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FAIRNESS OPINIONS: HOW FAIR ARE THEY AND WHAT CAN BE DONE ABOUT IT?

LUCIAN ARYE BEBCHUK†
AND MARCEL KAHAN*

INTRODUCTION

Fairness opinions have become a regular feature of every major corporate control transaction. Whether in negotiated mergers,[1] freeze-out mergers,[2] hostile tender offers,[3] friendly tender offers,[4] self-tenders,[5] leveraged buyouts,[6] negotiated share repurchases,[7] or negotiated sales of treasury stock,[8] directors seek the blessing of investment banks before approving transactions or adopting defensive measures. These banks give their blessings in the form of fairness opinions, which usually consist of short letters that state an opinion about whether a proposed transaction is "fair" or "adequate."[9] In addition, the banks often give presenta-

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[1] *See, e.g.*, Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 821-22 (D. Del. 1974). *See generally* Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third Party Sale Value" the Appropriate Standard?*, 36 BUS. LAW. 1439, 1442-43 (1981) (fairness opinions commonplace in merger transactions).

[2] *See, e.g.*, Anderson v. Boothe, 103 F.R.D. 430, 433 (D. Minn. 1984); Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 82 (E.D.N.Y. 1969), *modified*, 478 F.2d 1281 (2d Cir. 1973); Weinberger v. UOP, Inc., 457 A.2d 701, 707-08 (Del. 1983).

[3] *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) (poison pill proposal), *rev'd*, 481 U.S. 69 (1987); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 271 (2d Cir. 1986) (lock-up option); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 950 (Del. 1985) (rejected tender offer); MacAndrews & Forbes Holdings v. Revlon, Inc., 501 A.2d 1239, 1243 (Del. Ch. 1985) (purchase rights issue), *aff'd*, 506 A.2d 173 (Del. 1986).

[4] *See, e.g.*, Danziger v. Kennecott Copper Corp., N.Y.L.J., Dec. 7, 1977, at 7, col. 1.

[5] *See, e.g.*, Kahn v. United States Sugar Corp., No. 7313, slip op. at 3-5 (Del. Ch. Dec. 10, 1985) (Westlaw, 1985 WL 4449).

[6] *See, e.g.*, Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 190 (3d Cir. 1988), *cert. denied*, 109 S. Ct. 1315 (1989); Beebe v. Pacific Realty Trust, 578 F. Supp. 1128, 1135 (D. Or. 1984).

[7] *See, e.g.*, Kaplan v. Goldsamt, 380 A.2d 556, 561 (Del. Ch. 1977).

[8] *See, e.g.*, Treadway Cos. v. Care Corp., 638 F.2d 357, 365 (2d Cir. 1980).

[9] *See, e.g.*, Crouse-Hinds Co. & Belden Corp., Joint Proxy Statement exhs. C-E (Oct. 14, 1980) (merger is "fair and equitable"; merger is "fair from a financial point of view"; tender offer is

tions to boards of directors in which the banks justify and explain their opinions.[10]

One reason why corporate directors obtain fairness opinions is to help persuade shareholders to approve transactions.[11] More importantly, however, directors obtain fairness opinions in order to satisfy their fiduciary obligations.[12] Indeed, courts have indicated that they give weight to fairness opinions in their analyses of fiduciary obligation. For example, in *Tanzer Economic Associates Profit Sharing Plan v. Universal Food Specialties, Inc.*, a New York court relied on a fairness opinion obtained by the defendants, concluding that "[i]t is apparent that [the terms of the freeze-out constitute] no palpable or gross undervaluation, which on its face would shock the conscience of the Court."[13] In *Cottle v. Storer Communication, Inc.* the Eleventh Circuit noted that "[t]he fact that the board consulted [an investment bank] simply weighs in favor of finding that the directors did not abuse their discretion."[14] And in *Smith v. Van Gorkom*, the court, in holding that the directors violated their duty of care, emphasized the directors' failure to obtain a fairness opinion.[15]

This Article analyzes the problems with judicial reliance on fairness opinions and considers the extent to which courts should give weight to such opinions. One aim of the Article is constructive—to suggest a judicial approach that may improve the reliability of fairness opinions; an-

"inadequate from a financial point of view"); Alleghany Corp. & Investors Diversified Servs. Inc., Joint Proxy Statement annexes III, IV (Mar. 29, 1979) (merger is "fair from a financial standpoint" and "fair from a financial point of view," respectively); UOP Inc., Proxy Statement app. D (May 5, 1978) (merger is "fair and equitable").

[10] *See, e.g.*, Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 126 (1979) (banker provides detailed analysis and procedures used to develop fairness opinion); *see also* Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 83 (E.D.N.Y. 1969) (bank discloses financial data used in fairness opinion), *modified*, 478 F.2d 1281 (2d Cir. 1973); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 950 (Del. 1985) (same). *But see* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275-76 (2d Cir. 1986) (conclusory opinion; no documentary support provided).

[11] *See, e.g.*, Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 821 (D. Del. 1974) (independence and reputation of investment banker adds persuasive support for management's position).

[12] *See* Chazen, *supra* note 1, at 1442; Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1453 (1985); Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 120-21 (1986).

[13] 87 Misc. 2d 167, 178, 383 N.Y.S.2d 472, 481 (Sup. Ct. 1976).

[14] 849 F.2d 570, 578 (11th Cir. 1988).

[15] 488 A.2d 858, 876-78 (Del. 1985); *see also* Treadway Cos. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980) (fairness opinion evaluating merger proposal shows good faith); Kors v. Carey, 158 A.2d 136, 141 (Del. Ch. 1960) (use of outside experts factor in finding absence of misconduct); Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 572, 473 N.E.2d 19, 27, 483 N.Y.S.2d 667, 676 (1984) (dictum) (fairness opinion good proof that freeze-out price fair); Danziger v. Kennecott Copper Corp., N.Y.L.J., Dec. 7, 1977, at 7, col. 1 (obtaining independent financial advice before making tender offer factor in holding that directors discharged fiduciary duties).

other is critical—to show the limitations of possible improvements and, accordingly, to warn against excessive reliance on fairness opinions.

The first two parts of this Article systematically analyze the problems with fairness opinions. Part I shows that investment banks possess significant discretion in issuing fairness opinions. One source of this discretion lies in alternative definitions of "fair price." Another lies in the alternative ways of measuring fair price, however defined. As a result, investment banks have a choice among several widely disparate estimates of fair price, all of which are justifiable.

Part II examines the conflicts of interest that investment banks face in issuing fairness opinions. Conflicts of interest derive from the investment banks' fee structure, from their desire to retain and attract clients, and possibly also from the bankers' psychological loyalty to managers. These conflicts encourage investment banks to render the opinions most conducive to the interests of the managers that hired them, and not those that best reflect the bankers' genuine beliefs. This part further argues that neither reputational concerns nor internal procedures and guidelines will significantly diminish this problem.

Part III suggests a judicial approach to fairness opinions. This approach describes how courts should scrutinize the definition of fairness, the measurement of fair price, and the banker-company relationship; the approach also suggests that courts should exercise substantial residual caution and limit their reliance on fairness opinions.

I. THE PROBLEM OF DISCRETION

In this part, we show that investment banks possess substantial discretion in determining what prices are "fair" to shareholders. Because of this discretion, investment banks can arrive at widely differing estimates of "fair price," all of which would be reasonable and none of which could be shown to be "wrong" (or unfair) under objective criteria.[16] That financial analysts can regard widely differing figures as "fair" is problematic for two reasons. First, the subjective nature of fairness opinions reduces their value. Even if an investment bank rendered an opinion based on its genuine beliefs about fair price, that would be just one bank's *opinion*. Since other analysts could (legitimately) arrive at very different opinions, no single opinion should receive excessive weight.[17]

[16] *See, e.g.*, Joseph v. Shell Oil Co., 482 A.2d 335, 339 (Del. Ch. 1984) (estimates ranging from $53 to $85 per share); Kahn v. United States Sugar Corp., No. 7313, slip op. at 18 (Del. Ch. Dec. 10, 1985) (Westlaw, 1985 WL 4449) (from $52 to $122); Kaplan v. Goldsamt, 380 A.2d 556, 566-67 (Del. Ch. 1977) (from $7.25 to $9.50).

[17] A possible solution to this problem is to obtain more than one fairness opinion. *See, e.g.*, Brunswick Corp., Proxy Statement (Mar. 9, 1977) (charter amendment providing that certain trans-

Second, and more importantly, this discretion enables investment banks to act opportunistically. Investment bankers can formulate fairness opinions serving their and the managers' interests, rather than ones reflecting their best judgments of fair price. And, as the next part points out, investment banks have strong incentives to write opinions that satisfy the managers who hire them and negotiate their fees.

Investment banks' discretion in fashioning fairness opinions derives from two main sources. First, as section A argues, the concept of fair price is ill-defined. Second, as section B shows, even financial analysts who use the same definition of fairness can differ in their assessments of fair price, because of the subjective nature of the estimation process.

A. *The Definitional Problem*

Underlying the differences in analysts' fair-price estimates is a conceptual confusion about the definition of fair price.[18] Courts have failed to specify which definition of fair price investment banks should use,[19] and investment banks generally do not disclose which definition of fair price they have used;[20] their fairness opinions simply state that prices are "fair from a financial point of view"[21] or "inadequate."[22] Different definitions can, however, lead to significantly different estimates.[23] Since a variety of justifiable definitions of fair price have been proposed, this definitional problem can be quite complex.

In addition, the suitability of any one definition depends on the kind

actions be found fair by two independent investment banks). Even multiple fairness opinions, however, might not provide much information, because of the potentially wide discrepancies in price estimates. Furthermore, shareholders must bear the higher costs of multiple opinions.

[18] Fair price is sometimes defined as the price at which a rational buyer with knowledge of the relevant facts would sell the shares in an arm's-length transaction. *See* Nathan & Shapiro, *Legal Standard of Fairness of Merger Terms Under Delaware Law*, 2 DEL. J. CORP. L. 44, 48 (1977). This definition, however, begs the question: different rational buyers might consider different definitions of fair price appropriate.

[19] *See, e.g.*, Kahn v. United States Sugar Corp., No. 7313, slip op. at 29 (Del. Ch. Dec. 10, 1985) (Westlaw, 1985 WL 4449) (court declined opportunity to specify appropriate definition of fair price); Joseph v. Shell Oil Co., 482 A.2d 335, 343-45 (Del. Ch. 1984) (same).

[20] *But cf. Kaplan*, 380 A.2d at 563-64 (board compared fairness of price in negotiated share repurchase to cost of shares in tender offer).

[21] *See, e.g.*, Crouse-Hinds Co. & Belden Corp., *supra* note 9, exh. D. Even practitioners do not always know what "from a financial point of view" means. *See* Chazen, Friedman & Feuerstein, *Premiums and Liquidation Values: Their Effect on the Fairness of an Acquisition*, in ELEVENTH ANNUAL INSTITUTE ON SECURITIES REGULATION 143, 156 (A. Fleischer, M. Lipton & R. Stevenson eds. 1980) (statement of Joseph Flom).

[22] *Cf.* 1 M. LIPTON & E. STEINBERGER, TAKEOVERS AND FREEZE-OUTS § 6.01[1][c][i] (1988) (recommending that investment bank simply "opine as to the adequacy of the price offered").

[23] *See, e.g.*, *Joseph*, 482 A.2d at 339 (different definitions resulted in estimates of $53, $80-85, and $91 per share); *Kaplan*, 380 A.2d at 556-67 (different definitions resulted in estimates ranging from $7.25 to $8.25 per share).

of transaction at issue[24] and the particular context of that transaction.[25] Take, for example, a company facing an acquisition offer. The buyers might seek to acquire the company through a merger, a friendly tender offer, or a hostile tender offer. In this acquisition context, commentators have suggested a variety of definitions of fair price. First, fair price could refer to the value of the company as an independent entity—i.e., its value if it does not engage in the proposed acquisition or any other.[26] One may seek to justify this definition of value as being most relevant to the choice facing the shareholders: should they approve the merger, tender the shares, and receive the value offered, or should they reject the merger and (at least for the moment) remain an independent entity?

Second, some have suggested that fair price should be defined as the value shareholders would receive if their company were auctioned off to the highest bidder.[27] While shareholders do not necessarily have this choice, there is no reason in principle why a company should not be auctioned off if that would enable shareholders to obtain a higher price. Consequently, any price below the value that shareholders would receive in an auction is arguably "unfair" to the shareholders.

A third definition of fair price might be the value that bilateral, arm's-length bargaining would yield.[28] This value is useful because it

[24] *See, e.g.*, Chazen, *supra* note 1, at 1443-50 (proposing different fairness standards for non-negotiated acquisitions by controlling shareholders, negotiated acquisitions by controlling shareholders, and acquisitions by unaffiliated purchasers). Making the definition of fair price dependent on the type of transaction in question poses the danger that banks will manipulate definitions to favor management. For example, an opinion that the terms of a merger are fair apparently means that the price is within a range of fair prices, but not the highest price attainable. *See* Chazen, Friedman & Feuerstein, *supra* note 21, at 147. But an opinion that the terms of a hostile takeover bid are inadequate merely signifies that, even though the terms are fair, better terms can be obtained. *See* Weiss, *The Law of Take Out Mergers:* Weinberger v. UOP, Inc. *Ushers in Phase Six*, 4 CARDOZO L. REV. 245, 256 (1983).

[25] *Cf.* Saffer, *Touching All Bases in Setting Merger Prices*, MERGERS & ACQUISITIONS, Fall 1984, at 42 (discussing which valuation method bidders should use in which context).

[26] *See, e.g.*, Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. LEGAL STUD. 165, 165-67 (1988). Because Schwartz believes that a company's independent value is given by the market price of its shares, he probably would see no need for fairness opinions written by bankers. If a company's shares are not publicly traded or if the share price does not reflect the company's value as an independent entity (e.g., because of the existence of significant nonpublic information), Schwartz would presumably advocate that a bank base its fairness opinion on the company's value as an independent entity.

[27] *See, e.g.*, Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1038-41 (1982); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 868-75 (1981) (arguing for auction strategy in respouse to tender offer).

[28] *Cf.* Pepper v. Litton, 308 U.S. 295, 306-07 (1939) (in self-dealing, test of fairness is whether transaction has earmarks of arm's-length bargain). This definition of fair price also follows from the "sole owner standard" put forward in Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197, 197-98 (1988).

shows shareholders whether they might be better off not selling but rather returning to the bargaining table or waiting for another bid.[29] This value also shows whether managers adequately represented shareholders in negotiating transaction terms and in structuring takeover defenses. In particular, use of this definition can indicate whether or not a conflict of interest affected managers during negotiation.[30] Moreover, if an acquisition creates unique gains that would not arise from acquisition by another party, bargaining would arguably lead to a fair division of these gains.

This list of definitions is not meant to be exhaustive; indeed, some may advance several other definitions of fair price, such as the value of the company's net assets[31] or the value of the company as an independent entity plus a fraction of any gains resulting from the acquisition. Moreover, one can combine these definitions to form new definitions: fair price, for example, can be defined as the average of several definitions, under the argument that each definition captures one aspect of value.[32]

The appropriateness of any definition also might depend on the context of the acquisition in question. If several suitors showed interest in a company, an auction price might arguably be more appropriate than the independent value of the company;[33] if the acquisition would produce

[29] Empirical evidence shows that many unsuccessful merger negotiations and tender offers are followed by successful bids. Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers*, 11 J. FIN. ECON. 183, 188 (1983) (of 112 unsuccessful tender offer targets, 86 were acquired within 5 years). This suggests that shareholders can reasonably expect to realize a value above a company's independent value even if they reject an acquisition proposal.

[30] Courts and commentators generally agree that corporate control transactions involve the potential for conflicts of interest. *See* R. CLARK, CORPORATE LAW §§ 4.1, 12.2.5, 13.2.1 (1986).

[31] *See, e.g.*, E.I. du Pont de Nemours & Co. v. Collins, 432 U.S. 46, 54-56 (1977) (net asset value is fair price); Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 100 (E.D.N.Y. 1969) (same), *modified*, 478 F.2d 1281 (2d Cir. 1973).

[32] If measurement of fair price according to each definition will result in an unbiased but inaccurate estimate of the true fair price, an appropriately weighted average will result in a more accurate estimate. *See generally* T. WONNACOTT & R. WONNACOTT, INTRODUCTORY STATISTICS FOR BUSINESS AND ECONOMICS 129-31, 179-85 (2d ed. 1977) (Unless multiple estinators are perfectly correlated, the variance of their sum is less than the sum of their variances; therefore, some weighted averages of several unbiased estimators will be a more accurate estimator than any one estimator alone.).

Courts generally use a weighted average of different measures of value in the context of appraisal rights. *See, e.g.*, Piemonte v. New Boston Garden Corp., 377 Mass. 719, 733, 387 N.E.2d 1145, 1153 (1979) (upholding weighted average of market value, earnings value, and net asset value); Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585, 587, 338 N.E.2d 614, 616, 376 N.Y.S.2d 103, 106 (1975) (to determine fair value, court should consider net asset value, investment value, and market value). *But cf.* Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983) (overruling precedents that used weighted average to exclusion of other accepted valuation techniques).

[33] *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (when company's sale to one of several bidders becomes inevitable, directors obliged to conduct neutral auction).

unique gains, the negotiation price might arguably be more appropriate than the auction price. Another factor that investment banks apparently consider relevant is whether a bank renders a fairness opinion in a friendly or a hostile deal. In the former, the opinion indicates whether a reasonably prudent board could accept the offered terms;[34] in the latter, it states whether the bank believes that a better offer can be obtained.[35]

Turning from acquisitions to other transactions, it seems that every type of transaction might require a different definition of fair price. Take freeze-out mergers as an example. In these mergers, fair price might focus on the company's value as an independent entity,[36] as the market price of the minority shares,[37] or as the price the minority shares would receive if auctioned off as a block.[38] In addition, one might add to any of these measures a fraction of any freeze-out gains[39] that might arise, or an appropriation for the tax expenses and reinvestment transaction costs[40] that minority shareholders must incur.[41]

[34] As investment bankers like to stress, a "fair" price is not the highest price obtainable, but rather a price within the range that a reasonable and prudent board would accept. *See* Chazen, Friedman & Feuerstein, *supra* note 21, at 147; Fleischer, *A "Fairness Letter" is Just an Opinion*, N.Y. Times, June 8, 1986, § 3, at 2, col. 3.

[35] *See* Weiss, *supra* note 24, at 256.

[36] *See* DEL. CODE ANN. tit. 8, § 262(h) (1983) (in determining fair value for purposes of appraisal rights, court should ignore any value arising from accomplishment or expectation of merger and consolidation); MODEL BUS. CORP. ACT § 13.01(3) (1985) (defining "fair value" for purposes of dissenters' rights as excluding any "appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable").

[37] *See* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 723-31 (1982) (minority shareholders should receive market value for shares in freeze-out merger); *cf.* DEL. CODE ANN. tit. 8, § 262(b)(1) (appraisal remedy not available in cases involving publicly traded stock).

[38] *See* Chazen, Friedman & Feuerstein, *supra* note 21, at 160 (price obtainable for minority shares as block provides possible measure of fair price). These authors believe that the block price would be below the market price, since investors would have to sell at a liquidity discount. If the same person owned all the minority shares, however, he would have greater incentives and abilities to monitor the majority shareholders. In such a case, the majority would presumably be less able to divert gains from the minority, and the minority stock's block price might exceed the value of the stock to dispersed investors.

[39] *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 345 (1974) (fair treatment requires that gains be shared).

[40] Toms, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 COLUM. L. REV. 548, 577 & n.104 (1978) (suggesting modification of traditional intrinsic value standard to compensate for factors reducing actual value of frozen-out shareholder interests).

[41] In other transactions, different definitions of fair price can be justified. For example, in a management buyout, fair price might mean: a company's independent value; the market price of the shares; the price obtainable in an auction; the independent value plus a fraction of the gains expected from the buyout (e.g., tax savings from increased leverage and gains from improved incentives to managers); or the value of the company assuming management made all changes it planned to make after the buyout (which would include tax savings from increased leverage but might not include gains from improved incentives to managers). *Cf.* Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 779-84 (1985) (arguing for an auction rule in leveraged buyouts).

Investment bankers are free to choose from any of these definitions.[42] In part III we will suggest a twofold approach to help solve the definitional problem: first, courts should clarify which definitions of fair price they view as legitimate; second, investment banks should state the definitions underlying their opinions. As explained below, however, the definitional problem is not the only source of bankers' discretion. Even in the absence of this definitional problem, investment banks would still retain significant discretion because of the measurement problem.

B. *The Measurement Problem*

Even financial analyses that employ the same definition of fair price can arrive at widely differing results.[43] To measure fair price, however defined, any analysis must make a variety of simplifications, assumptions, and estimates. Since analysts simplify, assume, and estimate in different ways[44] that are all reasonable and justifiable, they often arrive at different estimates of fair price.[45]

Assume, for example, that the appropriate definition of fair price is a company's independent value. An analyst must first decide whether he should estimate this value by the value of the company's net assets,[46] the discounted value of the company's future profits,[47] a multiple of past earnings,[48] the discounted value of future dividend payments,[49] the share

[42] Managers sometimes select the definition of fairness that investment banks must use in writing opinions. *See, e.g.*, Kaplan v. Goldsamt, 380 A.2d 556, 563 (Del. Ch. 1977) (in negotiated share repurchase, bank asked to estimate cost of buying equivalent amount of shares through tender offer); Longstreth, *New Controls for Leveraged Buyouts*, N.Y. Times, Nov. 6, 1983, § 3, at 3, col. 2 (bankers sometimes asked not to consider liquidation value).

[43] Some courts have recognized the subjective nature of price estimates. *See* Radol v. Thomas, 534 F. Supp. 1302, 1305 (S.D. Ohio 1982) (price estimates necessarily imprecise); *Kaplan*, 380 A.2d at 567 (valuation depends upon numerous subjective judgments); *cf.* Kahn v. United States Sugar Corp., No. 7313, slip op. at 18 (Del. Ch. Dec. 10, 1985) (Westlaw, 1985 WL 4449) (expert valuations based on subjective judgments); Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984) (expert appraisers usually express different opinions even if using same data).

[44] For examples of how different assumptions can influence estimates, see *Kahn*, No. 7313, slip op. at 18; *Kaplan*, 380 A.2d at 567 (estimates depend on approach taken by those rendering them).

[45] *See also* Fischel, *supra* note 12, at 1452 (discounted-cash-flow technique can "come up with just about anything"); *cf.* Note, *supra* note 12, at 124 (modern valuation techniques do not permit investment bankers to determine fair price with absolute precision).

[46] *See, e.g.*, Piemonte v. New Boston Garden Corp., 377 Mass. 719, 733, 387 N.E.2d 1145, 1153 (1979) (net asset value factor in determining fair value); Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585, 587, 338 N.E.2d 614, 616, 376 N.Y.S.2d 103, 106 (1975) (same).

[47] *See, e.g.*, B. MALKIEL, A RANDOM WALK DOWN WALL STREET 115 (4th ed. 1985) (describing fundamental analysis); *see also* Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983).

[48] *See, e.g.*, *Kahn*, No. 7313, slip op. at 19 (experts used multiples of past earnings to determine value); *In re* Valuation of Common Stock of Libby, McNeill & Libby, 406 A.2d 54, 65-66 (Me. 1979) (multiple of past earnings given weight of 40% in calculating fair value under appraisal statute).

price,[50] or some average of these measures.[51]

Suppose the analyst decides to estimate the company's value by the discounted value of its future profits. She must then collect information on which to base his estimates. At this stage, the analyst determines the appropriate information sources, the required amount of information, the accuracy of any company-supplied information, and the necessity of independently verifying that information.

Based on this information, the analyst must make assumptions about increases in company costs, revenues,[52] and future tax rates.[53] These assumptions, in turn, depend on such unpredictable variables as future inflation rates, new product development, market competition, and the general political climate. Moreover, the analyst might have to repeat her calculations for each of a company's product lines.

Finally, the analyst must estimate the discount rate for future profits. Assume that the analyst decides to use the capital asset pricing model to determine the discount rate. Even if she wanted to apply the same discount rate in each time period and to each item of revenue and cost, she would have to determine the risk-free rate, calculate the covariance of cash flows with the company's market portfolio, and estimate the market risk premium.[54]

Assume that the impossible happens and two analysts agree that a company will have profits of $100,000 in each coming year, but one analyst determines that the proper discount rate is eight percent a year while the other believes the proper rate is ten percent a year. This two percent difference in the discount rates will result in estimates that diverge by twenty-five percent. The first analyst will estimate the company's value at $1,250,000, while the second analyst will estimate it at $1,000,000.[55] Of course, if the analysts do not agree on the amount of future profits,

[49] R. BREALY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 45 (2d ed. 1984).

[50] *See, e.g.*, Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 13-14 & n.28 (1982) (liquid markets offer ready price for shares); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165-67 (1981) (under efficient capital market theory, share price represents true value of firm); Schwartz, *supra* note 26, at 165; *cf.* DEL. CODE ANN. tit. 8, § 262(b)(1) (1983) (appraisal rights not available for publicly traded stocks).

[51] *See, e.g.*, Piemonte v. New Boston Garden Corp., 377 Mass. 719, 733, 387 N.E.2d 1145, 1153 (1979) (weighted average); Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585, 587, 338 N.E.2d 614, 616, 376 N.Y.S.2d 103, 106 (1975).

[52] *See, e.g.*, R. BREALY & S. MYERS, *supra* note 49, at 85-96.

[53] *See, e.g.*, Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 184 (3rd Cir. 1988) (fairness opinion assumed tax laws would not change), *cert. denied*, 109 S. Ct. 1315 (1989).

[54] R. BREALY & S. MYERS, *supra* note 49, at 128-35 (describing how to apply the capital asset pricing model).

[55] One can obtain the present value of such a cash flow by dividing the annual flow by the difference between the discount rate and the absolute rate of growth of the cash flow.

their estimates might be even further apart.[56] For example, if the first analyst thinks profits will grow at an annual rate of four percent, and the second analyst thinks they will grow at only two percent, their respective estimates will be $2,500,000 and $1,250,000. These analyses—both legitimate under prevailing standards—would produce very different conclusions about whether a price of, say, $2,000,000 is fair.

A different definition of fair price conld complicate the estimation process even more. Assume, for example, that fair price is defined as the result of takeover negotiations conducted bilaterally and at arm's length, which presumably includes part of the net gains from an acquisition. Assume that an analyst hired by the acquiring corporation first estimates the value of the acquiring company as an independent entity. Next, he estimates the value of the target company as an independent entity and the value of both companies together. From these three figures, the analyst then calculates the net gains from the transaction.

Estimating the value of the target company and of both companies together creates even greater leeway than estimating just the value of the acquiring company. The analyst will ordinarily have less information—and will thus be forced to make more estimates—about the target company than about the company that hired him. Similarly, the analyst will often not know how the surviving company will be managed, and even if he did, determining the effects on value wonld leave a wide margin of tolerance.

Finally, in deciding how to split the net gains from the acquisition, the analyst can justify the-use of several estimation methods. The analyst might assess how companies in other transactions have split gains; alternatively, he might assume that gains would be divided equally, on a per-dollar basis,[57] on a percentage of independent value basis,[58] or on some other basis.

In sum, however fair price is defined, an investment bank might base its estimate on a variety of justifiable information sources, assumptions, and measurement techniques.[59] By relying on different sources of infor-

[56] Statistically independent estimates of each item would limit differences between analysts' estimates as a whole. The estimates on each item would tend to balance the estimate as a whole: an analyst who makes a relatively high estimate of the profits on product *A* might make a relatively low estimate of the profits on prodnct *B*.

There are, however, two reasons to believe that estimates on each item are not independent. First, some analysts might take a generally positive or negative approach to the developments in the company's industry or the economy in general. Second, as part III will show, analysts have incentives to arrive at price estimates that satisfy the managers that hired them.

[57] *See* Brudney & Chirelstein, *supra* note 39, at 316.

[58] *See id.* at 320-21.

[59] Even if an analyst regards the stock price as the fair price, he must decide whether to include or ignore several factors: a prospective transaction's impact, the timing of disclosure for that

mation, making different assumptions, and using different techniques, banks might arrive at widely different results. Even if no definitional problem existed, investment banks would retain significant discretion.

II. The Problem of Conflicts of Interest

The existence of substantial discretion would present significant problems to those wishing to rely on fairness opinions even if bankers faced no conflict of interest. Even if all bankers sought to render opinions best reflecting their judgment, the presence of discretion would imply that any one opinion might only reflect one banker's opinion and, as such, differ markedly from opinions that other analysts would reach. As this part explains, however, the existence of discretion presents an especially severe problem because bankers do face significant conflicts of interest. Bankers are thus likely to use their discretion to render opinions that serve the interests of managers. By managers, we refer to those officers and directors of corporations who wield the power to select investment bankers and set their compensation schemes.[60] For example, if managers want shareholders to approve a merger, banks will tend to conclude that the merger terms are fair. On the other hand, if managers want to adopt defenses to a hostile takeover, banks will tend to conclude that the proposed takeover terms are unfair.

This Part demonstrates the pervasiveness of such conflicts of interest by analyzing their sources and by refuting the alleged grounds for the independence of investment bankers. The Part first considers in detail the causes of conflicts of interest: the fee structure for compensating investment banks and the incentives that structure creates, the banks' desire to retain and attract clients, and psychological and social factors. Lastly, this Part argues that investment banks' reputational concerns and internal procedures will not eliminate these conflicts of interest.

transaction, and the effect of this information on the stock price. *Cf.* Fischel, *The Appraisal Remedy in Corporate Law,* 1983 AM. B. FOUND. RES. J. 875, 893-94 (describing econometric market model for reconstructing market price while excluding effects of a prospective corporate control transaction).

[60] Many have expressed the view that fairness opinions often do nothing more than rubber-stamp management decisions. *See, e.g.,* McGough, *Fairness for Hire,* FORBES, July 29, 1985, at 52; Weiss, *supra* note 24, at 255; Note, *supra* note 12, at 127-28; Stein, *Investment Banking's Dirty Little Secret,* N.Y. Times, June 8, 1986, § 3, at 2, col. 3; Longstreth, *supra* note 42, at 3, cols. 3-4; *see also* Fischel, *supra* note 14, at 1453 (some experts always willing to opine that price significantly higher than share price is fair). Thus, the contribution of this part lies not in the novelty of its claim that a conflict-of-interest problem exists but rather in its systematic analysis of the factors producing this problem.

A. *The Fee Structure*

One reason why investment banks have an incentive to write fairness opinions consistent with managerial desires stems from the fee structure under which banks are compensated. An investment bank generally does more than just write the fairness opinion for a transaction; the same bank often controls other financial aspects of the transaction.[61] For example, in a merger, a bank writing a fairness opinion might also give a company general financial advice;[62] in a hostile takeover defense, the bank might arrange financial aspects of a lock-up option[63] or a poison pill.[64]

Although banks often receive a fixed fee for fairness opinions,[65] other fees that investment banks receive are frequently contingent.[66] For example, in many friendly deals, a significant fraction of the total fee is payable on the condition that the transaction is consummated,[67] and the size of this contingent fee may depend on the company's sale price.[68] In other instanees, fees are contingent on a raider's failure in a proxy chal-

[61] *See* Chazen, *supra* note 1, at 1442-43 (typically, fairness opinion is only one of several services furnished by investment bank); *see also* Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) (investment bank provided fairness opinion and advice on proxy fight), *rev'd*, 481 U.S. 69 (1987); MacAndrews & Forbes Holdings v. Revlon, Inc., 501 A.2d 1239, 1243-44 (Del. Ch. 1985) (investment bank wrote fairness opinion and structured hostile tender defense), *aff'd*, 506 A.2d 173 (Del. 1986).

[62] *See, e.g.*, Kohn v. American Metal Climax, Inc., 458 F.2d 255, 267 (3d Cir. 1972) (bank served as general financial adviser during amalgamation discussions), *cert. denied*, 409 U.S. 874 (1972); Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 82-83 (E.D.N.Y. 1969) (bank provided services involving debt issue prior to merger), *modified*, 478 F.2d 1281 (2d Cir. 1973); Alleghany Corp. & Investors Diversified Serv. Inc., *supra* note 9, at 21 (Alleghany's investment bank to receive fees for financial advice and fairness opinion).

[63] *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 270-71 (2d Cir. 1986) (Goldman Sachs structured lock-up option and declared that it was fair).

[64] *See e.g.*, *Dynamics Corp.*, 794 F.2d at 257-58 (Smith Barney structured poison pill and wrote opinion that tender offer was unfair).

[65] *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 706 (Del. 1983) (Lehman Brothers received $150,000 for fairness opinion).

[66] Investment banks usually receive a single fee for all services involving one transaction. Confidential interview with Shearson Lehman Hutton personnel (Nov. 1988).

[67] For example, in the acquisition of ABC by Capital Cities, ABC's bank was to receive $2 million if ABC's shareholders approved the deal and $4.5 million if the deal was finalized. American Broadcasting Companies, Inc. & Capital Cities Communications, Inc., Joint Proxy Statement 7 (May 10, 1985).

[68] *See, e.g.*, Radol v. Thomas, 534 F. Supp. 1302, 1315 n.19 (S.D. Ohio 1982) (investment bank received base fee plus 1% of share price in excess of $85); Joseph v. Shell Oil Co., 482 A.2d 335, 339 (Del. Ch. 1984) (investment bank received fixed sum plus a bonus dependent on price eventually paid for minority shares). *See generally* Carrington, *Merger Advisers Say the Big Fees They're Charging Are Warranted*, Wall St. J., July 17, 1981, at 29, col. 3, col. 4 (in friendly deals, seller's investment bank usually receives percentage fee).

lenge,[69] on the bank's recruitment of a white knight,[70] or on the company's making the fairness opinion public.[71]

Fees contingent on a transaction's consummation create enormous incentives for investment bankers to help execute deals.[72] In such situations, investment banks face two alternatives: they can earn contingent fees if they characterize management proposals as fair, or they can garner modest fees if deals collapse as a result of their opinions.[73]

For instance, in the merger of Cleveland Electric and Toledo Edison, Morgan Stanley was to receive $3.794 million if the companies actually merged, but only $350,000 otherwise.[74] In the acquisition of Allied Stores by Campeau, Goldman Sachs was to receive a straight fee of $1 million and an additional fee in the amount of one-third of one percent (estimated to be $13 million) of the total price paid for Allied shares, minus the $1 million straight fee.[75]

Another example is the involvement of Smith Barney in Dynamics' hostile tender offer and proxy contest for CTS. CTS retained the bank to write a fairness opinion on the tender offer and to give other financial advice.[76] If Dynamics, the hostile raider, lost the proxy contest, Smith Barney would receive a bonus of $75,000.[77] Thus, Smith Barney had an incentive to find the tender offer unfair. If Smith Barney had found the tender offer fair, Dynamics would have been more likely to win the contest and the bank would have lost its bonus. Similarly, if a bank's fees are contingent on the appearance of a white knight, the bank has incentives to find the original raider's offer unfair; if fees are contingent on the opin-

[69] *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) (in hostile tender offer, investment bank hired to determine fairness received bonus if hostile suitor lost proxy fight), *rev'd*, 481 U.S. 69 (1987).

[70] *See, e.g.*, *Radol*, 534 F. Supp. at 1315 (bank's fee contingent upon success of white knight's tender offer).

[71] *See, e.g.*, Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 183 (3d Cir. 1988) (bank received $75,000 if opinion published and $50,000 if not), *cert. denied*, 109 S. Ct. 1315 (1989); Anderson v. Boothe, 103 F.R.D. 430, 435 (D. Minn. 1984) (bank received fixed fee of $250,000 for opinion and additional $150,000 if opinion made publicly available).

[72] *See Anderson*, 103 F.R.D. at 436 (contingent fees could bias fairness opinion); Note, *supra* note 12, at 128 (contingent fees create conflict of interest).

[73] To be sure, an investment bank's judgment that a price is unfair does not necessarily destroy a deal; nor does an opinion that the proposed terms are fair ensure a transaction's consummation. As long as a favorable opinion increases the chances of a deal's consummation, though, investment banks will face the incentives we describe.

[74] Centerior Energy Corp., Cleveland Elec. Illum'n Co. & Toledo Edison Co., Joint Proxy Statement 12 (Oct. 4, 1985).

[75] Allied Stores Corp., Information Statement 9 (Dec. 9, 1986).

[76] Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986), *rev'd*, 481 U.S. 69 (1987).

[77] *Id.*

ion's publication, a bank will have an incentive to render an opinion favorable to management interests.

Since banks are compensated primarily for services *other* than writing fairness opinions, they have incentives to render pro-management opinions even in situations involving noncontingent fees, because such opinions will typically generate more work than opposition opinions.[78] For example, a merger-killing negative opinion will destroy all the business that a merger would have created for a bank. Thus, even under a noncontingent fee scheme, banks' pro-management opinions create higher revenues (and profits). The difference in incentives between contingent and noncontingent fees is therefore ouly a matter of degree: investment banks compensated on the basis of work performed will face smaller (but still positive) ineentives to generate pro-management opinions than will banks compensated on a contingent basis.[79]

Some investment bankers and commentators argue that contingent fees operate in a different way: under a compensation scheme that makes fees a percentage of the final deal price, banks maximize fees by seeking high prices.[80] Thus, the scheme provides banks with incentives to find deals unfair in order to induce higher sales prices. However, only contingent fees that depend on final sales prices ("percentage fees") provide such countervailing incentives to a seller's investment bank, and fees are often contingent on other factors.[81] For example, they can be contingent on a deal's execution but not be derived from the price payable to shareholders.[82] Such contingent fces create no countervailing incentives, and purchase prices under such a scheme are not likely to increase.

[78] Management might desire an opinion that a particular merger proposal or tender offer is unfair in order to justify defensive tactics. In some cases, the fees that banks can earn in the prevented corporate control transactions might be larger than the fees from structuring the defenses. Even in such cases, though, investment banks will have an incentive to render the opinion desired by management. If the bank were to issue an opinion favoring the transaction, management would in all likelihood not retain the writing bank for the control transaction, and the bank would not profit from larger fees. If the bank writes the opinion desired by management, it will at least earn the small fees for structuring the defenses.

[79] Incentives to write pro-management opinions under a contingent fee system will be larger than those generated under a noncontingent fee system ouly if an investment bank has worked on a deal prior to writing the fairness opinion at issue. In such a case, the fairness opinion will affect both the expected profits from any work to be done in the future and the compensation for work already completed. If, however, the bank has rendered no other servieès before writing the fairness opinion, incentives under both compensation systems should be equal. Under either system, the fairness opinion will affect expected profits from work to be done in the future, and there is no reason to assume that these expected profits are larger if the bank is compensated on a contingency basis.

[80] *See, e.g.*, Fleischer, *supra* note 34, at 2, col. 4 (contingent fees act as incentive for investment banks to obtain highest possible price).

[81] *See supra* notes 75-77 and accompanying text.

[82] *See, e.g.*, Beatrice Cos., Proxy Statement 12 (Mar. 11, 1986) (fec of $15 million payable immediately when merger consummated; otherwise payable in installments).

Moreover, even with respect to percentage fees, a bank that rejects a proposed price as unfair must consider the possibility that such a rejection will jeopardize the entire deal.[83] An attempt to push up the price will pay only if the likelihood of killing the deal is relatively small. Assume, for example, that an investment bank stands to receive 0.1% of the purchase price on consummation of a deal. A bank wonld benefit from trying to raise the price from $100 million to $110 million only if the probability of killing the deal were less than approximately 10%. Thus, even with percentage fees, banks often would not attempt to increase purchase prices.

In summary, both contingent and noncontingent fee structures create incentives for investment banks to write opinions aligned with management interests. Under contingent fee structures, pro-management opinions increase the likelihood that the specified contingencies will take place; under noncontingent fee schemes, such opinions increase the amount of work available to the writing bank. In both cases, pro-management opinions increase investment banks' revenues.

B. *The Desire to Attract and Retain Clients*

Assume, as before, that an investment bank receives 0.1% of the purchase price if a potential sale is consummated. Assume further that the bank perceives only a 5% chance that increasing the price from $100 million to $110 million will kill the transaction. A bank attempting to maximize its fees should try to increase the purchase price, because the expected fee from the sale wonld increase from $100,000 to $104,500.

In each transaction, however, an investment bank must consider both the possible fees from this particnlar transaction and the impact of that transaction on future business. Investment banks have an incentive to write opinions that attract future clients. The ultimate question, then, remains: what do clients want from investment banks when they retain them to write fairness opinions? Investment banks that deliver what clients want will attract future business; investment banks that do not, will not.

Although formally an investment bank's clients are corporations themselves, it is certain officers and directors—referred to here as managers—who select investment banks. Since managers decide which investment banks to hire, banks will attract business by satisfying managers. Because managers are likely to be well informed about an investment

[83] Note that fees of investment banks representing buyers are sometimes a percentage of the sales price. *See, e.g.*, Carrington, *supra* note 68, at 29, col. 4 (First Boston, representing du Pont in its bid for Conoco, received 0.2% of sales price as fee). Apparently, in these instances, buyers do not believe that such fees create strong incentives for investment banks to increase sales prices.

bank's reputation and its approach to fairness opinions, the bank's performance affects its future employment prospects with both its present client and other potential clients. In particular, one would imagine that word would quickly spread if an investment bank killed a deal by trying to increase the purchase price of a corporation. Furthermore, major law firms retained by managers provide information about the reputation of most investment banks. Thus, incentives created by investment banks' desire to be hired for future transactions are potentially much stronger than incentives created by fee structures in an individual transaction.

Because investment banks have strong incentives to satisfy managers, fairness opinions are unlikely to serve as an effective independent check on managerial activity. To the contrary, the desire to retain and attract clients will lead investment banks to write the fairness opinions that managers wish to see. Banks that adapt their fairness opinions to the wishes of managers will tend to be rehired, whereas banks that write contrary opinions are less likely to be retained.

C. *Psychological and Social Factors*

The psychological and social loyalty that investment bankers sometimes feel toward managers reinforces the economic incentives created by the fee structure and by the desire to retain and attract clients. Because many investment bankers personally know the managers who hired them,[84] bankers tend to feel more sympathetic to managers than to shareholders and tend to place greater weight on managerial goals and views. As a result, fairness opinions often favor managerial interests.[85]

Even in the absence of persoual relations between bankers and managers, though, many transactions create an atmosphere of common purpose that tends to reduce bankers' objectivity.[86] For instance, a bank evaluating a transaction may have assisted managers in creating and structuring that transaction.[87] Or, a bank retained to defend against a hostile takeover might help to search for a white knight.[88] In such in-

[84] *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 706 (Del. 1983) (fairness opinion prepared by investment banker who was also a longtime director of UOP).

[85] *Cf.* Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 95 (E.D.N.Y. 1969) (prior business relation raises doubts about investment bank's impartiality), *modified*, 478 F.2d 1281 (2d Cir. 1973).

[86] *See, e.g.*, MacAndrews & Forbes Holdings v. Revlon, Inc., 501 A.2d 1239, 1243 (Del. Ch. 1985) (investment bank and management together developed defensive share repurchase plan and poison pill), *aff'd*, 506 A.2d 173 (Del. 1986).

[87] *See, e.g.*, *Gerstle*, 298 F. Supp. at 95 (structuring merger and evaluating its fairness "blurred" investment bank's "lenses," resulting in failure to note erroneous property valuation).

[88] *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 268-69, 271 (2d Cir. 1986) (investment banker involved both in preparation of fairness opinion and in search for white knight).

stances, bankers and managers share a team spirit,[89] even a siege mentality. In addition, banks and corporations often establish continuing relationships that add to this collaborative atmosphere.[90] These relationships may lead bankers to give undue weight to managers' goals, at the cost of shareholder interests.

D. *Objections to the Analysis*

This section discusses and rejects the commonly given reasons why bankers are likely to write fairness opinions that reflect their best, unbiased judgments. In particular, the section argues: first, that a concern for professional reputation does not lead investment banks to render unbiased fairness opinions, and second, that internal procedures and guidelines fail to eliminate the conflicts of interest facing investment banks.

1. *Professional Reputation.* One familiar argument holds that investment banks' desire to maintain a professional reputation may lead them to provide unbiased fairness opinions. A professional reputation for quality work is an important asset to an investment bank, so the argument goes, and banks might well be reluctant to jeopardize such a reputation by writing biased opinions. Managers use these opinions to convince courts that fiduciary duties have been met and to persuade shareholders to approve transactions.[91] Since courts and shareholders would place less weight on fairness opinions known to be biased, banks have a clear interest in upholding their reputation for unbiased opinions.

Courts, however, have not indicated that they pay close attention to the trustworthiness of fairness opinions written by specific banks.[92] Rather, courts fail to differentiate among investment banks as long as

[89] *See, e.g., MacAndrews & Forbes,* 501 A.2d at 1243 (investment bankers, managers, and lawyers together developed program to protect company against tender offer).

[90] For example, Merrill Lynch represented Alleghany in its merger with Investors Diversified Services (IDS) in 1979. Prior to that, Merrill Lynch had represented Alleghany in its 1975 merger with MLS; in a 1977 tender offer for IDS stock; twice in 1977 with respect to IDS Realty Trust; and again in 1978 with respect to the trust. In total, Merrill Lynch earned revenues of over $500,000 in these transactions. Similarly, in the three years prior to the Alleghany merger, Salomon Brothers, which represented IDS, had earned about $4.5 million from earlier representation of IDS. Alleghany Corp. & Investors Diversified Servs. Inc., *supra* note 9, at 27-28.

[91] *See supra* notes 11-15 and accompanying text.

[92] In the acquisition of Stokely-Van Camp, Dillon Read, an investment bank, advised the directors that the proposed price of $55 in a management buyout was fair. Quaker Oats eventually acquired Stokely for $77 per share and Quaker Oats apparently made significant profits in the deal. McGough, *supra* note 60, at 52. Nonetheless, courts have not discounted fairness opinions issued by Dillon Read. *See, e.g.,* Cottle v. Storer Communication, Inc., 849 F.2d 570, 578 (11th Cir. 1988) (fairness opinion by Dillon Read given weight).

those banks have sufficient credentials.[93] Furthermore, to the extent that courts *do* pay attention to professional reputation, they are likely to evaluate fairness opinions on the basis of a bank's general reputation rather than on the basis of its reputation with respect to fairness opinions.[94] Shareholders, while they might pay more attention to the general reputation of investment banks, are likely to have less specific information about investment banks than managers have. Shareholders are, at most, aware of the general reputation of investment banks,[95] and this knowledge alone should not preclude managers from selecting an investment bank that is willing to write a pro-management opinion.[96] Thus, investment banks that enjoy a broad reputation for providing high-quality work will still have incentives to write pro-management fairness opinions.

To maintain credibility with courts and shareholders, investment banks need ouly avoid writing fairness opinions that they cannot reasonably justify. That is, investment banks must not opine that utterly unreasonable prices are fair or that clearly fair prices are inadequate. If a particular bank's opinions were repeatedly outside this range of legitimate fair prices, its reputation would decline so noticeably that courts and shareholders would give less weight to its opinions. As part I points out, however, such a reasonableness requirement imposes only a limited constraint on choices available to investment banks; banks may still write pro-management opinions as long as their opinions remain within this range of legitimate fair prices.

2. *Internal Procedures and Guidelines.* One might also argue that internal procedures and guidelines ensure that investment banks write unbiased opinions. A bank will issue fairness opinions only according to these procedures and guidelines. For example, some investment

[93] *Cf.* Kahn v. United States Sugar Corp., No. 7313, slip op. at 29 (Del. Ch. Dec. 10, 1985) (Westlaw, 1985 WL 4449) (noting "impressive credentials" of experts that valued same company at $52 and $122 per share, respectively).

[94] *See, e.g.,* Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 821 (D. Del. 1974) (noting reputation of Lehman Brothers in investment banking field).

[95] *Cf. id.* (finding it difficult to overestimate impact to shareholders of reference to Lehman Brothers).

[96] One might wonder why courts and shareholders do not pay closer attention to the reputation of investment banks. One reason why courts do not scrutinize reputation might be that legally admissible evidence will not provide a reliable picture of reputation. Another possible reason is that all reputable investment banks give pro-management fairness opinions. Thus, a court could not denounce a particular bank's behavior as different from the norm; all that courts could possibly do is to criticize the behavior of the whole investment banking industry. Shareholders, of course, lack the incentives to acquire information about the reputation of investment banks, because most of them own only a small fraction of a company's shares and because their vote is unlikely to make a difference.

banks have established internal committees that monitor the issuance of fairness opinions.[97]

A primary reason for establishing these procedures or guidelines, however, is to ensure that individual bankers act in the interest of the investment bank as a whole.[98] If it is in the interest of the bank itself to write pro-management opinions, procedures and guidelines will direct employees to do the same. Internal procedures and guidelines thns should tend to produce fairness opinions that increase fees and help to retain and attract clients.[99]

To be sure, guidelines and procedures have some beneficial effect on the quality of fairness opinions. In order to maintain a professional reputation, banks are likely to write guidelines and procedures ensuring that all fairness opinions have a reasonable basis.[100] Furthermore, internal procedures and guidelines might try to limit the psychological and social factors which lead individual bankers to issue an opinion that is more pro-management than is in the bank's interest. However, the incentives to render pro-management opinions that are created by the fee structure and the desire to retain and attract clients affect the interest of the bank itself, rather than ouly the interests of individual bankers. Therefore, internal procedures and guidelines should be expected to solidify, rather than reduce, the force of these pro-management incentives.

[97] Shearson Lehman Hutton has a committee that monitors all fairness opinions before they are issued. Confidential interview, *supra* note 66.

[98] Another reason, presumably, is to avoid legal liability arising from fairness opinions. In that case, the procedures and guidelines can be expected to reach as far as potential legal liability. But to establish liability shareholders must establish that the investment banker knowingly misrepresented the contents of a fairness opinion. *See* Note, *supra* note 12, at 128-30 (reviewing the standards for investment banker liability under both federal and state law). Even under a uegligence rule, investment bankers would not be liable for a fairness opinion that could be reasonably justified.

[99] The various formulations used in fairness opinions might illustrate how guidelines can produce pro-management opinions. In mergers, fairness opinions conventionally state whether the terms are fair, i.e., within a range of values a reasonable prudent board would accept. In hostile tender offers, fairness opinions state whether the terms are adequate, i.e., whether better terms could be obtained. *See* Weiss, *supra* note 24, at 256. Since terms must generally be higher to be adequate than to be fair, terms that are fair in mergers (which the managers generally like to approve) are inadequate in hostile tender offers (which the managers generally do not like to approve). The lack of specific guidelines can also serve these purposes. Shearson Lehman Hutton, for example, has no written guidelines and no fixed standards for issuing fairness opinious. Rather, each case is evaluated individnally. Confidential interview, *supra* note 66. Such an ad hoc approach would enable a bank, if it so desired, to conform the content of the fairness opinion to the wishes of the management.

[100] For instance, Shearson Lehman Hutton considers varions measures of fairness before it issues a fairness opinion. Confidential interview, *supra* note 66.

III. A Recommended Judicial Approach

This part suggests a judicial approach for dealing with the problems analyzed above. By following this approach, courts can reduce both the discretion that investment banks currently possess and the conflicts of interest that they face. Sections A, B, and C explain, respectively, how courts should scrutinize the definition of fairness, the measurement of fair price, and the banker-company relationship. Finally, Section D suggests that, even with such scrutiny, courts should still exercise substantial residual caution in dealing with fairness opinions.

A. *Scrutinizing the Definition of Fair Price*

The two most natural ways to attack the multiple-definition problem are: first, for courts to clarify the definitions of fairness that banks should use while preparing opinions, and second, for banks to disclose the definition underlying each opinion. Courts should recognize the conceptual confusion that surrounds the definition of fairness and try to build a system of definitions through precedent. These precedents will, over time, establish definitions appropriate to each context. Although these precedents alone may not eliminate all uncertainty about the proper definition of fairness, it is likely to reduce the range of definitions that are arguably proper in any one transaction.

In particular, courts should examine the different standards that investment banks use to evaluate friendly deals and hostile deals. In friendly transactions, banks couch opinions in terms of fairness (Would a rational board accept the offer?), whereas in hostile deals banks evaluate offers in terms of adequacy (Can a higher offer be obtained?).[101] Unless courts conclude that these different standards are warranted, they should not give weight to fairness opinions written in this fashion.[102]

At the same time, courts should require that investment banks explicitly state the definitions of fairness used in preparing their opinions. Banks should be free to use several definitions if they so desire; in that case, however, banks should state under which definitions the price is fair, and under which definitions the price is unfair. For example, an opinion should not state that a price is fair from a financial point of view; rather, it should state that the price is fair compared to the pre-merger-announcement stock price or fair compared to the price the company

[101] *See* Weiss, *supra* note 24, at 256.

[102] *See id.* (in take-out mergers, fairness opinions should be framed in terms of adequacy, not fairness).

would carry in an auction.[103]

The inclusion of explicit definitions of fairness will assist judicial analysis of fairness opinions. The respect accorded any given fairness opinion should depend on whether the definitions used in the opinion's preparation conform to the appropriate contextual definitions. Thus, if courts have established a proper definition, investment banks will know exactly how to prepare opinions that the courts will respect. But even if such a definition is not judicially established when a fairness opinion is written, courts will be able to judge the extent to which the definition used deviates from the proper definition and then decide how much weight to give the fairness opinion.

This approach is not overly demanding. It neither requires that fairness opinions use the judicially established definitions nor requires that companies obtain fairness opinions. If, however, a company does obtain a fairness opinion, the opinion should explicitly state the definitions it uses. And, as courts determine which definitions are proper, they should indicate them to enable companies to obtain opinions based on those definitions, and courts should give weight only to opinions that use such definitions.

B. *Scrutinizing the Measurement of Fair Price*

The problem of evaluating bankers' measurement processes is more difficult to solve. Price estimates are inherently imprecise. Courts are unable (and should not attempt) to specify in advance what assumptions bankers should make and what valuation techniques they should use.[104] Rather, courts should weigh an opinion depending on whether it states a range of fair prices[105] and on the extent to which its conclusion is sensitive to its assumptions. Thereby, fairness opinions will convey more information and investment banks will have less discretion.

[103] One might wonder why investment bankers have not themselves clarified the definitions of fair price. One reason why the confusion has remained might be, as we suggested in part II, that managers benefit from it: the less defined the concept of fair price, the higher the discretion to the investment bankers, and the greater their opportunity to arrive at a satisfactory opinion.

[104] *Cf.* Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983) (all generally accepted valuation techniques may be used to estimate fair value for purposes of appraisal rights). Note that the standard for fairness opinions should be based on valuation techniques used in estimating prices for purposes other than fairness opinions. If the standards were based on techniques used solely for fairness opinions, the investment banking industry would tend to develop standards that would make it easy to render pro-management opinions.

[105] Investment banks are often reluctant to specify numbers for fair prices. Chazen, Friedman & Feuerstein, *supra* note 21, at 146. However, in some cases, they are apparently willing to give ranges of fair prices. *See, e.g.*, Kahn v. United States Sugar Corp., No. 7313, slip op. at 30 (Del. Ch. Dec. 10, 1985) (Westlaw, 1985 WL 4449) (Bear Stearns gives price range of $62 to $68 per share).

In concluding that a price is fair without giving a range of prices, banks can base opinions on barely reasonable assumptions. For example, if reasonable fair stock prices for a company involved in a merger range from $50 to $90 per share, a bank will have no difficulty in justifying an opinion that a merger price of $55 is fair. If banks are forced to give a *range* of fair prices, however, it will become harder for them to make bad deals look good. Because assumptions become more difficult to justify as they become more extreme, banks will be unable to come up with arbitrary price ranges. For instance, a bank might arrive at $50 to $70 as a fair price range, with the merger price of $55 close to the bottom of this range. With a lower price range, however (say, $45 to $65), the bank might open itself to attack with respect to the (fairly unreasonable) assumptions that resulted in a $45 estimate. In such an example, directors would incur the risk of censure for accepting a blatantly biased fairness opinion, and banks would incur the risk of gaining a reputation for rendering unreasonable opinions.

Analyzing the sensitivity of price estimates to assumptions serves the same purpose as requiring specification of fair-price ranges. In performing sensitivity analyses, analysts construct a base scenario and then show how the outcome of that scenario varies with changes in assumptions.[106] In showing how estimates change as assumptions vary, this analysis indicates the type of assumptions one must make for a seemingly fair price to become unfair. A sensitivity analysis, like specification of price ranges, will tend to show *how* fair or unfair a price is, not merely whether the price is fair or not.

In giving weight to fairness opinions, courts should consider whether a corporation's directors have been told a range of fair prices and the results of a sensitivity analysis. Take a hostile tender offer as an example: if directors approve a defensive measure, a fairness opinion should receive greater weight if the directors were informed that the hostile bid was significantly below the range of fair prices and would remain below such a range even if certain (specified) assumptions were modified, and less weight if directors were merely told that the price was inadequate, was in the middle of the range of fair prices, or was unfair under some "reasonable" assumptions but fair under other "reasonable" assumptions.

Finally, in certain sufficiently unusual situations, courts should be willing even to engage in an independent review of the reasonableness of the assumptions and techniques[107] used to prepare fairness opinions and,

[106] *See generally* R. BREALY & S. MYERS, *supra* note 49, at 195-202.

[107] *See, e.g., Kahn*, No. 7313, slip op. at 29-33 (court examined assumptions on which valuations were based).

in turn, the reasonableness of directors' reliance on those opinions.[108] Such scrutiny, of course, requires that banks disclose their assumptions and techniques to directors and to courts.[109]

However, even if all these steps are taken, investment banks will retain a significant amount of discretion. Bankers can reasonably differ on the upper and lower limits of fair price ranges and on methods of performing sensitivity analyses. And courts must allow directors to rely on a variety of reasonable assumptions and techniques. Thus, our approach will only constrain—but not eliminate—investment banks' ability to manipulate fair-price measurements.

C. *Scrutinizing the Banker-Company Relationship*

As discussed,[110] the nature of the relatiouship between investment banks and corporations creates conflicts of interest that tend to produce a pro-management bias in fairness opinions. Courts should reduce this bias by scrutinizing the banker-corporation relationship. As a first step, courts should discount fairness opinions for which any part of the bank's fee is contingent. Fees contingent on results other than the eventual purchase price are especially suspect because they give banks no countervailing incentives to increase the purchase price. Although some courts have realized that investment banks in such situations hardly function as independent and objective advisors,[111] most courts have not expressed such concerns about contingent fee arrangements.[112]

One might respond that contingent fees create efficiencies that make their use desirable. In particular, contingent fees may give investment banks performance incentives. For example, fees contingent on the price shareholders receive for their shares will give banks an incentive to increase the purchase price. Fees that are contingent on winning a proxy contest or on procuring a white knight will provide incentives to assist in the proxy contest or to look for a white knight.

[108] *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275 (2d Cir. 1986) (directors obligated to become reasonably familiar with investment banker's report); *see also* Note, *supra* note 12, at 134 (directors should be able to rely only on fairness opinions that conform to accepted standards in investment banking industry).

[109] Proxy statements do not generally include calculations made in arriving at their fairness opinion. *Cf.* Chazen, Friedman & Feuerstein, *supra* note 21, at 151 (calculations usually not helpful).

[110] *See supra* notes 60-99 and accompanying text.

[111] *See* Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) (Posner, J.) (critical comment on incentives created by contingent fee), *rev'd*, 481 U.S. 69 (1987).

[112] Many opinions fail to mention that the investment bank involved received a contingent fee. *See, e.g.*, Cottle v. Storer Communication, Inc., 849 F.2d 570, 578 (11th Cir. 1988).

We do not suggest, however, that investment banks should be prohibited from negotiating and executing any type of fee arrangement, including contingent fees.[113] Rather, we only point out that courts must recognize the inevitable conflicts of interest that contingent fees create and should accordingly discount fairness opinions written under contingent fee arrangements.

Note that the beneficial incentives created by contingent fees do not relate to fairness opinions themselves; rather, the incentives operate with respect to other serviees provided by investment banks. If managers want both unbiased fairness opinions and contingent fee arrangements, they can hire a second investment bank solely to write a fairness opinion. By doing so, they maintain incentives for the bank in charge of the bulk of a transaction without creating a conflict of interest for the bank writing the fairness opinion. Managers, though, remain free to obtain fairness opinions from banks compensated under contingent fees (opinions to which courts will give less weight) or, for that matter, to obtain no fairness opinions whatsoever.

Hiring a second investment bank—preferably one that is not involved in other aspects of the transaction and has no longstanding relationship with the corporation—is preferable to eliminating the contingent fee for other reasons as well. As we have shown, even noncontingent fees create incentives to render pro-management fairness opinions; these pro-management opinions usually help to create follow-up work for the writing bank. If, however, a bank writing a fairness opinion is not involved with other aspects of the transaction, such a bank will not be influenced by the possibility that a particular fairness opinion might create more work. Furthermore, hiring an "outside" bank will reduce the psychological and social factors that tend to create pro-management fairness opinions. A second investment bank will be at a distance from the transaction and thus more likely to write a more neutral opinion.

Retaining a second investment bank just to write a fairness opinion will of course create some costs. This second bank will have to duplicate some of the lead bank's work. Lacking familiarity with the company, an "outside" bank will need to do more work to determine fair prices than would an investment bank that already knows the company. A second bank might also be hard to find. By writing a fairness opinion for a fairly small fee, such a bank disqualifies itself from representing other potential

[113] One might draw an analogy, though, to the position of public accountants, which is similar to that of investment bankers. Managers hire accountants in order to certify books prepared under management supervision. Accountants, however, may not be compensated by contingent fees. CODE OF PROFESSIONAL ETHICS § 302, Rule 302.01 (Am. Inst. of Certified Pub. Accountants 1988).

bidders for the company and earning a significantly larger fee. Lastly, although the second investment bank earns only a relatively small fee, it stands to bear all the possible liability.[114]

One should not, however, exaggerate the extent of these costs. The cost of issuing a fairness opinion is often trivial in relation to the amounts involved in a transaction as a whole.[115] The concern about disqualification would seem to apply only in the context of hostile takeovers; a bank asked to evaluate the fairness of a merger or a freeze-out price would have little hope of being hired by a newly emerging bidder. Furthermore, market forces can respond to concerns about disqualification; if these concerns really matter, some specialized investment banks that do nothing but write fairness opinions (and thus do not have to worry about disqualification) will emerge. Lastly, investment banks can insure against legal liability and, in any case, the threat of legal liability will have positive effects as investment banks exercise more care and neutrality in rendering fairness opinions.[116]

D. *Residual Skepticism*

Even if courts follow the above approach, we feel that they should still use substantial caution in relying on fairness opinions. While our approach addresses some of the problems inherent in fairness opinions, significant residual problems remain. First, although our approach does much to reduce the discretion rooted in the definition of fairness, investment banks would retain significant discretion in measuring fair price. Estimating the value of uncertain future income streams, assets that are not openly traded in the market, or prices that companies would command in an auction that is never held is an inherently subjective and imprecise activity. Specifying price ranges and performing sensitivity analyses would reduce these subjective elements, but even these remedies would not magieally transform fairness opinions into objective yardsticks of a company's value.

Second, our approach does not completely eliminate all incentives for banks to write pro-management fairness opinions. The scrutiny we propose would reduce the conflicts of interest inherent in the fee structure, but would not reduce the incentives created by the desire to retain and attract clients. Even uninvolved "outside" banks would still have

[114] *See* Note, *supra* note 12, at 135-39 (discussing investment banker's potential liability).

[115] *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 704-06 (Del. 1983) (bank given $150,000 for fairness opinion in cash tender offer of over $90,000,000, which involved a premium over market price of more than $30,000,000).

[116] *Cf.* Note, *supra* note 12, at 135 (advocating increased liability of investment banks).

incentives to deliver opinions that retain and attract clients.[117]

Third, even if these reputational incentives to render pro-management opinions were absent, the simple fact that managers select investment banks leads to biased opinions. Investment banking firms are likely to differ in how they measure fair prices and in whether their estimates tend to come out high or low. For example, it might become known that a particular bank tends to rely on adjusted share prices to determine fair prices. Managers could select that bank if such a method of determining price were likely to result in the desired fairness opinion.

Fourth, courts would have to remain aware that fairness opinions are, in part, necessarily based on information provided by managers themselves, such as managerial opinions about future business prospects[118] or internal profit forecasts.[119] Managers have an obvious incentive to provide banks with the kind of information that tends to encourage pro-management opinions.[120] Investment banks generally do not verify the information they receive in preparing their opinions;[121] rather, they premise their opinions on the assumption that the information given to them is accurate and complete.[122] For this reason as well, fairness opinions will tend to remain pro-management in character.

In light of these residual problems, the question arises whether courts should simply ignore fairness opinions. We think not: for all their problems, fairness opinions have a positive potential. Although investment banks retain some discretion, many prices will clearly fall inside or outside specified reasonable price ranges and banks will thus have to find those prices fair or unfair. Even though investment banks will have incentives to develop pro-management reputations, if they are too blatant about it, they will risk losing credibility with the courts. Therefore, as

[117] Such incentives would be especially strong for investment banks that specialize in writing fairness opinions. Those banks would derive a significant part of their revenues from these opinions. A reputation for not agreeing with managers would go to the heart of their business.

[118] *See, e.g.*, Crouse-Hinds Co. & Belden Corp., *supra* note 9, exhs. C, D (both investment banks, in preparing their fairness opinions, held discussions with management about future business prospects).

[119] *See, e.g.*, Alleghany Corp. & Investors Diversified Servs. Inc., *supra* note 9, annex III (Merrill Lynch using internal forecasts in developing its fairness opinion).

[120] One commentator has proposed that directors should be under a duty to convey accurate information to investment banks. *See* Note, *supra* note 12, at 132-33. Such a rule might prevent outright lies, but not more subtle forms of bias.

[121] *See, e.g.*, Crouse-Hinds Co. & Belden Corp., *supra* note 9, exhs. C, D; Alleghany Corp. & Investors Diversified Servs. Inc., *supra* note 9, annexes III, IV (no independent verification of information provided by the company); *see also* Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 822 (D. Del. 1974) (investment bank relied on management valuation of timber assets and conducted no independent evaluation).

[122] *See, e.g.*, Crouse-Hinds Co. & Belden Corp., *supra* note 9. exhs. C, D: Alleghany Corp. & Investors Diversified Servs. Inc.. *supra* note 9. annexes III, IV.

long as excessive judicial reliance on fairness opinions is avoided, such opinions do have the potential for serving a useful function.

IV. Conclusion

The purpose of this Article has been to analyze the problems with fairness opinions and to suggest a judicial approach for evaluating such opinions. Fairness opinions are problematic because investment banks have substantial discretion in rendering such opinions. The banks' discretion derives from two sources: first, the concept of fair value is not clearly defined, and banks can thus choose among several proposed definitions of fairness; second, the subjective nature of the estimation process creates discretion in measuring fair price, however it is defined.

Investment banks face conflicts of interest that lead them to use their discretion to render pro-management fairness opinions. For one, pro-management opinions generally increase banks' revenue. Such opinions make banks more likely to receive contingent fces or, where a bank does not receive a contingent fee, generate further work. Furthermore, rendering pro-management opinions will help banks to retain and attract clients. These incentives are enhanced by psychological and social loyalty that some bankers may feel towards managers. Neither the desire to preserve a professional reputation nor the presence of internal procedures will significantly reduce these problems.

To deal with these problems, we recommend an approach that helps courts to scrutinize definitions of fair price, the measurement of fair price, and the company-banker relationship. 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. This discounting will reduce incentives for rendering pro-management opinions. In any case, since the recommended approach would reduce, but not eliminate, discretion and pro-management incentives, courts should exercise substantial caution in assessing and giving weight to fairness opinions.