

## ARE FAIRNESS OPINIONS IN MERGERS AND ACQUISITIONS CONFLICTED?

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### **Abstract**

Fairness opinions sought by boards from deal advisors have been criticized for providing boards' legal protection against potentially disgruntled shareholders and for aiding bankers further their goal of completing the deal as opposed to aiding boards (and shareholders) by providing an honest appraisal of deal value. We find empirical support for this criticism. We find that shareholders on both sides of the deal, aware of the potential conflicts of interest associated with advisor-provided fairness opinions rationally discount such opinions in their assessment of the deal, more so when board and managerial incentives have the potential to conflict with those of shareholders. The reputation of the advisor serves to mitigate this discount, while the contingent nature of advisory fees appears to have no impact. Thus, altogether our findings suggest that investment bankers and boards may be complicit in using fairness opinions to further their own interests at the expense of shareholders.

JEL Classification: G34, G24

Keywords: Fairness Opinions, Mergers and Acquisitions, Investment Banking

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Fairness opinions sought by boards from deal advisors have been criticized for providing boards' legal protection against potentially disgruntled shareholders and for aiding bankers further their goal of completing the deal as opposed to aiding boards (and shareholders) by providing an honest appraisal of deal value. We find empirical support for this criticism. We find that shareholders on both sides of the deal, aware of the potential conflicts of interest associated with advisor-provided fairness opinions rationally discount such opinions in their assessment of the deal, more so when board and managerial incentives have the potential to conflict with those of shareholders. The reputation of the advisor serves to mitigate this discount, while the contingent nature of advisory fees appears to have no impact. Thus, altogether our findings suggest that investment bankers and boards may be complicit in using fairness opinions to further their own interests at an expense to shareholders.

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## FAIRNESS OPINIONS IN MERGERS AND ACQUISITIONS

### 1. Introduction

In evaluating merger and acquisition (M&A) proposals, corporate boards often seek third party assessments of the “fairness” of the financial terms of the proposed transaction to shareholders. Although these so-called “fairness opinions” can be provided by entities specializing in valuation – accounting firms, consulting firms or appraisers for instance, they are for the most part sought by boards from investment banks who also act as advisors on the deal. In recent years, the practice of advisors providing fairness opinions has generated considerable controversy over the lack of independence in the provision of fairness opinions.<sup>1</sup> Critics contend that boards seek fairness opinions from deal advisors for the “legal cover” they provide against disgruntled shareholders, and that investment banks oblige by opining favorably on deals that may otherwise be financially inadequate to realize deal-contingent advisory fees. Investment banks counter such claims by arguing that their proximity to the firm and intimacy with the deal’s terms uniquely disposes them to attest to the fairness of the financial terms involved in the transaction. The controversy surrounding fairness opinions has attracted widespread attention from the business press, industry participants, lobbyists and regulatory bodies, despite which, there is little by way of systematic evidence capable of informing the debate and evaluating the proposals aimed at addressing the conflicts of interest associated with fairness opinions. In this paper we examine the issue from the shareholder’s perspective to provide just such evidence.

Acquisition values determine the division of the gains from the change in control between shareholders and other corporate claimants. It is a well known empirical fact that these acquisition values differ substantially from the target’s open market stock price (they typically involve a premium over the stock price), implying that the target firm’s pre-offer stock price is an

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<sup>1</sup> A representative sample of reports about the controversy from the *Wall Street Journal* includes articles by Davis (2004a, 2004b), Davis and Langley (2005), Davis and Berman (2005), and Davis (2005). A *Business Week* report is by David (2003).

inadequate measure of its acquisition value. The target firm's post-offer stock price is also inadequate, given the uncertainty over the outcome, final price and the existence of other buyers and their offer terms. This inability to rely on stock market prices to value a proposed transaction can generate disagreements among shareholders over the exchange value of their claims, more so because managers may possess inside information and have interests that conflict with shareholders. Consequently boards engage an investment bank to perform a valuation analysis and deliver an opinion on the fairness of the proposed transaction to shareholders.

A successful merger requires the cooperation of multiple corporate stakeholders. Consequently, there is no theoretically correct way to divide the joint gains in mergers, and hence no one "fair" acquisition price. When boards obtain a third-party valuation of the firm that ratifies an offer as "fair", shareholders have to judge to what extent the process (a) was itself fair and (b) generated fair valuations. A "fair" opinion may represent the board (management) and the investment banker's belief that the offer price represents fair value. Alternatively, it may, as critics contend, represent the investment banker's judicious manipulation to rationalize management dictated terms to shareholders. Either way, the fairness opinion affects the allocation of real assets in the economy by setting the bounds on the range of feasible acquisition values, and hence shareholder wealth. Absent the ability to observe individuals' beliefs', it is an empirical question as to how shareholders view fairness opinions in their assessment of a merger, and what signals they rely on to infer the dominant motive behind the fairness opinion.

Two aspects of the "practice" of fairness opinions – that fairness opinions are always observed to be "fair" and are predominantly provided by deal advisors, influence how shareholders can incorporate fairness opinions in their assessment of a merger. In their role as deal advisors, investment banks help negotiate the terms of the deal to arrive at a premium that can be ratified as "fair" (i.e. the merger premium and the "fair" opinion are jointly determined). Consequently, shareholders observe only "fair" opinions. This lack of cross-sectional variation in opinions (fair or unfair) robs an opinion of its potential informational value (from the valuation

analyses in the opinion) and forces shareholders to rely on the process that generated an opinion, rather than the opinion itself, in discriminating across mergers.

The very fact that the board sought a fairness opinion, despite the fact that it always turns out to be fair, as opposed to not seeking one at all could convey information to shareholders. The absence of a fairness opinion could either imply that the valuation uncertainty was not sufficient to warrant an opinion, or that the board could not get a “fair” opinion. The presence of a fairness opinion could represent to shareholders the intent of the board to ensure that the offer is in the best interests of shareholders. Alternatively it could represent the conflicted interests of the board in seeking a fairness opinion from the deal advisor in situations involving low merger premiums, or those of advisors providing fairness opinions opportunistically to ensure that deals involving low merger premiums consummate. Shareholders could seek to infer the motive behind the fairness opinion based on the board’s choice of the fairness opinion provider – whether the board sought the opinion from the deal advisor or from an independent entity. However, the fact that fairness opinions are predominantly provided by deal advisors, limits this option.<sup>2</sup> Absent any other way to infer the underlying motive behind the fairness opinion, it is an empirical question as to how shareholders view fairness opinions on average in their assessments of mergers.

We examine a cross-section of deals over a 25 year period and find that targets seek fairness opinions from their advisors when merger premiums are low. We do not find such a relationship on the acquirer side. Using stock price reactions at the time of the merger announcement to assess how shareholders respond to the announced merger premium conditioned by the presence of a fairness opinion, we find that shareholders on either side of the deal perceive the average advisor-provided fairness opinion to be conflicted. Both target and acquirer shareholders react negatively to merger premiums ratified by advisor-provided fairness opinions relative to when they are not ratified by a fairness opinion. These findings suggest that

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<sup>2</sup> We test for this possibility with the small sample of fairness opinions provided by non-advisors available in our sample. While the evidence is suggestive that shareholders perceive advisor-provided fairness opinions are conflicted, it is not conclusive.

shareholders are aware of the conflicts of interest associated with advisors providing fairness opinions and rationally account for it.

Faced with always observing “fair” opinions provided for the most part by advisors, shareholders will have to rely on other “signals” to infer the dominant motive behind the fairness opinion in their assessment of the merger. In formulating fairness opinions, investment banks have substantial subjectivity and discretion through which to affect the outcome of the valuation exercise. Since there is no codified set of “best practices” to follow in issuing fairness opinions to ensure exacting valuations, the wide latitude available to investment banks in the valuation process subjects them to the risk of reputation loss over unreasonable opinions. Thus when negotiating premiums in their capacity as advisors that they can ratify with a fairness opinion, the risks to their reputation provide investment bankers the incentive to avoid “rubber stamping” deals. Consequently reputation of the advisor providing the fairness opinion can serve to condition shareholder assessments of the merger. We find that that target shareholders perceive fairness opinions provided by reputable advisors to be credible in that they do not react negatively to the merger premiums certified by such advisors. We are not able to empirically distinguish such an effect on the acquirer side. Our results thus provide some support that reputation helps advisors credibly commit against opportunistic behavior.

The compensation paid to advisors (for both the fairness opinion and the other services provided in connection with the transaction) is often tied to the successful consummation of the transaction – the so-called “success” fees. Investment banks argue that deal-contingent fees ensure that the fairness opinions they provide are in the best interest of shareholders, while critics single out these same contingent fees to buttress their claims of conflict of interest when advisors provide fairness opinions. Other critics contend that even non-contingent advisory fees would result in favorable opinions because providers risk the loss of future advisory fees if they opine unfavorably. Thus whether the nature of the compensation contract can serve to inform shareholders of the dominant motive behind the fairness opinion is theoretically unclear.

Whether it does or not is an empirical question. We do not find any evidence that advisory compensation contracts serve to condition shareholder responses -- shareholders perceive the average advisor-provided fairness opinions to be conflicted irrespective of whether the advisor has a deal-contingent advisory fee contract or not.

Management may enter into deals that assure them private benefits from the deal at the expense of their shareholders. In such situations captured boards may seek fairness opinions from their advisors to protect themselves against shareholder lawsuits. Shareholders, aware of such a possibility will rely on the characteristics of the boards and management to infer the motive behind the “fair” opinion. Thus managerial stock holdings (where small stakes would suggest that their private benefits could outweigh their losses as a shareholder) and board composition (whether insiders dominate the board) can condition how shareholders incorporate advisor provided fairness opinions in their assessments of mergers. We find that in deals where insiders own small stakes in the firm (and hence are more likely to pursue deals where they trade off lower merger premiums for higher private benefits) target shareholders react negatively (positively) when insider (outsider) dominated boards obtain fairness opinions to ratify the merger premium received. We are unable to find such evidence on the acquirer side. These findings lend some support to critics’ claims that although fairness opinions are sought for the ostensible purpose of certifying the deal value, boards often seek them for the legal cover they provide against disgruntled shareholders.

Three contemporaneous papers in the finance literature also study fairness opinions in M&A.<sup>3</sup> Cain (2007) examines the valuation analyses reported in the fairness opinions filed as

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<sup>3</sup> Fairness opinions have been the subject of several law articles. For instance, Bebchuk and Kahan (1998) examine the judicial reliance on fairness opinions and critically consider the extent to which courts should give weight to fairness opinions. Bowers (2002) assesses the extent to which the *Van Gorkom* ruling encouraged the use of fairness opinions and the influence it had on the revenues that investment banks derive from M&A advisory services. Bowers and Latham (2004) examine whether boards seek fairness opinions to resolve valuation uncertainty or to protect themselves against legal liability. Our study differs from those in the law literature in that it seeks to determine if shareholders perceive fairness opinions as valuable.

part of the merger proxy for friendly negotiated mergers. Based on a comparison of the average of the mid-points of the various valuations ranges reported in the opinion to the merger premiums offered, he concludes that acquirer advisors' valuations of target firms are optimistic while target advisors' valuations are realistic. While an examination of valuation analyses may reveal biases on *average* (although in the absence of a theoretical fair price, it is difficult to define a bias), our study emphasizes that while evaluating an *individual* merger, shareholders have no way of using the valuation analyses contained in the opinion in a discriminatory fashion and instead have to rely on the process that generated the opinion in their assessment of the merger. Kisgen et al. (2007) examine the effect fairness opinions have on the completion and performance of deals over the decade 1994 – 2003. They find that acquirer fairness opinions increase the likelihood of deal completion, result in lower merger premiums and engender insignificant or negative shareholder responses to the deal announcement, leading them to conclude that acquirer fairness opinions appear to provide value to shareholders. Finding no such effects associated with target fairness opinions, and based on the characteristics of the targets seeking such opinions, they further conclude that fairness opinions provide legal cover to targets. Chen and Sami (2006) examine deals in the time period, 1997 – 2003, and find that acquirers vulnerable to litigation seek fairness opinions. Furthermore they find that acquirer shareholders react negatively to merger announcement involving fairness opinions, leading them to conclude, in contrast to Kisgen et al., that fairness opinions provide legal cover to acquirers. In contrast to these studies, our approach to studying fairness opinions explicitly recognizes that the value of advisor-provided fairness opinions to shareholders cannot be ascertained without considering the endogenous nature of merger premiums and fairness opinions and the signals that shareholders can rely on given the limitations imposed by the “practice” of fairness opinions. Furthermore, our approach also emphasizes that it is difficult to reconcile the differences observed in the relationship between merger premiums and fairness opinions on both sides of a deal unless one uses the deal as a unit of analysis.

The rest of the paper proceeds as follows. In the next section, we provide a brief description of fairness opinions and the controversy they have generated. In section three, we provide sample related details. We present our empirical analyses in section four. We conclude in section five with a summary of our findings.

## **2. Fairness opinions**

A fairness opinion in a merger or acquisition is a third party assessment of the deal price in relation to company value. The fairness opinion is issued in the form of a letter addressed to the target or acquirer board and dated as of the date the board meets to vote and announce the proposed transaction. Unless the engagement letter executed at the time the banker is recruited specifies otherwise, there is no obligation on the part of the banker to update (or in industry parlance “bring down”) the opinion to a later date. This opinion letter is subsequently included as an exhibit to the relevant statements (merger proxy) filed with the SEC in conjunction with the proposed transaction.

The fairness opinion speaks only to the fairness of the transaction from a financial point of view in a restrictive way. The opinion does not address whether the price or consideration to be received or paid by the shareholders represents the best or highest price. Instead, all that it speaks to is that the price is in the range of fair values. The opinion does not address the merits of the transaction relative to alternative courses of action that the board may adopt, nor does it constitute a recommendation to shareholders about actions to be taken to consummate the proposed transaction. In providing a fairness opinion, the banker avows all responsibility for independent verification of the information publicly available or furnished by management and used in the valuation.

According to the trade paper “The Daily Deal”, the rule of thumb pricing for fairness opinions is 25% of the advisory fee. It is an additional charge paid regardless of whether the deal

closes or not. In most cases, the exact fees are not public knowledge as there is no regulatory filing requirement, but are thought to range from a few thousand to millions of dollars.

Fairness opinions were introduced into the M&A calculus through a Delaware Supreme Court (the Court) ruling in a case involving the sale of Trans-Union Corporation to the Pritzker family (*Smith v. Van Gorkom*, 488 A.2d 858, Del. 1985). Despite the offer involving a premium for Trans-Union shareholders, the Court found that the board of Trans-Union, while acting in good faith had nonetheless been grossly negligent in recommending the merger by not making an informed decision, and therefore in violation of its “duty of care” to its shareholders.<sup>4</sup> In its ruling, the Court stated that obtaining a fairness opinion would have helped the board fulfill its duty of care to shareholders. In doing so, the Court sought to ensure that when evaluating a merger or takeover proposal, corporate directors inform themselves of information that was reasonably available and relevant to the decision.<sup>5</sup> Although the Court did not specify any legal credentials for fairness opinion providers, nor mandate the use of fairness opinions in M & A’s, the Court did stress that the providers of fairness opinions be “qualified and independent”.

Critics contend that the intent behind the Court’s ruling – to ensure that the *process* by which boards evaluate M&A proposals is fair to shareholders, is rarely served by obtaining a fairness opinion. Fairness opinions, they contend, are ubiquitous, loaded with legal disclaimers, out of date by the time shareholders vote on the deal, and so narrowly focused on the specifics of the deal that they do not address the possibility of other potentially superior alternatives available

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<sup>4</sup> “Apart from the Company's historic stock market price, and Van Gorkom's long association with Trans Union, the record is devoid of any competent evidence that \$55 represented the per share intrinsic value of the company... Here, the judgment reached as to the adequacy of the premium was based on a comparison between the historically depressed Trans Union market price and the amount of the Pritzker offer. Using market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious, premise, as the defendants' own evidence demonstrates....a substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price” (*Smith v. Van Gorkom*, 875-876).

<sup>5</sup> “We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors maybe fully protected in relying in good faith upon the valuation reports of their management.” (*Smith v. Van Gorkom*, 876)

to shareholders. Furthermore, they claim that they are provided by advisors whose material relationships with firms seeking such opinions compromises their ability to render an objective fairness opinion. They argue that the “success fees” investment banks stand to collect if the deal goes through, leads them to “do what it takes” to opine favorably and effectively “rubber stamp” such deals.<sup>6</sup>

Concerns over the influence of deal-contingent fees on fairness opinions provided by advisors have led to extreme proposals calling for an outright ban on advisors providing fairness opinions.<sup>7</sup> As a less extreme step, several legal scholars have proposed mandating that boards obtain a second fairness opinion from an independent bank that does not have a stake in the transaction other than the fee for the fairness opinion as a way of dealing with the conflict of interest in advisor provided fairness opinions (Bebchuk and Kahan, 1989; Elson et al., 2003). The idea of organizations being set up to deliver unbiased fairness opinions has been applauded by prominent observers. For instance, Paul Volcker, the former chairman of the Federal Reserve has commented that “... if there was ever going to be a market for this kind of thing it will be now. It strikes me that it would be very valuable. A lot of mergers are promoted for the benefit of those involved”. Others have argued that such independent opinions would not ameliorate the problem as the independent banks rendering them are effectively dependent in practice. Davidoff (2006) and Sorkin (2005) point out that so-called independent banks would be more likely to rubber-stamp a fairness opinion than banks with a long-term relationship with the firm as they have more to lose by not accommodating the companies that hire them. To paraphrase Sorkin (2005), “If an “independent” firm was called in to issue a fairness opinion and refused to do so, who would hire it again?”

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<sup>6</sup> For instance, in response to the NASD notice requesting comment on whether the issue should be addressed from a regulatory perspective, the AFL-CIO raised doubts over “how any board of directors can rely on a fairness opinion provided by an investment bank when the lion’s share of that bank’s fee is contingent on the underlying transaction closing” (see NASD notice filed by AFL-CIO on January 10, 2005)

<sup>7</sup> See comment letters filed by CALPERS and AFL-CIO in response to the NASD notice on February 1, 2005 and January 10, 2005, respectively

Wall Street firms defend the practice of providing fairness opinions, arguing that it is important for a company to receive a fairness opinion from its advisor on the transaction because the advisor, having helped negotiate the transaction or brought it to the firm's attention in the first place, is most familiar with the company and the terms of the deal. They claim to manage any conflicts that arise by having special committees of senior management review such opinions. They further argue that the risk to their reputations and the contingent nature of their advisory fees aligns their incentives with those of the shareholders (see Davis and Langley, 2004). The industry's main lobbying group, the Securities Industry Association (SIA) and the M&A attorneys' lobbying group, the M&A committee of the Association of the Bar of the City of New York, have declared the status quo as adequate and intensified their efforts to preempt any potentially far-reaching regulatory changes.

### **3. Sample**

#### *3.1 Sample details*

To construct the sample for empirical analysis, we start with all mergers and tender offers available in the Securities Corporation Database (SDC) Merger and Acquisition File for the years 1980 to 2004. From this set of 6,488 deals, we eliminate deals where SDC does not identify the advisors on either the target or acquirer side (3,191 deals), deals which are pending, incomplete, or withdrawn (38 deals), minority acquisitions -- deals where the acquirer does not obtain a majority stake in the target subsequent to the acquisition (378 deals), cleanup offers -- where the acquirer holds more than 50% of the target shares prior to the acquisition, and private acquisitions -- deals where we cannot obtain the requisite target or acquirer data from CRSP and COMPUSTAT data (952 deals). This process yields a sample of 1927 deals.

We use the institutional assignments reported on SDC to identify deals with and without fairness opinions. For every institution associated with the deal, SDC reports whether it was an advisor and whether it was additionally involved in the following capacities: initiating the deal,

representing shareholders, board of directors, seller, major holder or other claimants, as a dealer manager, lead or other underwriter, and as a fairness opinion provider. If an institution was involved as an equity participant and/or arranged financing, it is not reported unless it performs any of the above mentioned roles.

Our ability to identify deals with fairness opinions is affected by two issues. First, the SEC requires firms to disclose material information to shareholders when seeking their vote on a proposed transaction and trading exchange rules require listed firms to seek shareholder approval when issuing shares that are in excess of 20% of the outstanding shares.<sup>8</sup> Thus, fairness opinions, which are considered material information, may be obtained, but are less likely to be observed in hostile tender offers or in cash-financed mergers where acquirer shareholder approval is not required. They are more likely to be observed in stock-financed, friendly mergers which always require a vote from target shareholders. The SEC disclosure requirements imply that we potentially classify deals as not having a fairness opinion when they indeed have one. However, this “censorship” imparts a conservative bias to our study in that it biases us against finding results associated with fairness opinions. At the limit, it restricts our findings to negotiated cash deals. Second, even if a fairness opinion is associated with the deal, there is the possibility that SDC fails to record it. Kisgen et al. (2007) express concern over SDC’s coverage of fairness opinions. Thus, we may be classifying deals where a fairness opinion is present as not having one. However, this should also impart a conservative bias to our study in that it biases us against finding any results associated with fairness opinions. To ensure that we have enough observations with a reported fairness opinion on SDC, we sample over a 25-year period.

Approximately 59% of all deals in the sample have a fairness opinion on either side of the deal. About half of all the deals in the sample have a fairness opinion on the target side (53.14%), a third a fairness opinion on the acquirer side (30.88%), and a quarter have fairness

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<sup>8</sup> See SEC Schedule 14A, item 14(7)(b)(6), NYSE Listed Company Manual Section 312.03 (c), AMEX Company Guide Section 712 (b), and NASDAQ Marketplace Rule 4350(i)(1)(C).

opinions on both sides (24.75%). There are multiple fairness opinions on the target side in 124 deals, and on the acquirer side in 39 deals. A majority of the fairness opinions on either side the deal are provided by investment banks advising on the deal (87% on the target side and 86% on the acquirer side).

Table 1 presents the yearly distribution of sample deals with a fairness opinion on either side and on the target and acquirer sides. A disproportionate number of the deals with fairness opinions on either the target or acquirer side appear in the latter half of the 1990s, paralleling the increased merger activity during that time period.

Table 2 presents the distribution of target (acquirer) fairness opinions in the sample by target (acquirer) industry. Excluding the one deal in the public administration industry, there is no remarkable pattern in the distribution of fairness opinions across industries.

Table 3 presents the descriptive statistics on target, acquirer and deal characteristics for deals with and without fairness opinions. As expected by the disclosure requirements, the data in the table indicate that targets are observed to obtain fairness opinions less often when the offer is hostile, the acquirer makes a tender offer for the target's shares, the method of payment is cash, the acquirer is small or when they have few growth options. Similarly, acquirers seek fairness opinions less often in hostile, cash tender offers where there is competition to acquire the target. They, however, obtain a fairness opinion more often if they are acquiring a target of similar size in the same industry. Both targets and acquirers seek fairness opinions more often when they commit to termination fee agreements.

Table 4 identifies the major fairness opinion providers in our sample. The top five and eight out of the top ten providers of fairness opinions are identical for both targets and acquirers. To better understand the provision of fairness opinions, we classify the providers based on their reputation in the mergers and acquisition (M & A) market. Rau (2000) classifies M&A advisors into bulge bracket (top five) or into major bracket (ranks six to twenty) investment banks based on the value of deals over the period, 1980 – 1994. Based on Rau's observation that the rankings

are relatively stable over the years, we classify the advisors in our sample as bulge or major bracket banks if they happen to be any of his original set of banks or their subsequent incarnations. Thus, First Boston is a bulge bracket bank till 1998 and Credit Suisse – First Boston the bulge bracket bank thereafter. Of the top five fairness opinion providers, two are bulge-bracket advisors in the M&A market. Grouping First Boston and Credit Suisse-First Boston together, four of the top ten fairness opinion providers are bulge-bracket advisors and seven of the top ten are bulge and major-bracket advisors.

## **4. Empirical Results**

### *4.1. Fairness opinions and merger premiums*

We first examine the association between merger premiums and fairness opinions. To do so, we compute three measures of premium offered to targets using both the “component” and “price” data provided by SDC, and express it as a percentage of the target’s share price four weeks prior to the announcement of the offer. The first measure is computed by aggregating the amount of each form of payment to the target (equity, debt, cash, etc.). The second and third measures use the final and initial price per share of target stock offered by the acquirer with no consideration given to the method of payment. Table 5 presents descriptive statistics on these measures of deal premiums broken down by the presence or absence of a fairness opinion in the deal and on the target and acquirer sides. Although one would expect the three measures of premium to be consistent, the premium computed using component data is systematically higher than the premiums computed using price data. This seems to be particularly the case in the extremes of the distribution as reflected in the means across the various measures. Moreover, these measures produce extreme values, some of which are economically meaningless (below zero).

Hence, as in Officer (2003), we compute a fourth “combined” measure (MP) that integrates both the component and price measures but eliminates outliers in both distributions.

This combined measure is the premium computed using component data if it falls between 0% and 200% (the upper bound of 2 is arbitrary). If it does not, the combined measure is the recomputed using initial price data (or final price data if the initial price data is missing) provided it produces a premium between 0% and 200%. If both these conditions are not met, the combined premium is recorded as a missing observation. It is this measure of merger premium that is used in all our analysis.

Table 6 presents descriptive statistics on MP. Panel A of the Table indicates that the average premium for all deals in the sample is 50.85% while the median premium is 40.67%. The Panel reveals no difference in the merger premiums between deals with and without a fairness opinion. Similarly, Panel B of the Table reveals no difference in the merger premiums between deals that have a target fairness opinion and deals that do not. Panel C of the Table however indicates that both the mean and median merger premium in deals with an acquirer fairness opinion (48.26% and 38.23%, respectively) are statistically lower than their counterpart premiums in deals without an acquirer fairness opinion (52% and 42/07%, respectively).

To further examine the association between merger premiums and fairness opinions, we deconstruct the deals with a fairness opinion into deals (a) where the advisor provides the fairness opinion (conflicted fairness opinion) (b) where the advisor does not provide the fairness opinion (independent fairness opinion), and (c) where there is both a conflicted and an independent fairness opinion.<sup>9</sup> Panels B and C also provide premium values for these deal sub-samples. Panel B reveals that the average merger premium in the 695 deals that have a target conflicted fairness opinion (48.35%) is statistically lower than the average premium observed in the 691 deals without a target fairness opinion (52.42%), although the median premiums are not statistically different. Similarly, Panel C shows that the mean and median merger premiums in deals with an acquirer conflicted fairness opinion (46.32% and 35.83%, respectively) are

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<sup>9</sup> If the institution represented other stakeholders (minority shareholders, bondholders, etc.) besides management and the board of directors, it is classified as providing an independent fairness opinion. Our results are not sensitive to this classification.

statistically lower than their corresponding values in deals without an acquirer fairness opinion. In contrast, both Panels B and C also show that the merger premiums in deals with a target (acquirer) independent opinion are no different from those deals without a target (acquirer) fairness opinion. The sub-sample of deals where there is both a conflicted and an independent fairness opinion is small (33 on the target side and 6 on the acquirer side), precluding any meaningful comparisons. Thus, at the Univariate level, it appears that deals with lower premiums are associated with a fairness opinion provided by advisors.

To further assess whether fairness opinions are sought from advisors when merger premiums are low, we model the likelihood of a fairness opinion as a logit function of merger premiums and other control variables. Table 7 presents the results from the logit estimation. Models 1 and 2 relate to target fairness opinions while Models 3 and 4 to acquirer fairness opinions. All coefficients presented are maximum-likelihood estimates. Coefficient standard errors are adjusted for heteroskedasticity and cross-sectional correlation across observations involving the same acquirer. Models 1 and 2 indicate that target fairness opinions are less likely when the target is large and the acquirer makes a tender offer. The models also indicate that target fairness opinions are more likely when there is a poison pill present and when the acquirer also seeks a fairness opinion. Model 1 indicates that there is no relationship between the merger premiums offered (MP) and the choice of the target to seek a fairness opinion. In Model 2, which restricts the choice to advisor-provided fairness opinions, the coefficient on MP is -0.30 and statistically significant at conventional levels, indicating that lower merger premiums are associated with targets seeking fairness opinions from their advisors. Models 3 and 4 indicate that acquirer fairness opinions are more likely when the target is large and seeks a fairness opinion, and less likely in cash tender offers made by large acquirers. In contrast to what was observed in Univariate tests on the acquirer side, there is no association between merger premiums and acquirer fairness opinions even when they are sought from advisors. In sum, it appears that targets seek fairness opinions from their advisors when merger premiums are low.

#### *4.2 Fairness opinions, merger premiums and abnormal returns*

To examine how shareholders view fairness opinions in their assessment of mergers, we analyze how shareholders respond to the announced merger premiums conditioned by the presence of a fairness opinion. Table 8 provides descriptive statistics for both target and acquirer cumulative abnormal returns (CAR) over the window (-1, 0) where event day 0 is the merger announcement day. Abnormal returns are computed using a market model with an estimation period of 255 trading days ending 46 trading days before the merger announcement day. Panel A of the Table provides values for both the target and acquirer CAR for all the deals and by deals with and without fairness opinions while Panels B and C provide target and acquirer CAR values for deals with and without target and acquirer fairness opinions, respectively.

Panel A shows that for the sample of 1488 deals, the mean (median) target CAR is 16.25% (11.34%) and the mean (median) acquirer CAR is -1.92% (-1.28%). In the 886 deals with a fairness opinion, the mean (median) target CAR (14.61% (10.38%)) is lower than the corresponding mean (median) target CAR in the 602 deals without a fairness opinion (18.66% (12.22%)). Both the mean and median are statistically different across the two sub-samples. Panel A however shows no difference in the acquirer CARs across deals with and without fairness opinions.

Panel B of the Table shows that in the 797 deals where there is a target fairness opinion, both the mean and median target CARs (14.78% and 10.37%, respectively) are statistically lower than the mean and median target CARs (17.94% and 11.99%, respectively) in the 691 deals without a target fairness opinion. The Panel further reveals that the lower target CARs observed in deals with a target fairness opinion arise from the 695 deals where the fairness opinion is provided by the target advisor. Panel B also shows that there is no difference in the acquirer CARs across deals with and without target fairness opinions.

Panel C of the Table shows a similar pattern for acquirer CARs. The mean (median) acquirer CAR (-2.30% (-1.75%)) in the 455 deals with an acquirer fairness opinion is statistically

lower than its corresponding value (-1.76% (-1.17%)) in the 1033 deals without an acquirer fairness opinion. Again the lower acquirer CARs observed in deals with an acquirer fairness opinion can be traced to the 387 deals where the acquirer advisor provides the fairness opinion. Interestingly, Panel C also shows that target CARs are lower in deals with an acquirer fairness opinion when compared with deals without an acquirer fairness opinion.

We next examine the CARs in a multivariate context using a regression model. The dependent variable in all our models is the target (acquirer) CAR. All models include MP and MP conditioned by the presence and absence of a fairness opinion as an independent variable in addition to other independent variables. These other independent variables are identified from a vast literature aimed at explaining merger premiums. This literature includes but is not limited to Huang and Walkling (1987), Bradley et al. (1988), Comment and Schwert (1995), Betton and Eckbo (2000), Officer (2003) and Bates and Lemmon (2003). Specifically, this literature finds that merger premiums are higher when the attitude of target management towards the bid is hostile, the mode of acquisition is a tender offer, the method of payment is cash, the target has a poison pill, both sides of the deal have termination clauses, and when multiple bidders compete for the target. Consequently, in our specifications we include dummy variables that indicate whether the bid is hostile (HOSTILE), the mode of acquisition is a tender offer (TENDER), the payment for the target is in cash (CASH), the target has a poison pill (POISON), the acquirer and target have termination fee agreements (ATERMF and TTERMF), and if there are multiple bidders for the target (COMPETITION). Merger premiums have also been observed to be lower when the acquirer obtains a toehold in the target firm or seeks to acquire a target with high market capitalization or high market to book ratio. Hence, we also include a dummy variable TOEHOLD, which takes the value of 1 if the fraction of the target stock held by the acquirer on the bid announcement day is greater than 5% and 0 otherwise, the target's market capitalization (TarMVE), and market to book ratio (TarM2B). Finally, we also control for the acquirer's market capitalization (AcqMVE), market to book ratio (AcqM2B), and whether both the acquirer

and target are in the same industry (SIND) or are financial firms (FINSERV).<sup>10</sup> The regressions are estimated using Ordinary Least Squares and coefficient standard errors are corrected for heteroskedasticity and cross-sectional clustering across observations involving the same acquirer.

Table 9 presents the results of our regression estimation. The dependent variable in Model 1 is the target CAR and in Model 2 it is the acquirer CAR. In Model 1, the coefficient on the MP variable is 0.20 and is statistically significant indicating that the merger premium offered positively influences the target shareholder's announcement reaction. The coefficient on the variable MP X TarFO is -0.07 and is statistically significant, implying that target shareholders react less positively (by 7% less) if the merger premium is ratified by a target fairness opinion relative to when it not ratified by a fairness opinion. Additionally, the statistically insignificant coefficient on the variable MP X TarConfFO implies that the negative effect associated with target fairness opinions is no different whether the fairness opinion is provided by the target advisor or not. The presence of an acquirer fairness opinion does not materially impact the reaction of the target shareholders to the merger announcement.

In Model 2, the coefficient on MP is -0.02 and is statistically significant, indicating that the premium offered negatively influences acquirer shareholder reactions to the merger announcement. The coefficient on the MP X AcqFO variable is insignificant, but the coefficient on the MP X AcqConfFO variable is -0.07 and is statistically significant, implying that when the premium offered to targets is certified by a fairness opinion provided by the deal advisor, acquirer shareholders react even more negatively to the merger announcement relative to when the merger premium is not certified by a fairness opinion. This negative effect due to a conflicted fairness opinion on the acquirer side remains despite the presence of a conflicted fairness opinion on the target side of the deal (MP X AcqConfFO + MP X TarConfFO X AcqConfFO).

These regression results provide evidence that both target and acquirer shareholders perceive the average advisor-provided fairness opinion to be conflicted. The negative

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<sup>10</sup> All the variables are described in a reproducible way in the appendix.

shareholder response also implies that shareholders, aware of the conflicts, rationally discount the certification of the deal that advisors provide through fairness opinions.

#### *4.3 Advisor Reputation*

Investment banks allude to their reputation to rebut claims of conflicts in the provision of fairness opinions by pointing to the scrutiny they face from sophisticated institutional investors every time they write fairness opinions, and claim to manage any conflicts that arise by having special committees of senior management review such opinions. If investment bank advisors stand to suffer losses to their reputation capital when they provide fairness opinions opportunistically, as they claim, then high-reputation advisors would be more apt to provide fairness opinions that are in the shareholders' best interests.

To test whether target shareholders perceive fairness opinions provided by reputable advisors as credible, we run Model 1 in Table 10. The dependent variable in Model 3 is the target CAR. In addition to control variables used previously in the CAR models in Table 9, we include MP and two interaction variables, MP X TarFO and MP X TarFO X TarHirep as independent variables. The negative and significant coefficient on MP X TarFO (-0.06) confirms that target shareholders discount deals certified by a fairness opinion. However, the positive and significant coefficient on MP X TarFO X TarHirep (0.06) reveals that target shareholders perceive deals certified by a fairness opinion from a reputable advisor to be credible. A similar exercise with acquirer CARs (not reported in the Table) does not suggest any role for advisor reputation on the acquirer side.<sup>11</sup>

#### *4.4 Contingent advisory fees*

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<sup>11</sup> These results are qualitatively similar if we use a more restrictive categorization of advisor reputation based on membership in the set of top 5 M&A advisors.

Critics contend that the undesirable incentives facing advisors to complete otherwise financially inadequate deals due to the contingent nature of their advisory fees compromises their ability to provide unbiased fairness opinions. Investment banks counter such claims by arguing that it is the contingent nature of their fee contract that aligns their incentives with those of the shareholders. Whether contingent fee contracts serve to align the incentives of fairness opinion providers any more than flat fee contracts is thus an empirical issue.<sup>12</sup>

We examine if target shareholders perceive fairness opinions to be credible if they are provided by advisors with contingent fee contracts in Model 2 in Table 10. Model 2 is identical to Model 1 except that it includes two variables,  $MP \times TarConfFO$  and  $MP \times TarConfFO \times TarContingent$ , and replaces the variable  $MP \times TarFO \times TarHirep$ . The coefficient on the  $MP \times TarFO$  variable is -0.05 but loses its statistical significance relative to Model 2 in Table 9 due to the loss of 370 observations for which we do not have data on the nature of the advisors contract. The coefficients on both the  $MP \times TarConfFO$  and  $MP \times TarConfFO \times TarContingent$  variables are insignificant indicating that target shareholders do not factor the contingent nature of the advisor's contract in their assessment of the credibility of the fairness opinion.

#### *4.5. Legal cover*

Thus far, we have focused on the “supply side effects” relating to the conflicts facing the advisors providing fairness opinions. We now examine “demand side effects” that arise from the conflicts of interest between managers and shareholders in seeking a fairness opinion.

A consequence of the hostile takeover wave of the 1980s was that firms adopted a number of effective takeover defenses which decreased the probability of a successful hostile

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<sup>12</sup> Contingent fee contracts can be either a constant percentage of deal value, where the advisor is paid a fixed percentage of the deal value (typical for a target advisor), or a constant dollar form where the advisor is paid a fixed dollar value irrespective of deal value (typical for an acquirer advisor). While both types of contingent contract provide the incentive to complete the transaction, the constant percentage type provides target advisors an incentive to increase the deal value. Acquirer advisors, however, do not face any explicit contractual incentives to lower deal value given the difficulty in writing such a contract. McLaughlin (1990, 1992) provides a detailed study of the fee contract structures and their incentive properties.

takeover and resulted in the 1990s largely being an era of friendly mergers. With takeover defenses having shifted the balance of power in target firms away from shareholders and towards management, bidders in the 1990s had to focus their efforts on convincing target management to agree to the merger as opposed to enticing shareholders with large premiums and bypassing management as they had done in the 1980s. A way to successfully consummate a merger at a low price (premium) was to offer target management private benefits from the deal in the form of attractive positions and remuneration packages in the combined firm, to induce them to approve the merger (Hartzell et al., 2004). Arguing that the cost to shareholders of blocking such transactions rises with management control, Moeller (2005) finds support for this argument in the form of a positive association between merger premiums in the 1990s and target shareholder control. Acquirer management may be similarly motivated to seek private benefits from the deal at the expense of acquirer shareholders. Grinstein and Hribar (2004) find that managerial power results in mergers that result in private benefits to acquirer management in the form of merger bonuses but are not necessarily in the best interests of the acquirer shareholders.

In such an environment, fairness opinions could play a critical part. Independent boards, concerned about the possibility of management seeking to enter into deals to realize private benefits would want to monitor against such a possibility and may use a fairness opinion as a certification instrument to assure themselves that the deal is in the interests of shareholders. Alternatively, as critics argue, captured boards seeking to protect management and themselves may seek a fairness opinion for the legal cover it provides against shareholders unhappy with the deal's terms. Several characteristics associated with fairness opinion use suggest this latter possibility. First, as Tables 1 and 3 indicate, despite the *Van-Gorkom* ruling being in 1985, a majority of the fairness opinions appear in friendly mergers in the 1990s. Second, although management controlled firms could seek to reassure shareholders that the deal does not enrich management at the expense of shareholders by obtaining a fairness opinion from a non-advisor,

such instances are few. Third, “unfair” opinions are never observed. Investment bankers claim to negotiate the terms of the deal to arrive at a price at which a fairness opinion can be delivered.

If the private benefits drive managements to enter into deals and captured boards seek fairness opinions for legal cover reasons from advisors who in turn are happy to accommodate in order to realize deal related fees, then advisor provided fairness opinions in such deals should be detrimental to their shareholders. To test this argument, we run Model 3 which is similar to Model 1 in Table 10. We construct a dummy variable, *TarInsider*, which takes on the value of 1 if the percentage of shares owned by insiders is less than the median ownership of 5.79% for the sample, and 0 otherwise to proxy for the potential for management to trade off lower merger premiums for higher private benefits from the deal. We also construct a dummy variable, *TarInsideBoard*, which takes on the value of 1 if more than half the board members are insiders and 0 otherwise, to represent captured boards. We obtain the data on insider ownership and board composition from the Disclosure database. The three variables of interest in this regression are  $MP \times TarFO$ ,  $MP \times TarFO \times TarInsider$  and  $MP \times TarFO \times TarInsider \times TarInsideBoard$ . The coefficients on the first two variables are insignificant while it is -0.10 and is statistically significant on the third, indicating that shareholders value fairness opinions sought by independent boards when the potential for management to trade off lower merger premiums for higher private benefits exists, but discount them when captured boards seek fairness opinions in similar situations. A similar exercise on the acquirer side does not yield any significant results. We interpret our findings as providing support to critics’ claims that while boards seek fairness opinions for the purpose of certifying deal value they often obtain them for the legal cover they provide against shareholders unhappy with the deal.

## **5. Conclusion**

It is common for boards to seek fairness opinions in M&A transactions with the ostensible purpose to vet the transaction. It is routine for investment banks to provide such

fairness opinions while advising on the same transaction. Critics contend that this practice is fraught with conflict of interest. They contend that boards seek fairness opinions for the legal cover they provide against disgruntled shareholders, and investment banks, motivated to earn advisory fees that are payable only upon the successful consummation of the deal, are only too happy to acquiesce. The investment banking industry has countered in defense of current practice. They claim that their intimate knowledge of the terms of the deal as advisors allows for a better appraisal of the proposed transaction. Further, they point out that for reputation reasons, and because of the contingent nature of their advisory fees, their interests are aligned with those of shareholders.

Our examination of 1927 M & A deals over the period, 1980 to 2004, yields results that provide support to the critics' claims that fairness opinions do not credibly certify deals. We find that shareholders on both sides of the deal rationally discount deals certified by advisor fairness opinions, implying that shareholders view the certification provided by such fairness opinions to be conflicted. Supporting bankers' claims, we find that, when fairness opinions are provided by reputable advisors, they are associated with relatively higher merger premiums and are perceived to be valuable by target shareholders. However, we find no evidence that shareholders perceive fairness opinions to be unbiased when the providing banker's compensation is linked to deal completion, contrary to the contention that such compensation schemes align advisors' incentives with those of shareholders. We also find evidence that supports critics' claims that boards seek fairness opinions for the legal cover they provide against shareholders unhappy with the deal's terms.

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**Table 1**  
**Distribution of fairness opinions across years**

The sample consists of 1927 mergers and tender offers from 1980 to 2004 identified from the Securities Data Corporation's (SDC) Mergers and Acquisitions Database. The sample consists of deals where the target (acquirer) is present on both the CRSP and COMPUSTAT databases and has advisor data available on SDC. The sample only includes deals where the acquirer holds less than 50% of the target's shares prior to the acquisition, and upon completion of the acquisition, owns a majority of the target's shares (greater than 50%).

<i>Deals With</i>							
<i>Year</i>	<i>Number of deals</i>	<b>Fairness Opinions</b>		<b>Target Fairness Opinion</b>		<b>Acquirer Fairness Opinion</b>	
		<b>Number (%)</b>	<b>Total %</b>	<b>Number (%)</b>	<b>Total %</b>	<b>Number (%)</b>	<b>Total %</b>
1980	4	3 (75%)	0.16%	3 (75%)	0.16%	1 (25%)	0.05%
1981	10	7 (70%)	0.36%	7 (70%)	0.36%	2 (20%)	0.10%
1982	6	5 (83%)	0.26%	5 (83%)	0.26%	3 (50%)	0.16%
1983	20	15 (75%)	0.78%	12 (60%)	0.62%	7 (35%)	0.36%
1984	24	12 (50%)	0.62%	12 (50%)	0.62%	8 (33%)	0.42%
1985	56	16 (29%)	0.83%	15 (27%)	0.78%	3 (5%)	0.16%
1986	48	28 (58%)	1.45%	27 (56%)	1.40%	11 (23%)	0.57%
1987	49	40(82%)	2.08%	37 (76%)	1.92%	15 (31%)	0.78%
1988	33	21 (64%)	1.09%	19 (58%)	0.99%	7 (21%)	0.36%
1989	36	24 (67%)	1.25%	23 (64%)	1.19%	12 (33%)	0.62%
1990	23	20(87%)	1.04%	18 (78%)	0.93%	13 (57%)	0.67%
1991	28	24 (86%)	1.25%	24 (86%)	1.25%	17 (61%)	0.88%
1992	27	26 (96%)	1.35%	25 (93%)	1.30%	15 (56%)	0.78%
1993	67	61 (91%)	3.17%	60 (90%)	3.11%	32 (48%)	1.66%
1994	93	65 (70%)	3.37%	58 (62%)	3.01%	37 (40%)	1.92%
1995	113	64 (57%)	3.32%	50 (44%)	2.59%	37 (33%)	1.92%
1996	133	90 (68%)	4.67%	85 (64%)	4.41%	61 (46%)	3.17%
1997	182	139(76%)	7.21%	126 (69%)	6.54%	76 (42%)	3.94%
1998	190	97 (51%)	5.03%	83 (44%)	4.31%	47 (25%)	2.44%
1999	215	149 (69%)	7.73%	139 (65%)	7.21%	78 (36%)	4.05%
2000	168	31 (18%)	1.61%	23 (14%)	1.19%	12 (7%)	0.62%
2001	140	48 (34%)	2.49%	29 (21%)	1.50%	29 (21%)	1.50%
2002	69	19 (28%)	0.99%	16 (23%)	0.83%	4 (6%)	0.21%
2003	95	63 (66%)	3.27%	57 (60%)	2.96%	31 (33%)	1.61%
2004	98	75 (77%)	3.89%	71 (72%)	3.68%	37 (38%)	1.92%
<b>Total</b>	<b>1927</b>	<b>1142</b>	<b>59.26%</b>	<b>1024</b>	<b>53.14%</b>	<b>595</b>	<b>30.88%</b>

**Table 2**  
**Distribution of fairness opinions across industries**

The sample consists of 1927 mergers and tender offers from 1980 to 2004 identified from the Securities Data Corporation's (SDC) Mergers and Acquisitions Database. The sample consists of deals where the target (acquirer) is present on both the CRSP and COMPUSTAT databases and has advisor data available on SDC. The sample only includes deals where the acquirer holds less than 50% of the target's shares prior to the acquisition, and upon completion of the acquisition, owns a majority of the target's shares (greater than 50%). Target and Acquirer industry classifications are based on the 2-digit SIC code from CRSP.

Industry	<i>Targets</i>			<i>Acquirers</i>		
	# of Mergers	# with Fairness Opinions	% with Fairness Opinion	# of Mergers	# with Fairness Opinions	% with Fairness Opinion
Mining and Oil Extraction	72	32	44.44%	64	25	39.06%
Construction and Basic Materials	14	7	50.00%	14	5	35.71%
Food and Tobacco	29	14	48.28%	32	6	18.75%
Textiles, Clothing and Consumer Products	12	7	58.33%	16	5	31.25%
Logging, Paper, Printing and Publishing	47	25	53.19%	48	8	16.67%
Chemicals and Allied Products	98	50	51.02%	132	29	21.97%
Petroleum Refining and Related Industries	22	8	36.36%	22	3	13.64%
Metal, Machinery, and Equipment Supply	381	201	52.46%	365	95	26.03%
Transportation	34	17	50.00%	29	6	20.69%
Communication	92	52	56.52%	107	38	35.51%
Utilities	81	49	60.49%	93	33	35.48%
Wholesale and Retail Trade	118	72	61.02%	119	37	31.09%
Financial Services	533	284	53.28%	550	187	34.00%
Recreation, Entertainment and Services	394	206	52.28%	335	117	34.93%
Public Administration	0	0	0.00%	1	1	100.00%
<b>Total</b>	<b>1927</b>	<b>1024</b>	<b>53.14%</b>	<b>1927</b>	<b>595</b>	<b>30.88%</b>

**Table 3****Descriptive statistics for target, acquirer and deal Characteristics**

The table contains means and associated test statistics for target, acquirer and deal characteristics for the sample of 1927 mergers and tender offers over the time period 1980 to 2004 identified from Securities Data Corporation's (SDC) Mergers and Acquisitions Database. The sample consists of deals where the target (acquirer) is present on both the CRSP and COMPUSTAT databases and has advisor data available on SDC. The sample only includes deals where the acquirer holds less than 50% of the target's shares prior to the acquisition, and upon completion of the acquisition, owns a majority of the target's shares (greater than 50%). Target and Acquirer industry classifications are based on the 2-digit SIC code from CRSP.

HOSTILE is a dummy variable equal to one if SDC records the bid as "hostile" or "unsolicited" and zero otherwise. TENDER and CASH are dummy variables equal to one if the bid involved a tender offer or a payment of cash (even if there were other associated methods of payment) and zero otherwise. SIND is a dummy variable equal to one if both the target and the acquirer are from the same two-digit SIC industry. POISON is a dummy variable equal to one if that target has a poison pill in place at the time of the merger or tender offer and zero otherwise. PHELD is the percentage of the target's stock held by the acquirer on the bid announcement date. TOEHOLD is a dummy variable equal to one if PHELD is greater than 5% and zero otherwise. COMPETITION is a dummy variable equal to one if another bid is recorded by SDC and zero otherwise. TTDEAL and EQUAL are dummy variables equal if the deal was two-tiered or was classified as a "merger of equals" by SDC respectively and zero otherwise. TarTF and AcqTF are dummy variables equal to one if the target or the acquirer had a termination fee contract respectively and zero otherwise. TarMVE and AcqMVE are the market values of the target and acquirer (in \$ millions) on the day prior to the merger announcement. TarM2B and AcqM2B are market to book ratios for the target and acquirer respectively computed using COMPUSTAT data from the year of the bid. \*\*\* and \*\* indicate that the mean values are different between the fairness opinion and no fairness opinion sub-samples at the 1% and 5% level respectively.

Variable	<i>Target</i>		<i>Acquirer</i>	
	Fairness Opinion	No Fairness Opinion	Fairness Opinion	No Fairness Opinion
HOSTILE	0.02	0.04**	0.01	0.04***
TENDER	0.13	0.21***	0.05	0.22***
CASH	0.37	0.44***	0.23	0.49***
SIND	0.68	0.68	0.73	0.66***
POISON	0.01	0.01	0.00	0.02**
TOEHOLD	0.02	0.03	0.02	0.03**
PHELD	0.76	0.66	0.59	0.76
COMPETITION	0.06	0.05	0.04	0.06*
TTDEAL	0.02	0.02	0.02	0.03
EQUAL	0.03	0.03	0.06	0.02***
TarTF	0.61	0.59	0.61	0.60
AcqTF	0.23	0.20**	0.31	0.17***
TarMVE	1208.4	1483.1	1548.6	1243.17
AcqMVE	6601.0	11170.0***	3693.7	10997.0***
TarM2B	2.40	3.86**	2.43	3.39
AcqM2B	7.85	5.14	10.59	4.83

**Table 4****Institutions providing fairness opinions**

The table provides the distribution of institutions providing fairness opinions to targets in 1024 deals and acquirers in 595 deals. The sample consists of 1927 mergers and tender offers from 1980 to 2004 identified from the Securities Data Corporation's (SDC) Mergers and Acquisitions Database. The sample consists of deals where the target (acquirer) is present on both the CRSP and COMPUSTAT databases and has advisor data available on SDC. The sample only includes deals where the acquirer holds less than 50% of the target's shares prior to the acquisition, and upon completion of the acquisition, owns a majority of the target's shares (greater than 50%). Highlighted institutions are among the top 5 advisors in mergers and acquisitions over our sample period.

**Panel A: Top 20 providers of fairness opinions**

<i>Target</i>		<i>Acquirer</i>	
Institution	Number of Fairness Opinions	Institution	Number of Fairness Opinions
<b>Goldman Sachs &amp; Co</b>	91	<b>Morgan Stanley</b>	51
<b>Morgan Stanley</b>	86	<b>Goldman Sachs &amp; Co</b>	42
Merrill Lynch	72	Merrill Lynch	40
Donaldson Lufkin & Jenrette	44	Donaldson Lufkin & Jenrette	37
Bear Stearns & Co Inc	43	Bear Stearns	24
Lehman Brothers	40	Lehman Brothers	24
<b>Salomon Brothers</b>	34	<b>Salomon Brothers</b>	22
<b>First Boston Corp</b>	30	Smith Barney	18
Keefe Bruyette & Woods Inc	29	JP Morgan	17
Sandler O'Neill Partners	29	<b>First Boston Corp</b>	16
<b>Credit Suisse First Boston</b>	27	<b>Credit Suisse First Boston</b>	16
JP Morgan	26	Keefe Bruyette & Woods Inc	12
Alex Brown & Sons Inc	20	<b>Lazard Freres</b>	11
<b>Lazard Freres</b>	20	Houlihan Lokey Howard & Zukin	11
Smith Barney	19	Montgomery Securities	11
Dillon, Read & Co Inc	19	<b>Salomon Smith Barney</b>	10
<b>Salomon Smith Barney</b>	17	PaineWebber	9
Paine Webber	15	Piper Jaffray Inc	9
Shearson Lehman	14	Stephens Inc	8
Kidder Peabody & Co Inc	13	Robert W Baird & Co Inc	8
Total number of fairness opinions	1148	Total number of fairness opinions	634

**Table 5**  
**Descriptive statistics for merger premiums**

The table contains means and medians for various measures of the premium offered to target shareholders for the sample of 1927 mergers and tender offers from 1980 to 2004 identified from the Securities Data Corporation's (SDC) Mergers and Acquisitions Database. The sample consists of deals where the target (acquirer) is present on both the CRSP and COMPUSTAT databases and has advisor data available on SDC. The sample only includes deals where the acquirer holds less than 50% of the target's shares prior to the acquisition, and upon completion of the acquisition, owns a majority of the target's shares (greater than 50%). The different premium measures are computed using SDC data. The premium offered to target shareholders is computed as the percentage the acquirer's offer is above the market value of the target's shares four weeks prior to the announcement of the offer. The first measure uses the aggregate value of all the component elements (cash, stock and other securities) as the acquirer's offer. The second and third measures use the "final" and "initial" price offered by the acquirer. \*\*\*, \*\*, and \* indicate that the mean (median) merger premium is different across the fairness opinion sub-samples at the 1%, 5% and 10% level respectively.

Premium Definition	Full Sample	<i>All Deals</i>		<i>Target</i>		<i>Acquirer</i>	
		Fairness Opinion	No Fairness Opinion	Fairness Opinion	No Fairness Opinion	Fairness Opinion	No Fairness Opinion
Premium based on component data	52.00% (41.58%) N = 1398	51.18% (41.74%) N = 831	53.21% (41.07%) N = 567	50.61% (42.07%) N = 747	53.61% (41.21%) N = 651	50.51% (40.04%) N = 423	52.65% (42.63%)* N = 975
Premium based on final price data	46.00% (39.20%) N = 1418	45.50% (39.92%) N = 847	46.73% (38.60%) N = 571	45.50% (39.96%) N = 764	46.58% (38.69%) N = 654	42.37% (35.03%) N = 434	47.60%*** (40.34%)* N = 984
Premium based on initial price data	46.05% (39.27%) N = 930	44.77% (39.54%) N = 473	47.38% (38.33%) N = 457	44.40% (39.20%) N = 424	47.44% (39.34%) N = 506	43.23% (35.95%) N = 220	46.93% (39.90%)** N = 710
MP	50.85% (40.67%) N = 1488	50.02% (41.22%) N = 886	52.06% (39.31%) N = 602	49.48% (41.15%) N = 797	52.42% (39.55%) N = 691	48.26%* (38.23%)* N = 455	52.00% (42.07%) N = 1039

**Table 6****Descriptive statistics for combined measure of merger premium (MP)**

The table contains means and medians (in parentheses) of the combined measure of merger premium (MP) for 1488 mergers and tender offers from 1980 to 2004. The premium offered to target shareholders is computed as the percentage the acquirer's offer is above the market value of the target's shares four weeks prior to the announcement of the offer. MP is first computed using the aggregate value of all the component elements (cash, stock and other securities) of the acquirer's offer to target shareholders. If it fails to produce a value between 0% and 200%, it is recomputed using the final offer price. If the premium computed using the final price also fails to produce a value between 0% and 200%, it is recomputed using initial price offered. If the premium computed using the initial price still does not fall between 0% and 200%, the merger is deleted. It is this combined measure of merger premium (MP) that is used in all subsequent analyses in the paper. A deal is classified as having a conflicted fairness opinion if an institution providing a fairness opinion on the deal also has an advisory role in the merger. Similarly, a deal is classified as having an independent fairness opinion if an institution providing a fairness opinion on the deal has no advisory role in the merger. \*\*\*, \*\* and \* indicate that the mean (median) merger premium is different from the mean (median) merger premium of the no fairness opinion sub-sample at the 1%, 5% and 10% level respectively.

	<b>Number of deals</b>	<b>MP Mean (median)</b>
<b>Panel A: All Deals</b>		
<b>Full sample</b>	1488	50.85% (40.67%)
<b>No Fairness Opinion</b>	602	52.06% (39.31%)
<b>Fairness Opinion</b>	802	50.02% (41.22%)
<b>Panel B: Target</b>		
<b>No Fairness Opinion</b>	691	52.42% (39.55%)
<b>Fairness Opinion</b>	797	49.48% (41.15%)
<b>Conflicted fairness opinion</b>	695	48.35%** (40.00%)
<b>Independent fairness opinion</b>	69	54.38% (53.06%)
<b>Conflicted and Independent fairness opinion</b>	33	62.99%* (52.05%)*
<b>Panel C: Acquirer</b>		
<b>No Fairness Opinion</b>	1039	52.00% (42.07%)
<b>Fairness Opinion</b>	455	48.26%* (38.23%)***
<b>Conflicted fairness opinion</b>	387	46.32%*** (35.83%)***
<b>Independent fairness opinion</b>	62	60.18%* (49.30%)
<b>Conflicted and Independent fairness opinion</b>	6	49.78% (40.65%)

**Table 7****Fairness opinions and merger premiums**

The logit regressions are based on a sample of 1488 merger and tender offer bids between 1980 and 2004. The dependent variables TarFO and AcqFO are dummy variables equal to one if the deal has an institution providing a fairness opinion to the target and acquirer respectively and zero otherwise. The dependent variables TarConfFO and AcqConfFO are dummy variables equal to one if the deal advisor provides a fairness opinion on the target or acquirer side respectively and zero otherwise. All other independent variables are as defined in previous tables and the appendix. Z-statistics computed after correcting the standard errors for heteroskedasticity and cross sectional clustering across observations involving the same acquirer are in parentheses. \*\*\*, \*\* and \* indicate that the parameter estimate is significantly different from zero at the 1%, 5% or 10% respectively.

	Model 1	Model 2	Model 3	Model 4
Independent Variable	TarFO	TarConfFO	AcqFO	AcqConfFO
Intercept	1.26 (1.62)	0.51 (0.63)	0.79 (0.85)	-0.96 (-0.86)
MP	-0.17 (-1.05)	-0.30* (-1.89)	-0.02 (-0.11)	-0.29 (-1.41)
TarFO			1.98*** (11.63)	2.29*** (12.04)
AcqFO	1.87*** (12.07)	1.76*** (12.15)		
HOSTILE	-0.32 (-0.75)	0.04 (0.10)	-0.87 (-1.25)	-0.66 (-0.90)
TENDER	-0.49** (-2.47)	-0.37* (-1.82)	-1.25*** (-3.15)	-1.39*** (-3.15)
CASH	0.24* (1.74)	0.14 (1.03)	-0.96*** (-5.52)	-0.89*** (-4.97)
POISON	1.10* (1.94)	1.00* (1.72)	-0.43 (-0.41)	-0.20 (-0.19)
AcqTermFee	0.56 (0.35)	0.01 (0.08)	0.06 (0.32)	0.22 (1.14)
TarTermFee	-0.04 (-0.30)	0.04 (0.26)	-0.02 (-0.14)	-0.22 (-1.21)
COMPETITION	0.52* (1.78)	0.13 (0.45)	-0.29 (-0.85)	-0.39 (-1.14)
TOEHOLD	-0.32 (-0.80)	-0.26 (-0.68)	-0.26 (-0.44)	-0.25 (-0.43)
SIND	-0.20 (-1.38)	-0.21 (-1.45)	0.49 (0.28)	0.16 (0.86)
FINSERV	-0.09 (-0.54)	-0.06 (-0.39)	-0.15 (-0.81)	-0.21 (-0.99)
Log(AcqMVE)	0.06 (1.33)	0.09* (1.81)	-0.93*** (-11.93)	-0.95*** (-11.76)
Log(TarMVE)	-0.14** (-2.52)	-0.14** (-2.55)	0.89*** (11.02)	0.93*** (11.07)
Log(AcqM2B)	0.02 (0.25)	0.08 (0.91)	-0.01 (-0.10)	0.05 (0.49)
Log(TarM2B)	-0.02 (-0.26)	-0.07 (-0.78)	-0.06 (-0.49)	-0.15 (-1.18)
N	1375	1375	1375	1375
Pseudo R <sup>2</sup>	0.110	0.11	0.30	0.32

**Table 8****Descriptive statistics for abnormal returns**

The table contains means and medians (in parentheses) of the cumulative abnormal return over the window (-1,0) where event day 0 is the merger announcement day. Abnormal returns are computed using a market model with an estimation period of 255 trading days ending 46 trading days before the event. The sample consists of 1488 mergers and tender offers from 1980 to 2004. A deal is classified as having a conflicted fairness opinion if an institution providing a fairness opinion on the deal also has an advisory role in the merger. Similarly, a deal is classified as having an independent fairness opinion if an institution providing a fairness opinion on the deal has no advisory role in the merger. \*\*\*, \*\* and \* indicate that the mean (median) merger premium is different from the mean (median) merger premium of the no fairness opinion sub-sample at the 1%, 5% and 10% level respectively.

	<b>Number of Deals</b>	<b>Target CAR (-1, 0)  Mean (median)</b>	<b>Acquirer CAR (-1, 0)  Mean (median)</b>
<b>Panel A: All Deals</b>			
<b>Full Sample</b>	1488	16.25% (11.34%)	-1.92% (-1.28%)
<b>No Fairness Opinion</b>	602	18.66% (12.22%)	-2.10% (-1.29%)
<b>Fairness Opinion</b>	886	14.61% *** (10.38%)*	-1.80% (-1.28%)
<b>Panel B: Target</b>			
<b>No Fairness Opinion</b>	691	17.94% (11.99%)	-2.08% (-1.30%)
<b>Fairness Opinion</b>	797	14.78% *** (10.37%)*	-1.79% (-1.27 %)
<b>Conflicted fairness opinion</b>	695	14.65% *** (9.82%)*	-1.82% (-1.26%)
<b>Independent fairness opinion</b>	69	14.93% (12.10%)	-1.43% (-1.36%)
<b>Conflicted and Independent fairness opinion</b>	33	17.22% (15.95%)	-1.85% (-1.39%)
<b>Panel C: Acquirer</b>			
<b>No Fairness Opinion</b>	1033	18.21% (12.24%)	-1.76% (-1.17%)
<b>Fairness Opinion</b>	455	11.80% *** (8.99%)*	-2.30%* (-1.75%)*
<b>Conflicted fairness opinion</b>	387	11.05% *** (8.46%)*	-2.54%** (-1.93%)*
<b>Independent fairness opinion</b>	62	16.46% (13.44%)	-0.64% (-0.26%)
<b>Conflicted and Independent fairness opinion</b>	6	12.65% (2.93%)	-3.93% (-2.51%)

**Table 9****Fairness opinions, merger premiums and abnormal returns**

The regressions are based on a sample of 1488 merger and tender offer bids between 1980 and 2004. The dependent variable is the target's (acquirer's) cumulative abnormal return over the window (-1,0) where the event day 0 is the merger announcement day. Abnormal returns are computed using a market model with an estimation period of 255 trading days ending 46 trading days before the event. MP is the combined measure of merger premium offered to target shareholders as defined in previous tables. TarFO and AcqFO are dummy variables equal to one if the deal has an institution providing a fairness opinion to the target and acquirer respectively and zero otherwise. TarConfFO and AcqConfFO are dummy variables equal to one if the deal advisor provides a fairness opinion on the target or acquirer side respectively and zero otherwise. All other independent variables are as defined in previous tables and the appendix. Heteroskedasticity consistent t-statistics are in parentheses. \*\*\*, \*\* and \* indicate that the parameter estimate is significantly different from zero at the 1%, 5% or 10% respectively.

Independent Variable	Target CAR (-1,0) Acquirer CAR (-1,0)	
	Model 1	Model 2
Intercept	0.16** (2.49)	0.06** (2.48)
MP	<b>0.20***</b> (7.21)	<b>-0.02***</b> (-4.25)
MP X TarFO	<b>-0.07*</b> (-1.77)	0.01 (1.06)
MP X TarConfFO	0.07 (1.54)	-0.00 (-0.21)
MP X AcqFO	-0.05 (-0.98)	0.02 (1.43)
MP X AcqConfFO	-0.02 (-0.36)	<b>-0.07***</b> (-3.19)
MP X TarFO X AcqFO	0.10 (1.33)	-0.02 (-0.61)
MP X TarConfFO X AcqConfFO	-0.09 (-1.20)	<b>0.06*</b> (1.91)
HOSTILE	-0.00 (-0.08)	0.02** (2.24)
TENDER	0.08*** (3.77)	0.00 (0.07)
CASH	0.00 (0.22)	0.02*** (5.07)
POISON	0.01 (0.22)	-0.01 (-0.28)
AcqTermFee	0.02* (1.74)	-0.00 (-0.34)
TarTermFee	-0.00 (-0.00)	-0.01 (-1.48)
COMPETITION	-0.08*** (-4.23)	0.00 (0.46)
TOEHOLD	-0.04 (-1.48)	0.03*** (3.07)
SIND	0.01 (1.03)	0.00 (0.63)
FINSERV	0.00 (0.11)	-0.01* (-1.78)
Log(AcqMVE)	0.03*** (5.83)	0.00* (1.66)
Log(TarMVE)	-0.04*** (-6.25)	-0.01*** (-4.38)
Log(AcqM2B)	0.00 (0.29)	-0.00 (-0.57)
Log(TarM2B)	-0.02** (-2.55)	-0.00 (-0.64)
N	1375	1375
Adjusted R <sup>2</sup>	0.22	0.09

**Table 10****Fairness opinions, advisor reputation, fee structure, merger premiums and abnormal returns**

The regressions are based on a sample of 1488 merger and tender offer bids between 1980 and 2004. The dependent variables are MP, the combined measure of the merger premium offered to target shareholders as defined in previous tables and the target's (acquirer's) cumulative abnormal return over the window (-1,0) where the event day 0 is the merger announcement day. Abnormal returns are computed using a market model with an estimation period of 255 trading days ending 46 trading days before the event. The dummy variables TarFO, AcqFO, TarConfFO and AcqConfFO are as defined in previous tables. TarHirep and AcqHirep are dummy variables equal to one if the institution advising the target or acquirer respectively on the deal is among the top ten advisors in the M&A market over the sample period and zero otherwise. TarContingent and AcqContingent are dummy variables equal to one if the institution advising the target or acquirer respectively on the deal had a fee contract that was contingent on the consummation of the deal and zero otherwise. TarInsider is a dummy that takes on the value of one if the percentage of shares owned by insiders is less than the sample median value of 5.79% and zero otherwise. TarInsideBoard is a dummy variable that takes on the value of one if the board is dominated by insider (> 50%) and zero otherwise. Other independent variables as defined in the appendix are included in all regressions but are not presented in the table. T-statistics computed after correcting the standard errors for heteroskedasticity and cross sectional clustering across observations involving the same acquirer are in parentheses. \*\*\*, \*\* and \* indicate that the parameter estimate is significantly different from zero at the 1%, 5% or 10% respectively.

Independent Variable	Target CAR (-1,0)		
	Model 1	Model 2	Model 3
Intercept	0.20*** (2.72)	0.17** (2.15)	
MP	<b>0.19***</b> (7.32)	<b>0.20***</b> (5.99)	<b>0.19***</b> (7.32)
MP X TarFO	<b>-0.06**</b> (-2.21)	-0.05 (-1.21)	-0.03 (-1.07)
MP X TarFO X TarHirep	<b>0.06*</b> (1.65)		
MP X TarConfFO		0.03 (0.60)	
MP X TarConfFO X TarContingent		-0.02 (-0.33)	
MP X TarFO X TarInsider			0.01 (0.27)
MP X TarFO X TarInsider X TarInsideBoard			<b>-0.10**</b> (-2.47)
N	1375	1005	1375
Adjusted R <sup>2</sup>	0.21	0.23	0.21

## Appendix: Variable definitions

Variable	Definition
HOSTILE	A dummy variable equal to one if SDC records the bid as “hostile” or “unsolicited” and zero otherwise.
TENDER	A dummy variable equal to one if SDC records the bid as involving a tender offer and zero otherwise.
CASH	A dummy variable equal to one if the bid involved a payment of cash (even if there were other associated methods of payment) and zero otherwise.
POISON	A dummy variable equal to one if that target has a poison pill in place at the time of the merger or tender offer and zero otherwise.
AcqTermFee	A dummy variable equal to one if the acquirer had a termination fee contract and zero otherwise.
TarTermFee	A dummy variable equal to one if the target had a termination fee contract and zero otherwise.
COMPETITION	A dummy variable equal to one if another bid is recorded by SDC and zero otherwise.
TOEHOLD	A dummy variable equal to one if the fraction of the target’s stock held by the acquirer on the bid announcement date is greater than 5% and zero otherwise.
SIND	A dummy variable equal to one if both the target and the acquirer are from the same two-digit SIC industry.
FINSERV	A dummy variable equal to one if both the bidder and the target are in the financial services industry and zero otherwise.
LAMVE	Log of the market value of the acquirer (in \$ millions) on the day prior to the merger announcement.
LTMVE	Log of the market value of the target (in \$ millions) on the day prior to the merger announcement.
LAMB	Log of the market to book ratio for the acquirer computed using COMPUSTAT data from the year of the bid.
LTMB	Log of the market to book ratio of the target computed using COMPUSTAT data from the year of the bid.