



FAIRNESS OPINION ALERT II

Recently, there has been increasing press coverage and heightened regulatory scrutiny regarding possible financial conflicts-of-interest in corporate transactions involving directors, controlling shareholders, and other fiduciaries. This activity suggests that real or apparent conflicts-of-interest, or a lack of adherence to fiduciary duty, are increasingly likely to lead to challenges, severe sanctions, and even multi-million dollar litigation.

Key Issues

Since *Smith vs. Van Gorkom*, 488 A.2d 858 (Del. 1985), one of the most effective tools used to prevent such negative outcomes and demonstrate reasonable business judgment on the part of the directors or fiduciaries has been to obtain a fairness opinion before completing such a transaction.

A fairness opinion is a document that states whether a transaction, or the consideration payable in a transaction, is fair, from a financial point of view, to a particular group of investors or beneficiaries. Fairness opinions serve two purposes: (i) to provide key decision-makers with information which may affect their analysis of the transaction, and (ii) to serve as evidence in litigation that the decision-makers used reasonable business judgment in approving a transaction. Under the concept of business judgment, courts will generally look for evidence that directors have acted (1) on an informed basis, (2) in good faith, (3) in a manner they reasonably believe to be in the best interest of the company, and (4) without fraud or self-dealing.

A recent key issue has now become the basis for determining “fairness”. How has “fairness” been determined, and to what extent has this determination been “independent”?

Current Trends

As a result of the current focus on directors or other fiduciaries exercising their fiduciary responsibilities, a number of changes have taken place regarding the application of “reasonable business judgment” by the appropriate parties. These changes include an emphasis on independence in the determination of “fairness”, and the responsibility of the directors or other fiduciaries to look beyond the mere opinion to the underlying analysis in the determination of fairness.

On January 24, 2005, *The Wall Street Journal* (“WSJ”) reported that more Wall Street firms are requesting second opinions when faced with possible conflicts-of-interest by investment bankers who provide both M&A advisory services and fairness opinions for the same transactions.

According to the *WSJ*, “U.S. regulators are ratcheting up scrutiny of the value and independence of so-called “fairness opinions”, which companies seek from their banking advisors to show that a planned merger or acquisition is “fair” to shareholders. Such opinions have become the

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standard tool used by corporate boards to protect against lawsuits and investor criticism.” Some Wall Street firms that perform both duties (issuing a fairness opinion and advising on the transaction) are rethinking their approach. For example, the Credit Suisse First Boston unit of Credit Suisse Group and Goldman Sachs Group, Inc., are requiring or recommending second opinions in certain transactions in which they have increased conflicts of interest.

According to *Insights*, Autumn 2004 issue, published by Willamette Management Associates, independent directors and board special committees are seeking a second fairness opinion from independent financial advisors with increasing frequency. With “dual” financial advisors, the target company board can benefit from both (1) the overall transaction assistance of the success-fee motivated investment banker and (2) the unbiased viewpoint of an independent financial advisor.

The NASD, the main self-regulatory body for brokerage firms, has said it is considering requiring bankers to publicly state whether the company executives they are working for might be biased toward a deal because they will receive “juicy” post-merger bonuses. In addition, it is considering policing how bankers select certain valuation methods to evaluate a company.

When a Fairness Opinion Should Be Used

A fairness opinion is obtained by a company’s board of directors to provide it with assurance that the price or terms of a transaction are fair and reasonable to shareholders. Also, a fairness opinion serves to protect the board of directors from potential lawsuits brought by shareholders. However, a fairness opinion is not an opinion that the transaction is fair from a legal point of view, not a recommendation for the transaction, not a conclusion that the consideration paid is optimal, but it is an expression of a viewpoint (hopefully an independent one) that the consideration to be paid is within a “range of fairness”. In the current atmosphere of Sarbanes-Oxley and the associated attention directed toward potential conflicts of interest, boards of directors must be especially concerned with demonstrating good corporate governance.

Fairness opinions are used in a number of instances. Boards of directors, institutional investors, employee stock ownership plan (ESOP) trustees, and other fiduciaries must meet a high standard of due diligence when acting on behalf of their constituencies. Some examples of when fairness opinions should be considered include:

1. Independent directors and fiduciaries in transactions between the company and related parties.
2. Sellers in the sale of a company for cash and/or securities.
3. Sellers in the sale or spin-off of material assets, divisions, or subsidiaries.
4. Purchasers in the acquisition of a company, if material to the acquirer.
5. Purchasers in the acquisition of material assets, divisions, or subsidiaries.
6. Purchasers in the buyback of outstanding securities.
7. Limited partners regarding contributions to, or sale of assets by, a partnership.
8. Trustees in the acquisition or divestiture of securities or businesses.
9. Bond trustees when required by the indenture.
10. For regulatory agencies in the conversion of nonprofit organizations to for-profit stock corporations.

Fairness opinions historically have been delivered in the form of a brief letter addressed to (i) a company’s board of directors or (ii) a special sub-committee of disinterested directors formed to

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consider a proposed transaction, or (iii) other fiduciaries considering a financial transaction. Fairness opinions must include the following:

1. a description of the proposed transaction,
2. a summary of the financial advisor's due diligence investigations,
3. a statement of significant assumptions or conditions,
4. a statement of any significant limitations on use, and
5. a statement of conclusion (e.g., that the proposed transaction consideration is fair, from a financial point of view).

These opinions have generally not included detailed explanations or other evidence to support the opinion that a transaction is "fair". As we will discuss in a later "Fairness Opinion Alert", significant change is surfacing in this area.

Important Considerations

Recent events and lawsuits have expanded the role of fairness opinions in the defense of corporate board of director actions. Corporate directors increasingly insist that transaction fairness opinions be provided by independent financial advisors, because in the event of a lawsuit involving directors, it may be difficult for defendant board members to claim reliance on a fairness opinion unless the fairness opinion is free of both real and perceived conflicts of interest.

We highly recommend that in the case of material corporate transactions, a fairness opinion be obtained from an experienced financial advisor who does not have an advisory or other potentially conflicting role in the transaction. We also advise that independent directors and boards obtain a second fairness opinion from an experienced and independent financial advisor in all situations in which the investment banker leading the transaction is both expecting to receive a success fee for closing the transaction and providing a fairness opinion for that same transaction.

Coming Topics

In upcoming issues of "Fairness Opinion Alert", we will be discussing the following topics: guidelines for board of directors' evaluation and use of fairness opinions, how "fairness" is determined, the form and content of the opinion letter and supporting documentation, as well as other important topics.

This is the second in a six-part series of updates on the "state-of-the-market" and some guidelines relating to the use of this important tool for fiduciaries.

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