Since the Delaware Supreme Court’s 1985 decision in *Smith v. Van Gorkom (Trans Union)*, the market for “fairness opinions” has been robust. In *Van Gorkom*, the directors of Trans Union approved a sale of the company to the Marmon Group in a cash transaction representing a 48 percent premium over the last closing price of Trans Union stock. A group of shareholders challenged the transaction, arguing that the board breached its fiduciary duties by not fully informing themselves before approving the transaction. Despite what seemed to be a good deal for the shareholders, the Delaware Supreme Court found that the directors breached their duty of care and held them personally liable for $25 million. One of the court’s criticisms of the board was that it did not elicit a fairness opinion. While the court did not find that fairness opinions were required in every merger or acquisition (indeed, it expressly said otherwise), these investment bank “approval stamps” have become nearly ubiquitous in public change of control transactions.

Over 25 years after *Van Gorkom*, and countless fairness opinions later, however, there still is very little guidance in the case law on liability standards for investment banks issuing these opinions. A fair amount has been written about who may bring an action against an investment bank, but less has been written on the issue of when an investment bank will be held liable.

This two-part article analyzes three issues in connection with an investment bank’s issuance of a fairness opinion: (i) the types of shareholder claims an investment bank may face, (ii) the limited guidance courts have provided on the “standard of care,” and (iii) how investment banks may attempt to mitigate the risk of liability. Part One of the article reviews types of shareholder claims and judicial guidance on the standard of care, and Part Two will discuss strategies to mitigate the risk of liability.
Types of Claims Faced by Investment Banks

– **Negligence/Fiduciary Duty Claims**

The most common claims asserted by shareholders against investment banks for issuing fairness opinions sound in fiduciary duty and negligence.7 The key element in both claims is, of course, duty.

– **Duty: Contractual Privity Not Required**

In the late ‘80s and early ‘90s, there were a handful of cases that held that contractual privity was **not** required in order for shareholders of a company to bring suit against an investment bank that issued a fairness opinion to the board.8 As stated by these courts, the test for shareholder standing is whether the investment bank should have foreseen shareholder reliance on the fairness opinion.9

The court disagreed. It focused on the relationship between the special committee and the shareholders, concluding that such relationship “was essentially that of principal and agent[.]”10 Because the special committee was an “agent” of the shareholders, the court found that the bankers’ duty to the special committee extended to the shareholders, as the “principals” of the special committee.11 Significantly, the court’s holding suggested that the bank’s duty to shareholders was “automatic,” and that there was no need even to show that it was foreseeable that the shareholders would rely upon the fairness opinion.12

– **What Types of Conduct Would Be Actionable**

 Assuming that a “duty” can be established, plaintiffs must still show that the investment bank breached that duty and/or acted negligently. There has, however, been a relative dearth of case law discussing what specific conduct would be considered “negligent” or a breach of fiduciary duty in the preparation of fairness opinions.13 The principal problem is that each fairness opinion is transaction-dependent—involving unique financial considerations and assumptions—so it is difficult to establish a uniform “standard of care.”14

As a general matter, courts have applied a “reasonable investment bank” standard to such claims, looking for evidence that the investment bank did more than “rubber stamp” the fairness of the transaction.15 We address below a handful of cases that have given at least some specific guidance on the standard of care issue.

– **Failure to Use Certain Valuation Methods**

*City Partnership v. Lehman* involved a claim by certain limited partners that their vote to approve a sale of the partnership’s assets was solicited through a misleading proxy statement and fairness opinion. The limited partners claimed that the investment bank that issued the fairness opinion—Lehman Brothers—was negligent for not using a discounted cash flow (DCF) analysis, and that had it used such an analysis, its valuation of the assets would have been considerably higher (making the sale price “unfair”).16

While the court found it a “bit troubling” that the proxy statement did not reference the fairness opinion’s employing a DCF method, it held that such an omission was the responsibility of the partnership, not Lehman.17 Additionally, the limited partner plaintiffs, as sophisticated investors, “would have been cognizant of such an omission had they conducted more than a superficial review of the materials.”18 The court went on:

> Should Lehman have nevertheless conducted a cash flow analysis and disclosed its results? Perhaps so to make the Fairness Opinion a more complete statement of the market value of the Riverside System rather than an abstract concept. *However, an arguably less than ideal or complete valuation does not necessarily constitute a fraudulent or misleading valuation effort.*19

Credit: Daniel Acker/Bloomberg

Probably the most troubling of these opinions for investment banks was *Schneider v. Lazard Freres & Co.*10 In *Schneider*, shareholders of RJR Nabisco contended that the board conducted a faulty auction of the company that resulted in acceptance of a bid that was considerably lower than could have been obtained in a fair auction. The shareholders sought damages from the investment banks that rendered advice to the special committee of the board that supervised the auction. The bankers argued that their advice was provided solely to the special committee and that, therefore, the shareholders had no right to rely upon that advice.
Assumptions About Future Economic Conditions

In Herskowitz v. Nutri/System, Inc., Connecticut National Bank (CNB) was hired by a special committee of Nutri/System to issue a fairness opinion in connection with a proposed sale of the company. CNB issued a fairness opinion that the $7.16 per share offer was fair, premised upon cash flow projections that assumed a 46 percent corporate tax rate for the next five years. At the time, however, there was pending legislation that would have reduced the corporate tax rate. If the legislation passed and was applied to CNB’s DCF valuation, the company’s value would have increased and the $7.16 per share offer would no longer have been fair.

Shareholders brought suit against CNB, arguing that the opinion’s reliance on the 46 percent tax rate was unreasonable. The district court disagreed, granting CNB a directed verdict because the proxy statement indicated that the applicable tax rate could change.

The Third Circuit reversed, finding there was a question whether it was reasonable for CNB to have relied on the then-current 46 percent tax rate. In so holding, it relied upon the plaintiffs’ expert’s opinion that, at the time of the fairness opinion, the tax reform legislation “was virtually certain to become law.” The court also noted that CNB employees who worked on the fairness opinion testified that they were aware of the impending tax reforms.

Claims Arising Under the Federal Securities Laws: To Be Actionable, the Opinion Must Be Objectively and Subjectively False

Fairness opinions are often required to be disclosed in registration statements and proxy statements, and are sometimes also disclosed in solicitation/recommendation statements issued in response to tender offers. Investment banks, therefore, sometimes find themselves defending shareholder suits under Section 11 of the Securities Act of 1933 and Sections 14(a) and (d) of the Securities Exchange Act of 1934, which create civil liability for false statements in public disclosure documents.

To successfully bring a claim under these provisions, shareholders must show that the fairness opinion is false. Courts have held that showing that the investment bank was “negligent” in preparing the fairness opinion is insufficient to show “falsity.” As the district court noted in In re McKesson HBCO, Inc. Securities Litigation, “the securities laws do not create a general cause of action for negligence by investment advisers—they only reach false statements made by those investment advisers.”

Because a fairness opinion is, by definition, an “opinion,” courts have held that it will be deemed a “false statement” for the purposes of the federal securities laws only if it is “objectively and subjectively false.” A fairness opinion is “objectively false if the subject matter of the opinion is not, in fact, fair, and is subjectively false if the speaker does not, in fact, believe the subject matter of the opinion to be fair.” Similarly, a claim under Section 10(b) of the Exchange Act requires shareholders to show scienter, i.e., that “the firm purposefully and intentionally caused a false statement to be issued.”

The court’s holding suggested that the bank’s duty to shareholders was “automatic,” and that there was no need even to show that it was foreseeable that the shareholders would rely upon the fairness opinion.

The “falsity” and/or scienter requirements of the federal securities laws have led a number of commentators to conclude that shareholders bringing such claims face an uphill battle. Look in the next week’s issue of Bloomberg Law Reports—Corporate and M&A Law for Mr. Casey’s insights into mitigation of risk in connection with issuing fairness opinions.

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1 488 A.2d 858 (Del. 1985).
2 Id. at 869.
3 Id. at 893.
4 Id. at 876.
5 M. Breen Haire, The Fiduciary Responsibilities of Investment Bankers in Change-of-Control Transactions: In re Daisy Systems, Corp., 74 N.Y.U. L. Rev. 277, 292-93 (1999) (“Since [Van Gorkom], [fairness opinions] have become a practical necessity; in fact, the failure to obtain one in a major transaction today would be deemed exceptional.”).
6 Stephen I. Glover & Doreatra M. Vansimme, Fairness Opinion Issues Anything but Routine, Nat’l L. J., April 15, 1996, at C13 (“In virtually every significant transaction, the board of directors of the selling company will request at least one investment banking firm to confirm that the price to be paid is fair from a financial point of view . . . . While not required by law, fairness opinions have become standard in mergers and acquisitions.”
8 See, e.g., Charles M. Elson, Fairness Opinions: Are They Fair or Should We Care?, 53 Ohio St. L.J. 951, 954 (1992); Ted J. Fillis, Responsibility of Investment Banks to Shareholders, 70 Wash. U. L.Q. 497 (1992); Michael J. Kennedy, Functional Fairness—The Mechanics, Functions and Liabilities of Fairness Opinions, Practising Law Institute, Corporate Law and Practice Course Handbook Series, 1255 PLI/CORP 605, 658-667 (May/June 2001); John. S. Rubenstein, Merger & Acquisition Fairness Opinions: A Critical Look at Judicial Extensions of Liability to Investment Banks, 93 Geo. L.J. 1723 (June 2005). As these authors conclude, the case law is still fairly unsettled on the issue of when shareholders may bring suit against an investment bank for issuing a fairness opinion.

1. See Wells, 127 A.D.2d at 202 (“assuming [the investment banks] were aware (as they must have been) that their opinion would be used to help shareholders decide on the fairness of Metromedia’s stock offering, they can be liable to the shareholders”); Dowling, 735 F. Supp. at 1124-25 (“Salomon was hired to assess the adequacy of the proposed purchase price for NCC’s assets. That assessment was patently intended to guide shareholders in deciding whether to approve the sale. Consequently, Salomon’s duty to exercise reasonable care in preparing its assessment extended to NCC’s shareholders.”).

10. 159 A.D.2d 291.

11. Id. at 297.

12. Id. at 296.

13. Id.; see also Kennedy, supra note 6, at 663.

14. See, e.g., Steven M. Davidoff, Fairness Opinions, 55 Am. U.L. Rev. 1557, 1567 (Aug. 2006) (“the exact scope of an investment bank’s liability to stockholders for the rendering of an ‘incorrect’ fairness opinion is still uncertain and subject to much judicial and academic debate”); Haare, supra note 5, at 294 (“There are no objective guidelines or systematic criteria for use in determining whether a control transaction is fair.”).

15. See, e.g., Elson, supra note 6, at 998. (“If” from a juridical standpoint . . . 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 . . . . 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?); Bowers, supra note 5, at 575 (noting that fairness opinion cases are “relatively small in number and too divergent to establish a legal standard”).

16. One commentator has noted that “[r]elevant questions to determine if the investment bank acted negligently when rendering an opinion could include (1) whether the assumptions used to project financial statements for the valuation analyses were reasonable and (2) whether, under the circumstances, the investment bank’s reliance on its client’s projections was reasonable.” Rubenstein, supra note 6, at 1732; see also Fills, supra note 6, at 519 (suggesting the following general standard of care for investment banks in issuing fairness opinions: *(1)* maintaining the appropriate level of skill; *(2)* selecting and disclosing the appropriate fairness concept for the transaction; *(3)* selecting, disclosing, and explaining the measurement techniques used—e.g., discounted cash flow, liquidation value; *(4)* fully disclosing any and all of the bankers’ conflicts of interest; and *(5)* fully disclosing all qualifications, assumptions and sensitivity studies deemed necessary to give an adequate comprehension of the opinion”; Martin, supra note 7, at 167 [*[3]*] three pronged standard of care can be construed for investment bankers who render fairness opinions upon which third party shareholders rely: *(1)* a duty to investigate; *(2)* a duty to perform a reasonable analysis; and *(3)* a duty to disclose the bases for the opinion”). See also City Partnership Co. v. Lehman Brothers, Inc., 344 F. Supp. 2d 1241, 1249 (D. Colo. 2004) (investment bank not negligent where “[s]afeguard information, financial and otherwise, as it possessed or was provided by [the client], it processed such information, it did not disregard information it was provided, it held internal meetings to discuss the fairness opinions, and it met with the client to share its results. . . . [T]here is no credible basis for establishing that Lehman engaged in a charade or merely rubber-stamped a predetermined result sought by [the client].”)


18. Id. at 1249-50.
Since the Delaware Supreme Court’s 1985 decision in *Smith v. Van Gorkom (Trans Union)*, opinions by investment banks on the fairness of proposed deals have become nearly ubiquitous in public change of control transactions. This two-part article analyzes three issues in connection with an investment bank’s issuance of a fairness opinion: (i) the types of shareholder claims an investment bank may face, (ii) the limited guidance courts have provided on the “standard of care,” and (iii) how investment banks may attempt to mitigate the risk of liability. Part One of the article (in our August 29, 2011 issue) focused on the types of shareholder claims common in challenging fairness opinions, and judicial guidance on the standard of care. Part Two discusses the strategies to mitigate the risk of liability.

Both regulatory and case law support the proposition that disclaimers that banks are not independently verifying information provided by the board will be upheld.

Strategies to Mitigate Litigation Risk

Largely in response to the *Schneider* case discussed in Part One of this article, the practice of investment banks in issuing fairness opinions evolved. Specifically, in an attempt to prevent a finding of any duty to shareholders, investment banks began to stress in engagement letters and fairness opinions themselves that their opinions were being provided exclusively to the board and that
they were offering no opinion regarding whether shareholders should approve the proposed transaction. Additionally, to prevent court attempts to broaden the measure of review required of investment banks in the preparation of fairness opinions, banks also began including disclaimers that they were relying on—and not independently verifying—information provided by the board.4

Disclaimers that the Fairness Opinion Is Meant Only for the Board and Is Not a Recommendation to Shareholders

Three recent opinions from Illinois discuss “intended for the board only” disclaimers. In Young v. Goldman Sachs & Co.,7 the Circuit Court of Cook County, Illinois, distinguishing Schneider and Wells,4 discussed in Part One of this article, held that an investment bank issuing a fairness opinion to a board did not owe duties to the shareholders because the engagement letter and fairness opinion both stated that the advice was solely for the board:

[The] stockholders were made aware that the advice offered by Goldman Sachs was solely for the benefit of the Board of Directors, thus, the holdings in Schneider and Wells are simply not applicable to the instant matter and cannot be relied upon to support the proposition that Goldman Sachs owed a duty to Plaintiff.7

Similarly, in Joyce v. Morgan Stanley & Co., Inc.,8 the U.S. Court of Appeals for the Seventh Circuit upheld the dismissal of a shareholders’ action challenging Morgan Stanley’s fairness opinion because Morgan Stanley owed the shareholders no duty. In so holding, the court relied upon disclaimer language in Morgan Stanley’s engagement letter and fairness opinion that Morgan Stanley owed duties only to the board, that the opinion was intended only for the board, and that it expressed no opinion on how the shareholders should vote on the transaction.9

Another recent Illinois decision, City of St. Clair Shores Gen. Employees Ret. Sys. v. Inland W. Retail Real Estate Trust, Inc.,9 reached a different result. In St. Clair, plaintiff shareholders of Inland Real Estate Investment Trust (REIT) alleged that the proxy statement and fairness opinion used to solicit their vote on an acquisition was misleading because it overvalued the target entities. The investment bank that issued the opinion moved to dismiss the complaint, arguing that: (i) the fairness opinion was properly based on data provided by the board, (ii) the bank did not have a contractual duty to research the accuracy of these numbers, and (iii) the opinion was provided solely to the special committee, not the shareholders.

The court denied the investment bank’s motion to dismiss, relying upon language in the proxy materials which stated that the fairness opinion “related . . . to the fairness from a financial point of view, to us [the directors] and our stockholders of the consideration to be paid by us in the merger.”10 Even though the proxy materials stated that the fairness opinion did not constitute a “recommendation” to shareholders, the court held that the “bottom line” was that “plaintiffs have alleged that [the investment bank] issued a misleading Fairness Opinion on the financial fairness of the Internalization, the Opinion was foreseeably included in the Proxy, and the Shareholders relied on the Opinion in deciding how to vote on the Internalization.”12 With additional allegations that the investment bank was familiar with “red flags” in the financial information provided by the Board and was in part compensated on the contingency that the transaction was consummated, the court concluded that “[t]his is enough, at the pleading stage, to support a § 14(a) claim against [the investment bank.]”12

To prevent court attempts to broaden the measure of review required of investment banks in the preparation of fairness opinions, banks also began including disclaimers that they were relying on—and not independently verifying—information provided by the board.

Disclaimers that the Investment Bank Is Relying Upon—and Is Not Independently Verifying—Information Provided by the Company

Both regulatory and case law support the proposition that disclaimers that banks are not independently verifying information provided by the board will be upheld.

FINRA Rule 5150

In December 2007, the U.S. Securities and Exchange Commission approved Financial Industry Regulatory Authority (FINRA) (f/k/a the NASD) Rule 2290 (later re-numbered Rule 5150), which requires that, if a member firm knows or has reason to know that its fairness opinion will be provided or described to a company’s public shareholders, that firm must make specific disclosures in the fairness opinion. One of the required disclosures is that, “If any information that formed a substantial basis for the fairness opinion that was supplied to the member by the company requesting the opinion concerning the companies that are parties to the transaction has been independently verified by the member and, if so, a description of the information or categories of information that were verified.”14 The inclusion of this rule suggests that the SEC does not require the investment bank to independently verify information provided by the board.
— The Case Law

Consistent with the FINRA rule, courts historically have upheld disclaimers in fairness opinions that the investment bank is relying on information provided by the company and is not independently verifying that information.

— In re Global Crossing

In In re Global Crossing, Ltd. Securities Litigation, plaintiffs brought a claim under Section 11 of the Securities Act of 1933 against an investment bank, Donaldson, Lufkin & Jenrette (DLJ), that issued fairness opinions in connection with two of Global Crossing’s (GC) acquisitions. Plaintiffs argued that DLJ was “at least negligent in not uncovering the illusory basis for GC’s revenues and revenue projections.” The court disagreed based on DLJ’s express statement that it was relying on management’s projections and made no independent verification of them:

DLJ had not purported to make a reasonable investigation of the financial information provided by GC. To the contrary, it expressly revealed that it had taken the information at face value, and opined only that, if that information was true, the [transaction] was fair.

While that disclaimer would not exempt DLJ from liability for making false statements under Section 11, plaintiffs offered no evidence that DLJ was aware that the projections were not reliable or that DLJ was “privy to information known to GC executives that would have undermined the financial information on which DLJ purported to rely.”

— The HA2003 Liquidating Trust

In The HA2003 Liquidating Trust v. Credit Suisse Securities (USA) LLC, the bankruptcy trustee of HA-LO Industries brought a negligence claim against Credit Suisse First Boston (CSFB) over a fairness opinion it issued in connection with HA-LO’s acquisition of an e-commerce business, Starbelly.com. CSFB expressly stated that it was relying on the projections provided by HA-LO’s management and would not independently verify those projections.

The trustee complained that CSFB should not have relied on management’s projections and should have heeded the warnings of HA-LO’s accountant, Ernst & Young, which told management that the projections were unrealistic. The trustee further argued that CSFB should have withdrawn or amended its opinion after the market price of many Internet stocks began to decline.

The district court found for CSFB, noting that CSFB’s engagement letter, the fairness opinion itself and the proxy statement all provided that CSFB would rely on management projections and would not conduct any independent verification thereof. The court noted that, even if CSFB had duties beyond those set forth in its engagement letter, they would not have encompassed independently verifying the projections, given that HA-LO never asked CSFB for its view on the acquisition and excluded it from board meetings, and rejected the plaintiff’s claim that CSFB failed to “update” the opinion because HA-LO never asked it to do so.

On appeal, Judge Easterbrook of the Seventh Circuit affirmed. In relying on management’s projections, “CSFB followed the norm in this business—more to the point, it followed the rules in its contract with HA-LO—and relied on management’s numbers.” The court noted that E&Y told management that its projections were unrealistic, but management ignored its advice—”[the bankruptcy trustee] can’t blame that on CSFB.” The court also rejected the trustee's contention that CSFB should have foreseen the end of the dot-com boom. That claim, the court held, was “an appeal to hindsight.”

According to the court, if CSFB was too optimistic about Internet stocks, so too were all of HA-LO’s managers and thousands of other investors. The court concluded that an “[i]nability to see the future, differs from gross negligence.”

As for CSFB’s “failure to update” the fairness opinion, Judge Easterbrook again relied upon the plain language of the engagement letter, which required only a single fairness opinion—“CSFB undertook to deliver an opinion as of one date”—and there was nothing requiring the bank to supplement its original opinion. In short, the engagement letter “says that CSFB has no duty to double-check the predictions about Starbelly.com’s future revenues and no duty to update its opinion. CSFB did what it was hired to do.”

The Seventh Circuit’s opinion should provide some comfort for investment banks, as reliance on management projections is standard fare for fairness opinions. Additionally, unless the engagement letter requires the investment bank to update its opinion, in Judge Easterbrook’s view, such an update or amendment is not required—no matter how greatly circumstances have changed since the fairness opinion was originally issued.
Conclusion

Although the case law is far from fully developed, it seems clear that investment banks should include the following categories of language in the engagement letter, in the fairness opinion, and in any proxies or registration statements in which their fairness opinions are discussed: (i) the investment bank’s duty runs only to the board/special committee and not to the shareholders or any other party; (ii) only the relevant board/special committee members in their capacities as directors/committee members are the intended parties; (iii) the opinion is not a recommendation to the shareholders or to anyone else; and (iv) the investment bank relied upon the information provided by the board and did not independently verify it.

More fundamentally, in issuing a fairness opinion, an investment bank should act as a “reasonable investment banker.” Although there is no set of prescribed rules on this topic, the case law—and common sense—suggest at least the following: (i) using appropriate valuation techniques and comparables; (ii) undertaking appropriate due diligence; (iii) making assumptions consistent with current and future economic realities; (iv) critically analyzing management projections (even though it is fairly well-established that investment banks may rely upon management information); (v) ensuring that the individuals responsible for the work are sufficiently experienced in fairness opinions and valuation techniques; and (vi) employing rigorous internal procedures—including the use of a separate fairness opinion committee to review any such opinions before they are issued—that test the decisions/assumptions made.

Taking these steps should help to mitigate the litigation risks faced by investment banks when issuing fairness opinions.

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1 488 A.2d 858 (Del. 1985).
3 Note that the U.S. Securities & Exchange Commission has stated in writing that disclaimers from investment banks that expressly state that shareholders do not have a right to rely upon the fairness opinion are improper because they are “inconsistent with the balance of the registrant’s addressing the fairness to shareholders of the proposed transaction from a financial perspective.” See SEC, Division of Corporation Finance’s Current Initiatives and Rulemaking Projects at 12 (Nov. 14, 2000). In response to the SEC’s concerns, investment banks generally have come up with alternative disclaimer language that—while not expressly stating that shareholders may not rely upon the opinion—indicates that the opinion is for the use of the board/special committee and that the investment bank expresses no opinion on how shareholders should vote on the proposed transaction.
4 See Steven M. Davidoff, Fairness Opinions, 55 Am. U.L. Rev. 1557, 1567 (Aug. 2006); see also Deborah A. DeMott, Bank Conflicts Raise Threats of Lawsuits over M&A, Int’l Fin. L. Rev. (Aug. 2004) (“In general, a bank’s exposure to liability is limited by the content of a fairness opinion. That is, fairness opinions conventionally state the materials the bank worked with in preparing the opinion and disclose whether the bank relied on representations made by the company’s management and whether the work done was subject to limitations. These statements and disclosures limit the bank’s exposure to liability by explicitly informing the reader that a fairness opinion is subject to limitations.”); Steven J. Cleveland, An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions, 58 Ala. L. Rev. 299, 322 (2006) (“Bankers commonly assume the accuracy of management’s projections.”).