

# ARTICLES

## FAIRNESS OPINIONS

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## INTRODUCTION

A fairness opinion is an opinion provided by an outside advisor, usually, though not necessarily, an investment bank, that a transaction meets a threshold level of fairness from a financial perspective. Typically, these opinions are rendered to a corporation's board of directors, or a committee thereof, in connection with a corporate control transaction such as a sale, leveraged buy-out,<sup>1</sup> leveraged recapitalization,<sup>2</sup> going-private transaction,<sup>3</sup> or otherwise.<sup>4</sup> The board will rely on this opinion to

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1. A leveraged buy-out is the acquisition for cash of the outstanding stock of a publicly traded corporation. The cash consideration is principally obtained through debt financing secured by the assets of the acquired corporation. *See generally* Tom Ablum & Mary Beth Burgis, *Leveraged Buy-outs: The Ever Changing Landscape*, 13 DEPAUL BUS. L.J. 109, 109-14 (2000/2001) (discussing the history and parameters of leveraged buy-outs in the United States); Bill Shaw & Edward J. Gac, *Fairness Opinions in Leveraged Buy-outs: Should Investment Bankers Be Directly Liable to Shareholders?*, 23 SEC. REG. L.J. 293 (1995) (discussing the use of fairness opinions in leveraged buy-outs).

2. A leveraged recapitalization is similar to a leveraged buy-out except that, in addition to cash consideration for their shares, the public stockholders of the corporation receive equity in the post-transaction, leveraged corporation. *See generally* Franci J. Blassberg & Peter J. Shabecoff, *Structuring Issues for Financial Sponsors in Leveraged Recapitalization Transactions*, in 2 ACQUIRING OR SELLING THE PRIVATELY HELD COMPANY 2004, at 371 (PLI Corp. Law & Practice, Course Handbook Series No. B-1432, 2004) (discussing the structure of a leveraged recapitalization). The public stockholders retain a smaller aggregate interest in the equity of the corporation with the remaining equity held by the arranging participants of the recapitalization, typically management or a financial sponsor. *Id.*

3. A going-private transaction can be defined as one where an affiliate of a publicly held corporation (e.g., a member of management or a controlling stockholder) acquires the remaining corporate equity. Consequently, the corporation becomes "private," and its equity is no longer publicly traded. *See also* 17 C.F.R. § 240.13e-3 (2001) (setting forth the federal securities law definition of a going-private transaction). *See generally* Bradley R. Aronstam et al., *Revisiting Delaware's Going-Private Dilemma Post—Pure Resources*, 59 BUS. LAW. 1459 (2004) (discussing recent Delaware case law with respect to going-private transactions); Michael J. McGuinness & Timo Rehbock, *Going-Private Transactions: A Practitioner's Guide*, 30 DEL. J. CORP. L. 437 (2005) (describing the legal regulation of going-private transactions).

4. Corporate control transactions can also be defined as those fulfilling the Securities and Exchange Commission ("SEC") definition of a takeover set forth in Rule 145, 17 C.F.R. § 230.145 (2006), promulgated under the Securities Act of 1933, as amended (the "Securities Act"). 15 U.S.C.S. §§ 77a-77aa (2006). Rule 145 sets forth the federal securities law definition of a takeover transaction for purposes of an offer, offer to sell, offer for sale, or sale under the Securities Act when "there is submitted to security holders a plan or agreement pursuant to which such holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security." 17 C.F.R. § 230.145, preliminary note (2006). This is an overly broad definition for a corporate control transaction since it encompasses merger transactions that do not constitute a change of control for either party. The definition is also narrow since it excludes transactions that do not involve securities consideration. A corporate

satisfy its duty of care in the determination of whether or not to proceed.<sup>5</sup> There are other paradigms in which fairness opinions are utilized; however, the thrust of this Article is focused upon the use of such opinions by acquirers in a corporate control transaction.<sup>6</sup>

In the mid-1980s, the Delaware Supreme Court in *Smith v. Van Gorkom*<sup>7</sup> placed heavy reliance on the lack of a fairness opinion or other reliable valuation in a corporate control transaction to sustain a holding that an acquirer board breached its duty of care.<sup>8</sup> From this

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control transaction for purposes of this Article can be simply defined as a transaction, or series of related transactions, which constitute a transfer of control of a corporation or all, or substantially all, of its assets.

5. A board is subject under Delaware law to a fiduciary duty of care. In a corporate control transaction, this requires the board to “inform themselves fully and in a deliberate manner before voting” on a corporate control transaction. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368 (Del. 1993) (citing *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985)). This more specifically obligates a board to apprise itself “of all material information reasonably available to them.” *Van Gorkom*, 488 A.2d at 872 (quoting *Aronson v. Lewis*, 473 A.2d 858, 812 (Del. 1984), *overruled by Brehm v. Eisner*, 716 A.2d 244 (Del. 2000)). A plaintiff asserting a breach of this duty of care must establish that the board was grossly negligent in the referenced decision. *Id.* at 873. Simple negligence is insufficient. *Id.* A failure to establish gross negligence when asserting a breach of the duty of care will lead the Delaware courts to apply the business judgment rule; consequently, the courts will not second guess this business decision. *See Cede*, 634 A.2d at 361. *See generally* Craig W. Palm & Mark A. Kearney, *A Primer on the Basics of Directors’ Duties in Delaware: The Rules of the Game (Part I)*, 40 VILL. L. REV. 1297, 1307-08 (1995) (outlining the duty of care and the standard for breach thereof under Delaware law). To date, *Van Gorkom* is the leading Delaware case on the duty of care in the corporate control context. *See* discussion of case and its holding *infra* Part I.B; *see also In re Walt Disney Co. Derivative Litigation*, 2006 WL 1562466 (Del. 2006) (discussing scope of duty of care and the board decision-making process outside of the corporate control context).

6. Fairness opinions are also utilized in other corporate transactions to assist a board in setting price when conflicts of interest arguably exist, which require such additional aid or when a general need for information as to value is desirable. For example, fairness opinions are routinely provided in connection with split-offs and spin-offs. *See, e.g., Rosser v. New Valley Corp.*, 2005 WL 1364624, at \*3 (Del. Ch. 2005) (fairness opinion obtained in connection with recapitalization); *Gen. Motors, Definitive Proxy Statement (Form 14A)*, at E-2 (Aug. 21, 2003) (four fairness opinions obtained in connection with the split-off of Hughes Electronics by General Motors); *see also* Thomas Patrick Dore, Jr. & Peter Pattison, *Fairness Opinions in Corporate Real Estate Transactions*, N.Y.L.J., Nov. 27, 2002, at 4 (advocating use of fairness opinions in real estate transactions). However, the primary use of fairness opinions today is within the corporate control transaction. *See generally* Charles M. Elson et al., *Fairness Opinions—Can They Be Made Useful?*, 35 SEC. REG. & L. REP. (BNA) 1984 (Nov. 24, 2003) (setting forth illustrative corporate transactions wherein fairness opinions are typically rendered) [hereinafter Elson, *Can They Be Made Useful?*].

7. 488 A.2d 858 (Del. 1985).

8. *See* discussion of case and its holding *infra* at Part I.B. Corporate law in the United States is principally set by state law applied to a corporation based on its situs of incorporation. This Article focuses primarily on the general corporate law of Delaware when discussing state law and applicable governing corporate law. This is because Delaware is the principal and preferred place of incorporation for the majority of public corporations in the United States and is viewed as the national standard-setter for regulation of public corporations. *See* Lucian Arye Bebchuk &

singular act, academics and practitioners inferred and concluded, perhaps rightfully, that a fairness opinion was a virtually mandatory requirement for an acquiree board, or committee thereof, making a corporate control decision.<sup>9</sup> This was their practical conclusion. However, their critical response was heated, almost visceral in nature. Immediately after *Van Gorkom* and through the early 1990s, fairness opinions were derided as, among other things, conflict-ridden, subjective, rubber-stamps, meaningless, and hackneyed.<sup>10</sup> This burst of criticism dissipated as the Delaware courts continued to place

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Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 554 (2002) (stating Delaware “plays a central role in setting corporate governance rules for the nation’s publicly traded companies”); Website of Delaware Division of Corporations, <http://www.state.de.us/corp/> (last visited May 27, 2006) (noting that “more than 50% of all U.S. publicly traded companies and 60% of the Fortune 500” are incorporated in Delaware). For this reason, and Delaware’s perceived, well-qualified judiciary, Delaware courts regularly address major corporate law issues facing publicly traded corporations, and Delaware is therefore generally regarded to have the most trenchant case law. See E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1399-1411 (2005) (discussing the primacy of Delaware case-law in addressing corporate governance and related issues).

9. E.g., Michael J. Kennedy, *Functional Fairness—The Mechanics, Functions and Liabilities of Fairness Opinions*, in HANDLING HIGH-TECH M&AS IN A COOLING MARKET: ENSURING THAT YOU GET VALUE, at 605, 607 (PLI Corp. Law & Practice, Course Handbook Series No. B-1255, 2001) (noting that fairness opinions are delivered “in almost any transaction of note involving public companies”); Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1453 (1985) (asserting that after *Van Gorkom*, “no firm considering a fundamental corporate change will do so without obtaining a fairness letter”); Shaw & Gac, *supra* note 1, at 293 (“Over the last decade, the fairness opinion has become a necessary and integral aspect of every major corporate control transaction.”); Andre Ross Sorkin, *A Dual Role for Lehman in Deal Talks*, N.Y. TIMES, June 3, 2005, at C1 (noting as unusual the lack of a fairness opinion in the proposed transaction).

10. See, e.g., Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27, 29-38 (1989) (discussing the substantial preparer discretion with respect to a fairness opinion) [hereinafter Elson, *Are They Fair?*]; William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 532-37 (1992) (criticizing fairness opinions for lack of precision and inability to predict price); Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951, 952-70 (1992) (criticizing fairness opinions for having “dubious” value); Michael W. Martin, Note, *Fairness Opinions and Negligent Misrepresentation: Defining Investment Bankers’ Duty to Third-Party Shareholders*, 60 FORDHAM L. REV. 133, 140-41 (1991) (“[D]uring the mergers-and-acquisitions boom of the 1980s, the rendering of a fairness opinion became a mere formality performed after a deal was structured.”); Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 214 (1988) (“[T]he chicanery of using made-to-order fairness opinions is probably widespread.”); see also Bernard Black & Reinier Kraakman, *Delaware’s Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 555-57 (2002) (criticizing fairness opinions for their “doubtful” value); Elson, *Can They Be Made Useful?*, *supra* note 6, at 2-3 (discussing various criticisms of investment bank fairness opinions); David Henry, *A Fair Deal—But for Whom?*, BUS. WK., Nov. 24, 2003, at 108 (criticizing investment banks rendering fairness opinions for lack of objectivity and conflicts of interest).

persuasive reliance on fairness opinions and intermittently reasserted their implicit requirement for an acquiree fairness opinion in a corporate control transaction.<sup>11</sup> Today, the fairness opinion survives and thrives, earning investment banks millions, if not billions, of dollars yearly.<sup>12</sup>

This Article re-examines the fairness opinion, as well as its role and necessity. Corporate law and regulation, as well as attitudes with respect thereto, have advanced from the hallmark time of *Van Gorkom*.<sup>13</sup> Finance, a young discipline, has also progressed markedly, and previously held assumptions and methodologies have been rejected, refined, or revised.<sup>14</sup> This Article also analyzes the fairness opinion in light of these developments in law and finance.<sup>15</sup> I

11. See *infra* notes 219-226 and accompanying text.

12. One recent empirical study analyzed a significant sample of merger and acquisition transactions announced between 1994 and 2003 and found that a fairness opinion had been provided to approximately eighty percent of acquirees and thirty-seven percent of acquirers. See Darren J. Kisgen et al., *Are Fairness Opinions Fair? The Case of Mergers and Acquisitions* (Apr. 12, 2006), available at <http://ssrn.com/abstract=901475>; see also Helen M. Bowers, *Fairness Opinions and the Business Judgment Rule: An Empirical Investigation of Target Firms' Use of Fairness Opinions*, 96 NW. U. L. REV. 567, 577-78 (2002) (detailing an empirical study which found that approximately sixty-one percent of acquiree firms in selected, post-*Van Gorkom* corporate control transactions reported receipt of a fairness opinion, while over ninety percent of firms during this period disclosed that they had engaged a financial advisor for the transaction).

13. This is particularly true in the post-Enron/Worldcom universe. For a discussion of this heightened scrutiny of corporate actions and increased regulation of corporations post-Enron/Worldcom, see, *inter alia*, William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953 (2003) (discussing possible corporate governance and regulatory reforms in the 21st century); Faith Stevelman Kahn, *Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 TUL. L. REV. 1579 (2002) (tracing the development of post-Enron/Worldcom reforms and arguing for increased legal corporate reform based on core American values of equality and meritocracy); Gretchen Morgenson, *An Emboldened Investor Class Is Not Likely to Go Away Soon*, N.Y. TIMES, Mar. 3, 2004, at C1 (reporting increased supervision of corporate practices by stockholders post-Enron/Worldcom).

14. For a history of these developments, see generally JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., *A HISTORY OF CORPORATE FINANCE* (1997); RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE*, at 995-98 (7th Int'l ed. 2003); SHANNON P. PRATT ET AL., *VALUING A BUSINESS* 4-18 (4th ed. 2000).

15. Criticism and review of the fairness opinion has, in recent years, percolated into the public realm. Elliot Spitzer, Attorney General of the state of New York, stated publicly in 2003 that an inquiry should be made of investment bank fairness opinion practices. To date, though, his office has not taken any public action. See Patrick J. Leddy & Randall M. Walters, *The Growing Storm over Fairness Opinions*, MERGERS & ACQUISITIONS J., Mar. 2005, at 35-36. Additionally, there has been a recent investigation into fairness opinion practices by the Massachusetts Secretary of the Commonwealth and regulatory action by the National Association of Securities Dealers ("NASD"). The investigation of the Massachusetts Secretary of the Commonwealth is discussed *infra* note 164 and accompanying text. The new proposed NASD regulation is discussed *infra* at Part III.B. See also Ann Davis, *Wall Street's 'Fairness Opinions' Draw Fire from Calpers*, WALL ST. J., Feb. 8, 2005, at C1

conclude that current fairness opinion practice is still deeply flawed. Fairness opinions, and their underlying valuation analyses, are prone to subjectivity and are frequently prepared utilizing methodologies that simply do not jibe with best practices.<sup>16</sup> These defects are exacerbated by the recurring problem of investment banks who are conflicted in their provision of fairness opinions.<sup>17</sup>

This Article, however, does not call for the fairness opinion's death. Rather, I argue for a conditioned place in corporate control transactions, albeit legally diminished, for the fairness opinion. The pre-condition is the remedy of current defects through revision in the practice and requirements of fairness opinion preparation, form, and disclosure. These suggested reforms should be implemented in a practical manner through a quasi-public, standard-setting body. Creation of this body and adoption of guidelines and standards, should also reduce the subjectivity and increase the reliability of fairness opinions enhancing their signaling, screening and informational qualities. Implementation of these reforms would also do more to alleviate the related and repeatedly cited problem of investment bank conflicts-of-interest than prior disclosure-based proposals.<sup>18</sup>

Even if these proposals are adopted, the fairness opinion, in and of itself, is not a panacea. For two reasons, it will always be an inferior substitute for a market-based approach to determine the fairness of the consideration in a corporate control transaction. First, valuation analysis, even if disciplined, can only inform as to value. It will never definitively predict price—only the market can do this. Second, a fair price from the acquiree stockholder perspective is one that is set through an effective market-based process. Accordingly, a fairness opinion in a corporate control transaction, from the perspective of the acquiree's stockholders, could arguably be defined as an opinion that an offered price is within a minimum range that otherwise would have been obtained in such a market-based process.<sup>19</sup> A fairness opinion becomes redundant, at best, if such process is adhered to,

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(reporting that the California Public Employees Retirement System is now recommending that investment banks be prohibited from issuing fairness opinions when also providing general financial advice).

16. See *infra* Part II.A.

17. See *infra* Part II.B.

18. See *infra* Part IV.B.3.

19. Cf. Bebchuk & Kahan, *supra* note 10, at 31 (stating that some consider fair price in a corporate control transaction to be the price that acquiree stockholders would receive through an auction-process).

and a reformed fairness opinion will always be an imperfect substitute for an effective market-based price.

However, a valuation conducted with rigor and in accordance with disclosed guidelines and standards can materially inform as to value. It is for this reason that, provided reform comes, a fairness opinion, and its underlying valuation analyses, can still have utility whenever an effective market-based price is unobtainable. In such circumstances, a fairness opinion can inform the board in satisfaction of its duty of care by providing confidence that the consideration offered is commensurate with a minimum price range achievable in the functioning market. Even in such situations, though, the inherent limitations of state-of-the-art valuation should be recognized; a fairness opinion should only be one of many tools to assist a board in gauging what is a “fair” price. The Delaware courts should recognize this, repudiating *Van Gorkom*’s wholesale, implicit fairness opinion requirement when the agreed price is a market-based one. In other circumstances, a fairness opinion should not be required, but if received, it should be considered by the Delaware courts as only one indicative factor used to assess a board’s satisfaction of its duty of care.<sup>20</sup>

Part I of this Article examines the fairness opinion; its scope, purpose, form and judicially-spurred adoption. Part II discusses the perceived flaws and tension points in the reliance upon fairness opinions in corporate control transactions. This Part examines the indeterminate qualities of valuation as well as the current problematical practices and conflicted status of investment banks in the preparation and rendering of fairness opinions. Part III surveys the response of various corporate regulators, the Delaware judiciary, and academics to the fairness opinion and its increased utilization post-*Van Gorkom*. Part IV proposes needed legal reform to today’s existent fairness opinion regime.

## I. RISE OF THE FAIRNESS OPINION

### A. *The Fairness Opinion—Scope, Purpose, and Form*

In the corporate control transaction, a fairness opinion is typically provided to a board, or a committee thereof, at the time of its consideration of the relevant transaction.<sup>21</sup> The fairness opinion is

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20. See *infra* Part IV.A.

21. This permits a board to properly assess, under its duty of care, the fairness

usually delivered orally at this meeting by the investment bankers in attendance and confirmed in a subsequent, written letter addressed to the board from the investment bank.<sup>22</sup> This two or three page letter also sets forth the transaction terms, as well as the qualifications and assumptions underlying the investment bank's fairness determination.<sup>23</sup> In fact, this is the letter's primary purpose, to manage and restrict the investment bank's liability for rendering the opinion: the laundry list of qualifications and assumptions is the bulk of the text.<sup>24</sup> It is only at the letter's end, in one sentence, wherein

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opinion and any related information at or before the time of its decision to enter into a corporate control transaction. *Cf.* *Smith v. Van Gorkom*, 488 A.2d 858, 881 (Del. 1985) (holding that Trans Union's Board was grossly negligent because it failed to act with informed deliberation before agreeing to a corporate control transaction). However, fairness opinions are sometimes rendered after the board's decision and corporation's agreement to enter into the transaction. *See* Andrew L. Bab, Collins and the Pitfalls of Post-Signing Fairness Opinions, 14 INSIGHTS 16, 17-18 (Dec. 2000) (outlining three circumstances under which post-signing fairness opinions are sought: in cases of substantial change, upon board request, and as a closing condition to a transaction agreement). A fairness opinion is typically provided in such situations to account for changed circumstances and to revalidate the consideration offered. *See, e.g.*, Worldwide Rest. Concepts, Inc., Definitive Proxy Statement (Form 14A), at cover page (Aug. 22, 2005) [hereinafter Worldwide Proxy Statement] (disclosing that board requested its investment bank to "issue an update to its previously issued fairness opinion in the form of a 'bring-down' opinion so that the stockholders will have updated information available for consideration prior to the vote"). Such an opinion is not necessarily a legal requirement under Delaware law unless the board obtains information that the previously rendered opinion is no longer true or otherwise cannot be maintained. *See* *Emerald Partners v. Berlin*, 2003 WL 21003437, at \*26 (Del. Ch. 2003) (affirming board decision not to obtain updated fairness opinion), *aff'd*, 840 A.2d 641 (Del. 2003); *In re Unocal Exploration Corp. S'holders Litig.*, 793 A.2d 329, 350 (Del. Ch. 2000) (holding updated fairness opinion not legally required since investment bank still believed transaction to be fair); *Behrens v. United Investors Mgmt. Co.*, 1993 WL 400209, at \*11-12 (Del. Ch. 1993) (stating that intervening changes may require board to inquire whether fairness opinion has been adversely affected).

22. *See generally* Kennedy, *supra* note 9, at 654-56 (discussing the fairness opinion preparation and board delivery process).

23. For recent examples of fairness opinions, *see* *Maytag Corp.*, Definitive Proxy Statement (Form 14A), at Annex B (Nov. 21, 2005) [hereinafter *Maytag Proxy Statement*] (containing the fairness opinion of Lazard Frères & Co., LLC delivered to the Maytag board in connection with Maytag's proposed acquisition by Whirlpool Corporation for cash and securities); *PeopleSoft, Inc.*, Amendment to Recommendation Statement (Form 14D9/A), at Exs. (a)(143) & (a)(144) (Dec. 15, 2004) (containing the fairness opinions of Citigroup Global Markets, Inc. and Goldman, Sachs & Co. delivered to the PeopleSoft board in connection with PeopleSoft's acquisition by Oracle Corporation for cash); *Plains Resources, Inc.*, Definitive Proxy Statement (Form 14A), at App. B (June 23, 2004) [hereinafter *Plains Resources Proxy Statement*] (containing the fairness opinion of Petrie Parkman & Co., Inc. delivered to the special committee of the Plains Resources board in connection with the corporation's going-private).

24. *See supra* note 23 for examples of fairness opinions which contain this restrictive language and *infra* notes 36-39 and accompanying text for a further discussion of these qualifications and limitations; *see also* Kennedy, *supra* note 9, at 611-13 (discussing customary fairness opinion language).



the fairness of the transaction at-hand is opined to.<sup>25</sup> In a corporate control transaction, this is a statement that the consideration<sup>26</sup> paid or received in the transaction is “fair from a financial point of view” to a specified party.<sup>27</sup> The party is dependent upon the form and posture of the transaction, but the opinion is typically directed to the party receiving or paying the transaction consideration. For example, in an opinion delivered to an acquirer board considering the transfer of corporate control through a corporate sale, the opinion would be to the corporation’s selling stockholders.<sup>28</sup>

A fairness opinion is not an appraisal. It does not specify a set value or presume to be a determination of price.<sup>29</sup> What a fairness opinion is, is the opinion of a financial or other advisor that a specified transaction is within a range of values encompassing financial fairness.<sup>30</sup> A more specific definition of fairness in these

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25. See, e.g., Plains Resources Proxy Statement, *supra* note 23, at B-3.

26. If the transaction is structured as a stock-for-stock merger or exchange offer, wherein the consideration paid by the acquirer consists of securities to be exchanged for acquirer stock, the consideration for purposes of the opinion as to fairness would be the stock exchange ratio. E.g., AT&T, Definitive Proxy Statement (Form 14A), at Annex B (May 23, 2005) [hereinafter AT&T Proxy Statement] (advising on the stock-for-stock merger of AT&T and a wholly-owned subsidiary of SBC Communications, Credit Suisse First Boston LLC opined that “[a]s of the date hereof, the Exchange Ratio [wa]s fair, from a financial point of view, to the holders of Company Common Stock”).

27. The phrase “from a financial point of view” is not typically defined in the written opinion but can be put forth for its plain meaning: financial fairness is assessed based on a numerical range of value. Put another way, one practitioner commentator has proposed “from a financial point of view” to mean “that the bank’s opinion is based on numbers and manipulations and comparisons of these numbers. No other non-number factors . . . are taken into account.” Kennedy, *supra* note 9, at 615-16. It has at times been proposed that the definition of fairness be expanded beyond a financial assessment to encompass retention and compensation arrangements entered into in connection with corporate control transactions. The rationale is to limit officer and director rent-seeking through a fairness check to ensure that these arrangements are not exigent. These proposals should be rejected. Certainly, these and other arrangements and the real and potential problem of abuse are a troublesome issue in corporate control transactions. This is not in doubt. However, addressing these issues through the fairness opinion regime misses the point of a fairness opinion and, at best, conflates the solution to the problem. A fairness opinion speaks only to a price. It can be defined as an opinion that a price is within a range of acceptable values. See *infra* notes 163-65 and accompanying text (discussing the limitations of a fairness opinion with respect to ascertainment of price). Stockholders should evaluate the consideration paid and retention and other compensation arrangements separately. Fairness opinions should opine only to financial fairness.

28. For these purposes, the opinion would be only to those stockholders who are unaffiliated with the acquirer. For example, in one recent going-private transaction, the opinion stated that the consideration was fair, from a financial point of view, to the public stockholders other than the members of management who were stockholders and participants in the transaction and their affiliates. See Plains Resources Proxy Statement, *supra* note 23, at App. B, B-3.

29. Kennedy, *supra* note 9, at 612.

30. *Id.* at 613; see also Yasuhiro Ohta & Kenton K. Yee, The Fairness Opinion

circumstances is almost never proposed or spelled out.<sup>31</sup> In fact, the definition of fairness varies in context and, in each instance, is subject to debate among practitioners and academics.<sup>32</sup> In a corporate control transaction, one definition of fairness, from an acquirer's perspective, is a minimum range of values that the corporation's unaffiliated stockholders would otherwise receive in a board-run auction process conducted in a fair, open, and equivalent manner.<sup>33</sup> However, the definition of fairness runs depending upon the opinee, as well as the transaction and its unique characteristics.<sup>34</sup> To date, there is no agreed-upon standard definition among academics,

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Puzzle: Board Incentives, Information Asymmetry, and Bidding Strategy (May 2006) (unpublished manuscript, on file with author) (arguing that acquirer fairness opinion ranges are a product of game theory—more specifically, a “cheap talk” game between the board and existing stockholders as well as future stockholders, designed to simultaneously convince current stockholders to support the transaction while talking up the price to future stockholders if the transaction fails).

31. See Bebchuk & Kahan, *supra* note 10, at 30 (“[I]nvestment banks generally do not disclose which definition of fair price they have used; their fairness opinions simply state that prices are ‘fair from a financial point of view.’”). In the eighties and early nineties, fairness opinions sometimes stated that a transaction was also equitable or otherwise briefly defined fairness. *E.g.*, *In re Tri-Star Pictures, Inc.*, Litig., 634 A.2d 319, 323 (Del. 1993) (fairness opinion stated that “the financial terms of the [transaction] are fair and equitable”). However, due to liability concerns, today it is extremely rare for an investment bank to go beyond a simple opinion that a proposed transaction is “fair” or “inadequate.” See *infra* note 36 (discussing the scope of liability for statements of opinion under the federal securities laws). However, fairness opinions in non-U.S. transactions still sometimes do go farther where it may be a requirement or practice of the local jurisdiction. *E.g.*, Sinopec Beijing Yanhua Petrochemical Co. Ltd, Transaction Statement (Form 13e-3), at D-15 (Jan. 19, 2005) [hereinafter Sinopec Form 13e-3] (fairness opinion stated that the terms of the transaction were “fair and reasonable”).

32. See, *e.g.*, Bebchuk & Kahan, *supra* note 10, at 30-34 (noting lack of agreement on the appropriate fairness standard); Leonard 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 (1981); Kennedy, *supra* note 9, at 616-17 (discussing the definition of fairness).

33. There are, however, other definitions. Fairness here could alternatively be formulated as one of the following: the price that otherwise would be arrived at through independent bargaining between the acquirer and the acquirer; the acquirer's liquidation value; the value of the acquirer absent any control premium, transaction cost-savings, synergies, or other transaction-related value; or the value of the sum of the acquirer's businesses. See generally Bebchuk & Kahan, *supra* note 10, at 30-34 (outlining various possible definitions of fairness in a corporate control transaction). One commentator has rejected all of these definitions; he defines fairness as simply the price that any selling stockholder is willing to accept. Elson, *Are They Fair*, *supra* note 10, at 953. However, I would suggest that an appropriate definition of acquirer fairness in any context, absent unusual circumstances, is the price that otherwise would be set in an effective market, and I would put forth an auction-based process as the optimal mechanism for achieving such price in a corporate control transaction.

34. See Bebchuk & Kahan, *supra* note 10, at 32 (noting that context can influence the definition of fairness).

practitioners, or standard-setters of what fairness is in any circumstance. This is startling.<sup>35</sup>

Liability concerns have driven fairness opinion structure and form. Investment banks have eschewed definitional fairness, since elaboration provides further facts and conclusions upon which to challenge the validity or preparation of an opinion or to otherwise assert under the federal securities and other disclosure-based laws that it is a statement of fact rather than opinion.<sup>36</sup> The qualification and assumptions are crafted responses designed in part to restrict or obviate court attempts to broaden the measure of review incumbent upon investment banks in the preparation of fairness opinions,<sup>37</sup> as

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35. Cf. Ted J. Fiflis, *Responsibility of Investment Bankers to Shareholders*, 70 WASH. U. L.Q. 497, 517 (1992) (“The profusion of differing concepts of value may cause both director and banker error.”).

36. An opinion will be deemed untrue for purposes of the federal securities laws if it is “issued without a genuine belief or reasonable basis.” *Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179, 185 (3d Cir. 1988) (quoting *Eisenberg v. Gagnon*, 766 F.2d 770, 776 (3d Cir. 1985)); see also *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977) (“An opinion or prediction is actionable if there is a gross disparity between prediction and fact.”); *In re McKesson HBOC, Inc. Secs. Litig.*, 126 F. Supp. 2d 1248, 1265 (N.D. Cal. 2000) (holding that “material statements of opinion are false only if the opinion was not sincerely held” and “[i]n the case of a fairness opinion, then, the plaintiff must plead with particularity why the statement of opinion was objectively and subjectively false”). While *Herskowitz* and *McKesson* established that liability could be had for an untrue fairness opinion, as a practical matter, it is difficult to prove that a subjective opinion is untrue for purposes of the federal securities law. See *Herskowitz*, 857 F.2d at 185; *McKesson*, 126 F. Supp. 2d at 1265.

37.

A fairness opinion, for example, will typically state that we have not assumed any responsibility for independent verification of any of the foregoing information and have relied on its being complete and accurate . . . [w]e have not been requested to make, and have not made, an independent evaluation or appraisal of the assets or liabilities . . . of the [acquiree] or [acquirer], nor have we been furnished with any such evaluations or appraisals.

AT&T Proxy Statement, *supra* note 26, at B-1, B-2. Absent unusual circumstances or contradictory information, an investment bank may rely exclusively upon and assume, without independent verification or investigation, the accuracy of any information provided to it for purposes of its fairness opinion. See MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS AND FREEZEOUTS § 8.06.5 (2005) (citing cases finding a duty to investigate where the investment bank had some basis to believe that the information provided was inaccurate or misleading). In addition, in a public corporate control transaction, a corporation can put limitations upon the information provided to the investment bank so long as this stricture is disclosed to stockholders. See *Dowling v. Narangasset Capital Corp.*, 735 F. Supp. 1105, 1119 (D.R.I. 1990) (holding board limitation on the scope of information utilized by investment bank was required to be disclosed in proxy statement); *Joseph v. Shell Oil Co.*, 482 A.2d 335, 341-42 (Del. Ch. 1984) (holding corporation failed to “clearly and unequivocally” disclose that essential and necessary information had been withheld from the provider of a fairness opinion). For a thorough discussion of other routine limitations and qualifications placed by investment banks in fairness opinions, see *Kennedy*, *supra* note 9, at 223-25; Dennis J. Block & Jonathon M. Hoff, *Reliance on Fairness Opinions*, N.Y.L.J., June 16, 1994, at 5.

well as the scope of an investment bank's duty to the relevant corporation's stockholders.<sup>38</sup> Even the addressee, the board, is a creature of liability concern. The board, rather than stockholders, is the addressee in order to refute stockholder claims of reliance upon the opinion.<sup>39</sup> Ultimately, while a full review of the fairness opinion form is beyond the scope of this Article, it can be claimed that these caveats and omissions eat up much of the worth of any fairness opinion. These failings are exacerbated by the customary indemnification arrangements and measured release from liability that investment banks demand and regularly receive in connection with their provision of a fairness opinion.<sup>40</sup>

However, criticizing the obvious limitations of the fairness opinion form may be tendentially unfair to investment bankers. A fairness opinion delivered orally or in writing by the preparer at a board meeting is almost always, at least in a corporate control transaction, accompanied by a "board book."<sup>41</sup> The board book details the

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38. A typical acquiree-side fairness opinion in a corporate control transaction will state that the opinion therein is only provided to the board in connection with the board's consideration of the transaction at hand and "does not constitute a recommendation to any stockholder as to how such stockholder should vote or act on any matter" relating to the transaction. AT&T Proxy Statement, *supra* note 26, at B-2. This statement is placed solely to restrict the investment bank's potential liability to stockholders, and it is of doubtful effect since, in a public corporate control transaction, the opinion is required to be publicly disclosed and will be reviewed and possibly relied upon by the corporation's stockholders. *See infra* Part III.A (discussing fairness opinion disclosure requirements under the federal securities law). Nonetheless, with or without these disclaimers, the exact scope of an investment bank's liability to stockholders for the rendering of an "incorrect" fairness opinion is still uncertain and subject to much judicial and academic debate. For further discussion of this point and the potential scope of investment bank liability with respect to fairness opinions, *see* Fiflis, *supra* note 35; Giuffra, *supra* note 10; M. Breen Haire, *The Fiduciary Responsibilities of Investment Bankers in Change-of-Control Transactions*: In re Daisy Systems Corp., 74 N.Y.U. L. REV. 277 (1999); Martin, *supra* note 10; Tariq Mundiya, *Liability of Investment Banks: An Update on Recent Developments*, 11 INSIGHTS 15 (Oct. 1997); Dale A. Oesterle, *Fairness Opinions as Magic Pieces of Paper*, 70 WASH. U. L.Q. 541 (1992); John S. Rubenstein, Note, *Merger & Acquisition Fairness Opinions: A Critical Look at Judicial Extensions of Liability to Investment Banks*, 93 GEO. L.J. 1723, 1729-41 (2005); Shaw & Gac, *supra* note 1; Randall S. Thomas & Robert G. Hansen, *A Theoretic Analysis of Corporate Auctioneers' Liability Regimes*, 1992 WIS. L. REV. 1147, 1158-71 (1992); 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, 611-21 (1991).

39. It is therefore a strange dichotomy that a fairness opinion can opine that the consideration is fair to the corporation's stockholders but is addressed and delivered to the board.

40. This limitation of liability usually releases an investment bank from all but its own willful misconduct or gross negligence. For an example of an investment bank engagement letter containing such provisions, *see* John F. Seegal, *Negotiating the Investment Banking Engagement Letter*, in ACQUIRING OR SELLING THE PRIVATELY HELD COMPANY, at 173 (PLI Corp. Law and Practice, Course Handbook Series No. 61494, June-July, 2005).

41. *See generally* Kennedy, *supra* note 9, at n.29 (asserting the importance of

underlying analyses conducted by the opiner to arrive at and conclude financial fairness.<sup>42</sup> It is here that the meat of the investment banker's work lies.<sup>43</sup> A well-advised board will review this book in connection with their receipt of a fairness opinion and question the bankers as to their derivation of fairness.<sup>44</sup> It is in these actual analyses that the meaning and worth, if any, of a fairness opinion lies.<sup>45</sup>

### *B. The Fairness Opinion—Delaware's Pivotal Role*

The primacy and role of the fairness opinion stems from the vicissitudes of Delaware corporate law. This is a fairly recent development. Prior to 1985, the role and necessity of the fairness opinion in a corporate control transaction was a legal uncertainty.<sup>46</sup> These opinions existed solely as an investment banking product.<sup>47</sup> This is not to say that legal practitioners perceived these opinions as valueless in aid of board decision-making and satisfaction of a board's fiduciary duties. They did see such utility and routinely advised their obtainment.<sup>48</sup> However, the need for a fairness opinion was not, at this time, recognized by the Delaware courts as an integral, or indeed

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carefully reviewing the banker's financial analyses set forth in a board book).

42. For examples of a board book, see *Chiron Corp.*, Transaction Statement (Form 13e-3), at Ex. C3 (Nov. 11, 2005); *Sungard Data Systems, Inc.*, Transaction Statement (Form 13e-3), at Ex. C7 (Apr. 12, 2005).

43. See generally Kennedy, *supra* note 9, at 653-54 (observing that the bulk of the investment banker's involvement is in the information-gathering and analysis stage, rather than in the actual delivery of the opinion).

44. *Van Gorkom* arguably set a legal requirement for this review under Delaware law by finding a board to have breached its duty of care in part due to the board's failure to inquire and scrutinize the valuation information presented to it. *Smith v. Van Gorkom*, 488 A.2d 858, 877 (Del. 1985). This obligation was affirmed in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, when the Second Circuit applying Delaware law found a board to have breached its fiduciary duties by 'baldly' relying on a fairness opinion. 781 F.2d 264, 289 (2d Cir. 1986). The court held that a board has "some oversight obligations to become reasonably familiar with an opinion, report, or other source of advice before becoming entitled to rely on it." *Id.* at 275. However, subsequent Delaware courts have tended to assign less significance to such a review; permitting boards to *prima facie* rely on fairness opinions and financial valuations without significant or, in some instances any, inquiry. See *infra* notes 219-226 and accompanying text (discussing the post-*Van Gorkom* treatment of fairness opinions by the Delaware courts).

45. See *infra* notes 229-233 and accompanying text for further discussion by the Delaware Court of Chancery of this distinction.

46. See *supra* Introduction.

47. See generally Feinstein, *Valuation and Fairness Opinions*, 32 BUS. LAW. 1337 (1977).

48. One empirical study found that from 1980-1985, acquirees obtained fairness opinions in fifty-seven percent of public corporate control transactions (defined for such purposes as a merger, tender offer, exchange offer or leveraged buy-out). However, by 1985, only nineteen percent of acquirees obtained a fairness opinion in such transactions. Bowers, *supra* note 12, at 573-74.

any, part of the corporate control transaction process, and, prior to 1985, fairness opinions were rarely mentioned in Delaware jurisprudence.<sup>49</sup>

In 1985, the Delaware Supreme Court issued its opinion in *Van Gorkom*.<sup>50</sup> The Court found the board of the Trans Union Corporation to have breached its duty of care by approving the acquisition of the corporation in a cash-out merger in a manner that was not the product of an informed business judgement.<sup>51</sup> A full discussion and criticism of the facts and ruling of *Van Gorkom* could be, and has been, the topic of full academic study.<sup>52</sup> However, for this Article it is sufficient to state that one of the principal bases for the Court's holding was the failure of the board in its decision-making process to obtain or consider a well-prepared financial analysis as to the intrinsic worth of Trans Union.<sup>53</sup> The Court stated:

Several defendants testified that [they were legally advised] that Delaware law did not require a fairness opinion or an outside valuation of the Company before the Board could act on the Pritzker proposal. If given, the advice was correct. However, that did not end the matter. Unless the directors had before them adequate information regarding the intrinsic value of the Company, upon which a proper exercise of business judgment could be made, mere advice of this type is meaningless . . . .<sup>54</sup>

The Court held that the board's failure to obtain anything more than a rough and unquestioned estimate of possible value from the corporation's chief financial officer did not satisfy this explicated duty.<sup>55</sup> More was required.<sup>56</sup> However, it was obvious from any reading of the opinion, and reflected in the quote above, that a fairness opinion was not necessarily this requirement. Rather, an acquiree board, as part of its greater duty of care in a corporate control transaction, was now obligated to duly inform itself as to its corporation's sale value through a well-prepared financial analysis.<sup>57</sup>

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49. A Westlaw search in the Delaware state law case database resulted in only thirteen opinions issued prior to *Van Gorkom* which referenced a fairness opinion. The first mention of a fairness opinion in the case database is in the year 1977.

50. 488 A.2d 858 (Del. 1985).

51. *Id.* at 888.

52. *See, e.g.,* Fischel, *supra* note 9; Leo Herzl & Leo Katz, Smith v. Van Gorkom: *The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986); Symposium, *Van Gorkom and the Corporate Board: Problem, Solution, or Placebo*, 96 NW. U. L. REV. 449 (2002); Jonathan R. Macey & Geoffrey P. Miller, Comment, *Trans Union Reconsidered*, 98 YALE L.J. 127 (1988).

53. *Van Gorkom*, 488 A.2d at 881.

54. *Id.*

55. *Id.* at 877-78.

56. *Id.*

57. *Id.* at 876.

The fairness opinion would become institutionalized due to other entwinements of Delaware law.

The transforming actor was Delaware statute title 8, section 141(e) of the Delaware Code. This provision of the Delaware General Corporation Law provides that directors are “fully protected in relying in good faith . . . upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees . . . or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence.”<sup>58</sup> The directors in *Van Gorkom* had claimed reliance on this statute based upon the advice of the corporation’s chief executive and chief financial officers.<sup>59</sup> The Court rejected this defense in those circumstances but did strongly imply that the obtainment of a thoroughly prepared valuation study or a fairness opinion would satisfy not only the board’s duty of care to be duly informed as to corporate value, but would establish sufficient basis to rely on section 141(e).<sup>60</sup> Later, Delaware court opinions would provide further buttressed support for this inference, particularly with respect to fairness opinions.<sup>61</sup>

Interestingly, on this basis, academics and practitioners put forth the fairness opinion and not the financial analysis itself as a means for a board to advantage itself among the cross-currents of section 141(e) and *Van Gorkom*’s holding.<sup>62</sup> However, it is clear that an outside valuation akin to the board book analysis should suffice thereunder—a natural conclusion since the fairness opinion is derivative of the underlying valuation.<sup>63</sup> There is nothing in the literature or that has otherwise been put forth to support this distinction. It appears to have just happened, and post-*Van Gorkom*, the use of fairness opinions by acquirers in corporate control transactions became routine.<sup>64</sup> As

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58. DEL. CODE ANN. tit. 8, § 141(e) (2001).

59. *Van Gorkom*, 488 A.2d at 875.

60. *Id.* at 876-77 (citing tit. 8, § 141(e) and stating that “under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management”).

61. See *infra* notes 219-226 and accompanying text (discussing post-*Van Gorkom* reliance on and endorsement of fairness opinions by Delaware courts).

62. See *supra* note 9 (discussing academic conclusions that, post-*Van Gorkom*, fairness opinions became a mandatory legal obligation).

63. See *generally supra* notes 41-45 and accompanying text.

64. According to one empirical study, in the period 1986-1989 following *Van Gorkom*, fairness opinions were obtained by acquirers in fifty-five percent of public corporation control transactions (defined for such purposes as a merger, tender offer, exchange offer or leveraged buy-out). In 1986, fairness opinions were obtained by forty-two percent of acquirers in such transactions as opposed to only nineteen of acquirers in 1985, the year of *Van Gorkom*. Bowers, *supra* note 12, at 574-75.

to why the fairness opinion was outsourced to investment banks and other financial advisors rather than internal corporate officer analysis, the reasons are straight-forward. First, the delivery of this financial information through an investment bank shifts potential liability from internal corporate actors to outside, more liability-remote parties. Second, if the recipient is the acquirer in a corporate control transaction it avoids systemic management conflict, since officers oftentimes benefit substantially from a corporate control transaction in disproportion to unaffiliated stockholders.<sup>65</sup>

Finally, in *Van Gorkom*, the court treated the need for a well-prepared financial analysis of value in a corporate control transaction as a creature independent of the process utilized to arrive at an offered price.<sup>66</sup> That is, the court treated the need for this analysis as an island divorced from other considerations and actions in a corporate control transaction. The court did pay credence, but did not accept, commonly held finance principles as to value being the price in the efficient market and the post-agreement market check<sup>67</sup> or auction process as an alternative to achieving fair value

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65. This benefit most commonly takes the form of "golden parachutes," accelerated option vesting, and other compensation mechanisms which award executives upon a change in control of the corporation. However, the disproportionate gain can also take the form of employment or consulting arrangements, non-competition agreements, or other future benefits provided by the acquirer to the acquirer's management. See also LIPTON & STEINBERGER, *supra* note 37, § 10.09 (discussing executive compensation in merger and acquisition transactions and the tax treatment thereof); Richard P. Bress, Note, *Golden Parachutes: Untangling the Ripcords*, 39 STAN. L. REV. 955, 955-63 (1987) (detailing use and structure of golden parachutes). See generally Barbara B. Creed & Jay David Gayner, *Terms of Employment: A Review of Employment Practices Related to Changes in Corporate Control*, in EXECUTIVE COMPENSATION 1987: PLANNING TECHNIQUES AND STRATEGIES (PLI Corp. Tax Law and Practice Course Handbook Series, No. 254, 1987) (discussing various types of executive compensation in the corporate change of control context).

66. The court did this by establishing a *per se* requirement for a financial analysis in a corporate control transaction. *Van Gorkom*, 488 A.2d at 875.

67. A market check is a mechanism whereby a corporation will agree to be acquired without conducting an auction or soliciting all potential acquirers. The post-agreement price will then be "checked" via the market. More specifically, if a second, higher offer does emerge after announcement of the agreement, the acquirer retains the ability to terminate the initial agreement and enter into a new acquisition agreement with the second, higher bidder. Under Delaware corporate law, a market check is a permitted acquisition mechanism. Additionally, in connection with its agreement to a market check, an acquirer may agree to deal protection devices that inhibit but do not prevent a second, higher bid and that require payment of a break-up fee to the initial acquirer if their agreement is terminated due to a second bid. See, e.g., *In re Pennaco Energy, Inc. S'holders Litig.*, 787 A.2d 691, 705-06 (Del. Ch. 2001); *Matador Capital Mgmt. Corp. v. BRC Holdings, Inc.*, 729 A.2d 280, 292-93 (Del. Ch. 1998); *In re Fort Howard Corp. Shareholders Litigation*, 1988 WL 83147, at \*13 (Del. Ch. 1988). See generally Charles F. Richards, Jr. & J. Travis Laster, *The Return of the Market Check*, 15 No. 6 INSIGHTS 20, 20 (2001) (outlining the contours of a Delaware post-agreement market check).



independent of a valuation or fairness opinion delivered to a board.<sup>68</sup> However, this does not comport with finance beliefs then or now. Assuming financial analysis actually can inform as to value, the minimum value range that a similarly informed financial analysis should arrive at should roughly equate with the unaffected, minimum price achievable in a properly run market-based process such as an auction. If such process is actually utilized, a financial analysis or fairness opinion to confirm the “fairness” of a price is superfluous.<sup>69</sup> The Delaware courts’ response to (or more appropriately conscious ignorance of) this dichotomy is discussed further *infra* at Part III.C.

## II. REVIEW OF THE FAIRNESS OPINION

This Part explores the limitations of the fairness opinion. More specifically, it could be posited that the Delaware Supreme Court’s endorsement of a required acquiree financial analysis in *Van Gorkom* was a flawed one because it rested on quicksand assumptions about the inherent accuracy and comparability of the valuation practices undergirding fairness opinions. These deficits were compounded by a process-based defect: the inherent conflicts in investment banking fairness opinion practices post-*Van Gorkom*. By stress-testing the fairness opinion with the weight of these arguments, this Part attempts to outline the true parameters of the fairness opinion’s utility.

### A. The Valuation Problem

#### 1. Subjectivity

A fairness opinion’s worth ultimately lies in the reliability and accuracy of its underlying valuation analyses.<sup>70</sup> This is the realm of finance—and academics have made significant strides in the previous decades to develop techniques by which a theoretically reliable range

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68. The defendants argued in *Van Gorkom* that any breach of their duty of care had been cured by the post-agreement market check conducted by Trans Union. *Van Gorkom*, 488 A.2d at 878. The court dismissed this argument on the basis that the agreements and time limitations agreed to by the Trans Union board did not truly permit a meaningful market test. *Id.* at 880, 885. The court did not address whether a proper market check would have cured the found breach. In comparison, the dissenting opinion in *Van Gorkom* cited the market test conducted by Trans Union approvingly as “buttressing” an informed business judgment. *Id.* at 897 (McNeilly, J., dissenting).

69. I flesh out this argument *infra* notes 305-308 and accompanying text.

70. See generally Ruthford B. Campbell, Jr., *The Impact of Modern Finance Theory in Acquisition Cases*, 53 SYRACUSE L. REV. 1 (2003) (surveying several financial theories and methodologies used in valuation analyses and the comparative utility of each).

of values can be achieved.<sup>71</sup> However, there is still an element of subjectivity present in the choice and application of these methods.<sup>72</sup> The end-result is to provide the preparer discretion to effect the outcome of a valuation and a diminished ability for outsiders to make comparative assessments of analyses.

There are a number of different underlying valuation analyses upon which a fairness opinion can rest. The most common and accepted techniques are discounted cash flow,<sup>73</sup> comparable companies,<sup>74</sup> premium,<sup>75</sup> break-up,<sup>76</sup> and liquidation analysis.<sup>77</sup> The

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71. See *supra* note 14 (citing historical discussions of these developments).

72. See *infra* notes 78-89 and accompanying text for a discussion of these issues.

73. A discounted cash flow analysis calculates the present value of the future free cash flows of the corporation by discounting the cash flows at a specific discount rate. In practice, a discounted cash flow of a corporate entity consists of three principal components. First, an estimate is made of the future free cash flows of the corporation over a set period of time, typically three to ten years but variant depending upon available projections. Second, a value of the corporation's free cash flows in perpetuity after this discrete period is forecasted. This second value is known as a terminal value, and it is typically calculated by applying a perpetual growth rate to the estimated cash flow in the first year of this period. Finally, the cash flows derived in the first two steps are discounted back at an appropriate discount rate to arrive at a present value of all of the future cash flows of the corporation. See generally BREALEY & MYERS, *supra* note 14, at 75-80, 551 (outlining the methodology for conduct of a discounted cash flow analysis of a business); MARK GRINBLATT & SHERIDAN TITMAN, FINANCIAL MARKETS AND CORPORATE STRATEGY 299-324 (2d ed. 2002) (outlining the methodology for conduct of a discounted cash flow analysis of real assets); PRATT ET AL., *supra* note 14, at 155-62 (outlining the methodology for conduct of a discounted cash flow analysis of a business).

74. A comparable companies analysis compares the corporation being valued against selected similarly situated, publicly traded companies. These companies are compared using price multiples of each corporation's stock against selected benchmarks, such as price to future earnings, price to forecasted sales, or price to book. A well-performed comparable companies analysis will adjust the capital structures of each comparable company in order to more accurately compare them with the corporation being valued. See generally ASWATH DAMODARAN, INVESTMENT VALUATION, at 453-56 (2002) (discussing various methods of comparable company valuation); KRISHNA G. PALEPU ET AL., INTRODUCTION TO BUSINESS ANALYSIS & VALUATION 7-16 - 7-23 (1997) (noting the complexities and difficulties that arise in comparable companies valuation).

75. A premium analysis compares the premium being paid in the corporate control transaction against historical premiums paid, for selected, similarly-situated companies. Typically, a premium analysis is conducted side-by-side with a comparable companies analysis often utilizing the same corporate entities. See generally DAMODARAN, *supra* note 74, at 712 (discussing parallel use of these techniques in change of control transactions).

76. A break-up analysis, sometimes called a sum-of-parts analysis, assumes that the different businesses of the corporation will be parceled out separately and sold. It then values each of these units on a stand-alone basis to derive a value for the entire corporate entity. See generally Kennedy, *supra* note 9, at 650 (discussing the application of a break-up analysis in the fairness opinion context).

77. A liquidation analysis assumes that the assets of the corporation will be sold separately in an orderly liquidation of the firm. It then values the assets of the corporation on this basis. It is different than a break-up analysis in that it assumes that each business entity can be liquidated and sold as other than a going-concern, whereas a break-up analysis assumes that each business will be sold intact. See

preparer of a fairness opinion will typically utilize a weighted combination of these to arrive at a fairness conclusion.<sup>78</sup> The choice of a particular analysis to employ and the weight given to each is partially subjective and depends upon the asset being valued and the relevant circumstances.<sup>79</sup> For example, in the corporate control transaction paradigm the most important analysis is, absent unusual

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Kennedy, *supra* note 9, at 640-42 (discussing application of a liquidation analysis in the fairness opinion context).

78. See, e.g., Maytag Proxy Statement, *supra* note 23, at 59-63 (fairness opinion prepared by Lazard Freres & Co., LLC based in part on discounted cash flow, comparable company, and premiums paid analyses); Toys "R" Us, Inc., Definitive Proxy Statement (Form DEF14A), at 24-30 (May 23, 2005) (fairness opinion prepared by Credit Suisse First Boston LLC based in part on discounted cash flow, comparable company, premiums paid, and break-up analyses); Cysive, Inc., Definitive Proxy Statement (Schedule 14A), at 38-46 (Nov. 7, 2003) [hereinafter Cysive Proxy Statement] (fairness opinion prepared by Broadview International, LLC based in part on comparable company, premiums paid, and liquidation analyses).

79. For example, a discounted cash flow analysis generally requires that the stream of future free cash flows be steady and ascertainable. See, e.g., Cysive Proxy Statement, *supra* note 78, at 45 (disclosing that fairness opinion did not rely upon a discounted cash flow analysis since the corporation's "business model has never been cash flow positive and management was uncertain in estimating . . . the future cash flows"). Thus, for a recently-formed corporation or one that is in a state of flux with no reliable, forecasted free cash flows, a discounted cash flow analysis is inappropriate. See, e.g., *Doft & Co. v. Travelocity.com Inc.*, 2004 WL 1152338, at \*7 (Del. Ch. 2004) (using comparable company analysis to value corporation for purposes of an appraisal proceeding and stating that a discounted cash flow analysis for these purposes would be of marginal utility "in the absence of reasonably reliable contemporaneous projections [and] the degree of speculation and uncertainty characterizing the future prospects of [the corporation]"). Meanwhile, a comparable companies analysis can only be conducted when there exists comparable publicly traded companies. This is sometimes not the case. See, e.g., *In re Radiology Assoc., Inc. Litig.*, 611 A.2d 485, 490 (Del. Ch. 1991) (asserting that differences between proposed comparable companies were so large that any comparable companies comparison was meaningless). Similarly, a break-up analysis is only appropriate when the corporation consists of a discrete set of separately identifiable businesses. See generally Dean LeBaron & Lawrence S. Speidell, *Why Are the Parts Worth More than the Sum? "Chop Shop," A Corporate Valuation Model*, in *THE MERGER BOOM* 78 (Lynn E. Browne & Eric S. Rosengren eds., 1987). Finally, a liquidation analysis is typically employed when the viability of the corporation as a going-concern is at issue or otherwise when the corporation consists primarily of real assets, such as oil deposits, since liquidation analysis fails to capture good-will and other inherent value in the corporation as a going-concern. See, e.g., *In re Cysive, Inc. S'holders Litig.*, 836 A.2d 531, 538 (Del. Ch. 2003) (stating that directors of the corporation preferred sale of corporation rather than liquidation, "as such a transaction could result in a recognition of the value [of the corporation], whereas a liquidation was unlikely to yield as high a price"); *In re Appraisal of Shell Oil Co.*, 1990 WL 201390, at \*16-\*17 (Del. Ch. 1990) (noting use of liquidation analysis to value oil corporation for fairness opinion, but stating that the investment bank did not primarily rely upon this analysis as it considered such a liquidation unlikely). See generally DAMODARAN, *supra* note 74, at 946-50 (describing available business valuation models and the appropriate use of each to arrive at a reasonable value determination); ASWATH DAMODARAN, *THE DARK SIDE OF VALUATION* (2001) (examining the use and limits of valuation techniques in the context of valuing high technology and new economy firms); Kennedy, *supra* note 9, at 617-44 (explaining various recurring valuation techniques and the appropriate use of each in the fairness opinion context).

circumstances, the discounted cash flow calculus.<sup>80</sup> However, in the investment banking community, there are no uniform, specific, and objective guidelines as to the exact mix and weight to assign to each of these methods to arrive at fairness.

Each of the techniques in and of themselves is also prone to subjectivity. For example, a discounted cash flow analysis is conducted by discounting back at a chosen discount rate the projected future free cash flows and terminal value of an asset.<sup>81</sup> In performing this analysis there are three central choices, which must be made, each of which can significantly affect the final valuation. These are the correct forecasted free cash flows to utilize,<sup>82</sup> the appropriate discount rate,<sup>83</sup> and the terminal value of the asset.<sup>84</sup>

80. BREALEY & MYERS, *supra* note 14, at 75-80; DAMODARAN, *supra* note 74, at 11. This preference extends to the Delaware courts. *See, e.g.,* Andaloro v. PFPC Worldwide, Inc., 2005 WL 2045640, at \*9 (Del. Ch. 2005) (“The [discounted cash flow] method is frequently used in this court and, I, like many others, prefer to give it great, and sometimes even exclusive, weight when it may be used responsibly.”); Cede & Co. v. Technicolor, Inc., 1990 WL 161084, at \*7 (Del. Ch. 1990) (claiming the discounted cash flow analysis “is in theory the single best technique to estimate the value of an economic asset”).

81. *See supra* note 73 and accompanying text (elaborating on the parameters of a discounted cash flow analysis and the definition of terminal value).

82. These are generally available forecasts previously prepared by management of the corporation. BREALEY & MYERS, *supra* note 14, at 551. *Cf. Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218, at \*7 (Del. Ch. 2003) (asserting that management projections are particularly useful in the appraisal context because they are by definition not tainted by transaction pressures and hindsight), *aff'd in relevant part*, 875 A.2d 602 (Del. 2005). However, sometimes such forecasts do not exist or are otherwise unreliable. In such circumstances, free cash flow numbers must be created out of whole cloth with consequent heightened subjectivity, uncertainty, and manipulability.

83. The accepted industry method for computation of a discount rate is to compute the corporation's weighted average cost of capital (“WACC”), otherwise known as the corporation's opportunity cost of capital for its assets. WACC is typically computed in accordance with the following formula:  $r_{debt}(1 - T_c)(D/V) + r_{equity}(E/V)$  where  $r_{debt}$  = rate of return on the corporation's debt;  $r_{equity}$  = rate of return on the corporation's equity;  $D$  = value of the corporation's debt;  $E$  = value of the corporation's equity;  $V = D + E$ ; and  $T_c$  = the corporation's marginal tax rate. BREALEY & MYERS, *supra* note 14, at 230-31. The computation of WACC requires ascertainment of the rate of return on the corporation's equity or  $r_{equity}$ . A corporation's return on equity can also be phrased as the risk premium of the corporation's stock over and above the market risk premium which itself is the general return of the market over and above the risk free rate. There is debate and disagreement over the appropriate methodology to estimate a corporation's  $r_{equity}$ ; however, industry practice is to use the capital asset pricing model (“CAPM”). *See infra* notes 92-93 and accompanying text. The CAPM is calculated in accordance with the following formula:  $R_{equity} = R_{free} + (\text{Beta}) \times (R_{market} - R_{free})$  where  $R_{free}$  = risk free rate (e.g., rate on governmental bonds); (Beta) = covariance between the market's return and the individual corporation's stock return; and  $R_{market}$  = return on the market. BREALEY & MYERS, *supra* note 14, at 169-77, 194-97; *see also* DAMODARAN, *supra* note 74, at 154-59, 181-206 (setting forth example calculation methods for  $R_{free}$ ,  $R_{market}$  and Beta).

84. Terminal value typically comprises the majority of the future free cash flows of the corporation. BREALEY & MYERS, *supra* note 14, at 531.

There is substantial leeway to determine each of these, and any change can markedly affect the discounted cash flow value.<sup>85</sup> For example, a change in the discount rate by one percent on a stream of cash flows in the billions of dollars can change the discounted cash flow value by tens if not hundreds of millions of dollars.<sup>86</sup> However, again there is no standard-setting or other body guiding these or other preparation decisions. Rather, a discounted cash flow analysis, like other valuation analyses, is typically compiled using historically developed and unguided industry practices as influenced and first

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85. Future free cash flows, as with any forecast, are predictions of future performance that may or may not be correct and are subject to the preparer's best judgement. It is no understatement to assert that there can be vast disagreement on what constitutes the best estimates of future performance and the appropriate future forecasted free cash flows of a corporation. See Kenton K. Yee, *Combining Value Estimates to Increase Accuracy*, 60 FIN. ANAL. J. 23, 23 (July/August 2004) (stating that "[b]ecause of uncertainty in prospective cash flows [discounted cash flow analysis] inevitably leads to an imprecise answer"). The calculation of the discount rate using the CAPM involves estimates of  $R_{\text{free}}$ ,  $R_{\text{market}}$ , and Beta. There is potential subjectivity in each of these decisions.  $R_{\text{market}}$  has historically been thought to be seven to nine percent but recent studies have argued that it is a lower figure, in the five to six percent range. See ELROY DIMSON ET AL., TRIUMPH OF THE OPTIMISTS: 101 YEARS OF GLOBAL INVESTMENT RETURNS 165, 175, 211 (2002) (stating that over one hundred and one years "the annualized (geometric mean) US equity risk premium relative to bills was 5.8[%]" and that this is 1.5% lower than those of previous long-term studies of the U.S. markets); see also DAMODARAN, *supra* note 74, at 162 (noting that the market risk premium can range from 4.5%-12.67% depending upon preparer choice); PRATT ET AL., *supra* note 14, at 177 n.20 (identifying differences of opinion as to methods of calculating equity risk premium).  $R_{\text{free}}$  can vary depending upon the country and the period referenced for determination of the rate. For example, each of the one-year, ten-year, and thirty-year government bond rates differ, but it is possible to rationally select any of them depending upon the circumstances. DAMODARAN, *supra* note 74, at 162-64; GRINBLATT & TITMAN, *supra* note 73, at 155. Finally, Beta, when calculated using regression, is subject to variance depending upon the length of time and measure of the market returns utilized. *Id.* at 158. If the corporation is not publicly traded, then estimating Beta becomes more difficult and subject to increased uncertainty and discretion. BREALEY & MYERS, *supra* note 14, at 234-38; DAMODARAN, *supra* note 74, at 191-207. Terminal value is typically calculated using a perpetuity:  $X/(r-g)$  where X = an estimate of the future free cash flows in the first year of the perpetuity, r = WACC, and g = the perpetual growth rate. *Id.* at 305. X is a forecast and subject to the same caveats made *supra* with respect to forecasts. The subjectivity inherent in WACC calculations is also discussed *supra*. Finally, there is no agreed upon standard perpetual growth rate, though it is typically in the two to three percent range.

86. If the discount rate is ten percent on a stream of cash flows that is \$100 million in each of years one through five, and thereafter has a terminal value of \$1 billion (terminal value being calculated here using a zero percent perpetual growth rate and a cash flow in year six of \$100 million so that \$1 billion = TV = \$100 million/10%), the discounted cash flow value is \$944 million. See generally *supra* notes 73 & 85 (setting forth method of calculation of discounted cash flow and terminal value, respectively). If the discount rate is lowered to nine percent, the discounted cash flow value is now \$1.051 billion. Thus, here a 1% change in the discount rate results in an 11.4% difference in value. Cf. *Metlyn Realty Corp. v. Esmark, Inc.*, 763 F.2d 826, 835 (7th Cir. 1985) (stating that "valuations are highly sensitive to assumptions about the firm's costs and rate of growth, and about the discount rate").

put forth by academic practitioners. This lends itself to differences in valuation approach in each application and among institutions as each of them develops their own individual approach.<sup>87</sup> This issue arises not only with a discounted cash flow analysis, but with each of the other valuation techniques.<sup>88</sup>

This dazzling variability makes it difficult to rely, compare, or analyze the valuations underlying a fairness opinion unless full disclosure is made of the various inputs in the valuation process, the weight assigned for each, and the rationale underlying these choices. The substantial discretion and lack of guidelines and standards also makes the process vulnerable to manipulation to arrive at the “right” answer for fairness.<sup>89</sup> This raises a further dilemma in light of the conflicted nature of the investment banks who often provide these opinions, an issue discussed *infra* at Part II.B.

## 2. Best practices

The issues with valuation practice today are not limited to a problem of subjectivity. Industry valuation practice, as it is currently conducted, also lags in many material respects and in circumstances is even contradictory to modern finance theory. For example, investment banks typically use the capital asset pricing model (“CAPM”)<sup>90</sup> to calculate the weighted average cost of capital (“WACC”), or discount rate,<sup>91</sup> for a discounted cash flow analysis.<sup>92</sup> However, current academic literature disputes the empirical validity of this tool and instead has suggested alternatives to attain greater

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87. See generally BREALEY & MYERS, *supra* note 14, at 75-80 (observing the differing results obtainable depending upon the choice of inputs for a discounted cash flow analysis).

88. See *supra* notes 74-77 and accompanying text (discussing different approaches for preparing comparable companies, premium, break-up, and liquidation analyses).

89. See generally Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 218 (1997) (arguing that financial valuation is inescapably subjective and therefore, if viewed with suspicion is “inherently manipulable”).

90. See *supra* note 83 (defining the CAPM).

91. See *supra* note 83 (defining WACC and discount rate).

92. See DAMODARAN, *supra* note 74, at 219 (discussing recent study of industry practices with respect to estimation of the cost of equity). Investment banks are not the only entities who continue to use this model. A recent empirical survey of 392 firms found that seventy-four percent of them always, or almost always, utilize the CAPM to value real assets. John R. Graham & Campbell R. Harvey, *The Theory and Practice of Corporate Finance: Evidence from the Field*, 60 J. FIN. ECON. 187, 197 (2001). However, there is disparity here as well, and investment banks have been known to use other methods to calculate WACC. See, e.g., Sungard Data Systems, Inc., Definitive Proxy Statement (Schedule 14A), at 34-35 (June 27, 2005) [hereinafter Sungard Proxy Statement] (disclosing investment bank calculated discount rate for fairness opinion analysis by referencing WACC of comparable companies).

accuracy.<sup>93</sup> Furthermore, academic research concerning market risk premiums has found the seven to nine percent rate historically utilized for purposes of the CAPM to be overstated and actually in the five to six percent range—this too has only been partly translated into industry practice.<sup>94</sup> The consequent result is that fairness opinions today are frequently premised upon uncertain valuation methodology.<sup>95</sup>

The most likely reason for this failure to follow best practices is the absence of a direct conduit between academics and practitioners for the transmission of theories, developments, and research. Rather, these are currently communicated through osmosis as practitioners interact with academics and employ graduated students taught these new methods. Investment banks also have limited incentive to improve upon this inefficient method of knowledge transfer. Corporations regularly purchase this product as prepared now (and if an acquirer is essentially required to make such buy); as with any bad habit, why change if there is no impetus to do so?<sup>96</sup> The result is the slow and haphazard adoption of new techniques and principles as well as recognition of incorrect practices. More specifically, industry valuations are regularly compiled based upon tenets that academics no longer deem valid or otherwise dispute.<sup>97</sup>

It is not only a matter of increased communication and earlier absorption of research findings. Academics are in disagreement over aspects central to valuation practice. For example, studies dispute the appropriate methodology to calculate many of the various inputs in the CAPM,<sup>98</sup> a tool which, as noted, itself is also disputed.<sup>99</sup> These

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93. See BREALEY & MYERS, *supra* note 14, at 198-210 (outlining criticisms of the CAPM and possible greater utility of multi-factor models); GRINBLATT & TITMAN, *supra* note 73, at 158-68, 175-209 (describing empirical tests of the CAPM and multi-factor models). See generally SHANNON P. PRATT, *COST OF CAPITAL: ESTIMATION AND APPLICATIONS* (2d ed. 2002) (exploring the principles underlying estimation of the CAPM and addressing commonly encountered variations in its application).

94. DIMSON ET AL., *supra* note 85, at 211-12.

95. See, e.g., Arthur H. Rosenbloom & Drew G.L. Chapman, Commentary, *Fairness Opinions—Can They be Made Useful?*, 9 ANDREWS DERIVATIVES LITIG. REP. 12 (2003) (noting several examples of investment bank failure to follow best practices).

96. This is particularly true in today's current regime where there are no governing standards, an uncertain liability regime governing the provision of fairness opinions, and, to the extent permitted by law, a blanket practice of corporations indemnifying and releasing investment banks from liability for the provision of a fairness opinion. See, e.g., Bowers, *supra* note 12, at 575 (stating that cases on investment bank liability for fairness opinions are "relatively small in number and too divergent to establish a legal standard"); Fiflis, *supra* note 35 (discussing grounds for investment bank liability for rendering defective fairness opinions).

97. See, e.g., Fiflis, *supra* note 35 (examining investment bank deficiencies in the preparation of fairness opinions).

98. See *supra* note 85. See generally GRINBLATT & TITMAN, *supra* note 73, at 155-58

conflicts have led to a pick-and-choose approach among practitioners with an obvious possible bias towards choosing the course indicative of the desired outcome.<sup>100</sup>

### 3. A telling example

Illustrative of the difficulties and issues delineated *supra* is a recent Delaware Court of Chancery opinion issued by Vice Chancellor Strine in *Andaloro v. PFPC Worldwide, Inc.*<sup>101</sup> *Andaloro* was a consolidated appraisal<sup>102</sup> action arising out of the acquisition by PNC Financial Services Group (“PNC”) of the two percent minority interest that it did not own in its subsidiary, PFPC Worldwide, Inc. (“PFPC”) at a price of \$34.26 per share.<sup>103</sup> Vice Chancellor Strine’s appraisal required him to make a judicial determination in accordance with Delaware corporate law as to the fair value of the minority stake on the date of acquisition.<sup>104</sup> The intricacies of appraisal proceedings and the Delaware standard governing such matters have been the subject of much study.<sup>105</sup> It is fair to say that the statutory manner in

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(surveying the various discretion and disagreement in determining the inputs for the CAPM model).

99. See *supra* note 93.

100. See, e.g., *Andaloro*, 2005 WL 2045640, at \*2 (Del. Ch. 2005) (stating that financial valuation “calling for the court to derive a single best estimate of value based on the ‘expert input’ of finance professionals paid to achieve diametrically opposite objectives tends, regrettably, to surface minor, granular issues . . . which are not well addressed in the academic literature”).

101. *Id.*

102. Delaware law provides that in certain mergers, consolidations, and other transactions a stockholder can “dissent” and seek appraisal by the Delaware Court of Chancery of his or her stock. The stockholder is then entitled to payment of the appraisal amount, together with interest, if any, by the surviving or resulting corporation in the relevant transaction. DEL. CODE ANN. tit. 8, § 262 (2001).

103. *Andaloro*, 2005 WL 2045640, at \*1. The Court of Chancery in *Andaloro* was also confronted with a claim of equitable breach of fiduciary duty. *Id.* However, the court only addressed the appraisal question in its opinion as its findings thereto were dispositive of the breach of fiduciary duty claim. *Id.* at \*1, \*22.

104. Under Delaware law, the Court of Chancery in an appraisal proceeding is required to determine fair value by establishing the value of the entity as a going concern. DEL. CODE ANN. tit. 8, § 262(h) (2001). For these purposes, the value arising from the transaction itself is excluded. *Id.* However, any minority discount is also eliminated. *Andaloro*, 2005 WL 2045640, at \*8.

105. See, e.g., Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV. 1121 (1998) (critiquing the Delaware appraisal remedy under a preference reconciliation theory); Bayless Manning, *The Shareholder’s Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962) (arguing that the Delaware appraisal remedy is legally disconnected from its’ traditionally justified purpose); Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79 (1995) (recommending a more-tailored Delaware appraisal remedy); Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 DEL. L. REV. 1 (2000) (tracing the history of the Delaware appraisal remedy and proposing revision); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal’s Role in Corporate Law*, 84 GEO. L.J. 1 (1995) (arguing for a modernization of the Delaware appraisal remedy).



which they are required to be conducted does not comport with modern finance principles or theory.<sup>106</sup> Nonetheless, to compute fair value, Vice Chancellor Strine, *inter alia*, conducted a valuation of the minority stake using a discounted cash flow analysis.<sup>107</sup>

Vice Chancellor Strine was aided in this task by the petitioners' and respondent's experts who each prepared his own valuation.<sup>108</sup> Not surprisingly, there was a marked difference of opinion between the two: the petitioners' expert discounted cash flow analysis arrived at a price of \$60.76 per share while the respondent's expert computed a price of \$21.35.<sup>109</sup> Also not surprisingly, each purported to be based on the right principles but was prepared using different methodologies, approaches, and numbers.<sup>110</sup> Nonetheless, Vice Chancellor Strine used these two valuations as a touchstone; he traced each step in the valuation process and picked from one or the other expert's choice, and, in certain circumstances, he deviated from both and made his own conclusions.<sup>111</sup>

First, Vice Chancellor Strine settled on the appropriate forecasted free cash flow numbers to conduct the discounted cash flow calculation.<sup>112</sup> Here, the two expert parties were in material agreement that available management projections were the best available figures.<sup>113</sup> This was fortuitous for valuation purposes, as disagreement about the underlying numbers would have led to even more divergent expert results.<sup>114</sup> Vice Chancellor Strine, accordingly,

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106. See William T. Allen, *Securities Markets as Social Products: The Pretty Efficient Capital Market Hypothesis*, 28 J. CORP. L. 551, 560 (2003) (commenting that the Delaware courts have neglected increasing doubts about the CAPM's perceived "inability to explain significant aspects of market returns"); Campbell, *supra* note 70, at 4 (claiming that courts "have, to a significant extent, failed to base their opinions on modern finance theory"); William J. Carney & Mark Heimendinger, *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*, 152 U. PA. L. REV. 845 (2003) (arguing that use of control premiums in appraisal proceedings is not supported by modern corporate finance theory).

107. *Andaloro*, 2005 WL 2045640, at \*9-\*16.

108. *Id.* at \*2. The petitioners in the appraisal proceeding were the dissenting minority stockholders of PFPC. The respondent in the proceeding was PFPC. The parties were also plaintiffs and defendant, respectively, for purposes of the breach of fiduciary duty claim. *Id.* at \*1.

109. *Id.* at \*10. Salomon Smith Barney had previously found a valuation range for PFPC of \$20.78 to \$34.26 per share. This range removed any minority discount and included a squeeze-out premium. Salomon Smith Barney rendered a fairness opinion to PNC based on this valuation. *Id.* at \*8.

110. See *infra* notes 113-142 and accompanying text.

111. *Andaloro*, 2005 WL 2045640, at \*9-\*16. Vice Chancellor Strine stated that "at the margins, [I have] resolved doubts in favor of the plaintiffs. In other words, the valuation I set forth is more optimistic than is strictly justified." *Id.* at \*9.

112. *Id.* at \*10-\*11.

113. *Id.*

114. See, e.g., *Kleinwort Benson Ltd. v. Silgan Corp.*, 1995 WL 376911, at \*5-\*8 (Del. Ch. 1995); see also *supra* note 86 (discussing the effect of a revision in the

relied upon these management projections with only one slight alteration recommended by the petitioners' expert.<sup>115</sup>

Second, Vice Chancellor Strine calculated PFPC's terminal value<sup>116</sup> by adopting petitioners' expert's three-stage terminal value approach.<sup>117</sup> In doing so, he rejected the two-stage model proposed by respondent's expert.<sup>118</sup> The three-stage approach divides up terminal value into two different periods of higher than normal growth.<sup>119</sup> While theoretically this approach should arrive at the same result as a two-stage analysis, which only uses one period for terminal value, it more precisely illustrates actual corporate growth.<sup>120</sup> For this three-stage model, petitioners' expert employed a second-stage, four-year growth rate of 13.2% and a third-stage, terminal value perpetual growth rate of five percent versus respondent's steady terminal value perpetual growth rate of five percent.<sup>121</sup> Vice Chancellor Strine combined these approaches and chose a three-stage approach using a three-year growth rate of eight percent followed by a perpetual growth rate of five percent.<sup>122</sup> In his opinion, Vice Chancellor Strine rebutted petitioners' initial choice of a higher rate but did not explain the basis for his choice of eight percent and five percent, other than a statement that he disagreed with petitioners' expert, but was more "bullish" than respondent's expert.<sup>123</sup> In fact, a five percent perpetual growth rate is simply wrong as it assumes that PFPC would,

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numbers utilized on a discounted cash flow valuation).

115. *Andaloro*, 2005 WL 2045640, at \*11.

116. *See supra* note 73 (defining terminal value and discussing its role in a discounted cash flow calculation).

117. *Andaloro*, 2005 WL 2045640, at \*12-\*13.

118. *Id.* at \*12.

119. *Id.*

120. *Id.* A three-stage growth rate approach is more illustrative because a corporation may have changing forecasted growth rates. If this is true, separating terminal value into two different periods more accurately captures the different projected future growth rates of the corporation over time. However, a two-stage approach should theoretically arrive at the same result because the perpetual growth rate would take into account this differential growth as an average over time.

121. *Id.* at \*12-\*13. Petitioner estimated post-2007 growth by "decreasing PFPC's growth in a linear way from the last year of the management projections in 2007, which [he] calculated as a 20.3% increase in unlevered free cash flow, adjusting for Retirement Services." *Id.* The court did not put forth the rationale behind petitioners' expert's choice of five percent for the tertiary stage of growth. *Id.* Respondent's expert posited that growth would slow after 2007 and therefore set a growth rate of five percent by assuming that PFPC would grow at six percent for the three years after 2007 and that a five percent figure thereafter was more in line with national economic growth. *Id.* Whether any of these is right is anyone's guess. *See generally* DAMODARAN, *supra* note 74, at 268-99 (outlining techniques to estimate future growth for purposes of estimating future cash flows).

122. *Andaloro*, 2005 WL 2045640, at \*13.

123. *Id.*

using historical rates, eventually outgrow the size of the U.S. economy—an impossibility.<sup>124</sup>

Third, Vice Chancellor Strine set the corporation's going-forward capital structure.<sup>125</sup> This is a required pre-step in the determination of a corporation's WACC.<sup>126</sup> Respondent's expert targeted an all-equity structure for PFPC based on comparative assessment of PFPC's competitors, while petitioners' expert had assumed the continued existence of PFPC's \$1.29 billion parent-subsidiary indebtedness for a hybrid debt/equity structure.<sup>127</sup> Vice Chancellor Strine found compelling respondent's expert's argument, and adopted an all-equity model.<sup>128</sup> Accordingly, he discounted the value of the corporation's debt at maturity.<sup>129</sup> He then discounted it back at the ultimate discount rate he determined for the cost of equity and deducted this amount from the total value derived.<sup>130</sup> While the opinion is unclear on this point, Vice Chancellor Strine's decision to discount the debt from maturity appears to unjustifiably reduce the debt's value due to its equity nature when discounting at the cost of equity alone should be sufficient. The result appears to be a double-discount of the debt. The petitioner's position therefore appears

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124. From 1929 to 2002, the average annual rate of growth of real United States Gross Domestic Product was 3.4%. BUREAU OF ECON. STATISTICS, *News Release: National Income and Product Accounts Comprehensive Revision*, Dec. 10, 2003, available at [http://www.bea.gov/bea/newsrel/2003cr\\_newsrelease.htm](http://www.bea.gov/bea/newsrel/2003cr_newsrelease.htm). Thus, the five percent (presumed real) number is well above the growth rate of the U.S. economy. See DAMODARAN, *supra* note 74, at 306 (“[The] growth rate cannot exceed the growth rate of the economy in which a firm operates . . .”). Vice Chancellor Strine even acknowledged that this was a high number. *Andaloro*, 2005 WL 2045640, at \*12 n.49. Possibly, he chose this high growth rate because of the petitioners' and respondent's experts' unexplained agreement upon such figure, as well as his statement in the opinion that he would err in his valuation on the side more favorable to the petitioners. *Id.* Another explanation is that Vice Chancellor Strine used a nominal rather than a real rate. However, all of this is conjecture.

125. *Andaloro*, 2005 WL 2045640, at \*13-14.

126. BREALEY & MYERS, *supra* note 14, at 532-36; see also *supra* note 83 (defining WACC).

127. *Andaloro*, 2005 WL 2045640, at \*13. Petitioners' expert likely favored the maintenance of outstanding debt in this instance as the addition of debt results in tax shields which lower WACC and increase the value of the corporation. BREALEY & MYERS, *supra* note 14, at 533.

128. *Andaloro*, 2005 WL 2045640, at \*13. Vice Chancellor Strine adopted this approach since the indebtedness was owed to PFPC's parent and could not otherwise have been incurred in the market. It was therefore akin to an equity investment and should be treated as such. *Id.* at \*13-14.

129. *Id.* at \*14.

130. *Id.* In contrast, respondent's expert had “subtracted out the net debt of PFPC, using the par value of the debt to PNC in that calculation, from its capital structure.” *Id.* at \*13. Vice Chancellor Strine adopted a different approach since PNC did not have the right, as of the merger date, to demand full repayment of the loan. *Id.* at \*14. Accordingly, Vice Chancellor Strine argued that, “[g]iving some weight to the contractual terms of the note, one can make the case for some discount from par in the value of the debt to PNC.” *Id.*

correct and is supported in the literature which recommends petitioner's approach when subtracting out debt for purposes of calculating the cost of equity and WACC.<sup>131</sup>

Finally, Vice Chancellor Strine used the CAPM to calculate the return on equity for purposes of determining WACC.<sup>132</sup> Vice Chancellor Strine utilized the same rates assigned by petitioners' and respondent's experts for the risk free rate—4.7%, and market risk premium—seven percent.<sup>133</sup> However, the seven percent figure, as noted *supra*, is most likely a percentage point or two high. For the required Beta<sup>134</sup> figure the experts diverged in opinion as to method of calculation.<sup>135</sup> They both referenced the same comparable company Betas but measured them over different periods (five years versus two years) and unlevered them in a different manner.<sup>136</sup> Vice Chancellor Strine rejected both methods and instead averaged four separate Beta calculations—the median of the petitioners' and respondent's experts' Betas and the average Betas of four core companies over two-year and five-year horizons.<sup>137</sup> This decision to average the four Betas in this manner is not supported by the literature as an accepted method to calculate Beta for a private corporation.<sup>138</sup> Nonetheless, Vice Chancellor Strine computed a Beta of 1.20 versus 1.22 for the respondent's expert and 1.04 for the petitioners' expert.<sup>139</sup> He then inputted these numbers into the CAPM to arrive at a WACC of 13.92%.<sup>140</sup> He then inexplicably

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131. BREARLY & MYERS, *supra* note 14, at 532-36.

132. *Andaloro*, 2005 WL 2045640, at \*14-\*16; *see also supra* note 83 for a discussion of the CAPM and the return on equity and their respective roles in the calculation of WACC.

133. *Andaloro*, 2005 WL 2045640, at \*14. Because Vice Chancellor Strine had decided to set an all-equity capital structure for PFPC, WACC for these purposes was PFPC's cost of equity. Vice Chancellor Strine therefore was not required to determine the corporation's cost of debt or marginal tax rate. BREALEY & MYERS, *supra* note 14, at 531. In any event, a market risk premium of seven percent is higher than what recent academic studies believe is correct. DIMSON ET AL., *supra* note 85, at 211-12.

134. For a definition of Beta and its role in the CAPM, *see supra* note 83.

135. *Andaloro*, 2005 WL 2045640, at \*15.

136. *Id.*

137. *Id.*

138. *Andaloro*, 2005 WL 2045640, at \*15.

139. *See* DAMODARAN, *supra* note 74, at 198 (stating that average Beta should be computed using market-weighted or equal-weighted averages of the comparable companies). As noted, Vice Chancellor Strine also stated that the experts did not unlever their Betas in an identical way. *Andaloro*, 2005 WL 2045640, at \*15. However, he did not discuss in the opinion how they or he conducted the required comparable company Beta unlevering. *Id.*; *see also* PRATT ET AL., *supra* note 14, at 167-68 (outlining requirement to unlever comparable company Betas to adjust their capital structure to that of the valued corporation).

140. *Id.*

rounded down this percentage to 13.5%.<sup>141</sup> Using this 13.5% figure to discount back the modified management projections and terminal value, Vice Chancellor Strine arrived at a discounted cash flow value for PFPC of \$32.08.<sup>142</sup>

Is this right? Well, no. There are obvious flaws in Vice Chancellor Strine's valuation. The calculation of the equity discount rate, including Beta and terminal values, as well as the market risk rate employed and manner of readjusting PFPC's capital structure to an all-equity model each appear to be contrary to agreed finance methodology.<sup>143</sup> Additionally, some of the chosen numbers, such as the terminal value, perpetual growth rate, and final discount rate seem capricious.<sup>144</sup> However, a critique of the Delaware court's valuation practices, although certainly needed, is not the purpose of this Part.<sup>145</sup> Rather, the goal here is to illustrate the issues outlined *supra* at Parts II.A.1 and II.A.2 and the effect of an absence of any clear-cut valuation guidelines or standards and a body administering them.<sup>146</sup> Practitioners and even the judiciary itself therefore apply their own subjective biases with no coherence to valuation using different "pick-and-choose" methods and approaches.<sup>147</sup> The consequences are evidenced by the three quite different discounted cash flow figures (\$21.35, \$32.08, and \$61.76) produced in *Andaloro*.<sup>148</sup>

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141. *Id.*

142. *Id.* at \*16.

143. *See supra* notes 112-142 and accompanying text.

144. *See supra* notes 122-142 and accompanying text.

145. *See supra* note 106 for a citation of articles that have in part addressed this topic.

146. This is also illustrated by the comparable company analysis conducted by the Court of Chancery in *Andaloro*. In *Andaloro*, the petitioner's expert did not conduct a comparable company analysis for valuation purposes because he believed it was not feasible in light of PFPC's past, poor performance and situation as well as the stock market decline in 2002. 2005 WL 2045640, at \*15. The respondent's expert disagreed and did conduct such an analysis, as did Vice Chancellor Strine. However, both Vice Chancellor Strine and respondent's expert again came up with different numbers and used differing methodologies in deriving these numbers, albeit with some overlap. *Id.* at \*16-\*20. Vice Chancellor Strine then ascribed two-thirds weight to the discounted cash flow analysis and one-third weight to the comparable company analysis to derive an ultimate valuation of PFPC of \$32.81. *Id.* at \*20. He provided greater weight to the discounted cash flow analysis due to the presence of what he perceived as "responsible" management projections and the superiority of this technique for valuation purposes when such information is available. *Id.* The subjectivity problem here, even in this cursory summary, is again transparent.

147. The criticism here is not directed at Vice Chancellor Strine. Rather, the opinion in *Andaloro* is meticulous and shows a judge struggling mightily (and admirably) to practice the art of valuation amidst highly divergent views and a lack of set guidelines or standards.

148. The results in *Andaloro* are also not the only examples in the Delaware appraisal context of the valuation disparities which can arise when valuation is

### B. The Conflicts Problem

The discretion and divergence in valuation practice outlined *supra* compounds a procedural concern with fairness opinion practice. The typical issuers of fairness opinions, investment banks, have been subject to repeated criticism for potential and actual conflicts in the rendering of these opinions.<sup>149</sup> The primary issue is this: investment banks delivering fairness opinions in a corporate control transaction typically are also retained to render general financial advice with respect to the relevant transaction.<sup>150</sup> They are well-compensated for this work. The fee can be millions of dollars: the amount variant depending upon the transaction size.<sup>151</sup> The manner of compensation is a success fee payable to the bank at transaction milestones such as announcement or completion.<sup>152</sup> The compensation for a fairness opinion is often subsumed into this larger fee and is therefore also dependent upon the transaction's occurrence.<sup>153</sup> The investment bank therefore has a hefty incentive to ensure that the contemplated transaction for which it will issue a

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conducted in these circumstances. *See, e.g., In re Emerging Communications, Inc. S'holders Litig.*, 2004 WL 1305745 (Del. Ch. 2004) (noting that respondent's expert calculated discounted cash flow of \$10.38 per share and petitioners' expert calculated discounted cash flow of \$41.16 per share; court calculated discounted cash flow value of \$38.05 per share); *Doft & Co. v. Travelocity.com Inc.*, 2004 WL 1152338 (Del. Ch. 2004) (noting that respondent's expert calculated going concern value of \$20.00 per share and petitioners' expert calculated going concern value of at least \$35.00 per share; court valued corporation at \$32.76 per share).

149. *See infra* at Parts III.B and III.D for a review of such criticism by regulators and academics; *see also* Andrew Ross Sorkin, *Dealbook; Good Deals for Banks, Both Coming and Going*, N.Y. TIMES, Sept. 5, 2004, at C1 (criticizing conflicted practices by investment banks in the rendering of fairness opinions); Gretchen Morgenson, *Mirror, Mirror, Who is the Unfairest*, N.Y. TIMES, May 29, 2005, at C31 (discussing regulator inquiries into conflicted fairness opinion practices by investment banks).

150. *E.g.*, MAYTAG PROXY STATEMENT, *supra* note 23, at 63 (retaining an investment bank to render financial advice with approximately ninety percent of fee contingent upon success of the transaction); The Gillette Co., Definitive Proxy Statement (Form DEFM14A), at 54, 56 (May 27, 2005) (retaining two investment banks to render financial advice with a substantial part of their fee contingent upon the success of the transaction) [hereinafter *Gillette Proxy Statement*]; AT&T PROXY STATEMENT, *supra* note 26, at 41 (retaining investment bank to render financial advice with approximately ninety-one percent of fee contingent upon success of the transaction). *See generally* Kennedy, *supra* note 9, at 265-67 (detailing the typical structure of investment bank financial advisory fees).

151. *E.g.*, MAYTAG PROXY STATEMENT, *supra* note 23, at 63 (estimating fee paid to investment bank at approximately \$17.4 million for financial advice and a fairness opinion); GILLETTE PROXY STATEMENT, *supra* note 150, at 54, 56 (disclosing fee paid to two investment banks at \$30 million each for financial advice and a fairness opinion); AT&T PROXY STATEMENT, *supra* note 26, at 41 (estimating fee paid to investment bank at \$29 million for financial advice and a fairness opinion); PLAINS RESOURCES PROXY STATEMENT, *supra* note 23, at 74 (estimating fee paid to investment bank at approximately \$2.05 million for financial advice and a fairness opinion).

152. *See supra* note 151 for example transactions.

153. *See* Kennedy, *supra* note 9, at 265-67.

fairness opinion progresses to completion. But, conflict arises where a bank is asked to opine and advise on a transaction that it stands to benefit from only if the transaction transpires. In fact, under the fee structure explicated above the bank will not be paid if it cannot find fairness. This charge can be made even if the fairness opinion compensation is paid separate from the larger success fee. If the transaction occurs, the remaining overall compensation is significant enough to raise conflict issues.<sup>154</sup>

This explicit conflict is also accompanied by a more subtle one. The relationships between investment banks and corporate management can run deep, and an investment bank often has business with the corporation and its management that span more than one transaction. In these situations, investment banks may be influenced to find a transaction fair to avoid irritating management and other corporate actors who stand to benefit from the transaction.<sup>155</sup> This will ensure future lucrative business.

Finally, there are other situations where investment banks do not do themselves proud. For example, they often maintain business interests that extend to both sides of a corporate control transaction

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154. Even if separated out, fairness opinion fees themselves are often quite large and sustaining of an argument that incentives are misaligned. *See, e.g., In re Tele-Communications, Inc. Shareholders Litigation*, No. 16470, 2005 WL 3642727, at \*10 (Del. Ch. 2005) (stating that contingent fee payable to investment bank of approximately \$40 million “creates a serious issue of material fact, as to whether [investment bank] . . . could provide independent advice to the Special Committee”). In some instances, to refute this charge, the fee is payable whether or not the bank is able to render a fairness opinion. *E.g., PLAINS RESOURCES PROXY STATEMENT*, *supra* note 23, at 74 (disclosing that \$1 million fee for fairness opinion is payable regardless of the conclusion expressed by the investment bank in the opinion). However, many fee arrangements are dependent upon delivery of a fairness opinion. *E.g., 7 Eleven, Inc., Solicitation/Recommendation Statement* (Form SC 14D9), at 3 (Sept. 19, 2005) (disclosing that a \$1.25 million fee for a fairness opinion is due when opinion is delivered); NYSE Group, Inc., *Registration Statement* (Form S-4), at 78 (July 21, 2005) (disclosing that \$500,000 of a \$2 million fee for a fairness opinion was due upon execution of an engagement letter with the remaining \$1.5 million due upon delivery of the opinion). In addition, if the fee is not contingent upon a fairness determination, management and other pressures arguably still force investment banks towards the “right” fairness conclusion. *See infra* note 155 (citing evidence of management influence on investment bank fairness opinions).

155. *See, e.g., Kahn v. Dairy Mart Convenience Stores, Inc.*, No. 12489, 1996 WL 159628, at \*9 (Del. Ch. 1996) (noting evidence of investment bank revising its fairness opinion from negative to positive at management’s behest in order to secure future business); *see also* Timothy L. O’Brien, *The Man With the Golden Slingshot*, N.Y. TIMES, June 5, 2005, at C1 (describing the verdict of \$1.45 billion issued to Ron L. Perelman’s affiliates against Morgan Stanley with respect to the acquisition of Coleman by Sunbeam based upon claims that the investment bank, advisor to Sunbeam, “conceal[ed] Sunbeam’s true financial condition” due to its lending relationship with Sunbeam and millions in fees earned).

and beyond their own opinion.<sup>156</sup> The most common example today is stapled-financing. In its most prominent form, an acquirer, in an auction situation, will offer the acquirer a financing package that is sponsored by the acquirer's investment bank.<sup>157</sup> This is termed stapled-financing. The bank will render a fairness opinion to the acquirer board and, once the transaction is negotiated and agreed to, switch-sides and provide acquisition financing to the acquirer.<sup>158</sup> The added conflict here, beyond the fact of dual-representation, is that the investment bank has an incentive for a lower target price so that the acquirer will not be over-leveraged after the acquisition and therefore be better positioned to repay the indebtedness incurred to the investment bank.<sup>159</sup>

### 1. *The search for meaning*

There are substantial criticisms outlined above that can be levied against the fairness opinion, but there are two important distinctions to be made in its defense. First, in light of the criticism levied *supra* at Parts II.A and II.B, it would not be surprising if one completely discredited valuation analysis. This would be incorrect. Valuation today is an imperfect science; however, empirical research has proven that it can materially and beneficially inform as to value.<sup>160</sup> Furthermore, exact certainty as to price other than through market-

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156. For example, when JP Morgan acquired Bank One in 2004 the fairness opinion for JP Morgan was rendered by JP Morgan itself. Morgenson, *supra* note 149; see also Sorkin, *supra* note 149 (criticizing investment banks who render fairness opinions while also participating in multiple aspects of the transaction).

157. See generally Ari Nathanson, *Mid-Market I-Banks Keen On Stapled Financing*, BUYOUTS, Sept. 5, 2005, at 2005 WLNR 14049532 (noting the increased use of stapled-financing).

158. See *id.* (explaining the incentives and benefits leading investment banks to provide stapled-financing).

159. See Sorkin, *supra* note 149 (criticizing acquirer-side investment banks who render fairness opinions and also provide stapled-financing); see also *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1006 (Del. Ch. 2005) (stating that board decision to permit post-agreement stapled-financing by investment bank who rendered fairness opinion to board was not inappropriate but "was unfortunate, in that it tends to raise eyebrows by creating the appearance of impropriety"). In fact, due to the issues raised, both Goldman Sachs and Credit Suisse now recommend that clients obtain a second, separate fairness opinion when the bank represents the acquirer and provides stapled-financing. Michael J. Halloran & Jessica L. Hackman, *Overview of Liability Issues Confronting Investment Banks: Emphasis on Mergers and Acquisitions* 9 No. 1 M & A LAWYER 20 (May 2005).

160. See, e.g., BREALEY & MYERS, *supra* note 14, at 198-210 (outlining empirical studies finding utility of valuation techniques); GRINBLATT & TITMAN, *supra* note 73, at 158-68, 175-212 (outlining empirical tests finding utility of valuation techniques). See generally John Graham & Harvey Campbell, *The Theory and Practice of Corporate Finance: Evidence from the Field*, 60 J. OF FIN. ECON. 187 (2001); Steven N. Kaplan & Richard S. Ruback, *The Valuation of Cash Flow Forecasts: An Empirical Analysis*, 50 J. OF FIN. ECON. 1059 (1995).



based mechanisms will never be possible, but continuing research and study is making valuation practice and techniques more accurate every day.<sup>161</sup> The issue in the fairness opinion context arises from the subjectivity inherent in this valuation process combined with the conflicted nature of the preparers and failure to follow best practices. However, an unconflicted valuation conducted with rigor and discipline in accordance with current academic precepts and without biased manipulation of subjective inputs can materially inform as to value.<sup>162</sup>

Second, valuation can inform as to value but it is not a prediction of price. There are numerous examples of fairness opinions rendered to acquirers in corporate control transactions where later offers emerged for higher, sometimes substantially higher, amounts.<sup>163</sup> A recent investigation by the Massachusetts Secretary of the Commonwealth into the fairness opinion delivered to the board of Gillette in connection with its acquisition by Procter & Gamble (“P&G”) focused on whether Gillette’s investment banks violated the Massachusetts Security Act by issuing a fairness opinion in light of what the attorney general believed was the low price offered by P&G.<sup>164</sup> It is this miscomprehension which often drives the criticism of fairness opinions: the search for metaphysical certainty in valuation practice. Yet, this is not the fairness opinion’s or valuation’s

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161. See *supra* note 14 (citing academic review of these developments).

162. See *supra* note 160 for citation of studies on the efficacy of valuation; see also DAMODARAN, *supra* note 74; Kennedy, *supra* note 9, at 265-68 (outlining rigorous, benchmark fairness opinion preparation procedures); Andrew L. Bab et al., *Faulty Assumptions*, THE DAILY DEAL, Sept. 3, 2004 (arguing that “[c]ritics of fairness opinions appear not only to misunderstand their purpose, but also to overlook the meticulous work and rigorous vetting that goes into them . . .”).

163. There are literally hundreds of examples. Two of recent note are first, Maytag’s agreement to be acquired by Whirlpool at a price of \$21 after a prior agreement to be acquired for \$14 a share. Whirlpool Corp., Registration Statement (Form S-4), at 48, 57 (Sept. 29, 2005). Second, Guidant’s agreement to be acquired by Boston Scientific at a price of \$80 a share after a prior agreement to be acquired at approximately \$64. Guidant Corp., Definitive Proxy Statement (Form DEFM14A), at 86 (Mar. 3, 2006). Fairness opinions were rendered to the acquirer with respect to the initial acquisition price in both instances.

164. GILLETTE PROXY STATEMENT, *supra* note 150, at 40. For further discussion of the Massachusetts investigation, see generally Brent Shearer, *State Officials Get Tough On Regulation of M&A*, MERGERS & ACQUISITIONS: DEALMAKERS J., Aug. 1, 2005; Andrew Ross Sorkin, *You Can Call It a Fairness Opinion, But That Wouldn’t Be Fair*, N.Y. TIMES, July 10, 2005, at C33 (reporting William F Galvin, Massachusetts secretary of state, has accused Gillette’s investment banks of rubber stamping a below-market sale price). See also Andrew Caffey, *Markey to Open Probe into Fairness Opinions*, BOSTON GLOBE, June 7, 2005, at D2 (stating “US Representative Edward J. Markey, Democrat of Malden, said he will investigate the so-called fairness opinions that investment banks issue to corporate clients in mergers and acquisitions”); Andrew Ross Sorkin, *Mergers: Fair Should Be Fair*, N.Y. TIMES, Mar. 20, 2005, at C6 (discussing inherent conflicts with investment bank fairness opinions in corporate control transactions).

purpose. In the corporate control transaction, fairness opinions do not exist to select the correct or even highest price that would or could be paid. This is impossible given the limitations of valuation today, information disparities, and simple game theory.<sup>165</sup> Rather, I believe the fairness opinion aids the board in satisfaction of its duty of care by providing confidence that the price offered for the sale or purchase of a corporation is within a reasonable range for a corporate control transaction of this nature. This is not price.

### III. RESPONSE TO THE FAIRNESS OPINION

This Part examines the fairness opinion post-*Van Gorkom*. More specifically, it discusses the regulatory, judicial, and academic response to fairness opinions and their increased utilization. First, I examine Securities and Exchange Commission ("SEC") regulatory action vis-à-vis fairness opinions both pre- and post-*Van Gorkom*. Thereafter, I survey the responses of the National Association of Securities Dealers ("NASD"), Delaware courts, and academia.

#### A. The SEC Response

The SEC has adopted a disclosure-based approach to the treatment of fairness opinions in corporate control transactions. The SEC has promulgated these disclosure requirements in two categories of takeover regulation: going-private transactions<sup>166</sup> and proxy solicitations.<sup>167</sup> Surprisingly, the SEC has not proposed or otherwise extended these disclosure obligations to the cash tender offer.<sup>168</sup>

In 1979, the SEC adopted rules governing going-private transactions by public companies and affiliated entities.<sup>169</sup> The SEC

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165. See generally BREARLY & MYERS, *supra* note 14, at 716 (noting acquirer has information that is often unavailable publicly or to acquiree); Bernard Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989) (arguing that acquirers tend to overpay in corporate control transactions); Carney, *supra* note 10, at 533-36 (discussing limitations of valuation in the context of predicting the price an acquirer is willing or otherwise agrees to pay); Kenton K. Yee, *Control Premiums, Minority Discounts, and Optimal Judicial Valuation*, 48 J.L. & ECON. 517 (Oct. 2005) (reviewing methodology to calculate acquirer control premiums).

166. For a definition of a going-private transaction, see *supra* note 3.

167. The definition of "proxy" and a "solicitation" for purposes of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), are set forth in 17 C.F.R. § 240.14a-1 (2005).

168. This is inexplicable. If there is a need to disclose information concerning the fairness opinion in a corporate control transaction then the manner in which it is conducted (i.e., stockholder vote through a proxy solicitation or cash tender offer) should not affect the disclosure requirement.

169. Going-Private Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 34-16075, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82166 (Aug. 2, 1979) [hereinafter *Going-Private Adopting Release*].

prescribed these rules in order to bestow added protections to unaffiliated stockholders due to their susceptibility for abuse in these transactions.<sup>170</sup> In these rules, the SEC set forth the first meaningful, explicit requirement under the federal securities laws for public disclosure of fairness opinions and their underlying analyses. Additionally, the new going-private rules mandated disclosure concerning potential conflicts-of-interest for any investment bank rendering a fairness opinion in such transactions.<sup>171</sup>

The SEC set forth these strictures in new Rule 13e-3.<sup>172</sup> Rule 13e-3 required, and still requires, that a corporation or affiliate thereof implementing a Rule 13e-3 going-private transaction be subject to the increased disclosure and filing obligations set forth in Schedule 13e-3.<sup>173</sup> Schedule 13e-3 obligates the filer to disclose whether or not the corporation or its affiliate has received a fairness opinion or similar report, and, if so, to furnish a summary of the fairness opinion.<sup>174</sup> In addition, the fairness opinion must be filed as an exhibit to the Schedule.<sup>175</sup> The Schedule also requires that any underlying written analyses (e.g., the board book), or any other report prepared by the investment bank in connection with the fairness opinion, must be attached as an exhibit to the Schedule.<sup>176</sup>

The Schedule 13e-3 fairness opinion summary disclosure requirements are not specific: they require disclosure of the bases for and methods of arriving at the finding of fairness but do not provide any guidance as to the scope or content of this mandated disclosure.<sup>177</sup> However, the SEC staff review of, and comment upon, Schedule 13e-3s has provided such definition. More specifically,

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170. See *Going-Private Transactions by Public Companies or Their Affiliates*, Exchange Act Release No. 34-14185, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81366, at 88736-39 (Nov. 17, 1977) (outlining various prior abusive practices undertaken by affiliates in going-private transactions) [hereinafter *Going-Private Proposing Release*].

171. See *GOING-PRIVATE ADOPTING RELEASE*, *supra* note 169, at 82124-25.

172. 17 C.F.R. § 240.13e-3 (2005); see also *GOING-PRIVATE ADOPTING RELEASE*, *supra* note 169, at 82125-31 (providing an overview of Rule 13e-3's requirements).

173. 17 C.F.R. § 240.13e-3(d) (2005).

174. 17 C.F.R. § 240.13e-3(e) (2005).

175. 17 C.F.R. § 240.13e-100 (2005) (Item 16).

176. *Id.* This can be interpreted to include oral reports delivered to the board; see *Applicability of Item 9 of Schedule 13E-3 to Purchase Price Allocation Reports*, SEC No-Action Letter, 1987 WL 108650 (Sept. 30, 1987) (requiring "oral presentation [to] be summarized fairly" and filed as an exhibit to the Schedule 13E-3). Drafts of fairness opinions, board books and other analyses provided to the board may also require disclosure. The staff of the SEC has been known to query whether such drafts were provided to the board and to require disclosure of any material differences in these drafts and the final versions. Meredith M. Brown & Gregory V. Gooding, *What's Different About Going-Private*, 13 No. 8 *INSIGHTS* 14, 16 (Sept. 1999).

177. 17 C.F.R. § 240.13e-100 (2005) (Item 9).

since 1979, the staff of the SEC has regularly interpreted Schedule 13e-3 to require disclosure of the methodologies utilized in preparing a fairness opinion, the results of such methodologies, and the basis for selecting each one.<sup>178</sup> The extent of this obligatory disclosure has varied with the intensity of SEC review but has commonly tracked the disclosure made by investment banks in their board books.<sup>179</sup> In this regard, the staff of the SEC has most frequently required disclosure of the discount rates and terminal value used in a discounted cash flow analysis and the companies referenced in a comparable company's analysis.<sup>180</sup> However, rarely has the SEC staff gone further and required disclosure of all material inputs in the selected calculations, such as requiring full disclosure of the method of computation of the discount rate in a discounted cash flow analysis.<sup>181</sup>

Schedule 13e-3 also requires disclosure of certain potential investment banking conflicts. The Schedule mandates disclosure of "any material relationship that existed during the past two years or is mutually understood to be contemplated . . . ." between the corporation receiving the fairness opinion and the investment bank rendering the fairness opinion and each of their affiliates.<sup>182</sup> The "compensation received or to be received" by the investment bank as a result of any such relationship must also be disclosed.<sup>183</sup> SEC staff review has again delineated the true contours of this disclosure. However, this review has been hit or miss. While the staff has sometimes required full disclosure of relationship details as well as monetary and other compensation provided,<sup>184</sup> it has also frequently permitted boiler-plate responses. This boiler-plate typically was descriptive rather than numerical and did not detail the true nature

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178. Edward D. Herlihy et al., *Disclosure of the Analyses Underlying Investment Banker Fairness Opinions*, 6 No. 3 INSIGHTS 11, 11 (1992).

179. *Id.*

180. *Id.*

181. See, e.g., Shopko Stores, Inc., Definitive Proxy Statement (Form DEFM14A), at 64 (Nov. 23, 2005); Brookstone, Inc., Definitive Proxy Statement (Form DEFM14A), at 50-51 (Aug. 22, 2005) [hereinafter Brookstone Proxy Statement]; WORLDWIDE PROXY STATEMENT, *supra* note 21, at 17-18; SUNGARD PROXY STATEMENT, *supra* note 92, at 34-35, 40-41. Thus, while filers might do otherwise voluntarily, SEC disclosure requirements under Rule 13e-3 have generally been limited to disclosure of the analyses set forth in the board book. *But see* Vermont Teddy Bear, Inc., Definitive Proxy Statement (Form DEFM14A), at 41-42 (Sept. 20, 2005) (disclosing cash flow numbers discounted and choice of the CAPM to calculate return on equity as well as the risk free rate, market risk premium and Beta utilized in the CAPM calculation).

182. 17 C.F.R. § 240.13e-100 (2005) (Item 9).

183. *Id.*

184. See, e.g., PLAINS RESOURCES PROXY STATEMENT, *supra* note 23, at 74 (disclosing that the investment bank "has in the past provided financial advisory services to Plains Resources and, since 2000, has received fees totaling \$2,845,000 for such services").

and extent of the investment bank and corporate relationship, past and present, nor the amount of compensation received by the investment bank.<sup>185</sup>

In 1986, the SEC comprehensively revised the proxy rules and adopted stated disclosure requirements for fairness opinions provided in corporate control transactions similar to those within Rule 13e-3 and Schedule 13e-3.<sup>186</sup> The only notable difference was that these revised proxy rules did not mandate disclosure of board books and other related financial analyses delivered by an investment bank to the board.<sup>187</sup> However, while the explicated rules were similar, the staff of the SEC adopted a different approach in its implementing review. The SEC staff, in fact, took a “hands-off” position of no review at all.<sup>188</sup> Accordingly, until the early 1990s, disclosure in proxy statements with respect to fairness opinions was quite limited and typically confined to a summary of the opinion itself.<sup>189</sup> However, in the early 1990s, the SEC staff revised these practices, initiating rigorous review on level with SEC review of Schedule 13e-3 statements and requiring similar disclosure.<sup>190</sup> The SEC did not, either in the early 1990s or thereafter, state a reason for this shift.

In more recent times, the SEC has again reverted to a more relaxed review process for proxy statements. As a result, the majority of proxy statement filers in corporate control transaction today disclose only bare information with respect to the assumptions underlying the fairness opinion valuation analyses—this is oftentimes the discount rates and terminal value methodology utilized for a discounted cash flow analysis and the companies referenced for a comparable companies analysis. Filers also now often make boilerplate disclosure that describes fees and relationships as “customary”

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185. See, e.g., SINOPEC SCHEDULE 13E-3, *supra* note 31, at Ex. A(5)(v), p.36 (Jan. 20, 2005) (disclosing that investment bank received a “customary” fee for rendering the fairness opinion); BROOKSTONE PROXY STATEMENT, *supra* note 181, at 52 (disclosing that investment bank provided services to “affiliates of the members of the investor group” for unspecified “compensation”).

186. Proxy Rules—Comprehensive Review, Exchange Act Release No. 34-23789 [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83901 (Nov. 10, 1986). The SEC also adopted similar rules for Form S-4 registration statements filed in connection with securities offerings involving a corporate control transaction under Rule 145 or an exchange offer. *Id.*

187. However, since the early 1990s the SEC has often requested confidential submission of board books to ensure that the fairness opinion public disclosure is consistent with the book’s contents. Herlihy et al., *supra* note 178, at 11-12.

188. *Id.* at 12-13.

189. *Id.* at 11.

190. See *id.* at 13 (discussing the SEC’s increased proxy statement disclosure requirements for fairness opinions).

and as existent, rather than disclosing specific numbers or the details of relationships. This has been true at times even of the fee paid for the fairness opinion itself.<sup>191</sup> In light of this backsliding and back-and-forth, public pronouncement of the SEC staff's policy on fairness opinion disclosure would be helpful for consistency's sake, if nothing else.

The SEC has not provided any justification for the aforementioned disclosure obligations other than a single statement in the going-private proposing release that the fairness opinion disclosure requirements adopted therein "are intended to ensure full disclosure concerning the material elements in the determination of the consideration to be offered . . . ."<sup>192</sup> Beyond this, it can be surmised that the SEC adopted these disclosure obligations to align with the general tenor of the new going-private rules—providing stockholders with information as to price equivalent to that placed before the board in a going-private transaction and sufficient for an educated stockholder investment decision.<sup>193</sup> This would conceivably limit the potential for abuse of these stockholders by an affiliate or the corporation itself.<sup>194</sup> The rationale for SEC extension of these strictures in the revised proxy rules has never been stated but is presumably based in part upon these same principles.

Nor has the SEC ever recognized or even acknowledged any issues with fairness opinion practice or assessed the intrinsic worth of these opinions. Instead, the SEC disclosure requirements *ab initio* assumed the fairness opinion's significance and the usefulness of at least partial disclosure of the underlying valuation analyses. In addition, beyond the disclosure requirements enumerated above, the SEC has never addressed the issue of investment banks rendering fairness opinions and their potential conflicted status. The absence on both counts is a bit puzzling since such recognition should presumably form the foundation for any rule-making on this subject. Nevertheless, this is what has unfolded.

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191. See, e.g., Scientific Atlanta, Inc., Definitive Proxy Statement (Form DEFM14A), at 24-25 (Jan. 3, 2006) (stating that investment bank "in the past ha[s] provided, and in the future may provide, investment banking and other financial services" to acquiree and that it would receive a "customary" fee for its services for the current fairness opinion); American Water Works, Inc., Definitive Proxy Statement (Form DEFM14A), at 26 (Dec. 5, 2001) (disclosing that the investment bank was paid a "customary" fee for the fairness opinion and advisory services).

192. GOING-PRIVATE PROPOSING RELEASE, *supra* note 170, at 88752.

193. *Id.* at 88750-53.

194. See *id.* at 88738 (arguing that SEC regulation of going-private transactions is necessary to maintain full investor confidence in the U.S. capital markets).

*B. The National Association of Securities Dealers Response*

The only other significant regulatory action with respect to fairness opinions has been the recent, in-progress rule-making of the NASD.<sup>195</sup> In November 2004, the NASD promulgated a notice to members requesting comment on whether to propose new rules “that would address procedures, disclosure requirements, and conflicts of interest when members provide fairness opinions in corporate control transactions.”<sup>196</sup> More specifically, the NASD requested comments concerning methods to “improve the processes by which investment banks render fairness opinions and manage inherent conflicts.”<sup>197</sup> The NASD put forth three reasons for requesting comment. First, the disclosure mandated under SEC regulation for fairness opinions could be perceived as insufficient “to inform investors about the subjective nature of some opinions and their potential biases.”<sup>198</sup> Second, fairness opinions are by nature subjective and consequently there has arisen a “perceived tendency” that these opinions often support management.<sup>199</sup> Finally, unaffiliated stockholders sometimes do not receive the benefits in a corporate control transaction that management, directors or other employees do. The NASD hypothesized that this disparity may create biases in favor of the transaction if the people involved in the current or future hiring of the investment bank are those with a differential benefit.<sup>200</sup>

The NASD subsequently proposed rule 2290 in response to solicited member comments.<sup>201</sup> Rule 2290 was announced and filed with the SEC for approval on June 22, 2005, and, in response to SEC

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195. The NASD is a self-regulating organization, and the private regulator of the U.S. securities industry. Every securities firm doing business with the American public must register with the NASD, and all of the bulge-bracket, multi-function investment banks and most other investment banks are members of the NASD and subject to its regulation. See generally Maria A. Volarich, Note, *Easing the Regulation of a Pan-European Securities Market: Applying the Recommendations of the Rudman Report to Easdaq*, 19 FORDHAM INT'L L.J. 2230, 2241-44 (1996) (outlining the history and role of the NASD). The SEC has oversight of, and ability to regulate, the NASD under Section 19 of the Exchange Act. 15 U.S.C.A. § 78s (2005).

196. Request For Comment—Fairness Opinions Issued by Members, NASD Notice to Members 04-83, at 1009 (Nov. 2004), available at [http://www.nasd.com/web/idcplg?IdcService=SSGET\\_PAGE&ssDocName=NASDW\\_012249](http://www.nasd.com/web/idcplg?IdcService=SSGET_PAGE&ssDocName=NASDW_012249).

197. *Id.* at 1012.

198. *Id.* at 1011.

199. *Id.*

200. *Id.* at 1012.

201. Proposed Rule Change to Establish New NASD Rule 2290 Regarding Fairness Opinions, SR-NASD-2005-080 (June 22, 2005), available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW\\_014559](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_014559). The NASD received twenty comment letters, available at [http://www.nasd.com/web/idcplg?IdcService=SSGET\\_PAGE&ssDocName=NASDW\\_012249&ssTargetNodeId=567](http://www.nasd.com/web/idcplg?IdcService=SSGET_PAGE&ssDocName=NASDW_012249&ssTargetNodeId=567).

comments, amended three times.<sup>202</sup> The rule was published in the Federal Register on April 11, 2006.<sup>203</sup> It is currently in a comment period, and will likely be approved by the SEC in the coming months, thereby becoming effective under the Securities Exchange Act of 1934, as amended.<sup>204</sup>

Rule 2290 in its current form sets forth requirements for the disclosure of potential conflicts and minimum procedures with respect to NASD member investment bank's internal approval and vetting of fairness opinions.<sup>205</sup> The rule is primarily one of mandated disclosure triggered only if a fairness opinion is provided or otherwise referenced to public stockholders. In such a situation, four categories of disclosure are required. First, all compensation payable to the member investment bank that is contingent upon the successful completion of the transaction must be disclosed in the fairness opinion.<sup>206</sup> Second, any material relationship that existed during the two years prior to the rendering of the fairness opinion or is contemplated between the companies involved in the transaction and the member investment bank must be disclosed in the fairness opinion.<sup>207</sup> Third, the fairness opinion must state whether or not it has been approved or issued by a fairness committee.<sup>208</sup> Finally, the fairness opinion must disclose the categories of information that formed a substantial basis for the fairness opinion and whether any such information in each such category was independently verified by the member investment bank.<sup>209</sup>

The rule in its current proposed form is largely uneventful and a disappointment given the NASD acknowledgement of the issues before it.<sup>210</sup> The procedural requirements for internal fairness

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202. Amendment Nos. 1, 2 and 3 to Proposed Rule Change to Establish New NASD Rule 2290 Regarding Fairness Opinions, SR-NASD-2005-080 (Nov. 30, 2005), available at [http://www.nasd.com/web/idcplg?IdcService=SS\\_GET\\_PAGE&ssDocName=NASDW014559](http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW014559).

203. Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2, and 3 thereto to Establish New NASD Rule 2290 Regarding Fairness Opinions, 71 Fed. Reg. 34-53598 (Apr. 4, 2006) [hereinafter Proposed Rule Change Regarding Fairness Opinions].

204. This is legally required under Section 19(b) of the Exchange Act. 15 U.S.C.A. § 78s(b) (2005).

205. PROPOSED RULE CHANGE REGARDING FAIRNESS OPINIONS, *supra* note 203, at 18395 (Proposed Rule 2290).

206. *Id.* (Proposed Rule 2290(a)(1), (2)).

207. *Id.* (Proposed Rule 2290(a)(3)).

208. *Id.* (Proposed Rule 2290(a)(5)).

209. *Id.* (Proposed Rule 2290(a)(4)).

210. Several commentators argued for stronger medicine, including prohibiting investment banks from receiving success fees if rendering a fairness opinion, requiring disclosure of all material inputs in the preparation of any underlying valuation analysis, requiring distinct disclosure of fairness opinion fees from general



opinion approval are, with one significant exception, already largely followed voluntarily by the investment banks.<sup>211</sup> This exception is a provision requiring a regulated investment bank rendering a fairness opinion to follow a procedure which evaluates “whether the amount and nature of the compensation from the transactions underlying the fairness opinion benefiting any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company is a factor in reaching a fairness determination.”<sup>212</sup> I have read and re-read this provision and the NASD commentary upon it. While the purpose can be easily surmised—addressing inordinate retention and compensation paid in connection with change of control transactions—I look forward to learning how the investment banks implement this provision, because I honestly do not know how they can or will other than via the usual boiler-plate response. In any event, this requirement misapprehends what a fairness opinion does and opines to. Retention and other compensatory arrangements do arguably result in a lower price to acquiree stockholders, but do not affect whether the ultimate price itself is fair within the financial parameters of the value of the corporation or the consideration paid. To rephrase the point, the price can be financially fair in a corporate control transaction but the retention and other compensatory arrangements still egregious. Trying to analyze them together scrambles the egg.<sup>213</sup> The NASD should address these issues separately.

The disclosure requirements of the rule were watered down in the NASD and SEC review process. The NASD ultimately did not go so far as to require member investment banks to disclose “any significant conflicts of interest” as it initially considered.<sup>214</sup> Instead, the disclosure requirements with respect to contingent consideration and

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advisory fees and the adoption of a code of best practices for fairness opinion preparation. See *inter alia* comments of CalPERS (submitted Feb. 1, 2005), Charles M. Elson et al. (submitted Dec. 21, 2004) and Standard & Poor’s Corporate Value Consulting (submitted Jan. 10, 2005), available at [http://www.nasd.com/web/idcplg?IdcService=SSGETPAGE&ssDocName=NASDW\\_012249&ssTargetNodeId=56](http://www.nasd.com/web/idcplg?IdcService=SSGETPAGE&ssDocName=NASDW_012249&ssTargetNodeId=56); see also Ann Davis, *Wall Street’s ‘Fairness Opinions’ Draw Fire From Calpers*, WALL ST. J., Feb. 8, 2005, at C1 (discussing CalPERS comments on the NASD proposed Rule 2290).

211. PROPOSED RULE CHANGE REGARDING FAIRNESS OPINIONS, *supra* note 203, at 18395 (Rule 2290(b)).

212. PROPOSED RULE CHANGE REGARDING FAIRNESS OPINIONS, *supra* note 203, at 18395 (Rule 2290(b)(3)).

213. The issue of fairness opinions and retention and compensatory arrangements is discussed further *supra* note 27.

214. PROPOSED RULE CHANGE REGARDING FAIRNESS OPINIONS, *supra* note 203, at 18397.

relationships largely overlap with current federal securities law.<sup>215</sup> The two other disclosure obligations concerning opinion committees and independent verification of information will likely be met with more boiler-plate responses—a practice which the rule effectively permits.<sup>216</sup> Furthermore, in the amending releases the NASD also relaxed the rule's bite; removing a good bit of the potential for it to go beyond SEC regulation. For example, the NASD took the position in the amending releases that disclosure of contingent compensation and material relationships under the rule can be descriptive and not quantitative; a statement as to whether it exists or not sufficient.<sup>217</sup> Yet, the number is the important element here: if the amount is high it has more potential to result in bias.<sup>218</sup> In addition, the rule does nothing about the subjectivity inherent in fairness opinion preparation. It simply addresses the conflicts issue with redundant disclosure requirements, which permit investment banks to engage in the similar practices with little, if any change.

However, there is hope. The NASD has achieved something the SEC has not. The NASD has actually recognized problems with fairness opinion practice today. It is here that I believe the value of these new NASD rules will ultimately lie, in their unrealized potential and significance in the recognition by a regulator of underlying problems with fairness opinion practice and the limited regulation thereof put forth by the SEC. The SEC and other corporate actors now have no excuse: the NASD has put them on notice.

### *C. The Delaware Courts Response*

#### *1. The fairness opinion's enduring strength*

Steadfast would be a good description of the Delaware courts' treatment of fairness opinions post-*Van Gorkom*. The courts have

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215. See *supra* Part III.A (outlining federal securities law fairness opinion disclosure requirements). The rule requires disclosure of "material relationships" between the member investment bank and all of the companies involved in the transaction, as opposed to the federal requirement that only relationships with the fairness opinion recipient need be disclosed. However, contrary to the federal requirement, the rule does not require that relationships between the investment bank's affiliates and the fairness opinion recipient be disclosed. See PROPOSED RULE CHANGE REGARDING FAIRNESS OPINIONS, *supra* note 203, at 18397.

216. PROPOSED RULE CHANGE REGARDING FAIRNESS OPINIONS, *supra* note 203, at 18398.

217. *Id.* at 18397.

218. This is particularly true, since, unless forced by SEC staff comments, filers arguably do not need to disclose these numbers. See *supra* notes 185-191. See also *In re Tele-Communications, Inc. Shareholders Litigation*, No. 16470, 2005 WL 3642727, at \*10 (Del. Ch. 2005).

explicitly and repeatedly clung to *Van Gorkom's* holding that a well-prepared financial analysis from either management or an outside advisor is necessary but that a fairness opinion is not. So, for example, the Court of Chancery recently stated that in the corporate control transaction "fairness opinions . . . are generally not essential, as a matter of law, to support an informed business judgment,"<sup>219</sup> a statement that had been reiterated by the Delaware courts throughout the preceding twenty years.<sup>220</sup>

However, the Delaware courts' assertions that a fairness opinion is not explicitly required in connection with the board's consideration of a corporate control transaction have been undermined by the credence and weight paid by the courts to fairness opinions in such paradigms. In case after case where a board's decision-making process has been challenged, the Delaware courts have noted the receipt of a fairness opinion, in and of itself, as a strong, if not dispositive, indicator that the board properly acted in making the relevant decision to proceed with the transaction.<sup>221</sup> More broadly, the courts have repeatedly and approvably cited fairness opinions as sufficing to provide protection from liability under title 8, section 141(e) of the Delaware Code.<sup>222</sup> In both instances, this endorsement has come without significant qualification or analysis such that the

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219. *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 984 (Del. Ch. 2000).

220. *See, e.g., Merchants' Nat'l Props., Inc. v. Meyerson*, 2000 WL 1041229, at \*6 (Del. Ch. 2000); *Wacht v. Cont'l Hosts, Ltd.*, 1994 WL 525222, at \*3 (Del. Ch. 1994); *Oberly v. Kirby*, 592 A.2d 445, 472 (Del. 1991).

221. *See, e.g., In re Compucom Systems, Inc. Stockholders Litig.*, 2005 WL 2481325, at \*7 (Del. Ch. 2005) (holding board reasonably relied on fairness opinions which "were supported by a number of financial analyses"); *Angelo, Gordon & Co., L.P. v. Allied Riser Commc'ns Corp.*, 805 A.2d 221, 229 (Del. Ch. 2002) (noting concerns as to the fairness of the transaction as a whole, but taking no action as the investment bank "has not withdrawn its fairness opinion nor has it told [the corporation] that it may no longer rely upon it"); *Ash v. McCall*, 2000 WL 1370341, at \*9 (Del. Ch. 2000) (stating that retention and advice of investment bank, together with accounting firm, "permits one conclusion: that the [corporation's] directors' reliance on the views expressed by their advisors was in good faith" and therefore the board acted with due care); *Wis. Inv. Bd. v. Bartlett*, 2000 WL 238026, at \*6 (Del. Ch. 2000) (noting with approval receipt of fairness opinion to sustain rejection of claim that board breached its duty of care). *See generally In re Dairy Mart Convenience Stores, Inc.*, 1999 WL 350473, at \*13 (Del. Ch. 1999) (stating that "an outside financial advisor's opinion on the terms of a transaction generally gives the court comfort with respect to the reasonableness of the board's action"); *Adam O. Emmerich & Paul K. Rowe, Acquisitions Gone Sour: Whose Fault?*, N.Y.L.J., Apr. 23, 2001, at S4 (asserting that "if the acquiring firm's board is advised by independent financial and legal professionals who 'green light' the transaction, the directors will be protected from litigation challenging their pre-closing conduct"). *Cf. In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1278 (N.D. Cal. 2000) (dismissing pendent Delaware state law claims of breach of the duty of care due to, among other factors, the board's receipt of a fairness opinion).

222. *See, e.g., Crescent/Mach I Partners*, 846 A.2d at 985; *In re RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036, at \* 16 (Del. Ch. 1989).

receipt of a fairness opinion appears, absent egregious factors, to *per se* provide protection.<sup>223</sup> Obviously, from the board and practitioner perspective the consequence is to sustain the implicit structural requirement for these opinions.

The Delaware courts have also looked to these opinions as a substantive determinator that can guide them in their own fairness determinations. For example, in *Seagraves v. Urstadt Prop. Co., Inc.*,<sup>224</sup> the Court of Chancery, conducting an entire fairness analysis, stated that in a going-private transaction, a board of directors has no legal obligation to obtain a fairness opinion, but that the employment of such a "procedural safeguard" will be seen as strong evidence of a fair transaction.<sup>225</sup> The ostensible result of the opinion's caveat has been to ensure a strong, if not mandatory, role for a fairness opinion in a board recommended going-private transaction. However, it is also yet another example of the high place Delaware courts have accorded fairness opinions as stand-alone instruments.<sup>226</sup>

The Delaware courts have at times acted in this manner without any searching examination of the analyses underlying the opinion or even the utility of the underlying valuation.<sup>227</sup> They also have not,

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223. The Delaware courts have at times noted that a fairness opinion that is unreasonably relied on or acted upon in bad faith is not sufficient to establish the protections of DEL. CODE ANN. tit. 8, § 141(e) (2001). Yet, cases criticizing fairness opinions that have actually found such lack of reliance or bad faith are few and far between, and criticism of fairness opinions in the Delaware courts has more often occurred in the context of a failure to disclose deficiencies in the preparation of the fairness opinion rather than in its use. *See, e.g.*, *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1988) (holding that to rely upon DEL. CODE ANN. tit. 8, § 141(e) (2001), a board "may not avoid its active and direct duty of oversight in a matter as significant as the sale of corporate control"); *Grubb v. Bagley*, 1998 WL 92224, at \*2 (Del. Ch. 1998) (holding that the statute insulates director's from liability when relying on a fairness opinion only if the board acts "reasonably in good faith," and that reasonable and good faith reliance are material issues of fact).

224. 1996 WL 159626, at \*1 (Del. Ch. 1996).

225. *Id.* at \*5 (citations omitted).

226. *See, e.g.*, *In re Tele-Communications, Inc. S'holders Litig.* 2005 WL 3642727, at \*14 (Del. Ch. 2005) (holding that defendant's had failed to demonstrate fair price due to board's failure to obtain a fairness opinion analyzing the fairness of the high-vote stock exchange ratio to the holders of high-vote stock and the fairness of the low-vote stock exchange ratio to the holders of low-vote stock where two classes of stock existed, one high-vote and the other low-vote); *McMillan v. Intercargo Corp.*, 768 A.2d 492, 505 n.55 (Del. Ch. 2000) ("The board's reliance upon an investment banker (whose independence and qualifications are not challenged in the complaint) is another factor weighing against the plaintiffs' ability to state an actionable claim that the defendant directors breached their fiduciary duties by failing to secure the highest value reasonably attainable."); *Kahn v. Lynch Commc'n Sys., Inc.*, 1995 WL 301403, at \*2 (Del. Ch. 1995) (noting fairness opinions are "further evidence of the fairness of the price offered").

227. To be fair, the Delaware courts have at times in the past criticized fairness opinions when their preparation was blatantly deficient. These cases, though, are largely from the 1980s. *See, e.g.*, *Associated Imports, Inc. v. ASG Indus., Inc.*, 1984 WL 19833, at \*7-\*8 (Del. Ch. 1984) (criticizing investment bank for acting as a

until recently, made any substantive recognition, beyond *Van Gorkom's* implicit distinction, between the opinion itself and the valuation forming the basis of such an opinion.<sup>228</sup> Instead, it can be alleged that the Delaware courts have often endowed the fairness opinion with an almost magical status and ability to act as a golden ticket, alleviating an insouciant board from liability and the transaction at hand from challenges regarding the price aspect of the board's duty of care.

However, the Court of Chancery recently deviated in part from this practice. In *In re Pure Resources, Inc., S'holders Litig.*,<sup>229</sup> Vice Chancellor Strine gave voice to the first Delaware Court of Chancery opinion to recognize that the fairness opinion is merely a lightning rod and fundamentally a function of the underlying analyses. He stated:

[C]ourts must be candid in acknowledging that the disclosure of the banker's "fairness opinion" alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability. The real informative value of the banker's work is not in its bottom-line conclusion, but in the valuation analysis that buttresses that result.<sup>230</sup>

Vice Chancellor Strine concluded that this information was material to an acquiree stockholder's informed investment decision as to whether the price in a going-private transaction was appropriate and, consequently, whether or not to accept the offer.<sup>231</sup> He accordingly held that, in the context of a going-private transaction involving a Delaware corporation, a fair summary of the analyses supporting the acquiree fairness opinion must be disclosed in the related tender offer documentation.<sup>232</sup>

This case marked the first true recognition by the Delaware courts of the role of the fairness opinion, the underlying analyses as key to the fairness opinion's value, and the distinction between the two.<sup>233</sup> However, *In re Pure Resources* was at its heart a disclosure case which

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"negotiator" rather than an "expert" by preparing two separate fairness opinion letters for delivery at a board meeting, one of which was blank); *Joseph v. Shell Oil Co.*, 482 A.2d 335, 343 (Del. Ch. 1984) (criticizing the failure of tender offer materials to disclose that fairness opinion had been prepared after only eight days of scrutiny); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712 (Del. 1983) (finding a lack of fair dealing where corporation failed to disclose "cursorily" prepared fairness opinion which was brought to the board meeting with the price left blank).

228. See *infra* notes 229-233 and accompanying text.

229. 808 A.2d 421 (Del. Ch. 2002).

230. *Id.* at 449.

231. *Id.* at 449-50.

232. *Id.* at 449.

233. *Id.*

arose due to the SEC's illogical failure to maintain similar disclosure requirements for fairness opinions in cash tender offers as in proxy solicitations and going-private transactions.<sup>234</sup> The Delaware Court of Chancery held that in the absence of such federal obligation, Delaware law required such disclosure in the going-private, cash tender offer context.<sup>235</sup>

Ultimately, it is uncertain what this holding's implications are for fairness opinions and the weight paid to them under Delaware jurisprudence. This is particularly true since the Delaware courts, even in *In re Pure Resources*, have remained resolutely confident in the worth of the valuation processes underlying a fairness opinion.<sup>236</sup> This is true despite repeated examples thrust upon these courts of the arguable flaws in valuation practice, the embedded investment banking conflicts inherent in the rendering of these services, and the sometimes poor, and possibly negligent, practices by investment banks.<sup>237</sup> Rather, the courts have continued to pay high regard to, and placed confidence in, valuation techniques and their ability as currently practiced to find meaningful prices and value ranges. The holding of *In re Pure Resources* is but one such example. Another is found in Delaware appraisal and entire fairness proceedings where valuation techniques are routinely utilized by the Delaware courts themselves and the experts who appear before them.<sup>238</sup> Here, the courts have not only placed confidence in these practices as currently conducted but endorsed a view that the courts are quite capable as the sole arbiter in these matters.<sup>239</sup> Former Chief Judge Veasey of the Delaware Supreme Court expressed this mindset best when he stated:

The laborious process of trying an appraisal case in the Court of Chancery, with its "battle of the experts" tendency, requires patience and an intellectually disciplined approach by the trial judge. As one can glean by reading the recent Court of Chancery

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234. See *supra* note 168 and accompanying text for a discussion of this failing.

235. *In re Pure Resources*, 808 A.2d 421, 449-50 (Del. Ch. 2002)

236. See, e.g., *id.* at 449 (stating that the work of an investment bank is supported by the "work of the judiciary itself, which closely examines the underlying analyses performed by the investment bankers").

237. See *supra* Part II for a discussion of these practices.

238. See *supra* Part II.A.3 for a discussion of one such example.

239. See *Cede & Co. v. Technicolor, Inc.*, 758 A.2d 485, 496 (Del. 2000) (holding that appraisal proceedings must be entirely conducted by the judges of the Court of Chancery and therefore "the use of masters to determine the ultimate valuation are not permitted by the present statutory appraisal scheme"); *Gonsalves v. Straight Arrow Publishers*, 701 A.2d 357, 361 (Del. 1997) (holding that the Court of Chancery is required to "independently determine the value of the shares that are the subject of the appraisal action"). This approach in appraisal proceedings has been partially fostered upon the courts by the terms of the Delaware appraisal statute itself. DEL. CODE ANN. tit. 8, § 262 (2005).

appraisal cases, there is much for bankers, M&A lawyers, and corporate officials (including directors) to learn and apply in any major M&A transaction. It would be a wise step for the participants in such transactions to review and analyze some of the cases . . . .<sup>240</sup>

Thus, in the world-view of the Delaware courts, the issues raised *supra* at Part II are not particularly relevant for placing the fairness opinion's role in the corporate control transaction. Valuation, as practiced today, is not only a reliable indicator of both price and value, but the Delaware courts are a first choice for conducting these machinations. The fairness opinion itself has equivalent status as a reflection of these analyses to the extent that any distinguishment is even attempted. The consequences of this attitude and perspective are not surprising; the Delaware courts have repeatedly relied, without material question, upon the fairness opinion as a virtually required, reliable, and useful mainstay in a corporate control transaction in satisfaction of the board's duty of care.

## 2. *The fairness opinion's context*

Interestingly, the role of the fairness opinion in the Delaware takeover regime—other than as an essentially obligatory requirement in satisfaction of the board's duty of care—has never been explored by the Delaware courts. The Delaware courts, post-*Van Gorkom*, have erected in *Reulon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>241</sup> *Paramount Communications, Inc. v. Time, Inc.*,<sup>242</sup> *Paramount Communications Inc. v. QVC Network Inc.*<sup>243</sup> and other cases a takeover regime that permits a corporation to “just say no” and effectively refuse a takeover offer.<sup>244</sup> In addition, the Delaware courts have established a takeover code, which permits an acquiree to agree to deal protection devices.<sup>245</sup> Theoretically, these devices could differ depending upon the sale posture, i.e., through a full or modified auction or upon agreement with one bidder subject to a post-agreement market check. However, in none of these circumstances did the Delaware court address whether variance of the sale process

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240. Veasey & Di Guglielmo, *supra* note 8, at 1495.

241. 506 A.2d 173 (Del. 1986).

242. 571 A.2d 1140 (Del. 1989).

243. 637 A.2d 34 (Del. 1993).

244. See generally Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994).

245. Discussion of the Delaware takeover regime, its parameters and argued failings is legion. For two more interesting and current articles, see Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002); Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic “Just Say No” Question*, 55 STAN. L. REV. 863 (2002).

and structure of the transaction should alter or affect the necessary requirement for an acquiror fairness opinion or financial analysis.

The Delaware courts have also never examined within the overall takeover regime, or otherwise, the why or when of their virtual requirement for a fairness opinion and actual requirement of an underlying valuation. The courts have simply stated that this is an obligation in satisfaction of the duty of care.<sup>246</sup> This is a failing: the analyses or fairness opinion are simply a means to inform an acquiror board as to whether a price offered is within an appropriate range of values.<sup>247</sup> However, as briefly noted *supra* at Part II.C, an appropriate price, upon a board- or stockholder-initiated decision to sell, is one set by the effective market.<sup>248</sup> Absent other factors, the resulting price

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246. See *Smith v. Van Gorkom*, 488 A.2d 858, 881 (Del. 1985).

247. See *supra* notes 29-35 and accompanying text.

248. The academic and judicial communities are generally in agreement that in a perfect market this is the correct conclusion for not only price but as a fundamental guidepost for structuring a legal takeover regime. See *Allen, supra* note 106, at 561-62 (discussing the effect of market prices on the takeover code structure); see also Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970) (outlining the various forms of the efficient capital markets hypothesis); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (examining the underlying reasons for the efficient capital markets hypothesis and its consequences for the legal system). However, this harmony disappears if the market or derived price is perceived as either imperfect or inefficient. In this regard, there is no consensus as to whether and when the market is efficient and its implication for value and price. In addition, in circumstances where the market is possibly inefficient, there is no consensus concerning the extent to which market-based mechanisms can and should suffice as a true indicator of price within a legal takeover regime. See ROBERT SHILLER, *IRRATIONAL EXUBERANCE* 171-90 (2001) (arguing against the efficient markets hypothesis due to numerous contrary indicators); Daniel R. Fischel, *Market Evidence in Corporate Law*, 69 U. CHI. L. REV. 941, 942-49 (2002) (discussing the debate and arguing that market-based prices are the superior method of valuation and price determination). I think it is fair to say that the answer lies somewhere in the middle, which is that market-based prices are the truest indicator of value. *But see* *Rapid-American Corp. v. Harris*, 603 A.2d 796, 806 (Del. 1992) ("Recent price changes in the stock market dramatically illustrate the defects of an overstated reliance on market price to determine a corporation's intrinsic value in an appraisal proceeding.") (citing *Application of Del. Racing Ass'n*, 213 A.2d 203, 211 (Del. 1965)). However, for purposes of this Article, it is not necessary to wade into the deeper debate concerning how efficient the market is and its implications for a takeover code. Rather, once a corporation makes a decision to sell, the only question should be the appropriate legal and procedural mechanisms necessary to achieve the highest price reasonably available. See *infra* note 249 (discussing this standard and dovetailing it with what is a "fair" price). The aim of any takeover code should be to encourage such resultant prices, and I would argue that an auction-based process is the most effective mechanism to produce such a price. However, where an effective market-based price is not possible due to market failures, such as in going-private transactions, or market inefficiencies price may be achieved or validated through other means. The underlying question is then the level of court supervision or legal regulation necessary to ensure that the non-market-based price is one that is "fair." Relatedly, there is also the question of how ineffective the market must be before non-market-based measures are introduced, and a consequent assessment in such cases of the trade-off between monitoring and regulation and a less market-based



arrived at through such a mechanism would be a fair one to the acquiree's stockholders.<sup>249</sup> The Delaware courts have never truly recognized this in their takeover jurisprudence, particularly in the fairness opinion context.<sup>250</sup> In fact, they have never acknowledged any definition of fairness for purposes of a fairness opinion. Instead, fairness opinions in the Delaware takeover regime have been endowed with independent worth and significance. This results in needless redundancy. It does not recognize that the opinion mandate is inherently circular—a fairness opinion opines to a result if a process were followed, yet at the same time is required even if the process is so adhered to.

This is important. The Delaware courts have set up a system that virtually requires an acquiree board of directors in a corporate control situation to obtain these opinions in order to satisfy the board's duty of care. Yet, in doing so, the Delaware courts have assumed that these opinions can definitively validate a given negotiated price.<sup>251</sup> In fact, under Delaware law a board relying in good faith upon a fairness opinion to determine price is protected from liability on this matter.<sup>252</sup> This all provides too much weight to the fairness opinion. Instead, it should be recognized for what it is: a substitute and simply one factor to be used in setting price.

An explanation for this may be the cleverness of the Delaware courts. Having erected a takeover system that is not purely market-based, retention of the fairness opinion serves as a check; it affirms

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price. Compare McGinty, *supra* note 89 (arguing for adoption of a mandatory auction process under Delaware law in order to maximize stockholder value in all corporate control transactions), with Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 21 (1982) (concluding that "[t]he available data support a no-auction rule, and the possibility of diversification all but ensures that investors prefer to maximize the gains from the monitoring and takeover process rather than to maximize the price a given target may fetch in an auction"). Finally, all of this concerns a "fair" price for an acquiree—the calculus for an acquirer is wholly different as a market price may not be the appropriate one due to bidder irrationality, possible overpayment and information asymmetry. See generally Black, *supra* note 165, at 623-34. *Caveat emptor*.

249. Fair is a relative concept, but here a fair "price" can be defined as the highest price reasonably available. See *supra* note 33 and accompanying text. This is the standard set forth in Delaware for a corporate board when it initiates a change of control or break-up of the corporation. *Revlon*, 506 A.2d at 182.

250. In fact, the courts have readily acknowledged the opposite, justifying their approach due to market inefficiencies and irregularities and ostensible protection of unaffiliated stockholders. See, e.g., *Rapid-American Corp.*, 603 A.2d at 806; William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067 (2002); Strine, *supra* note 245.

251. See *supra* Part III.C.1.

252. There is an ostensible requirement of reasonable reliance here, but the courts have rarely scrutinized this element. See *supra* note 223 (discussing this failure).

that the ultimate paid price is within a range of values that would otherwise have been paid had the system been so situated. Alternatively, a fairness opinion confirms that a range of values is appropriate for a transaction agreed upon in an imperfectly-conducted auction or other market-based mechanism. In this role, the fairness opinion can act as a cure for an otherwise deficient sale process. Yet, this has never been enunciated, and the Delaware courts have not defined “fairness” to encompass this idea. These explanations also assume that fairness opinions and their underlying analyses can provide reliable value ranges. Even if reliable valuation is possible—and I believe it is<sup>253</sup>—the better approach would arguably be to establish a takeover regime which produces a market-based price, the true price, rather than a *per se* procedural requirement for an imperfect substitute.

#### *D. The Academic Response*

The legal academic community has cast a limited gaze upon the fairness opinion, and only a handful of articles and notes have been written on the topic. The majority of these pieces were published in the ten-year period following *Van Gorkom* and focused on the nature and scope of an investment bank’s liability for rendering a fairness opinion.<sup>254</sup> However, there have been three significant law review articles that went beyond the liability prism; addressing the scope, role, and need of fairness opinions within the skein of Delaware takeover jurisprudence.

In an article published in 1989, *Fairness Opinions: How Fair Are They and What Can be Done About It?*,<sup>255</sup> the authors, Professors Lucian Arye Bebchuk and Marcel Kahan, criticized fairness opinion practice for two existent, fundamental faults. First, Professors Bebchuk and Kahan cited investment banker discretion inherent in the preparation of these opinions.<sup>256</sup> The authors segmented this into “definitional” and “measurement” problems. The “definitional” problem posited by the authors was the lack of any meaningful explanation in these opinions as to what constituted a fair price.<sup>257</sup> The “measurement problem” constituted embedded subjectivity in the valuation techniques underlying fairness opinions.<sup>258</sup> Second, the

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253. See *supra* notes 160-162 and accompanying text (discussing studies supporting the utility of valuation).

254. See *supra* note 38 for citation of these articles.

255. Bebchuk & Kahan, *supra* note 10.

256. *Id.* at 29-37.

257. *Id.* at 30-34.

258. *Id.* at 34-37.

authors asserted that the investment banks rendering these opinions were conflicted due to, among other reasons, their incentive-based fee structure and desire to maintain and initiate future client relationships.<sup>259</sup>

The remedy proposed by the authors for these perceived defects was a judicial one keyed to each of the two faults. First, Professors Bebchuk and Kahan recommended that courts should put forth definitions of fairness and determine the appropriate parameters and circumstances for each.<sup>260</sup> The authors briefly suggested possible definitions for fairness in various types of corporate control transactions, but they did not explicate further on this point, stating that this was better left to the courts.<sup>261</sup> Investment banks would then utilize these judicially-enunciated standards to define fairness in fairness opinions.<sup>262</sup> Fairness opinions that did not so define fairness would be disregarded by the courts.<sup>263</sup>

Second, Professors Bebchuk and Kahan recommended that the courts mitigate the “measurement problem” by “weigh[ing] an opinion depending on whether it states a range of fair prices and on the extent to which its conclusion is sensitive to its assumptions.”<sup>264</sup> The authors argued that this would reduce subjectivity by conveying more information and limiting investment bank discretion.<sup>265</sup> More specifically, this would engender more exacting valuations since the specification of a range and the conduct of a sensitivity analysis would shine sunlight upon the investment banks’ valuation practices, and subject investment banks to the risk of reputational loss for rendering unreasonable opinions.<sup>266</sup> This would restrict investment bank discretion in the preparation of fairness opinions since it would “become harder for them to make bad deals look good.”<sup>267</sup> The authors, however, stated that theirs was an imperfect fix, and investment banks would still maintain discretion at an uncertain level, which could permit manipulation. However, no other reforms in this arena were proposed.<sup>268</sup>

Professors Bebchuk and Kahan then advocated for courts to discount fairness opinions rendered by investment banks whose fees

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259. *Id.* at 37-43.

260. Bebchuk & Kahan, *supra* note 10, at 46-49.

261. *Id.* at 46-47.

262. *Id.*

263. *Id.*

264. *Id.* at 47.

265. Bebchuk & Kahan, *supra* note 10, at 47.

266. *Id.* at 48.

267. *Id.*

268. *Id.* at 49.

were in any measure contingent upon the success of the related transaction.<sup>269</sup> However, the authors recognized a difficulty in this approach for dealing with this perceived investment bank conflict.<sup>270</sup> The rendering of a fairness opinion in many corporate control transactions is ancillary to the core service of general transaction advice.<sup>271</sup> The authors' proposal would eliminate the ability of investment banks to charge their normal contingency fee for this general advice.<sup>272</sup> The authors recognized that this would be impractical.<sup>273</sup> Accordingly, the authors proposed that in such situations a second investment bank be retained to render the fairness opinion.<sup>274</sup> The authors argued that this would reduce, if not eliminate, the conflict.<sup>275</sup> This would obviously create additional transaction costs, but Professors Bebchuk and Kahan were not troubled, as these costs would be "trivial in relation to the amounts involved in a transaction as a whole."<sup>276</sup>

Professors Bebchuk and Kahan then argued that although their proposed remedies provided meaning and a role for fairness opinions the courts must nevertheless recognize the limited nature of fairness opinions.<sup>277</sup> The authors stated that "as long as excessive judicial reliance on fairness opinions is avoided, such opinions do have the potential for serving a useful function."<sup>278</sup> Other than this statement, the authors did not discuss *Van Gorkom's* requirements, the future contours of judicial reliance on fairness opinions, or the exact going-forward role for the fairness opinion.

The two other articles, published in 1992, had different focuses and placed a far more skeptical eye on the fairness opinion. The first was Charles M. Elson's *Fairness Opinions: Are They Fair or Should We Care?*<sup>279</sup> The second was William J. Carney's *Fairness Opinions: How Fair Are They And Why We Should Do Nothing About It.*<sup>280</sup> They each had sound-bite worthy titles but advocated different roles for the fairness opinion while repudiating Delaware's *per se* fairness opinion requirement.

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269. *Id.* at 49-50.

270. Bebchuk & Kahan, *supra* note 10, at 49.

271. *Id.*

272. *Id.* at 49-50.

273. *Id.* at 50.

274. *Id.*

275. *Id.* at 50-51.

276. Bebchuk & Kahan, *supra* note 10, at 51.

277. *Id.* at 51-53.

278. *Id.* at 52-53.

279. Elson, *Are They Fair*, *supra* note 10.

280. Carney, *supra* note 10.

Professor Elson's article highlighted the subjectivity in the valuation calculations underlying a fairness opinion and the consequent problem of reliance. Professor Elson traced through each of the valuation techniques underlying a fairness opinion and briefly noted the discretion inherent.<sup>281</sup> He then explored the perceived conflicts in fairness opinion analyses and the potential for manipulation that this could engender.<sup>282</sup> He wrote that given these problems, "truly objective and independent valuation advice is, as a practical matter, difficult to achieve."<sup>283</sup>

Confronting these issues, Professor Elson threw up his hands. The subjectivity and conflict issues made the fairness opinion, in his colorful words, "as necessary to valuation analysis as is the appendix to the human digestive system . . . [and] [o]ther than producing profits for the investment banking industry, it produces no benefit for the shareholders."<sup>284</sup> Professor Elson asserted that the market was the true and correct arbiter of price, and the fairness opinion was an unnecessary and valueless substitute.<sup>285</sup> He argued that the Delaware courts should therefore repudiate *Van Gorkom's* financial analysis requirement.<sup>286</sup> However, Professor Elson, despite his dim view on its worth, was not ready to discard the fairness opinion altogether.<sup>287</sup> Fairness opinions would still be sought and received, since these opinions were, in his belief, a cheap substitute for insurance.<sup>288</sup> This is because the fairness opinion in a corporate control transaction established needed liability protection for directors under title 8, section 141(e) of the Delaware Code.<sup>289</sup> Fairness opinions would therefore provide boards necessary latitude in corporate control transactions by bestowing protections equivalent of the business judgment rule to their actions.<sup>290</sup>

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281. Elson, *Are They Fair*, *supra* note 10, at 961-65.

282. *Id.* at 965-70.

283. *Id.* at 970. Professor Elson also surveyed the grounds for investment banker liability for rendering an incorrect fairness opinion. *Id.* at 970-95. He concluded that imposing negligence liability on investment bankers for inaccurate fairness opinions was economically ineffectual and counter-productive. *Id.* at 995-1000.

284. *Id.* at 1002.

285. *Id.* at 1000-03.

286. *Id.* at 1002.

287. *Id.* at 1002-03.

288. *Id.*

289. DEL. CODE ANN. tit. 8, § 141(e) (2001).

290. Elson, *Are They Fair*, *supra* note 10, at 1002-03. Professor Elson later co-authored an article on fairness opinions wherein he appears to have revised his views and adopted a differing position with respect to fairness opinions. Elson, *Can They Be Made Useful*, *supra* note 6. In this brief article, Professor Elson appears to have changed his opinion that fairness opinions are of little use: the authors state that "we believe that properly priced fairness opinions can fulfill the function for which they were intended." *Id.* at 5. The authors, however, propose two reforms be

Professor Carney adopted a viewpoint similar to Professor Elson's with respect to the fairness opinion. In his article, Professor Carney argued that the fairness opinion is a poor, formalistic substitute for the market and reliance on these opinions ignores how price is set in the market.<sup>291</sup> Furthermore, Professor Carney asserted that a fairness opinion delivered to an acquirer in a corporate control transaction can never determinatively ascertain price, fair or otherwise.<sup>292</sup> The reasoning behind this statement is that, absent inside information, an investment bank cannot predict the mindset and situation of the acquirer and therefore the ultimate price that it would be willing to pay.<sup>293</sup> Accordingly, investment banks in such a situation can never specify a single price but can only provide a range of values.<sup>294</sup> Professor Carney found such a range to be of little use.<sup>295</sup>

Consequently, Professor Carney stated that fairness opinions are a "costly legal tax that legal rules impose on business transactions."<sup>296</sup> He posited that they "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 opinions of experts."<sup>297</sup> Rejecting the first rationale, he argued that insurance would be cheaper than the formal requirement of a fairness opinion he endowed with little, if any, worth.<sup>298</sup> Ultimately, Professor Carney viewed the market as the gatekeeper, concluding that *Van Gorkom* should be overturned and that fairness opinions should be discarded as an inappropriate transaction cost.<sup>299</sup> The informational aspect and protection for stockholders, if any, provided by the fairness opinion would be better expressed for the acquirer in the corporate control transaction through stockholder decisions to sell based on market forces and, in minority take-outs and other situations where

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implemented in order to transform fairness opinions into more useful tools. First, the authors address investment banking conflicts. They argue that boards should "consider having the fairness opinion rendered by an investment bank other than the one receiving the success fee." *Id.* Second, the authors address the issue of subjective valuation. They propose "standards to guide investment banks in their due diligence and pricing of transactions requiring fairness opinions." *Id.*

291. Carney, *supra* note 10, at 537-40.

292. *Id.* at 533-35.

293. *Id.*

294. *Id.* at 534.

295. *Id.* at 534-35. Professor Carney also discussed setting liability rules for the rendering of fairness opinions. He rejected setting such standards, since he believed that courts would be unable to craft minimum standards of care due to the inherently subjective nature of the valuation exercise and consequent increased costs. *Id.* at 537.

296. Carney, *supra* note 10, at 528.

297. *Id.* at 525.

298. *Id.* at 528.

299. *Id.* at 538.

stockholder choice was not an effective check, through independent directors, appraisal remedies, and the courts.<sup>300</sup>

#### IV. REFORM OF THE FAIRNESS OPINION

This lands us at today. Fairness opinion practices remain virtually unchanged since the sea shift engendered by *Van Gorkom*. Since *Van Gorkom*, the Delaware courts have consistently encouraged, if not ostensibly required, these opinions in corporate control transactions. The result is continued doctrinal incoherence and redundancy in the Delaware takeover regime. An instrument of questionable utility is *per se* required when market-based mechanisms would be better suited and more effective tools to inform board and stockholder decisions in corporate control transactions. The SEC and NASD have also promulgated or proposed limited disclosure requirements with respect to fairness opinions rendered in corporate control transactions.<sup>301</sup> Yet, these disclosure requirements do not effectively address the current deficiencies in the fairness opinion regime. This Part outlines my proposals for economic and beneficial reform of the fairness opinion.

##### A. *The Fairness Opinion's Necessity*

Given the criticism levied against the fairness opinion, intellectual and academic honesty requires that the merits and necessity of the fairness opinion be explored before proposing reform. Professors Elson and Carney prefer to discard the fairness opinion.<sup>302</sup> They view it as an imperfect market substitute that at best serves as a species of board insurance.<sup>303</sup> Professors Bebchuk and Kahan do not address the issue in any substantive manner. They assert that one should avoid excessive judicial reliance on these opinions, but they assume the utility of the fairness opinion and propose reforms to endow it with greater meaning.<sup>304</sup>

So, what to do? First, one should not lose sight of the ultimate goal of a corporate control transaction. From the acquiree stockholders' perspective, the goal is receipt of the highest price reasonably available.<sup>305</sup> Both Professor Elson and Professor Carney correctly note

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300. *Id.* at 533-36.

301. *See supra* Parts III.A & III.B.

302. *See supra* notes 284-99 and accompanying text.

303. *Id.* Professor Elson later argued for the adoption of standards in the preparation of fairness opinions. *See supra* note 290.

304. *See supra* notes 255-278 and accompanying text.

305. This is the standard under Delaware law when a board initiates a sale of corporate control. *Revlon Inc. v. MacAndrews & Forbes Holding, Inc.*, 506 A.2d 173,

that only the market can obtain such a price with certainty.<sup>306</sup> Upon a stockholder or board decision to sell, the highest price reasonably available can be set through an effective market-based mechanism, such as an open, informed, and inclusionary auction process with limited or no exogenous burdens and equal bidder information on the acquiree.<sup>307</sup> There are other similar formulations, but if the corporate control transaction price is set in the foregoing manner or as close thereto as possible, a fairness opinion or a financial analysis for the acquiree board to satisfy its duty of care is unnecessary. This is *Van Gorkom's* downfall and Delaware courts should recognize it as such. More specifically, the Delaware courts should acknowledge that a fairness opinion, or underlying financial analysis, is only a substitute for an effective market-based process to determine a "fair" price. *Van Gorkom's* holding should be overturned and a fairness opinion or financial analysis should not be required when price is determined through such means.<sup>308</sup>

This does not slam the door on the fairness opinion for duty of care purposes. A price in a corporate control transaction cannot always be set through such a market-based process. For example, the posture of the transaction may not permit it. This occurs in going-private transactions when the acquirer has informational or other process-based advantages or can otherwise block interested acquirers through a substantial shareholding.<sup>309</sup> Practical barriers may also bar

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182 (Del. 1986).

306. See *supra* notes 285, 291 and accompanying text.

307. Of course this formulation is an impossibility to achieve in practice. However, the closer to this marker that one comes, the "truer" the market-based price. See generally Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); R. Preston McAfee & John McMillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699 (1987).

308. Instead, I would argue that the Delaware courts should focus on creating a takeover scheme that encourages and produces such effective market-based results. More specifically, there should be a legal prohibition on takeover defenses and deal protection devices in order to facilitate a market-based takeover regime and produce "purer" market-based prices albeit with concomitant protections against coercive and other abusive practices as well as takeover rules that address information asymmetry and other unavoidable market inefficiencies. The discussion of the application of my proposal's implications and conclusions beyond fairness opinions is well outside the scope of this Article. See Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 878-79 (1981) (proposing the adoption of a tender offer rule prohibiting acquirees from taking any action that "could interfere with the success of the offer or result in the shareholders of the [acquiree] being denied the opportunity to tender their shares").

309. See, e.g., *Crescent/Mach I Partners*, 846 A.2d 963, 986 (Del. Ch. 2000) (holding that the board was not required under Delaware law to auction the corporation where the majority stockholder owning 61.5% of the corporation could have thwarted such effort); *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987) (holding that the board was not required under Delaware law to auction the corporation where the majority stockholder owning sixty-five percent of the



implementation of effective market-based processes. A market-based mechanism such as an auction can be disruptive to the business of a corporation, creating uncertainty with customers, suppliers, and employees.<sup>310</sup> Alternatively, corporations may not have time to conduct an auction process due to their own corporate difficulties. These two situations are noteworthy because Delaware law allows corporations to avoid these difficulties by choosing to be acquired outside of an auction process subject to a post-agreement market-check.<sup>311</sup> Thereafter, an auction may develop, but it will be inhibited, though not prevented, by deal protection devices such as break-up fees and non-solicits.<sup>312</sup> Thus, in each of these two circumstances, price is still set in an imperfect, albeit judicially-permitted, market.

The fairness opinion can function as a useful check and informational tool in these situations, informing the acquiree board as to the value of the corporation when a market-based mechanism is not available. However, even here, the fairness opinion has inherent limitations. The underlying financial analyses cannot ascertain or predict price. They cannot set price since they can only provide a range of values that the fairness opinion can opine to as fair, utilizing a presumed definition of fairness.<sup>313</sup> Additionally, given that the acquirer's mindset and information are not available to the acquiree or to the investment bank, a fairness opinion cannot forecast the price an acquirer would ultimately be willing to offer, over and above the intrinsic value of the corporation to its current stockholders.<sup>314</sup>

However, financial analyses can calculate a base value range of the acquiree's worth. This range can then be compared to premiums paid in comparable acquisitions to arrive at a takeover base price

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corporation could have thwarted such effort).

310. See, e.g., *In re MONY Group Inc. Shareholder Litigation*, 852 A.2d 9, 21 (Del. Ch. 2004) (holding that the board's decision against initiating an auction was reasonable in light of its judgment that an auction would jeopardize the corporation's workforce and allow competitors to benefit).

311. See *supra* note 67 for a discussion of the contours of a market check under Delaware law.

312. See, e.g., *In re MONY Group*, 852 A.2d at 24 (permitting a post-agreement market check with a non-solicit clause and a termination fee that amounted to 3.3% of the acquired corporation's equity value and 2.4% of the total transaction value); *In re Pennaco Energy*, 787 A.2d 691, 707 (Del. Ch. 2001) (permitting a post-agreement market check with a non-solicit clause and a termination fee that amounted to three percent of the acquired corporation's equity value).

313. See *supra* notes 163-65 and accompanying text (discussing the limitations of valuation with respect to predicting and setting price).

314. This is primarily due to the frequent behavioral irrationality of acquirers and the problem of asymmetrical information. See *supra* note 165. See generally SCHILLER, *supra* note 248 (discussing aspects of investor irrationality and its effect on markets); ANDREI SCHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000) (describing various theories of behavioral finance and investor behavior).

range—a minimum auction price. The resultant opinion has worth since it can inform the board in an imperfect market situation that a given price is fair on a base case level or by any other measure that defines fairness.<sup>315</sup> However, even in these circumstances, fairness opinions and financial analyses are not a talismanic cure-all. Their imperfections make them only one element in the total mix of information that an acquiree board should consider when deciding to engage in a corporate control transaction.

Therefore, the Delaware courts should place value on these opinions to determine if a board has satisfied its duty of care in paradigms where an effective market-based price cannot be or is not obtained.<sup>316</sup> So, for example, a fairness opinion or financial analysis would neither be required nor considered relevant in the duty of care analysis if the process followed by the acquiree board was correctly structured to produce a market price. In transactions where such a process was not or could not be followed, a fairness opinion or financial analysis would be only one factor to be considered along with the process actually followed and the price actually produced relevant to the market. The fairness opinion or financial analysis delivered in this context would be an indicator, but not a presumptive one, that the board satisfied its duty of care.<sup>317</sup>

Here, one must consider whether the fairness opinion or the underlying financial analysis is more appropriate, as they are functional equivalents. However, the fairness opinion is the better form because it distills the underlying analysis, permitting inexperienced directors and stockholders to point to an easily comprehensible statement that a transaction is fair, rather than a

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315. See Arthur Fleischer, Jr., *A 'Fairness Letter' is Just an Opinion*, N.Y. TIMES, June 8, 1986, at Section 3, 2 (arguing that fairness opinions serve an important purpose by informing directors of value).

316. The investment bank as a corporate control financial advisor to acquirees would not disappear under my proposals. Investment banks provide four principal services to acquirees in corporate control transactions: first, as a broker, finding and introducing companies that may be interested in corporate control transactions; second, advising on corporate control transaction processes and structure; third, advising on consideration by assessing stock consideration and recommending consideration types; and fourth, rendering a fairness opinion and providing financial valuation advice. Under my proposals, there is no change to the investment bank's first three roles. In addition, investment banks would still be retained for financial advice, including the initial decision to sell, even if they do not render a fairness opinion.

317. The argument that boards would nonetheless seek and obtain fairness opinions because they shield companies from liability or serve as a form of insurance is discussed *infra* at Part IV.C. In addition, this proposal would preserve, albeit to a diminished extent, the investment bank's role as a gatekeeper in corporate control transactions. See also Filflis, *supra* note 35, at 513-15 (arguing for investment banks as gatekeepers in providing fairness opinions).

thirty-page board book. In any event, I would argue that financial analyses that do not find a numerical range of fairness are deficient since they do not properly inform their recipients of the analyses' actual meaning.<sup>318</sup> So, the fairness opinion remains the lightning rod in my proposals and should survive as the focused instrument typically delivered to a board in the circumstances previously described.

Now I diverge from the opinions of Professor Elson and Professor Carney. Both view the market as the arbiter, even in market-imperfect situations; for them, the fairness opinion or underlying financial analysis has nothing to legally add except as a form of insurance.<sup>319</sup> I disagree. I do so because I make two critical assumptions about fairness opinions. First, financial analyses can inform as to value.<sup>320</sup> Second, the perceived and actual conflicts of investment banks are not impediments to rendering worthwhile fairness opinions.<sup>321</sup> However, if the fairness opinion is to have a useful role, it must be subject to reform. In the next section, I discuss these proposals for improvement.

## *B. The Fairness Opinion's Regulation*

### *1. Guidelines and standards*

If fairness opinions are to have meaning, the opinion itself and the underlying financial analysis must be prepared in accordance with issued guidelines and standards and subject to supervision by a quasi-public body, an Investment Banking Authority (the "IBA"). The IBA, a guideline and standard-setting body, would serve three purposes with respect to fairness opinions and valuation practice. First, the IBA would reduce subjectivity and investment banking discretion by promulgating guidelines and standards for valuation practice. Second, by serving as a corridor between academia and industry, the IBA would ensure that guidelines and standards are kept up-to-date and best practices are adhered to. Finally, the IBA would supervise fairness opinion preparation procedures, investment bank internal

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318. This is arguably the case under Delaware law. See *Sutton Holding Corp. v. DeSoto, Inc.*, Nos. 11221, 11222, 1990 WL 13476, at \*8 (Del. Ch. 1990) (holding that the failure of the board to obtain or receive a fairness opinion with a fair value range was unreasonable in light of the unsolicited acquirer's willingness to consider raising its offering price).

319. Carney, *supra* note 10, at 528. See generally Elson, *Can They Be Made Useful?*, *supra* note 6.

320. See *supra* notes 160-162 and accompanying text.

321. See *infra* Part IV.B.3.

approval and vetting processes, due diligence requirements, conflicts, and other matters appurtenant to fairness opinions.<sup>322</sup> The IBA would also be an interactive body that industry practitioners could consult for guidance on issues as they arise.<sup>323</sup> I envision that this body would ultimately work on issues much broader than fairness opinions, that is, all aspects of corporate investment banking. This wider supervision is, I think, sorely needed.<sup>324</sup>

The IBA would not promulgate a strict statutory equivalent code that would step-by-step direct valuation practice. This is neither desirable nor possible. Rather, the IBA would issue general guidelines and standards for valuation practices akin to the current practice of the Financial Accounting Standards Board (the "FASB") in the accounting industry.<sup>325</sup> These guidelines would outline acceptable valuation methodologies and procedures. The IBA would also set standards and a designated course to follow to solve disagreements on valuation techniques. In addition, specific requirements would be mandated by the IBA where necessary in order to prudently reduce subjective decision-making to the greatest extent feasible. These guidelines and standards would go much farther than the limited requirements that Professors Bebchuk and Kahan propose.<sup>326</sup> While the IBA would chart its own course, I envision that the guidelines and standards would encompass the following minimum requirements:

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322. See also Elson, *Can They Be Made Useful?*, *supra* note 6, at 5 (proposing the adoption of standards governing fairness opinion preparation); *Investment Banker Liability: A Panel Discussion*, 16 DEL. J. CORP. L. 557, 601-02 (1991) (panel discussion covering the scope of a possible code of professional conduct for fairness opinion practice).

323. The U.K. Panel on Takeovers and Mergers in the United Kingdom (the "Panel") functions in this matter. Practitioners can go before the executive office of the Panel and ask about the possible effects of the U.K. takeover regime on future transactions. The Takeover Panel Home Page, <http://www.thetakeoverpanel.org.uk/new/>. The Financial Accounting Standards Board (the "FASB") has a similar system to permit technical inquiries. FASB Home Page, <http://www.fasb.org/inquiry/>.

324. I believe this due to the many conflicting and possibly negligent practices of investment banks that have come to light in the post-Enron/Worldcom world. See Issac Lustgarten & Jonathan C. Stapleton, *Corporate Governance Reform and Financial Institution Intermediaries*, 18 No. 2 Insights 4 (Feb. 2004) (outlining post-Enron/Worldcom SEC enforcement actions and civil suits against investment banks with respect to corporate scandals and conflicts); Hillary A. Sale, *Banks: The Forgotten(?) Partners in Fraud*, 73 U. CIN. L. REV. 139, 144-54 (2004) (outlining investment banks' roles in the Enron fraud). Of course, whether this regulation should come from the SEC, NASD, or an IBA is debatable. However, an IBA would be able to provide directed, specific oversight and regulation of investment banks in a manner that a broader regulatory agency may not be able or desire to do.

325. For a description of the nature and role of the FASB, see *Facts About FASB*, <http://www.fasb.org/facts/index.shtml#mission>.

326. See generally *supra* notes 264-278 and accompanying text.

*Valuation Techniques.* The IBA would establish guidelines and examples for appropriate and preferred valuation techniques for use in different valuation contexts.

*Valuation Inputs.* Where possible, the IBA would issue guidance or strict directives on the selection of valuation inputs. The implementation of set standards should be possible in many areas of valuation such as the appropriate methodology for calculation of a discount rate, as well as the risk-free rate and market-risk rate.<sup>327</sup>

*Valuation Weight.* The IBA would put forth guidance on the weight to be provided to different techniques in evaluating fairness.

*Valuation Disclosure.* The IBA would issue disclosure standards for fairness opinions, their underlying financial analyses, and potential conflicts. This would include requirements as to disclosure of compensation and indemnification arrangements. These standards would mandate that disclosure be numerically meaningful and prohibit boiler-plate or cursory responses.

*Valuation Preparation.* Procedural requirements would be set forth by the IBA for the preparation of fairness opinions and underlying valuation. This would include minimal requirements for investment bank fairness opinion internal review and approval procedures.

*Valuation Due Diligence.* The IBA would establish minimum standards concerning the scope of investment bank review of corporate information in the preparation of a fairness opinion.

*Fairness Opinion Form.* The IBA would issue standards for the fairness opinion form. This would encompass acceptable and impermissible disclaimers and qualifications that could be made in the fairness opinion itself.

*Fairness Opinion Definition.* Fairness opinions must do more than just state they are fair. Fairness should be defined and given context in the issuing letter. Accordingly, the IBA would issue guidelines mandating this and setting forth model definitions for use in variant corporate control transactions.

The IBA would not be a government-controlled body within the SEC or another government agency, but would be a constituency-based, quasi-public organization akin to the FASB.<sup>328</sup> I believe that this distance would increase industry buy-in to the IBA while

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327. See generally Campbell, *supra* note 70, at 45-47 (discussing possible valuation inputs wherein governing rules could be appropriate).

328. I believe that it would be better to have a stand-alone, newly-formed IBA than to form a branch or division of another existing entity such as the NASD. I believe that this will bring focus to the organization and permit it to build an internal code of conduct free from pre-conceived institutional biases.

achieving a similar purpose.<sup>329</sup> The officers and directors of the IBA could be appointed by a board of trustees, itself appointed by public organizations with an interest in its operation. This is the current structure of the FASB,<sup>330</sup> and it would inhibit possible industry capture of the IBA. To further encourage industry buy-in, the IBA would not initially have the ability to impose fines or other penalties. However, implementation of the IBA's directives would come by court fiat. Fairness opinions that were not prepared according to IBA guidelines and standards would be disregarded by the courts. In addition, the IBA would set an industry benchmark, which investment banks would ignore at their peril.<sup>331</sup>

I realize that the investment banks would fight this proposal tooth and nail, but I believe that the IBA would actually benefit the industry. The value of a fairness opinion would increase, and perhaps make them even more sought after, particularly by acquirers, for their informational, screening, and signaling benefits.<sup>332</sup> The IBA would also make fairness opinion and valuation practices easier by standardizing the process. Finally, the IBA would provide crystal guidelines and standards to assess appropriate investment banking practices and potential liability in the rendition of fairness opinions. This is an improvement on today's regime where liability is uncertain and litigation exposure unknown due to the lack of common guideposts for proper fairness opinion practice and valuation technique.<sup>333</sup> Alternatively, if the investment banking community does not act, the deep flaws in current fairness opinion practice may ultimately lead to scandal and reform in a measure and content that the investment banks cannot control and may not desire. Acting beforehand upon this or similar proposals would permit investment banking industry participation and a say in any reform.

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329. This has been true of both the FASB and the Panel, which both succeeded as regulators while remaining quasi-public organizations.

330. *Facts About FASB*, <http://www.fasb.org/facts/index.shtml#mission>.

331. This would occur because courts would presumably look to IBA standards as a touchstone to determine investment bank liability in connection with the rendering of fairness opinions.

332. For two recent interesting and informative empirical studies of fairness opinions and these potential benefits, see Helen M. Bowers & William R. Latham III, *Information Asymmetry, litigation risk, uncertainty and the demand for fairness opinions: Evidence from U.S. mergers and acquisitions, 1980-2002* (Apr. 13, 2006), available at SSRN: <http://ssrn.com/abstract=626321> (finding that the probability of a corporation obtaining a fairness opinion is increased by asymmetric information, litigation risk and other transactions uncertainty measures), and Kisgen et al., *supra* note 12 (finding fairness opinions are more common in transactions where uncertainty and legal risk are high).

333. See Rubenstein, *supra* note 38, at 1729 (noting that "[t]he only existing regulation [of fairness opinions] is based on the imposition of negligence liability").

The costs of the IBA would be borne by the investment banking industry through a mandatory membership fee or other industry-based contribution mechanism. The increased costs should be substantially outweighed by the greater utility and predictability of fairness opinions and valuation practices and more certain liability standards. I believe that this would be true even if fairness opinions are not as frequently requested and are relied upon less frequently by the courts.

The IBA and its issued guidelines and standards would not eliminate all subjectivity from fairness opinions and financial analyses. However, they would create a regime of more uniform, predictable, and improved valuation and related investment banking practices. Subjectivity would also be limited by the ability of outside parties to better compare and deconstruct valuations. This and other improvements engendered by the IBA would increase the utility and reliability of the fairness opinion and its underlying valuation. Fairness opinions would more fully inform as to value in corporate control transactions, permitting more confident reliance upon them for determining the fairness of an offered price as well as informational, signaling, screening and other purposes.

## 2. *Disclosure*

Disclosure requirements for fairness opinions and financial analyses in corporate control transactions should mandate disclosure of all material points in any valuation underlying a fairness opinion. This would ensure that opining investment banks adhere to any guidelines and standards set by the IBA. I define material for these purposes to include any subjective decision-point that could materially influence valuation. A disclosure obligation keyed to this standard would highlight its beneficial effects on the subjective inputs in any valuation. This would also place underlying financial analyses under greater outside scrutiny, thereby inhibiting subjectivity and use of out-dated or incorrect practices. Accordingly, the argument for this heightened disclosure becomes stronger if my IBA proposal is not adopted.

The disclosure regulation for fairness opinions promulgated by the SEC, NASD, and the Delaware courts, and that recommended by Professors Bebchuk and Kahan is accordingly insufficient in that it does not require disclosure at this level.<sup>334</sup> The SEC, the primary

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334. See *supra* at Parts III.A & III.B for a discussion of the SEC and NASD requirements, respectively. Delaware has a judicially-promulgated disclosure requirement of "a fair summary of the substantive work performed by the investment

regulator in this area, should remedy this defect. In addition, the SEC should fix the existing discrepancy with respect to cash tender offers in its regulatory scheme by requiring this proposed disclosure for acquirees in all public corporate control transactions where a fairness opinion has been received and its existence is publicly disclosed. To the extent that the SEC or the courts do not mandate such disclosure, the IBA, if it comes into existence, should implement such requirements.

I justify this disclosure primarily as a check on investment banking and board behavior, rather than for the utility of the information. Retail stockholders are more likely to find meaning in market prices and the headline number, rather than attempt to understand valuation practices. In addition, sophisticated investors tend to conduct their own analysis. Here, disclosure of these inputs will aid their work, even if it is unlikely to change their investment decision. However, if investment banks are required to disclose these points, they will be presumably more careful and deliberate in their choices and, hopefully, boards, knowing this information will be disclosed, would probe it to a greater extent than they currently do. This would ultimately benefit stockholders by increasing the quality of information available to board decision makers, thereby facilitating more informed board choices to enter into corporate control transactions. Again, this is an increased need in the absence of an IBA and guidelines and standards.

### 3. Conflicts

There have been a number of proposed solutions to the issue outlined *supra* at Part II.C with respect to investment bank conflicts. The NASD and SEC have adopted a disclosure-based approach.<sup>335</sup> Professors Bebchuk and Kahan argue that boards should obtain a second fairness opinion from an independent bank that does not have a stake in the success of the transaction other than a fee for the fairness opinion.<sup>336</sup> Neither of these fully addresses the heart of the

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bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely." *In re Pure Resources*, 808 A.2d 421, 449 (Del. Ch. 2002). The full parameters of this obligation have yet to be judicially outlined.

335. See *supra* at Parts III.A & III.B.

336. See generally Elson, *Can They Be Made Useful?*, *supra* note 6 (advocating for "independent directors [to] consider having the fairness opinion rendered by an investment bank other than the one receiving the success fee"); Mark J. Mihanovic, *Legal Perils Mount For M&A Advisers*, *MERGERS & ACQUISITIONS J.*, Nov. 1, 2005 (stating that due to conflict and other issues "[t]here is good reason to believe that the trend toward greater use of second fairness opinions will continue"); Joan Harrison, *Pitching Deals to Increasingly Skeptical Boards*, *MERGERS & ACQUISITIONS J.*, Aug. 1, 2005



conflicts issues or the current problems with fairness opinion practice.

Disclosure-based solutions only partially address the issue. Certainly, this disclosure is worthy; boards and stockholders should be aware of the potential conflicts that an investment bank may have. This disclosure should be meaningful; boiler-plate disclosures should be prohibited. It should include a requirement to disclose exact compensation numbers for the fairness opinion itself and for other “material relationships.”<sup>337</sup> It should also include a requirement to disclose the exact details of any indemnification and liability-limiting arrangements.<sup>338</sup> In addition, egregious practices, such as dual representation, should be prohibited. However, the problem is not that stockholders, directors, officers, and others do not know of these conflicts. They are all too aware of them.<sup>339</sup> The problem is that disclosure-based solutions do not address the ultimate issue with these opinions; the search for meaning in an instrument that has underlying subjectivity, a fluid and undefined conclusion of fairness and that is not prepared according to best practices or any fixed set of disclosed guidelines and standards. The conflicts issue is acute only because of the ability of potentially-conflicted investment banks to manipulate the process due to these failings. If the subjectivity and best practices issues were addressed through the proposals made herein, then the conflicts problem should be manageable, albeit with recommended supervision by an IBA.

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(noting that investment banks are “seeing more requests for dual fairness opinions”); Ann Davis & Dennis K. Berman, *Checkup Prompts Search for Second Opinions*, WALL ST. J., Jan. 24, 2005, at C-1 (outlining the increased tendency of boards to seek a second fairness opinions). Interestingly, in connection with its consideration of the regulation of going-private transactions, the SEC proposed requiring that two independent advisors (presumably investment banks) evaluate the consideration offered. This requirement was never adopted. See Notice of Public Fact-Finding Investigation and Rulemaking Proceeding in the Matter of ‘Going-Private’ Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 34-11231 [1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) (Feb. 6, 1975).

337. See *supra* note 218 and accompanying text (highlighting the importance of this disclosure).

338. See also Oesterle & Norberg, *supra* note 10, at 254 (proposing that “[w]henver an advisor is rendering a fairness opinion under a waiver or indemnification of duty of care liability, specific and *conspicuous* disclosure of the waiver should . . . be presented to shareholders”).

339. This is illustrated in the new disclosure trend by acquirees to include, purportedly at SEC staff request, a risk factor in their transaction documentation concerning contingent compensation and past relationships with their investment banks. See, e.g., Supervalu Registration Statement (Form S-4), at 22-23 (Apr. 28, 2006) (disclosing as a risk factor that “[s]ome of the financial advisors to [the transaction participants] have had prior business relationships with one or more of the parties to the transactions and are entitled to contingent fees in connection with the transactions”).

It is for these reasons that I believe the idea of a second investment bank is misguided. While this double-down ameliorates the conflicts issue at the high cost of a second opinion, it does not deal with what I see as the real issues.<sup>340</sup> Ignoring this point for the moment, the benefits of a second opinion are probably not worth the costs. An investment bank is typically under pressure to arrive at the “right” outcome for the board that retained it; a bank that regularly went against its mandate would soon find itself with little business. So, in circumstances where there is room for manipulation of the valuation, with no guidelines or standards, and on the edge of fairness, the bias will tend towards the “right” result—agreement with management—no matter which bank is rendering the opinion, even if its purpose is to render independent opinions.<sup>341</sup>

In spite of these difficulties, the idea of creating separate investment banks dedicated solely to rendering fairness opinions has also been intermittently proposed.<sup>342</sup> However, this does not appear to be the answer either. First, corporations generally require and desire the general financial advice that investment banks provide. So, again, as even Professors Bebchuk and Kahan recognize, two investment banks would need to be retained, thereby alleviating the conflict issue, but creating additional transaction costs.<sup>343</sup> Second, investment banks that regularly refused to render fairness opinions would soon find themselves with little business. I find no significant purchase in the possible contrary argument that a market in quality would develop whereby fairness opinions delivered by such banks would be highly valued and sought after. My rationale is this: I see no incentive or desire, legal or otherwise, in today’s market for this development. There is also little value in creating such incentives due to the high transaction costs of a second investment bank. Again, this would be a misdirected solution.

Ultimately, though, it is only on the edges where these conflict issues typically arise. Even in today’s fairness opinion regime, a bank has substantial reputation and even liability risks that limit its ability

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340. It can also be argued that the utilization of a second investment bank for a fairness opinion deprives the corporation and its stockholders’ of the financial advisor who understands the finances of the corporation and therefore is in a better position to render an opinion as to fairness. I agree with this argument in the presence of fairness opinion guidelines and standards.

341. See *infra* notes 344-346 and accompanying text for a discussion of investment bank reputational incentives with respect to fairness opinion practices.

342. See Morgenson, *supra* note 149 (reporting on a newly formed investment bank organized solely to render fairness opinions, but not provide financial advice, in order to stem potential conflicts).

343. Bebchuk & Kahan, *supra* note 10, at 49-51.

to fudge a fairness opinion. These impetuses are reinforced by the review procedures in place at each investment bank. They can be further restricted through more exacting valuation practice and fairness opinion procedures combined with heightened disclosure standards implemented through the IBA. A recent study by Professors Charles W. Calomiris and Donna M. Hitscherich, provides support for this position.<sup>344</sup> The authors analyzed fairness opinion fees in friendly, cash tender offers from 1994-2002 and concluded that there was no statistically significant difference in acquisition premia when the fairness opinion fee was fixed rather than contingent.<sup>345</sup> The authors therefore concluded that there was no evidence that “investment banks are suborned by acquirers with whom they have had a prior banking relationship.”<sup>346</sup>

### C. *The Fairness Opinion’s Insurance Aspect*

If fairness opinions are no longer a *per se* requirement under the proposals set forth herein, it could be argued that they would still be regularly sought and obtained by boards due to the inoculating effect of title 8, section 141(e) of the Delaware Code.<sup>347</sup> This is the insurance justification put forth by both Professor Elson and Professor Carney.<sup>348</sup> However, as a practical matter under Delaware law, this belief overlooks the effect of another provision of the Delaware Code. Post-*Van Gorkom*, Delaware adopted title 8, section 102(b)(7),<sup>349</sup> which permits a Delaware corporation to, in its certificate of incorporation, relieve its directors *en toto* from monetary

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344. Charles W. Calomiris & Donna M. Hitscherich, *Banker Fees and Acquisition Premia for Targets in Cash Tender Offers: Challenges to the Popular Wisdom on Banker Conflicts* (Apr. 20, 2005), available at <http://ssrn.com/abstract=708222>.

345. *Id.*

346. *Id.* at 31. *But see In re Tele-Communications, Inc.*, 2005 WL 3642727, at \*10 (stating that “[a] contingently paid and possibly interested financial advisor might be more convenient and cheaper absent a deal, but its potentially misguided recommendations could result in even higher costs . . . .”); Kisgen et al., *supra* note 12, at 25 (empirical study finding that, in the case of acquirers, when the investment bank advisor receives a contingent advisory fee acquirers have lower post-announcement period returns).

347. *See supra* notes 58-60 and accompanying text (outlining the protections afforded by a fairness opinion for purposes of DEL. CODE ANN. tit. 8, § 141(e)).

348. *See supra* notes 288-300 and accompanying text.

349. DEL. CODE ANN. tit. 8, § 102(b)(7) (2001). This provision was adopted in the wake of *Van Gorkom* to alleviate vocal concerns by corporations that their directors would now be subject to increased liability exposure and that director’ insurance premiums would consequently increase because of *Van Gorkom*’s holding. *See Tamar Lewin, Delaware Law Allows Less Director Liability*, N.Y. TIMES, June 19, 1986, at D1; *see also* Stephen A. Radin, *Director Protection Statutes after Malpiede and Emerald Partners*, 16 No. 2 INSIGHTS 10 (Feb. 2002) (discussing grounds and procedural mechanisms for directors to assert a defense under DEL. CODE ANN. tit. 8, § 102(b)(7) (2001)).

liability for breach of their duty of care.<sup>350</sup> Almost every publicly traded corporation organized under the laws of the State of Delaware has opted into this provision.<sup>351</sup> For directors of these corporations, a fairness opinion and the cloak of title 8, section 141(e) do not provide them any further substantive protection. Likewise, Professor Elson and Professor Carney's arguments that a fairness opinion alleviates liability concern and establishes equivalent protections of the business judgment rule do not have significant persuasion.

There is still some protection that a fairness opinion does provide in cases where title 8, section 102(b)(7) is applicable. A fairness opinion establishes a defense under title 8, section 141(e) from a suit that seeks equitable relief premised upon a breach of the board's duty of care.<sup>352</sup> However, if the proposals put forth herein were adopted, fairness opinions would not be required implicitly or otherwise nor would they provide persuasive or definitive evidence of satisfaction of either the duty of care or fairness itself. Depending upon the circumstances of the corporate control transaction, they would be only one factor to be considered, if at all, by the Delaware courts. A Delaware court considering whether to apply the prophylactic protections of title 8, section 141(e) should therefore adopt the same analysis. This would better comport with the true nature and role a fairness opinion has in informing the board in a corporate control transaction.

This leads to a cost-benefit component of this scrutiny, which is applicable whether or not the proposals made herein are fully implemented.<sup>353</sup> In all of these circumstances, the board should assess the costs of the fairness opinion, the legal, informational and

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350. See *In re Ply Gem Indus., Inc. S'holders Litig.*, No. 15779-NC, 2001 WL 755133, at \*10 (Del. Ch. 2001) (stating that the exculpatory provision in certificate of incorporation "authorized by DEL. CODE ANN. tit. 8, § 102(b)(7), generally shields directors from monetary liability for a breach of their duty of due care").

351. See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 490 (2000) (finding that "[c]harter provision enabling statutes like Delaware's Del. Code tit. 8 section 102(b)(7), moreover, have been almost universally implemented by corporations to which such laws apply"); see also Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 62 (1989) (stating that of a sample of 593 public firms "it appears that 94% (559/593) of Delaware firms amended their articles of incorporation in accordance with DEL. CODE ANN. tit. § 8, 102(b)(7)").

352. See, e.g., *Crescent/Mach I Partners v. Turner*, 846 A.2d 963, 985 (Del. Ch. 2000) (rejecting the "allegation that the director defendants 'breached their fiduciary duties' by approving an allegedly defective [fairness] opinion" on the basis that it was barred by DEL. CODE ANN. tit. 8, § 141(e)).

353. In this regard, it is interesting to note that one empirical study conducted after *Van Gorkom* concluded that the value of Delaware firms fell significantly around the time of the enactment of Del. Code tit. 8, § 102(b)(7). Bradley & Schipani, *supra* note 351, at 74.

other benefits that it can bestow, and the feasibility of other alternative measures. In order to facilitate this choice, SEC or IBA disclosure requirements should mandate that the amount of an investment bank's fee that is allocable to a fairness opinion, even if contingent, should be separately disclosed from any other fees. This will permit companies to assess the need for a fairness opinion and its relative value and for stockholders to be able to critique this decision.

#### CONCLUSION

Fairness opinions are complicated beasts that are given high regard by Delaware courts, and have a central, virtually mandatory role in the corporate control transaction. This reliance is not currently justified. Fairness opinions and underlying valuation practices are problematic. They are prone to subjectivity and prepared by investment banks that are conflicted and who do not follow optimal valuation methodologies. Absent these issues, fairness opinions are an imperfect substitute for a price engendered by an effective market-based mechanism. Accordingly, fairness opinions in corporate control transactions should not be required by the Delaware courts, implicitly or otherwise, nor should they provide persuasive or definitive evidence of satisfaction of either a board's duty of care or the fairness of a transaction. Rather, fairness opinions should be only one factor, if at all, for the courts to consider in their analysis of an acquiree board's satisfaction of its duty of care in the corporate control transaction decision. This more limited role for fairness opinions is desirable only if fairness opinions are subject to preparatory guidelines and standards, more fulsome disclosure requirements, and limitations on egregious, conflicted practices. These new strictures should be administered by a new, quasi-public IBA. If these reforms are implemented, fairness opinions and their underlying valuation analyses can become valuable instruments for boards and stockholders considering a price offered or to be paid in a corporate control transaction. This is particularly so if there is no effective market-based process available to establish price. As an added bonus, the adoption of these reforms should significantly alleviate the often-cited problem of investment bank conflicts in the provision of fairness opinions.

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