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FAIRNESS OPINIONS: HOW FAIR ARE THEY AND WHY WE SHOULD DO NOTHING ABOUT IT

WILLIAM J. CARNEY*

INTRODUCTION

Professor Fiflis has provided an interesting description of the legal theories available to hold investment bankers liable for negligence for giving fairness opinions in takeout mergers and management buyouts.¹ Professor Fiflis has focused his presentation on a limited set of investment bankers' opinions—those ostensibly addressed to shareholders, or intended for shareholders' consumption.

Had he chosen, Professor Fiflis could have given us a parade of horrors, showing the dubious independence of investment bankers in all kinds of transactions. Investment bankers produce these opinions at the onset of takeover bids to permit directors to decide whether to defend against a bid; to justify the extent of the defense; and to justify arm's-length mergers, recapitalizations, and other transactions.² One could recite any number of cases in which investment bankers have given opinions about fairness, only to have a bid come in later at a price well above the range or price expressed in the opinion.³ Similarly, different invest-

* Charles Howard Candler Professor, Emory University Law School. I thank William L. Floyd, of the law firm of Long, Aldridge & Norman in Atlanta, for his helpful discussions on this subject. I also acknowledge the work of Lucian Bebchuk and Marcel Kahan, for providing the inspiration for this title. Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27. At the deadline for submission of the manuscript for these comments, I did not have access to a complete version of Professor Fiflis' paper, so it is possible that some of my comments may not fully address his article as it appears in print.

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

2. Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27.

3. For example, when management proposed a management buyout of Stokely-Van Camp at \$55 per share, which an investment bank declared "fair and attractive," a third-party bid appeared at \$77 per share. See Robert McGough, *Fairness for Hire*, FORBES, July 29, 1985, at 52; Longstreth Says Federal, State Laws Are Not Assuring Fairness in Buyouts, Sec. Reg. & L. Rep. (BNA) No. 40, at 1908, 1909 (Oct. 14, 1983); Robert J. Giuffra, Jr., Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 121 n.12 (1986). In *Kramer v. Western Pacific Industries, Inc.*, 546 A.2d 348, 350 (Del. 1988), an investment banker opined that a bid of \$155 was

ment bankers can arrive at widely differing estimates of a fair price.⁴ In one merger transaction, we witnessed an investment banker lower its estimate of the value of the target and raise its estimate of the value of the bidder to justify an exchange ratio.⁵ In a recapitalization transaction the market price of the stock quickly exceeded the investment banker's estimate of fairness, which required an increase in the cash payment to shareholders from seventy to eighty dollars.⁶ In one case, the investment banker added five dollars per share to its estimate of the value of a management recapitalization when a hostile bidder raised its bid.⁷ In another, an investment banker set the value of a company at forty-five dollars per share in response to a hostile bid, and within a year declared that thirty-eight dollars and fifty cents was fair in a friendly acquisition.⁸ In a squeezeout merger, a banker claimed that twelve dollars was fair, even though it previously had stated that sixteen dollars was an excellent value for the shares.⁹ In other cases in which managers were fending off bids, investment bankers made predictions about future values of the target that were off the mark in spectacular fashion.¹⁰

In short, one might argue that Professor Fiflis has been too kind, since his paper does not contain the parade of horrors I have just recited. That is, however, not the point. Rather, I argue that Professor Fiflis has misconceived the role of the fairness opinion. Rationales for imposing

fair, only to see a subsequent bid at \$163. *See also* *In re Trans World Airlines Shareholder Litig.*, No. 9844, 1988 Del. Ch. LEXIS 139 (Del. Ch. Oct. 21, 1988) (investment banker concluded that \$20 cash plus \$20 in notes was fair, followed by a bid of \$20 cash and \$30 in notes).

4. *See, e.g.*, *Bebchuk & Kahan, supra* note 2, at 29 n.16 (citing *Joseph v. Shell Oil Co.*, 482 A.2d 335, 339 (Del. Ch. 1984) (estimates ranging from \$53 to \$85 per share); *Smith v. Shell Petroleum, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,316 (Del. Ch. June 19, 1990) (parent's expert said \$55 was fair while the subsidiary's banker stated that \$75 was the lower end of fairness); *Kahn v. United States Sugar Corp.*, No. 7313, 1985 WL 4449 (Del. Ch. Dec. 10, 1985) (from \$52 to \$122); *Kaplan v. Goldsamt*, 380 A.2d 556, 566-67 (Del. Ch. 1977) (from \$7.25 to \$9.50)). *See also* *Kahn v. Household Acquisition Corp.*, 591 A.2d 166 (Del. 1991) (\$6 to \$10 from opposing experts).

5. *In re Triton Group Shareholders Litig.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,876 (Del. Ch. Feb. 22, 1991).

6. *FMC Corp. v. Boesky*, 727 F. Supp. 1182, 1186-87 (N.D. Ill. 1989).

7. *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772, 774-78 (D. Del. 1988).

8. *Beebe v. Pacific Realty Trust*, 578 F. Supp. 1128 (D. Or. 1984).

9. *Simons v. Cogan*, 549 A.2d 300 (Del. 1988).

10. *See, e.g.*, *Paramount Communications, Inc. v. Time, Inc.*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,514, at 93,273 (Del. Ch. July 14, 1989) (predictions of a range of prices for 1991 of \$159 to \$247 when actual prices for the twelve months ended Nov. 7, 1991 ranged from \$72 to \$125, with a closing price of \$87.75), *aff'd*, 571 A.2d 1140 (Del. 1989).

liability on investment bankers should not be drawn from cases involving accountants. This is an area in which we should observe Cardozo's caution to beware of metaphors, or in this case, similes.¹¹ Instead, we should examine with care the distinctive role played by investment bankers in corporate America.

It is more useful to think of fairness opinions as assuring the continued application of the business judgment rule during an era when it has been under severe attack. Viewed in that light, the fairness opinion has served corporations and their stockholders well. I believe that fairness opinions exist for two reasons: a judicial belief in the determinacy of value, and legal rules that shelter the business judgment of a board when based on reliance on the opinion of experts. Except in rare instances, investment bankers do not deliver fairness opinions for the benefit of public shareholders. Further, the nature of the fairness opinion is such that neither courts nor investors should attach too much weight to it nor impose liability because of it, except in instances of fraud.

I. FOR WHOM DO INVESTMENT BANKERS DELIVER OPINIONS?

A. *The Real Function of Fairness Opinions*

The purposes of the business judgment rule are at least two. First, the rule confines directors and courts to their own fields of competence. Second, and more important, it encourages directors to take reasonable risks in the face of uncertainty.¹² The takeover movement of the 1980s highlighted the problems facing directors in making decisions. The decisions involved larger sums, and the difficulties of obtaining complete information were all that much more obvious. A mistake under these conditions could be a billion dollar mistake.¹³

That by itself was not bad, although it would make even the boldest director fear legal liability. But when courts began to second-guess directors, the message became quite clear: the business judgment rule appeared to be eroding.¹⁴

11. *Berkey v. Third Ave. Ry.*, 155 N.E. 58, 61 (N.Y. 1926), cited in Fiftis, *supra* note 1, at 500.

12. See generally *Joy v. North*, 692 F.2d 880, 885 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

13. For a general description of the complexities of responding to unsolicited bids, see William J. Carney, *Controlling Management Opportunism in the Market For Corporate Control: An Agency Cost Model*, 1988 WIS. L. REV. 385.

14. Recognizing that unsolicited takeover bids place management in a peculiar position, similar but not identical to a conflict of interest, the Delaware Supreme Court crafted an intermediate stan-

The Delaware Supreme Court created more mischief than it knew in the *Trans Union* case when it stated that the *Trans Union* Board had an obligation to investigate the intrinsic value of *Trans Union* before agreeing to sell the company.¹⁵ Because of past references to the market price of the company's stock as below its "intrinsic value," the court held that the board could not rely on the market price alone in determining that the price offered, a thirty-eight percent premium over the market, was fair.¹⁶ While the opinion was explicit that fairness opinions were not required as a matter of law, it was also explicit that something more than knowledge of the market price was required, and that somehow the Board should have tried to determine the intrinsic value of the stock.¹⁷ Since that time, the Delaware courts have had to repeat their claim that fairness opinions are not required as a matter of law, apparently because litigants believed the holding more than the dicta in the *Trans Union* case.¹⁸

Now, I am not a believer in intrinsic values of economic goods.¹⁹ Justice White expressed it well in *Basic, Inc. v. Levinson*, when he criticized the majority's reference to the value of stock:

dard of review in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985), requiring managers first to demonstrate a threat to the corporation and then that the response is "reasonable in relation to the threat posed." *Id.* at 955.

The Delaware Supreme Court hinted that the Chancery Court had intruded too far into the board's domain in *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152 (Del. 1989). The court mentioned some lower court opinions that the *Time* plaintiffs had used to argue that only a coercively structured two-tier bid was justification for management resistance. The court stated that this would involve substituting the court's view of what is a better deal for that of the board of directors, and "[t]o the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis." *Id.* at 1153.

15. *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985).

16. *Id.* at 878.

17. *Id.*

18. The dicta appears *id.* at 881. Subsequent restatements are found in *Oberly v. Kirby*, 592 A.2d 445, 472 (Del. 1991); *Seagraves v. Urstadt Property Co.*, 1989 Del. Ch. LEXIS 155 (Del. Ch. Dec. 4, 1989); *Ince & Co. v. Silgan Corp.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,842 (Del. Ch. Feb. 7, 1991). See also *Cottle v. Storer Communication, Inc.*, 849 F.2d 570, 578 (11th Cir. 1988). But see *NCR Corp. v. AT&T*, 761 F. Supp. 475, 492 (S.D. Ohio 1991) (rejecting adoption of a leveraged ESOP as a defense without a fairness opinion as to the unsolicited takeover bid).

19. The leading finance text contains no reference whatever to "intrinsic value." See generally RICHARD BREALEY & STEWART MYERS, *PRINCIPLES OF CORPORATE FINANCE* (2d ed. 1984). For a general description of valuation, see *id.* at 61-83; see also Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. BAR FOUND. RES. J. 875, 885-89 (1983); David Cohen, Comment, *Valuation in the Context of Share Appraisal*, 34 EMORY L.J. 117 (1985).

[T]he meaning of this phrase eludes me, for it implicitly suggests that stocks have some "true value" that is measurable by a standard other than their market price. While the Scholastics of Medieval times professed a means to make such a valuation of a commodity's "worth," I doubt that the federal courts of our day are similarly equipped.²⁰

I believe he would make the same comment about investment bankers. A good is only worth what a willing buyer will pay for it — no more, no less. The Delaware Supreme Court ignored this fundamental truth of economics, ignored the efficient market in which the company's stock was traded, and concluded that the board either must have additional information before deciding to recommend a sale to the shareholders or face the risk of liability.

That single opinion could be called the Investment Bankers' Civil Relief Act of 1985. Other opinions overthrew board actions for lack of sufficient information and disinterested advice.²¹ The strong message was that boards could protect their decisions only if they met a quantitative standard of information set by the courts.²² Only if they met this threshold could they be permitted to say they had made an informed business judgment. I believe these decisions were misguided to the extent the courts second-guessed the decisions of boards about how much information they required before acting. A decision about the quantity of information required for a decision is no less a business judgment than the decision of what to do about it.²³

The pressure to use investment bankers was reinforced by specific statutory language protecting directors from liability when they rely on the advice of experts. This language is found not only in Delaware's act, but also in virtually every such statute in the country.²⁴ These statutes pro-

20. *Basic, Inc. v. Levinson*, 485 U.S. 224, 255 (1988) (White, J., concurring) (citations omitted).

21. *See, e.g., Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986) (failure of board to be sufficiently critical of fairness opinion). I have a personal recollection of the impact of this decision, recounted *infra* text following note 54, when the investment bankers involved in the Hanson Trust decision made every effort to make a record that additional information would not change their opinion.

22. The model was set in *Hanson Trust*, 781 F.2d at 275, in which the court cited the procedures followed in *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 384 (2d Cir. 1980), as an example of the procedures omitted by the SCM board. The result, of course, has been the production of a script for the successful defense of board actions defending against a hostile bid.

23. William J. Carney, *Section 4.01 of the American Law Institute's Corporate Governance Project: Restatement or Misstatement?*, 66 WASH. U. L.Q. 239, 281-83 (1988).

24. DEL. CODE ANN. tit. 8, § 141(e) (1991); REV. MODEL BUSINESS CORP. ACT § 8.30(b) (1984).

vide that a director shall "be fully protected in relying in good faith upon . . . information, opinions, reports or statements presented . . . by any . . . person as to matters the member reasonably believes are within such other person's professional or expert competence. . . ."25

Under these circumstances, it is not surprising that every board in the country, faced with a decision about selling the company or engaging in any other transaction in which an expert's opinion would provide some cover, would seek such an opinion. These opinions served primarily to protect decisions boards had already decided to make and to protect board members from huge potential liabilities.

These opinions provide less information than they do protection. And the protection is not for shareholders, but for the directors themselves, and for their decision. The investment banker's fairness opinion thus becomes another costly tax that legal rules impose on business transactions.

B. Disclosure to Investors: By Contract or By Mandate?

Professor Fiflis squarely addresses the doctrinal difficulties involved in arguing that fairness opinions are produced for the benefit of shareholders. In his discussion of *Schneider v. Lazard Freres & Co.*, he notes that the case is grounded on the unique circumstances of a buyout, in which the court could argue that shareholder, rather than corporate, action was involved, and that the special committee served as an agent for the shareholders.²⁶ He then examines whether that rationale would be available in other transactional contexts as well. But he does not examine whether *Schneider's* rationale was correct. It was not. The proposed transaction involved a merger, which, as a matter of Delaware law, required a vote of the board.²⁷ Thus it involved corporate action, not shareholder action, at least within the conventions of corporate law. As one article pointed out, the board "has an independent and non-delegable statutory duty to approve the proposed transaction: it is only if the board approves the proposed merger that it goes to the shareholders with the Board's

25. DEL. CODE ANN. tit. 8, § 141(e) (1991).

26. Fiflis, *supra* note 1, at 506 (discussing *Schneider v. Lazard Freres & Co.*, 552 N.Y.S.2d 571 (App. Div. 1990)).

27. See *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,194 (Del. Ch. Jan. 31, 1989); DEL. CODE ANN. tit. 8, § 251(b) (1991). For further criticism of the *Schneider* decision, see John C. Coffee, Jr., *New York's New Doctrine of Constructive Privity*, N.Y. L.J., Jan. 25, 1990, at 5; Donald Lund, Comment, *Toward a Standard for Third-Party Advisor Liability in Mergers and Buy-Outs: Schneider and Beyond*, 52 U. PITT. L. REV. 603, 618-20 (1991).

recommendation."²⁸ Further, Professor Fiflis ignores Delaware courts' explicit holdings that there is no legal obligation to obtain a fairness opinion for the benefit of shareholders.²⁹

Agency is a consensual relationship, and consent by the investment bankers to serve as shareholders' agents is generally lacking in the context of fairness opinions.³⁰ There is some evidence about the nature of the contracts investment bankers enter into with boards, but Professor Fiflis does not discuss it. In some hostile takeover situations, the investment banker's fairness opinion will be delivered for one price if it is available only for the board and management, and for a higher price if it is made public.³¹ Obviously, the possibility of public disclosure is a contemplated contingency, but it is equally obvious that bankers regard such disclosure as a negative event for which they demand a higher fee. There may, of course, be cases in which investment bankers contract to represent public shareholders, but I suspect these have been the exceptions, and that few well-informed bankers will do so today, given the current state of New York law.³²

In the context of a takeover merger or a management buyout of public shareholders, there is no chance of keeping the opinion private because Schedule 13E-3 requires its disclosure.³³ I am informed by a wise and experienced practitioner that the same is true today in arm's-length mergers because the SEC staff insists on equivalent disclosures. Under these circumstances, fee arrangements will not contain two separate scales since there is nothing voluntary about the disclosure. Would the opinion otherwise be disclosed to public shareholders? One can only conclude that the perceived need to mandate such disclosure suggests

28. Herbert M. Wachtell et al., *Investment Banker Liability to Shareholders in the Sale-of-Control Context*, N.Y. L.J., Mar. 29, 1990, at 1. The law has changed somewhat in Model Act jurisdictions, where the board can now forward a proposal to the shareholders without recommendation, if it provides the reasons for doing so. REV. MODEL BUSINESS CORP. ACT § 11.03(b)(1) (1984).

29. See *supra* note 18 and cases cited therein.

30. Lund, *supra* note 27, at 620. Certainly investment bankers would not voluntarily assume such sweeping fiduciary duties.

31. See, e.g., *Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179, 183 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054, 1060 (1989); *Anderson v. Boothe*, 103 F.R.D. 430 (D. Minn. 1984). *But see Hecco Ventures v. Avalon Energy Corp.*, 606 F. Supp. 512 (S.D.N.Y. 1985) (fixed fee).

32. See, e.g., *Drobbin v. Nicolet Instrument Corp.*, 631 F. Supp. 860 (S.D.N.Y. 1986).

33. Schedule 13E-3, Item 9, 17 C.F.R. § 240.13e-100 (1991). I am informed that the SEC staff requires similar information in connection with self-tender offers under Schedule 13E-4, 17 C.F.R. 240.13e-101 (1991), and in connection with arm's-length mergers under Rule 145, 17 C.F.R. § 230.145 (1991) and Form S-4, although these requirements are not explicit in the forms.

that it would not. The SEC seems to admit in its rules mandating disclosure to shareholders that the opinion is not produced for them, but for the board.³⁴

All of this discussion begins with a handful of cases involving the liability of accountants to third parties for negligent audits.³⁵ But the analogy to the accountants' certificate is less than compelling. Accountants produce a certificate knowing that someone other than the board will attach significance to it. The modern theory of the firm argues that an independent audit is one way in which managers promise shareholders, prospective investors, and creditors that they will not divert funds for their own purposes, and that the audit is a means by which investors and creditors can be assured of monitoring managers' performance.³⁶ Viewed in this light, the early cases and their progeny are outdated, since accountants are today on notice that shareholders, prospective investors, and creditors would rely on their certificate. And yet the law has not gone that far, as Professor Fiflis has pointed out in his discussion of *Credit Alliance Corp. v. Arthur Andersen & Co.*³⁷

The New York case law is troubling on a variety of scores. The *Wells*³⁸ opinion asserts that the special committee of the board was constituted to serve the shareholders by determining the fairness of a management buyout.³⁹ The opinion cites no facts in support of that conclusion; it merely asserts this based on the pleadings. One could just as easily conclude that the special committee was created to insulate the transaction from charges of conflict of interest and to shift the burden of proof on the fairness question from the directors to the plaintiffs.

A recent decision refusing to dismiss a suit against investment bankers illustrates the point. In *Coronet Insurance Co. v. GACC Holding Co.*,⁴⁰

34. See Coffee, *supra* note 27.

35. See, e.g., *Ultramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931) (holding accountants not liable); *Credit Alliance Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110 (N.Y. 1985) (distinguishing between lenders who relied on audited financial statements on the basis of "near privity"). But see *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968) (holding accountants liable).

36. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 323 (1976).

37. 483 N.E.2d 110 (N.Y. 1985), discussed in Fiflis, *supra* note 1, at 500.

38. *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 8 (N.Y. 1988).

39. *Id.* at 2. Coffee, *supra* note 27, states that the decision could be read as a misrepresentation case, but "the language of the decision comes close to adopting an agency theory. . . ."

40. No. 90-c-07189, 1991 U.S. Dist. LEXIS 12120 (N.D. Ill. Aug. 27, 1991) (applying New York law). The investment banker's contract with the debtor expressly provided that "nothing in

the investment bankers gave an opinion on the interest rate required to bring reset notes to 101% of par, and were sued on the theory that the noteholder-plaintiffs were third-party beneficiaries of the contract between the debtor corporation and the investment bankers. The court noted that the Noteholders Agreement required the use of an investment banker to reset the interest rate, and held that this created a reasonable expectation of reliance by the noteholders on the investment bankers. No such agreement exists in the ordinary takeover situation.

Professor Fiflis relies on Judge Duffy's dissent in *Weinberger v. UOP* for his conclusion that *Wells* would lead to a holding that minority shareholders would have standing in Delaware to sue investment bankers for negligent preparation of a fairness opinion.⁴¹ He has not discussed a 1990 opinion of the Chancery Court, *In re Shoe-Town, Inc. Stockholders Litigation*, that distinguished *Wells* because the investment advisor in *Wells* was hired by a special committee charged solely with determining the fairness of the transaction for the shareholders.⁴² That distinction seems largely artificial, since the *Shoe-Town* transaction was a management-led buyout, as was that in *Wells*. Vice Chancellor Chandler rejected a reading of the Chancery Court opinion in *Weinberger v. UOP* as providing a blanket rule that investment bankers owe fiduciary duties to shareholders in rendering fairness opinions.⁴³ The language of the opin-

this agreement, expressed or implied, is intended to confer on holders of the securities . . . any rights or remedies under or by reason of this agreement." *Id.* at *1. The court recognized the general rule that allows disclaimers of third-party rights, but questioned "the underlying soundness of applying that rule under the particular circumstances present here, where the party alleged to have committed a breach is on notice that its own contract has its genesis in a prior contract establishing both the existence of a beneficiary and obvious reliance by the beneficiary on the services at issue." *Id.* at *9. The court ignored the contrary holding of *City of New York v. Kalisch-Jarcho, Inc.*, 554 N.Y.S.2d 900, 901 (App. Div. 1990).

41. Fiflis, *supra* note 1, at 503 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)). In *In Re Shoe-Town, Inc. Stockholder Litigation*, No. 9483, 1990 Del. Ch. LEXIS 14, at *19 (Del. Ch. Feb. 12, 1990), the Chancery Court noted its own opinion in *Weinberger v. UOP, Inc.*, 426 A.2d 1333, 1348 (Del. Ch. 1981), to the effect that ". . . Plaintiff has offered no authority to indicate that an investment banking firm rendering a fairness opinion as to the terms of a merger owes the same fiduciary duty to the minority as does the majority. . . ."

42. *Shoe-Town*, 1990 Del. Ch. LEXIS at *20-21. The Chancery Court attempted to distinguish *Wells* because the investment banker that advised the special committee in *Shoe-Town* was hired by management, rather than by the special committee, as in *Wells*. *Id.* at *20. But this only means that the disinterestedness of the investment banker was subject to question in *Shoe-Town*, not that its contractual obligations were different. The statement that Professor Fiflis had not discussed the *Shoe-Town* decision refers to the paper presented at the conference, which formed the basis for these comments.

43. *Id.* at *19-20.

ion on the subject is fairly sweeping:

Indeed, it escapes reason to say that an investment bank hired by a management group taking a company private, such as in the present situation, would stand in a relationship with a given corporation and its stockholders similar to the relationship of a trustee to his *cestui que trust*. [citation omitted] In addition, because a fairness opinion or an outside valuation is not an absolute requirement under Delaware law, it makes little sense to strap those investment banks, who are retained, with the duties of a fiduciary.⁴⁴

This Chancery Court opinion is consistent with the law in at least some jurisdictions other than New York.⁴⁵ This is not to deny that other courts have held that investment bankers can be liable to shareholders for negligent preparation of fairness opinions.⁴⁶ It is, however, to deny that this extension of liability represents good policy.

II. DIFFERENCES BETWEEN FAIRNESS OPINIONS AND ACCOUNTANTS' CERTIFICATES

A. *The Objects of Measurement of Fairness Opinions and Accountants' Certificates*

There are distinct differences in what accountants and investment bankers measure that should give pause in using the analogy to accountants to justify imposing negligence liability on investment bankers. Accountants verify observable historical facts that have been recorded in business records. They can seek evidence to support the entries in these records. Because of the objectivity of the facts they examine, they can establish regular audit procedures designed to assure, with reasonable certainty, that a company's financial records fairly reflect its financial condition. Indeed, if there is a criticism of what accountants do, it is that they are so bound to historical transaction records that their work is of little use in determining the value of an enterprise.⁴⁷ That value is determined less by past transactions than by future transactions and the future revenues they will produce.

Professor Fiflis correctly notes the lack of an agreed definition of fair-

44. *Id.* at *21-22.

45. Lund, *supra* note 27, at 605-08 (discussing Pennsylvania law).

46. *Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054, 1060 (1989); *Dowling v. Narragansett Capital Corp.*, 735 F. Supp. 1105 (D.R.I. 1990); *Schneider v. Lazard Freres & Co.*, 552 N.Y.S.2d 571 (App. Div. 1990).

47. George J. Benston, *Accounting Numbers and Economic Values*, 27 ANTITRUST BULL. 161 (1982).

ness.⁴⁸ In Delaware, a management leveraged buyout presumably triggers a *Revlon* obligation to put the company into an auction, which suggests that a fairness opinion must address the probable outcome of an auction.⁴⁹ On the other hand, the measure of fairness in a cash take-out merger is less obvious. One might argue that the company is in effect being sold to a majority shareholder, which should trigger *Revlon*, but this is inconsistent with the realities, in which the majority shareholder is merely exercising powers that all investors knew in advance it possessed and for which it presumably paid a control premium.⁵⁰ Thus, we must consider whether the minority is only entitled to some measure of firm value less a minority discount. Even that begs the question of what value we should use. Should we assume that the minority is under no obligation to sell, and is entitled to bargain at arm's length with the majority? As I said, that may be a useful fiction, but it remains very much a fiction.

B. *The Difficulties With Fairness Predictions*

Whatever legal measure we set for fairness only deals with the easiest of the problems in determining it. It is easy to give fairness opinions when an auction has been conducted, and every potential bidder has had the opportunity to inspect the selling corporation before deciding whether to bid. In a fairness opinion delivered under circumstances in which no auction has been held, as in a take-out merger, the investment banker is asked to render an opinion about the probable behavior of many participants in the market without observing them. This is the most hypothetical of exercises, one economists traditionally avoid in favor of observing revealed preferences. The investment banker cannot predict with accuracy the fit of the target's business with that of all prospective bidders. In many cases, the investment banker cannot foresee the particular synergies that might impel one firm to bid. For that reason, investment bankers cannot specify a single price that is "fair." They can only specify a range of prices that reflect their educated guesses about the probable range of synergies available to various buyers. The reports are full of cases in which investment bankers do no more than

48. Fifiis, *supra* note 1, at 517; see also Bebchuk & Kahan, *supra* note 2, at 30-34.

49. *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

50. See generally William J. Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 WASH. U. L.Q. 1 (1987). In a recapitalization, the Chancery Court was offered the opportunity to say that the *Revlon* duties were triggered, but declined to do so. *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787, 801-04 (Del. Ch. 1988).

indicate a range of fairness or whether a particular price falls within such a range.⁵¹ The reports are, to my knowledge, devoid of any cases in which investment bankers zero in on a single number called "intrinsic value." As Judge Easterbrook has said, "fairness is a range, not a point."⁵² It is not surprising that the range of prices usually covers the price at which the takeout or management buyout is to occur. Judge Easterbrook has pointed out that a price could be within a range of fairness and still be inadequate, presumably if the investment banker believed there was a high probability that the winning bid would be in the upper half of the range.⁵³

Another difficulty with asking investment bankers to predict the hypothetical outcome of an auction is that they are faced with the "Winner's Curse," which suggests that the winner of any auction is the one who paid too much.⁵⁴ "Too much" in these cases is based on the consensus valuation of the other participants in the auction, all of whom agree that the winner paid too much. How can an investment banker be expected accurately to predict an outcome when some behavior is viewed as irrational by most informed observers?

Anecdotal evidence is always suspect, but one example from my own experience may be helpful in understanding this point. A few years ago, a potential buyer approached the officers of a small public company. In the course of two days of intensive negotiations, they struck a deal for a cash merger, and a board meeting was called to approve the transaction. The directors were assisted in their evaluations by well-known investment bankers who had participated in the negotiations and who were prepared to render a fairness opinion. The essence of the fairness opinion

51. See, e.g., *Ridings v. Canadian Imperial Bank of Commerce Trust Co.* (Bahamas), 94 F.R.D. 147 (N.D. Ill. 1982); *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279 (Del. 1989); *In re Triton Group Shareholders Litig.*, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,876 (Del. Ch. Feb. 22, 1991); *Braunschweiger v. American Home Shield Corp.*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,779 (Del. Ch. Oct. 26, 1989); *Freedman v. Restaurant Assoc. Indus., Inc.*, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,502 (Del. Ch. Oct. 16, 1987).

52. *Harris Trust & Sav. Bank v. Ellis*, 810 F.2d 700, 706 (7th Cir. 1987).

53. *Id.*

54. See, e.g., Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 625-26 (1989); James C. Cox & R. Mark Isaac, *In Search of the Winner's Curse*, 22 ECON. INQUIRY 579-80; Paul Milgrom, *Auctions and Bidding: A Primer*, 3 J. ECON. PERSP., Summer 1989, at 3, 3-4; Paul Milgrom, *Private Information in an Auctionlike Securities Market*, in AUCTIONS, BIDDING AND CONTRACTING: USES AND THEORY 137, 140 (Richard Engelbrecht-Wiggans et al. eds., 1983); Michael Bradley et al., *Synergistic Gains From Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, 21 J. FIN. ECON. 3, 27-30 (1988).

was as follows: "We are not prepared to name a range of fairness, much less a single 'fair' price. The price being offered for your company is so high it is off any chart we might prepare." In this case, using even the most optimistic projections of future earnings for the seller, the expected returns on the purchase price appeared to be below two percent per annum. Apparently, the buyer knew something the target did not know and could not even imagine. Yet placing too much weight on a fairness opinion assumes that the investment banker will be able to divine all that information.

Finally, let us examine the hypothetical situation in which the take-out merger involves a negotiated transaction between the majority shareholder and independent directors who represent the minority shareholders. The banker is asked to determine the gains from trade, which consist in part of agency-cost savings (which cannot be accurately predicted) plus the gains to the majority shareholder from being freed of constraints imposed by the presence of minority shareholders,⁵⁵ less the corresponding costs of the takeout, which may consist of the increased risk associated with reduced diversification and higher leverage. The banker must then predict the outcome of bargaining between the two parties over how these gains will be shared. Keep in mind that neither party knows the exact extent of these gains or what the other party believes those gains to be. In economic terms, they are asked to predict the situation portrayed by the Edgeworth Box⁵⁶—bargaining under conditions of bilateral monopoly—when there is general agreement that the outcome is indeterminate.

All this suggests that the preparation of a fairness opinion is an art and not a science. It does not lend itself to the precision of the accountants' certificate. The creation of due-diligence check lists under these circumstances is the creation of an illusion of precision. To expect the courts skillfully to craft minimum standards of care is to expect too much.

III. INVESTMENT BANKERS AS GATEKEEPERS

Professor Fifis argues that holding investment bankers liable for negli-

55. For an explanation of the costs of co-ownership, see Carney, *supra* note 50.

56. See generally ARMEN A. ALCHIAN & WILLIAM R. ALLEN, *UNIVERSITY ECONOMICS* 47-49 (3d ed. 1972); see also Robert L. Birmingham, *Damage Measures and Economic Rationality: The Geometry of Contract Law*, 1969 *DUKE L.J.* 49; Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 *COLUM. L. REV.* 554, 563-68 (1977).

gent preparation of fairness opinions is justified by the reliance of shareholders on investment bankers' opinions. He presents no evidence to support his assertion, and he misses the point. The real question should be: Do shareholders have any reason to rely on these opinions? Rather than answer that question, Professor Fiflis argues instead that bankers should serve as gatekeepers and that good public policy argues for holding them liable, since bankers can stop transactions that would be harmful to shareholders.⁵⁷

Professor Fiflis relies on the work of Reinier Kraakman for his gatekeeper arguments.⁵⁸ Kraakman's approach focuses on events that are relatively specific—securities fraud being the primary example.⁵⁹ As I have tried to argue, nothing is less specific than the question of fairness. Indeed, Kraakman argues that imposition of gatekeeper liability “requires the prudent crafting of circumscribed duties to monitor and to respond that, above all, do not ask too much from their targets.”⁶⁰ Nothing could be further from that description than imposing gatekeeper liability on investment bankers for fairness opinions.

IV. DIFFICULTIES WITH REFORM PROPOSALS

A. *The Objections to Reform Proposals*

The proposals for reform of the legal rules governing fairness opinions illustrate what critics think is wrong with them. While some of the proposals seem harmless enough, others would increase the cost of such opinions and thus would increase the regulatory tax on the transactions in which they are required. But even the harmless proposals would do little to further the goals of the critics.

The most modest proposals for reform attempt to set up procedural safeguards to protect investment bankers from conflicts of interest. To this extent, they do little more than mirror several court decisions. For example, these proposals would ban the use of performance fees, tied to defeat of bids or to success of white-knight transactions, for investment bankers rendering fairness opinions.⁶¹ One might also expect the critics to encourage retention of investment bankers for this purpose by in-

57. Fiflis, *supra* note 1, at 514-15. See also Giuffra, *supra* note 2, at 125-27 (1986).

58. Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984), cited in Fiflis, *supra* note 1, at 514 n.75.

59. Kraakman, *supra* note 58, at 888-96.

60. *Id.* at 893.

61. See Bebchuk & Kahan, *supra* note 2, at 38-41, 49-51 and cases cited therein.

dependent directors, rather than by the managers who have proposed a particular course of action.

The European Economic Community has gone one step further in its proposals for the harmonization of legal rules governing business combinations. It requires the use of experts appointed by a government agency for the purpose of rendering a fairness opinion.⁶² To my knowledge, no one has yet suggested for American corporations that extreme an abandonment of the primary role of the board in selecting experts on whom they can rely, but it does represent a logical, if extreme, step in eliminating concerns over conflicts of interest.

The problems with liability rules are the extreme difficulties in formulating useful standards, coupled with the costs imposed on transactions by the risks and uncertainties created. I have little hope that American courts can develop a reasonable set of due-diligence standards that will allow them to impose liability for negligent preparation of fairness opinions without creating such costs. The Delaware courts, for example, have been noteworthy in their obtuseness in developing valuation techniques in appraisal proceedings. The Delaware Block method of valuation has been cogently criticized as bearing no particular relationship to values that might be set either by markets or modern financial analysis.⁶³

B. *Who Will Protect Shareholders?*

Professor Fifiis has described a dilemma that I have thus far evaded: if directors can gain the shield of the business judgment rule by employing investment bankers for fairness opinions, and if investment bankers are not liable to shareholders for negligent preparation, what protects shareholders?⁶⁴ Contracts, markets, independent directors, and courts willing to set aside unfair transactions can provide protection. New liability rules are not required for this purpose.

Nothing prevents shareholders from writing contracts to preclude majority shareholders of a corporation from engaging in a takeout merger or to forbid managers from engaging in a buyout. Indeed, in the context of hostile takeover bids, these contracts are well known in the form of shark-repellent amendments.⁶⁵ To suggest that investors cannot obtain

62. European Community, Third Council Directive of 9 Oct. 1978, (78/855/EEC), Ch. II, Art. 10 (Official Journal No. L295).

63. Fischel, *supra* note 19, at 890-93; Cohen, *supra* note 19, at 126-27.

64. See, Fifiis, *supra* note 1, at 506-07.

65. See generally William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and*

such protection is to engage in the notion Frank Easterbrook once described as the investor waking up from a deep sleep and saying, "Woe is me, I'm powerless. . . ." ⁶⁶ There are any number of ways investors can contract against takeout mergers, or at least against overreaching in such mergers. ⁶⁷ It would be as simple to preclude managers from offering to buy the firm. We do not see such contracts, strongly suggesting that many such offers benefit shareholders. ⁶⁸

Markets may provide the strongest form of protection for minority and public shareholders in takeouts and management buyouts. I know of no case in which shareholders have agreed to a transaction when the consideration was below the pre-announcement market price. If that is so, and if there are comparable investments available in the market, investors are always better off in takeouts and buyouts to which they assent. ⁶⁹ Even in takeouts in which minority shareholders have no voice, because the merger is either a short form or is not conditioned on approval of the minority shareholders, the number of cases in which the consideration is below the pre-announcement market price is either zero or trivial. In most cases, even if the consideration were below market price, shareholders would be protected by appraisal rights, although admittedly this is not the case in Delaware. ⁷⁰ That such takeouts or buyouts do not occur even absent such appraisal protection strongly suggests that market forces, not legal rules, are the primary protection for

Takeout Mergers: The Case Against Fiduciary Duties, 1983 AM. BAR. FOUND. RES. J. 341 [hereinafter *Shareholder Coordination Costs*]; William J. Carney, *Two-Tier Tender Offers and Shark Repellents*, 4, No. 2 MIDLAND CORP. FIN. J., Summer 1986, at 48.

66. Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 542 (1984).

67. Carney, *supra* note 50, at 49-53.

68. See Jeffrey Davis & Kenneth Lehn, *Information Asymmetries, Rule 13e-3 and Premiums in Going Private Transactions*, 70 WASH. U. L.Q. 587 (1992).

69. Cf. Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982). (This depends on the adoption of efficient decision rules within firms, however. See Carney, *Shareholder Coordination Costs*, *supra* note 65.) I thus reject the thesis of A.A. Sommer, Jr., in "Going Private" *Seventeen Years Later*, 70 WASH. U. L.Q. 571 (1992), that going private is nearly always unfair, because managers or majority shareholders earn some profits that otherwise could have been earned for all shareholders. That is a form of the Nirvana fallacy, which compares an ideal world with the second-best position of the real. The point is not that managers could have earned these profits for all shareholders; they did not, and whatever incentive arrangements the firm had were insufficient to eliminate this agency cost.

70. DEL. CODE ANN. tit. 8, § 262(b)(1) (1991) (excluding appraisal rights for shareholders in corporations either listed on a national stock exchange or held of record by 2,000 or more stockholders). This exception fails to provide protection for shareholders when an announced merger drives the price of the company's stock down.

minority shareholders.⁷¹

Independent directors are perhaps the most abused group in the corporate law literature. No one seems to believe in their independence.⁷² Yet these directors do not depend for their employment on the insiders proposing takeouts or management buyouts. They are generally individuals of stature in the corporate world as well as in their own communities, with a lifetime of reputational capital built up. As the dissenting judge in the Trans Union case put it, they are unlikely to be taken by a "fast shuffle."⁷³ There is evidence in the reports of vigorous representation of public or minority shareholders under the circumstances we are discussing.⁷⁴ Davis & Lehn's work in this Symposium provides evidence that there are no significant differences in results for public shareholders when management or third parties engage in buyouts.⁷⁵

The best evidence of the performance of boards is found in the battles for corporate control in the 1980s. In virtually all cases, incumbent management was a competing bidder for control.⁷⁶ Despite these conflicts of interest, huge gains were obtained for target shareholders throughout the decade.⁷⁷ Firms found it possible to structure the incentives of management and directors to perform well for shareholders by providing them with forms of compensation related to shareholder welfare.⁷⁸ If disloy-

71. However, nothing in *Weinberger* would preclude judicial action setting aside such a merger.

72. MYLES L. MACE, *DIRECTORS: MYTHS AND REALITY* (1971); James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 *LAW & CONTEMP. PROBS.* 83 (1985).

73. *Smith v. Van Gorkom*, 488 A.2d 858, 894 (Del. 1985) (McNeilly, J., dissenting).

74. See, e.g., the RJR Nabisco leveraged buyout, in which management complained that the special committee of the board favored not the inside bidders, but the outsiders. *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-90 TRANSFER BINDER] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. Jan. 31, 1989).

75. Davis & Lehn, *supra* note 68, at 595-96.

76. Michael L. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 *J. FIN. ECON.* 5, 6 (1983).

77. Bernard S. Black & Joseph A. Grundfest, *Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986: \$162 Billion Is A Lot of Money*, 1 *J. APPLIED CORP. FIN.* 5 (1988) (estimating gains for shareholders at \$162 billion between 1981 and 1986). See also Jensen & Ruback, *supra* note 76, at 10-14 (average bid premiums of 29% in hostile bids and 15.9% in mergers); Bradley, *supra* note 54, at 11; Debra K. Dennis & John J. McConnell, *Corporate Mergers and Security Returns*, 16 *J. FIN. ECON.* 143 (1986).

78. Carney, *supra* note 13, at 429 (citing Ralph A. Walkling & Michael S. Long, *Strategic Issues in Cash Tender Offers: Predicting Bid Premiums, Probability of Success, and Target Management's Response*, 4, No. 2 *MIDLAND CORP. FIN. J.* 57, Summer 1986, at 63-64; Ralph A. Walkling & Michael S. Long, *Agency Theory, Managerial Welfare, and Takeover Bid Resistance*, 15 *RAND J. ECON.* 54 (1984)).

alty of outside directors is a perceived problem, nothing prevents providing the outsiders with a compensation arrangement that keys their wealth to the welfare of the public or minority shareholders. Indeed, more and more boards take part or all of their compensation in the form of stock, options, or other stock-related compensation. This means they find their wealth keyed to that of the public investors, if they are not included in the insider group. If they are included in the insider group, then they are no longer independent for purposes of the buyout or take-out decision.

The final source of protection, when private arrangements fail, is the courts. If the courts observe a process dominated by insiders, in which the insiders select the investment bankers and counsel for the special committee, and in which the committee is supine in the face of an offer from the insiders, then the courts have shown themselves capable of setting aside such transactions.⁷⁹

V. CONCLUSION

It would be wonderful if a few procedural reforms or imposition of legal liability could improve the accuracy of fairness opinions. Some modest changes may be quite harmless and relatively inexpensive. But any radical changes in this area will only increase costs and risks for participants in corporate transactions without delivering the promised truth about values. No one, unfortunately, has such truth until values are revealed in markets by real, rather than hypothetical, transactions.

79. *See, e.g.,* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1281 (Del. 1989) (declining to allow a special committee to rely in good faith upon financial and legal advisors chosen by the management team that was a competing bidder for the company).