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BDO PERSPECTIVE

LIFE SCIENCES AND PRIVATE EQUITY: 2015 OUTLOOK

By Ryan Starkes & John Kwon

Last year was one for the books in the private equity world, with deal volume reaching historic highs and investors clamoring for investment opportunities. After coming off of a particularly strong year, our sixth annual *PErspective Private Equity Study* found that fund managers are cautiously optimistic going into 2015.

Fifty-six percent of fund managers characterize the current market as either very or somewhat favorable, a decline from the 72 percent expressing a positive outlook in 2014. Yet even with this slightly tempered outlook, there is one hot area of investment on the heels of 2014 that may pay out big this year – the healthcare and biotech sector.

The study found that while only 15 percent of fund managers identify the healthcare and biotech sector as the leading investment target in 2015, there are still high performance expectations for the industry. When it comes to valuations, fund managers believe that technology (70 percent), healthcare and biotech (67 percent) and manufacturing (37 percent) are the top three industries most likely to experience increases during the next 12 months.

2014 MARKED BY HIGH PERFORMANCE, FLOWING CAPITAL, M&A

Why are fund managers anticipating heightened valuations? Following a strong year of activity, investors are looking to capitalize on the fruits of their labor in 2015.

According to CB Insights, life sciences companies raised $8.2 billion from venture capital in 2014 – up 28 percent year-over-year. This flow of capital was reflected across

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PitchBook data reveals that in Q1 2015, there were 790 private equity investors with deals, with $186.1 million being the median platform buyout deal size. Additionally, 469 investors exited PE deals in Q1; North American exits totaled $47.5 billion.

Fortune reports that Q1 was the richest quarter for mergers & acquisitions since 2007. Globally, there has been more than $843 billion in global M&A – 23.3 percent higher than $694 billion in Q1 2014. U.S. M&A activity was particularly strong, hitting $414.7 billion – the largest first quarter since 2000.

Using Renaissance Capital data, BDO's ***Spring 2015 Initial Offerings Newsletter*** finds that after two consecutive years of robust growth, the U.S. market for initial public offerings (IPOs) has experienced a steep drop in activity during the initial months of 2015. With just 34 IPOs, activity is down 47 percent from Q1 2014 and, similarly, total proceeds ($5.4 billion) are down 49 percent year-over-year. This makes Q1 2015 the least active quarter in offering activity in two years (31 IPOs in Q1 2013), and the weakest in terms of proceeds raised since Q3 2011 ($3.5 billion).

According to ***Preqin's*** *Q1 2015 Private Equity Fundraising*, aggregate capital raised by private equity funds closed in Q1 2015 totaled $94 billion, 16 percent less than funds closed in the same period last year. At the end of Q1, PE dry powder totaled $1.23 trillion.

ValueWalk reports that North American funds led the fundraising charge in Q1 2015. North American-focused funds attracted 67 percent of all capital raised in the first quarter. Comparatively, European-focused funds generated 19 percent of all capital raised.

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both public and private companies. And last year, NASDAQ's biotech index outperformed the broader market by 60 percent, according to *Quartz*.

Capital flow was not limited to private biotech companies – *Dow Jones VentureSource* reported that venture capital companies took a record 58 biotech companies public in 2014. In fact, IPOs in the biotech industry dominated the headlines in 2014. Life sciences IPOs skyrocketed to 79 in 2014, a jump from the 37 in 2013 and 11 in 2012, according to *Silicon Valley Bank*.

Finally, 2014 ended on a high note when it came to M&A activity in the life sciences sector. According to *Thomson Reuters*, Q4 saw 119 M&A deals, with a disclosed value of $114.4 billion. While Q4 only saw two more deals than Q3, the deal value increased by $64.4 billion. Specifically, large pharmaceutical companies are eyeing biotech firms to increase their drug pipeline and compete effectively. The latest deal by AbbVie in early March made significant headlines as many investors questioned whether the $21 billion price tag to buy Pharmacyclics was too steep, but as long as the marketplace remains competitive, valuations will remain high. This continues a trend of robust deal activity – in terms of both deal size and deal flow – that began in Q2 of 2013 and appears to be continuing into Q1 2015. Meanwhile, current transaction multiples seem similarly strong (generally in the mid to high teens), in large part due to the strong potential buyers see in target companies' development pipelines.

PRODUCT LAUNCHES, DRUG APPROVALS STIMULATE THE MARKET

Numerous advances last year ripened the market for development. Perhaps most notably, 2014 was the year of increased efficiency in drug approvals. The FDA approved 44 drugs – the best year since the all-time high in 1996, according to *Forbes*. When considering the high failure rate drug developers have historically experienced, as well as the lengthy road to approvals, this increase is particularly significant. Not only does a speedier approval process have implications for patients, but also gives companies the chance to recoup R&D costs.

Biosimilars, or pharmaceuticals that are highly similar to already-licensed drugs, may also influence market opportunities in 2015. On March 6, the FDA cleared the country's first biosimilar, approving Novartis' white blood cell-boosting Zarxio. While the future impact of biosimilars and subsequent investment in the U.S. life sciences industry remains to be seen as a result of recent progress, the sector is accelerating across the border. In January of this year, Canadian biotech company Plantform Corporation engaged Legacy Partners Wealth Strategies Inc. to launch a $20 million private equity offering to advance three biosimilar drug candidates.

The medical device sector continues to be an attractive area of investment for both sellers and buyers. In fact, 2015 is already making headway in sales, with Johnson & Johnson announcing in March the sale of its Cordis unit, which makes vascular technology, to Cardinal Health for nearly $2 billion. In the same month, Mallinckrodt acquired Ikaria for almost $2.3 billion to expand its neonatal care capabilities – all pointing to continued momentum in this sector.

Though private equity fund managers might be wary coming off such a strong 2014, expectations for the healthcare and biotech sectors are high. Following a year of high market performance and innovation, 2015 will be an exciting time for both life sciences companies and their investors.

For more information, please contact Ryan Starkes, Leader of BDO's Life Sciences practice, at rstarkes@bdo.com, or John Kwon, Managing Director with BDO Consulting's Valuation Services, at jkwon@bdo.com.

BEHAVIORAL HEALTH: A MARKET RIPE FOR GROWTH AND CONSOLIDATION

By Dr. Bill Bithoney

This article originally appeared on the BDO Knows Healthcare *blog*.

Over the past six years, a number of unprecedented changes have occurred in the behavioral health market that are spurring anticipated growth and expected consolidation in the industry in the coming months. The number of covered lives is growing faster than the availability of services to treat them – creating compelling investment opportunities, as demand is significantly outstripping services supply.

The initial and primary motive force for increased demand and reimbursement for behavioral health services occurred in 2008 when Congress passed the Mental Health Parity and Addiction Equity Act (MHPAEA). This act requires that insurers equalize coverage for behavioral health and medical health benefits in terms of copays, deductibles, lifetime caps and access to providers. Also in 2008, Congress passed the Medicare Improvements for Patients and Providers Act (MIPPA), which increased access to mental health in federal programs. In 2013, Congress issued clarifying legislation imposing penalties and sanctions on insurers that did not comply with these requirements. In 2010, the Affordable Care Act (ACA, Obamacare) allowed adult children aged 18 through 26 to remain on their parents' insurance. It also built on MHPAEA with the requirement that

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most insurance plans cover mental health and substance abuse services – the largest expansion of such coverage in a generation. These major changes in reimbursement and confluence of regulatory events have resulted in marked improvements in the financing of behavioral health.[1]

While financing for behavioral healthcare services has improved, the pool of qualified providers – specifically psychiatrists, particularly those certified in addiction treatment – is rapidly shrinking. Given this supply/demand imbalance, the market is ripe for growth. Further, the behavioral health market is fragmented and overwhelmingly dominated by small providers with no national footprint. By some estimates, only a small fraction of mental healthcare is delivered by large national providers. Private equity-based roll-ups of smaller providers therefore may be able to drive significant economies of scale, resulting in both clinical and administrative standardization. In other areas of the healthcare market, such standardization has resulted in improved health outcomes and decreased costs.

Another driver of interest in this market is the fact that psychiatric hospitals have markedly streamlined billing structures, typically billing for only 15 to 17 DRGs, unlike acute-care hospitals, which may bill as many as 800 DRGs. Thus, issues of clinical documentation and justification as well as inadvertent billing errors and contested billings are far less prevalent.

Given the ease of billing, supply/demand imbalance and newly mandated insurance coverage for millions of new patients, it is not surprising that it is common for behavioral health programs to have financial margins of 20 percent to 30 percent. Further, due to the chronicity of the diseases treated, these revenue streams are secure. For example, patients treated for opioid abuse frequently require chronic mental health consultation and treatment with drugs such as naltrexone, methadone or buprenorphine.

THE MARKET IS LARGE

The Federal Substance Abuse and Mental Health Services Administration (SAMHSA) estimates that 23.9 million Americans over age 12 were addicted to or abused drugs or alcohol in the year they were surveyed. Diseases such as autism spectrum disorder affect one in 68 children. Clinically significant eating disorders affect 20 million women and 10 million men in the United States. One in three seniors dies with Alzheimer's or another dementia. The NIH estimates that 9 percent of the U.S. population suffers from personality disorders including major clinically significant depression, schizophrenia and bipolar disorder, among others.

The advent of cognitive behavioral therapy and applied behavioral therapy has resulted in the realization that some of these disorders are amenable to clinical amelioration. The advent of tele-psychiatry and software-based clinical interventions has also resulted in a recognition that consolidation of small one-off providers can result in more efficiency and profitability. Recently, we have also seen some of the largest payers and coordinators of behavioral care, such as Magellan, beginning to adopt Internet-based therapy modules.

LOOKING AHEAD: INTEGRATION WILL DRIVE NEW GROWTH

The behavioral health and medical care delivery systems have long been separate. However, we're starting to see more of a push to integrate the two. This is true particularly where state and federal programs are encouraging proactive integration to reduce emergency room admissions and readmissions: Approximately 75 percent of high users of hospital inpatient services have behavioral health diagnoses. Therefore, in 2015, BDO expects to see continued changes in efforts to increase behavioral health service capacity and better integrate it with clinical care through more formal affiliations, partnerships and merger activity.

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BEHAVIORAL HEALTH

We envision this integration happening both voluntarily and via mandates similar to the Medicaid Redesign/Delivery System Reform Incentive Payments (DSRIP) program in New York state and California. Such integration of physical and mental health providers will result in the screening and identification of even more patients who will have insurance coverage for behavioral health issues resulting in an increased demand over and above what has been seen thus far.

SUMMARY

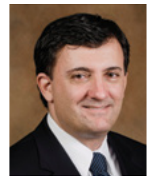
The clinical care of behavioral health issues such as substance abuse, attention deficit disorder, autism and eating disorders has arrived at a crucial nexus. Significant new funding is available to providers skilled in treating these disorders. Simultaneously, there are fewer providers with the appropriate skill sets required to treat these patients. While potential threats to Obamacare are currently being lodged by the new congressional majority, BDO believes that while the ACA may be modified, it is unlikely to be repealed. Over the next five years, we envision more and more consolidations, mergers and acquisitions in this field as investors recognize the unique confluence of investment opportunities inherent in a market dominated by small niche behavioral health programs. As these programs join together, they will be able to create value for patients, communities and investors. The efficiencies created should result in improved care delivered by highly profitable, clinically excellent programs.

1 Special thanks to McGuireWoods and HCP & Co's Law 360 July 2014 summary of these legislative issues and their implications.

For more information, please contact Dr. Bill Bithoney, Chief Physician Executive and Managing Director, BDO's Center for Healthcare Excellence and Innovation, at bbithoney@bdo.com.

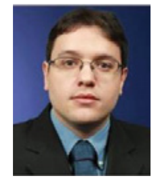
BDO PRIVATE EQUITY SPOTLIGHT: BRAZIL

Fred Campos, Director of Transaction Advisory Services at BDO USA, sat down with **Romina Lima**, Senior Corporate Finance and M&A Manager, and **Vinicius Evangelinos**, Transaction Services Manager, both of BDO Brazil, to discuss the latest PE trends in the region. Here are some insights from their conversation.



Fred Campos

Romina Lima



Vinicius Evangelinos

Despite a recent economic slowdown, Brazil remains an attractive market for buyers looking for growth opportunities. What trends are you seeing?

First, we are noticing a shift in the type of investments that PE firms are pursuing in Brazil. Investors who are looking for value opportunities are capitalizing on the current Brazilian market conditions, which have recently led to cooling prices, lower valuations and a favorable exchange rate. As such, many investors are looking for well-priced investments that offer a mid- to long-term exit strategy. The current market offers these exit strategies, as well as many low-risk investment and acquisition options.

Changes in leadership in the Brazilian government at the end of 2014, specifically changes to the economic team, are also likely to affect the investment environment. Newly elected government officials have noted that total investment accounts for approximately 18 percent of Brazil's GDP, a relatively low number that the market-friendly government is looking to change. To increase investments, the government plans to invest heavily in infrastructure and incentivize more public/private partnerships. These moves are highly anticipated by large companies looking for further opportunities in Brazil.

What industries do you think will be most attractive to investors looking into Brazil?

Merger Market data shows that most deals are currently in the energy, mining and utilities sector, followed by industrial/chemical and consumer goods. While these industries have shown strong growth recently, there are external factors that may impede their continued success.

For energy, mining and utilities to remain ripe for investment, there would need to be a large investment in infrastructure, specifically roads and pipelines – commitments the new government has stated will be a priority in an effort to curb critical energy shortages nationwide. In addition, oil prices have hit record lows, and there is little indication that recovery is on the horizon. The decreased profitability may deter investors.

The consumer goods industry could remain an attractive market for investors. Brazil's sizable population – over 200 million – makes it a natural target for consumer-focused industries. Over the past few years, a rapidly growing middle class has created increased purchasing power and sizable demand for goods. Consumer goods companies are taking notice of this shift as are funds playing in that sector. We may also see some tangential growth in the technology sector as a result of the growing consumer base, with credit card processing, mobile payments and online gaming specifically ripe for PE investment in the coming months. However, Brazil's economy continues to grapple with high inflation, electricity and water shortages, and general instability, all of which may deter consumer confidence in the near term, suggesting that investments in the consumer business and technology segments may be a longer game.

Finally, we have started to see some interest in the healthcare sector as a result of recently passed legislation lifting Brazil's long-standing ban on foreign investment in the industry. The healthcare industry accounts for about one-tenth of Brazil's GDP, but is in dire need of funds to update its aging infrastructure and to grow its ranks of care providers. Furthermore, the industry is highly fragmented, which presents another opportunity for private equity firms to consolidate through add-on

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SPOTLIGHT

acquisitions that will help drive up value at exit. But we expect the investments to come in slowly from foreign PE funds, as they will likely wait to better understand the complexities of the Brazilian healthcare sector and how the legislation will be ultimately implemented.

What type of capital flow are you seeing coming into Brazil right now?

Right now, we're seeing a traditional flow of capital, a north-to-south flow. More and more, we're also seeing Brazil as a site for experimental funding. PE firms are taking an opportunistic approach and testing the waters, investing a marginal amount, such as 10 percent, instead of creating a dedicated Brazilian fund. Latin American funds are again growing in popularity, and Brazil is becoming a larger investment target within those funds.

What is the untapped market in Brazil or the next hot opportunity for PE investment locally?

One investment vehicle that will likely improve the capital flow in both Brazil and the greater Latin American region are family offices. These wealthy families, who in the past have invested more informally and conservatively, are shifting their investing style to follow a more formalized model and strategic approach. Specifically, we are seeing more family offices becoming big players in the M&A space. These family groups have significant resources, and are moving to purchase companies in a manner similar to that of a private equity firm.

Anything else to note?

Conservative investors are watching the market and investing in countries like Mexico, Peru and Colombia until they see how the economy fares. The more aggressive investors are bullish and willing to put money down in Brazil right now to multiply it later on when the growth resumes. They're counting on the growing population, shifting income and demand for goods as a sign of positive things to come.

For more information, please contact Fred Campos, Director of Transaction Advisory Services, at fcampos@bdo.com. For more information about private equity in Latin America please see our BDO Spotlight with Bernardo Soto of BDO Mexico here.

R&D CREDIT PROVIDES OPPORTUNITIES FOR PORTFOLIO COMPANIES

By Chris Bard & Chai Hoang

In 2012, the most recent year of reported IRS figures, nearly 16,000 companies reported over $10.8 billion in federal Research & Development (R&D) tax credits for their investments in the development or improvement of products, processes and software. These credits enable many private equity portfolio companies, irrespective of their size or stage of development, the capital to expand their labor force, invest in new technologies and finance other business objectives. Further, 2014 was a milestone year for R&D developments, setting the groundwork for PE companies and their holdings to prosper in 2015.

R&D credits are dollar-for-dollar offsets against tax liability that can allow companies to reduce their effective tax rate and increase their earnings per share and cash flow. Portfolio companies can also benefit from credits even if they're not currently paying tax – many states will pay a business the value of its credits, and both federal and state credits can be carried back to earlier years or forward to later ones.

Also, PE-backed holdings in almost every industry qualify for (and report) significant R&D tax credits, including companies in the agriculture, biotech, construction, food and beverage, information services, manufacturing, oil and gas, pharmaceutical and software sectors. Naturally, the potential cash savings as a result of R&D credits for the portfolio companies translates to more favorable overall fund returns.

Since 2012, the number of R&D credits reported has continued to increase, and recent events have made the credit even more attractive. The benefits of the credit can make a difference for both portfolio companies under pressure to streamline their spending, as well as private equity funds that are focused on reducing costs.

In the beginning of this year, the Treasury Department proposed taxpayer-friendly regulations concerning the research tax credit and its treatment of expenditures related to the development of internal-use software (IUS). Before the regulations, activities to develop or improve such software had to meet higher standards in order to qualify. The regulations narrow the definition of IUS, broadening the range of software development expenditures eligible for the research credit.

Under the new regulations, IUS is defined as software developed to complete the back-office functions almost every business performs, including financial management, human resource management and support services.

A notable breakthrough in the regulations is that software will not be treated as IUS, and consequently not subjected to the higher standards, if it is developed to either:

1) Be commercially sold, leased, licensed or otherwise marketed to third parties;

2) Enable a taxpayer to interact with third parties; or

3) Allow third parties to initiate functions or review data on the taxpayer's system.

Thus, if the software benefits third parties, it may be treated as non-IUS, where under prior law, this characteristic wasn't enough to treat software as non-IUS.

Another recent development was the release of regulations published by the Treasury last year, which now allow companies to claim the Alternative Simplified Credit (ASC) on amended returns. This is significant because the ASC method is the simpler of the two available methods of claiming the credit. The ASC method only requires using financial information for the current and past three tax years, while the other approach, the Regular method, is more onerous and can sometimes require information dating back to 1984.

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R&D CREDIT

Because of this new rule, companies may be able to take advantage of benefits from prior years that they had previously missed.

And in a case filed on Oct. 1, 2014, *Suder v. Commissioner*, the U.S. Tax Court rejected many arguments often made by tax authorities to disallow credits. The Court provided guidance and support to help businesses claim R&D tax credits, including the following:

- **Executives' Activities:** 75 percent of the CEO's time, and 100 percent of other senior management's time, were qualified, including time spent attending strategy meetings, brainstorming ideas for new and improved products, following up throughout the development process and reviewing and signing off on specifications;
- **Qualified Activities:** activities tax examiners have previously disallowed as "routine engineering" or "routine software development" were upheld as qualified;
- **Patent-Related Expenses:** expenses for patent research and prosecution were permitted; and
- **Oral Testimony:** considerable weight was given to employee oral testimony in finding how much time an employee spent performing qualified research activities; historically, extensive documentation was the primary requirement to prove qualified research activities performed.

Because of *Suder* and the other recent tax developments, businesses have more of an opportunity to claim and support R&D tax benefits. Many companies, however, are still not reporting initiatives, often believing that the stringent legal standards the IRS has been applying since the late 1990s still apply. *Suder*, as well as other recent cases and regulations, reject those standards. Portfolio companies may be surprised to learn that they qualify for federal R&D credits, as well as the many state R&D credits modeled on the federal credit.

For more information, please contact Chris Bard, National Leader of STS R&D and Sec. 199 Tax Services, at cbard@bdo.com.

FAIRNESS OPINIONS: BOARD OF DIRECTORS' FIDUCIARY DUTIES

By Anthony Alfonso

According to the *BDO PErspective Private Equity Study*, "deal flow may slow this year, but fund managers are looking to make bigger investments," making valuation a top-of-mind issue for directors with fiduciary duties.

Additionally, the D&O Diary notes that "the number of securities class action lawsuit filings rose slightly in 2014 compared to 2013, although the number of filings during the year was below longer term annual average number of filings."

Business Judgment Rule versus Entire Fairness Test

In lawsuits alleging that a corporation's directors violated their duty of care to the company, courts will evaluate the case based on the **Business Judgment Rule**. Under this standard, a court will not second guess the decisions of a director as long as they are made in good faith, with the care that a reasonably prudent person would use and with the reasonable belief that they are acting in the best interest of the corporation.

If the party challenging the board's decision is able to allege and prove that those involved in the decision-making process lack independence or otherwise breached any of their fiduciary duties, the presumptions of the Business Judgment Rule are taken away and the court will apply the **Entire Fairness Test**. As a result, the burden shifts to the company's directors to prove that both the process that was followed (so-called "fair dealing") and the price that was achieved are fair to the stockholders of the corporation.

Concept of Fairness

As mentioned above, the concept of fairness has two components: **fair dealing** and **fair price**.

The **fair dealing** element looks at the various procedural elements of the transaction, including:

- Timing:
  - Did the timing of the transaction benefit the proponents of the transaction to the detriment of the company or its minority shareholders?
- Initiation, structure and negotiation:
  - Did the structure of the transaction favor insiders to the detriment of the company or its minority shareholders?
  - Was the negotiation of the transaction conducted, controlled or overseen by competent and independent individuals free of conflict of interest?
  - Was a competitive bidding process implemented so as to maximize shareholder value?
- Disclosures & approvals:
  - How was the transaction disclosed to the directors, and how were the approvals of the directors and the stockholders obtained?
  - Were the directors fully informed and provided with all relevant information?

The **fair price** element takes into consideration the economic and financial aspects of the transaction, including:

- Financial and economic considerations, including:
  - Market value of the company's shares
  - Historical and future earning potential
  - Underlying asset values
- Other relevant factors that affect the value of the corporate stock, including:
  - Transaction synergies
  - And were the directors committed to obtaining the most advantageous value that can reasonably be available to the stockholders under the given circumstances?

Fairness Opinions

Obtaining a fairness opinion can help fiduciaries fulfill their responsibilities to consider whether a completed transaction is fair, from a financial point of view, to those to whom a duty of care is owed.

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The following is a list of upcoming conferences and seminars from the leading private equity associations and business bureaus:

MAY

May 14
Debtwire European Mid-Market Forum 2015
Marriott Grosvenor Square
London

May 26
Real Estate Investment World Latin America 2015
Four Seasons Hotel
Miami

JUNE

June 1-2
***The Wall Street Journal* Private Equity Analyst Conference**
Essex House
New York

June 2-3
ACG DealFest Northeast 2015*
Renaissance Boston Waterfront Hotel
Boston

June 8-9
2015 Upper Midwest ACG Capital Connection
Hyatt Regency
Minneapolis

June 11-12
2015 Mid-South ACG Capital Connection
Downtown Marriott
Louisville

June 15-16
Private Investment Funds Tax Master Class*
The Princeton Club
New York

June 15-16
U.S. Real Estate Opportunity & Private Fund Investing Forum
Grand Hyatt
New York

June 25
The Private Debt Investment Summit
The Princeton Club of NY
New York

JULY

July 30
2015 Northwest Middle Market Growth Conference
The Fairmont Olympic Hotel
Seattle

** Indicates that BDO is attending and/or sponsoring this event.*

CONTACT:

LEE DURAN, San Diego
858-431-3410 / lduran@bdo.com

SCOTT HENDON, Dallas
214-665-0750 / shendon@bdo.com

KEVIN KADEN, New York
212-885-8000 / kkaden@bdo.com

RYAN GUTHRIE, Costa Mesa
714-668-7385 / rguthrie@bdo.com

DAN SHEA, Los Angeles
310-557-8205 / dshea@bdocap.com

JOE BURKE, McLean, VA
703-770-6323 / jburke@bdo.com

FRED CAMPOS, Miami
305-420-8044 / fcampos@bdo.com

JERRY DENTINGER, Chicago
312-239-9191 / jdentinger@bdo.com

JOE GORDIAN, Dallas
214-969-7007 / jgordian@bdo.com

TUAN HOANG, Los Angeles
310-557-0300 / tmhoang@bdo.com

TODD KINNEY, New York
212-885-7485 / tkinney@bdo.com

MATT SEGAL, Chicago
312-616-4630 / msegal@bdo.com

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FAIRNESS OPINIONS

Examples of transactions for which fiduciaries should consider obtaining a fairness opinion include, but are not limited to, the following:

- Takeover bids
- Compulsory transactions and buyouts of minority security holders
- Capital reorganizations
- Going-private transactions
- Related party transactions
- Transactions with persons in positions of influence
- Share buybacks
- Tender offers
- Sale or merger transactions not involving an auction

Conclusion

The business judgment rule provides a layer of judicial protection to decisions made by directors acting in an informed manner with full knowledge of the cost / benefit of a given transaction. However, the protections of the business judgment rule are not absolute, and the entire fairness test of a transaction can undergo a rigorous review by the courts.

Being a decision-maker in regards to business transactions has increasing risk associated with it, especially when large dollar amounts are at stake. Depending on the nature of the transaction and potential conflicts of interest, directors should take appropriate procedural safeguards, such as engaging a special committee and obtaining a fairness opinion, to better position them against a verdict based on a breach of a director's fiduciary duties.

For more information, please contact Anthony Alfonso, Valuation & Business Analytics National Leader with BDO Consulting, at aalfonso@bdo.com.

BDO PRIVATE EQUITY PRACTICE

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