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www.mercercapital.com
mcm@mercercapital.com

What's Fair is Fair?

By Z. Christopher Mercer, ASA, CFA
mercerc@mercercapital.com

Boards of directors have engaged investment banking firms to provide fairness opinions for many years. Questions about the fairness of many fairness opinions have also been raised for many years.

A recent *Dealbook* column in *The New York Times* by Andrew Ross Sorkin ("Mergers: Fair Should be Fair", Sunday, March 20, 2005) discusses the issue of fairness opinions one more time.

It is often thought that boards obtain fairness opinions in order to assure the fairness of transactions from the viewpoint of their companies' shareholders. However, the real reason that fairness opinions are obtained is to protect boards from lawsuits arising from corporate transactions. This has always been true, but especially since the landmark Delaware case of *Smith v. van Gorkham* was decided in 1985. While this and subsequent cases do not require the use of fairness opinions, they make clear that their use helps assure that boards have exercised their "duty of care" in the exercise of their business judgments.[1]

There are numerous nuances to the definition of *fair*, but one or two in particular are instructive (definitions found at Merriam-Webster OnLine):

> **"6 a :** marked by impartiality and honesty **:** free from self-interest, prejudice, or favoritism <a very fair person to do business with> **b** (1) **:** conforming with the established rules **: allowed** (2) **:** consonant with merit or importance **: due** <a *fair* share> **c :** open to legitimate pursuit, attack, or ridicule <*fair* game>
>
> **10 :** sufficient but not ample **: adequate** <a *fair* understanding of the work>"

On the one hand, to be *fair* is to be marked by impartiality and honesty and to be free from self-interest and favoritism. On the other hand, the concept of *fair* does not imply an abundance, but rather a sufficiency.

In some respects, the investing public has been led to believe that if a company obtains a fairness opinion for a transaction, it is offering the best possible deal to its shareholders. *Simply not so.*

[1] There is a several page discussion of fairness opinions in my first book, *Valuing Financial Institutions* (Homewood, IL, Business One Irwin, 1992), including a brief overview of *Smith v. Van Gorkham*. (http://www.mercercapital.com/Images/PDF Images/VFIFairnessopinion.pdf)

We can begin to understand the public misunderstanding of the meaning of a fairness opinion when we investigate the concept of *fairness*:

> "- **fair•ness** *noun*
> **synonyms fair, just, equitable, impartial, unbiased, dispassionate, objective** mean free from favor toward either or any side. **fair** implies an elimination of one's own feelings, prejudices, and desires so as to achieve a proper balance of conflicting interests <a *fair* decision>. **just** implies an exact following of a standard of what is right and proper <a *just* settlement of territorial claims>. **equitable** implies a less rigorous standard than **just** and usually suggests equal treatment of all concerned <the *equitable* distribution of the property>. impartial stresses an absence of favor or prejudice <an *impartial* third party>. **Unbiased** implies even more strongly an absence of all prejudice <your *unbiased* opinion>. **dispassionate** suggests freedom from the influence of strong feeling and often implies cool or even cold judgment <a *dispassionate* summation of the facts>. **objective** stresses a tendency to view events or persons as apart from oneself and one's own interest or feelings <I can't be *objective* about my own child>. **synonym** see in addition **beautiful**"

With synonyms like *just, equitable*, *impartial*, *unbiased*, *dispassionate*, and *objective*, one would think that fairness opinions would exhibit the same qualities. However, go back to the basic meaning of fair, which simply means adequate, or, say, average. Well, the concept of average is a range concept. So a fairness opinion is an opinion regarding the pricing (and process) of a deal that concludes that a deal is fair, within a range. And the range is virtually never specified in a fairness opinion.

This suggests that while one deal may be *fair*, another deal may be *more fair* or *less fair* and still be *fair*. How are investors to know what a fairness opinion means under such circumstances?

The *New York Times* article referenced above noted that the National Association of Securities Dealers (NASD) has just completed a comment period during which it asked the public to make suggestions about how to change the rules for issuing fairness opinions.[2]

Why? Because in many instances, the very investment bankers who stand to gain the most from completing transactions are the ones opining to their *fairness*. For example, assume that an investment bank has initiated a transaction and, upon its completion, will earn a success fee of $20 million. The board requires a fairness opinion and the bank offers to provide that opinion for a separate fee of, say, $500 thousand. Is that deal fair? *You betcha!*

Some investment banks believe they are able to render fairness opinions for one side in a deal when they are providing services to the other side *in the same deal*. This situation arises when a bank represents one side in a deal and provides or arranges financing for the other side. The term used for this type of financing is "staple financing."

Sometimes, investment banks have taken things to the extreme. For example, when J.P. Morgan Chase acquired Bank One in 2004, J.P. Morgan Chase *wrote its own fairness opinion for the deal!* How objective, dispassionate, impartial, or unbiased was that?

And strangely enough, there are precious few rules requiring that the various actual or perceived conflicts be disclosed to boards of directors or the investing public.

So what should we think about the imprimatur of "fair, from a financial point of view" by investment banks who stand to make far more from other aspects of transactions than from the preparation of fairness opinions?

The obvious conflicts of interest with investment banks opining on their own deals has long been apparent, yet little has changed with the rules for rendering fairness opinions (except for a bit more disclosure in proxy statements) in more than 20 years.

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[2] Information on the request for comments and posted comments can be found on the NASD website (www.nasd.com).

The NASD Notice to Members dated November 2004 summarizes the SEC's proxy rules for fairness opinion disclosure and then notes:

> Fairness opinions typically disclose that in preparing the opinion, the investment bank has assumed and relied on the accuracy and completeness of all information made available to the investment bank by the company and the investment bank has not assumed any responsibility to independently verify such information or undertaken an independent appraisal of the assets or liabilities of the company.
>
> Notwithstanding the proxy statement disclosure requirements, NASD is concerned that these disclosures may not sufficiently inform investors about the subjective nature of some opinions and their potential biases.
>
> In addition, the multiplicity of valuation methodologies employed, the sensitivity of results to small changes in the underlying assumptions, and a perceived tendency to make judgment calls that support the company managers' preferred outcome have been the subject of criticism.
>
> NASD is considering whether to propose a new rule that would require members to:
>
> (1) disclose in any fairness opinion appearing in any proxy statement any significant conflicts of interest, including, if applicable, that the member has served as an advisor on the transaction in question, and the nature of compensation that the member will receive upon the successful completion of the transaction; and
>
> (2) require specific procedures that members must follow to identify and disclose potential conflicts of interest in rendering fairness opinions.

On the other hand, doesn't it seem like a good idea that firms offering transactional advice should not provide fairness opinions in the same transactions? Wall Street has resisted change in this area, but will likely survive any new disclosure requirements. After all, the upshot may well be that boards will choose to hire a second investment bank to provide the fairness opinion to eliminate the conflict with the transactional adviser. If one fairness opinion is good, they may hire two investment banks to doubly insure that the deal is average, or, rather, fair.

I specifically recall a 1985 article in *Forbes* addressing fairness opinions because I wrote a letter to the editor which was published in the September 23, 1985 issue:

> **All's fair in love and...?**
>
> SIR: In "Fairness for hire" *(July 29)* you discussed the conflicts faced by investment bankers in rendering fairness opinions. There are numerous business valuation firms that routinely value companies and evaluate transactions from the point of view of various shareholder factions. They do not expect to manage the next underwriting. They get used, for the most part, in "small" transactions. The investment banking community has successfully perpetuated the concept that only an investment banking firm can render a fairness opinion in "big" deals. After all, what's fair is fair.

In the ensuing almost twenty years, little has changed, except that some of the business valuation firms have grown in size and capabilities and remain available to provide independent, unbiased, impartial, dispassionate and objective fairness opinions on behalf of boards of directors of private and public companies engaging in substantial transactions needing independent review.

Alphonse Karr's cynical adage could seem appropriate: *Plus ça change, plus c'est la même chose*.◆

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Z. Christopher Mercer, ASA, CFA

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Timothy R. Lee, ASA and
Brent A. McDade

May 19, 2005
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June 2, 2005
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NACVA Business Valuation Conference
Philadelphia, Pennsylvania
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Matthew R. Crow, ASA, CFA, moderator

June 9-10, 2005
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Z. Christopher Mercer, ASA, CFA

August 2, 2005
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Travis W. Harms, CFA, CPA/ABV and
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MERCER CAPITAL

Business Valuation • Investment Banking

Headquarters:
5860 Ridgeway Center Parkway, Suite 400
Memphis, Tennessee 38120
901.685.2120 • Fax 901.685.2199

Midwest Office:
511 South 5th Street, Suite 206
Louisville, Kentucky 40202
502.585.6340 • Fax 502.585.6345

www.mercercapital.com