

France set to expand use of fairness opinions

Fairness opinions in France usually play a minor role in tender offers. That is about to change, thanks to a new set of recommendations. Eric Cafritz, James Gillespie and Jean-Florent Rérolle explain

On April 14 2005, the French securities regulator, the *Autorité des marchés financiers* (AMF) issued a report proposing dramatic changes to the rules governing public tender offers. The report, prepared by an advisory committee chaired by AMF commissioner Jean-Michel Naulot, is intended to strengthen minority shareholder protection and heighten the board of directors' responsibility in situations involving potential conflicts of interest. If the report's recommendations are adopted as expected, fairness opinions will be required for many categories of French securities transactions in which they are at present optional, and fairness opinions will provide much more information to shareholders concerning the valuation of the offer.

The new report proposes to make fairness opinions mandatory for all

transactions in which a "potential conflict of interest exists," including squeeze-outs, mergers, certain public tender offers and exchange offers, and reserved capital increases. The report also proposes rules that would require fairness opinions to provide more information, with higher due diligence requirements and independent analysis. The report suggests rules to establish the independence of experts providing fairness opinions, and clarify the board's responsibility to oversee the process of preparing the fairness opinion.

Extending the scope of fairness opinions

The report would extend the obligation to obtain a fairness opinion to a broad range of transactions, in addition to squeeze-out offers.

Public tender offers and exchange offers would require a fairness opinion when there is a conflict of interest between the offeror and the target's board. In particular, the report provides that all simplified tender offers and exchange offers should be the subject of a fairness opinion when the offeror is already the controlling shareholder of the company, defined as owning shares conferring the majority of the voting rights, or where the company makes a bid for its own shares.

For tender offers and exchange offers not initiated by a controlling shareholder, fairness opinions would remain optional, unless special or atypical circumstances would make it difficult for shareholders to understand the offer, or would create the possibility of a conflict of interest. As examples of such circumstances, the report cites an offer at a price less than market price, remuneration through complex securities, side transactions, or substantial personal benefits to management.

The report does not specify whether a tender offer launched by a minority shareholder, followed shortly thereafter by a squeeze out, would qualify as an offer by an existing majority shareholder for the purposes of requiring a fairness opinion, and this point will need to be addressed in the AMF's regulations.

The report also suggests that capital increases at a price below market be accompanied by an independent financial analysis. However, the report does not establish *when* the fairness opinion should be issued. The opinion could become part of the documentation provided to the shareholders at the time of the general assembly held to approve the capital increase, or it could be presented to the board of directors before they fix the price of the issuance. In the former case, AMF regulations will need to coordinate the independent expert's role with that of the *commissaire aux comptes*, who is required by French corporate law to provide an opinion concerning the elimination of the shareholders' preferential subscription rights, the appropriateness of the elements of the price calculation, and the effect of the issuance on existing shareholders as well as on the market price of the shares.

In the case of mergers, French corporate law already provides for a *commissaire à la fusion*, an independent, court-appointed expert charged with delivering a report on the fairness of the transaction and of the relative values assigned to the

Fairness opinions in French tender offers to date

The delivery of an independent fairness opinion in connection with a public tender offer is much more common in the US than in France. Between 1990 and 2000, about 60% of all public tender offers in the US were accompanied by a fairness opinion. In France, by comparison, of more than 30 tender offers launched between May 2002 and November 2003, only one (excluding squeeze outs) was the subject of a disclosed fairness opinion.

Neither US securities regulations nor US corporate law explicitly require that a board obtain a fairness opinion in the context of a tender offer. But the US concept of directors' fiduciary duty, as applied and developed by the courts, imposes on directors a triple obligation of duty, loyalty, and transparency toward the company and its shareholders. In transactions involving a change of control, or other situations in which directors can have potential conflicts of interest, courts are much more aggressive in examining whether these obligations have been fulfilled. In such situations, an independent fairness opinion can support the directors' demonstration of proper care and impartiality in reviewing the transaction.

In France, by contrast, fairness opinions

have been considered more a matter of securities law than of corporate law, and have been required in only limited circumstances. At present, fairness opinions are required by the AMF only in the case of squeeze-out offers. French securities regulators have also indicated that independent evaluations should be carried out either by the offeror or by the target company in other transactions, such as tender offers, mergers or capital increases, in cases where there are potential conflicts of interest that could jeopardize the shareholders' interests. Since this recommendation was issued in 2002, the use of fairness opinions has increased sharply.

In practice, the evaluation performed in France as the basis for a fairness opinion in the context of a squeeze-out is frequently less thorough than in the US. Practitioners and regulators have expressed concerns that the experts selected to perform evaluations are insufficiently independent from the parties; lack the necessary financial expertise; and tend to base their evaluation solely on the figures produced by the offeror's financial advisers without performing additional analysis of the target company.

participating companies' shares. The report proposes that the *commissaire's* report will suffice as a fairness opinion if the *commissaire* adheres to the same standards of independent analysis as would be required for a fairness opinion in a tender offer situation, as defined in the report. If the *commissaire à la fusion* does not meet these standards, the report implies that a separate fairness opinion would be required.

A *commissaire à la fusion* is appointed by the court and is subject to different professional and procedural rules than those to be prescribed for independent experts. The report argues that the AMF's regulations should be modified to favour mergers by means of public offers, in which case a fairness opinion, as defined in the report, would be obligatory. The report proposes that the EU Directive on Public Tender Offers be quickly transposed into French law; that the threshold for mandatory squeeze-outs be reduced to 90% from the current level of 95% of voting rights; and that the offeror in a combined tender offer and squeeze out be allowed to pay for the squeeze-out portion of the transaction either in cash or in securities of the merged company.

Strengthening the fairness opinion

In addition to extending the use of fairness opinions to transactions in which they are not mandatory, the report introduces requirements that would strengthen the opinion itself.

Experts would be held to higher standards of independence from the parties and from the transaction, and the report would be more detailed.

The report says the expert responsible for preparing a fairness opinion

must be completely independent of the offeror, the target, and their respective financial advisers. An investment bank could not, therefore, hold a mandate both as underwriter and as independent expert for the same transaction. In addition, the independent expert must not have acted as adviser to the offeror for a period of two years before the transaction. These new requirements would be an advance over current US law as regards experts' independence.

The expert would be required to sign and publish a declaration of its independence from the parties to the deal. The independent expert would be remunerated only on a flat-fee basis, and would be prohibited from having any financial interest in the completion or success of the transaction. The report suggests that the expert's fee be made public, as an indication of the effort dedicated to the preparation of the opinion.

The report would require the appropriate associations of financial professionals to establish codes of ethics for independent experts, and any firm acting as an independent expert would be required to draw up its own internal ethics policy. Firms would also be responsible for setting up internal procedures and fairness committees to monitor compliance with rules of ethics, and to control the quality of the fairness opinion.

According to the report, independent experts would no longer need to be accredited in advance by the AMF. The report's authors consider that the approval process tends to be too rapid and superficial to provide substantive quality control. Instead, they propose a system of *à posteriori* examination by the AMF, intended to verify that the expert's fairness opinion complies with mandatory standards of transparency and methodology. Violations discovered during such an examination could be sanctioned by various levels of public reprimands, fines, or prohibitions on

practicing as an independent expert.

As regards the opinion itself, the report suggests that the expert's work should involve greater analysis. The expert should not merely evaluate the offeror's methodology for

arriving at the offering price, but should undertake its own independent valuation of the target. The report specifies, for example, that the expert should engage in discussions with the target's management and its financial advisers concerning its financial status and business plans.

The report would also require that a substantial amount of information related to the fairness opinion be made public. The target's published response to the tender offer would be required to state

what due diligence exercises were carried out by the board of directors; how the expert was chosen; the expert's level of competence and independence; what resources were put at its disposal; what examinations were carried out by the expert; its fees; the time that was available to the expert to prepare its opinion; and a precise calendar of its work program. The opinion itself would present the context of the operation; an evaluation of the target company; a discussion of the expert's methodology; a critical examination of the offeror's financial analysis of the transaction; a description of the independent research carried out; and a statement of the expert's opinion as to the transaction's fairness.

The report envisages the fairness opinion as a comprehensive examination of the value of the target company and the offer. The requirements of independent examination go beyond what is now standard in France, and a full, public report on the company's financial and business valuation would exceed the standards of market practice in the US.

The report proposes that the independent expert must be given at least 20 days in which to prepare its opinion. This rather lengthy period will result in a substantial pre-filing obligation, and will require boards of directors to act as early as possible to engage an expert when a fairness opinion will be required. The report says that the expert's opinion should be made public as soon as the offer is filed, requiring that the expert commence its analysis before the offer is public.

This timing poses several problems. In certain cases, such as a hostile tender offer, the target is generally not aware of the offer until it is filed. French regulations currently allow the target only 10 days to file its response to a hostile offer, insufficient time for the examination required by the report to be completed. In other situations, the financial viability of an offer may depend on rapidly changing market conditions, and a 20-day delay may prove impractical.

In addition, the report says that the expert should provide a "first level of appreciation" before the AMF grants its approval for the opening of the offer. The AMF has only five days after filing of an offer in which to grant its approval. It is not clear from the text of the report what is meant by a "first level of appreciation," but this requirement creates the disturbing possibility that an expert could provide a favourable first impression and

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subsequently recant upon completing the report, after the offer has officially and irrevocably opened.

The report stresses that the target's board of directors bears ultimate responsibility for assuring the proper development of the fairness opinion. The authors specify that the board must protect shareholders' interests; appoint a committee of independent directors (if any) to supervise the independent expert; appoint the expert as early in the transaction as possible; and put in place all measures necessary to assist the expert's analysis of the company. In general, boards will be expected to become much more closely involved in the development of the fairness opinion.

A consequence of the measures suggested in the report will be greater potential liability both for independent experts and directors. At present, the rules concerning the preparation of fairness opinions are vague, and minority shareholders would have difficulty proving that either the independent expert or the board

breached a legal duty in commissioning and preparing an opinion. The report proposes numerous requirements for the proper preparation of fairness opinions. Failure to comply with these requirements will provide grounds for legal action against the directors or the expert responsible for the opinion.

Towards better fairness opinions

It seems that most of the report's proposals will be transposed into regulation in the form in which they are presented. The report takes important steps to strengthen the independence of the expert and to make the fairness report a substantive analysis. The measures suggested will also encourage boards to appoint experts before the determination of the price of an offer and to take an active role in managing the preparation of the fairness opinion. These proposals represent a big advance for the protection of minority shareholders in France and will be a strong incitement to improve corporate

governance at the board level.

Several questions concerning the report's implementation remain. There are numerous technical questions concerning the timing of the process, which will have to be worked out in the implementing regulations. Some of the terms used in the report are vague and will require elaboration either by the legislature, the AMF or the courts.

Shareholder suits against directors are more difficult in France than in the US, and French courts as a body are less equipped to deal with complex financial litigation than their US equivalents. A greater responsibility for shareholder protection therefore falls on the AMF. The system proposed by the report depends largely on the quality of the independent experts, the support of experts' professional organizations, and ultimately on the AMF's diligence in conducting *à posteriori* reviews of the experts' work. Without rigorous oversight, the rules proposed could become a fairly superficial box-checking exercise. Nevertheless, the report is a step forward from existing rules and market practices. ■

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