



Focus on Fairness Opinions

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"While fairness opinions are now routinely obtained in public transactions involving substantial corporate assets, a variety of potential conflicts of interest inherent in current fairness opinion practice has drawn criticism and regulatory scrutiny."

One of the latest areas of corporate governance to receive heightened scrutiny is the practice of fairness opinions. Recently the NASD stated its concern with potential conflicts that can arise in connection with fairness opinions - particularly when the investment bank rendering the opinion also has a substantial "success fee" at stake in the transaction. At the same time, more diligent efforts to satisfy fiduciary obligations have led boards of directors and their advisors to obtain an independent fairness opinion in a wider variety of contexts, including private transactions.

Independence of the Opinion

Fairness opinions are intended to provide a board of directors with essential financial information and analyses sufficient to support their reasonable business judgment that the consideration offered in a transaction is fair from a financial point of view.

Typically, the opinion is supported by a variety of financial analyses that consider, among other factors, comparable public multiples, comparable transactions, and discounted projections of future cash flows. Qualitative factors such as industry market dynamics, competitive landscape, operating profile, and technology platform that collectively impact financial performance are also integrated into the analyses. In situations where the purchase consideration includes stock, both the target and acquiring company are valued.

While fairness opinions are now routinely obtained in public transactions involving substantial corporate assets, a variety of potential conflicts of interest inherent in current fairness opinion practice have drawn criticism and regulatory scrutiny. Foremost is the concern that often the bank rendering the opinion is also serving as

advisor to one side of the transaction and has a large success fee contingent upon the deal being approved.

In cases where the investment bank also provides "staple" financing to the buyer, the conflict is even greater, as a single bank stands to collect not only a sell-side advisory fee and a fairness opinion fee, but also a fee for arranging the financing to complete the deal.

Additionally, in the hope of securing future business, banks with long-standing relationships with individual executives may be more likely to support transactions in which the executive stands to gain personally. Similarly, if the opinion is being rendered to the acquirer or the seller is divesting only a portion of the business, the banker is likely to have an ongoing relationship with the client, leading critics to question the independence of the opinion.

Even when the investment bank is not involved in the transaction, conflicts can arise as a result of lending, shareholder, directorship, research coverage or other commercial relationships.

Concern over potential conflicts of interest led the NASD to recommend new procedures requiring disclosure of conflicts of interest in proxy materials, establishing procedures for identifying potential conflicts, and setting standards for investment banks' internal opinion-rendering processes.

While regulatory agencies are unlikely to place a blanket ban on employing the same bank as both financial advisor and fairness opinion provider, the conflicts inherent in this practice suggest that the prudent course for boards and their advisors is to obtain a fairness opinion (or, as in a growing number of instances, a second opinion) from a bank that has no financial interest in the transaction or history of business dealings with the company or its principals.

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Expanding Role for Fairness Opinions

Greater sensitivity to corporate governance issues and increased use of special committees of the board have also expanded the type and frequency of circumstances in which fairness opinions are obtained. The wide variety of transactions in which a fairness opinion is advisable includes:

- Mergers & Acquisitions – Both sell-side and buy-side parties in transactions involving substantial corporate assets.
- Take Private Transactions – Management-led buyouts and private party acquisitions of public companies.
- Stock Repurchases – Buy-backs of outstanding securities in non-open market transactions.
- PIPES – Private placements of public equities, often at a discount to market.
- Related Party Transactions – Any substantial transaction involving related parties or affiliates.
- Exchange Offers – Transactions involving the exchange of debt or equity securities.

Fairness opinions are also being obtained with greater frequency in transactions involving private companies, particularly where there are shareholder groups with diverse economic and legal interests. Circumstances where it may be advisable for a majority stockholder or independent board of a private company to obtain a fairness opinion include the issuance of stock to insiders, the purchase of stock from minority shareholders, management sponsored buyouts, and transactions in which management or certain shareholders are to receive additional consideration such as bonuses, em-

ployment agreements or other incentive compensation.

In our recent experience, boards of venture-backed companies are increasingly seeking fairness opinions to help evaluate transactions. Due to the difficult funding environment of the past several years, many early stage companies have complicated capital structures with multiple layers of institutional preferred stockholders or large numbers of angel investors. Such complexity in the capital structure is leading boards to take the precaution of obtaining a fairness opinion. This is particularly true when, upon sale of the business, shareholder classes with priority positions would receive widely divergent economic outcomes from those of subordinate shareholders and management, thereby greatly increasing the prospect of litigation from disappointed stakeholders.

About Stonebridge Associates, LLC

Stonebridge Associates is an NASD-registered investment banking firm that provides mergers and acquisitions, private placements of debt and equity securities, fairness opinions, and other strategic and financial advisory services to middle market and emerging growth companies. The firm's division, Stonebridge Technology Associates, specializes in raising equity capital and providing merger and acquisition advisory services to software, hardware, Internet, healthcare, and other technology product and service companies. To learn more about Stonebridge, please visit our website at www.stonebr.com.