Independent valuation required in certain circumstances
- **Policy 3-37 later extended to take-over bids made by an insider or affiliate**

History of Securities Regulation of Certain Transactions In Ontario

- **1978 going private transactions review**
  - Recommended mandatory valuations, majority of the minority voting and disclosure requirements, rather than substantive fairness rules
  - OSC would prefer not to become a regular arbiter of substantive fairness
- **OSC Policy 9.1 issued in 1982**
  - Covered going private transactions, issuer bids and insider bids
  - Required a valuation prepared in accordance with certain procedures

History of Securities Regulation of Certain Transactions In Ontario

- Required minority approval for a going private transaction
  - ✓Two-thirds minority approval if transaction consideration less than mid-point of range of valuation
- Mandated disclosure of business goal, material changes, tax consequences, any summary of the valuation in the information circular

➢**Revised Policy 9.1 issued 1991 and amended 1992**

- Significantly increased the regulation of going private transactions

History of Securities Regulation of Certain Transactions In Ontario

- Detailed procedures for disclosure, valuation and minority approval
  - ✓ Qualified and independent valuer
  - ✓ Must examine several valuation approaches
  - ✓ Formal valuation report containing specific information required
  - ✓ Extensive mandatory disclosure in information circular
  - ✓ Use of special committees strongly recommended
  - ✓ Minority approval voting requirements retained
- Introduced regulation of related party transactions

History of Securities Regulation of Certain Transactions In Ontario

- **At conferences and in the press the OSC indicated that it assumed the market cannot be relied upon to ensure that minority shareholders receive a fair price for their shares**
  - Policy 9.1 directed at complicated Hees-Edper structure and succession of issuer bids with related party standby commitments
- **Revamped Rule 61-501 enacted 2000 and subsequently further amended**

History of Securities Regulation of Certain Transactions In Ontario

- Quebec has adopted and subsequently amended Policy Q-27 to track Ontario Rules
- CDNX has adopted Policy 5.9

Requirements of Rule 61-501 for Valuations

- Independence Rules
  - ✓Consider deemed lack of independence if assisting in the negotiations of a transaction and then providing a valuation report on the same transaction (see 6.1(3)(b) of 61-501)
- Disclosure in transaction document re qualification and independence facts
- Rule re what securities/assets have to be valued
- Form and content of valuation report

Requirements of Rule 61-501 for Valuations

- Form and content of valuation summary
- Valuer's consent (Note: Bill 198 implications)
- Disclosure of prior valuation

Rule 61-501 Recent Amendments – Valuation Highlights

- Independent committee of the board will have to use its best efforts to ensure that a formal valuation for an insider bid is completed and provided to the offeror in a timely manner
- Introducing additional exceptions to the requirement for a formal valuation (where expense outweighs benefits, especially with respect to junior issuers)
- Prohibition on certain downward adjustments (liquidity, minority discount, effect of the transaction) is limited to offeree securities

Fairness Opinions Versus Valuations

- **Central difference:**
  - Valuation report gives an opinion of value or range of values for a security
  - Fairness opinion is merely an opinion that the consideration being offered for the security is fair, including factors which may not be quantifiable with precision
- **Fairness opinions not required by statute, but likely required in fulfilment of fiduciary duty**

Fairness Opinions Versus Valuations

- **Stock Exchanges occasionally require fairness opinions in transactions with potential conflicts**
- **Valuations required in distinct circumstances by statute:**
  - Corporate law in respect of going private transactions and certain takeover bids
  - Rule 61-501 for insider bids, issuer bids, going private transactions and related party transactions

Fairness Opinions Versus Valuations

- **Rule 61-501 and applicable corporate law prescribe certain procedural and substantive requirements for valuations that are not stated to apply to fairness opinions**
  - "qualified valuer"
    - ✓Auditor won't qualify
  - "Independent valuer"
    - ✓Rule 61-501 prescribes certain guidance
    - ✓Prior relationships
    - ✓Success based fees

NASD Proposed Rule 2290

➢ Rules for disclosures within Fairness Opinion

- Whether acted as financial adviser in the transaction
- Whether receiving contingent consideration based on successful completion
  - ✓ For issuing the fairness opinion
  - ✓ For advisory services
  - ✓ For any other reason
- Material relationships within the past two years or mutually understood to be contemplated with any party to the transaction
  - ✓ Compensation received or to be received from such relationships
- Information supplied to adviser by company requesting opinion and whether it has been independently verified
  - ✓ Typical bulk statements of reliance expressly deemed insufficient in commentary
- Whether Fairness Opinion approved by in-firm Rule 2290 procedures

NASD Proposed Rule 2290

- **Required in-firm approval procedures:**
  - Circumstances where it will require a Fairness Opinion Committee review
  - Process for selection Committee members and necessary qualifications
  - Process to ensure a balanced review by the Fairness Committee by non-deal-team personnel
  - Processes to determine whether valuation analysis is appropriate for the deal
  - Process to evaluate degree as to which amount and nature of compensation from transaction accruing to directors, officers and employees, relative to benefit to shareholders, is a factor in reaching a fairness determination

Proposed NASD Regulation

- Notice to Members 04-83 Nov. 2004 solicited comments
- Proposed Rule 2290 filed with the SEC June 22, 2005 (SR-NASD-2005-080)
- Rules for disclosures within Fairness Opinion
- Rules for procedures to address approvals of Fairness Opinion by issuing firm

DOCUMENTING THE ADVICE

Form of Documentation

- **During 1980's regulators become concerned about lack of explicit analysis of statement of assumptions and methodology in fairness opinions and valuations.**
  - Take-over bid circulars only required "summary valuation"
- **1993: CICBV report concluded that disclosure in more than half of valuation and fairness opinions was inadequate**

Form of Documentation

- **1993 CICBV adopted a disclosure standard for its members with respect to valuations conducted for purposes of Policy 9.1**
  - Appendix A to Standard #110
- **Investment Dealers Association of Canada adopted by-laws 29.14 to 29.25 concerning disclosure standards for formal valuations and fairness opinions**

Compliant Fairness Opinion/Valuation

1. **Scope of engagement and transaction**
2. **Consent to inclusion of report in disclosure materials and delivery to regulators**
    a)SEC Review: Now includes backup analysis – including management projections
3. **Prior relations with any party**
4. **Statement of independence**
5. **Transaction terms**
6. **Credentials**
7. **Detailed review of materials, at meetings and other input**
    a)State what materials or interviews weren't reviewed/finished
8. **Assumptions and limitations**
    a)Errors in constating documents
    b)Representation letters
        i.Rely without independent investigation and assume full, true and plain disclosure
    c)Assumptions as to future growth in revenue or value of contracts
    d)Subject carve outs – tax, regulatory, accounting

Compliant Fairness Opinion/Valuation

9. **Limited reliance**
10. **Definition of fair market value and approach to value**
    a)Will differ depending on use of report and legal threshold for Board decision
11. **Analysis**
12. **Sensitivity analysis**
    a)Such as change in cap rates, occupancy rates, rental rates, timing of development, extent of leverage
13. **Prior valuations by expert or company**
    a)Reliance on prior work?
14. **Valuation of consideration**
15. **Special purchaser value**
16. **Valuation range and conclusion**
17. **Fairness opinion, including definition of fairness and required criteria**
    a)Must also examine financial impact on purchaser, such as "accretion" analysis for GAAP and pro forma numbers
18. **No Obligation to Update**
    a)The "perils of post-signing fairness opinions"

Required Disclosure to Public

➢ OSC:

- Specific requirement of Form 32 takeover bid circular but only "general requirement" in Form 30 information circular
- Rule 61-501 requires opinion and summary description where formal valuation

➢ US:

- Historically 13e(3) going private transactions
- Recently expanded disclosure requirements for proxy statements
  - ✓ SEC Reviews increasing from historical 25%-35%
  - ✓ File opinion and detailed disclosure statement
    - ❖ Even if information ("blue book") not given to Board
    - ❖ D.S. outlines in summary form the materials reviewed, matters considered, assumptions made, valuation methodologies used, analysis conducted and conclusions
    - ❖ Sufficient to consider valuation rather than replicate it
- Corporate law ambivalent on whether details are "material"

SEC Preferred Proxy Statement Disclosure

- **Identity, qualifications and method of selection of valuator**
- **Prior dealings with issuer**
- **How paid and how $$ determined**
- **Instructions and limitations on mandate and permitted scope of investigation**
- **Background and events leading up to the mandate**
- **Purpose of the transaction**
- **Alternative transactions considered and why rejected**
- **Summary of investigations made**
- **Discussion of findings and how arrived at**
- **Statement of conclusions re fairness**
    - Detailed discussion

Engagement Letter Issues

- **Fee structure and requirement for two advisors**
  - Difficult to get OSC exemption
  - Work fee and partially refundable opinion fee may be acceptable
- **Indemnity and release from liability**
- **Types of situations attracting liability**
- **Standard of care**
- **Typical negotiation points**
- **Negotiate the rep letters as well**

Valuation Issues

1. **Opinion shopping**
2. **Prior valuations within previous two years**
    a) Why is this a concern?
        i. Tactical business concerns and monetary concerns
    b) Can explain away
        i. Shift in time or market
    c) How to avoid:
        i. Decide up front whether fairness opinion or valuation required and watch paper trail
        ii. Ask third party to not present detailed backup behind fairness opinion
        iii. If valuation required defer formal presentation until transaction is a certainty
    d) Drafts required by regulators
    e) Effect of new accounting rules
        i. Periodic review of carrying value of goodwill

Valuation Issues

3. Independence and the special committee process

"It's Just Not Fair" – Heightened Expectations for Fairness Opinions and Update on Recent Developments in Corporate and Securities Law for Business Valuators

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**Presentation to 2005 CICBV Eastern Regional Conference,
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