

FAIRNESS OPINIONS AS MAGIC PIECES OF PAPER

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The prior presenters, Professors Fiflis¹ and Carney,² and I agree that in the last ten years there have been startling cases of misbehavior by investment bankers who provide "fairness opinions" in corporate acquisitions. Yet nary a banker has paid a penny in damages for a contrived fairness opinion.³ Professor Fiflis would remedy this situation by holding investment bankers liable directly to shareholders under a fiduciary duty standard. Professor Carney finds nothing to remedy except, perhaps, the excessive meddling of state courts and the Securities and Exchange Commission (SEC).

I offer a third approach, more modest than Professor Fiflis' and more ambitious than Professor Carney's. I would encourage state courts to move in two corroborating directions. The first suggestion is a change in doctrine; the second is a change in the application of existing doctrine.

First, the legal relationship of an investment banker providing a fairness opinion and a *client firm* ought to be defined by fiduciary principles rather than straight contract principles. Unlike Professor Fiflis, I would limit, absent special circumstances, an aggrieved shareholder's remedy to a shareholder derivative action. Second, state courts, evaluating the conduct of directors, should view the directors' reliance on a questionable fairness opinion as evidence of an *absence* of due care. Courts at present seem to use a one-way gate: good-faith reliance on a fairness opinion is evidence of due care while reliance on an inappropriate opinion is oddly neutral in the due-care analysis, eliminating only the potential benefit of an expert's assistance as justificatory. Reliance on a contrived fairness opinion ought to be evidence of, first, a board's efforts to hoodwink its

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1. Ted J. Fiflis, *Responsibility of Investment Bankers to Shareholders*, 70 WASH. U. L.Q. 497 (1992).

2. William J. Carney, *Fairness Opinions: How Fair Are They and Why Should We Do Nothing About It*, 70 WASH. U. L.Q. 523 (1992).

3. This Article does not cover the liability of an investment banker to an opposing party in a negotiated acquisition. See *CPC Int'l, Inc. v. McKesson Corp.*, 514 N.E.2d 116 (N.Y. 1987) (complaint stated a valid cause of action in fraud).

shareholders and, second, a board's failure to use legitimate, reputable experts to inform itself diligently and conscientiously on crucial matters.

I explain each suggestion in Section IV below, after I discuss the merits of the approaches of Professors Carney and Fiffis in Sections II and III. Section I contains a background discussion on the nature of fairness opinions.

I. FAIRNESS OPINIONS AS WINDOW DRESSING

The worst abuses associated with fairness opinions have occurred in leveraged buyouts (LBOs) of publicly traded firms. In most LBOs, an LBO promoter—typically either a specialized partnership⁴ or the merchant banking division of an investment bank⁵—joins forces with senior management of a publicly held firm and raises enough capital to buy all the stock, taking the firm private. The LBO group can be the victorious bidder in an auction, either stimulated by the LBO announcement or by a hostile takeover bid, or it can be the only bidder.

Participants in LBOs turn to investment banking firms for assistance in structuring bids and mounting defenses. The investment bankers advise on strategy, evaluate offers, secure private financing, and underwrite public distributions of debt securities. Formal, written price evaluations, "fairness opinions," appear in two contexts. First, in defense of hostile tender offers, target managers invariably obtains a statement from a financial advisor that the offered price is "grossly inadequate." Second, in support of an LBO, a board of directors' subcommittee, consisting of the outside directors, invariably obtains a statement from a financial advisor that the offer of the buyout group is "within the range of fair prices." In both situations, depending on context, federal securities law may require the communication of the opinion's contents to firm shareholders.

As Professor Carney points out, directors use formal, written fairness opinions primarily to protect themselves from personal liability in the inevitable shareholder lawsuits that follow all major acquisitions. The defendant board points to its good faith reliance on an expert opinion in support of its decision to sell or not to sell the firm. If a board communicates the contents of an opinion to shareholders, the board also intends to

4. For example, Adler Shaykin, Clayton Dubilier, Forstmann Little, Gibbons Green, Hick & Hass, Kelso, Kohlberg Kravis Roberts, Riordan Freeman, Thomas Lee, Warburg Pincus, and Wesray.

5. For example, Allen & Company, Bankers Trust, Citicorp, Donalson Lufkin & Jenrette, First Boston, Merrill Lynch, and Morgan Stanley.

use the opinion to influence shareholder action—to deter shareholders from tendering stock into a hostile offer or to encourage shareholders either to vote for or tender into a buyout group's offer. The second purpose is less important than the first, however, as the board recognizes that its own recommendation, artfully communicated to shareholders even if without the gloss of an expert's support, is usually enough to influence shareholder action in desired directions.

Suspicious fairness opinions have helped LBO groups buy firms very cheaply by understating the value of the firm and have helped target managers repel very generous hostile bids by overstating the value of the firm. Professor Carney's citation of numerous examples of problematic opinions does not exhaust the field. I would be more sympathetic to the argument that fairness opinions involve complex projections that have an inherently high degree of error if I could find more inaccurate fairness opinions that were against the interests of the hiring board—fairness opinions that overstated the value of the firm in a management-led buyout or that understated the value of the firm in defense of a hostile bid. The few examples that do exist are dwarfed by the cases that involve errors in favor of the interested board.

My favorite example is the 1983 transaction that had every CEO in the country calling a buyout promoter—the Metromedia LBO.⁶ John Kluge's "legal" theft of his own company, making him overnight the wealthiest individual in America, is to LBOs in the 1980s what the Beach Boys were to surfer songs in the 1960s. In December 1983, four senior officers, led by CEO John Kluge, proposed an early form of a leveraged buyout—the company was to be taken private by merging it into a company privately owned (ninety-six percent) by the officers. Each share of Metromedia was to be converted into cash and subordinated debentures worth around forty dollars a share for a total purchase price of \$1.1 billion. The stockholders, in a class action, sued, attacking the price as inadequate.

The Metromedia directors appointed four of their own, who were not part of the buyout group, to represent the interests of the shareholders. The special committee hired two investment banks, Shearson Lehman and Bear Stearns, to give fairness opinions. Both opined that the firm was worth \$1.114 billion, adding \$.69 a share to the original offer. Me-

6. See Benjamin J. Stein, *Where are the Shareholders' Yachts: But John Kluge Pockets Billions from Metromedia's LBO*, BARRON'S, Aug. 16, 1986, at 6-7. There is some minor dispute over the exact numbers. The text uses the numbers from the court litigation. See *infra* note 7.

tromedia used the opinions to settle the class action, obtaining judicial approval from the Delaware Chancery Court. The opinions were also included in proxy material sent to shareholders, leading the shareholders to vote overwhelmingly in favor of the merger.

Less than a year later, Metromedia sold its television stations for two billion dollars, and within two years it liquidated its remaining assets for \$2.5 billion, for a total of \$4.5 billion. Had the public shareholders participated in the liquidation, they would have received around eighty-four more dollars a share than the cash-out price. Angry shareholders, who had released their claims against Metromedia and its officials in settling the class action, looked for new defendants. The obvious target was the investment bankers who had undervalued the firm in their fairness opinions.

In subsequent litigation against the investment bankers, the plaintiffs alleged that Shearson Lehman had been paid four million dollars for its fairness opinion, seven hundred and fifty thousand up front and just over three million contingent on the merger's succeeding. The plaintiffs also alleged that Bear Stearns was paid over two million dollars for its opinion, five hundred thousand up front and two million contingent on the success of the buyout. The New York Court of Appeals dismissed the case, over a vigorous dissent, on the grounds that the class action settlement agreement, releasing "anyone else in connection with . . . the action," covered the investment bankers, even though the bankers were not parties to the original action.⁷ The plaintiffs' lawyers who settled the shareholder class action on the cheap, by the way, pocketed one million dollars for their efforts.

John Kluge became a very wealthy man and, to the business community, he did it "legally." The LBO stampede was on.

II. FAIRNESS OPINIONS AS "MAGIC PIECES OF PAPER"

Professor Carney makes three basic points. First, fairness opinions are useful to shore up breaches in the business judgment rule, weakened without justification by state courts. He argues that these stylized, brief pieces of paper seem to appease and calm meddling state courts who, without the paper, would over-regulate board decisions in major acquisitions. The cost of a fairness opinion is, therefore, best understood as a

7. *Wells v. Shearson Lehman/American Express, Inc.*, 526 N.E.2d 8, 10 (N.Y. 1988).

judicial tax on deals, transferring wealth to investment bankers and necessitated by the officiousness of state court judges.

Unfortunately, this view of fairness opinions is widely held in the investment banking community. Consider the remarks of Saul Cohen, at the time general counsel of Drexel Burnham:

[L]ook at the reality of deals and what investment bankers do and do not do. It is important not to get hung up on a piece of paper seven paragraphs long, which disclaims knowledge of everything, and at its end notes, from a financial point of view, that this price is within a range of fairness, or words to that effect. That opinion should be seen as a "magic" piece of paper which people need to close deals. Within the process as a whole, it really should not be taken as much more than a "magic" piece of paper. . . . [W]hat do the shareholders (and I do not believe there are any shareholders at the end of these situations, so for shareholders read "arbitragers") rely on, save for the bank's reputation for getting deals done?⁸

In other words, a fairness opinion is demanded by directors worried about personal liability; they will not close a deal without one.

This pragmatic, almost cynical view of fairness opinions is a cute dodge for not dealing with the problems of fairness opinions' content. Investment bankers and their clients play the fairness opinion game to close deals, nothing more. The opinions are designed to satisfy the whims of judges, who are looking for clear, clean sign posts in their evaluation of director conduct in acquisitions.

The problem with this view is that it is self-defeating. Courts will catch on (and I note the smiling visage in the audience of Justice Moore of the Delaware Supreme Court). When they do, a seven paragraph fairness opinion may be evidence not of director care but of director negligence. A short fairness opinion may come to be itself a red flag for

8. *Investment Banker Liability: Transcription of a Panel Discussion*, 16 DEL. J. CORP. L. 557, 574 (1991) (remarks of Saul Cohen). Other remarks by Mr. Cohen include the following:

Bershad (a plaintiff's lawyer): Fairness opinions and how they are developed really count

...

Cohen: Opinions create the nexus for the (read "your") lawsuit . . . How seriously are such opinions entitled to be taken? They are a page and a half, perhaps seven paragraphs in all. The first couple of paragraphs say what the argument is. The next paragraph says what the banker has looked at. The next paragraph says what the banker has not looked at. The next paragraph says we have no appraisals from third parties and did not make any ourselves. And at the end, with a reference to "from a financial point of view," the opinion says it is within a range of fairness.

Bershad: The courts are striking down these boilerplate opinions. They will not accept such drivel.

Cohen: Fairness opinions reflect the process that precedes them.

director misconduct. Far from protecting directors, conclusory fairness opinions will increase director exposure to liability.

The same transition from salve to salt is occurring with solvency opinions: written, formal, conclusory opinions given by investment bankers in LBOs that a firm, immediately after the LBO is "solvent." Solvency declarations were intended to inhibit fraudulent-conveyance-act liability for selling shareholders, acquisition lenders, and professional advisors if a firm took bankruptcy within five years of the buyout.⁹ Bankruptcy judges have come to view the letters as unacceptable excuses for a board's lack of a thorough internal review of the solvency of a post-LBO firm.¹⁰

Professor Carney's second argument is more serious. Assuming fairness opinions are useful, that is, that their content has meaning, he argues that the opinions necessarily must be general and inherently imprecise. Valuations of a target firm float free of the stock market's estimates of aggregate value because the bids are invariably and expectantly at a substantial premium over pre-announcement stock market prices. Accordingly, valuations become extremely speculative as the bankers balance many factors, value illiquid and fluctuating assets, follow different valuation standards, and use different goals. In sum, the margin for error in the predictions of any fairness opinion, even the most conscientiously and capably rendered, is huge.

As a consequence, Professor Carney argues, courts are incapable of judging whether an investment banker misbehaved in providing any one specific opinion. Courts will not be able to distinguish between good opinions that proved to be wrong and bad opinions that were inappropriate when written. At the hands of ignorant, unctuous judges, innocent defendants will suffer and shareholders will enjoy windfall gains.

Fairness opinions will become deal insurance or one-way earnouts for selling shareholders; if post-LBO events show a purchase price to be low, selling shareholders can claim additional proceeds by suing on the opinion. If the selling price is high, on the other hand—the LBO goes into immediate bankruptcy, for example—the buyout group cannot recover some of the sale proceeds from the shareholders. Of course, this will affect dramatically and adversely the incentives of LBO buyout groups.

9. See DALE A. OESTERLE, *THE LAW OF MERGERS, ACQUISITIONS, AND REORGANIZATIONS* 201-17 (1991).

10. See Joseph H. Levie, *Do Solvency Letters Help? Or Are They Dangerous?*, N.Y. L.J., Sept. 5, 1991, at 5.

Fewer will bid, and those that do will pay less because they can no longer recover the full value of their post-LBO efforts to improve the firm.

Professor Carney has a valid point, but he proves too much. In making an argument that courts should not hear shareholder suits against investment bankers on fairness opinions because the opinions are so necessarily imprecise, he overlooks the many other situations in which courts must evaluate the content of fairness opinions. Two of these situations are close to his heart. First, he asks that courts apply business judgment rule principles to protect directors who rely on fairness opinions. But the directors' reliance, under most corporate codes, must be reasonable and in good faith. He admits that the courts have a role to play and that they ought to (and do) step in occasionally to block some acquisitions.¹¹ In such cases, an evaluation of the reasonableness and good faith of the directors' reliance on a fairness opinion will include an evaluation of, at minimum, the ostensible sensibility of the content of the opinion relied on.

Second, to control investment bankers' misfeasance, Professor Carney necessarily relies on the ability of the firm (rather than firm shareholders) to sue investment bankers under contract theories for inappropriate opinions. By rendering a bad opinion, the bankers have breached their contract with the client firm. Yet in any such case, the court will have to evaluate the content of the opinion to see if the contract was breached or performed.

A better solution would seem to admit that we have to help our courts, not fight them. We need to improve the quality of fairness opinions. Optimally, the investment banking community would itself take the lead. It could develop professional standards that educate our judges on what they ought to expect from a sound, professional opinion.¹² Bankers could define and articulate various standards for fairness opinions and suggest when the use of one standard may be more appropriate than another. Moreover, bankers could suggest minimum criteria for investigating particular kinds of valuations. Finally, bankers should consider developing basic conflict-of-interest rules for those providing fairness opinions. In the absence of a professional declaration, courts or the SEC necessarily will have to assume this role.

Instead of the infamous seven paragraphs, fairness opinions ought to

11. See Carney, *supra* note 2, at 540.

12. See *infra* note 42 and accompanying text.

begin with a statement of the kind of standard used and then reveal the bases of the estimates. Ideally, the explanation of the calculations will become more valuable than the ultimate recommendation, as others can use the full document to reach their own, perhaps different, conclusions. The opinion itself ought to disclose the compensation arrangement for the opinion and whether the preparer is otherwise interested in the consummation of the transaction.

At issue, however, is how courts can encourage bankers to develop and use more professional standards for fairness opinions.¹³

Professor Carney's third point has a familiar melody—the stock market works well without reference to fairness opinions; fairness opinions are simply inconsequential and ought not be the subject of inherently spurious litigation. His evidence is twofold. First, selling shareholders in LBOs and cash-out mergers usually receive well in excess of the pre-transaction market price for their shares. Accordingly, they cannot have been injured by contrived fairness opinions. Indeed, if the fairness opinions are a necessary artifice to close deals (to appease directors worried about meddling courts), contrived fairness opinions have benefitted, not injured, selling shareholders who have profited handsomely from the transactions. Second, he argues that shareholders could, if they wished, protect themselves by favoring firms that sport provisions in corporate charters prohibiting LBOs or cash-out mergers. He infers from the absence of such provisions that shareholders generally favor the prospect of LBOs or cash-out mergers.

In his third argument, Professor Carney trivializes the dominant problem in LBOs—agency costs. The LBO buyout group has the benefit of the knowledge and expertise of firm insiders and is acting cohesively. Their opposites in the deal are a diffuse group of public shareholders who typically do not have intimate access to firm information and who cannot, without great difficulty, act in unison. The buyout group has an informational and a structural bargaining advantage. Complicating the picture is the shareholders' patterned reliance on law—their managers owe them the duties of due care and loyalty.

The opportunities for abuse are obvious—managers can use LBOs to trade on many forms of insider information. But even the most favored rationale for LBOs has a dark side. Finance experts have come to justify

13. On this matter Professor Fiftis and I agree that some change in doctrine may be necessary; we disagree on the details of the change.

LBOs as a positive realignment of management incentives.¹⁴ LBOs give managers a more substantial equity stake in the corporation and thus induce them to achieve more faithfully the goal of maximizing the worth of the business. The position is not very satisfying, however, because it necessarily means that managers are acting suboptimally for their public shareholders.

Why do the managers not do all the value-enhancing asset manipulation we see after an LBO when they earn over a million dollars or so a year as fiduciaries for public shareholders? More specifically, why do we not tie managers' compensation in publicly traded companies exclusively to stock performance to achieve the same incentive effect as is present in an LBO? Is it because managers in publicly traded companies control in large part their own methods of compensation? A troubling conclusion to all this could be that managers protect themselves from the negative effects of shirking in publicly traded companies (earning substantial salaries) and then, when the adverse effects on the firm accumulate, take the firm private and profit personally from undoing the harm they have caused.

In this context, Professor Carney's bid-price data seem incomplete.¹⁵ Buyout groups must, of course, bid over pretransaction prices for any LBO to succeed, and the bid itself reveals significant new information to the stock market. Insiders believe that they can make a profit by manipulating or massaging firm assets in ways not pursued by existing

14. See, e.g., Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989).

15. There are better data for Professor Carney's argument from the fine work of Steven Kaplan, who gathers data on the LBOs of the 1980s. In a 1989 paper studying LBOs from 1980 to 1986, Kaplan found that mean market-adjusted returns to prebuyout investors were 46.7% as compared with mean market-adjusted returns to post-buyout investors (including equity and debt) of 41.9%. Kaplan, *supra* note 14, at 237-38. His data is susceptible to other interpretations. He does not break out the market-adjusted returns of post-buyout equity holders from debt holders. The nominal or real returns to post-buyout equity holders has a mean of 4,274.6%! Calculating a market-adjusted return would discount this figure for the extreme risk absorbed by post-LBO equity holders. But one must be careful here. The risk absorbed is tempered by the effects of inside information. In layperson's terms, if you know you can do it, it isn't risky.

At issue, however, is why a buyout is necessary to record such gains and why officials managing publicly held firms do not, by manipulating assets in ways that match the post-LBO behavior of managers, provide a larger share of the gains to public shareholders.

Kaplan also found that 32 buyout companies provided usable projections in their proxy statement, projections that presumably were also behind fairness opinions. Those companies consistently *underachieved* their projections. If managers are duping shareholders, one would expect the opposite to be true. I have trouble reconciling this data with the huge gains made by post-buyout equity holders.

management. At issue is the ability of the shareholders to bargain effectively to claim a sizeable part of the value of this new information. The LBO group has an incentive to understate the new value.¹⁶ The occasional appearance of an outside bidder provides some (although not perfect) guarantee of disclosure, through price, of the buyout group's valuation of the firm,¹⁷ but many LBOs are uncontested. Thus the argument that LBO prices always exceed pretransaction prices for firm stock proves little.

Moreover, there are real social costs to disabling selling shareholders across the board from bargaining effectively in LBOs. A limit on the potential upside returns in LBOs will cause all shareholders to discount all stock systematically. Stock prices will be uniformly lower and all firms' costs of capital uniformly higher. In this sense, Professor Carney's argument has a self-serving quality to it, as the pretransaction prices will

16. *But see supra* note 15.

17. Kaplan finds that market-adjusted returns earned by prebuyout shareholders in buyouts with and without active third-party participation are 33.1% and 37.1% respectively. *See* Kaplan, *supra* note 14, at 247. The four percent difference is statistically insignificant. *See also* Jeffrey Davis & Kenneth Lehn, *Information Asymmetries, Rule 13e-3 and Premiums in Going-Private Transactions*, 70 WASH. U. L.Q. 587 (1992) (premiums in third-party takeovers are equivalent to premiums paid in LBOs). Why do LBO premiums match average premiums third-party bidders pay? In a real sense, actual or *potential* premiums third-party bidders offer will affect the strategy of LBO offers. If any one factor protects shareholders in LBO, it is this. Of course, as the likelihood of competing bidders diminishes, the protection evaporates. In assessing the damage contrived fairness opinions caused in any individual case, the presence or threat of a third-party bidder will be an important factor in a judge or jury's finding of causation.

But there is a flip side to the analysis: the LBO bid will also affect any third-party bid. An insider's bid for its own firm imparts material information about the firm to all market participants, including third-party bidders. In a real sense, the premium offered by a credible offer from an LBO firm puts a ceiling range on the price many third-party firms, with inferior information, ought to offer to buy the firm (unless there are unique synergies available to the third party that the insiders cannot claim). How, for example, can an outsider justify to its own investors relying on projections of firm value that insiders think are wildly optimistic? In other words, LBO bids may affect outside bids as much as outside bids affect LBO bids. If an LBO bid is undervalued and yet credible (because of the manipulation of disclosed information through, *inter alia*, fairness opinions), third-party bids also may be undervalued.

Finally, in comparing LBOs and third-party takeovers one may be comparing apples and oranges. In third-party takeovers bought by operating firms, motivation is largely strategic. The firm hopes that the combined operation of two firms will generate real efficiencies in operation or finance. In LBOs, existing managers manipulate existing assets to generate new value; synergy gains typically are not available. Thus LBOs generate gains, through pure firm asset manipulation, that are equal to projected gains from strategic mergers (which include asset manipulation and synergy gains). Third-party bidders with full information ought to pay significantly *more* than LBOs groups. They do not, indicating, perhaps, a fundamental information disparity that advantages LBO groups in the bidding.

be lower in some amount because of the absence of shareholder bargaining power in LBO negotiations.

Professor Carney's answer to this concern is his second bit of data. If there is systematic stock price depression, firms individually could lower their cost of capital and be more successful competitors in the products markets by choosing to insert firm-specific prohibitions against LBOs in their corporate charters. Since firms do not do this, the agency costs of LBOs must be overstated. Yet, the same problems of corporate structure that create the agency costs, which allow public managers to shirk and which protect their compensation from the effects of shirking, also will enable managers to block any provision that may inhibit their power to participate in an LBO. Managers will not favor anti-LBO provisions and they will block them in their own interest, even if not in the interest of their firms. Without changing the current corporate legal structure, one cannot expect managers to encourage their firms to adopt such provisions.

There are additional rebuttals as well. Any firm that wishes to insert such a provision in its charter faces severe drafting problems. How can firms distinguish and prohibit, in specific language, only inappropriate LBOs? A provision eliminating all LBOs drastically will reduce the financing flexibility of the firm; any firm making the effort would undoubtedly find that it has unintended and harmful consequences.¹⁸ And the provision would be permanent; to be effective, it would have to carry very high super-majority vote protection, applying in votes on statutory mergers and asset sales as well as charter modifications. If such a provision acts to limit the potential upside returns from appropriate LBOs, it would depress the value of the stock.

The best rule would seem to be the one courts are now working to put in place. In other words, drafters of corporate charter provisions, if put to the task, would be drafting a language that mimics evolving law. LBOs must be fair to shareholders, and fairness is measured by price alone if there are no procedural protections. Fairness opinions, properly used, aid directors in their assessment of a fair price.

Even if shareholders could get charter prohibitions against LBOs capably drafted and passed, perhaps we do not see such provisions because they do not get at the core of the agency problem—agency costs in pub-

18. How would a drafter exempt an honest merger of a publicly held firm into a privately held firm in which the managers of the publicly held firm retained their positions?

licly traded companies. Eliminating the prospect of management participation in LBOs will not improve the incentives and performance of managers in publicly held companies.¹⁹ LBOs allow shareholders, in some cases, a partial recovery of lost agency costs. Some relief is better than none. As such, LBOs are a pitifully poor stop-gap remedy to a problem that is more endemic and needs deeper and more lasting solutions, solutions that focus on executive compensation in publicly traded companies.²⁰

III. FAIRNESS OPINIONS AS THE "NEXUS FOR LAWSUITS"²¹

Professor Fiflis, on the other hand, searches precedent to support a new source of liability.²² He argues that investment bankers who write fairness opinions ought to assume the legal status of fiduciaries to shareholders and, as such, ought to be directly liable to shareholders for lack of due care. In sum, our courts ought to use investment bankers as gatekeepers, responsible to shareholders for stopping improvident deals.

This would be a major change in doctrine. At present, investment bankers are not liable directly to shareholders under state law unless they aid and abet directors who themselves breach their fiduciary duty to the firm.²³ Investment bankers also may be directly liable to shareholders under various provisions of the federal securities acts and rules if, for example, they fail to exercise due diligence as "experts" under Section 11

19. Unless, of course, one believes that the prospect of LBOs creates a moral hazard—executives deliberately erect removable problems in their firms to depress firm prices in anticipation of an LBO, after which they will correct the problems and enjoy the benefits of the increased firm value. This is dangerous. It may attract unwanted competitive bidders who have discerned the ploy.

20. For a description of the lack of correlation between executive pay and performance, see GRAEF S. CRYSTAL, *IN SEARCH OF EXCESS: OVERCOMPENSATION OF AMERICAN EXECUTIVES* (1992).

21. See *supra* note 8.

22. He is not the first. See Carol B. Haight, Note, *The Standard of Care Required of an Investment Banker to Minority Shareholders in a Cash-Out Merger: Weinberger v UOP, Inc.*, 8 DEL. J. CORP. L. 98 (1983); Robert J. Giuffra, Jr., Note, *Investment Bankers' Fairness Opinions in Corporate Control Transaction*, 96 YALE L.J. 119 (1986).

23. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1283-84 n.33 (Del. 1988) (investment banker tipped off the management bidder on the content of an opposing bidder's sealed bid). Aiding and abetting liability requires that the plaintiff establish that a fiduciary relationship existed between the plaintiff and the directors, that the directors breached that fiduciary duty, and that the investment banker knowingly participated in the director's breach. See Ronald A. Brown, Jr., Note, *Claims of Aiding and Abetting A Director's Breach of Fiduciary Duty—Does Everybody Who Deals with a Delaware Director Owe Fiduciary Duties to that Director's Shareholders?*, 15 DEL. J. CORP. L. 943 (1990).

of the Securities Act of 1933,²⁴ engage in willful violations of various antifraud provisions in the Exchange Act of 1934 (SEC Rule 10b-5, section 14(e), or Rule 13e-3),²⁵ or engage in negligent violations of SEC Rule 14a-9.²⁶ Each of these forms of liability is fairly narrow.

Professor Fiflis acknowledges that Delaware case law does not presently support his theory.²⁷ He also acknowledges that the two New York cases on which he relies, both from intermediate appeals courts, do not directly support his theory. In my view, the cases also do not comport with New York law as defined by its top court, the Court of Appeals.²⁸ They may not be good law. In any event, the Court of Appeals would be

24. The 1933 Act may apply if the LBO group is exchanging securities, usually debt or preferred stock, for outstanding common stock in a publicly held firm. The 1933 Act requires that the group file with the SEC and give to all purchasers a disclosure document (a prospectus). If the disclosure document is false or misleading, all those who participate in its creation are potentially liable under § 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1988). Experts can, however, establish a "due diligence" defense. A false fairness opinion, included in the disclosure document, could make its authors liable under § 11.

25. See generally *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (scienter required for Rule 10b-5 violations). See also *Giuffa*, *supra* note 22.

26. *Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179, 190 (3d. Cir. 1988), *cert. denied*, 489 U.S. 1054, 1060 (1989). Section 14(a) of the Exchange Act of 1934 only applies, of course, if an LBO target seeks a vote of its public shareholders approving the transaction. In *Herskowitz*, a fairness opinion was included in the offending proxy statement. See 15 U.S.C. § 78n(a) (1988).

27. See *Haight*, *supra* note 22. See also *In re Shoe-Town*, No. 9843, 1990 Del. Ch. LEXIS 14 (Del. Ch. Feb. 12, 1990).

28. The near privity test laid out by the court of appeals in *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985), *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931), and *Glanzer v. Shepard*, 135 N.E. 275 (N.Y. 1922), seems to require very specific knowledge on the part of accountants of the identity of an affected third party. Under *Credit Alliance*, an audit intended to influence a pre-identified potential bank lender would subject the auditor to liability, but an audit intended to influence an unspecified group of potential lenders would not. An ever-changing, amorphous group of shareholders has not yet and would not seem to qualify under the near privity test. If so, the even more restrictive opinion in *Wells v. Shearson Lehman/American Express, Inc.*, 514 N.Y.S.2d 1 (App. Div. 1987), *rev'd on other grounds*, 526 N.E.2d 1 (N.Y. 1988), would seem to be inconsistent with the court of appeals' view. In any event, in *Schneider v. Lazard Freres & Co.*, 552 N.Y.S.2d 571 (App. Div. 1990), the court's attempt to use a bizarre notion of agency, attaching only to special subcommittees of the board empowered to sell the firm, and thus to avoid the acknowledged limits of *Credit Alliance*, is a fanciful reconstruction of fiduciary doctrine. For an example of one of the few cases that meets the very narrow confines of a "near privity" rule, see *Ossining Union Free School District v. Anderson*, 539 N.E.2d 91 (N.Y. 1989).

For an argument in favor of *Wells* and against *Schneider*, see John C. Coffee, *New York's New Doctrine of "Constructive Privity"*, N.Y. L.J., Jan. 25, 1990, at 5. Professor Coffee also suggests that the SEC, in combination with *Wells*, could act to moot *Schneider*. If the SEC required full disclosure of fairness opinions in all tender offers and in all proxy statements dealing with control changes, then *Wells* would control all significant cases of investment banker liability. Both Professors Carney and Fiflis note that the SEC is already doing just that. Carney, *supra* note 2, at 529; Fiflis, *supra* note 1, at 498.

well advised to reject any extension of either *Wells* or *Schneider* on policy grounds.

Professor Fiflis's argument pushes foreseeability of harm, an important component of tort liability, beyond historical limits. Since investment bankers can foresee the effects of fairness opinions on firm shareholders, bankers should be responsible to those shareholders for any injury caused by a negligently prepared opinion. Yet tort law has never succumbed to the allure of relying exclusively on foreseeability in defining liability.²⁹ Instead, throughout tort law are examples of caps on liability even when harm is plainly foreseeable.³⁰

The reasons for tort law's refusal to depend exclusively on foreseeability of harm as defining liability—fear of excessive liability, exaggerated damages, and relaxed self-protection—apply with force to investment banker liability. Any fairness opinion rendered in a large LBO (recall that the RJR Nabisco LBO was for over twenty-five billion dollars) exposes an investment banker to staggering potential liability, hundreds or even thousands of times any fee charged for the service. The problem is compounded by the transferability of the firm's shares during periods affected by any fairness opinion. Buyers and sellers between the announcement date of the deal (or public disclosure of the fairness opinion) and the relevant shareholder act (either a vote or a tender of their stock) and, perhaps even to the closing, all will be potential claimants.

Moreover, the harm shareholders suffer is a small part of the total losses that may be tied to an unsuccessful LBO. Debt-holders, employees, and other affected parties injured, and foreseeably so, by an improvident deal will argue for treatment similar to that given shareholders. Any theory of liability favoring shareholders will have to cap damages at some multiple of fees, perhaps, and explain to discouraged debtholders why they, and not shareholders, go away with empty pockets.

Investment banker liability to shareholders also will encourage shareholders to exaggerate their losses to get damages when any LBO fails. There are numerous types of these spurious claims. Sophisticated share-

29. For the general argument, see John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929 (1988). But see RESTATEMENT (SECOND) OF TORTS § 552(2) (1976) (providing an actual foreseeability standard in negligent misrepresentation cases).

30. See Siliciano, *supra* note 29, at 1942-51 (discussing tort law's reluctance to allow third-party recovery for pure economic loss). See also *Robins Dry Dock & Repair Co. v. Flint*, 275 U.S. 303 (1927).

holders who supported the transaction, based on their own sources of information and without significant reliance on any fairness opinion (perhaps they view the opinion as Profess Carney does—as “a magic piece of paper” necessary to close deals), will claim foul. Consider as well the position of arbitrageurs (arbs), those who buy after the announcement but before the exchange or tender of firm shares. An inappropriately low evaluation of value in a fairness opinion will injure those who sell to arbs, but arbs will have priced the low evaluation in what they will pay for the stock. Are the arbs injured when they tender or exchange their stock to close the deal if the final deal price, influenced by the opinion, is unfairly low? Arbs will, of course, claim injury based on their loss of upside potential gains, and courts will be hard pressed to ignore their pleas.

Finally, consider the effect of such a rule on the conduct of the major actors. Optimally, exposing investment bankers to shareholder actions will change bankers' behavior to reduce the number of negligently prepared fairness opinions. The deterrence rationale is simple and classic; yet, it is inherently overly optimistic. The reaction of investment bankers may not be to provide better fairness opinions as much as it will be to devise other strategies for limiting their liability exposure. The most obvious strategy is for investment bankers to refuse to give fairness opinions in high-risk cases. This is perhaps the most telling rebuttal to Professor Fiftis' gatekeeper scheme: there is no rule that forces investment bankers to stand guard at the gate.

Other avoidance strategies include indemnification provisions in client contracts³¹ or contractual provisions that limit damages.³² At a minimum, we ought to expect a magnification of current practice in which the bankers expressly disclaim any attempt at independent investigation and proclaim absolute reliance on figures submitted by firm employees in hopes that any errors in the opinion can be blamed on firm employees. Finally, as suggested by one court and favored by Professor Fiftis, bankers concerned with open-ended liability could “expressly limit in their certificates [read: fairness opinions] the persons or class of persons who

31. Professor Fiftis would prohibit indemnification provisions, but it is doubtful that investment bankers, as fiduciaries, would be entitled to less indemnification protection than that currently available to officers and directors. See REV. MODEL BUSINESS CORP. ACT, Subch. E, §§ 8.50-8.58 (1991). Professor Coffee suggests indemnification as a way out. See Coffee, *supra* note 28.

32. See Coffee, *supra* note 28. Coffee also suggests that a firm could agree to arbitration and forum selection clauses. Could the parties stipulate that Delaware, instead of New York, law applies to such suits?

would be entitled to rely upon the audit [read: evaluation]."³³

Even if there are marginal gains in the total quality of fairness opinions under a shareholder liability rule, such gains may be offset by the social losses generated by a reduction in the shareholders' incentive to look after their own affairs. The prospect of recovery from investment bankers for an improvident LBO could encourage shareholders to relax the vigilance they otherwise would have to maintain to look after their own interests.³⁴ In addition, a special committee of the board of directors, charged with representing the interests of the shareholders in an LBO and able to secure a comforting fairness opinion, also may relax its efforts to make sure the deal is priced fairly. For shareholders and for special committees, shareholder liability tends to transform a fairness opinion into a partial warranty of the LBO's fairness, and depresses such parties' incentives to take independent care. This, of course, would not be lost on investment bankers operating under a Fiftis rule; bankers would intensify their strategic efforts to avoid exposure to liability.

IV. FAIRNESS OPINIONS AS EVIDENCE OF DIRECTOR [Mis]CONDUCT

My approach to the question of liability for negligently prepared investment banker fairness opinions, initially outlined briefly four years ago in an article in the *Vanderbilt Law Review*,³⁵ is similar to that Bebchuk and Kahan take in their article in the *Duke Law Journal*.³⁶ The basic legal rules of current case law are essentially sound and need only a bit of tinkering to tune them up.

Apart from specialized violations of the federal securities acts and rules, investment bankers are not liable directly to shareholders for poorly prepared fairness opinions unless they aid and abet a breach of

33. *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138, 152 (N.J. 1983).

34. See Robert L. Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment*, 37 STAN. L. REV. 1513 (1985) (discussing tort law's effect on incentives).

35. Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 249-54 (1988).

36. Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27. The authors make the following recommendations: First, courts should develop a definition of fair price that they consider proper. Investment banks, in turn, should disclose their definitions of fair price. Second, to reduce discretion in the measurement of fair price, the weight given to a fairness opinion should depend on whether the opinion contains information on the range of fair prices and on the sensitivity of the price estimate. Third, courts should discount fairness opinions when the writing bank is compensated by a contingent fee, when it is involved in other aspects of the transaction, and when it has had prior dealings with the company at issue.

Id. at 53. I argue, in essence, that the third recommendation does not go far enough.

fiduciary duty by a firm's directors or officers. Shareholders must prove a breach of duty by directors or officers and knowing assistance in the breach by investment bankers. If proven, the primary defendants and the aiders and abettors are jointly and severally liable for the plaintiff's injury.³⁷ The threshold requirement of proof of a fiduciary breach by an officer troubles Professor Fiftis. He wants investment bankers to be culpable even if boards are not. I would rather that we narrow the size of the class of these cases; culpability of investment bankers usually ought to signal culpability of the board. Outside of aiding and abetting violations, shareholder's primary target ought to remain their own directors.

Boards use fairness opinions as shields to liability: a board relying on an expert opinion exercises due care. It ought to be evidence of a lack of due care, however, if a fairness opinion is patently contrived to support a board's predetermined result. Courts, outraged with providers over the shoddiness of conclusory fairness opinions, ought to turn their outrage against requesting boards as well for attempting to hide behind such ruses. Too often, courts stop one step short. Complaints about the practices of an investment banker should lead to inquiries into the practices of the requesting board. They should state that for a board to attempt to use shoddy opinions of experts in justification of proposed firm actions (or, at minimum, to waste a substantial amount of a firm's assets in paying for such poor work) is *evidence* of a possible breach of fiduciary duty.³⁸

Thus, if a board commissions a fairness opinion under a contingent fee, as in the *Metromedia* case, or commissions a fairness opinion from an investment banker who also will underwrite any debt securities used in a successful deal, and then relies heavily on such an opinion in pushing the transaction with its shareholders or in justifying its action before the courts, courts ought to use the board's opportunism against it. It is a racket, and the courts ought to label it as such. Of course, broadening the class of cases in which a board is liable primarily for a breach of duty to shareholders will also increase the number of potential aiding and abetting claims against bankers.

At present, an aiding and abetting charge against investment bankers,

37. *Laventhol, Krekstein, Horwath & Horwath v. Tuckman*, 372 A.2d 168 (Del. 1976).

38. For three examples in which courts did hold conclusory fairness opinions against sitting boards, see *Howing Co. v. Nationwide Corp.*, 826 F.2d 1470 (6th Cir. 1987), *cert. denied*, 486 U.S. 1059 (1988); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1988); *In re Meyers Parking Sys., Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,333 (Sept. 12, 1988).

brought by shareholders, requires knowing assistance by the defendants in a board's breach of duty to shareholders. Knowing assistance in such cases ought to include the preparation of fairness opinions that contain evaluations of a fair price when a banker knows he or she has done insufficient investigation and synthesis of even readily available facts, or when a banker knows that the opinion is misleading because it is grounded in an undisclosed and nonobvious standard of fairness.³⁹

It is possible (although much less likely than a collusion scenario) that a board has relied reasonably on an investment banker (the banker operated under no apparent conflict of interest, had sufficient time to do an investigation, had a reputation for competence and integrity, and responded well to board questions) and the fairness opinion later turns out to have been prepared incompetently. In those few cases in which a board is innocent of any culpable complicity in hiring an investment banker who submits a poorly done fairness opinion, the board as now ought to remain the primary complainant in court, basing its allegations for recovery from bankers on a breach of contract or a malpractice theory. These cases occur most frequently when a failed LBO firm is placed in the hands of a debtor in possession in bankruptcy, who, responsible for augmenting the bankruptcy estate for the benefit of the creditors, is looking for litigation targets.⁴⁰ Outside of bankruptcy proceedings, shareholders upset over a board's refusal to sue breaching investment bankers can bring a shareholder derivative action on behalf of the firm. At minimum, the board, in moving to dismiss a suit brought by shareholders, must explain to a judge its failure to prosecute.⁴¹

In suits against investment bankers, a change in doctrine on applicable standards of conduct is necessary to increase, at the margin, the routine performance of investment bankers who seek, for a fee, to provide fairness opinions. First, the courts and the SEC ought to look to the investment banking community for a better definition of professional standards

39. For a discussion of the many different *undisclosed* standards of fairness one sees in an opinion, see Bebchuk & Kahan, *supra* note 36, at 29-34.

40. The only case I know of in which an investment banker was held liable in damages was a case brought by a client, Rawson Food Stores, in Florida. The case is unreported. Rawson paid Prudential Bache Securities to advise it on the acquisition of 43 stores. When Rawson filed for bankruptcy, the debtor in possession sued Prudential, contending that the value of the purchased stores was far less than Prudential had opined. A jury awarded \$2 million to Rawson's owner and \$21.6 million to the company. See *Jury Awards Rawson \$23.6 million from Prudential Bache*, Assoc. Press, Aug. 30, 1988, available in LEXIS, Nexis library, AP file.

41. See *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (interested board may move to dismiss derivative action if adjudged by a court to be in the best interests of the firm).

that control the content of fairness opinions.⁴² If investment bankers balk, courts, relying on expert testimony,⁴³ or the SEC, using its rule-making authority, ought to encourage the investment banking community to action by threatening to fashion default rules. The SEC has made sporadic, tentative moves in this direction in its drafting Item 8 in Schedule 13e-3.⁴⁴

Second, and perhaps more important, is a recharacterization of the obligation of the investment banker to a client *firm* as one of fiduciary duty as well as contract, similar to the relationship of a lawyer to a client firm.⁴⁵ The traditional elements of a fiduciary relationship are present: the client hires an expert, relying on his or her reputation for competence and integrity, to give service that involves the sophisticated exercise of trained professional judgment and discretion and that a client cannot assess for quality at the time it is provided. An investment banker providing a fairness opinion should be treated like an attorney providing a legal opinion, an accountant providing an audit opinion, or a portfolio manager providing an investment opinion. Such a shift in doctrine would limit permissible conflicts of interest and establish minimum, nonwaivable standards of performance. Fiduciary principles add a duty of loyalty and a minimum standard of due care to the basic contractual duty of adequate performance as specified or implied in the terms of the agreement.⁴⁶ If courts treat investment bankers as fiduciaries (not to the shareholders but to the *firm*), courts will necessarily play a larger role

42. For an excellent preliminary effort at such guidelines, see Arthur H. Rosenbloom & Arthur H. Aufses III, *On Understanding Investment Banker Liability*, INSIGHTS, Apr. 1990, at 3.

43. See *Investment Banker Liability: Transcription of a Panel Discussion*, *supra* note 8, at 590-92, 597-601 (Remarks of Vice-Chancellor Carolyn Berger of the Delaware Court of Chancery; Remarks of Dale Arthur Oesterle). See also *Howing Co. v. Nationwide Corp.*, 826 F.2d 1470, 1479 (6th Cir. 1987), *cert. denied*, 486 U.S. 1059 (1988) (detailing requirements for a proper fairness opinion).

44. See, e.g., *Management Buyouts: Hearing Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce*, 100th Cong., 2d Sess. 1-10 (1988) (statement of SEC Chairman David Ruder) (the SEC was considering an expansion of the scope of SEC Rule 13e-3, 17 C.F.R. § 240.13e-3 (1991)). Item 8(a) contains a substantial amount of detail. It does not, however, ask drafters to specify the exact standard of fairness used. See *supra* note 25.

45. The relationship of investment banker to firm seems easily to meet the first part of the well-known basic definition. A fiduciary relationship exists when parties to a transaction do not meet on equal footing, i.e., when one party has full knowledge and the other does not, and the latter places confidence in the former, or whenever confidence is reposed in one who is able to exert influence over the party entrusting confidence. See *Dawson v. National Life Ins. Co.*, 157 N.W. 929 (Iowa 1916).

46. See *Broad v. Rockwell Int'l Corp.*, 614 F.2d 418, 430-31 (5th Cir. 1980) (distinguishing fiduciary duty from contract obligations).

regulating conflicts of interest.⁴⁷ Investment bankers will be prohibited from providing fairness opinions when they have conflicts of interest unless they, at minimum, fully disclose those conflicts to client boards and receive boards' assent and waiver.⁴⁸ Moreover, as for lawyers, in extreme cases broad grants of waiver, even with knowledge, will not sanitize the offending conduct. There are some cases in which bankers should not be able to provide fairness opinions because the conflict of interest is too severe.⁴⁹

CONCLUSION

We ought not use fairness opinions from investment lenders as substitutes for sound board judgment (as some boards have done) or for sound judicial evaluation of board judgment (as some courts have done) in control-change transactions. Nor should we use investment bankers as involuntary public policemen in such transactions; coercing both the police and the policed in such a system seems doomed in the long run, as both parties have incentives to collude in effecting the regulation's defeat. Rather, we ought to recognize that investment banker fairness opinions are primarily information for boards and, secondarily, if both opinion providers and boards agree, advertising aimed at shareholders. In both cases, the opinions are essentially optional, and the business judgment of a board, not a court, ought to be the primary determinate of whether a fairness opinion will be useful.

Moreover, the recipients of a fairness opinion expect that the service will meet minimal standards of competence and integrity, and this expectation, if frustrated, ought to give the direct recipients redress in court. If boards use contrived fairness opinions to protect themselves from shareholders' suits or to mislead shareholders who must approve a control change transaction, both board and banker ought to be liable jointly. Any more than this is problematic.

There is an overwhelming and understandable temptation for parties (including judges) involved in high stakes, high risk control change transactions to reduce their individual exposure to the risk of a decision that

47. For a fine discussion of the many conflict-of-interest problems found in the writing of fairness opinions, see Bebchuk & Kahan, *supra* note 36, at 37-45.

48. Boards ought to disclose fully those conflicts to shareholders as well whenever a board decides to communicate the contents of an opinion to them.

49. An investment banker representing both buyer and seller, for example, ought not to issue fairness opinions for either, even if either board solicits, with full knowledge, an opinion.

later proves wrong. This temptation often can lead to calls for soothing legal rules, as judges, for example, look for easy signposts for decisions in these complicated cases and as potential defendant classes seek either safe harbors or methods of shifting liability for decisions onto the backs of others participating in the transaction. We ought to resist such narcotics.

