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# Best Practices for Fairness Opinions in GP-Led Secondary Transactions

*By Michelle Heisner*

On August 23, 2023, the US Securities and Exchange Commission (SEC) adopted rules applicable to investment advisers to private funds.[1] Included among these rules was the requirement that a registered investment adviser conducting an adviser-led secondary transaction with respect to any private fund that it advises (other than a securitized asset fund) must obtain, and distribute to investors in the private fund, a fairness or valuation opinion.[2]

While on its surface, the SEC's new rule may not appear to change the practice of many funds—after all, the practice of obtaining fairness opinions in general partner (GP)-led secondaries and disclosing them to limited partner advisory committees (LPACs) has become increasingly common—the language of the SEC's rule and the color provided by its adopting release do not explicitly address a number of existing market practices. As such, now is an appropriate time for stakeholders to level set expectations around fairness opinions to better ensure smooth delivery and consistency in the market.

This article provides practical guidance to private equity funds and their financial advisers in the rendering of fairness opinions under the newly adopted rules. It does not address valuation opinions. With the cost differential between fairness opinions and valuation opinions narrowing in recent years, their market prevalence vis-à-vis valuation opinions can be expected to increase.

## Background

Fairness opinions arose out of Delaware law. In the now famous Van Gorkom decision, the Delaware Supreme Court found that the directors serving on the Trans Union board breached their fiduciary duty of care when they approved a merger without substantial inquiry or expert advice.[3] In the nearly 40 years that followed, fairness opinions have been sought to mitigate the risk of personal liability.

None of the SEC, the Financial Industry Regulatory Authority (FINRA), or state corporate laws have heretofore required that fairness opinions be obtained. Such opinions were instead a protective tool for the duty-obligated insider in a transaction. The disclosure-based federal securities laws merely stipulated, in certain circumstances, disclosure of when fairness opinions had been obtained and the underlying financial analyses. This approach governed even the most conflicted of transactions, such as transactions subject to Rule 13e-3 promulgated under the Exchange Act.[4]

A federal regulation requiring a fairness opinion, let alone suggesting that it would serve as an investor protection, is groundbreaking. However, the SEC's goal in its final rule does not appear to have been to create a new product. Accordingly, the final rule should be examined against existing market practices.

## Who Should Be the Recipient of the Fairness Opinion in a GP-Led Secondary Transaction?

Historically, fairness opinions are prepared by a provider for a client solely for the purpose of assisting such client in fulfilling its duty of care in connection with an action or recommendation.

In the case of a GP-led secondary transaction, it is the GP with fiduciary duties, and it is the GP that is typically required to determine whether or not to approve the proposed transaction.

Nonetheless, a limited exception has emerged in some secondary transactions with LPAC members, who are deciding whether to waive the GPs' conflicts, being granted reliance but only in their capacity as members of the LPAC and not as investors or representatives thereof.

While the final rule specifies that fairness opinions must be distributed to fund investors, the rule does not specify to whom a fairness opinion must be delivered. It further does not require that the private fund and/or its investors be allowed to rely on the opinion. As such, my expectation is that the existing practice of fairness opinions being delivered for the benefit of a stakeholder with fiduciary duties with LPAC members being granted limited reliance will remain. (*See* Exhibit 1.)

## What Should a Fairness Opinion in a GP-Led Secondary Cover?

Under the final rules, a fairness opinion is defined as "a written opinion stating that the price being offered to the private fund for any assets being sold as part of an adviser-led secondary transaction is fair." This definition differs from the formulation of a fairness opinion in several ways.

First, the definition does not explicitly specify to whom the price being offered must be fair.

Given the reference to the price being offered to the "private fund," it seems fair to imply that fairness would continue to be measured with respect to the price received by investors who are not affiliates of the GP. Fairness to the unaffiliated investors, however, should not be confused with an evaluation of the fairness of the terms of the transaction actually offered to such investors. Amounts ultimately received by investors as distributions will depend on the rights and preferences of different classes of securities as well as management fees and performance interests. These considerations are contractual in nature and are never the purview of a fairness opinion.

Further, funds should expect that opinion providers may require that the fairness be with respect to the investors who are making cash elections. Opining on the fairness of noncash consideration that an investor may be electing to receive is technically problematic from a valuation perspective.

Second, the opinion is required to look at the "price" being offered rather than the "consideration" being exchanged in the transaction.

The reference to price suggests that the consideration being received is cash. However, many of the adviser-led secondary transactions involve an option for fund investors to exchange their existing securities for the securities of a new fund.

In transactions with noncash consideration, the financial analyses supporting the fairness opinion

**Exhibit 1**

| Category | Fiduciary Duty | Fairness Opinion Use Case |
|---|---|---|
| GP | Yes | Reliance |
| LPAC members | No (but makes a decision) | Potential to evolve. To the extent reliance is given, it should only be given in the capacity as committee members |
| Fund and its limited partners | No | Non-reliance |

will typically assess the value of the noncash consideration. However, valuations of noncash consideration could be difficult in the context of secondary transactions, particularly where the new fund has not completed its fundraising and/or is not yet fully invested in the securities it will ultimately hold.

The SEC was aware of this concern, which was raised in several comment letters, but did not directly address the topic in its final rule. Nonetheless, given that the SEC was satisfied with a valuation opinion over assets sold in lieu of a fairness opinion, it would, in my view, be reasonable to limit financial analyses to the cash price offered rather than engaging in the additional valuation of securities possibly being received as consideration. To frame it in another way, it would, in my view, be reasonable for the opinion provider to assume that none of the investors elect to receive noncash consideration and, as a result, for the opinion to be over the enterprise value of the portfolio company or other entity whose securities are actually being sold.

Finally, the definition does not stipulate that fairness is only evaluated "from a financial point of view."

A customary fairness opinion does not address the overall fairness of a transaction but rather the fairness "from a financial point of view" to a party paying or receiving consideration in a transaction. Financial fairness means that fairness is based on numbers and the manipulation and comparison of numbers. The financial consideration being evaluated, and not various side arrangements (for example, retention payments in change of control transactions or management fees or the value of the opportunity of the short-term liquidity being offered in GP-led secondaries), must be within a range that would be considered fair by a reasonable buyer or seller (as applicable).

The SEC requested comment on whether the scope of fairness opinions should be expanded to cover all or only certain terms of the GP-led secondary transaction. Many commentators responded that fairness opinions exclude from their analysis side arrangements and that to require their inclusion in a fairness analysis would call into question how financial analyses would be conducted and whether a market would develop to render such opinions. The SEC agreed that it was not necessary to expand the scope of a traditional fairness opinion since "an adviser's economic entitlements will likely be based on the asset value."

## What Disclosure Does the SEC's New Rule Require and How Should This Disclosure Requirement Be Met in Practice?

The final rule requires that the fairness opinion itself and "a written summary of any material business relationships the adviser or any of its related persons has, or has had within the two-year period immediately prior to the issuance of the fairness opinion or valuation opinion, with the independent opinion provider" be disclosed.

- Unlike rules associated with Rule 13e-3 promulgated under the Exchange Act, the SEC's new rule does not require any summary of the financial analyses undertaken by the opinion provider or the financial information, including projections and the assumptions thereunder, given to and used by the opinion provider.
- The disclosure requirement with respect to past relationships is similar to that required under FINRA Rule 5150. The SEC has stated that material business relationships would typically include "audit, consulting, capital raising, investment banking, and other similar services."

The SEC did not state that disclosure of amounts of compensation received by the opinion provider or details whose disclosure would breach confidentiality obligations was required. Thus, I would expect that the disclosure requirement would be met in a manner similar to that customarily employed in meeting FINRA standards, with actual amounts of compensation not being disclosed and confidential engagements being discussed in clear but generic terms.

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Notable differences between the SEC and FINRA rules are (a) that the FINRA rule only requires disclosures where compensation was or is contemplated to be received by the opinion provider and (b) the SEC rule does not state that relationships contemplated at the time of opinion issuance must be disclosed. Nonetheless, I would expect that opinion providers would apply the most stringent level of disclosure across the board, as sunshine is said to be the best disinfectant.

The fund adviser must distribute both the opinion and summary of material business relationships to private fund investors prior to the due date of the election form for the secondary transaction. Opinion providers are likely to continue to require that the distribution of their opinions be on an informational and non-reliance basis. Such restrictions are not so much intended to limit informational disclosure but rather to limit the potential liability of the opinion provider to such persons. The easiest way of obtaining an acknowledgment of non-reliance from investors may be through the use of a click-through web portal where the materials for the election, including the opinion and summary of material business relationships, are posted.

## What Sort of Indemnification Arrangements Should Be Put in Place to Benefit Opinion Providers?

Opinion providers manage risk by combining reliance on their opinion to indemnification with limitations on liability. Opinion provider engagement letters require clients and/or certain of their affiliates to indemnify and release the provider from and against losses, claims, damages, expenses, and other liabilities related to or arising out of the firm's engagement, subject to limited exceptions (for example, gross negligence).

Opinion providers in GP-led secondary transactions are likely to be particularly attuned to practical recoverability under indemnification arrangements. A fund may be nearing the end of its life, facing failed fundraising, or even having a troubled portfolio. In general, funds should expect opinion providers to seek indemnification from upstream entities with liquid assets, such as a GP and/or investment adviser.

## Can Clients Stipulate the Types of Financial Analyses Used by the Opinion Provider in Reaching Its Fairness Opinion?

While it may be tempting as a cost-savings measure to limit the type of financial analyses employed by a fairness opinion provider, such measures should be engaged in with caution.

While the SEC's rule does not stipulate the types of financial analyses used to support a fairness opinion, limiting the professional judgment of the opinion provider calls into question the value and validity of the opinion. The traditional allocation of responsibility with respect to fairness opinion is that the provider is responsible for its financial analyses, including the selection of which such analyses are appropriate, and the client specifies the financial projections and assumptions to be used by the opinion provider. This approach allocates risk to the parties most appropriate—with the opinion provider responsible for its expertise in financial valuation and the client responsible for its insider knowledge of the assets being valued.

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**NOTES**

1 *See Private Fund Advisers; Documentation of Registered Investment Adviser Compliance*, SEC Release No. IA-6383 (August 23, 2023), available at: *https://www.federalregister.gov/documents/2023/09/14/2023-18660/private-fund-advisers-documentation-of-registered-investment-adviser-compliance-reviews*.

2 The new rules provide for varied compliance dates, with advisers having $1.5 billion or more in private fund assets under management subject to a compliance date of 12 months (that is, September 14,

2024), and advisers with less than $1.5 billion in private fund assets under management subject to a compliance date of 18 months (that is, March 14, 2025), in each case, after the final rules are published in the Federal Register. These rules are potentially applicable to all private funds managed by US-domiciled SEC-registered advisers. Only US-domiciled private funds fall within the new law's scope for non-US-domiciled advisers.

[3] Smith v. Van Gorkom, 488 A. 2d 858 (Del. 1985).

[4] Even the proposed rules governing de-SPAC (Special Purpose Acquisition Companies) transactions have only required disclosure of board determinations of fairness and not imposed a requirement to obtain a fairness opinion. The SEC's adopted rules declined to impose a requirement that the SPAC board state whether their de-SPAC transactions are fair. *See Special Purpose Acquisition Companies, Shell Companies, and Projections,* SEC Release No. 33-11265 (January 24, 2024).

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