

VALOREM PRINCIPIA

The Principles of Value

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The Value of Fairness Opinions

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Two decades ago, fairness opinions became a common element in mergers, acquisitions and other significant corporate transactions where the board of directors faced conflicts of interest or a sale of corporate control was contemplated. The corporate scandals of the past several years, as well as regulatory initiatives including those contemplated by the NASD (National Association of Securities Dealers) have heightened the scrutiny of many corporate activities and transactions. As a result, the importance of fairness opinions as an integral part of the transaction process is arguably greater than ever. The list of transactions where a fairness opinion is often obtained has consequently expanded and includes:

- ◆ Mergers;
- ◆ Acquisitions;
- ◆ Restructurings;
- ◆ Going-private transactions;
- ◆ Recapitalizations;
- ◆ Stock repurchases; and
- ◆ Divestitures.

Fairness opinions are typically addressed to a company's board of directors, special committee of the board of directors, or trustees of an ESOP (Employee Stock Ownership Plan), and opine as to whether the proposed transaction is fair from a financial point of view, as opposed to a legal one, to the corporation and its shareholders. While a fairness opinion is not intended to constitute a recommendation as to how the directors or shareholders should vote on any action and is not a substitute for the board's own determination, it is an important tool to both aid the board in making its decision with respect to a proposed transaction and to evidence that the directors met their fiduciary obligations in doing so. In an increasing litigious corporate environment, fairness opinions play an important risk mitigation role for the directors.

Know Thy Duty

Under Delaware and other corporate law, directors owe fiduciary duties of care and loyalty to the corporation and its shareholders. With respect to the duty of care, the "business judgment rule" provides a defense for the board of directors in a situation where litigation is brought to challenge the prudence or wisdom of a corporate action that they have authorized. The following succinctly states the rule:

The business judgment rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. A key aspect of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to a rational business purpose.

For the business judgment rule to apply, however, three preconditions must be met: care, loyalty and independence. In determining whether a board of directors has acted with care, a court will look at the process that the board adopted in considering and ultimately approving the corporate action in question. One of the key elements of that process is whether the board was fully informed with respect to the transaction. Obviously, the fairness of the consideration received by the corporation or its stockholders in the deal is of central importance as well. The directors are entitled to consider the advice of outside experts. Hence,

the value of a fairness opinion is readily apparent, as it is one indicia that a board of directors has met its duty of care.

In transactions where a board of directors has a conflict of interest, such as a management buyout where management directors are part of the acquiring group, and situations where a sale of control of the corporation is contemplated, the board's actions will be scrutinized by a higher standard, often referred to as "entire fairness", than the business judgment rule. Obviously, in these types of transactions, a fairness opinion takes on even greater importance. Other types of fiduciaries, such as controlling shareholders, trustees of ESOPs and other benefit plans, general partners and limited liability company managers often have similar fiduciary duties to those of corporate boards of directors.

Who's Opinion . . . ?

Board members must take an active role in selecting and monitoring the financial advisor charged with evaluating the terms of a possible transaction. Merely selecting a financial advisor without carefully considering its qualifications and blindly relying on its opinion is most likely insufficient to satisfy the board's duty of care. The board's role with respect to the opinion process includes choosing the financial advisor, monitoring progress, reviewing the preliminary analysis, and analyzing the final opinion.



The process begins with hiring an experienced professional firm that is qualified to render an opinion on fairness. The valuation expert should be someone who is independent of any of the parties to the transaction and who possesses the education, experience, and expertise needed to analyze the financial terms of the proposed transaction. The firm should have thorough knowledge of the fairness opinion process from rendering such opinions over the years.

Issues involving the potential for conflict can arise when the opinion is delivered by an investment bank that is also acting as an adviser to the acquiring firm and stands to collect a contingency fee if the deal goes through. This practice is still relatively commonplace, but the potential conflict of interests have led some in the M&A community to advocate the use of independent valuation advisors to provide fairness opinions in deals.

In order for a fairness opinion to provide the maximum benefit to the board of directors, it is important that the financial advisor rendering the opinion be selected as soon as reasonably possible once the transaction process has started to ensure that there is ample time available to conduct a thorough analysis prior to rendering the opinion. Similarly, the financial advisor needs to have full access to relevant information and personnel. The financial advisor will also obtain information independent of the company, including market and industry data, to better evaluate the numerous factors that it will consider in rendering the opinion. A sample of factors that the independent advisor may look at while completing a fairness opinion are financial performance and issues impacting earnings; a thorough review of the merger agreement and its terms; an analysis of the investment characteristics; pricing of similar transactions; and dividend-paying history and capacity.

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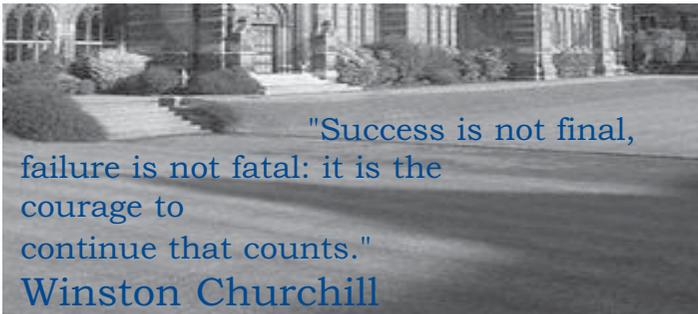
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The Measure of ValueSM

Business Valuations
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Client Showcase
LawFund Management Group, LLC

As business valuation experts, we often run into situations where business owners have been involved in legal problems, which can lead to costly litigation and limited options. This has been a challenge in the legal world, until the advent of LawFund Management Group, LLC (LFMG).

LFMG was formed to expand the legal choices of mid-sized businesses and individuals that have suffered substantial monetary damages and can't afford to fight back. LFMG works to make legal justice available to all.

"Too many individuals and businesses are finding it increasingly difficult to recover their damages," explains Herbert Dodell, LFMG's legal counsel. "Litigation is expensive and 'deep pocket' defendants know how to delay and avoid the process. Aggrieved parties often don't have the funds or the time to attend to the case and conduct business as usual."

Dodell emphasizes that LFMG is not a law firm. "But, unlike legal funding companies that lend money to plaintiffs or lawyers pre-litigation, either for a percentage, flat fees or high interest rate, LFMG provides the case management and services of a high quality law firm for the cases it selects."

Under its design, LFMG accepts qualifying cases on a contingency fee basis; contracts with outside attorneys with expertise relevant to the cases, on an hourly fee basis to litigate the case; oversees the litigation and management of the case to its conclusion; monitors the case, including all attorneys' activities; and participates in settlement negotiations.

LFMG has developed proprietary software that issues a Case Evaluation System score to each case submitted for evaluation. LFMG is the first company of its kind to employ a CES scoring process. "The accuracy this technology provides for our case selection is incredible," Dodell enthuses, "and truly demonstrates the value of a highly-functioning digital workplace."

LFMG takes cases referred from law firms that do not accept contingency fee cases, that do not have the expertise, experience or financial capability to take such a case, and from accountants or financial advisors whose clients require legal representation. No cases are accepted unless formally submitted by an attorney.

SP&H first became involved with LFMG because of its *Sharing with Others* program, which is a fundraising opportunity for nonprofit organizations. As part of SP&H's continued efforts to support charities in the LA area, LFMG's promise to donate a percentage of its net profits from the settlement or collected judgment to *Project Cuddle* (2004 SP&H reception sponsored charity) from each case SP&H refers to LFMG was very attractive. In addition, LFMG will donate 10 percent of its net profits from any award of punitive damages received by the client. In light of the fact that the average case size LFMG accepts has a \$1 million threshold, it is easy to see how much money could be raised for *Project Cuddle*, while at the same time assisting mid-size businesses struggling with legal issues.

In today's litigious society, it is quite common for businesses to become wrapped up in legal battles that deplete their resources and leave them with little fighting power. LFMG provides legal options for those in this predicament, and establishes a balance of power with its revolutionary practices. In addition to helping the business owner in need, LawFund also works to help charities and community organizations. SP&H is proud to be involved with this tremendous organization.

For more information, click on www.lawfundmgmtgroup.com or www.lfmg.net.

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As indicated, while the board of directors can take comfort in selecting a well qualified, independent financial advisor to deliver the fairness opinion, it is incumbent upon the directors to understand the basis of the opinion and the methodologies and assumptions underpinning the opinion. Typically, a financial advisor will make a presentation to the board of directors prior to delivering the opinion thus giving the board the ability to probe the investment advisor with respect thereto. From the directors' perspective, the key is that, while a fairness opinion is a valuable tool to be used by a board in reaching its decision in an informed matter, it is a tool that needs to be used actively and with careful thought.

WHEN SHOULD COMPANIES USE A FAIRNESS OPINION?

As indicated, the number of situations where fairness opinions are used has expanded over recent years. Board members, controlling shareholders, ESOP trustees, and other fiduciaries should be aware of the following factors in determining whether a fairness opinion is necessary:

◆ *Is a management buyout to take place?* Typically, in transactions where management is buying the company, a fairness opinion should be obtained. The inherent conflict in such a transaction heightens the threat of post-deal litigation. Other potential conflict of interest situations, such as where management is receiving above market compensation, which could be seen as value being diverted from the shareholders, also indicate that a fairness opinion be carefully considered as a part of the deal process.

◆ *Are company shares sold through 401(k) plans?* When this occurs, the chance that a minority shareholder will challenge the fairness of a transaction greatly increases.

◆ *Is there an ESOP?* ESOP companies are similar to publicly traded companies in that an ESOP company often encounters heightened regulatory scrutiny typically from the Department of Labor or the IRS as opposed to the SEC.

◆ *Is there a sale of control without an active auction process?* In situations where a company is being sold for cash or for stock of an acquiring company with a controlling shareholder or block of shareholders, the board's approval of the transaction is subject to higher scrutiny than in other sale contexts. Under the so-called Revlon duty, named after the seminal Delaware case, the board of directors is charged with "securing the transaction offering the best value reasonably available for the stockholders." In situations where a company has been actively shopped by investment bankers or otherwise, the board will often have a high degree of confidence that such standard has been met although fairness opinions are often still obtained in these situations. If the company has not been shopped, the board will need to take other steps to satisfy itself that the transaction represents the "best value reasonably available for the stockholders." Receipt of a fairness opinion is one (but not the only) such step.

In most situations, fairness opinions are not required by law. Nevertheless, the type of transactions where fairness opinions are now commonly obtained has expanded and is not limited to those outlined above and are also not limited to transactions involving public or ESOP companies. Private companies also should consider obtaining fairness opinions in many situations. It is important that you consult an M&A attorney or financial service provider when considering whether a fairness opinion is desirable in any given situation.

Boards of directors involved in corporate transactions are increasing their reliance on outside advisors to shield them from shareholder litigation. These advisors need to be aware of policies and procedures surrounding such transactions, including the appropriate use of fairness opinions. It is important to consult the proper service providers along the way to ensure that transactions are completed with applicable legal standards in mind. Assembling the right team of efficient, experienced professionals early on in the process prevents unnecessary litigation, controversy and expenses for all involved.

Jon W. Newby, Esq., is a partner in the Corporate Practice Group of Sheppard, Mullin, Richter & Hampton, and is based in their Century City office. Mr. Newby represents public and private companies in connection with mergers and acquisitions, public and private financings, and general corporate matters. Mr. Newby's clients range from large public to emerging growth companies in a variety of industries, including technology, manufacturing and consumer products. Mr. Newby also represents equity sponsors, investment banks and other institutional firms. He can be reached at 310/228-3737, or at jnewby@sheppardmullin.com.

Sanli Pastore & Hill, Inc. has wide-ranging experience in providing fairness opinions within a variety of corporate transactions involving both public and private companies. Please contact Nevin Sanli or Thomas Pastore at 310-571-3400, or nsanli@sphvalue.com, tpastore@sphvalue.com for more information.

Ask SP&H

In each edition of Valorem Principia, we will answer questions related to a different topic regarding SP&H.

Please submit questions to Nevin Sanli at nsanli@sphvalue.com, or 310/571-3400.

Topic: SP&H Fall Charity events

Q: Where did the idea to sponsor a charity in collaboration with the firm's open house come from?

A: SP&H has always been dedicated to giving back to the community, whether by individual donations, volunteering, etc. In November of 2003, we opened our door to Girls Inc. of Los Angeles, a non-profit organization, and sponsored them at our firm's open house at the Pacific Design Center in West Hollywood. We organized a silent auction, and all proceeds went directly to Girls, Inc. The over two hundred guests in attendance were introduced to the charity, amidst music, friends, food, and Girls Inc. representatives. It was such a success that we decided then and there to continue the tradition every year thereafter with a different charity from the Los Angeles area.

Q: How are the charities selected?

A: We have developed a process of sorting through the great many charities that we encounter and concentrating on those who will benefit the most from our efforts. Typically, the focus is on the smaller organizations where we can make a significant impact. The charity's financials are carefully reviewed, as are the staff and history of the organization, to ensure that the charity is run efficiently and that the money we raise goes directly to programs and not overhead. The average budgets are usually below \$500,000 per year, and are still run by the dedicated, energetic, workaholic founders who have an emotional link to the success of the charity. We narrow it down to two or three charities, and the firm decides which one should be sponsored at our Fall event.

Q: How do the charities benefit from your events?

A: First and foremost, the charities receive exceptional publicity out of our receptions, via our tremendous marketing efforts that start over six months prior to the actual event. The charity is introduced to our client base and friends, both at the reception and through our newsletter (average circulation is 20,000 people), website, and marketing materials that include invitations, faxes, emails, etc. The charity, with all of the names and business cards collected, turns the event into a continuous source of income. At our last fundraiser in November of 2004, we raised over \$12,000 in cash for Project Cuddle through a casino night, silent auction, raffle, and

private donations. Over 300 people joined us at Fox Studios, and the results were fantastic.

Q: How is the entertainment chosen?

A: The casino night was chosen because it is the most effective way to raise money for a cause while engaging people in a high-energy activity. The silent auction is somewhat of a tradition here at SP&H, and is a good way to get more people involved in our event. There is always a band, of course, because we have to have a way of getting Nevin out there to play one of his guitars!

Q: When is the next charity event?

A: The next event is scheduled for Friday, November 4, 2005, at Fox Studios. Due to the overwhelming success of the casino night and silent auction theme of the event, we have decided to continue the tradition in 2005. This year's reception promises to be bigger and better than ever. The time has been extended to 11pm, and it will be held on a Friday evening, thereby allowing for ample play time with almost no threat of 7am meetings the following morning! We are currently reviewing several charities for consideration in our 2005 event. Nominations of potential charities are greatly appreciated, and can be directed to Nevin Sanli at nsanli@sphvalue.com. Please have the charities' contact information, your affiliation with them, and other pertinent details ready at the time of submission.

Q: Are there sponsorship opportunities available?

A: YES! Everything, from the premier co-sponsorship to the dessert sponsor is open for the taking. Please check out our website at www.sphvalue.com for sponsorship details, or contact Nevin Sanli at nsanli@sphvalue.com. Don't miss out on this incredible opportunity to support a charity, be involved in a high-profile event, and most importantly, have FUN!



Project Cuddle
Debbe Magnusen
714-432-9681
www.projectcuddle.org



Girls Incorporated of LA
Kim Kearns
626-486-1050
www.girls-inc.org

"Spring Forward!"

SP&H Trivia Corner

The Truth Behind Daylight Saving Time

As Daylight Saving Time approaches this April, many of us may find ourselves questioning why we go through the ritual of setting the clocks backwards or forwards twice a year. Where did the process come from? Is it a law? Is it practiced everywhere? SP&H answers these and other questions pertaining to the mystery of Daylight Saving Time.

The idea of Daylight Saving Time was first conceived by

Benjamin Franklin during his sojourn as an American delegate in Paris in 1784. The concept was not advocated seriously until the early 1900's, and was not formally adopted in the United States until 1918, during World War I. The idea was to conserve fuel by lowering the need for artificial light. A law was passed that placed the country on Daylight Saving Time for the duration of the war.

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NEWSFLASH

January 28th - Sacramento, California
Developments in Eminent Domain in California
Forrest Vickery and Tom Pastore were panelists at this event.

March 9th -11nd - Anaheim, California
California Redevelopment Association Annual Expo
SP&H will be an exhibitor at this event.

April 27th - Los Angeles, California
LA Venture Association Investment Capital Conference
SP&H will be attending this event.

May 9nd - Anaheim, California
Harvard Business School Association of Orange County Entrepreneur's Conference
Nevin Sanli will be a panelist.

June 7th - San Diego, California
ACG San Diego Annual Awards Dinner
SP&H will be attending this event.



Valorem Principia

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However, the law proved to be so unpopular that it was repealed in 1919 over President Wilson's veto. It became a local option, and was continued in a few states across the nation.

From 1945 to 1966, there was no federal law about Daylight Saving Time, and states were permitted to choose whether to observe Daylight Saving Time and could choose when it began and ended. As can be imagined, this caused incredible confusion, and Congress decided to end the uncertainty and establish one pattern across the country. The Uniform Time Act of 1966 was signed into Law by President Lyndon Johnson, who stated that Daylight Saving Time would begin on the last Sunday of April and end on the last Sunday of October. Any state that wanted to be exempt from it could do so by passing a state law.

Under legislation enacted in 1986, Daylight Saving Time in the USA now:

- ◆ Begins at 2 a.m. on the first Sunday of April and
- ◆ Ends at 2 a.m. on the last Sunday of October

Clocks are advanced one hour in the Spring and moved back one hour in the Fall ("spring forward" or "fall back"). It is not observed in Hawaii or Arizona, and some other U.S. territories.

The changeover time was arbitrarily chosen to be 2 am, which is when most people are at home, thereby minimizing disruption. It is late enough so that operating bars, restaurants, and other establishments are lightly affected, and early enough so that the switch is made by dawn.

Daylight Saving Time has many advantages that one might not consider as a result of the decrease in darkness, including:

- ◆ Saves energy;
- ◆ Saves lives and prevents traffic injuries; and
- ◆ Prevents crime.

And that is the truth behind Daylight Saving Time. Now don't forget to set your clocks forward at 1:59 a.m. on Sunday, April 3, 2005!

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