FAIRNESS OPINION **Q&A**

This Q&A is not intended to constitute or substitute experienced legal counsel, accounting advice or tax consulting.

What is a fairness opinion?

- A fairness opinion is a form of valuation analysis, which differs from other valuation analyses in that it evaluates the value received in the transaction in addition to the value exchanged.
- Thus, a fairness opinion is an assessment of the financial details of a business transaction, evaluating whether the proposed consideration is fair from a financial point of view to a particular party.
- Fairness opinions typically culminate in a formal, written opinion to the engaging body (e.g. a special committee of the board of directors) making the fiduciary decision to proceed or not with the proposed transaction.
- Importantly, fairness opinions do NOT constitute recommendations to proceed with a transaction for many reasons, including because fairness opinions do NOT address the transaction from an accounting, insurance, legal, regulatory, tax or other point of view.

What does not qualify as a fairness opinion?

- A fairness opinion is an analysis of value, so it is NOT a replacement for the fiduciary's judgment, nor any sort of recommendation to the fiduciary to proceed with the transaction or not.
- A fairness opinion is NOT an evaluation of the company irrespective of the proposed transaction terms and consideration.
- A fairness opinion is NOT an evaluation of the business case of the proposed transaction.
- A fairness opinion is NOT a quantitative, point estimate of the value of the subject company.
- A fairness opinion is NOT an opinion from any sort of legal perspective.

What is the purpose of a fairness opinion?

- While the fiduciary standards required of corporate directors vary by jurisdiction, most jurisdictions hold a business judgment rule, which presumes that directors acted (i) on an informed basis, (ii) in good faith, (iii) in a manner that is honestly and reasonably in the best interests of the company and (iv) without fraud or self-dealing, when making a business decision.
- A fairness opinion may help reduce a fiduciary's exposure to a proposed transaction through reducing the perception of self-dealing via the engagement of an independent valuation firm and increasing the informed basis from which the fiduciary makes the ultimate decision.

Why do companies obtain a fairness opinion?

- California companies are required to obtain a fairness opinion for many transactions (e.g. asset sale, reorganizations, etc.) involving an interested party per California Corporations Code 1203.
- Fiduciaries of other companies seek a fairness opinion for:
- Improved decision making – Companies can gain outside perspective into details that might otherwise be overlooked due to their resulting bias from prolonged involvement and from being too close to the strategy and operations of the company.
- Potentially conflicted management teams – Management teams may be conflicted when considering a proposed transaction due to:
    - Potential bonus compensation
    - Favorable terms for equity units held (typically equity-based compensation)
    - Future employment and related compensation considerations
- Communication and transparency – A fairness opinion can communicate to stakeholders that board members are exercising prudence and care when contemplating a transaction.

What sort of transactions are typically accompanied by a fairness opinion?

- Mergers, acquisitions or change of control transactions
- Down-round financing
- Related party transactions, including transactions with insiders or controlling shareholders
- Tender offers including leveraged buyout, management buyout or another going private transaction
- Private placements and rights offerings, especially involving dilution of existing shareholders or below market prices
- Divestitures
- Corporate reorganizations or restructurings
- Dividend recapitalizations
- Negotiation or renegotiation of loan covenants
- Large block stock purchases
- Transactions with competing offers
- Transactions restricted by a bond indenture
- Hostile takeovers
- Continuation investment vehicles

If a company already has a 409A valuation, why would they need a fairness opinion?

- While fairness opinions and 409A valuations both involve valuing assets, they serve different purposes and are subject to different regulatory considerations

	409A	FAIRNESS OPINION
Nature	Required	Required
Engaging Body	Company Management	Typically a special committee of the board
Purpose	Determine the FMV of common stock for setting exercise prices for equity-based compensation (e.g. stock options)	Assess the fairness of proposed transaction terms from a financial point of view, relative to specified stakeholders
Independent Valuation Provider	Required	Highly Encouraged
Regulatory	Subject to IRS regulations and guidelines as outline in Section 409A of the Internal Revenue Code	Requirements varying by jurisdiction

Who provides fairness opinions?

- Independent valuation firms
- Investment banks involved in the transaction are sometimes engaged, because they are already familiar with the transaction; however, there is a potential for conflict of interest due to:
  - M&A success fees - The investment bank's disproportionate M&A success fee relative to the fairness opinion fee, creating an incentive or appearance of conflict for the bank to opine that the deal is fair.
  - Pressure to close the deal – The investment bank's determination and momentum with the management team to close the deal may create an incentive or appearance of conflict for the bank to determine that the deal is fair.
- To overcome conflicts, boards should strongly consider an independent provider that is paid a fixed fee (not a contingent fee) for the fairness opinion, regardless of the outcome of the transaction.

What is the typical process followed in a fairness opinion?

- There is relatively limited professional guidance for what must be done prior to the issuance of a fairness opinion, especially since fairness opinions vary based on the scope requested by the fiduciary; however, a typical fairness opinion includes:
  - Review of material assets, agreements and contracts involved in the transaction
  - Review applicable transaction documents
  - Discussions and interviews with management and company advisors (e.g. auditors, legal counsel, etc.)
  - Review historical financial statements and forecasted operating performance
  - Review historical stock trading and SEC filings (for publicly traded companies)
  - Review market data of other publicly traded companies
  - Review other recent transactions

What are the typical methodologies considered in a fairness opinion?

- Financial fairness requires professional judgment based on a variety of considerations, so financial analyses within a fairness opinion typically include:
  - Income approach considerations using a discounted cash flow analysis
  - Market approach considerations using shares of other public companies
  - Transaction approach considerations using terms from other recent transactions
  - Replacement value considerations using the current price of other assets
  - Net asset value considerations using historical financial statements

What perspectives may be considered in a fairness opinion?

- The value of the company on a stand-alone basis, without considering issues related to lack of control or lack of marketability
- The value resulting from an efficient and competitive auction process
- The value including any market premiums

What is the deliverable for a fairness opinion?

- The primary deliverable is a letter to the engaging body (typically a special committee of the board of directors) with the following elements:

OPINION LETTER COMPONENTS

- ☐ Introduction
- ☐ Transaction Summary
- ☐ Basis of Opinion
- ☐ Financial Analysis
- ☐ Other Factors Considered
- ☐ Assumptions & Limitations
- ☐ Opinion
- ☐ Appendices (Optional)
- ☐ Authorization

  - Introduction – Providing an overview of the purpose and context of the fairness opinion as to whether the transaction terms are fair from a financial point of view to the specified stakeholder
  - Transaction Summary - Providing a brief understanding of the proposed transaction, including the parties involved, the nature of the transaction and the key terms and conditions
  - Basis of Opinion – Detailing the process followed in the analysis, including the methodologies and assumptions used in the valuation
  - Financial Analysis - Including a review of the financial terms, an assessment of the valuation methodologies used and an evaluation of the transaction to relevant market benchmarks or other transactions
  - Other Factors Considered – Detailing additional inputs and factors reviewed, such as market conditions, industry trends, regulatory considerations and other relevant factors
  - Assumptions and Limitations – Outlining the assumptions made and the limitations of the analysis and the scope and boundaries of the opinion
  - Opinion – Concluding whether the transaction terms are fair or not from a financial point of view to the specified stakeholder
  - Appendices (optional) – Containing supplemental information, such as financial analyses, valuation models or market data
  - Authorization – Including the signatures and date by authorized representatives of the financial advisor providing the opinion

- Given constraints of compressed transaction timelines, the board often receives an opinion delivered orally, contingent on the written opinion being submitted prior to shareholder approval

What criteria should a board of directors use when selecting a valuation firm for perform the fairness opinion?

- Some factors the board should consider when selecting a valuation firm include:
  - The reputation and history of the firm
  - The credentials and experience of the individuals who will lead the engagement
  - The available resources the firm has relative to the transaction's timeline
  - Any independence issues or conflicts of interest
  - The fee relative to the scope and extent of the engagement, complexity of the transaction terms and timing of the transaction

How are fees determined for a fairness opinion?

- Like snowflakes, each fairness opinion is unique, whereby the scope can vary significantly from assignment to assignment
- When evaluating the fees quoted by valuation providers, fiduciaries should consider:
  - Independence of the firm
  - The scope and parameters of the analysis
  - The scope and extent of the opinion to be rendered
  - The timeline for the engagement
  - The reputation and history of the valuation firm

Contact our Weaver Valuation Services team for further assessment assistance:

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