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LEARNING OBJECTIVES

• Articulate the types of transactions that may necessitate an independent fairness opinion
• Identify the elements of a fairness opinion and the common valuation methods used
• Understand the role of fairness opinions in defending shareholder lawsuits
• Define the value that an independent fairness opinion provides to a board
AGENDA

• Legal Aspects for Boards
• Overview of Valuation Methodologies
• Transactions Requiring Fairness Opinions
• Conclusion

LEGAL ASPECTS FOR BOARDS
• Today is about Delaware law:
  - Delaware is home to more than 400,000 corporations, including:
    - more than half the nation's Fortune 500 companies
    - nearly half of all publicly traded companies
• M&A is a lightning rod for litigation
  - Lawsuits were filed in 93% of all M&A deals announced in 2014 valued at
    more than $100 million - 608 and in total.
  - In the same year, 96% of deals with an announced value of more than $1
    billion were challenged.
• Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985)
  - Directors held to be grossly negligent for approving the sale of a company in
    an all-cash LBO at a premium of roughly 50% over recent trading prices -
    because they did not obtain a fairness opinion and therefore had no idea
    what the “intrinsic value” of the company was.

FIDUCIARY DUTIES OF DIRECTORS

• The duty of loyalty
  - Requires directors to act in good faith to advance the best interests of the
    corporation and to refrain from conduct that injures the corporation.
  - Prohibits directors from using their positions to advance their own personal
    interests.
• The duty of care
  - Directors must exercise the care an ordinary person would use under similar
    circumstances.
  - “Prior to making a business decision,” directors must inform themselves “of
    all material information reasonably available to them.” Smith v. Van
    Gorkom.
• Statutory Protections
  - Elimination of personal liability for money damages under Section 102(b)(7)
    of the DGCL
  - Indemnification under Section 145 of the DGCL
STANDARDS OF LEGAL REVIEW

• The “Business Judgment” Rule
  - Courts will defer to the business judgment of directors, and will not review the business decisions of directors who performed their duties:
    - in good faith;
    - with the care that an ordinarily prudent person in a like position would exercise under similar circumstances; and
    - in a manner the directors reasonably believe to be in the best interests of the corporation.
  - To prevail, the plaintiff has the burden of proving that a director violated one of those conditions.
  - “Gross negligence” standard.

STANDARDS OF LEGAL REVIEW
Continued

• “Entire Fairness”
  - Triggered when a majority of the directors approving the transaction were interested or where a majority stockholder stands on both sides of the transaction.
  - If the standard is triggered:
    - The burden of proof shifts to the directors to demonstrate that the transaction was “entirely fair” to the stockholders, by demonstrating both:
      - Fair dealing - that the process followed by the directors was fair
      - Fair price - that the result achieved by the directors was fair
    - Much more severe scrutiny than the “business judgment” rule.
STANDARDS OF LEGAL REVIEW
Continued

• “Enhanced Scrutiny”
  - Applied “when directors face potentially subtle structural or situational conflicts that do not rise to a level sufficient to trigger entire fairness review, but also do not comfortably permit expansive judicial difference.” *In re Del Monte Foods Shareholders Litigation* (Del. Ch. Feb. 14, 2011).
  - In the M&A context:
    - The directors bear the burden of proving that “they sought to secure the transaction offering the best value reasonably available for the stockholders.”
    - If successful, the directors must then demonstrate that “their actions were reasonable in relationship to their legitimate objective.”
    - “In evaluating the adequacy of the directors’ decision-making and the information they had available, a reviewing court necessarily will consider the extent to which a board has relied on expert advisors.” Id.

THE COMMON DENOMINATORS

• Many of the techniques and tools available to directors to ensure a fair process and fair result will also help ensure that the “Business Judgment” Rule is satisfied:
  - The duty of care requires that directors inform themselves “prior to making a business decision, of all material information reasonably available to them.” *Smith v. Van Gorkom*.
  - Section 141(e) of the DGCL expressly protects directors who, in the performance of their duties, rely “in good faith upon ... such information, opinions, reports or statements presented to the corporation ... by any other person as to matters the member reasonably believes are within such other person’s expert competence and who have been selected with reasonable care by or on behalf of the corporation.”
WHAT ARE THOSE TOOLS?

- Conduct market tests:
  - Pre-signing
  - Post-signing (“go shop”)
- Conduct a formal, robust and *documented* process, with multiple meetings and real negotiations.
- If conflicts are perceived, form an committee of independent directors with powers to hire advisors (and to just say “no”).
- Condition the transaction on the vote of a “majority of the minority” stockholders.
- Obtain a fairness opinion, maybe two (that’s why we’re here....).
  - See Smith v. Van Gorkom.

THE ELEMENTS OF A FAIRNESS OPINION

- What the opinion says:
  - Description of the transaction
  - Cursory description of the documents relied on and the analyses performed
    - The details of the analysis are generally described in the proxy statement or other disclosure document
    - Assumes the accuracy of the information provided to financial advisor
  - **Conclusion**: “Based on and subject to the foregoing, it is our opinion that, as of the date hereof, and taking into account the terms and conditions set forth in the [Merger Agreement], the Consideration to be received by the Unaffiliated Stockholders pursuant to the Transaction is fair, from a financial point of view, to the Unaffiliated Stockholders.” (emphasis supplied).
THE ELEMENTS OF A FAIRNESS OPINION
Continued

• What the opinion *doesn’t* say:
  - Not an independent appraisal or valuation of the corporation’s assets
  - Not an opinion that the price is the best possible or even likely to be the best possible
  - Not an endorsement or a recommendation to vote in favor of the transaction
  - Not an indication of legality
  - Not an opinion on the non-financial terms
  - Not an opinion that the *process* was fair
  - Not an opinion on potential future valuations
  - Not an opinion on the tax-efficiency of the transaction
  - “Fair” is not even defined
STANDARDS OF VALUE

• Fair market value
  - “the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.” [Treasury Reg. 20.2031-1(b); Revenue Ruling 59-60, 1959 1 C.B. 237]

• Fair value - statutory
  - “the value of the shares immediately before the effectuation of the corporate action to which the shareholder objects, excluding any appreciation or depreciation in anticipation of the corporation action unless exclusion would be inequitable.” [Revised Model Business Corporation Act, 1984]

• Fair value - financial reporting
  - “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” [ASC 820]

• Investment value
  - “the value to a particular investor based on individual investment requirements and expectations” [International Glossary of Business Valuation Terms, 2001]

VALUATION AND FAIRNESS OPINION DIFFERENCES

• A valuation/appraisal opinion provides a single-point conclusion of value under the hypothetical willing buyer/seller paradigm.
  - Estate and gift tax (private company)
  - ESOP (private company)
  - GAAP/financial reporting (public and private companies)

• A fairness opinion validates the price and terms from the perspective of one party to a transaction.
  - Examines the value of the interests received as compared to the value of the interests given up.
  - Range of values are relevant.
    - Recognizes that there is not a single fair price in any transaction.
PUBLIC MARKET ANALYSIS

• For public companies, the stock price is assumed to provide a reliable indication of stand-alone value.

• Companies with low market capitalizations usually have limited stock trading volume and lack investment research coverage. In such situations, the market price may not be a reliable indicator of value.

• A study of price movements and trading efficiency of the common stock is required to support an efficient market assumption.

VALUATION METHODOLOGIES

• Market Approach
  - The Comparable Public Company method provides a valuation of a company relative to the prices of similar public companies as a multiple of financial metrics (such as revenue, EBITDA and EBIT).
  - Price represents minority interest value.
  - Companies are selected based on similarity of size (e.g., revenue), products and services, customers and markets served, among other factors.
  - The selection process is documented to support disclosures in a SEC review or to defend against “cherry picking” comparables in litigation.
  - To select multiples to apply to the subject company, financial characteristics are compared such as growth, profitability, earnings volatility, liquidity and financial leverage.
VALUATION METHODOLOGIES
Continued

• Market Approach
  - The Comparable Merger & Acquisition Transaction method provides a range of values, on a controlling basis, relative to transaction values of similar public and private companies.
  - The price paid, and the implied valuation multiples, reflect circumstances of the buyer and seller, transaction structure, form of consideration paid and any contingencies.
  - Each transaction, and its relevance to the subject company transaction, must be fully investigated before a range of values can be inferred.
  - Transactions are usually dated, thus changes in economic, industry and market conditions must be considered.
  - Similar to the Comparable Public Company method, the transaction selection process is documented.

• Income Approach
  - The Discounted Cash Flow (DCF) method generates a range of values based on a company’s ability to generate future free cash flows and provides a measure of intrinsic value.
  - Documented support for the projections is critical to the validity of the analysis (garbage in → garbage out).
  - Delaware courts have dismissed projections for companies with highly erratic earnings or a history of missing forecasts by a wide margin.
  - Requires an estimate of the subject company’s weighted average cost of capital and terminal values.
  - Delaware courts have been critical of adding a company specific risk premium to the cost of equity.
VALUATION METHODOLOGIES
Continued

• Income Approach
  - Leveraged Buyout (LBO) analysis is a variation of the DCF analysis, and while not a valuation method per se, it can be a useful cross-check on the valuation ranges.
  - Applicable in situations where the target has sufficient debt capacity and stable cash flow characteristics allowing for the use of financial leverage to fund a significant portion of the transaction price.
  - Produces a range of hypothetical values from the perspective of a financial buyer as opposed to a strategic buyer that can benefit from synergies.

• Asset Approach
  - Value indications are based on asset replacement cost or liquidation proceeds. Total liabilities (including off balance sheet liabilities) are subtracted from the appraised value of the assets to derive equity value.
  - Applicable for asset intensive firms where replacement cost is relevant or for companies holding real estate or investment portfolios.
  - Applicable to companies with losses, thus liquidation of assets may yield the highest value.
  - Cost methods do not measure going concern value of operating companies, therefore the method is normally used only to value non-operating assets.
CONTROL PREMIUMS PAID

• Control premium analysis examines the amount by which the proposed transaction price exceeds the market price at various dates prior to public announcement of the transaction. The premium to be paid for control of the target is then compared to premiums paid in similar transactions.

• A control premium is the result of a buyer’s valuation of the target and is not a valuation method. However, the metrics provide an important cross-check on the valuation analyses and transaction fairness.

• The reasonableness of a transaction premium is compared to the synergy or other economic benefits estimated to accrue to the buyer.

STOCK EXCHANGE

• Merger Analyses
  - The fairness of a merger is based on the fairness of the exchange ratio.
  - Review current and historical market prices of the two companies.

• Relative Contribution Analysis
  - Stand-alone financial contribution is based on a comparison of each company’s financial metrics to the combined firm relative to the proposed pro-forma ownership split. Assumes the target has a growth and risk profile similar to the acquirer (post-combination).
  - Value contribution is based on each company’s stand-alone valuation ranges to the combined firm relative to the proposed pro-forma ownership split. Appropriate where the companies have different growth and risk profiles.
STOCK EXCHANGE
Continued

• Merger Analyses
  - Assessment of the pro-forma combined company; diversification (customers, product and geography), growth, margins, financial leverage, dividends and stock trading liquidity.
  - From the target’s perspective, the valuation range of the target’s percentage interest of the pro-forma combined company (using the comparable public company and DCF methods) is compared to the target’s stand-alone valuation range.
  - Consider the pro-forma combined company’s value range with and without synergies
  - If the combined company has a control shareholder, a control premium to the target shareholders is required since the target has transferred control.

BUY-SIDE FAIRNESS OPINION

• The buy-side opinion answers the question of whether or not the acquirer is overpaying for the target.
• Fairness opinions for the acquiring company are common under the following circumstances:
  - Shareholder approval requirement
    - Acquirer proposes to issue 20% or more of its shares, per NYSE and NASDAQ rules.
    - Cash consideration and material to the acquirer based on market capitalization or enterprise value.
  - The target company has current losses or is otherwise difficult to value (e.g., high projected growth, unique assets).
  - The target is in a different line of business than the acquirer’s business.
  - Substantial synergistic benefits are required to justify the fairness of the deal.
  - Related party transaction/conflict of interest.
OBTAINING THE FAIRNESS OPINION

- If a financial advisor is already involved in the transaction, it can generally give a fairness opinion on its own deal.
- There’s an inherent conflict of interest, but the courts will tolerate that conflict if the process is otherwise reasonable.
- Counter-examples:
  - In re Rural/Metro Corporation Stockholders Litigation (Del. Ch. Mar. 7, 2014) (undisclosed conflict of interest in the sale of company due to advisor’s interest in pursuing buy-side financing for the acquisition)
  - In re Del Monte Foods Company Shareholders Litigation (Del. Ch. Feb. 14, 2011) (undisclosed conflict of interest in LBO due to interest in pursuing buy-side financing for acquisition, and tainted go-shop process)
OBTAINING THE FAIRNESS OPINION

Continued

• Insist on full disclosure from the financial advisor - control the process.
• If a second (“independent”) opinion is appropriate, start early.
  - However, simply obtaining a second fairness opinion from a conflict-free financial advisor does not negate the actual or potential conflicts that the original advisor may have, particularly when those conflicts are not disclosed to the board. In re Rural/Metro.
• The process is rigorous and can take months - try to do this in parallel with the negotiation of the deal itself; don’t wait until the end.
• Understand that the fee will be payable regardless of the outcome.
• Make sure that the advisor will “bring down” the opinion from signing to closing without extra cost.

TRANSACTIONS REQUIRING FAIRNESS OPINIONS

• Well, none, actually: neither federal law nor the DGCL requires a fairness opinion
  - One exception: Section 1203 of the California Corporate Code requires a fairness opinion for tender offers made by certain “interested parties.”
• But ... since Smith v. Van Gorkom, they’ve become increasingly standard.
  - “While a fairness opinion is not required under Delaware law ... a report from a disinterested third party is widely considered de rigeur [sic] to protect board members against lawsuits from disgruntled shareholders who expect a higher price.” Article in Investment Dealers’ Digest.
  - “A fairness opinion is necessary in every significant transaction involving the sale, purchase, or exchange of a company’s capital stock, especially when an identifiable group exists which might contest the transaction ...” Texas Bar Journal.
CHANGE-OF-CONTROL (SALE OF A COMPANY FOR CASH)

• This is *Smith v. Van Gorkom*
  - Increases the likelihood of protection under the “Business Judgment” Rule
  - But obviously useful if the “Enhanced Scrutiny” or “Entire Fairness” standard applies
  - May also help encourage shareholders to approve the transaction

• Not just a protection for *Targets*’ boards:
  - While generally thought of as a protection for Targets’ boards of directors, Buyers’ boards will often consider obtaining a fairness opinion, too, especially if the transaction is subject to the approval of the Buyer’s stockholders, or if the transaction is significant and outside the ordinary course of business, or will have a major impact on the way the company does business.

STOCK-FOR-STOCK MERGER OR SHARE EXCHANGE

• All the same issues as a cash sale, but:
  - The financial advisor must also analyze the value of the stock being received
  - Much more likely that both parties will seek their own opinions
SALE OF MATERIAL ASSETS

• A fairness opinion should be obtained unless the transaction is immaterial to the Seller.
• If stockholder approval is required (e.g., for the sale of “all or substantially all” of a company's assets) or involves a major operating division, a fairness opinion should be obtained.

PRIVATELY HELD SELLERS

• While we are generally concerned about publicly traded companies, privately held companies are increasingly seeking fairness opinions, too:
  - The standards of review are the identical
  - ESOP trustees are fiduciaries, just like directors of corporations
  - Venture capital firms (and their designated directors) frequently face conflicts of interest in sales of portfolio companies, since their liquidation preferences may mean that their interests are different from those of the common stockholders.
  - But see In re Trados Incorporated Shareholder Litigation (Del. Ch., Aug. 16, 2013):
    - The directors’ decision to sell a company at a price at which the common stockholders received nothing was upheld under the “entire fairness standard,” even without a fairness opinion.
    - Nevertheless: “One can remain appropriately skeptical of the value of fairness opinions while at the same time recognizing that an outside analysis of the alternatives available to Trados would have improved the record on fair dealing.”
“GOING PRIVATE” TRANSACTIONS AND MANAGEMENT BUYOUTS

• Self-dealing is inevitable, since management will benefit from a lower valuation, while other stockholders will suffer.
• Because these transactions are often structured as mergers, if the deal is concluded, even those stockholders who vote against it will lose their ongoing interest in the company.
• Rule 13e-3 does not require a fairness opinion, but the SEC staff will sometimes ask for them.
• Again, this applies to privately held companies, just as it does to publicly traded companies.
• Recent case study

REVERSE STOCK SPLITS

• Often used to eliminate the interests of small stakeholders and to go private or “go dark.”
• Even without going private, some stockholders will lose their ongoing interest in the company, regardless of whether they vote for or against the transaction.
AND STILL OTHERS....

- Hostile tender offers (called an “adequacy opinion,” in which the goal is to obtain an opinion that the price offered is not fair).
- Financings led by insiders, especially if no market-check is available.
- Recapitalizations, in which the form and rights of the equity changes.
- PIPE deals, especially with terms materially adverse to common stockholders.
- Deals with competing bids that are different in price or structure, which make it more difficult to know which is “best.”
- Deals in which different offers are made to different classes of stockholders.
- Deals of all kinds in which management’s (or the directors’) interests are not aligned with those of the stockholders.

CONCLUSION
AND IN CONCLUSION....

- “Process” is critical: regardless of whether a board has obtained a fairness opinion, the court will still look at the totality of the process. A fairness opinion is only one tool in the toolbox. Specifically, a risk-management tool, not a risk-elimination tool.

- Plaintiffs will attack the quality of the fairness opinion (and the analysis behind it), as well as any perceived conflicts of interest, but the directors may still be justified in relying on a “weak” opinion, particularly if they did not know it to be weak.

- No matter what standard of review applies, a fairness opinion increases the probability that directors’ decisions will be protected.

RESOURCES
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CONCLUSION
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SPEAKER BIOGRAPHIES
ALICIA AMARAL
Director of Business Development, Valuation & Business Analytics
aamaral@bdo.com
Direct: 617-422-7519

Alicia Amaral is a Business Development Director for the Valuation & Business Analytics practice at BDO. She has been in the financial services industry for twenty years. Her background includes experience in the valuation and public accounting fields.

Prior to joining BDO, Ms. Amaral opened the Boston office of Scalar Analytics where she was responsible for developing business for the valuation firm in the New England region. Prior to Scalar, Ms. Amaral was the CFO for Sentinel Benefits & Financial Group and a Controller for the engineering firm Haley & Aldrich. She was also an auditor with the public accounting firm, Arthur Andersen.

Ms. Amaral is an adjunct professor at Tufts University where she teaches finance and accounting in the Entrepreneurial Leadership Studies Program and the Master of Science in Engineering Management Program.

CARL F. BARNES
Partner cbarnes@mbbp.com
Direct: 781-697-2238

A corporate attorney for more than 30 years, Mr. Barnes represents companies of all sizes in mergers and acquisitions, joint ventures, public and private securities offerings, venture capital, and other complex transactions. He frequently serves as general outside counsel to his clients, advising senior management and Boards of Directors on a wide range of legal and business issues, including disclosure obligations under the securities laws, corporate governance, executive compensation, and the exercise of fiduciary duties.

Prior to joining the firm in 1999, Mr. Barnes served as vice president and general counsel of PAREXEL International Corporation, a publicly traded contract research organization; deputy general counsel of Thermo Electron Corporation (now Thermo Fisher Scientific Inc.), a publicly traded diversified technology company; vice president and general counsel of Sequoia Systems, Inc., a publicly traded computer hardware manufacturer; and as a partner in the Boston law firm of Hale and Dorr LLP (now Wilmer Cutler Pickering Hale and Dorr LLP).

Mr. Barnes has been a member of the National Association of Corporate Directors, is the former co-chair of the Boston Bar Association’s Securities Law and Corporate Law Committees, and is a frequent lecturer and speaker on legal matters.
JOHN STEVENSON, ASA
Director, Valuation & Business Analytics
jfstevenson@bdo.com
Direct: 952-656-2627

John Stevenson is a Director in the Minneapolis office of BDO Consulting, supporting the Valuation & Business Analytics practice. He has over twenty-five years of valuation and financial advisory experience. He has performed valuation analyses of business enterprises, intangible assets, limited partnership interests and preferred securities for M&A transactions, financial reporting and tax compliance. Mr. Stevenson also has extensive experience in conducting fairness opinions primarily for M&A transactions involving public companies.

Mr. Stevenson’s experience encompasses a broad range of industries including medical technology, consumer products, software & services, manufacturing, wholesale distribution, construction and financial services.

Prior to joining BDO, Mr. Stevenson was a Director with the valuation services group of McGladrey. He also held positions in the investment banking practice of Craig-Hallum Capital Group and the valuation practice of Deloitte.

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