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Fairness Opinions: Are They Fair or Should We Care?

“Mirror, mirror on the wall, Who is the fairest of them all?”

CHARLES M. ELSON*

Following the Delaware Supreme Court’s landmark ruling in Smith v. Van Gorkom,\(^1\) investment bankers’ fairness opinions have become almost as ubiquitous a part of the American financial landscape as fast food is to the American highway. Although certainly a popular tool for corporate directors seeking justification and insulation from liability for certain business decisions prior to Van Gorkom, fairness opinions have, since that ruling, become a necessary element in all sorts of corporate control transactions, including tender offers, mergers, sales of assets, stock repurchases, and leveraged buyouts.\(^2\) As the numbers of these opinions have proliferated, so has the revenue they produce for the large investment banking houses. Frequently the opinion is issued in conjunction with a number of other services the bank renders in connection with a control transaction. Fees for these activities have escalated significantly in recent years and can well exceed many millions of dollars.\(^3\) As the significance of the wealth transfers to the banks that these fairness opinions occasion has increased, so have the demands for bank liability and accountability from those groups of securities holders whose actions these opinions are designed to influence. If the banks are to receive such large fees for their services, the holders argue, should they not then be held accountable to the holders for inaccuracies contained in their opinions?

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1 488 A.2d 858 (Del. 1985).
3 See infra note 51 and accompanying text.
Traditionally, bank liability for misstatement or omissions was as difficult for a holder to obtain as winning the state lottery. Because these opinions were generally addressed to the company’s board of directors, the holders had no contractual action against the banks. Under a similar privity doctrine, an action grounded in tort was also unavailable. The holder’s only recourse was under the federal securities laws which the courts interpreted as requiring proof of scienter for liability for misstatements—certainly no easy task. If a fairness opinion was inaccurate, unless some sort of “evil” intent was demonstrated, the shareholder was out of luck.

Recently, however, on the basis of several court rulings, the tide may be turning in the shareholders’ favor. In a widely publicized and highly controversial 1987 case, Wells v. Shearson Lehman/American Express, Inc., a New York court, by liberalizing notions of privity, revived the once moribund state law tort of negligent misrepresentation and decreed its application to suits by shareholders for inaccuracies contained in investment bank fairness opinions. Other courts soon followed suit and momentum began to develop judicially for a new negligence standard of liability for fairness opinions. A lower standard of liability, of course, means a greater shareholder rate of success in actions brought on inaccurate opinions. The reasoning, put most simplistically, would seem to be that if the banks are paid huge fees to form opinions that act to insulate corporate directors from liability and have reason to know that others, obviously the shareholders, will rely on their opinions in deciding what action to take regarding corporate control transactions, then the opinion renderers should, as de facto “insurers,” be willing to stand behind their opinions. If they are wrong, they should pay. Such a regime would produce a strong deterrent effect and lead to better and more accurate opinions.

This argument for extending liability, though having a seeming moral and logical appeal, is fatally flawed. It will lead to judicial confusion, increased transaction costs and unfortunately, fairness opinions of dubious value that will provide no better basis for informed shareholder action than before. This Article will critique this new standard on economic and juridical grounds. It will suggest that no extension of liability is warranted.

The solution to the perceived problem of innocent shareholders relying to their detriment on inaccurate fairness opinions lies not in holding the bankers liable. The entire process of “independent” valuation is inherently suspect. Fairness opinions, this Article will argue, are inherently unfair. No process or

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4 See infra notes 81–132 and accompanying text.
judicially created liability scheme can make them “fair.” Structural considerations inherent in the way these opinions are formed prevent accurate valuation. Only the marketplace can determine what price is “fair” and what is not.

Indeed, the whole concept of price “fairness” is in and of itself a misnomer. There is really no such thing as a “fair” price. Fairness in the financial context is a fundamentally elusive concept. What to one person is an asset of great monetary value may to another be utterly worthless. Value is simply at what price level one individual, given all the facts necessary to permit an informed decision, is willing to buy or sell a particular asset at a particular point in time. In the broader sense, that is exactly what the marketplace itself does when it is asked to value a business. If the price offered is acceptable to them, the market participants will act. Their acceptance of a particular price demonstrates that they felt that the price was “fair” to them at that given point in time. Is this action determinative of fundamental fairness? No. There is in financial valuation no such thing as “fairness”—only price acceptability. This is the entire problem with judicial concern over price “fairness.” Fairness is simply individual price acceptability—it is not capable of uniform definition or application—at least not in the financial context. The price that market participants are willing to accept will vary with time and circumstance. The perceived, and judicially supported, “requirement” of a fairness opinion is thus unwarranted and only leads to increased transaction costs that are ultimately borne by the shareholder with no corresponding benefit. Fairness opinions exist, not as an aid to shareholder decisionmaking, but only as an insulator of director liability. Consequently, they should no longer be considered by the courts as an integral part of a prudent director’s decisionmaking process in a corporate control transaction. They do not result in the protection of shareholder wealth. The market is the best arbiter of acceptable value and protector of shareholder interests, not an investment bank retained by and beholden to the board of directors. Liability must follow economic reality—economic reality must not precede liability.

Part I of this Article discusses the composition of the fairness opinion itself. It examines the ever-fluctuating processes for determining “fair” value and the historical importance of such evaluations to a variety of financial transactions. It discusses the problem of “independent” evaluation when investment banks operate in a practical environment in which such independence is structurally virtually impossible.

Part II examines the traditional liability imposed on investment banks by the federal securities laws for inaccuracies contained in fairness opinions. It then examines the historical evolution of the tort of negligent misrepresentation and how the liberalization of notions of privity led first to its application to accountants for misstatements in audited financial statements and then, rather
logically, to another group of independent arbiters of value—investment bankers.

Part III critiques this new development on economic and juridical grounds. It argues that application of a negligence standard of care to these opinions, from an economic standpoint, will lead to more expensive and less informative opinions. The reduction in available information will lead to a less informed shareholder universe. Additionally, from a juridical standpoint, when so many accepted alternative valuation processes exist, each yielding widely differing results, it will be almost impossible for a court to formulate the “reasonable investment banker” standard necessary to determine either negligent conduct or the lack thereof. A rigid standard may lead a court to find either universal negligence or universal reasonable conduct—certainly an undesirable and unproductive result. Thus, this section concludes that the imposition of “negligence” liability on banks for improperly drawn fairness opinions by way of the tort of negligent misrepresentation is an ineffectual and even counterproductive process.

Finally, Part IV recommends a more equitable and economically sound approach to fairness opinions. Rather than attempting to define some rigid standard for the production of such opinions, which, as Part I argues, is a futile effort in any event, the “requirement” and consequent negligent liability standard should be abandoned entirely and market forces themselves be employed to evaluate “fairness.” This will not, of course, eliminate the use of the fairness opinion entirely, but will result in the information contained therein being available to the market at a lower cost, which investors may accept or reject as they see fit—which probably occurs anyway under the present regime, but because of liability concerns, at exorbitant prices.

I. THE VALUATION PROCESS

Under the business judgment rule, a corporate board of directors is protected from liability to the company’s shareholders for a detrimental business decision if that board can demonstrate that the decision was made in good faith, in an informed manner and was rationally based. Generally, the

7 See, e.g., Aronson v. Lewis, 473 A.2d 805 (Del. 1983), in which the Delaware Supreme Court described the business judgment rule as:

a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest . . . of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.
critical question today before a court considering whether to afford a board the protection offered by the rule concerns whether that board was properly “informed” in making the decision at issue. To meet this “informed” requirement, a board is entitled to rely on the opinions of a varied collection of business “experts” as to matters the directors reasonably believe to be within their professional competence. 8

Considered to have expertise in financial valuation, 9 investment bankers have for years been called upon by corporate directors to render advice

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Id. at 812 (citations omitted). Illustrating a shift in the business judgment rule from a judicial composition to a legislative codification is The American Law Institute—Principles of Corporate Governance which reads, in pertinent part:

(c) A director or officer who makes a business judgment in good faith fulfills his duty under this Section if:

(1) he is not interested ... in the subject of his business judgment;
(2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and
(3) he rationally believes that his business judgment is in the best interest of the corporation.


8 The American Law Institute—Principles of Corporate Governance states:

In performing his duty and functions, a director or officer who acts in good faith, and reasonably believes that his reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other financial data), decisions, judgments, and performance ... prepared, presented, made, or performed by:

(a) One or more directors, officers, or employees of the corporation, or of a business organization ... under joint control or common control ... with the corporation, who the director or officer reasonably believes merit confidence; or
(b) Legal counsel, public accountants, engineers, or other persons who the director or officer reasonably believes merit confidence.


concerning the financial appropriateness of various kinds of corporate control transactions. In rendering such advice, usually in the form of a “fairness opinion,” which is generally a short letter to the board opining that the transaction is “fair” from a financial standpoint, the banker acts to aid the

to rely on Salomon Brothers for “expert financial advice” on fairness of merger price valuation).

An illustrative and rather typical example of such was that rendered by the bankers engaged to evaluate the fairness of the RJR/Nabisco leveraged buyout. Lazard Freres and Dillon Read each produced fairness opinions. The language of the two opinions is identical:

Gentlemen and Madam:

We have acted as financial advisor to the Special Committee of the Board of Directors of RJR Nabisco, Inc. (the “Company”) in connection with its review of recent proposals to acquire the Company. In connection therewith, you have requested our opinion as to the fairness, from a financial point of view, of the consideration to be received by holders of common stock without par value ("Common Stock"), including the Associated Preferred Stock Purchase Rights, and Series B Cumulative Preferred Stock without par value ("Series B Preferred Stock") of the Company in connection with the proposed acquisition (the "Acquisition") of the Company by RJR Holdings Corp. ("Holdings"), a corporation organized by Kohlberg Kravis Roberts & Co. . . .

In arriving at our opinion, we have, among other things: (i) reviewed the terms of the Acquisition and of the acquisition proposals received from a group organized by certain members of the management of the Company, Shearson Lehman Hutton, Inc. and Salomon Brothers Inc., and a group organized by The First Boston Corporation and Resource Holdings Associates, (ii) reviewed certain business, and historical financial, information relating to the Company, (iii) reviewed certain financial forecasts and other data provided to us by the Company relating to the business and prospects of the Company, (iv) conducted discussions with members of the senior management of the Company with respect to the business and prospects of the Company, (v) reviewed publicly available financial and stockmarket data with respect to certain other companies in lines of business we believe to be generally comparable to the Company, (vi) reviewed the historical market prices and trading volumes of the Common Stock and the Series B Preferred Stock and of certain other securities, (vii) reviewed the terms of certain recent acquisition transactions, including business combinations, which we believe to be generally comparable to the Acquisition, (viii) conducted discussions with Holdings and certain of its financial advisors and financing sources with respect to the Acquisition, (ix) reviewed current market conditions, including the markets for securities comparable to the Exchangeable Preferred Stock and Converting Debentures, and (x) conducted such other financial studies, analyses and investigations, and considered such other information, as we deemed necessary or appropriate.

We have relied upon the accuracy and completeness of the financial and other information regarding the Company provided to us, and have not independently verified any such information. With respect to the financial forecasts referred to above, we have assumed that they have been reasonably prepared on bases reflecting the best currently
directors in meeting the requirement that the board acted in an informed manner. Once this requirement has been met, provided the other two steps of the business judgment rule have been complied with, the Board is protected from liability to the company's shareholders no matter how disastrous the decision turns out to be.

Investment banks have been providing this liability-precluding "advice" for a number of years and courts have been receptive to the concept. The use of available estimates and judgements of the Company's management as to the future financial performance of the Company. In addition, we have not made any independent evaluation or appraisal of any of the assets or liabilities (contingent or otherwise) of the Company. Further, our opinion is based on economic, monetary and market conditions existing on the date hereof.

Based upon and subject to the foregoing, it is our opinion that as of the date hereof, the consideration to be received in the Acquisition is fair, from a financial point of view, to the holders of each of the Common Stock and Series B Preferred Stock.

Very truly yours,

Lazard Freres & Co./Dillon Read


See, e.g., Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir. 1981) (reliance on outside experts including investment banker a factor in finding that directors satisfied business judgment rule), cert. denied, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980) (fairness opinion evaluating merger proposal a significant indicator of directors' good faith); Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 694 (2d Cir. 1980) (noting defendant's reliance upon financial analyst in denying plaintiff's claim that directors acted in bad faith); Kors v. Carey, 158 A.2d 136, 141 (Del. Ch. 1960) (reliance on outside experts element in finding lack of misconduct); Alpert v. 28 Williams St. Corp., 473 N.E.2d 19, 27 (N.Y. 1984) (fairness opinion may comprise good proof that freeze-out price is fair); Danziger v. Kennecott Copper Corp., N.Y. L.J., Dec. 7, 1977, at 7, cols. 1-2 (N.Y. Sup. Ct. Dec. 5, 1977) (retention of independent financial analyst's advice prior to launching tender offer significant factor in determining that directors fulfilled fiduciary duties). Commentators have also noted the prevalent use of fairness opinions. Professor Chazen has stated:

Fairness opinions have become so much a part of the routine of public company acquisitions that today the absence of such an opinion . . . would probably raise eyebrows . . . An investment banker's opinion on financial fairness may be influential with a court which reviews the fairness of the acquisition [and] . . . a fairness opinion may protect the acquired company[']s directors against a lawsuit charging that they failed to exercise reasonable business judgment when they approved the acquisition.
such expert advice aids a court in its determination that the directors have met
their fiduciary responsibilities. Of course, directors also use these opinions to
aid their efforts to achieve shareholder support for their actions, but the
primary goal appears to be liability limitation.

Although the use of fairness opinions in various forms of corporate control
transactions was not infrequent prior to 1985, following the Delaware Supreme
Court's expansive ruling in Smith v. Van Gorkom in March of that year, such
reports essentially became a legal necessity. Although the court explicitly stated
in that case that fairness opinions were not "required as a matter of law," still
the fact that the court imposed liability on a board which failed to obtain such
an opinion and indicated that procurement of such an opinion would have
insulated the directors from liability, suggested the imposition of an informal
"requirement." In short, the use of such an opinion would have supported a
finding of the board's informed business judgment which was necessary to
preclude liability. Thus, following Van Gorkom, prudent corporate counsel
mandated the acquisition of a fairness opinion in corporate control transactions

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12 See Bebchuk & Kahan, supra note 2, at 28; Bevis Longstreth, Fairness of
([F]airness opinions... are much more effective in protecting management than in
assuring the shareholder 'the most scrupulous inherent fairness of the bargain.'

13 See Id. at 876-78; see also Dennis J. Block and Jonathan M. Hoff, Investment
Banker Opinions and Directors' Right to Rely, N.Y. L.J., Nov. 17, 1988, at 5; Giuffra,
supra note 12, at 119-20; Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (board's reliance
on advice of investment banker aided finding of good faith and reasonable investigation);

14 488 A.2d 858 (Del. 1985).

15 Id. at 876.

16 See Id. at 876-78; see also Dennis J. Block and Jonathan M. Hoff, Investment
Banker Opinions and Directors' Right to Rely, N.Y. L.J., Nov. 17, 1988, at 5; Giuffra,
supra note 12, at 119-20; Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (board's reliance
on advice of investment banker aided finding of good faith and reasonable investigation);
as a vital prophylactic measure for the board. It is therefore not surprising that
the number of opinions rendered proliferated.\footnote{See Giuffra, supra note 12, at 119, 120. Professor Fischel, commenting on the Van Gorkom ruling shortly after its announcement, wryly commented that the “outside consultants are the biggest winners after [Van Gorkom]. The decision requires their participation as a type of insurance no matter how worthless their opinion is or how much it will cost.” Daniel R. Fischel, The Business Judgment Rule and the Trans Union Case, 40 BUS. LAW. 1437, 1453 (1985).}

If the fairness opinion is to provide the necessary “back-up” to a board’s
decision, the process by which that opinion was formed must necessarily be
well-reasoned and honestly and properly performed. The processes for
determining fair value are varied, however, and structural factors implicit in the
environment in which investment banks operate, impact on the degree of
“fairness” of any opinion rendered.

In the fairness opinion formulation process, investment bankers are called
upon by corporate boards to opine as to the fairness, from a financial point of
view, of a given transaction that the board desires to approve. If a uniform
definition of fairness or a uniformly accepted process for testing and
determining fairness existed, the bankers’ task would be relatively
straightforward and criticism of any deviation from that definition or process
would be easily formulated. As a number of commentators have noted,
however, no such uniform approach exists. Critiques of the varied approaches
to valuation are as numerous as the techniques themselves.\footnote{See Richard B. Schmitt, If an Investment Bank Says the Deal is Fair, it May or May Not Be, WALL ST. J., Mar. 10, 1988, at 1, 11. See infra notes 30–45 and accompanying text for a discussion of various valuation techniques and their deficiencies.}

The first problem, as Professors Bebchuk and Kahan have pointed out, is
definitional. There exists “conceptual confusion about the definition of fair
price.”\footnote{Bebchuk & Kahan, supra note 2, at 30.} No person nor court has formulated a precise, uniform definition of fair price. What is “fair” definitionally, varies from transaction to transaction. How one defines fairness in one transaction will greatly affect what price may be considered fair in another. The professors pose the hypothetical of a company being faced with a purchase offer. Depending on whether the proposed acquisition is to be a simple merger or friendly or hostile tender offer, a number of definitions have been proposed as to what would constitute a fair price for the business. Fair price may be the value of the company continuing to operate independently, the value as reflected by the price to be received if the business is sold in competitive auction to the highest bidder, or even the “value that bilateral, arm’s-length bargaining would yield.”\footnote{Id. at 31.} And, depending on the type of transaction contemplated—whether friendly or hostile—a crowded field or only one interested acquirer, a company “going
private” or auctioned to an outside interest, any one of these definitions may be arguably appropriate. In fact, a reasoned argument may be made for an application of any of the three separately or in combination. Unfortunately, depending on the definition used, the price deemed “fair” may vary significantly. Investment banks are certainly aware of this confusion and are given wide latitude in their choice of definition. Indeed, in the opinions themselves, the bankers frequently offer little clue as to what definition has been used to arrive at their conclusions; they simply speak only to the adequacy or inadequacy of price.

This definitional confusion is not limited to the board and bank’s valuation process but is a problem courts themselves have struggled with in valuing companies. There is no agreement as to how a company is valued in the context of a minority exercising its statutory appraisal rights. In *Piemonte v. New Boston Garden Corp.*, the Massachusetts Supreme Judicial Court approved a valuation of the Boston Garden Arena Corporation which was a weighted averaging of several separate methods of valuing a corporation: market value, earnings value, and net asset value. The Delaware Supreme Court in *Weinberger v. UOP, Inc.*, however, rejected a strict weighted averaging of value factors including assets, market price, and earnings, in favor of a “more liberal, less rigid and stylized approach.” The court recognized the “proof of value by any technique or methods which are generally considered acceptable in the financial community.” Neither decision provides a clear definition of value. No precise formula for determining relative weighing values is articulated by the Massachusetts court, and in the case of Delaware, there exists a multitude of techniques acceptable within the financial community for ascertaining values—all of which may yield radically different results.

Even if one universal definition of fairness may somehow be formulated and uniformly applied to valuation inquiries, the problem of inconsistent valuation still remains. There is no consistently accepted process for valuation and, consequently, the investment banking industry has no established uniform

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21 Chazen, *supra* note 9, at 1443–50.
22 Bebchuk & Kahan, *supra* note 2, at 34; see also Schmitt, *supra* note 18, at 1 ("Fairness can be subjective . . . . The approach can be massaged so it supports the desired result.").
23 *See supra* note 10 for a typical fairness opinion.
26 457 A.2d at 704.
27 *Id.* at 713.
procedure for valuing a company in the context of a fairness opinion. There are a number of procedures available to measure the value of an individual corporation each, unfortunately, yielding differing results. While the methods of valuing companies are as varied as the companies themselves, certain general classifications may be made. Specifically, four differing forms of valuation analysis are most commonly utilized.

The four methods include: discounted cash flow analysis, evaluation of comparable companies, evaluation of comparable acquisitions, and liquidation value. Although there are arguable merits to each method, it has been suggested that any proper valuation analysis should utilize a combination of some or all of these approaches, as “no single method of evaluating companies is entirely correct or truly comprehensive.”

The first, and widely perceived as the most prevalent, of the valuation methods is discounted cash flow analysis (“DCF”). DCF analysis generally involves the calculation of the net present value of the cash flows generated by

28 See, e.g., Giuffra, supra note 12, at 137. Providing an illustrative contrast are the generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP) that establish definitive measures governing accountants’ rendition of audits and other services. The rules provided by GAAS and GAAP set out normative standards against which the competence and reliability of accountants’ efforts and output may be judged. Investment bankers, however, are not constrained by any established industry norms governing the rendition of fairness opinions in corporate control contexts.


30 See, e.g., KUHN, supra note 9, at 97–123 (including book value and break-up analysis, as well as numerous qualitative evaluators); Michael W. Martin, Note, Fairness Opinions and Negligent Misrepresentation: Defining Investment Bankers’ Duty to Third-Party Shareholders, 60 FORDHAM L. REV. 133, 139–41 (1990) (listing break-up analysis as a fifth method); Arthur H. Rosenbloom & Arthur H. Aufses III, On Understanding Investment Banker Liability, 4 INSIGHTS, Apr. 1990, at 3, 4; Brian H. Saffer, Touching All Bases in Setting Merger Prices, Mergers & Acquisitions, Fall 1984, at 42 (concisely analyzing the strengths and weaknesses of the four techniques).

31 Saffer, supra note 30, at 42. As Professor Kuhn has noted:

Experience proves that no single method of valuing acquisition targets is always proper or truly comprehensive. The M&A process occurs in the real world when multiple forces interact on so many levels as to almost defy analysis; M&A is not sheltered by the highly stylized, well-controlled, idealized models of academics and computer programmers.

KUHN, supra note 9, at 98.
the operation of a business entity.\textsuperscript{32} The operational rationale behind the utilization of this method of valuation is that “anything is worth what it can earn.”\textsuperscript{33} Basically, in determining how much a company is worth by using this approach, an analyst will first make projections for a five to ten year period of the earnings and cash flow of the particular business. The analyst will then determine the business’s value at the end of the projection period, followed by a determination of the risk characteristics of the business and proper discount rate to be applied to the valuation. Finally, the process concludes with the actual computation of DCF values.\textsuperscript{34}

Unfortunately, it is the very essence of this process that constitutes the deficiencies evident in a DCF analysis. Primary among the shortcomings of this approach is the necessity for numerous and highly subjective forecasts and projections that must be made by the analyst.\textsuperscript{35} These include predictions regarding future discount and tax rates, industry and market vitality, future interest and inflation rates, and assumptions about the company’s unrealized future prospects.\textsuperscript{36} A slight adjustment to any of these core projections by the

\begin{itemize}
  \item Net present value (NPV) essentially equates the difference between expected outlays and the discounted present value of a target’s anticipated cash flows. See Kuhn, supra note 9, at 100. For a discussion of NPV principles, see Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 12-24 (net present value foundations), 29-33 (net present value calculation) (3d ed. 1988).
  \item Saffer, supra note 30, at 42. Indeed, the future-oriented outlook and intrinsic focus on an entity’s earning power furnished by DCF analysis is a principal advantage of this valuation method over older techniques that concentrate instead on historical based information, such as past earnings and market values. See generally Edward E. Shea, Modern Business Valuation Methods, Prac. Law., Oct. 1988, at 67, 69-71.
  \item Giuffra, supra note 33, at 76-79 (illustrating DCF mechanics). For a concise analytical study of DCF analysis as applied to the valuation businesses, see Brealey & Myers, supra note 32, at 62-66.
  \item “DCF can be precise (i.e., replicable) without being accurate (i.e., not conforming to reality).” Kuhn, supra note 9, at 101. The mutable nature of DCF inputs is not considered problematic in the context of everyday business transactions, such as capital budgeting decisions, because the analyst making the necessary assumptions is interested in obtaining an accurate figure and will utilize only factors of the highest quality. Outside of the ordinary business setting, however, the existence of any such inherent impetus for probity on the part of the analyst is questionable. See CEDE & Co. and Cinerama, Inc. v. Technicolor, No. CIV.A.7129, 1990 WL 161084, at *8 n.17 (Del. Ch. Oct. 19, 1990) (noting inherent veracity of DCF inputs in ordinary corporate decisions as compared to differing motivations underlying projections generated for litigation).

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analyst may substantially alter the ultimate valuation. Another problem with DCF analysis is that it may ignore other external economic forces that the market may be using to evaluate a particular investment, such as the idiosyncratic appeal of the entity to certain investment groups including corporate raiders or synergy-seeking business entities.

Another valuation method used by financial analysts involves comparing the business to be valued with companies possessing similar financial and operational profiles. The evaluator will examine the financial ratios of comparable businesses to obtain a range of reasonableness within which to bound the proposed value of a given entity. This method is based upon the theory that companies that look and operate alike are likely to be similar in value. The difficulty in propitiously using this technique, however, is finding a company or companies that effectively compare with the enterprise to be valued. Inevitably, some manipulation of the comparison business may be necessary to effectuate the analysis. This process, quite obviously, suffers from the same problems of subjectivity and uncertainty that accompany the DCF valuation procedure discussed earlier.

Another commonly used valuation technique is the comparable acquisitions method of analysis. Similar in rationale to the comparable companies valuation method, this technique focuses on measuring value through an examination of current acquisitions market forces. The assumption underlying this approach is that the acquisitions market is a "true reflection of the market interaction of willing buyers and willing sellers" and will thus provide valuable insight into the evaluated company's actual value. Unfortunately, the valuation judgments made by the market in other acquisitions are not always helpful in establishing the actual value of the business to be evaluated. The market will sometimes reflect "aberrations" involving an unusually low valuation caused by a comparable entity's distress sale, or "faddish buyer interests" bidding up a


40 Saffer, supra note 30, at 43.
comparable company’s price.\textsuperscript{41} Also, it is difficult to find truly comparable acquisitions. Few industries generate the sufficient number of transactions required to provide a representational cross-section relatively free of the influence of “aberrational” forces.

Still another widely used valuation technique, liquidation analysis, entails determining what a concern’s assets can be sold for in an orderly manner, the resulting surplus or shortfall, above or below liabilities comprising value.\textsuperscript{42} The apparent strength of this method is its reliance upon existing, quantifiable assets and liabilities. Its most striking flaw, however, is its inability to build into its valuation estimate the effect on value that the future earnings potential of a company and the management talent available to the operation may have.\textsuperscript{43}

Although the above discussed four valuation methods are commonly used, they are broadly classified and are by no means exclusive. A dizzying array of differing approaches to valuation involving combinations, in no particular uniform manner, of net asset value, past earnings multiplies, dividend payments, and share price are commonplace.\textsuperscript{44} In any event, most commentators agree that any valuation study should utilize several of the valuation methods discussed above or perhaps even a weighted average of the most common four.\textsuperscript{45}

As there has yet to emerge any consensus on the best method of valuing a business and the only consensus to result is that a blend of approaches may be best, the investment banker may use any of these methods without fear of violating recognized industry norms. Considering the vast numbers of combinations possible and the fact that each approach may yield “different ranges of values”\textsuperscript{46} a bank is confronted with the prospect of opining to the fairness of any number of values based on its valuation process. This fact suggests that a bank has the ability to be “offered” a conclusion as to value by a board seeking a finding of being properly informed, and, by using the right combination of valuation methods, may then create a process to justify the

\footnotesize{\begin{itemize}
\item \textsuperscript{41} Id. “[T]he M&A market often evinces aberrations—companies selling too low when suffering distressed conditions . . . and companies selling too high when faddish or foolish buyers are over-eager to acquire.” KUHN, supra note 9, at 104.
\item \textsuperscript{42} Saffer, supra note 30, at 43; KUHN, supra note 9, at 106–107.
\item \textsuperscript{43} Saffer, supra note 30, at 43.
\item \textsuperscript{44} See Bebchuk & Kahan, supra note 2, at 34–35 (listing assorted valuation approaches).
\item \textsuperscript{45} See, e.g., KUHN, supra note 9, at 98–99 (“It is a fundamental error not to employ multiple methods to assess valuation and price.”); Giuffra, supra note 12, at 138–39 (proposing liability for investment banks’ failure to utilize all four of the discussed methods).
\item \textsuperscript{46} Rosenbloom & Aufses, supra note 30, at 3. “[T]he range of fairness is too great to expect opinions to be a very good indicator of what a fair deal for shareholders might be.” Longstreth, supra note 13, at 19.
\end{itemize}}
preferred conclusion. A number of commentators have criticized this ability, suggesting that it creates the prospect of "fairness for hire." Indeed as one observer has commented, "the approach can be massaged so it supports the desired result." Theoretically, because the banks are independent entities with a strong motivation to maintain a reputational integrity that is bolstered by a perceived independence from their clients, this potential for abuse does not have to be realized. Structural factors, however, inherent in the way the investment banking industry functions, counterbalance any protection reputational concerns may provide. Conflicts of interest abound to threaten a bank’s independence from its clients.

Investment banks are, above all, entities formed to create profits for their investors. They are not governmental or philanthropic entities established for promoting the common welfare. Their sole motivation is economic. Either they produce monetary profits or they cease to function. The greater the profit produced, the better for their owners. Like any other profit-minded enterprise, the more the banks “sell,” the greater their return (and the happier the owners). It is this fundamental fact of their existence that creates the conflicts of interest that prevent any real independence from their clients and any truly objective analysis and evaluation of the “fairness” of their clients’ transactions.


48 Schmitt, supra note 18, at 1.

Fairness opinions also are something a client can hide behind. When Amsted Industries Inc. officials were seeking support for a proposed 1986 leveraged buy-out, they trotted out a Salomon Brothers fairness opinion in proxy materials. What shareholders didn’t see, however, was a Goldman Sachs estimate putting the value of the company as much as $100 million more than the management offer. Id. “Investment bankers do on occasion decline to render fairness opinions satisfactory to management. But this is more the exception than the rule.” Longstreth, supra note 13, at 19. See also Clinton A. Stuntebeck & Wayne M. Withrow, Fairness Opinions Should Offer More Detailed Financial Analyses, NAT’L L.J., June 13, 1988, at 22-23.

When a corporation’s management takes a company private through a management buyout (MBO), the buyout group will engage investment bankers to opine as to the fairness of the price it is offering to the corporation’s shareholders as a matter of course. Commentators have taken a dim view of such actions, especially when the resulting private company’s value is far in excess of the price paid. “There have been several MBOs where the value gap between what management paid and what they shortly realized was shocking . . . . A ‘fairness opinion’ that underestimates realized value by 80 percent is perhaps the newest candidate for the quintessential oxymoron.” ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 115 (1991).
Furthermore, two major structural problems, which are by-products of the banks profit-making motivation and competitive forces within the industry, act to preclude objectivity. The first is the fee structure by which the banks are compensated for their services, and the second is the need for developing a large and active client base to produce necessary revenue and profits.

Corporate control transactions are especially lucrative fee generation opportunities for investment banks. These transactions frequently involve a multitude of tasks that a bank may be asked to participate in and, obviously, profit from. In addition to rendering the fairness opinion for which the investment bank will generally receive a fixed fee, the bank often is responsible for advising on both general and specific financial strategy and arranging the necessary financing to effect the transaction. This is where the large profits are to be made. As the transactions have grown in size and complexity, the development and marketing of more creative and specialized financial instruments have been necessitated to fund these activities. The bankers have developed a virtual cornucopia of innovative types of securities to meet the challenge. As a consequence, underwriting and advisory fees for arranging the financing have become staggering—often fixed at some percentage of the total “value” of the transaction. The larger the size of the

49 Bebchuk & Kahan, supra note 2, at 38.
50 As examples of the new types of instruments the banks created in the 1980s, some of which were used to finance these transactions, are the following: Preferred Equity Redemption Cumulative Stock (PERCS); Variable Rate Preferred Stock; High Yield Bonds (“Junk Bonds”); Spread-Adjusted Notes (SPANs); Asset-Backed Securities; Medium Term Notes. Miriam Bensman, The 1980s, The Decade That Transformed Corporate Finance, INV. DEALERS DIG., Jan. 8, 1990, at 16; Michael Liebowitz, New Credit-Adjusting Debt Keeps Interest-Rate Risk; Merrill Product Doesn't Wait for Rating Agencies, INV. DEALERS DIG., Mar. 12, 1990, at 26; Tom Pratt, How Percs Became the Year's Hottest Product; The Inside Story of Morgan Stanley's Three-Year Wait to Revive a Hybrid, INV. DEALERS DIG., Dec. 2, 1991, at 20.
51 The RJR Nabisco leveraged buyout, an approximately $25 billion transaction, was particularly lucrative for the investment bankers. Dillon Read and Lazard Freres rendered a fairness opinion and were the financial advisors in the transaction. Each bank received an initial $1.5 million advisory fee, an additional $3.5 million for the fairness opinion, and a further $9 million upon completion of the tender offer. The $14 million that each bank made, however, pales in comparison to the $400 million in fees that Wasserstein Perella, Morgan Stanley, Merrill Lynch, and Drexel Burnham Lambert split for financing the LBO. Alison L. Cowan, Investment Bankers' Lofty Fees, N.Y. TIMES, Dec. 26, 1988, § 1, at 41; RJR Nabisco Inc., Proxy Statement, supra note 10 at 11, 42. For an interesting account of the RJR LBO, see BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE (1990). Some other transactions:
deal, the greater the fees. A ten million dollar fee is not at all uncommon. Additionally, future noncontractual profits are ensured as the instruments created have become more complex; once issued, the bank may provide the only effective trading market for them, and, as the “market maker,” stands ready to earn substantial brokerage fees. A rather notorious example of this phenomenon involved Goldman, Sachs & Co., one of Wall Street’s most

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<th>DEAL</th>
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<th>ADVISORS</th>
<th>FEES (000)</th>
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respected banking houses. Goldman in the late 1980s participated in financing a number of leveraged buyouts. As some of the highly leveraged enterprises created by their efforts began to falter and the market for the “high yield” instruments used to finance these companies became chaotic, Goldman created an entity to participate in speculative arbitrage activities involving these bonds. (Shortly thereafter, confronted with significant adverse publicity and client resentment with this action, Goldman announced plans to terminate its “Water Street Fund”).\(^5\) In one instance, as a participant in the 1989 leveraged buyout of the Florida Steel Corporation, Goldman was responsible for arranging the sale of $110,000,000 of high yield securities to finance the transaction. It earned a significant fee for this activity. Two years later, Goldman was once again earning money dealing in these bonds, remarketing the instruments, which had become depressed in value, to new investors.\(^5\)

As the fees to be paid to the banks are frequently negotiated to be contingent on the success of the transaction, and fees on subsequent “market making” activities, although noncontractual, are certainly no less contingent and dependent on the transaction’s completion than the negotiated fee, there is a significant economic incentive on the bank to “make the deal happen.” Even if a bank is paid for its fairness opinion regardless of the transaction’s ultimate outcome, a successful transaction means substantial revenues, both contractual and noncontractual, and an aborted transaction leaves little to show for the effort. There is thus tremendous pressure on the bank called upon to opine as to the fairness of a proposed transaction, to deliver the opinion management desires that will best facilitate the deal’s completion.

A second industry-wide structural problem which impedes a banker’s ability to remain objective in rendering a fairness opinion involves the bank’s need to build and maintain an active client base. Like any other business, unless a bank can continue to attract and retain a stable customer pool, it will cease to profit or even function. The profit-producing potential of a corporate control transaction not only involves the transaction itself, but the future financing activities the surviving enterprise may produce.

It does not take a substantial leap of faith to realize that if a bank delivers a fairness opinion that is contrary to the wishes of management, future dealings with the corporation may be imperiled. Like any other professional rendering

\(^{52}\) Floyd Norris, *Goldman Phasing Out Big Junk Bond Fund*, N.Y. TIMES, May 3, 1991, at D1. Despite these plans, Goldman recently gained a dominant stake in the nation’s two largest wallboard manufacturers by investing 21% of the fund’s $1.15 billion value into the depressed bonds of the two companies. The depressed bond prices are the result of the companies’ taking on too much debt in leveraged deals in which Goldman was the advisor. Randall Smith, *Goldman’s in the Construction Business?*, WALL ST. J., Mar. 4, 1992, at C1.

advisory services, a banker is hired or fired by incumbent management. An action that is perceived as hostile to management, such as refusing to opine as to the fairness of a price management supports, will obviously not endear the bank to management and could thus dim future employment prospects. A banker who develops a reputation for being uncooperative is unlikely to be eagerly retained by either past clients or other managers who learn of the reputation. Cooperation breeds contentment and future employment. This fact, obviously not unknown to the banks, places significant pressure on them to at least consider acquiescence to the wishes of their customers.

Additionally, personal considerations inherent in the banker/manager relationship militate against objectivity. Despite the fact that, legally, the bank is employed by and is expected to advance the best interests of the corporation, bankers must work with managers. As most banking relationships become long-standing, personal relationships between the banker and manager develop that naturally impact on the advice rendered. It would be casting too pristine a light on fundamental human nature to assume that such personal friendships that develop over time between managers and bankers would be completely ignored when the bankers were asked to undertake an “independent” analysis. As in all human contact, personality and friendship play an inevitable and fundamental role.54

Finally, a further “structural” factor affecting a banker’s objective judgment is the actual origination of the transactions to be opined on. In the merger “mania” of the late 1980s, it was not at all uncommon that transactions which were the subject of the fairness opinions in question were the very creations of the opining banks. In order to boost revenues, banks, utilizing the services of legions of analysts, developed numerous transactional scenarios involving both present and hopefully future clients, which they then attempted to “shop” to the various parties involved.55 Once the deals were “sold” to various managers and boards of directors, it would be folly to believe that when asked to step back and deliver an opinion to the board or shareholders on the transaction’s fairness, a bank could remain totally objective. Imagine the reputational impact on a bank who, after convincing management that the purchase of another entity was a profitable business strategy, then refuses to

54 See Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 95 (E.D.N.Y. 1969) (prior business relationships with board raises question of bank’s impartiality), modified, 478 F.2d 1281 (2d Cir. 1973); see infra note 74 and accompanying text for discussion of Gerstle. See also Bebchuk & Kahan, supra note 2, at 42. In its proxy statement, a corporation usually justifies hiring a particular investment bank to render a fairness opinion by reciting the bank’s past services to the corporation. See RJR Proxy Statement, supra note 10, at 35–36.

opine that the price management decided to pay, after consultation, of course, with the proposing bank, was fair. True objectivity in this common circumstance is difficult to achieve.

In summary, because of the varying methods of valuation considered acceptable by the financial community, an evaluator of valuation is given a wide range of latitude in establishing the value of a particular enterprise. Given this fact and structural factors inherent to the investment banking business, including the necessity of transaction-driven fee generation, the “partisan” pressures placed on a bank asked to evaluate the “fairness” of a transaction are such that truly objective and independent valuation advice is, as a practical matter, difficult to achieve.

II. NEGLIGENT MISREPRESENTATION AND INVESTMENT BANKERS

Despite the escalation in the sheer numbers of fairness opinions that the investment banks have been asked to deliver and the corresponding increase in fee volume occasioned by this growth, until very recently there has been no corresponding increase in banker liability for inaccuracies contained within these opinions. Traditionally, banker liability for misstatements or omissions to the shareholders whose decisions were impacted by the faulty opinions was highly restricted. Because the banks were commonly retained by the company’s board of directors, and the opinions rendered were thus addressed to the board, the shareholders had no direct cause of action grounded in contract against the banks because of a lack of privity. Actions grounded in tort were also unavailable, under a similar privity doctrine that had been developed by the courts in the early 1920s. The shareholder’s only recourse lay under the federal securities laws. Yet this avenue too was unattractive. A high culpability standard traditionally required under these laws made any liability claim difficult to prove and win.

Recently, however, based on the liberalization of traditional notions of privity by several courts, the long-standing legal wall that had effectively precluded bank liability for faulty opinions may be crumbling. In several recent cases, the once discredited state law tort of negligent misrepresentation has been revived and applied to form the basis for liability to shareholders by the investment bankers for their inaccurately drawn opinions. Before examining this “revolution” in legal thought, it is important to look first at why the securities and contracts law have proven inhospitable to shareholder actions in this area.

At first glance, because of the oft-stated goal of full and fair disclosure, it would seem that the federal securities laws would provide fertile ground for an attack on a faulty fairness opinion. The various anti-fraud provisions of these laws provide numerous avenues for shareholder litigation, given the wide
variety of corporate control transactions for which opinions are rendered.\textsuperscript{56} And, in fact, a number of actions have been brought in the anti-fraud area.\textsuperscript{57} Unfortunately, two stumbling blocks exist that restrict the ultimate success of such actions; one, as the caselaw demonstrates, is surmountable, the other is much more problematic. The first involves the actual content of the opinions themselves. The anti-fraud provisions traditionally penalize misstatements or omissions of material fact.\textsuperscript{58} As fairness opinions are generally expressions of one's viewpoint as to financial adequacy, and not factual statements or conclusions, it is thus questionable whether "errors" within them constitute the

\textsuperscript{56} Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. \$ 78j(b) (1988), is a catch-all provision which prohibits the use of any manipulative or deceptive device in connection with the purchase or sale of a security that violates rules prescribed by the SEC. The SEC promulgated Rule 10b-5, 17 C.F.R. \$ 240.10b-5 (1992), under section 10(b). This rule prohibits fraudulent acts and material misstatement and omissions in connection with purchases and sales of securities. Section 14 of the 1934 Act, 15 U.S.C. \$ 78n, regulates proxy solicitation. Section 14(a), 15 U.S.C. \$ 78n(a) (1988), provides that it is unlawful to solicit proxies in violation of SEC rules. Rules 14a-3 through 14a-12, 17 C.F.R. \$\$ 240.14a3-240.14a-12 (1992), are designed to ensure full and fair disclosure to shareholders receiving proxy solicitations. Rule 14a-9 prohibits material misstatements, omissions, and fraud in connection with the solicitation of proxies. Section 14(e) of the 1934 Act, 15 U.S.C. \$ 78n(e) (1988), prohibits material misstatements, omissions, and fraudulent, deceptive, or manipulative acts or practices in connection with a tender offer. Section 13(e)(1) of the 1934 Act governs going private transactions. Section 13(e)(1), 15 U.S.C. \$ 78m(e)(1) (1988), prohibits an issuer of stock from purchasing its own stock unless it complies with SEC rules promulgated to prevent fraudulent, deceptive, or manipulative activities. Rule 13e-3, 17 C.F.R. \$ 240.13e-3 (1992), defines going private transactions subject to regulation and prohibits material misstatements, omissions, and fraudulent acts in connection with such transactions. Section 11(a) of the Securities Act of 1933, 15 U.S.C. \$ 77k (1988), provides a private right of action for securities purchasers when a registration statement contains an untrue statement or omission of material fact. See infra note 58 for additional discussion of the anti-fraud provisions.


\textsuperscript{58} The antifraud provisions prohibit the making of "any untrue statement of a material fact...necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading...." 15 U.S.C. \$ 78n(e) (1988) (Section 14(e) of the Williams Act, tender offers); 17 C.F.R. \$ 240.10b-5(b) (1992) (Rule 10b-5, catch-all antifraud provision); 17 C.F.R. \$ 240.13e-3(b)(ii) (1992) (Rule 13e-3, going private transactions); 17 C.F.R. \$ 14a-9(a) (1992) (Rule 14a-9, proxy statements). A fact is material whenever there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (construing Rule 14a-9); accord Basic, Inc. v. Levinson, 485 U.S. 224, 231 (1988) (applying TSC Industries rule of materiality to section 10(b) and Rule 10b-5 actions); see also THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION, \$\$ 11.4 & 13.5 (Practitioner's ed. 1990 & Supp. 1992).
factual misstatements the anti-fraud provisions address. But, as the United States Court of Appeals for the Third Circuit ruled in *Herskovitz v. Nutri/System, Inc.*, opinions" are actionable under the anti-fraud provisions. There the court stated that a banker’s "opinion or projection, like any other representation, will be deemed untrue for purposes of the federal securities laws if it is issued without reasonable genuine belief or if it has no basis." The case involved the issuance of a fairness opinion in the context of a leveraged buyout. In its opinion asserting the fairness of a particular price being offered the shareholders, the defendant bank based its conclusions on the assumption of a specific corporate tax rate. Yet, in the proxy statement containing the bank’s opinion, there was disclosure that tax reform measures were pending that could significantly reduce the tax rate then in effect. The court ruled that despite this disclosure, the “separate issue of possible fraudulence in the fairness opinion itself" must still be considered. Because the fairness opinion had “independent significance to shareholders,” if the


60 Id. at 184 (citing Eisenberg v. Gagnon, 766 F.2d 770, 776 (3d Cir. 1985)), cert. denied, 474 U.S. 946 (1985); Gottreich v. San Francisco Inv. Corp., 552 F.2d 866, 867 (9th Cir. 1977); First Va. Bankshares v. Benson, 559 F.2d 1307, 1314 (5th Cir. 1977), cert. denied, 435 U.S. 952 (1978); Marx v. Computer Sciences Corp., 507 F.2d 485, 489-90 (9th Cir. 1974); S.E.C. v. Okin, 137 F.2d 862, 864 (2d Cir. 1943). Recovery can be had when factfinder concludes that the expert adopts an objectively unreasonable assumption. *Herskovitz*, 857 F.2d at 185.

61 Nutri/System shareholders challenged senior management’s leveraged buyout of the corporation on the grounds that shareholder approval of the LBO was procured through the use of a materially false and misleading proxy statement in violation of sections 10(b) and 14(a) of the 1934 Act. 15 U.S.C. §§ 78j(b) & 78n(a). The shareholders also alleged that Nutri/System directors and officers violated their fiduciary duties to the shareholders in violation of Pennsylvania law by approving the LBO at an unfair price. *Herskovitz*, 857 F.2d at 182.

62 Id. at 184. The Connecticut National Bank used a discounted cash flow analysis to appraise the value of Nutri/System. For purposes of this analysis, the bank assumed that Nutri/System would be taxed at a corporate tax rate of 46% for the next five years after the LBO. Based on this assumption, the bank issued a fairness opinion stating that $7.16 a share price to shareholders for the LBO was fair. Nutri/System shareholders sued, alleging that $7.16 a share was too low because it was generally recognized in the field of financial analysis that Congress would soon reduce the corporate tax rate to between 33 and 36%. If the bank had used these percentages in its analysis, it would have come up with a range of prices between $7.58 and $10.35 a share. The district court issued a directed verdict in favor of the bank because the company’s proxy statement included disclosure of the pending legislation. Id. at 183–84.

63 Id.
bank based its opinion on assumptions that were “objectively unreasonable,” then that opinion was actionable.

The second and primary problem with bringing an action under the anti-fraud provisions involves the culpability standards that are required. The difficulty shareholders face in meeting these standards is the main reason why the federal securities laws are not hospitable territory for actions on fairness opinions. Generally, the anti-fraud provisions provide that the moving party must prove that the defendant acted with some degree of scienter. Rule 10b-5 under Section 10 of the Securities Exchange Act of 1934, the most popularly used section for private anti-fraud actions, requires the demonstration that the defendant acted with scienter, which the Supreme Court has defined as “intent to deceive, manipulate or defraud.” Although some lower courts have held that “reckless” conduct may be sufficient to impose liability under this section, regardless of whether scienter or recklessness is called for, this culpability standard is obviously not easy to meet. Consequently, it is a rare occurrence that a shareholder is able to show that an investment banker acted with the “evil” intent or reckless abandon in rendering a fairness opinion necessary for liability. Such an action is doomed to failure.

64 Id. at 185.
65 17 C.F.R. § 240.10b-5.
69 See, e.g., Johnston v. Wilbourn, 760 F. Supp. 578, 586, 590 (S.D. Miss. 1991) (banks’ motion for summary judgment granted because of lack of evidence that banks had knowledge of fraudulent purchase of stock); Mendell v. Greenberg, 612 F. Supp. 1543, 1552 (S.D.N.Y. 1985) (“Drexel also cannot be sued as an aider and abettor, because plaintiff has failed to allege the requisite scienter.”) rev’d in part on other grounds, 927 F.2d 667 (2d Cir. 1990); Baranski v. Serhart, 603 F. Supp. 232 (N.D. Ill. 1985) (allegation that bank knew or should have known of material facts showing existence of fraud insufficient to allege scienter); see also Giuffra, supra note 12 at 129 n.66; Don J. McDermett, Jr., Note, Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions, 62 TEX. L. REV. 1087, 1090 (1984).
Section 14 of the Securities Exchange Act which regulates proxy solicitations and tender offers contains its own set of anti-fraud provisions. 70 The proxy regulations forbid the use of any untrue or misleading statements in connection with a solicitation. 71 The courts, however, have divided on the culpability requirement for this area. While the Sixth Circuit in Adams v. Standard Knitting Mills, Inc. 72 called for proof of scienter in a Section 14(a) action against an outside accountant for an inaccurate financial statement attached to a proxy statement, the Third Circuit in its recent Herskovitz decision ruled that a bank may be held liable for a negligently rendered misrepresentation contained within a fairness opinion. 73 The Second Circuit has taken a middle ground. Although stating that a negligence standard would apply to the corporate issuers of a misleading proxy statement in Gerstle v. Gamble-Skogmo, Inc. 74 it left open the possibility of applying a stricter scienter standard to outside advisors. Section 14(e), which regulates tender offers, has been interpreted in various court rulings to require something more than negligence for the imposition of liability. 75 Finally, although private rights of action for false or misleading disclosure are allowed under Securities and Exchange Commission Rule 13e-3, 76 which involves “going private” transactions, it is unclear what culpability levels are required. 77

Despite the Third Circuit’s recent “liberalization” of the culpability requirement for an action under the proxy rules against a bank for a faulty fairness opinion in Herskovitz, 78 other courts have not rushed to follow its lead. Given this fact and the firmly rooted scienter requirement of Rule 10b-5 actions, it does not appear likely that shareholders angered by a misformed

71 17 C.F.R. § 240.14a-9; see infra notes 72–74 and accompanying text.
73 Herskovitz v. Nutri/System, Inc., 857 F.2d at 179, 189, 190 (3d Cir. 1988); see supra notes 59–64 and accompanying text.
74 478 F.2d 1281, 1300–01 (2d Cir. 1973).
75 See, e.g., Lowenschuss v. Kane, 520 F.2d 255, 268 n.10 (2d Cir. 1975) (plaintiff must allege facts implying knowledge or reckless disregard, mere negligence standard cannot be used); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341, 363 (2d Cir. 1973) (knowing or reckless failure to discharge obligations), cert. denied, 414 U.S. 910 (1973); Pryor v. United States Steel Corp., 591 F. Supp. 942, 956 n.20 (S.D.N.Y. 1984) (reckless disregard for the truth).
76 17 C.F.R. § 240.13e-3.
78 Herskovitz v. Nutri/System, Inc., 857 F.2d 179, 189–90 (3d Cir. 1988); see supra notes 59–64 and accompanying text; see also Bart Fraust, Court Ruling May Open Area of Liability for Banks, AMERICAN BANKER, Nov. 1, 1988, at 2.
fairness opinion will find any solace through an action under the federal securities laws.

Equally unavailing to frustrated shareholders has been the prospect of seeking redress against a bank under simple contractual principles. Because the bank has been hired by the board of directors and not the shareholders themselves, the shareholders are not in contractual privity with the bank and thus may not bring suit. Derivative actions are also ineffective. As Professor Coffee has pointed out, such actions “are effectively neutralized by the demand rule and the business judgment standard applied by many courts to a board determination to reject demand or seek dismissal of the suit.”79 Additionally, derivative actions become procedurally overwhelming because of the significant time and funding required.80

With securities and contract law basically unfriendly grounds for relief for an improperly drawn fairness opinion, investors have recently turned to a previously unlikely legal avenue for recovery—the law of torts and, more specifically, the tort of negligent misrepresentation. Enjoying a steadily expanding revitalization, this tort, once moribund, at least in its application to third-party advisors, now provides a remedy for individuals able to demonstrate reasonable and innocent reliance upon incorrect or misleading statements of third-party professionals including accountants, engineers, and other independent advisors, with whom they have no contractual privity but by whom they are now owed a legally recognized duty of care. While initially this action was used as the basis for assigning liability to accountants, lately other professional advisors have been included in this tort’s sweep. Most recently, investment bankers have found themselves facing such actions for faulty valuation opinions.

The roots of professional, specifically accountant’s, liability to third parties for misleading advice can be traced to the seminal case of Ultramares Corp. v. Touche.81 In Ultramares, a firm of public accountants retained by Fred Stern & Co., Inc. to conduct an annual audit and certify certain financial statements

80 See FED. R. CIV. P. 23.1. Plaintiff in derivative action must show: (1) plaintiff was shareholder at time of injury, (2) action is not collusive, (3) plaintiff tried to obtain action from board, (4) failure to obtain action, (5) plaintiff fairly and adequately represents shareholders. In addition to procedural requirements, some states require plaintiffs to post a bond to secure the defendants for their reasonable defense expenses should the defendants prevail. WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5971.10 (perm. ed. rev. vol. 1991); see also Donald Lund, Note, Toward a Standard for Third-Party Advisor Liability in Mergers and Buy-Outs: Schneider and Beyond, 52 U. PITt. L. REV. 603, 604 (1991).
81 174 N.E. 441 (N.Y. 1931).
negligently overvalued the company’s assets. A lender who advanced credit to the company, asserting reliance upon the certified balance sheet presented by Stern, sought recovery from the certifying accountants when Stern declared bankruptcy shortly after borrowing substantial funds. Citing a lack of privity between the parties, Justice Cardozo, speaking for the unanimous New York court observed:

If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences.

In denying the lender’s cause of action, it was necessary for Cardozo to distinguish the New York court’s earlier opinion in Glanzer v. Shepard. The plaintiff in Glanzer was a buyer of beans who overpaid his seller in reliance upon an erroneous certificate of weight issued by a public weigher. Notwithstanding the fact that the seller, as opposed to the buyer, hired and paid the public weigher, Cardozo stated that “assumption of the task of weighing was the assumption of a duty to weigh carefully for the benefit of all whose conduct was to be governed. We do not need to state the duty in terms of contract or of privity.” Purporting to support this contention, the Glanzer court noted its earlier decision in Macpherson v. Buick Motor Co. which eliminated privity as a prerequisite to recovery of damages when a manufacturer’s negligence caused personal injuries to third parties. Finding that the weigher’s certificate had been issued for the “end and aim” of shaping not the conduct of the payor but the performance of the plaintiffs, Cardozo declined to dismiss the action on traditional privity grounds and utilized newly expanding concepts of duty to provide a remedy.

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82 Id. at 442–44. While the defendants certified the corporation’s net worth as $1,070,715.26, a careful and proficient audit would have revealed that the company was in fact insolvent, as managers had boosted the balance sheet by falsifying accounts receivable and other assets. Id.

83 Id. at 442–43. Although initially asserting an action grounded solely on negligence, at trial the plaintiff added a claim for fraud. Id. at 443.

84 Id. at 444.

85 135 N.E. 275 (N.Y. 1922).

86 Id. at 276.

87 111 N.E. 1050 (N.Y. 1916).

88 Glanzer, 135 N.E. at 276.

89 Id. at 277. While professing that accountability expands with the knowledge of output’s anticipated use, Cardozo declared “[w]e state the defendants’ obligation, . . . in terms, not of contract merely, but of duty.” Id. at 276–77.
In *Ultramares* it was clear that Cardozo felt that he had gone too far in *Glanzer*, opening a virtual Pandora's box with the potential for indeterminate liability for any and all third-party advisers. Attempting to limit *Glanzer's* applicability, Cardozo described the services of the public weighers as being primarily intended to inform third persons, while referring to the lender's reliance on the accountant's certificate in *Ultramares* as only incidental or collateral.\(^9\) The feature that distinguished *Ultramares*, and thus precluded liability, was the fact that the bond between the public weighers and the plaintiffs in *Glanzer* "was so close as to approach that of privity, if not completely one with it. Not so in the case at hand."\(^91\) Summarizing his opinion that was to remain the law on accountant liability in most jurisdictions for nearly sixty years, Cardozo stated, "if there has been neither reckless misstatement nor insincere profession of an opinion, but only honest blunder, the ensuing liability for negligence is one that is bounded by the contract . . . ."\(^92\) Thus, in the absence of "privity," there was to be no action in tort by disgruntled individuals against third-party professionals for negligently rendered advice.

In an attempt to explain the rationale underlying *Ultramares'* embrace of "privity," several commentators have focused on the nature of the accounting profession in the early 1930s.\(^93\) Financial audits of that era were designed to serve principally as methods of discovering and informing management of employee theft and other financial irregularities. Consequently, businessmen of

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90 Ultramares Corp. v. Touche, 174 N.E. 441, 446 (N.Y. 1931). In making this determination, however, Cardozo appears to gloss over the fact that in *Ultramares* the defendants supplied the Stern Company with thirty-two numbered copies of the certified balance sheet to be exhibited by Stern in its usual course of securing credit and capital. *Id.* at 442.

91 *Id.* at 446. The crucial distinction appears to be the fact that in *Glanzer* "the transmission of the certificate to another was not merely one possibility among many, but the 'end and aim of the transaction,' as certain and immediate and deliberately willed as if a husband were to order a gown to be delivered to his wife . . . ." *Id.* at 445 (citations omitted).

92 *Id.* at 448. Apparently attempting to clarify an accountant's duty of care, in the opinion Cardozo stated that accountants owe their employers a contractual duty to render certificates with care and skill, as well as a legal responsibility to execute them free from fraud, while owing creditors and investors only the duty to avoid fraud. *Id.* at 444.

the era, aware of the primarily internal function of an accountant’s audit, did not reasonably expect that the auditor was acting to ensure third parties of his client’s economic health. \(^9\) However, as the nation’s economy and capital markets rapidly expanded and public ownership of corporate entities increased, the function of the audit itself changed dramatically to serve not only the demands of corporations but investors as well, providing independent evaluations on the fairness of a company’s accounting systems and the accuracy of its financial statements. \(^9\) Recognizing this change in approach and the corresponding development of the large-scale accounting firm, many courts have recently begun to liberalize the relational ties required in order to win a negligence action against an accountant.

Fifty years after its Ultramares decision, the New York Court of Appeals revisited the issue of accountant liability for negligent misrepresentation in Credit Alliance Corp. v. Arthur Andersen & Co. \(^9\) While reaffirming the Ultramares requirement that a claimant must prove a relationship essentially approaching privity to impose liability, the court sought to liberalize the standard a degree. It established a three-step analysis for identifying those persons in “near privity”:

Before accountants may be held liable in negligence to noncontractual parties who rely to their detriment on inaccurate financial reports, certain prerequisites must be satisfied: (1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely; and (3)

\(^9\) E.g., Wiener, supra note 93, at 250–51.


\(^9\) 483 N.E.2d 110 (N.Y. 1985). The Credit Alliance opinion decided two separate cases, each of which involved appeals by accounting firms seeking dismissal of lower court rulings that allowed negligence actions, brought by third parties, to proceed in the absence of strict privity. In the first of these appeals, Credit Alliance Corp. v. Arthur Andersen & Co., the New York Court of Appeals reversed the lower court’s decision and dismissed the negligence claim, essentially finding that the parties did not stand in a relation approaching that of near privity. Id. at 119–20. In European American Bank & Trust Co. v. Strauhs & Kaye, however, the second case, the court affirmed the lower court’s ruling, noting that the defendants, having directly communicated with the plaintiff, were fully aware that the purpose of their audit was actually to provide the third-party lender with data it required, thereby demonstrating a relationship “approaching privity.” Id. at 120.
there must have been some conduct on the part of the accountants linking them to that party or parties, which evinces the accountants' understanding of that party or parties' reliance.  

Although seemingly suggesting a narrow standard, the *Credit Alliance* decision opened the door to successful litigation by objectively articulating the requisite relationship that must be established in negligence actions brought against accountants.  

Although the New York court has liberalized its approach to the whole third-party liability question, many other jurisdictions have chosen to go even further. Today, it is generally acknowledged that an accountant's liability for negligence to third parties may proceed, depending on the jurisdiction involved, under three differing analytical approaches. These approaches, ranging in degrees of liberality, are: (a) privity, (b) reasonable foreseeability, and (c) actual foreseeability (as articulated in section 552 of the *Restatement (Second) of Torts*).

A. Privity

The traditional privity approach, as modified by the New York court in *Credit Alliance*, remains the accepted method of analysis in several jurisdictions.  

A recent Indiana case illustrates its application. In *Toro Co. v. Krouse, Kern & Co.*,  the plaintiff argued that it had advanced substantial amounts of credit to one Summit Power Equipment Distributors, Inc. in direct reliance upon erroneous representations made by the Krouse accounting firm in an audit it had conducted on Summit.  

Utilizing the three-step analysis posed in *Credit Alliance*, the Toro court stated that the facts indicated the first two prongs of the test had been met in that:

97 *Id.* at 118.

98 Accountants are not the only professionals who face liability under this standard. The Court of Appeals of New York four years later held that an engineer, hired by a school district's architect, was liable to the school district for negligently rendering advice as to the structural soundness of a high school annex. Although the school district and engineer were not in direct privity, because the engineer knew his report would affect the conduct of the school district, the relationship between them was “so close as to approach that of privity.” *Ossining School Dist. v. Anderson*, 539 N.E.2d 91, 95 (N.Y. 1989) (quoting *Ultramares*, 174 N.E. at 446). *See infra* notes 129–34 and accompanying text.


100 644 F. Supp. 986 (N.D. Ind. 1986), aff'd, 827 F.2d 155 (7th Cir. 1987).

101 *Id.* at 988.
a reasonable inference can be made that Krouse knew that the reports it furnished to Summit were to be used by Summit to induce [the plaintiff] Toro's extension of credit and distributing rights based on Toro's reliance on the information contained in the reports.

It is on the third prong of the test, however, that the complaint and supporting evidence fails. [With the exception of a phone call from Toro's credit manager to Krouse], there is no indication of conduct which can be remotely construed as providing the necessary "near privity" link between Krouse and Toro. . . . [The value of the phone call as evidence is minimal, especially] since . . . Toro contacted Krouse. The third part of the Credit Alliance test requires "conduct on the part of the accountants linking them to [Toro]." 102

Thus, although there was evidence indicating Krouse's awareness of the audit statements' prospective use, liability to Toro for errors in these materials did not adhere without some actual "linkage" to Toro by the accountants.

B. Reasonable Foreseeability

A second approach which is significantly more generous to prospective plaintiffs is liability based on a third party's "reasonably foreseeable" reliance. In this newest of accountant liability standards, courts apply traditional tort duty concepts to accountants, holding them liable to any reasonably foreseeable injured third party who relied upon their negligently drawn opinions. 103 The New Jersey Supreme Court became one of the first courts to adopt this rationale in its decision in H. Rosenblum, Inc. v. Adler. 104 In H. Rosenblum, the plaintiffs, when receiving stock in Giant stores in connection with the sale of their business, apparently relied on an audit of Giant conducted by the defendant accounting firm at Giant's behest. Giant stock later became worthless after disclosure that its audited statements were false, and the plaintiffs sought to recover for their now valueless holdings, asserting the auditing accountants' negligence as the proximate cause of their losses. 105 Denying defendants' summary judgment motion, the court ruled that when an independent auditor renders an opinion lacking any limitation as to whom the audited company may

102 Id. at 995 (quoting Credit Alliance Corp., 483 N.E.2d at 118).
105 Id. at 140.
distribute its financial statements, the auditor owes a duty to all those it should reasonably foresee as receiving the statements from the company and relying thereon for "proper business purposes."\textsuperscript{106} The \textit{H. Rosenblum} court held that the "[d]efendants' ignorance of the precise use to which the statements would be put does not eliminate their obligation \ldots. [I]t is necessary only that Giant, the entity for whom the audit was being made, used it for a proper business purpose."\textsuperscript{107}

A pair of subsequent California cases expanded accountant liability by finding for plaintiffs who could show that the independent auditor should have reasonably foreseen their reliance. In \textit{International Mortgage Co. v. John P. Butler Accountancy Corp.},\textsuperscript{108} the plaintiffs brought a negligence action against accountants who prepared erroneous financial statements for a party from whom the plaintiffs agreed to purchase and sell loans on the secondary market.\textsuperscript{109} Finding that independent public accountants owe ultimate allegiance to the lending and investing public,\textsuperscript{110} the court held that certified public accountants owe a duty of care to all reasonably foreseeable plaintiffs damaged as a result of their reasonable reliance on unqualified audited financial statements.\textsuperscript{111} The California Court of Appeals reaffirmed this approach four years later in its holding in \textit{Bily v. Arthur Young & Co.}\textsuperscript{112} The \textit{Bily} court upheld the rule of reasonable foreseeability established in \textit{International Mortgage}, and found in favor of the plaintiffs, purchasers of subsequently worthless stock and warrants who sought relief based upon reliance on the unqualified financial statements negligently prepared by the defendant-accountants.\textsuperscript{113}


\textsuperscript{107} \textit{Id.} at 155.


\textsuperscript{109} 223 Cal. Rptr. at 219–20.

\textsuperscript{110} \textit{Id.} at 224.

\textsuperscript{111} \textit{Id.} at 227.


\textsuperscript{113} 271 Cal. Rptr. at 472, 483. The plaintiffs in \textit{Bily} either purchased blocks of Osborne Computer Corporation stock from major shareholders or aided Osborne's quest for bridge financing, pending an initial public offering, by executing irrevocable standby letters of credit in favor of the bridge lender in exchange for warrants yielding favorable terms on Osborne stock. All but one of the plaintiffs asserted direct reliance upon an unqualified audit opinion authored by the defendants that failed to disclose profound weaknesses in Osborne's
However, two years later, the California Supreme Court, stating that “an auditor is a watchdog, not a bloodhound,” overruled the appellate court’s approach to auditor negligence liability. Suggesting that the lower court’s standard “raises the spectre of multibillion-dollar professional liability that is out of proportion” to fault, the court rejected the reasonable foreseeability approach in favor of the Restatement’s more conservative actual foreseeability standard.

It is important to note that the California court declined to adopt the New York court’s privity analysis which functions as the most stringent standard.

C. Actual Foreseeability—Restatement (Second) of Torts § 552

Functioning as an intermediate approach, residing midway between the seemingly bipolar concepts of privity and reasonable foreseeability, is a method of analysis suggested by section 552 of the Restatement (Second) of Torts.

Described by commentators as premising liability upon actual foreseeability, this section states:

(1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance on the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.

accounting procedures, resulting in financials that significantly overvalued the doomed computer venture to the investors detriment. Id. at 472–73.


115 Id. at *20.


117 See, e.g., Martin, supra note 30, at 156 (noting Restatement’s focus on plaintiffs whose reliance was “actually foreseen” by the defendant); Susan Getzendanner & Andrew S. Morrison, Liability of Advisors to Nonclients, M&A AND CORP. GOVERNANCE L. REP., Mar. 14, 1990 at 677 (this standard focuses upon accountant’s knowledge that its output would be distributed to an identified person or limited group of persons).
(2) Except as stated in Subsection (3), the liability stated in Subsection (1) is limited to the loss suffered:

(a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and

(b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.\(^\text{118}\)

The earliest case to make use of the Restatement standard in defining accountant liability to third parties was Rusch Factors, Inc. v. Levin.\(^\text{119}\) In Rusch, the plaintiff conditioned its extension of credit to a Rhode Island corporation upon receipt of certified financial statements which the corporation hired the defendant-accountants to prepare.\(^\text{120}\) Although the defendant certified the corporation as solvent, the business subsequently went into receivership, and the plaintiff sought recovery in a tort negligence action asserting reliance on the defendants' representations.\(^\text{121}\) Noting with approval the rationale outlined in section 552, the court held "that an accountant should be liable in negligence for careless financial misrepresentations relied upon by actually foreseeable and limited classes of persons."\(^\text{122}\)

Drawn by the appeal of moderately extending accountant liability, the Florida Supreme Court recently adopted the section 552 standard in First Florida Bank v. Max Mitchell & Co.\(^\text{123}\) The plaintiff in First Florida provided a line of credit to C.M. Systems, Inc., after acquiring certified financial statements and verbal assurances directly from the borrower's independent auditor. When the financial statements and the underlying audit proved faulty, the plaintiff brought suit against the independent accountants for recovery of its lost funds. Discarding restrictive privity antecedents, the court held that section 552 "balances, more so than the other standards, the need to hold accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from liability that unreasonably exceeds the

\(^{118}\) RESTATEMENT (SECOND) OF TORTS § 552 (1977).


\(^{120}\) Id. at 86.

\(^{121}\) Id. at 87.

\(^{122}\) Id. at 93. The court declined to rule on the efficacy of extending an accountant's liability to the bounds of actual foreseeability but instead left that issue to be developed judicially. Id.

bounds of their real undertaking.”

Ruling that an accountant may be liable to “those persons or classes of persons” whom he actually “knows’ will rely on his opinion,” the court concluded that First Florida’s direct communication with the defendants clearly met this standard and found in its favor. However, the court expressly refused to extend its new standard beyond “actual foreseeability” to classes of plaintiffs who an accountant “should have known” would read his works, because “an accountant controls neither his client’s accounting records nor the distribution of his reports.”

As the foregoing discussion detailed, liability actions against accountants by third parties for negligent misrepresentation have experienced a virtual renaissance in recent years following the liberalization of the strict privity requirement originally established in Ultramares Corp. v. Touche. Although widespread, the decline of the privity standard has not been uniform, with most jurisdictions proceeding along one of three progressively liberal paths: (1) the

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124 558 So. 2d at 16 (quoting Raritan River Steel Co. v. Cherry, Bekaert & Holland, 367 S.E.2d 609, 617 (N.C. 1988)).

125 Id.

126 Id. Although the Florida Supreme Court elected to adopt a Restatement (Second) of Torts §552 analysis when resolving the dispute in First Florida, it appears that the ruling and underlying facts of the case fall squarely within the reach of the more restrictive “approaching privity” standard outlined in Credit Alliance Corp. v. Arthur Andersen & Co., 483 N.E.2d 110 (N.Y. 1985). Indeed, in First Florida the court expressly noted that the accountants in question “personally delivered the financial statements to the bank with the knowledge that it would rely upon them in considering whether or not to make the loan.” 558 So. 2d at 16. This circumstance, arguably, exhibits a bond between First Florida Bank and the accountants “so close as to approach that of privity, if not completely one with it.” Credit Alliance, 483 N.E.2d at 117 (quoting Ultramares Corp. v. Touche, 174 N.E. 441, 446 (N.Y. 1931)). Thus, while the First Florida court couched its reasoning in terms of the “actually foreseeable” standard of Restatement (Second) of Torts §552, the factual basis underlying the court’s holding does not, in actuality, seem to stray far from a nexus between the parties that “approaches privity.” See supra notes 96–97 and accompanying text for a discussion of Credit Alliance’s “approaching privity” standard of accountant liability.

New York court's "approaching privity" standard as outlined in Credit Alliance;\textsuperscript{128} (2) actual foreseeability, as suggested by section 552 of the Restatement (Second) of Torts; and (3) reasonable foreseeability.

As one might expect, liability to third parties for poorly rendered advice, based on the tort of negligent misrepresentation, has not been limited to accountants.\textsuperscript{129} Also implicated as potential defendants are attorneys,\textsuperscript{130} abstractors,\textsuperscript{131} engineers,\textsuperscript{132} architects,\textsuperscript{133} and other professional advisors.\textsuperscript{134}

As the significant increase in merger activity in the mid 1980s led to tremendous and unprecedented profits for members of the investment banking community, it was inevitable that the investing public, concerned with present and prospective abuses by the banks arising out of this activity, would call for legal accountability and redress.\textsuperscript{135} A number of legal commentators supported

\textsuperscript{128} See supra notes 96–97 and accompanying text.

\textsuperscript{129} Indeed, in Glanzer v. Shepard, 135 N.E. 275 (N.Y. 1922), Cardozo advanced such instances as a negligent surgeon's liability to a minor patient, even though a parent paid the bill, and the duty owed by a bailee to care for goods bailed in the name of one person, though the deposit was made by another, in maintaining that the assessment of professional liability beyond the narrow bounds of privity was not a new legal concept. \textit{Id.} at 276 (citations omitted). Commenting on the state of professional liability it has been noted that "[p]rofessions once seemingly inviolate from litigation are no longer sacrosanct. The age-old axiom that physicians bury their mistakes, while attorneys and accountants file theirs away, has little relevance in modern-day America." Mess, \textit{supra} note 93, at 838 n.1 (quoting Stuart E. Eizenstat & G. William Speer, \textit{Accountants' Professional Liability: Expanding Exposure}, 22 FED'N INS. COUNS. Q. Summer 1972, 7).


\textsuperscript{132} See, \textit{e.g.}, Ossining School Dist. v. Anderson, 539 N.E.2d 91 (N.Y. 1989).

\textsuperscript{133} See, \textit{e.g.}, Bib Allen, \textit{Liabilities of Architects and Engineers to Third Parties}, 22 ARK. L. REV. 454 (1968).

\textsuperscript{134} See, \textit{e.g.}, Mary Van Osdel Manning, Comment, \textit{Liability to Third Parties for Economic Injury: Privity as a Useful Animal, or a Blind Imitation of the Past}, 12 SW. U. L. REV. 87 (1981).

\textsuperscript{135} Investment bank revenues increased dramatically during the 1980s and the mass media was highly critical of the banks' activities during that decade. Public disenchantment
this move, suggesting that the imposition of liability would lead to better bank behavior. An existing and logically transferable approach was the freshly-

with members of the financial community focused on certain individuals such as Ivan Boesky who, during an address to the 1985 graduating class of the University of California at Berkeley Business School, stated: "Greed is all right, by the way . . . I want you to know that. I think greed is healthy. You can be greedy and still feel good about yourself." David Elsner, "King of the Arbs" Topples, CHI. TRIB., Nov. 23, 1986, Business section, at 1. In both popular fiction and nonfiction, the investment banking community was a favorite target. "If you weren't making $250,000 a year within five years, then you were either grossly stupid or grossly lazy . . . . By age thirty, $500,000 . . . . By age 40 you were either making a million a year or you were timid and incompetent." TOM WOLFE, THE BONFIRE OF THE VANITIES 60 (Bantam ed. 1988); "Here he was about to launch the largest takeover battle of his career—indeed, in the history of Wall Street—and his advisors were more worried about their compensation than their tactics." BRYAN BURROUGH & JOHN HALYAR, BARBARIANS AT THE GATE 220 (1990); "He calculated that the fees alone would top the value of a $500 million buyout . . . . 'It's like throwing a hundred pounds of bloody meat into a shark pool,' he mused." Id. at 242-43.

See, e.g., Bebchuk & Kahan, supra note 2, at 46-52 (recommending close judicial scrutiny of fairness opinions to curb bank abuses); Ted J. Fiflis, Responsibility of Investment Bankers to Shareholders, 70 WASH. U. L.Q. 497 (1992) (proposing that investment bankers be liable to shareholders because of their role as gatekeepers for corporate control transactions); Giuffra, supra note 12 at 135 (arguing for imposition of negligence liability; also calls for industry-wide investment banking standards and stricter judicial scrutiny); Dale A. Oestrle, Fairness Opinions as Magic Pieces of Paper, 70 WASH. U. L.Q. 541 (1992) (suggesting that fairness opinions be used as evidence of director misconduct); Oestrle & Norberg, supra note 47, at 253 (argues for bank liability directly to the corporation as a fiduciary); Robert A. Prentice & John H. Langmore, Hostile Tender Offers and the "Nancy Reagan Defense:" May Target Boards "Just Say No?" Should They Be Allowed To?, 15 DEL. J. CORP. L. 377, 472 (1990); Donald Lund, supra note 80, at 627; Sherry R. Sontag, Eight Panels Set Hearings on Mergers, NAT'L L.J., Feb. 27, 1989, at 1, 29 (reporting on SEC proposals to make investment bankers legally liable for their opinions); Martin, supra note 30, at 133 (arguing for clearer judicial guidelines in negligent misrepresentation actions against investment bankers for faulty fairness opinions); Michael Schuldt, Comment, A Statutory Proposal for the Regulation of Fairness Opinions in Corporate Control Transactions, 56 MO. L. REV. 103 (1991) (proposing statutory scheme to regulate investment banks). But see, e.g., William J. Carney, Fairness Opinions: How Fair are They and Why We Should Do Nothing About It, 70 WASH. U. L.Q. 523 (1992) (observing that fairness opinions assure the continued application of the business judgement rule by sheltering boards of directors from liability and arguing that courts should only find investment banks liable for such opinions in instances of fraud).

Professor Carney's approach to the fairness opinion debate is engaging but does not, I believe, go far enough. He describes the fairness opinion as serving "corporations and their stockholders" by "assuring the continued application of the business judgement rule during an era when it has been under severe attack." Id. at 525. While I have no qualms with zealously continuing to protect board decisionmaking through a disciplined application of the business judgment rule, the formalistic "requirement" of the procurement of a fairness
evolved third-party liability standard applicable to accountants. If accountants could be held liable to third parties for negligent misrepresentation, why not investment bankers, who served in a similar financial advisory capacity and whose opinions were relied on by similar third parties? The theory of holding a banker liable for an inaccurate fairness opinion under the tort of negligent misrepresentation had thus been born. It would now be up to the courts to give the theory legitimacy.

In late 1987, in what was the first judicial application of newly liberalized negligent misrepresentation principles to financial advisors, a New York court ruled that, in certain instances, shareholders may assert a cause of action in negligence against investment bankers hired by their board of directors. This opinion prior to the application of the rule is not consistent with the purpose behind the business judgment rule, which is to protect the informed deliberations of the board. In fact, the fairness opinion requirement creates a disincentive on the part of the directors to adequately inform themselves. Thoughtful deliberation should be the board’s best protection, not the mechanistic employment of some beholden “expert.” This is sheer formalism with high cost, and, as I argue in this Article, little corresponding benefit.

I am also troubled somewhat by Professor Carney’s discussion of what constitutes a fair price. Id. at 533–35. While I agree with his conclusion that price “fairness” is an elusive concept, I am concerned with any attempt to introduce notions of fairness into the bargaining process at all. In a properly functioning market, a transaction is neither fair nor unfair, only acceptable to the transacting parties. What is of real importance is adequate disclosure. Any focus on fairness, or the lack thereof, misses the point. The problem is not that it is “difficult” to determine fairness, it is that the entire concept of “objective fairness” is inapplicable to an arm’s length transaction.

Delaware was actually the first state to examine the concept of holding an investment banker liable under negligent misrepresentation for an inaccurate fairness opinion. In Weinberger v. UOP, Inc., 426 A.2d 1333 (Del. 1981), rev’d, 457 A.2d 701 (Del. 1983), a minority shareholder attempted to hold an investment bank, among others, liable for what he considered a misleading opinion rendered in a cash-out merger. In a decision that was later withdrawn, the Delaware Supreme Court held that the bank had no liability under a contractual theory. In a dissenting opinion, however, Justice Duffy stated that the bank owed the minority shareholders a duty “to exercise reasonable care” in rendering its opinion as to the fairness of the price offered and “any failure to perform in accordance with that standard would make Lehman Brothers liable to the public stockholders for negligent misrepresentation under the circumstances stated in the Restatement of the Law, Torts 2d § 552.” Weinberger No. 58, 1981 slip op. at 7, 8 (Del. Feb. 9, 1982). In its final opinion in the case, the court omitted any discussion of the bank’s liability, leaving the issue thus unresolved—though the initial Duffy dissent served as a catalyst for discussion of the concept in various circles. For a detailed analysis of the Weinberger decision see Carol B. Haight, The Standard of Care Required of an Investment Banker to Minority Shareholders in a Cash-Out Merger: Weinberger v. UOP, Inc., 8 DEL. J. CORP. L. 98 (1983). See also, Jan G. Deutsch, Weinberger v. UOP: Analysis of a Dissent, 6 CORP. L. REV. 29 (1983); Marc I. Steinberg & Evalyn N. Lindahl, Note, The Duty Owed to Minority Shareholders by an Investment Banker in Rendering a Fairness Opinion, 13 S. REG. L.J. 80 (1985).
was considered a startling development by numerous members of the legal community.\footnote{138} In \textit{Wells v. Shearson Lehman/American Express, Inc.},\footnote{139} a special board committee, established to evaluate the fairness of a proposed management buyout of Metromedia Inc., hired a pair of investment banks, Shearson Lehman and Bear Stearns & Co., to examine and opine on the management’s proposal.\footnote{140} In a fairness opinion sent along with other proxy materials to the shareholders who were being asked to approve the buyout, the banks valued the business’s assets at $1.114 billion. Within a year of the transaction’s completion, however, a portion of the business was sold for $2 billion, and, subsequently, the company received an additional $2.5 billion in the sale of most of its remaining assets.\footnote{141} Distressed by these events, a former shareholder sued the two investment banks for negligently undervaluing the company’s true worth.\footnote{142} The banks responded by claiming that because they had not been retained by the shareholders themselves, there was no privity relationship on which to base liability. The court, however, refusing to dismiss the action on privity grounds, cited the \textit{Credit Alliance} decision,\footnote{143} and ruled that:

\begin{quote}
Assuming Shearson Lehman and Bear Stearns were aware (as they must have been) that their opinion would be used to help shareholders decide on the fairness of [management’s] stock offer, they can be liable to the shareholders.\footnote{144}
\end{quote}

Because of the court’s reference to \textit{Credit Alliance}, \textit{Wells} appears grounded firmly on misrepresentation principles. Since the fairness opinion rendered by the bankers was actually included in proxy materials sent to the

\begin{footnotes}
\item[140] In return for its services, Shearson Lehman was to receive $750,000 for its opinion, $685,000 in broker’s fees, and an additional $3.2 million if the transaction was completed. Bear Stearns was to receive $500,000 for its opinion and $2 million if the merger was consummated. \textit{Id.} at 2.
\item[141] \textit{Id.}
\item[142] The plaintiff also claimed that the banks intentionally undervalued the company to encourage the transaction’s completion in order that they could collect on the larger bonuses. \textit{Id.} at 2.
\item[143] \textit{See supra} notes 96–97 and accompanying text for a discussion of the New York Court of Appeals decision in \textit{Credit Alliance Corp. v. Arthur Andersen & Co.}, 483 N.E.2d 110 (N.Y. 1985).
\item[144] 514 N.Y.S.2d at 2 (citing \textit{Credit Alliance Corp. v. Arthur Andersen & Co.}, 483 N.E.2d 110 (N.Y. 1985)).
\end{footnotes}
shareholders,145 New York’s “approaching privity” standard had impliedly been met.146 One commentator, however, has suggested that the opinion was based on not only the newly expanded theory of negligent misrepresentation, but went even beyond this principle to adopt an agency theory of liability. The basic assumption underlying the application of an agency liability analysis to investment banks retained by special board committees, at least in the circumstance of a takeover, apparently relates to the theory that because such committees are established to protect shareholder interests, services performed for such committees by outside parties are purchased for shareholder benefit. In Wells, prior to examining the banks’ awareness that their report would be examined by the shareholders, the court stated:

Shearson Lehman and Bear Sterns make the untenable assertion that they represented the officers and therefore were not in privity to the shareholders. The officers, however, created a committee whose purpose was to serve the shareholders by determining the fairness of the buyout. The committee hired Shearson Lehman and Bear Stearns. Anybody hired by the committee, aiding in its endeavor, was actually retained to advise the shareholders.147

According to Professor Coffee, this court came close to premising liability on “agency theory: namely that those retained by a board or committee, at least in the context of mergers and buyouts, are in indirect privity with the shareholders and hence liable to them.”148 It must be noted, however, that, in Wells, the shareholders actually received the controversial fairness opinion in their proxy materials. Thus, actual shareholder reliance on the banks’ representations contained therein appears the primary vehicle for the imposition of liability, as one cannot otherwise explain the court’s citation of Credit Alliance.

While investment bank liability predicated on agency principles was an alternative seemingly suggested in Wells, agency theory was to provide the sole basis for liability in Schneider v. Lazard Freres & Co.,149 the most recent and controversial New York case in the bank negligence area. The same New York court that decided Wells stated that it would permit the imposition of liability for negligently rendered advice on two investment banks in favor of shareholders who never actually received nor even relied upon that advice. Schneider involved an action by former shareholders of RJR Nabisco who

145 Id. at 1.
146 See Coffee, supra, note 79, at 5 (noting that Wells can be viewed as falling within the Credit Alliance “approaching privity” standard); see also, Lund, supra note 80 at 613, 614.
147 514 N.Y.S.2d at 2.
148 Coffee, supra note 79, at 6.
alleged that the investment bankers who advised the Special Committee of the board of directors, established to evaluate competing bids for the company, had been negligent in rendering counsel and were consequently liable to the shareholders for their actions. The shareholders complained that on the recommendation of the banks the committee had prematurely terminated an auction for the company, resulting in the sale of the business to Kohlberg, Kravis, Roberts & Co. for a less-than-adequate price.\textsuperscript{150} The court began its analysis of the liability issue by first dismissing any negligent misrepresentation basis for liability. There was no \textit{Credit Alliance} “approaching privity” relationship between the shareholders and the bankers. As the court pointed out:

No claim is made by the shareholders that any of them actually relied on any advice the bankers gave the Special Committee concerning either the conduct of the auction or the relative values of the competing bids. Nor is there any allegation that any such advice was passed on, or intended to be passed on, to any of the shareholders for the purpose of influencing them to take any particular action in connection with the auction.\textsuperscript{151}

What then followed was what several prominent take-over lawyers characterized as a “new—and rather startling” approach for basing liability.\textsuperscript{152} The court, expanding a point vaguely alluded to in \textit{Wells}, suggested that there was contractual privity between the shareholders and the banks through the exercise of agency law principles. The Special Committee was established specifically to protect the shareholders’ interests in the auction. Consequently, a principal/agent relationship existed, with the committee functioning explicitly as the shareholders’ agent.\textsuperscript{153} Having leap-frogged the traditional corporate law principle not of an agency, but of a fiduciary obligation between board and shareholder, the court then stated that:

\textbf{[W]}e do not see how it can be said that a duty of care owed by the bankers to the Special Committee was not intended for the benefit of the shareholders . . . . We do not think it a startling proposition that a principal is in privity with his agent’s agent, or with anyone else his agent deals with on his behalf, so that a negligent statement made by a third person to an agent and relied on by the agent to the principal’s detriment is actionable by the principal.\textsuperscript{154}

\textsuperscript{150} \textit{Id.} at 571–72.

\textsuperscript{151} \textit{Id.} at 574.


\textsuperscript{153} 552 N.Y.S.2d at 574.

\textsuperscript{154} \textit{Id.} at 574–75 (citations omitted).
The bankers who were in contractual privity with the Special Committee were thus liable to the shareholders for any negligently rendered advice.

The imposition of agency principles on a liability action that centers on an allegedly improper board decision was a remarkable departure from the traditional model of corporate responsibility. The board is not the shareholders' agent, but a fiduciary, and is empowered to act independently. As Professor Coffee observed:

[Directors are not agents in the classic master/servant sense, but rather their relationship is sui generis and involves a level of discretionary authority that most agents do not possess. The business judgment rule reflects this broad ambit of authority by conferring a level of immunity from negligence that no other agent seemingly possesses.]

In an attempt to punish and deter slothy bank behavior, the New York court employed an unorthodox methodology that many warned would have a profound and unsound impact on the laws of corporate governance.

In an effort to blunt this criticism, the court limited its application of the agency concept to the extraordinary circumstance of the sale of a corporation. The court wrote:

[The sale of the control of a corporation is not corporate business of the type governed by traditional principles of corporate governance, and... the Special Committee stood in a relationship to the shareholders different from that which normally obtains between a corporation's board and shareholders. The Special Committee's purpose was not to judge transactions accruing to the benefit of the corporate treasury; nor was it concerned with any matters affecting RJR's internal affairs. Rather its purpose was to advise the shareholders with respect to a transaction that contemplated RJR's demise and whose end and aim was to obtain for the shareholders the highest possible price for their stock. In this "buyout" context, if something less than the highest possible price was obtained, the loss was sustained by the shareholders, not the corporation, and, for that reason, we are of the view that the relationship between the shareholders and the Special Committee was essentially that of principal and agent on which principles of corporate law should not be superimposed.]

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155 Coffee *supra* note 79, at 6. Coffee in this article was commenting on the lower court decision that was the basis for the *Schneider* appeal. The agency theory was initially developed at the Supreme Court level and adopted by the court of appeals in its decision, though with some limitation.


This limitation left most commentators unimpressed. Under the agency principles expounded by the court, any negligent third-party advisor to a board could be liable directly to shareholders in a sale-of-control context. Shareholders needed no longer demonstrate reliance and “the reasonable foreseeability and intention of that reliance by the third-party advisor.” The court had abandoned completely the liability-limiting role of privity traditionally applied. This highly suspect approach created a “justifiable fear of over expansive liability” for third parties fulfilling an advisory role in mergers and takeovers.

While prior to Wells a shareholder action against an investment banker for a negligently rendered fairness opinion had practically no chance of success, following Schneider, liability for the negligent banker appeared almost inescapable. Clearly, the most startling feature of Schneider is the fact that no shareholders ever suggested that they actually relied on the bankers’ advice, nor did they even claim that any of that advice was ever shown to them. To the contrary, the court expressly noted that the shareholders were merely expected to follow “passively” the Special Committee’s recommendations. Any attempt to conform the decision with pre-existing third-party advisor liability concepts simply fails, as the opinion is devoid of any facts upon which third-party negligent misrepresentation principles logically apply. Thus, one must view the case not as the logical outgrowth of developing misrepresentation theory, but as a radical and obviously controversial injection of agency law into the third-party liability arena. Although the case expands on the recent trend of liberalizing negligence actions against advisory professionals, because of its unusual approach to traditional corporate governance theory and highly vocal attendant criticism, it is unlikely that the approach will be adopted by very many courts. Nonetheless, the fact that it would allow a banker to be liable to a shareholder for a negligent fairness opinion is very much worthy of consideration.

Despite the unusual tangent taken by Schneider, shortly thereafter, in what is the most recent bank accountability case, a Rhode Island federal district court, deciding a Wells-like negligent misrepresentation claim, explicitly recognized potential investment bank liability to shareholders, utilizing the Restatement of Torts’ “actual foreseeability” approach. In Dowling v.

158 Lund, supra note 80 at 619; see also, Edward Brodsky, Investment Banker Liability to Shareholders, N.Y. L.J., May 3, 1990, at 3; Wachtel, et al., supra note 152, at 4.
159 Lund, supra note 80, at 620.
160 552 N.Y.S.2d at 574.
Narragansett Capital Corp., several former Narragansett shareholders, who dissented from a sale of the corporation’s assets to Monarch Capital Corporation, brought suit against, among others, the investment bankers hired by the Narragansett board to opine on the fairness of the transaction. The shareholders charged that the resulting purchase price was inadequate and that the Salomon Brothers, Inc. fairness opinion, which accompanied the proxy statement, negligently undervalued the company’s worth. Dismissing assertions that dissenting shareholders cannot logically assert reliance upon an investment banker’s advice and that fairness letters merely constitute unactionable opinion, the court proceeded to consider whether the bankers owed the shareholders any duty of care.

After examining Ultramares and its progeny, the court explained that those cases imposing third-party liability upon financial advisors generally involved situations in which the plaintiffs comprised a limited class of persons whose reliance was actually foreseen. Finding the Dowling facts to present such a pattern, the court explained that the opinion produced by Salomon Brothers was “patently intended to guide [the] shareholders,” whose reliance thereon was actually foreseeable. The court explicitly adopted the approach suggested by section 552 of the Restatement (Second) of Torts and held that, under the Dowling facts, the investment banker’s duty to employ reasonable care in rendering its opinion extended to the shareholders. The bank was thus potentially liable directly to the shareholders for any negligent errors contained within its fairness opinion.

Shortly before the release of the Narragansett Capital decision, a California federal district court similarly permitted a negligent misrepresentation claim to be brought against an investment bank in Klein v. King. There, the plaintiffs, shareholders of Informix Corporation, were suing, among others, Hambrecht & Quist, a San Francisco investment bank, who had authored a fairness opinion included in a proxy statement prepared in

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162 Id. at 1110.
163 Id. at 1125.
165 735 F. Supp. at 1125.
166 Id. The dispute in Dowling involved a motion to dismiss and after the court denied the defendant’s motion, the parties eventually settled the contest, thereby precluding the necessity of a final judgement on the issue of the bank’s asserted negligence. Id.
connection with a proposed merger between Informix and another company, Innovative Software. The shareholders alleged that the proxy statement was "overly favorable and deliberately misleading as to the potential success of the merger." Denying the defendants' motions to dismiss, the court allowed the negligent misrepresentation claim to proceed against the bank. The court, citing International Mortgage Co. v. John P. Butler Accountancy Corp., the 1986 California decision extending negligent misrepresentation liability to accountants on the "reasonable foreseeability" approach, ruled that "independent auditors owe a duty of care to reasonably foreseeable plaintiffs who rely on negligently prepared and issued unqualified and audited financial statements." Because the bank had purportedly "culpably participated in the preparation of the allegedly false and misleading proxy statement," the judge denied dismissal of the negligence misrepresentation claim against Hambrecht & Quist, stating that the bank "owed a duty to all plaintiffs who relied on the statement." Although the court gave no explicit reasoning for its decision to allow liability, its discussion of Butler suggests that it had adopted that case's "reasonably foreseeable" approach and extended it to govern both accountants and investment bankers. Bank liability, based on the ruling, seemed likely.

The Wells court's extension of negligent misrepresentation liability to investment bankers under a weakened privity analysis, followed, of course, by its agency liability decision in Schneider, when combined with the Rhode Island Narragansett Capital decision and the California Klein ruling, suggests a dramatic shift in the law of bank negligence responsibility. Whether the basis for liability lies under negligent misrepresentation principles or even the controversial agency analysis, the fact remains clear that courts and the shareholding public have a new tool for remediying slothy bank behavior. No longer need scienter be demonstrated, only negligence. Of course, this change
in approach raises some fundamental questions. Will this extension of liability result in better bank behavior and, consequently, fairer transactions for the shareholder? Put another way, will the benefits to shareholders and our market system generally, resulting from this new approach, outweigh any potential costs? Is there, in fact, any benefit to be derived ultimately from this development? If not, is there any other way to ensure bank probity, or should this so-called problem even be a concern?

III. A CRITIQUE OF THE EXTENSION OF NEGLIGENCE LIABILITY

Although theoretically, under the fundamental principles of tort law, extension of negligence liability to a party will deter careless behavior and consequently produce greater societal benefit, this principle is unworkable in its application to the fairness opinion produced by an investment bank. The negligence approach, advanced by both the courts and commentators as the panacea to faulty valuations, is flawed both economically and juridically.

Ideally, the imposition of negligence liability would force a bank to render an opinion as to the fairness of a given transaction only after extensive and careful study of the deal’s value. It is argued that the lower the standard of culpability, the greater the probity of the potentially liable party. If one is held not to a scienter standard, but negligence, one is expected to act in a more responsible manner. Most commentators have no argument with this approach. Their major concern seems to be with the development of a consistent valuation scheme, structural considerations hindering an independent evaluation, and consequent judicial caution in approaching the question of negligence.175 This “solution” is conceptually appealing and “morally” acceptable, but, in the final analysis, unsound, of little benefit, and ultimately harmful to the injured party—the shareholder.

Theoretically, the negligence approach will produce more “accurate” opinions. However, fundamental economic analysis suggests that, concurrent with this benefit, a number of unpleasant costs will result. If bankers are to be held responsible for the far-ranging (and expensive) consequences of a negligently rendered opinion, the risk of this liability will force higher rates for the delivery of the opinion itself. The bank, as a well-known deep pocket, will become, in effect, an insurer of the fairness of the transaction, and obviously will have to charge fees commensurate with the increased risk of liability exposure. As insurance companies charge more for insuring higher risk activities, so will the banks. How much more remains to be seen, but, given the enormous size of the transactions involved and huge consequent exposure, it is not unlikely that fees will escalate considerably. And who in the end must pay these higher fees?—the shareholders. Although the corporations engaging

175 See supra note 136.
the banks ostensibly pay their fees, in the final analysis it is the shareholders who must pay for their services by a reduced corporate asset base, or, in the sale of the company, a smaller price to be received for their interest after the banks' fees are deducted. Although the banks may still seek indemnification for liability from the companies who have retained them, it is unlikely, given the potential cost involved, that full indemnification will be provided, and, more importantly, a good argument may be made for denying indemnification as has been suggested in actions arising out of the federal securities laws. However, whether the banks are indemnified or not, the cost of a fairness opinion to the shareholders will escalate, whether the bank, or ultimately the corporation itself, must pay for damages arising out of a negligently rendered opinion.

In addition to making fairness opinions more expensive, imposition of negligence liability will also make them less informative. An individual who is to be held liable for inaccuracies in his speech is most likely to meet the threat by simply saying less. It is hard to be found responsible for the consequences of that which you have never said. The choice between saying much while paying more and speaking little while parting with less is an obvious one. Imposing a negligence standard will only cause the banks to write opinions that are less conclusive, more vague, qualified, and of less value to anyone reading and relying on them. Liability may breed caution, but caution may also breed silence. The cost of prodding a liability-conscious bank to say more will obviously result in a higher fee to be paid. The stockholder is caught in an untenable position as a result. He can, in effect, pay more to protect not his interest, but the pockets of his directors, or pay less and receive less "pertinent" information, if that is in fact the purpose of a fairness opinion. A similar problem exists in the accountancy field in which negligent misrepresentation liability is better established and more advanced. Accountants' opinion letters have become, with the imposition of liability, more expensive and less extensive. Indeed, even the legal profession itself

176 See Giuffra, supra note 12, at 140–41.
178 For an economic analysis of the impact of negligent liability on accountants see Thomas E. Bilek, Accountants' Liability to the Third Party and Public Policy: A Calabresi Approach, 39 Sw. L.J. 689 (1985). The increase in the number of judgments against accounting firms has apparently forced many of the smaller firms out of the auditing business. Those larger firms that remain take a number of steps to reduce liability. They have raised their fees to cover the cost of liability insurance as well as to take advantage of the reduced competition. Additionally, firms have become more cautious. In deciding
has become concerned with potential third-party liability for its own written opinions. A number of bar groups have proposed new forms of legal opinions that are much more cautious and limited in terms of their scope. The language of disclaimer abounds throughout the documents.\(^{180}\)

Although the imposition of liability will probably inspire more care in the banking community, will the resulting higher costs and less information dispensed be worth this potential benefit? If fairness opinions did in fact play a critical role in the evolution of a particular transaction by a shareholder, then perhaps one could argue that they would. But it is not clear who, other than the board which utilizes such opinions for liability limitation, actually bases an investment decision on them (although for liability purposes, most shareholders would ostensibly claim that they did). The surge in the sheer numbers of opinions issued took place following \textit{Van Gorkom}. If these opinions had been so critical to a shareholder’s decisionmaking process prior to that case, then no corresponding increase in opinions rendered would have been noted.

A distinction may also be made between the accountant’s report and a fairness opinion. A shareholder makes an investment decision by evaluating the financial condition of the enterprise and reaching his own conclusion based on his independent judgment. Essential to the integrity of the decisionmaking process is accurate financial information. An accountant’s opinion is designed to assure the reader that the company’s financials were prepared in accordance with generally accepted accounting procedures and were honestly prepared to the best of the accountant’s knowledge. Assuring the investor that the accountant’s opinion is accurate by the imposition of negligence liability might be worth the added expense. Making an investment decision without accurate numbers is as hazardous as driving an automobile with one’s eyes closed. The same may not, on the other hand, be true for a fairness opinion. A fairness opinion is simply one party’s conclusory judgment as to the validity of another’s conclusion on a financial matter. An opinion is only as important as the faith one has in the judgment of the opining party. An accountant’s report deals with the tangible, and accuracy as to the tangible is obviously valuable.

But, is “accuracy” as to the validity of one’s opinion worth the increased cost with less information? Probably not. Critical to this analysis is obviously the reliability of the process by which a banker forms an opinion. And, as discussed earlier, the variability of the analytic process combines with structural considerations inherent to the investment banking business that prevent truly independent evaluation, to cloud any image of reliability. Why not then “fix” the valuation process to ensure accuracy? If the procedure could be properly policed, could the benefits derived from an “accurate” valuation process outweigh any costs occasioned by negligence liability? Unfortunately not. This assumes that a “proper” valuation procedure may be developed, which is an unrealistic goal.

To impose a negligence liability regime on the investment banking industry first requires the development of a definition of what is “appropriate” conduct. Each of the commentators who have examined this phenomenon have called for the development of some universally accepted standard or standards for the preparation of a fairness opinion. One has even suggested the creation of a model statute defining what bank probity ought to entail.\(^1\) If standards for other professionals can be developed, why not do the same for the banking business? This approach is well-intentioned but terribly flawed. To have a standard by which to measure bank conduct, one must first reach some agreement as to what that standard should be. This cannot and will not occur.

First, as Professors Bebchuk and Kahan have pointed out, no one has yet even to agree what a “fair price” is definitionally.\(^2\) What is fair, and to whom? The concept is amorphous. If no one can agree what “fairness” stands for, how can we judge what is fair or unfair? Only hindsight, always 20/20, will tell. Second, and more importantly, there is no uniformly accepted valuation procedure by which the banks may arrive at a “fair price.” As noted earlier, there are at least four widely recognized and commonly utilized valuation processes. Each of these, used either independently or in combination, will yield very different results. It is difficult to suggest that any of these approaches is either totally without merit or the panacea. Each has benefits and each has equally significant disadvantages. That is probably why the better approach is some sort of combination of processes. Developing a uniform and proportional “combination,” however, may also prove to be an elusive effort. Each industry, indeed each company, has its own set of unique problems that prevents application of some standardized approach. The variables that comprise the various valuation processes are themselves often highly subjective, leaving much room for a bank to maneuver.

\(^1\) Schuldt, *supra* note 136, at 115–19. For discussion of proposed standards governing investment banking, see *supra* note 136.
\(^2\) See *supra* notes 19–27 and accompanying text.
Given the fact that each approach is highly supportable and each is subject to various drawbacks, we are left with a juridical problem in creating a system of negligence liability. The development of such a system requires first the creation of some notion of “reasonable” conduct, deviation from which is negligent.

Development of such a concept first requires some sort of agreement as to what constitutes reasonable behavior—that is, what approach (or approaches) to the valuation conundrum is the most thoughtful or precise? However, for the reasons stated ad infinitum (and ad nauseam) by those familiar with the field, the use of any or all the methods described above may be either fully justifiable, or, as each may produce radically differing results, utterly meaningless. Thus, we are faced with a valuation universe that will always produce highly varied results. But, as an asset can, in the final analysis, have but one value, each of the values “rationally” developed under accepted procedures that does not meet that one “right” price is thus incorrect. But was the process that created them negligent? Obviously not. If all methods used may be justified, and the “best”—that is, the one that produces the accurate result—is only determinable if the business in question is resold within some short period following the valuation, how will a court, faced with determining the existence of negligent conduct, be able to act in a fair and defensible manner? We are faced with two unpleasant prospects: (1) proof of the existence of a higher value than that opined on by the bank will always compel a finding of negligence, or (2) if any of the various accepted methods were used, then, absent absolutely atrocious behavior (which would probably end up proving to be fraudulent and thus actionable under other approaches) a court would never find negligence. Imposition of negligence liability sets the unwelcome stage for either the finding of universal negligence, or universal reasonable conduct. With the existence of so many acceptable valuation strategies, unfortunately, no other result appears likely. Those who attack the conclusions of a fairness opinion as “negligent” really have no strong argument against the “process” used for forming the opinion; they are really only quarreling with the result.\footnote{In actuality, they are really attacking the perceived “collusion” between the bankers and management that results in valuations they feel to be inadequate opined of as fair. “Collusion” is difficult to prove, however, while simple negligence is a much more promising basis for recovering the difference between what they received for their shares and what they felt they ought to have received. Therefore banker misconduct is not called fraudulent, but criticized as sloppy.} But to draw a parallel with the business judgment rule, as long as the process remains sound, then the result, no matter how awful, should be protected. Where numerous methods of valuation exist and no clear standard exists, or can exist, for determining the most acceptable method, short of hindsight, we will never develop that standard of “reasonableness” required for the proper application of a negligence standard. The concept of “making banks more
IV. THE “SOLUTION” TO THE FAIRNESS PROBLEM

If the imposition of negligence liability will not lead to bank probity, then what will? To find some solution to this problem, we must first re-examine the whole purpose for fairness opinions. Were they developed to create a better informed shareholder universe? Hardly. The tremendous demand for them that was created following the Van Gorkom ruling did not develop on the basis of shareholder interest. No mobs of shareholders formed outside corporate boardrooms demanding the employment of a neutral investment banker to protect their interests from the inept decisions of their boards. No shareholder resolutions were formulated calling for the engagement of, to use a popular cliche, these financial white knights. It was the boards themselves that sought out the banks’ services for their own interests, not those of the stockholders. The fairness opinion acted to insulate a board from liability for a decision later judged ill-conceived. The opinion following Van Gorkom was really only to act as a “type of insurance” to protect against board negligence liability to the shareholders.184 Given this illustrious history, the fact that the valuation process is so amorphous, and the banks themselves, due to structural considerations pointed out earlier, are pliable, is it any wonder why the entire process has come under attack?

Following the liability-imposing Van Gorkom decision, corporate directors faced a difficult dilemma when called upon to approve a corporate purchase or sale. If the price they voted to accept was later judged inadequate, they could incur significant liability unless they demonstrated that they were informed when making their decision.185 The fairness opinion provided the proverbial “easy out.” Once a price had been established, given the flexible valuation process and an investment banking community eager to please corporate management, a liability-limiting opinion was easily obtained. The ease of acquisition would of course, not come without its costs. Yet, for the added expense, the board’s personal wealth could remain intact. This phenomenon, while preserving director capital, did little to protect that of the shareholders. The cost of obtaining the opinion was simply passed on to the stockholders in the form of a smaller corporate asset base or lower price per share to be received at time of sale. The directors benefitted from the opinion, but did the shareholders gain anything from the transaction? Not at all. The opinion, drafted to suit the needs of the directors, offered little in terms of substantive

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184 Fischel, supra note 17, at 1453.
value for the stockholders. As Professor Fischel astutely predicted at the time of the Van Gorkom ruling:

Shareholders are the biggest losers after [Van Gorkom]. Firms will have no difficulty finding an “expert” who is willing to state that a price at a significant premium over the market price in an arm’s-length transaction is “fair.” (I wish someone would pay me several hundred thousand dollars to state that $55 is greater than $35.) But the cost of obtaining such an opinion is, in effect, a judicially imposed tax on fundamental corporate charges.186

If the process of valuation could be manipulated (by choosing the proper result-bearing technique) to “backstop” a board’s initial judgment on value, then all that resulted from the process was an additional cost borne by the shareholders with no corresponding benefit for them. Why not then have the directors themselves pay the cost of the fairness opinion? The result would be highly problematic. First of all, because of the tremendous expense required to procure these opinions, either directors fees would have to be increased to the point of irrationality or no one could be found to serve as a director. More importantly, if the goal of the court in Van Gorkom was to create an “informed” board process that would result in the shareholders receiving more for their investment,187 this solution, other than protecting the board, still does nothing to meet the court’s, and in fact the investing public’s, concerns.

In reality, the shareholders, most of whom in today’s market are sophisticated institutional investors, do not rely on these suspect opinions. And with popular attention also focused on the “fairness for hire” syndrome, it is doubtful that even individual investors actually fall prey to casual reliance.188 Although the imposition of negligence liability would provide them with at least one group from whom to seek financial redress for a retrospectively bad director decision, is it worth the cost? Probably not. If liability were imposed, the banks would say less and charge more. And, as noted earlier, either the courts would have a difficult time ever finding negligence because of the difficulty of developing a “reasonableness” standard or, following a universal

186 Fischel, supra note 17, at 1453.
187 As the court stated:

A director’s duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and shareholders. . . . Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.

Van Gorkom, 488 A.2d at 872 (citations omitted).
188 See supra notes 47–48 and accompanying text.
imposition of liability by the courts, the fees charged for such opinions would eventually equal the cost of such liability, or force banks out of the opinion business altogether, creating a zero-sum game for the shareholders.

To develop some solution to this difficult state of affairs, we must first examine the reasoning that lay behind the judicial imposition of the fairness opinion “requirement.” Ideally, the presence of an independent third-party valuation expert would ensure that the decision the board had reached as to price was fair. This was to protect shareholder wealth. Unfortunately, the third party proved neither independent, nor a particularly precise arbiter of value. In an attempt to force the banks to conform to their judicially created roles, it has been suggested that the imposition of negligence liability will bring about independence and valuation precision. As discussed, this is an unworkable approach. In the final analysis, the fairness opinion only leads to increased transaction costs that are ultimately paid by the stockholders without corresponding benefit. If such opinions act merely as self-serving shields of director behavior and are not true indicators of value, then what force exists to promote fair value for the stockholders? The simple operation of ordinary market forces acts to ensure value. Opinions on value are just that—opinions. Value is simply what one individual is willing to pay for a particular asset at a given point in time. Investors are aware of the problems inherent in fairness opinions—that is why the price ultimately received in a corporate control contest is often higher than that initially proposed. They make their own judgments on value when they decide to buy or sell based on their own conclusions on the financial information presented to them. It really matters little whether the opinion calls a price adequate or not. If the investors conclude that a price is fair, they will buy or sell on their own initiative. The market itself acts to determine price adequacy. A suspect fairness opinion adds nothing to the process.\textsuperscript{189} It is as necessary to valuation analysis as is the appendix to the human digestive system. Consequently, the \textit{Van Gorkom} “requirement” of a fairness opinion should be abandoned, along with any attendant negligence liability. Other than producing profits for the investment banking industry, it produces no benefit for the shareholders. If its real purpose is to protect corporate directors, such could be just as easily accomplished through the procurement of an insurance policy. To promote shareholder value, judicial integrity, and market efficiency, any sort of legal demand for such meaningless and value-appropriating opinions must be eliminated.

Elimination of the “requirement” and any accompanying liability will not end the use of the fairness opinion entirely. Prior to \textit{Van Gorkom}, such

\textsuperscript{189} \textit{See In Re Armsted Indus., Inc. Litig., No. 8224, 1988 Del. Ch. LEXIS 116, at *21 (Aug. 10, 1987) (“A decent respect for reality forces one to admit that such advice is frequently a pale substitute for the dependable information that a canvas of the relevant market can provide.”).}
opinions were utilized in a variety of transactions. The result, however, will be that these opinions will be viewed for what they really are—simply one individual’s view on value, to be discounted by how compromised that view may be due to relational factors. This is probably what occurs anyway under the present regime, but because of fear of liability, at great cost. Legal rules that fail to recognize this reality accomplish little and may even prove counterproductive to the goal of protecting shareholder capital. The fairness opinion “rule,” mainly the product of judicial formalism without any corresponding advantage, must be eliminated from the legal landscape if we are ever to accomplish maximum economic and societal benefit.