

Fairness Opinions Provide Added Security

Because the definition of "fairness" depends on the facts of each case, boards of directors and other fiduciaries often rely on an independent financial advisor to assist them in their review of a proposed transaction. While the preparation of a fairness opinion is a complex process, the financial advisor's role focuses on three main issues: 1) the value of the financial consideration received or paid, 2) the terms and structure of the transaction, and 3) the shareholder value under a potentially different scenario than the one under review.

TYPES OF OPINIONS

Transactions that typically require a fairness opinion include mergers and acquisitions, leveraged buyouts, financing, spin-offs, divestitures, employee stock ownership plans (ESOPs), and transfers of assets between affiliates. The following are some examples of recent engagements in which we were asked to provide a fairness opinion.

Acquisition - This transaction involved two publicly traded real estate investment trust (REIT) companies. We advised the seller as to the fairness of the offer price which consisted of either a) all cash, or b) a combination of cash along with senior debt and convertible subordinated debt issued by the buyer. We analyzed not only the economic implications of the transaction, but also reviewed the merger and financing documents. The board of directors needed the fairness opinion in order to protect themselves from any dissident shareholders.

Transaction between affiliates - In many instances, a debt indenture requires a fairness opinion in connection with any affiliate transaction exceeding a certain dollar amount. This is typically required in order to protect lenders from any fraudulent conveyance (an instance whereby a borrower transfers assets which may undermine the position of the lenders). In this particular transaction, our client wanted to transfer certain preferred stocks it held to a separate legal entity in return for cash and a note issued by the newly formed legal entity.

Transactions with related parties - When a transaction involves a related party, such as a director, president or investor, a fairness opinion is needed to protect the directors from being accused of unfair insider dealings. Recently, we provided a

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fairness opinion when companies transferred internet-related assets to a third company (in exchange for preferred stock in the new entity) that was being formed by managers of the other two companies. One of the investors in the new entity was also an investor in the other two entities. Of concern was whether some of the shareholders who were not participating in the new venture would be deprived of the benefit of the transferred assets, and whether the company would receive fair value for the assets that were effectively being sold.

Financing - Our client needed additional capital in order to fund its operations. A majority shareholder was willing to invest additional capital in the form of convertible preferred stocks. We were hired by the company to provide an independent evaluation of the terms and structure of the proposed financing, and its implication on the existing minority shareholders. We had to consider not only whether the proposed investment was fair to the company, but also whether the consideration given was fair relative to all the other classes.

PROCESS

Preparing a fairness opinion entails due diligence by the valuation professional. The process involves interviewing the company's management as well as its legal advisors, reviewing all legal documents, analyzing historical statements, and assessing business plans and financial projections. The method of exchange may present special considerations. For example, if payment was a convertible note, the validity of the note must be determined. Is the issuing company able to service the note? How does conversion, if applicable, impact the other classes in the capital structure?

The financial analysis may involve one or more of the following methods: the discounted cash flow approach, the comparable public companies approach, and the comparable transactions approach. The discounted cash flow approach considers the relevant projected cash flows which are then discounted back to the present using the corresponding discount rate. The comparable public companies approach involves an analysis of comparable companies using defined financial parameters. An analysis is completed for each company and compared to the subject company in order to obtain a relative value. Finally, the comparable transactions approach reviews various transactions that are comparable to the transaction under review.

THE IMPORTANCE OF INDEPENDENCE

It is critical that the provider of the fairness opinion be independent in order to avoid any perceived conflict as interpreted by the courts. In many instances, the financial advisor who initiated the transaction may not be well suited to provide such a fairness opinion due to its material relationship with the company. For more information regarding fairness opinions, contact Wassim Abourjeili at 213/624-4170 or Neil Kelly at 609/243-7013. **VR**