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

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Discussion Paper No. 50

12/88

Program in Law and Economics
Harvard Law School
Cambridge, MA 02138

The Program in Law and Economics is supported by
a grant from the John M. Olin Foundation.

forthcoming in
Duke Law Journal, February 1989
Symposium on Fundamental Corporate Changes:
Causes Effects and Legal Responses

Fairness Opinions: How Fair Are They And What Can Be Done About It

by

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ABSTRACT

Fairness opinions by investment bankers have become a regular feature in every major corporate control transaction. The use of such opinions is in large part due to the fact that, in determining whether directors have met their fiduciary obligations, courts give weight to the presence of a fairness opinion supporting the position taken by the directors.

In this paper, we analyze the problems involved in judicial reliance on investment bankers' fairness opinions. Investment bankers possess significant discretion in issuing such opinions. One source of this discretion lies in the alternative ways of defining fair price; another in the alternative ways of measuring fair price, however defined. As a result, an investment bank has a choice of arriving at widely differing estimates of fair price, all of which would be justifiable. Furthermore, the incentives bankers face would lead them to render the kind of opinion, within the wide range of reasonable fair prices, which is most conducive to the interest of the managers who hired them. These incentives arise from the fee structure according to which bankers are usually compensated and from their desire to retain and attract clients. It is shown that reputational concerns and internal procedures do not significantly diminish this problem.

Based on our analysis of the problems involved in relying on fairness opinions, we put forward an approach that we recommend courts to take in dealing with fairness opinions. We describe how courts should scrutinize the definition of fair price, the measurement of fair price, and the banker/ company relationship. Because such scrutiny would only diminish and not eliminate the problems identified, we recommend that, even when applying the suggested scrutiny, courts should still exercise significant residual caution and limit their reliance on fairness opinions.

Fairness opinions have become regular features in every major corporate control transaction. Whether in negotiated mergers[1], freeze-out mergers[2], hostile tender offers[3], friendly tender offers[4], self tenders[5], leveraged buyouts[6], negotiated share repurchases[7], or negotiated sales of treasury stock[8], directors seek the blessing of an investment bank before they approve the transaction or adopt a defensive measure. Such fairness opinions by investment banks usually

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[1] See e.g. Denison Mines Ltd. v.Fibreboard Corp., 388 F.Supp. 812, 821 (D.Del. 1974); see generally Chazen, Fairness from a Financial Point of View in Acquisitions of Public Companies: Is Third Party Sale Value an Appropriate Standard?, 36 Bus. Law. 1439, 1442 (1981).

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

[3] See e.g. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 950 (Del. 1985); MacAndrews & Forbes v. Revlon, 501 A.2d 1239, 1243 (Del.Ch. 1985); Dynamics v. CTS, 794 F.2d 250, 257 (7th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, 781 F.2d 264, 271 (2nd Cir. 1986).

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

[5] See e.g. Kahn v. U.S. Sugar, (Slip Opinion, Del.Ch. 1985).

[6] See e.g. Beebe v. Pacific Realty Trust, 578 F.Supp. 1128, 1135 (D.Ore. 1984); Herskowitz v. Nutri/System, 857 F.2d 179 (3rd Cir. 1988).

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

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

consist of a one or two page letter[9]. In this letter, the investment bank states, in general terms, how the fairness opinion was prepared and whether it believes that the proposed terms of the transaction are "fair" or "adequate"[10]. In addition, the investment banks will often give a more detailed presentation on the grounds for the opinion to the board of directors[11].

One of the reasons why fairness opinions are obtained is to persuade the shareholders to approve the transaction[12]. But, perhaps more importantly, directors obtain fairness

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[9] See e.g. Joint Proxy Statement, Crouse-Hinds Co. and Belden Corp., October 14, 1980, Exhibit C and D; Joint Proxy Statement, Alleghany Corp. and Investors Diversified Services Inc., March 29, 1979, Annex III and IV; Proxy Statement, UOP Inc., May 5, 1978, Appendix D; see generally Wander, Special Problems of Acquisition Disclosure: Investment Bankers' Reports and Conflicts of Interest, 7 Inst. On Sec. Reg. 157, 165 (1976).

[10] See e.g. Joint Proxy Statement, Crouse-Hinds Co. and Belden Corp., October 14, 1980, Exhibit C, D, and E (merger is "fair and equitable", merger is "fair from a financial point of view" and tender offer is "inadequate from a financial point of view", respectively); Joint Proxy Statement, Alleghany Corp. and Investors Diversified Services Inc., March 29, 1979, Annex III and IV (merger is "fair from a financial standpoint" and "fair from a financial point of view", respectively); Proxy Statement, UOP Inc., May 5, 1978, Appendix D (merger is "fair and equitable").

[11] See generally Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. Law. 101, 124 (1979); see also Unocal v. Mesa, 493 A.2d 946, 950 (Del. 1985); Gerstle v. Gamble-Skogmo, 298 F.Supp. 66, 83 (E.D.N.Y. 1969); but see Hanson Trust PLC v. ML SCM Acquisition, 781 F.2d 264, 275-276 (2nd Cir. 1986) (directors relied on conclusory opinion that prices were within the range of fair value and did not seek any documentary support).

[12] See e.g. Denison Mines v. Fibreboard, 388 F.Supp. 812, 821 (D.Del. 1984).

opinions in order to have courts find that they have met their fiduciary obligations[13]. Indeed, courts have indicated that they give weight to whether directors have obtained fairness opinions. For example, in Tanzer Economic Association v. Universal Food Specialties[14], the court relied on a fairness opinion obtained by the defendants in concluding that "it is apparent that [the terms of the freeze-out constitute] no palpable or gross undervaluation, which on its face would shock the conscience of the Court"[15]. In Cottle v. Storer Communication[16], the court noted that "the fact that the board did consult [an investment bank] simply weighs in favor of finding that the directors did not abuse their discretion"[17]. And in Smith v. Van Gorkom[18], the failure to obtain a fairness opinion was an important factor

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13 See Chazen, Fairness From a Financial Point of View in Acquisitions of Public Companies: Is "Third- Party Sale Value" the Appropriate Standard?, 36 Bus. Law. 1439, 1442 (1981) (directors obtain fairness opinions to protect themselves against lawsuits charging that they breached their fiduciary duties); Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 120 (1986) (hiring investment bank serves to delegate fiduciary duties to an outsider); Fischel, The Business Judgment Rule and the Trans Union Case, 40 Bus. Law. 1437, 1453 (1985) (fairness letters obtained as type of insurance against lawsuits).

14 383 N.Y.S.2d 472 (Sup.Ct. 1976).

15 383 N.Y.S.2d at 481.

16 849 F.2d 578 (11th Cir. 1988)

17 849 F.2d at 578.

18 488 A.2d 858 (Del. 1985).

in finding that the directors violated their duty of care[19].

The purpose of this paper is to analyze the problems involved in judicial reliance on fairness opinions and to examine the extent to which such opinions should be given weight. One aim of the paper is constructive -- to put forward a judicial approach that may improve the reliability of fairness opinions. Another aim is critical -- to show the limitations of possible improvements and, accordingly, to warn against excessive judicial reliance on fairness opinions.

The first two Sections of this paper present a systematic analysis of the problems involved in giving weight to fairness opinions. In Section I of the paper, we will show that investment banks possess significant discretion in issuing fairness opinions. One source of this discretion lies in the alternative ways of defining fair price; another in the alternative ways of measuring fair price, however defined. As a result, an investment bank has a choice of arriving at widely disparate estimates of fair prices, all of which would be justifiable.

In Section II we will analyze the conflicts of interest that

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[19] 488 A.2d at 876. Other cases in which weight was given to fairness opinions include Treadway v. Care, 638 F.2d 357, 384 (2nd Cir. 1980) (use of investment banker in evaluating merger proposal shows good faith); Kors v. Carey, 158 A.2d 136, 141 (Del.Ch. 1960) (use of outside experts factor in finding lack of misconduct); Alpert v. 28 Williams St., 483 N.Y.S.2d 667, 676 (Ct.App. 1984) (dicta that fairness opinion by investment bank is good means of proving fairness of freeze-out price fair); Danziger v. Kennecott Copper Corp., N.Y.L.J., Dec. 7, 1977, at 7, col. 1 (obtaining independent financial advise before making tender offer factor in finding that directors discharged their fiduciary duties).

investment bankers face in rendering fairness opinions. These conflicts will lead investment bankers to render the kind of fairness opinion that, within the range of reasonable fair prices, is most conducive to the interests of the managers that hired them -- and not the kind of opinion that best reflects their genuine beliefs. Conflicts of interest derive mainly from the fee structure according to which investment banks are compensated and from their desire to retain and attract clients. We will further argue that reputational concerns and internal procedures and guidelines will not significantly diminish this problem.

Section III of the paper will present the approach we recommend courts to take in dealing with fairness opinions. We will describe how courts should scrutinize the definition of fairness, the measurement of fair price, and the banker/ company relationship. However, even when applying such scrutiny, courts should exercise substantial residual caution and limit their reliance on fairness opinions.

I. The Problem Of Discretion

In this Section, we will show that investment banks possess substantial discretion in determining what price is "fair" to the shareholders. Because of this discretion, an investment banker, by using different approaches and assumptions, can arrive at widely differing estimates of "fair prices"[20] all of which would be reasonable and none of which could be shown to be "wrong" (or unfair) under any objective criteria. That financial analysts can regard widely differing figures as estimates of fair price is problematic for two reasons. First, the subjective nature of fairness opinions reduces their value. Even if an investment bank were to render opinions based on its genuine beliefs about the fair value of the company, those would just be the opinion by one investment bank. But as many other reputable financial analysts could arrive at very different opinions, one should not attach excessive weight to the one opinion[21].

Second, and more importantly, the existence of substantial discretion means that there exists significant room for opportunism. Investment bankers, if they so desire, can base their fairness opinions not on their best personal judgment of fair price; rather they can render those opinions that are most in line with their personal interests. And, as we will point out

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[20] See e.g. Joseph v. Shell Oil Co., 482 A.2d 335, 339 (Del. 1984) (value estimates by investment banks ranging from $53 to $85 per share); Kaplan v. Goldsamt, 380 a.2d 556 (Del.Ch. 1977) (estimates ranging from $7.25 to $9.50 per share); Kahn v. U.S. Sugar, (Slip Opinion, Del.Ch. 1985) (estimates ranging from $52 to $122 per share).

[21] A possible solution to this problem is to obtain more than one fairness opinion. See e.g. Brunswick Corp., Proxy Statement (Mar. 9, 1977) (charter amendment providing that terms of certain transactions be found fair by two independent investment banks). However, even several fairness opinions might, in light of the potentially wide discrepancies in estimates of fair price, not provide much information. On the other hand, of course, shareholders will have to bear the greater costs if more than one fairness opinion is obtained.

in the next Section, investment banks have strong incentives to render opinions on fair price that satisfy the managers. By managers, we mean those directors and officers that in fact select the investment bank and negotiate its fee.

The discretion investment banks possess in fashioning their fairness opinions derives from two main sources. First, as we will argue in Subsection A, the concept of fair price is ill-defined. Financial analysts using different definitions of fair price can therefore arrive at different fairness opinions. Second, as we will show in Subsection B, due to the subjective nature of the estimation process, financial analysts can differ in their assessment of fair price even if they use the same definition.

A. The Definitional Problem

The first reason why analysts might arrive at different estimates of what may constitute a fair price is the existence of a conceptual confusion about the definition of "fair price[22]". Estimates of fair price based on different definitions can differ

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22 Fair price is sometimes defined as the price at which a rational buyer with knowledge of the relevant facts would sell the shares. See Nathan & Shapiro, Legal Standard of Fairness of Merger Terms Under Delaware Law, 2 Del. J. Corp. L. 44, 48 (1977). This definition of fair price begs the question. Different rational buyers might consider different definitions of fair price as relevant.

significantly[23]. Courts do not specify which definition of fair price investment banks should use[24]. And, in most cases, investment banks do not disclose which definition of fair price they employed[25]; rather, fairness opinions merely state that the price is "fair from a financial point of view"[26] or "inadequate"[27]. Thus, when a fairness opinion is rendered, it will not be clear whether the opinion is based on a definition of fair price that courts would regard as proper[28].

This definitional problem is quiet complex. A variety of

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[23] See e.g. Joseph v. Shell Oil Co., 482 A.2d 335, 339 (Del. 1984) (different definitions of fair price resulted in estimates of $44, $53, $80-85, and $91 per share); Kaplan v. Goldsamt, 380 A.2d 556 (Del.Ch. 1977) (estimates by same expert using different definitions of fair price range from $7.25 to $8.25 per share).

[24] For purposes of appraisal rights, fair value is defined not to include any element of value arising from the transaction giving rise to the appraisal rights. See e.g. Gen Corp. Law of Del. sec. 262(h). In the context of fairness opinions by investment banks, however, courts, even when faced with price estimates based on differing definitions of fair price, have not made clear which definition investment banks should use. Joseph v. Shell Oil Co., 482 A.2d 335 (Del.Ch. 1984); Kahn v. U.S. Sugar Corp., (Slip Opinion, Del.Ch. 1985).

[25] But see Kaplan v. Goldsamt, 380 A.2d 556 (Del.Ch. 1977) (fairness of price in negotiated share repurchase compared to cost of buying shares through tender offer).

[26] See e.g. Joint Proxy Statement, Crouse-Hinds Co. and Belden Corp., October 14, 1980, Exhibit D. Even practitioners do not always know what "from a financial point of view" means; Chazen, Friedman & Feuerstein, Premiums and Liquidation Values: Their Effect On The Fairness Of An Acquisition, 11 Inst. On Sec. Reg. 143, 156 (statement by Mr. Flom) (1980).

[27] See e.g. 2 M. Lipton & E. Steinberger, Takeovers and Freezeouts N-10 (1978).

[28] Cf. Feuerstein, Valuation and Fairness Opinions, 32 Bus.Law. 1337 (1977) (fair economic value might not be fair in legal sense).

justifiable definitions of fair price have been proposed. Furthermore, which of these definitions is proper might depend on the kind of transaction with respect to which the fair price is measured[29] and with the particular context of the transaction[30]. Take for example a company that is facing an acquisition offer. The buyers might seek to acquire the company through a merger, a friendly tender offer, or a hostile one. Commentators have advocated a variety of definitions of fair price which could be used by an investment bank asked to prepare a fairness opinion. First, fair price could refer to the value of the company as an independent entity, i.e. its value if it does not engage in

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[29] See e.g. 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) (proposing different standards of fairness for non-negotiated acquisitions by controlling shareholders, negotiated acquisitions by controlling shareholders, and acquisitions by unaffiliated purchasers). Making the definition of fair price dependent on the type of transaction with respect to which the opinion is rendered carries the danger that the definition will be manipulated to favor management. For example, an opinion that the terms of a merger are fair is apparently taken to mean that the price is within a range of fair prices, but not the highest price attainable. See Chazen, Friedman & Feuerstein, Premiums and Liquidation Value: Their Effect on the Fairness of an Acquisition, 11 Inst. On Sec. Reg. 143, 147 (1980). But an opinion that the terms of a hostile takeover bid are inadequate merely signifies that, even though these terms might be within the range of fair prices, a higher price can be obtained. See Weiss, The Law of Take Out Mergers: Weinberger v. UOP, Inc. Ushers in Phase Six, 4 Cardozo L. Rev. 245, 256 (1983).

[30] Cf. Saffer, Touching All Bases In Setting Merger Prices, Mergers & Acquisitions, Fall 1984, at 42 (discussing which valuation method bidders should use in which context).

either the proposed nor any other acquisition[31]. This value can be justified as being most relevant for the choice facing the shareholders: shall they approve the merger or tender the shares and receive the value offered; or shall they not approve the merger and (at least for the moment) remain an independent entity.

Second, it has been suggested that fair price should be measured by the price shareholders would have received if the company were auctioned off to the highest bidder[32]. While shareholders do not strictly face the choice to auction off the company, there is no reason in principle why the company should not be auctioned off if shareholders would obtain a higher price such in an auction. Moreover, the value shareholders would receive in a free auction would come closest to the market price for the company as a whole.

A third definition of fair price that the investment bank might be able to use is the value that the shareholders could reasonably expect to result from bilateral, arm's length

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[31] See Schwartz, <u>The Fairness of Tender Offer Prices in Utilitarian Theory</u>, 17 J. Legal Stud. 165 (1988). As Schwartz apparently believes that a company's independent value is given by the market price of its shares, he probably would not see a need for a fairness opinion. However, if a company is not publicly traded or if the share price were not to reflect the value of the company as an independent entity (e.g. because of the existence of significant non-public information), Schwartz would presumably advocate that the fairness opinion be based on the value of the company as an independent entity.

[32] See Bebchuk, <u>The Case For Facilitating Competing Tender Offers</u>, 95 Harv. L. Rev. 1028 (1982); Gilson, <u>A Structural Approach To Corporations: The Case Against Defensive Tactics In Tender Offers</u>, 33 Stan. L. Rev. 819 (1981).

bargaining with the buyer[33]. This value would be of interest to shareholders since it shows whether they might be better off rejecting the present offer in order to return to the bargaining table or to wait for another bid[34]. This value would also show whether the managers represented the shareholders adequately in negotiating the terms of the transaction and in structuring takeover defenses. In particular, where shareholders suspect that management might have had a conflict of interest[35], this definition of fair price would provide an indication whether their suspicions were justified. Moreover, if the acquisition creates unique gains that would not arise from an acquisition by another party, the price that could reasonably be expected to result from bargaining would arguably constitute the most fair division of these gains.

This list of definitions of fair price is not meant to be exhaustive. Besides those listed, several other justifiable

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[33] Cf. Pepper v. Litton 308 U.S. 295, 306-307 (1939) (in self-dealing, test of fairness is whether transaction carries the earmarks of an arm's length bargain). That definition of fair price can also be said to follow from the "sole owner standard" put forward in Bebchuk, The Sole Owner Standard For Takeover Policy, 17 J. Legal Stud. 197 (1988).

[34] Empirical evidence shows that many unsuccessful merger negotiations and tender offers are followed by subsequent successful bids. Bradley, Desai & Kim, The Rationale Behind Interfirm Tender Offers, 11 J. Fin. Econ. 183, 187-188 (1983) (of 112 unsuccessful tender offer targets, 86 were acquired within 5 years). This suggests that shareholders could in fact reasonably expect to realize a value above the independent value of the company even if they reject the acquisition proposal.

[35] It is generally agreed that corporate control transactions involve the potential for conflicts of interests. See e.g. Clark, Corporate Law (1986) at 463 - 592.

definitions of fair price are conceivable, e.g. the value of the company's net assets[36] or the value of the company as an independent entity plus a fraction of any gains resulting from the acquisition. Moreover, the various definitions of fair price could be combined to form new definitions. For example, fair price can be defined as the average of several definitions[37] (arguing that each definition captures one aspect of value[38]).

Which definition is most appropriate might also depend on the context of the acquisition. If several suitors showed interest in the company, the auction price might be more

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[36] E.I. DuPont de Nemours & Co. v. Collins, 97 S.Ct. 2229 (1977) (upholding net asset value as fair price for closed end investment company, even though its share value was significantly lower); Gerstle v. Gamble-Skomo, 298 F.Supp. 66, 100 (E.D.N.Y. 1969) (exchange of shares in merger should have been based on liquidation value of one of the companies).

[37] A weighted average of different measures of value is generally used in the context of appraisal rights. See e.g. Matter of Endicott Johnson Corp. v. Bade, 376 N.Y.S.2d 103, 338 N.E.2d 614 (1975) (to determine fair value, net asset value, investment value, and market value ought to be considered with the weight for each factor determined by the factfinder); Piemonte v. New Boston Garden Corp., 387 N.E.2d 1145 (Mass. 1979) (weights of 10, 40, and 50 percent for market value, earnings value, and net asset value upheld); but see Weinberger v. UOP, 457 A.2d 701, 712-713 (Del. 1983) (overruling precedents that weighted average of market, earnings, and net asset value must be used and permitting as well other valuation techniques accepted in the financial community).

[38] If measurement of fair price according to each definition will result in an unbiased but inaccurate estimate of the true fair price, an appropriately weighted average will result in a more accurate estimate. See generally Thomas Wonnacott & Ronald Wonnacott, Introductory Statistics for Business and Economics (2nd ed. 1977) at 129-131, 179-185 (Unless two estimators are perfectly correlated, the variance of their sum is less than the sum of their variances; therefore, some weighted average of several unbiased estimators will be a more efficient estimator than any of the estimators standing alone).

appropriate than the independent value of the company[39]; or if unique gains can be realized by the acquisition, the negotiation price might be more appropriate than the auction price. Investment banks apparently also consider it relevant whether the fairness opinion is rendered in a friendly or in a hostile deal. In a friendly deal, the opinion signifies whether a reasonable prudent board could accept the offered terms[40]. In a hostile deal, it states whether the bank believes that a better offer can be obtained[41].

Differing definitions of fair price seem to exist in every context in which fairness opinions are rendered. Take freeze-out mergers as another example. In a freeze-out merger, fair price might be defined as the value of the company as an independent entity[42], as the market price of the minority shares[43], or as the

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[39] Cf. Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986) (when it becomes apparent that a company will be sold to one of several bidders, board of directors is under a duty to conduct neutral auction).

[40] As investment bankers like to stress, a "fair" price is not the highest price obtainable, but rather a price within the range that a reasonable, prudent board would accept. See Chazen, Friedman & Feuerstein, Premiums and Liquidation Values: Their Effect on the Fairness of an Transaction, 11 Inst. On Sec. Reg. 143, 147 (1980); Fleischer, A 'Fairness Letter' is Just an Opinion, New York Times, June 8, 1986 at F 2.

[41] In hostile deals, opinions generally state that the terms are inadequate, meaning that better terms might be obtainable. See generally Weiss, The Law of Take Out Mergers: Weinberger v. UOP, Inc. Ushers in Phase Six, 4 Cardozo L. Rev. 145, 156 (1983).

[42] Gen. Corp. Law of Del., Sec. 262(h) (in determining fair value under appraisal rights, court should not take into account any element of value arising from the accomplishment or expectation of the merger and consolidation); MBCA, section 13.01(2) (defining "fair value" for purposes of dissenters'

price the minority shares would receive if they were auctioned off as a block[44]. Lastly, to any of the above measures, one could add a fraction of any freeze-out gains[45] that might arise or an appropriation for the tax expenses and reinvestment transaction cost[46] that the minority shareholders have to incur[47].

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rights to exclude any "appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.")

43 Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L. Rev. 698, 723-731 (1982); Gen. Corp. Law of Del., section 262(b)(1) (appraisal remedy not available for publicly traded stock).

44 See Chazen, Friedman & Feuerstein, Premiums and Liquidation Values: Their Effect on the Fairness of an Transaction, 11 Inst. On. Sec. Reg. 143, 160 (1980) (price obtainable for minority shares as a block is possible measure of fair price). The authors believe that the block price would be below the market price for the stock since investors would have to sell at a liquidity discount. But if the same person owned all the minority shares, he would have greater incentives and abilities to monitor the majority shareholders. Then, the majority would presumably be less able to divert gains from the minority and the value of the minority stock held as a block might exceed the value of the stock to dispersed investors.

45 See Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 298 (1974) (fair treatment requires that gains be shared).

46 Toms, Compensating Shareholders Frozen Out in Two-Step Mergers, 78 Col. L. Rev. 548, 575-583 (1978).

47 In other transactions, yet other definitions of fair price can be justified. For example, in a management buyout, fair price could mean the company's independent value; the market price of the shares; the price obtainable in an auction; the independent value plus a fraction of the gains expected to result from the buyout (e.g. tax savings from increased leverage and gains from improved incentives to managers); the value of the company assuming management made all changes it planned to make after the buyout and could make in absence of a buyout (which would include tax savings from increased leverage but might not include gains from improved incentives). See also Lowenstein, Management Buyouts, 85 Columbia L. Rev. 730 (1985) (arguing for an auction rule in leveraged buyouts).

As there are several justifiable definitions of fair price, investment bankers that are hired to determine whether a certain price is fair are free to choose from any of these definitions[48]. In Section III, we will put forward an approach to diminish this definitional problem. We will recommend that courts make clear as much as possible which definitions of fair price they view as legitimate and that investment banks state which definition underlies their opinion. However, as we turn to explain, the definitional problem is not the only reason why financial analysts arrive at different estimates of fair price. Thus, even in absence of the definitional problem, investment banks would still have significant discretion in determining the fair price for a company.

B. The Measurement Problem

Even financial analysts that employ the same definition of fair price can arrive at widely differing estimates of fair price[49]. The reason is that, in order to measure fair price,

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48 Sometimes managers constrain the investment bank in their choice of the definition of price. See e.g. Kaplan v. Goldsamt, 380 A.2d 556 (Del.Ch. 1977) (in negotiated share repurchase, bank asked to estimate cost of buying equivalent amount of shares through tender offer); Longstreth, New Controls For Leveraged Buyouts, New York Times, November 4, 1983 at F 3 (bankers are sometimes asked not to consider liquidation value).

49 Courts have recognized the subjective nature of price estimates. Kaplan v. Goldsamt, 380 A.2d 556 (Del.Ch. 1977); Radol v. Thomas, 534 F.Supp. 1302, 1305 (S.D. Ohio 1982) (methods used in preparing price estimates are necessarily imprecise); Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del.Ch. 1984) (Court is

however defined, one must make a variety of simplifications, assumptions, and estimates. Analysts can make different simplifications, assumptions, and estimates[50], all of which might be reasonable and justifiable, and can thus arrive at different estimates of fair price[51].

Assume, for example, that it is agreed that the analyst should estimate the company's independent value. The first decision the analyst has to make is whether he should estimate this value by the net asset value of the company[52], the discounted value of the company's future profits[53], a multiple of

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aware that appraisers usually express different opinions even if they use same data); Kahn v. U.S. Sugar, (Slip Opinion, Del. Ch. 1985) (court noting that expert valuations were based on subjective judgments).

[50] For examples how different assumptions can influence estimates, see Kaplan v. Goldsamt, 380 A.2d 556, 567 (Del.Ch. 1977) and Kahn v. U.S. Sugar, (Slip Opinion, Del. Ch. 1985).

[51] See also Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 124 (1986) (noting that modern valuation techniques do not permit investment bankers to determine a fair price with absolute precision); Fischel, The Business Judgment Rule and the Trans Union Case, 40 Bus. Law. 1437, 1452 (1985) (discounted cash flow technique can "come up with just about anything").

[52] See e.g. Matter of Endicott Johnson Corp. v. Bade, 376 N.Y.S.2d 103, 338 N.E.2d 614 (1975) (net asset value to be considered in determining company's independent value); Piemonte v. New Boston Garden Corp., 387 N.E.2d 1145 (Mass. 1979) (weight of 50 percent given to net asset value).

[53] See e.g. Malkiel, A Random Walk Down Wall Street, (4th ed. 1985) at 115 (describing fundamental analysis); see also Weinberger v. UOP, Inc., 457 A.2d 701 [](Del. 1983)

past earnings[54], the discounted value of future dividend payments[55], the share price[56], or some kind of average of these measures[57].

Assume, the analyst decides to estimate the discounted value of future profits. Then, the analyst will have to collect the information on which his estimates will be based. At this stage the analysts has to decide which and how many information sources he should consult, whether he should independently verify the information supplied to him by the company, and whether he should assume that the information given to him by the managers is accurate or rather "discount" that information for possible conflicts of interest.

Next, on the basis of whatever information he has collected, the analyst will have to make assumptions about the development

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[54] See e.g. In re Valuation of Common Stock of Libby, McNeill & Libby, 406 A.2d 54 (Me. 1979) (multiple of past earnings given weight of 40% in calculating fair value under appraisal statute); Kahn v. U.S. Sugar, (slip Opinion, Del. Ch. 1985) (experts of plaintiff and defendant using multiples of past earnings to determine value).

[55] Brealy & Myers, Principles of Corporate Finance (2nd ed. 1984) at 45.

[56] See Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981); Easterbrook & Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1 (1982); Schwartz, The Fairness of Tender Offer Prices in Utilitarian Theory, 17 J. Legal Stud. 165 (1988); see also Gen Corp. Law of Del., sec. 262(b)(1) (appraisal rights not available for publicly traded stocks).

[57] See e.g. Matter of Endicott Johnson Corp. v. Bade, 376 N.Y.S.2d 103, 338 N.E.2d 614 (1975); Piemonte v. New Boston Garden Corp., 387 N.E.2d 1145 (Mass. 1979) (averages of net asset value, market value and earnings value used to determine fair value under appraisal statutes).

of the company's costs, the revenues the company expects to earn[58], and future tax rates[59]. These items will, in turn, depend on the future rate of inflation, how likely the company is to develop new products, whether new competitors enter or old ones leave the market place, and who will win the next election. These calculations might have to be repeated for each of the company's product lines.

Finally, the analyst will have to estimate the rate at which these future profits should be discounted. Determining the proper discount rate is far from being a one-step process. Assume the analyst decided to use the capital asset pricing model to determine the discount rate. Even if he wanted to apply the same discount rate in each time period and to each revenue and cost item, the analyst would have to determine the risk free rate, calculate the covariance of cash flows with the market portfolio, and estimate the market risk premium[60].

Assume the impossible happens and two analysts agree that the company will have profits of $100,000 in each coming year; but one analyst believes the proper discount rate is 8% per year

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58 See e.g. Brealy & Myers, Principles of Corporate Finance (2nd ed. 1984) at 85-96.

59 Cf. Herskowitz v. Nutri/System Inc., 857 F.2d 179 (3rd Cir. 1988) (jury could find that fairness opinion that assumed that tax laws would not change, even though tax reform legislation reducing marginal tax rates was expected to become enacted, is unreasonable).

60 Brealy & Myers, Principles of Corporate Finance (2nd ed. 1984) at 128-135 (describing how to apply the capital asset pricing model).

while the other believes the proper rate is 10% per year. This 2% difference in the discount rates will result in estimates that are 25% apart. The value of the company estimated by the first analyst will be $1,250,000; the value estimated by the second analyst will be $1,000,000. Of course, if the analysts did not agree on the amount of future profits, their estimates could be even further apart[61]. For example, if the first analyst thought profits would grow at an annual rate of 4%, and the second analyst thought they would grow at only 2%, the respective estimates would be $2,500,000 and $1,250,000. These analysts might have divergent opinions on whether a price of say $2,000,000 for the company is fair.

Under a different definition of fair price, the estimation process could be even more complex. Assume, for example, that the value to be estimated is the price shareholders could have reasonably expected to result from bilateral, arm's length

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[61] The differences in estimates of fair price would tend to be less pronounced, and the high number of items that must be estimated cause for less concern, if the estimates on each item were independent, e.g. if the estimates of net profits on product A is not related to estimate of net profits on product B and C. In that case, the estimates on each item would balance each other to some degree, i.e. an analyst who makes a relatively high estimate of the profits on product A might make a relatively low estimate of the profits on product B.

There are, however, two reasons to believe that the estimates on each item are not independent. First, some analysts might take a general positive or negative approach to the developments in the economy or the industry the company is engaged in. Second, as we will show in Section III, analysts will have incentives to arrive at price estimates that satisfy the managers. This will lead them to make, in each instance, the estimate most likely to result at such a price.

negotiations. This price will presumably involve some splitting of the net gains from the acquisition. As before, the analyst would probably first estimate the value of the company as an independent entity. Next, the analyst would have to estimate the value of the other company as an independent entity and the value of both companies together. From these three figure the analyst could calculate the net gains from the acquisition. Then the analyst would have to decide how these gains would be split.

Estimating the value of the other company and of both companies together will provide the analyst with even greater leeway. The analyst will ordinarily have less information -- and thus even more room to make assumptions -- with respect to the other company than with respect to the company by which he was hired. Similarly, the analyst will often not know how the companies together will be managed; and even if he did, determining the effects on value would leave a wide margin of tolerance.

In splitting the net gains, again, several methods for making estimates appear justifiable. The analyst could try to determine how companies in other transactions have split the gains. Alternatively, the analyst could assume that the gains would be divided equally on a per dollar basis[62], on a percentage of independent value basis[63], or on some other basis.

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62 See Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 316 (1974)

63 See Brudney & Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 320 (1974)

Thus, however fair price is defined[64], an investment banker could base his estimate of fair price on a variety of justifiable information sources, assumptions, and measurement techniques. By relying on different sources of information, making different assumptions and using different techniques, the banker could arrive at differing fairness opinions. Therefore, even if the definitional problem were solved, investment bankers would still possess significant discretion.

II. The Problem Of Conflicts Of Interest

In Section I, we have shown that investment bankers, in determining the fair price of a company, have wide discretion. For one, this discretion arises from the fact that the concept of fair value is not clearly defined. But, even if the definition of fair price were clarified, a significant margin of tolerance would remain. Because even a clearly defined fair price is hard to measure, investment bankers could still justify widely disparate estimates of fair price as reasonable.

Even if each investment bank were to base its fairness

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[64] Even is the stock price were regarded as the fair price, one would have to decide whether to use the stock price including or ignoring the impact of the prospective transaction, when the market first learnt of rumors of the transaction, which changes in the stock price can be attributed to these rumors and which are caused by other developments, etc. See also Fischel, The Appraisal Remedy in Corporate Law, 1983 Am. Bar Found. Res. J. 875 (describing econometric market model that can be used to reconstruct the market price ignoring the impact of a prospective corporate control transaction).

opinion on the definition of fairness and the valuation process it regarded as most accurate, a fairness opinion would still provide little certainty. One would always have to be aware that what this investment banker regards as fair might be regarded as unfair by other analysts, and vice versa. But, as we will argue in this Section, the problem is even more serious. As has been noted before, the investment bank will tend to base its fairness opinions not on its best estimates of fair price, but rather on what is most conducive to the wishes of management[65]. For example, if the managers want the shareholders to approve a merger, the bank will tend to conclude that the merger terms are fair. On the other hand, if the managers want the company to adopt a defense to a hostile takeover, the bank will tend to conclude that the proposed takeover terms are unfair.

In this Section we wish to demonstrate the pervasiness of conflicts of interest by systematically analyzing their sources and by refuting the grounds advanced for the alleged independence

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[65] The opinion that fairness opinions frequently only rubber stamp decisions by management has been frequently expressed. See McGough, Fairness for Hire, Forbes, July 29, 1985 at 52; Longstreth, New Controls for Leveraged Buyouts, New York Times, November 6, 1983 at F 3; Stein, Investment Banking's Dirty Little Secret, New York Times, June 8, 1986 at F 2; Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 127 (1986) (existing controls do not assure impartial fairness opinions); Weiss, The Law of Take Out Mergers: Weinberger v. UOP, Inc. Ushers in Phase Six, 4 Cardozo L. Rev. 245, 255 (1983) (often easy to find compliant banker to render fairness opinion); see also Fischel, The Business Judgment Rule and the Trans Union Case, 40 Bus. Law. 1437, 1453 (some experts will always be willing to opine that a price higher than the share price is fair); but see Fleischer, A 'Fairness Letter' Is Just An Opinion, id. (fairness opinions represent independent and objective judgments by outsiders).

of investment banks. The rest of this Section will consider in detail the causes of the conflicts of interest. We will first deal with incentives resulting from the fee structure according to which investment banks are compensated. We will then look at how a desire to retain and attract clients creates conflicts of interest. Next, we will point to psychological and social reasons why fairness opinions by investment bankers might be biased. Lastly, we will argue that reputational concerns and internal procedures will not eliminate these conflicts of interest.

A. The Fee Structure

One reason why investment banks have an incentive to render the fairness opinion desired by the managers lies in the fee structure according to which banks are compensated. Investment bankers are generally not hired just to render the fairness opinion; rather, the same investment bank that writes the fairness opinion is also in charge of the other financial aspects of the transaction[66]. For example, in a merger, the bank would

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[66] See 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, 1443 (1981) (typically, fairness opinion is only part of total package of services furnished by investment bank); see also MacAndrews & Forbes v. Revlon, Inc., 501 A.2d 1239 (Del.Ch. 1985) (investment bank rendering fairness opinion involved in structuring hostile tender defense); Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986) (investment bank advises on proxy fight).

give general financial advice to the company[67]; or in hostile takeover defenses, the bank would arrange the financial aspects of a lock-up option[68] or a poison pill[69].

The fee a bank receives for its fairness opinion is often a fixed amount negotiated upfront[70]. However, the other fees received by the investment bank are often contingent fees[71]. In many friendly deals, a significant part of the total fee is often payable only if the transaction is consummated[72]. Often, the size of this contingent fee depends on the price for which the company

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[67] See e.g. Kahn v. American Metal Climax, 458 F.2d 255, 267 (3rd. Cir. 1972); Gerstle v. Gamble-Skogmo, 298 F.Supp. 66, 82-83 (E.D.N.Y. 1969); Joint Proxy Statement, Alleghany Corp. and Investors Diversified Services Inc., March 29, 1979, at 27 (Alleghany's investment bank receiving fees for financial advice and rendering of fairness opinion); see generally Carrington, Merger Advisers Say the Big Fees They're Charging Are Warranted, Wall Street Journal, july 17, 1981, at 29.

[68] See e.g. Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2nd Cir. 1986) (Goldman Sachs opining that lock up option negotiated by itself with "white knight" solicited by itself was fair).

[69] See e.g. Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986) (Smith Barney opining that tender offer was unfair and structuring poison pill).

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

[71] If the investment bank providesas well services other than rendering the fairness opinion, it generally receives one fee for all its services. Private Information.

[72] For example, in the acquisition of ABC by Capital Cities, First Boston, ABC's bank was to receive $2 million upon approval of the deal by ABC's shareholders and $4.5 million upon its consummation. Joint Proxy Statement, American Broadcasting Corponies, Inc. and Capital Cities Communications, Inc., May 10, 1985, at 7.

is sold[73]. In other instances, fees can be contingent on the whether a raider fails in a proxy challenge[74], on whether the bank secures a "White Knight"[75] or on whether the fairness opinion is made public[76].

For instance, in the merger of Cleveland Electric and Toledo Edison, Morgan Stanley was to receive a $3.794 million fee is the merger is consummated, but only a $350,000 fee otherwise[77]. And in the acquisition of Allied Stores by Campeau, Goldman Sachs, Allied's bank was to receive a straight fee of $1 million, and an additional fee based on 1/3 of 1% of the price paid for Allied

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

74 See e.g. Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986) (In hostile partial tender offer, investment bank hired to determine fairness of tender offer was to receive a bonus if hostile suitor would lose proxy fight);

75 See e.g. Radol v. Thomas, 534 F.Supp. 1302, 1315 (S.D.Ohio 1982).

76 See e.g. Anderson v. Boothe, 103 F.R.D. 430, 435 (D.Minn. 1984) (Salomon Brothers received fixed fee of $250,000 for fairness opinion and additional $150,000 fee if opinion is made publicly available); Herskowitz v. Nutri/System, 857 F.2d 179 (3rd Cir. 1988) (Connecticut National Bank to receive $75,000 for fairness opinion if published and $50,000 if not).

77 Joint Proxy Statement, Ceterior Energy Corp., Cleveland Electric Illumination Co., and Toledo Edison Co., October 4, 1985, at 12.

shares estimated to be $13 million[78].

Contingent fees that are payable only upon consummation of a transaction create enormous incentives for investment bankers to have the deals consummated[79]. Only if the deal goes through will the investment banks earn the contingent fees, which, as we have seen, often dwarf the non-contingent fee. In such situations, the investment bank faces two alternatives: it can earn the much larger contingent fee if it blesses the management proposal as fair; or it will just get the modest fee, if, as a result of the opinion, the deal collapses[80].

As a different example, consider the involvement of Smith Barney in the hostile tender offer and proxy contest for CTS. CTS retained the bank in order to render a fairness opinion on the tender offer and to give other financial advise[81]. If Dynamics, the hostile raider, were to lose the proxy contest, Smith Barney

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78 Information Statement, Allied Stores Corp., December 9, 1986, at 8.

79 See Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 128 (1986) (contingent fees create conflict of interest); Anderson v. Booth, 534 F.Supp 430,436 (D.Minn. 1984) (contingent fees could bias fairness opinion).

80 To be sure, the fact that an investment bank judged a price to be unfair would not necessarily mean that the deal is off; nor does an opinion that the proposed terms are fair assure that the transaction will be completed. But as long as an opinion that the transaction is "fair" increases the chances of completion, the investment bank will face the incentives we describe.

81 Dynamics Corp. of America v. CTS, 794 F.2d 250, 257 (7th Cir. 1986)

would receive a bonus of $75,000[82]. Obviously, if Smith Barney had found that the tender offer was fair, Dynamics would have been more likely to win the contest, and Smith Barney would have lost the bonus. Similarly, if a fee is contingent on finding a white knight, the bank will face incentives to find the offer by the original raider unfair; and where the fee is contingent on whether the opinion is published, the bank will have an incentive to render the kind of opinion the managers would like to show to the shareholders.

But the very fact that the compensation of the investment bank is mainly based on services other than writing a fairness opinion would, even if their fees were non-contingent, create incentives to render pro-management opinions. By writing a pro-management opinion, investment banks will typically generate more work than by opposing management[83]. For example, by writing a negative opinion and killing a merger favored by the managers, the bank would lose all the other business that would have been

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82 794 F.2d at 257.

83 Writing an opinion opposed to management will not necessarily reduce the amount of work. In particular, management might desire an opinion that a particular merger proposal or tender offer is unfair in order to justify defensive tactics. In some cases, the fees to be earn in the prevented corporate control transactions might be larger than the fees from structuring the defenses. But even in such cases, investment banks will have an incentive to render the opinion desired by management. If the bank were to state that the tender offer price were fair, management would in all likelihood not retain the investment bank for the control transaction; thus the bank that rendered the fairness opinion will not profit from the larger fees. But if the bank renders an opinion desired by management, it will at least earn the smaller fees for structuring the defenses.

created by the merger. Thus, even if the fee were based on work actually performed, the revenues (and presumably the profits) that investment banks earn will be higher when they write pro-management opinions. Therefore, investment banks compensated on the basis of work performed might not face as great incentives to render pro-management opinions as those compensated on a contingency basis[84]; but the incentives they face will still be significant.

Some investment bankers and commentators argue that the contingent fee structure operates in a different way[85]. By having a compensation scheme where the fee is a percentage of the final deal price, the bank would maximize its fee by seeking the highest price possible. Thus, it is argued, the bank would have an incentive to threaten to find the proposed terms unfair in order to induce a higher offer to the shareholders.

But only contingent fees for the seller's investment bank that are dependent on the final price received by the

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[84] Incentives to render pro-management opinions under a contingency system will only be larger if the investment bank has done some work on the deal before the fairness opinion is completed. In that case, the fairness opinion will not only affect the expected profits from any work to be done in the future; rather, it will also affect whether the bank is compensated for the work it has done so far. If, however, no other services have been rendered before the fairness opinion is completed, incentives under both compensation systems should be equal. In either case, the fairness opinion will affect expected profits from work to be done in the future. And there is no reason to assume that these expected profits are larger if the bank is compensated on a contingency basis.

[85] See e.g. Fleischer, A Fairness Opinion is just an Opinion, New York Times, June 8, 1986 at F 2.

shareholders provide such countervailing incentives to determine that a price unfair. However, as mentioned before, in many cases, the fee is contingent on other factors, such as whether the opinion is made public or whether the company is sold to the hostile raider or to a white knight[86]. Or the fee is contingent on the deal going through but not based on a percentage of the price payable to shareholders[87]. Such contingent fees will only create incentives to render a pro-management fairness opinion and no countervailing incentives to push the purchase price up.

Even with respect to percentage fees to the seller's bank, the bank would have to consider whether, by rejecting the proposed price as unfair, it jeopardizes the entire deal[88]. It will only pay to attempt to push up the price if the likelihood of killing the deal is relatively small. Assume, for example, that the investment bank stands to receive 0.1% of the purchase price. It would only pay the bank to try to raise the price from $100 million to $110 million if the probability of killing the deal is less than approximately 10%. Thus, a bank that wanted to

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[86] See supra, notes 76 to 78.

[87] See e.g. Proxy Statement, Beatrice Companies, Inc., March 11, 1986 at 12 (fee of $15 million payable immediately when merger consummated; otherwise in installments).

[88] It is interesting to note that even the fees of investment banks that represent the buyers will sometimes be a percentage of the sales price. See Carrington, <u>Merger Advisers Say the Big Fees They're Charging Are Warranted</u>, Wall Street Journal, July 17, 1981, at 29 (First Boston, representing DuPont in its bid for Conoco, to receive as fee 0.2% of sales price). Apparently, in these instances, the buyers do not believe that such fees create strong incentives for investment banks to have the company bought at a higher price.

maximize its fee would not always try to have the purchase price increased.

Thirdly, even if, once the investment bank is hired, it faces incentives to push up the purchase price, the bank will also be concerned about its chances to be hired in future deals. The incentives created by this desire to retain and attract clients will be the subject of the next Subsection.

B. <u>The Desire to Attract and Retain Clients</u>

Assume, as before, that an investment bank will receive as fee for its services 0.1% of the purchase price if the transaction goes through. Further assume that the bank believes that, if it pushes up the price from $100 million to $110 million, the chances of jeopardizing the transaction are only 5%. If the investment bank wanted to earn higher fees in that single deal, it should try to push up the purchase price. Its expected fees would increase from $100,000 to $104,500.

But in each transaction, an investment bank will not only face the incentives created by the fees it can earn in that transaction; rather, an investment bank will also be concerned with the impact of the transaction on its future business. Therefore, an investment bank will have an incentive to render the kind of opinion that will attract more future clients and will allow it to charge a higher price for its services. The question thus is what clients look for in investment banks when they ask them to render fairness opinions. Investment banks that are known to deliver what clients want will attract future business; investment banks that are not, will not attract future business.

For the purposes of attracting future business, the client of an investment bank is the person who makes the hiring decision. Thus even though legally the client of the investment bank is the corporation, and even though the owners of the corporation are the shareholders, the managers will decide which investment bank to hire. Therefore, it will be the managers who investment banks try to satisfy.

The performance of an investment bank is not only important for being retained by the same managers for their future transactions. As long as other managers of other companies find out about the performance of the investment bank, it will affect their hiring decisions as well. In fact, there a good reasons to believe that managers will be well informed about the reputation of an investment bank even if they never had personal dealings with the bank. The approach an investment bank takes to fairness opinions is likely to be known in the corporate community. In particular, one would imagine that word would get around fast if an investment bank, by trying to push up the price, prevented a deal that the managers would have liked to see consummated. Furthermore, major law firms that are retained by the managers will be able to inform them about the reputation of most investment banks. Thus, incentives created by the desire to be hired for future transactions are potentially much more important than incentives created by the fee structure in an individual transaction.

As investment banks will have strong incentives to satisfy managers, it is unlikely that fairness opinions serve as an effective independent check on their activities. To the contrary, the desire to retain and attract clients will lead investment banks to write the fairness opinion managers wish to see. Investment banks that are known to adapt their fairness opinions to the wishes of management will tend to be rehired. Investment banks that have become known to insist on writing different opinions are unlikely to be retained to write many more.

C. Psychological and Social Biases

The psychological and social loyalty investment bankers sometimes feel towards the managers will reinforce the economic incentives created by the fee structure and by the desire to retain and attract clients. Many investment bankers will personally know the managers and thus often feel more sympathetic towards their views than towards the interests of anonymous shareholders. Even in the absence of such personal relations, many transactions will create an atmosphere of common purpose that will tend to reduce the bankers' objectivity.

The investment bank hired to render the fairness opinion has often worked with that company for many years before[89]. Presumably, in many cases, the investment bankers that are to prepare the opinion know the managers personally[90]. And even if the bankers do not personally know the managers before they get hired, they will get to know them while working together on the fairness opinion and on other aspects of the transaction[91]. Shareholders, on the other hand, will often be viewed as an anonymous and abstract mass. It would thus not be surprising if the investment bankers, consciously or subconsciously, place greater weight on and feel greater sympathy for the goals and views of the managers than for those of the shareholders. Therefore, their fairness opinions will tend to be predisposed towards the managers' interests[92].

Furthermore, in many transactions in which fairness opinions

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[89] For example, Merryl Linch, representing Alleghany in its merger with Investors Diversified Services ("IDS") in 1979, has represented Alleghany in 1975 in its merger with MLS; in 1977 in a tender offer for IDS stock; twice in 1977 with respect to IDS Realty Trust; and in 1978 again with respect to the trust. In total, Merryl Linch earned revenues of over $500,000 in these transactions. Salomon, representing IDS, has in the prior three years earned about $4.5 million in securities transactions it undertook for IDS. Joint Proxy Statement, Alleghany Corp. and Investors Diversified Services Inc., March 29, 1979, at 27-28.

[90] See e.g. Weinberger v. UOP, 457 A.2d 701 (Del. 1983) (fairness opinion prepared by investment banker who was also a long time director of UOP).

[91] See e.g. MacAndrews & Forbes v. Revlon, 501 A.2d 1239, 1243 (Del.Ch. 1985) (Investment bank and management developing together defensive share repurchase plan and poison pill).

[92] Cf. Gerstle v. Gamble-Skogmo, 298 F.Supp 66, 95 (E.D.N.Y. 1969) (Prior business relation raises doubt about ability of investment bank to be impartial arbiter).

are obtained, investment bankers and managers will feel an atmosphere of common purpose. For instance, the investment bankers and the managers might have together negotiated the agreement the investment bank is asked to evaluate[93]. Or the investment bank might have been retained in a "defense" against a "hostile" takeover by a "raider" to search for a "white knight"[94]. In such instances, it should not be uncommon that the bankers and managers share a team spirit[95] or even a siege mentality. This, as well, will lead the bankers to give undue weight to the goals of the managers at the cost of conflicting interests of the shareholders.

D. Objection to the Analysis

This Subsection will discuss the failure of commonly given reasons why bankers could be relied on to give fairness opinions that reflect their best, unbiased judgment. In particular, we will discuss two such arguments. First, we will analyze whether a concern for professional reputation will lead investment banks to

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93 See e.g. Gerstle v. Gamble-Skogmo, 298 F.Supp 66, 82 (E.D.N.Y. 1969) (investment bank reviews fairness of merger which it proposed itself); Kohn v. American Metal Climax, 458 F.2d 255, 267 (3rd Cir. 1972) (investment bank gives opinion on merger it helped to negotiate).

94 See e.g Hanson Trust PLC v. ML SCM Acquisition, 781 F.2d 264, 268-269 (2nd Cir. 1986).

95 See e.g. MacAndrews & Forbes v. Revlon, 501 A.2d 1239, 1243 (Del.Ch. 1985) (investment bankers, managers, and lawyers developing together program to protect company against tender offer).

render unbiased fairness opinions. Second, we will consider whether internal procedures and guidelines will eliminate the conflicts of interest investment banks face.

1. Professional Reputation

There is an argument that the desire of investment banks to maintain a professional reputation will lead them to provide unbiased fairness opinions. A professional reputation for quality work in an important asset to investment banks; and they might be reluctant to jeopardize it by writing biased fairness opinions. Reputation is important because it helps banks to attract clients. As we noted, the clients of investment banks are the managers. Managers use fairness opinions in order to influence courts to find that they met their fiduciary duty[96] and shareholders to approve their activities[97]. Thus, investment banks must be concerned not to have the weight given to these opinions by courts and shareholders reduced by writing biased fairness opinions. Otherwise, their opinions would no longer fulfill the purposes for which they were obtained.

Courts, however, have not indicated that they pay close attention to the trustworthiness of fairness opinions by specific

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[96] See supra, notes 14 to 20.

[97] See supra note 13.

investment banks[98]. Rather, they do not noticeably differentiate between investment banks as long as they have sufficient credentials[99]. Also, to the extent they do pay attention to professional reputation, courts are likely to judge the reputation of an investment bank regarding fairness opinions by its general reputation in the field of investment banking[100]. But investment banks enjoying a general reputation for delivering high quality word might still render very pro-management fairness opinions. Shareholders, while they might pay more attention to the reputation of investment banks, will not have the same information about the reputation of investment banks as managers. Many shareholders will at most be aware of the general reputation of an investment bank; e.g. they might know that Shearson Lehman Hutton is a reputable and generally trustworthy bank[101]. Thus, managers will be able to select an investment bank that will both

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98 In the acquisition of Stokeley-Van Camp, the investment bank, Dillon Read advised the directors that the proposed price of $55 in a management buyout was fair. Stokeley was eventually acquired by Quaker Oats for $77 per share; and Quaker Oats apparently made significant profits in the deal. See McGough, Fairness For Hire, Forbes, July 29, 1985 at 52. Still, courts have not discounted fairness opinions issued by Dillon Read. Cottle v. Sorer Communication, 849 F.2d at 578 (court giving weight to fairness opinion by Dillon Read).

99 Cf. Kahn v. U.S. Sugar, (Slip Opinion, Del.Ch. 1985) (court noting the "impressive credentials" of the experts that valued the same company with $52 and $122 per share, respectively).

100 Cf. Denison Mines v. Fibreboard, 388 F.Supp. 812, 821 (D.Del. 1974) (court noting reputation of Lehmann Brothers in the investment banking field).

101 Cf. Denison Mines v. Fibreboard, 388 F.Supp. 812, 821.

render a pro-management opinion and is trusted by shareholders[102].

To maintain credibility with courts and shareholders, investment banks merely need to avoid giving fairness opinions that cannot be reasonably justified. That is, the investment bank must not opine that an utterly unreasonable price is fair or that a price that is virtually certain to be the highest achievable is inadequate. If an investment bank frequently went outside the legitimate range of fair price, some of these cases might attract significant publicity. As a consequence, its reputation would decline so noticeably that courts and shareholders would give less weight to its fairness opinions. But as we pointed out in Section I, this limitation still leaves investment banks with a wide range of choices. If it can be done within this legitimate range, investment banks will seek to do whatever they can do for their clients, the managers, and render the most pro-management fairness opinion.

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[102] One might wonder why courts and shareholders do not pay closer attention to the reputation of investment banks. One reason why courts do not scrutinize reputation might be that legally admissable evidence will not yield a reliable picture of the reputation. Another possible reason is that all reputable investment banks give pro-management fairness opinions. Thus, it would not be possible for courts to denounce their behavior as different from the norm. It would be possible to criticize the behavior of the whole investment banking industry. However, such criticism might be perceived as less legitimate and would leave no investment bank whose behavior is faultless. Shareholders, of course, lack the incentives to acquire information about the reputation of investment banks because most of them own only a small fraction of all shares and because their vote is unlikely to make a difference.

2. Internal Procedures and Guidelines

It could also be argued that internal procedures and guidelines will assure that investment banks render unbiased opinions. Internal procedures and guidelines determine the internal standard for issuing fairness opinions. For example, some investment banks have established a committee within the bank that monitors the issuance of fairness opinions[103].

However, one of the main reasons[104] for establishing these procedures or guidelines is to insure that the agents of the investment bank, i.e. the individual bankers, act in the interest of the principal, i.e. the investment bank as a whole. Therefore if it is in the interest of the investment bank itself to render pro-management opinions, procedures and guidelines will direct the employees to act in accordance with this interest. Internal procedures and guidelines will thus tend to make the bankers write fairness opinions that increase the fees to be earned by

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[103] Shearson Lehmann Hutton has a committee that monitors all fairness opinions before they are issued. Private information.

[104] Another main reason is presumably to avoid legal liability for the fairness opinion. In that case, the procedures and guidelines reach as far as potential legal liability. But to establish liability shareholders must probably establish that the investment banker knowingly misrepresented the contents of a fairness opinion. See Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 128 (1986) (reviewing the standards for investment banker liability under both federal and state law). Even under a negligence rule, investment bankers would not be liable for a fairness opinion that can be reasonably justified.

the bank and help to retain and attract clients[105]. In order to have the bank maintain its professional reputation, guidelines and procedures would also try to assure that all fairness opinions have a reasonable basis[106]. And they might counteract the psychological and social biases individual bankers feel towards the managers. Psychological and social biases might lead bankers to issue pro-management opinions even when this is not in the bank's interest. However, within these constraints, procedures and guidelines will reinforce, rather than reduce, the incentives to render pro-management opinions that are created by the fee structure and the desire to retain and attract clients, as these incentives affect the interest of the bank itself, rather than the interest of individual bankers.

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105 The changing terms in fairness opinions might illustrate how guidelines can produce pro-management opinions. In mergers, fairness opinions conventionally state whether the terms are fair, i.e. within a range of values a reasonable prudent board would accept. In hostile tender offers, fairness opinions state whether the terms are adequate, i.e. whether better terms could be obtained. See Weiss, The Law of Take Out Mergers: Weinberger v. UOP, Inc. Ushers in Phase Six, 4 Cardozo L. Rev. 245, 256 (1983). Thus, the terms must generally be higher to be adequate than to be fair. The result of this convention is that terms that are fair in mergers, which the managers generally like to approve; are inadequate in hostile tender offers, which the managers generally do not like to approve. The lack of specific guidelines can also serve these purposes. Shearson Lehmann Hutton, for example, has no written guidelines and no fixed standards for issuing fairness opinions. Rather, each case is evaluated individually. Private information. This ad hoc approach would enable a bank, if it so desires, to conform the content of the fairness opinion to the wishes of the management.

106 For instance, Shearson Lehmann Hutton considers various measures of fairness before they issue a fairness opinion. Private information.

III. Recommended Judicial Approach

In this Section, we will recommend how to deal with the problems analyzed above. By following the recommended approach, courts would reduce both the discretion investment banks currently possess and the conflicts of interest they face. In Subsections A, B, and C, we will explain, respectively, how courts should scrutinize the definition of fairness, the measurement of fair price, and the banker/ company relationship. But, as we will show in Subsection D, even if courts employ the recommended approach, they should still exercise substantial residual caution in dealing with fairness opinions.

A. Scrutinizing the Definition of Fair Price

The natural way to attack the definitional problem is for courts to make explicit the definition of fairness investment banks should use in preparing fairness opinions, and for investment banks to disclose the definition they did use. Courts should recognize the conceptual confusion that surrounds the definition of fairness and try to build a system of definitions of fairness through precedents. These precedents will, over time, establish which definition of fairness should be used in which context. Even if these precedents will not eliminate all uncertainty about the proper definition of fairness, the range of definitions that are arguably proper in any one transaction will be significantly reduced.

In particular, courts should scrutinize the differing standards investment banks use in evaluating friendly and hostile deals. In friendly terms, the fairness opinion will be couched in terms of fairness, i.e. whether a rational board could accept the offer. In hostile deals, offers are evaluated in terms of adequacy, i.e. whether a higher offer could be obtained[107]. Unless courts conclude that these different standards are warranted, they should not give weight to the respective fairness opinions[108].

At the same time, courts should require investment banks to state explicitly what definition of fairness they used in preparing the fairness opinion. If they so desire, investment banks should be free to use several definitions of fairness. In that case, they should state under which definitions, if any, the price is fair, and under which definitions the price is unfair. For example, an opinion that the price in a merger is fair should not read that it is "fair from a financial point of view" but rather, for example, that the price is fair compared to the pre-merger announcement stock price and to the price the company

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[107] See Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 123 (1986).

[108] See also Weiss, The Law of Take Out Mergers: Weinberger v. UOP, Inc. Ushers in Phase Six, 4 Cardozo L. Rev. 245, 256 (In takeout mergers, fairness opinions should be framed in terms of adequacy not fairness).

would carry in an auction[109].

As investment banks explicitly state the definition of fair price they use, courts will know how much weight to give to the opinion. The weight courts give to a fairness opinion should depend on whether the definition used in preparing it conforms to the definition that is proper in the context. Thus, if the proper definition of fairness has been established, investment banks will know how to prepare a fairness opinion that will be given weight by the courts. But even if the proper definition has not been established before the opinion is rendered, courts would be able to judge to what extent the definition used deviates from the proper definition and then decide how much weight to accord to the fairness opinion.

It should be noted that this approach will impose virtually no additional costs. Investment banks will in any case know which definition of fairness they use in preparing their fairness opinion (and if they don't, they should). We would not require fairness opinions to use the definition of fairness set by the courts; nor would we require companies to obtain an opinion. If, however, a company decides to obtain a fairness opinion, the opinion should make clear which definition of fairness was used. Courts should make clear which definition of fairness they regard

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[109] One might wonder why investment bankers have not themselves clarified the definition of fair price they are using. One reason why the confusion has remained might be, as we suggested in Section II, that managers benefit from it: the less defined the concept of fair price, the higher the discretion to the investment bankers, the greater the opportunity to arrive at an opinion that satisfies them.

as relevant in order to enable companies to obtain a fairness opinion based on that definition. And they should give weight only to opinions using a proper definition of fairness.

B. Scrutinizing the Measurement of Fair Price

The measurement problem is harder to deal with than the definitional problem. Price estimates are inherently imprecise. Courts are not able, and should not try, to specify beforehand what assumptions investment bankers must make and what valuation techniques they must use[110]. Rather, courts should vary the weight given to fairness opinions depending on whether the opinions state a range of fair prices[111] and on how sensitive the fairness of the price is to the assumptions on which the opinion is based. Thereby, the fairness opinion will convey more information and the bank's discretion will be somewhat limited.

In determining whether a price is fair without giving a

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

111 Investment banks are often reluctant to specify numbers for fair prices. Chazen, Friedman & Feuerstein, Premiums and Liquidation Values: Their Effect oh the Fairness of an Acquisition, 11 Inst. On Sec. Reg. 143, 146. However, in some cases, they are apparently willing to give ranges of fair prices. See e.g. Kahn v. U.S. Sugar, (Slip Opinion, Del.Ch. 1985) (Bear Stearns giving price range).

range of fair price, the investment bank can base its opinion on assumptions that are barely reasonable. For example, if the reasonable range of fair merger prices is from $50 - $90 per share, the investment bank will have no difficulty in justifying a merger price of $55 as fair. But if the bank has to give a range of fair prices, it will become harder to make a bad deal look good. As assumptions will be more difficult to justify the more extreme they get, the investment bank could not come up with just any price range. Rather, the bank might, for instance, arrive at $50 to $70 as fair price range, signifying that the merger price of $55 is closer to the bottom of the range. With a lower price range, e.g. of $45 to $65, the bank might open itself up to attack as to why it made the fairly unreasonable assumptions that resulted in a $45 estimate, but did not make the fairly reasonable assumptions, that would have resulted in a $80 estimate. Directors would incur the risk of being censured for accepting a blatantly biased fairness opinion, and banks will incur the risk of gaining a reputation in court for rendering opinions that are without reasonable basis.

Analyzing the sensitivity of price estimates to assumptions will serve a similar purpose as giving a range of fair prices. In a sensitivity analysis, the analyst constructs a base scenario and then shows how the outcome of that scenario depends on the assumptions that were used in it[112]. Sensitivity analysis will

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[112] See generally Brealy & Myers, Principles of Corporate Finance (1984) at 195-202.

thus show by how much and in what direction the price estimates change as assumptions vary. Thus, it will become more evident what kind of assumptions one would have to make for a seemingly fair price to become unfair, and vice versa. Thus, a sensitivity analysis, like price ranges, will tend to show how fair or unfair a price is, not merely whether the price is fair or not.

Courts, in giving weight to fairness opinions, should consider whether the directors have been informed about the range of fair prices and the results of a sensitivity analysis. For example, if the directors approve a defensive measure, the fairness opinion should be given greater weight in judging whether the directors acted in good faith and with reasonable basis if they were informed that the hostile bid is significantly below the range of fair prices and would remain below such range even if certain assumptions were modified; and less weight if they are merely told that the price is inadequate; or that the price is in the middle of the range of fair prices, but not the highest fair price possibly obtainable; or that under assumptions the bank considers most reasonable the price is unfair, but under slightly different assumptions the price would be above the fair range.

Finally, courts should be willing to scrutinize the reasonableness of the assumptions and techniques[113] used to prepare the fairness opinion and the reasonableness of the

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[113] Cf. Kahn v. U.S. Sugar, (Slip Opinion, Del.Ch. 1985) (Court examining assumptions on which valuations were based).

directors' reliance on the opinion[114] when a specific opinion is challenged[115]. This, of course, requires that the investment banks, disclose to the directors and to courts the assumptions they made and techniques they used in rendering the fairness opinion[116].

However, even if all these steps are taken, the investment banks will retain significant discretion. Bankers can reasonably differ on the upper and lower limits of fair price ranges and on how to perform a sensitivity analysis. And courts will have to let directors rely on a variety of reasonable assumptions and techniques. Thus, the recommended approach will constrain, but not eliminate the ability of investment banks to manipulate the measurement of fair price.

C. Scrutinizing the Banker/ Company Relationship

As we showed in Section II, the nature of the relationship between the investment banker and the company creates conflicts of interest that make it likely for the fairness opinions to be

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114 See e.g. Hanson Trust PLC v. ML SCM Acquisition, 781 F.2d 264, 275 (2nd Cir. 1986) (directors have oversight obligations to become reasonably familiar with investment banker's report).

115 See also Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 134 (1986).

116 The proxy statements given to shareholders do generally not include the calculation the investment banks made in arriving at their fairness opinion. Chazen, Friedman & Feuerstein, Premiums and Liquidation Values: Their Effect oh the Fairness of an Acquisition, 11 Inst. On Sec. Reg. 143, 151.

biased in favor of management. Courts should reduce these biases by scrutinizing the investment banker/ company relationship. As a first step, courts should discount fairness opinions where any part of the bank's fee is contingent[117]. Fees that are contingent on issues other than the price eventually payable to the shareholders are especially suspect as they do not create any countervailing incentives to push the purchase price up. Some courts have realized that investment banks in such situations hardly fulfill the function of independent and objective advisors[118]. Most courts, however, have not expressed criticism of contingent fee arrangements[119].

One might retort that contingent fees have other efficiency properties that make their use desirable. In particular, contingent fees might provide better incentives to investment

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117 See also Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 133 (1986). The author would permit fees that are contingent upon improved offers by white knights or upon use of the opinion in disclosure statements because they do not impeach the bankers' independence. The ground for these exceptions is somewhat unclear. Investment banks that receive higher fees when a white knight makes an improved offer, but not when the original raider raises his offer, will hardly be neutral. Similarly, the content of an opinion would seem to influence the probability of whether the opinion will be used in disclosure statements.

118 See Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) (court, in opinion written by Judge Posner, commenting critically on the incentives created by a contingent fee).

119 Many opinions do not even mention that the investment bank received a contingent fee. See e.g. Cottle v. Storer Communication, 849 F.2d 570 (11th Cir. 1988) and Proxy Statement, Storer Communication, Inc., October 23, 1985, at 18 (court giving weight fairness opinion by bank to receive a fee of about $6 million contingent upon the consummation of the merger).

banks. For example, as we explained, fees that are contingent on the price which shareholders are paid for their shares will provide some incentives to increase the purchase price. Fees that are contingent on winning a proxy contest or on procuring a "White Knight" will provide better incentives than flat fees to assist in the proxy contest or to look for a "White Knight."

Investment banks will, however, remain free to be compensated on the basis of any fee arrangement to which they and the managers agree and can continue to use contingent fees when their use is efficient. We do not recommend that investment banks be prohibited from accepting contingent fees[120]. Courts should merely be aware of the conflicts of interest that contingent fees create and should accordingly discount fairness opinion substantially if the investment bank that renedered it stands to get a contingent fee.

It should also be noted that the asserted efficiencies do not relate to the issuance of fairness opinions; rather, the incentives created by contingent fees are desirable with respect to other services provided by investment banks. Thus, if managers want both a fairness opinion that is given greater weight and an investment bank that is compensated by contingent fees, they can hire a second investment bank to render a fairness opinion. In

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120 The position of public accountants is similar to the one of investment bankers. They are hired by managers in order to certify the books prepared under management supervision. It is interesting to note that accountants may generally not be compensated by contingent fees. Code of Professional Ethics for Certified Public Accountants, Rule 302.

doing so, they could maintain incentives to the bank in charge of the transaction without creating a conflict of interest for the bank in charge of the fairness opinion. But managers are also free to obtain a fairness opinion by a bank that received a contingent fee, which will be given less weight, or, for that matter, not to obtain any fairness opinion at all.

Hiring a second investment bank to render a fairness opinion, in particular one that is not involved in other aspects of the transaction and has had no longstanding relationship with the company, would also for other reasons be preferable to just eliminating contingent fees. As we pointed out, even non-contingent fees create incentives to render pro-management fairness opinions; pro-management opinions usually mean that there is more follow-up work on which the investment bank can earn profits. If, however, the investment bank that renders the fairness opinion is not in charge of other aspects of the transaction, it will not be influenced by the possibility that a particular fairness opinion would create more work. Furthermore, hiring a second "outside" investment bank will reduce the psychological and social biases to render a pro-management fairness opinion. A second investment bank will have more distance to the personalities and to the transaction and will thus be able to render a more neutral opinion.

Retaining a second investment bank just to render a fairness opinion will engender some economic costs. The second investment bank would, to some degree, have to duplicate the work done by the first investment bank. A second "outside" bank would also lack familiarity with the company and thus have to do more work to determine fair prices that an investment bank that already knows the company. A second bank might also be hard to find. By rendering a fairness opinion for a fairly small fee, the bank would disqualify itself from representing other potential bidders for the company and earning a significantly larger fee. Lastly, it might be regarded as unfair that the second investment bank, that earns only a small fee for rendering the fairness opinion, bears all the possible liability.

The extent of these economic costs should, however, not be exaggerated. The cost of the fairness opinion is often trivial in relational to the amounts involved in the transaction[121]. The concern about disqualification in representing an other bidder would seem to apply only to the hostile takeover context. An investment bank asked to opine whether a merger or a freeze-out price is fair would have little hope to be hired by a newly emerging bidder. Also, market forces would respond to concerns over disqualification. If they are really important, some specialized investment banks that only render fairness opinion and thus do not have to worry about disqualification would emerge. Lastly, investment banks will get compensated for

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[121] See e.g. Weinberger v. UOP, 457 A.2d 701, 704-706 (Del. 1983) (Lehmann Brothers charged $150,000 for its fairness opinion in a cash tender offer of over $90,000,000 which involved a premium over market price of over $30,000,000.)

potential legal liability by indemnification agreements[122] and by higher fees. In any case, the threat of legal liability will have positive effects as investment banks will exercise more care and neutrality in rendering fairness opinions[123].

D. Residual Skepticism

Even if the courts followed our recommended approach, they should still use caution in giving weight to fairness opinions. To be sure, the approach would address some of the problems, but, as we will explain, significant residual problems would remain. First, investment banks will still possess discretion in rendering fairness opinions. Although the recommended approach would do much to reduce the discretion rooted in the definition of fairness, investment banks will retain significant discretion in measuring fair price. Determining the probability distribution of uncertain future income streams, the value of assets that are not openly traded in the market, or the price a company would carry in an auction that is never held is inherently subjective and imprecise. Giving price ranges and performing sensitivity analyses would reduce these subjective elements, but will not

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[122] See e.g. Joint Proxy Statement, Crouse-Hinds Co. and Belden Corp., October 14, 1980, at 17; Joint Proxy Statement, Alleghany Corp. and Investors Diversified Services Inc., March 29, 1979, at 27 (investment banks to be indemnified for certain liabil

[123] Cf. Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 135 (1986) (advocating increased liability of investment banks).

magically transform a fairness opinion into an objective yardstick for the value of the company.

Second, the recommended approach will not eliminate incentives to render pro-management fairness opinions. The scrutiny we propose would reduce the conflicts of interest inherent in the fee structure, but not the incentives created by the desire to retain and attract clients. Even if the managers retain an investment bank that has had no prior dealings with the company and that is not involved in any other aspect of the transaction, the bank would still have an incentive to deliver an opinion that is more likely to result in the bank being rehired[124].

Third, even if these reputational incentives to render pro-management opinions were absent, the ability of management to select the investment bank could still lead to biased fairness opinions. Investment banking firms would probably differ in how they measure fair prices and in whether their estimates tend to come out high or low. For example, it might become known that some investment banks rely more on adjusted share prices, while others rely more on discounted cash flow analyses to determine fair prices. Managers would thus be able to select the investment banks whose approach in determining the fair price is most likely to result in the fairness opinion they desire.

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

Fourth, courts would have to remain aware that fairness opinions are, in part, based on information provided by the managers themselves, such as the managers' opinions about future business prospects[125] or internal profit forecasts[126]. Managers will obviously have an incentive to provide the bank with the kind of information that will lead it to render a pro-management opinion[127]. Investment banks generally do not verify the information they receive in preparing their opinion[128]; rather, they premise their opinions on the assumption that the information given to them was accurate and complete[129]. For that

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125 See e.g. Joint Proxy Statement, Crouse-Hinds Co. and Belden Corp., October 14, 1980, Exhibit C and D (Both investment banks, in preparing their fairness opinions, held discussions with management about future business prospects).

126 See e.g. Joint Proxy Statement, Alleghany Corp. and Investors Diversified Services, Inc., March 29, 1979, Annex III (Merryl Linch using internal forecasts in developing its fairness opinion).

127 One commentator has proposed that directors should be under a duty to convey accurate information to investment banks. See Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L. J. 119, 134 (1986). Such a rule might prevent outright lies, but not more subtle forms of providing biased information.

128 Investment banks generally do not verify the information they receive. See e.g. Joint Proxy Statement, Crouse-Hinds Co. and Belden Corp., October 31, 1980, Exhibit C and D; Joint Proxy Statement, Alleghany Corp. and Investors Diversified Services Inc., March 29, 1979, Annex III and IV (no independent verification of information provided by the company); see also Denison Mines v. Fibreboard, 388 F.Supp. 812, 822 (D.Del. 1974) (Investment bank relied on management valuation of timber assets and did not conduct an independent evaluation).

129 See e.g. Joint Proxy Statement, Crouse-Hinds Co. and Belden Corp., October 31, 1980, Exhibit C and D; Joint Proxy Statement, Alleghany Corp. and Investors Diversified Services Inc., March 29, 1979, Annex III and IV.

reason as well, fairness opinions will remain biased towards the interests of the managers.

In light of these residual problems, the question arises whether courts, rather than making the weight given to fairness opinions dependent on a variety of factors, should not just attribute no weight to any fairness opinion. But, for all their problems, fairness opinions also have a positive potential. Even though investment banks will have some discretion, many prices will clearly fall inside or outside the reasonable price range and will thus have to be found fair or unfair. And even though investment banks will have an incentive to develop a pro-management reputation, they cannot be too blunt about it, otherwise they would lose credibility with the courts. To be sure, one cannot be certain whether these benefits of fairness opinions warrant their costs. But fairness opinion have at least the potential for serving a useful function.

IV. Conclusion

The purpose of this paper has been to analyze systematically the problems arising from reliance on fairness opinions and to put forward a recommended approach as to how courts should treat such opinions. Investment banks have both discretion in rendering fairness opinions and face conflicts of interest which lead them to exercise their discretion to render pro-management opinions. The discretion of investment banks derives from two sources.

First, the concept of fair value is not clearly defined; thus, banks can choose among several proposed definitions of fairness. Second, due to the subjective nature of the estimation process, banks will have discretion in measuring fair price, however defined.

Several factors contribute to the incentives to render pro-management fairness opinions. For one, by rendering a pro-management opinion, the investment bank will ordinarily receive higher fees. Such opinions make it more likely to receive the contingent portion of the fee or, where the bank does not receive a contingent fee, generate more work on the transaction. Furthermore, rendering pro-management fairness opinions will help to retain and attract clients. These economic incentives are enhanced by psychological and social loyalty some bankers might feel towards the managers. Neither the desire to preserve a professional reputation with courts and shareholders nor internal procedures and guidelines will not significantly reduce this problem.

To deal with the problems of discretion and conflicts of interest, we recommend an approach as to how courts should scrutinize the definition of fair price, the measurement of fair price, and the banker/ company relationship. First, to reduce the discretion rooted in the definition of fair value, courts should develop a definition of fair price which they regard as proper; and investment banks, in turn, should disclose the definition of fair price on which their opinion is based. Second, to reduce the discretion in measuring fair prices, the weight given to fairness opinions should depend on whether the opinion contains information on the range of fair prices and on the sensitivity of the price estimate. Third, fairness opinions should be appropriately discounted where the investment bank is compensated by a contingent fee, where it is involved in other aspects of the transaction; this will reduce incentives to render pro-management opinions. Lastly, since the recommended approach would only reduce and not eliminate discretion and incentives, courts should still exercise significant residual caution in dealing with fairness opinions.