February 4, 1977

Investment Bankers' Fairness Opinions

The increasing and expanding use of investment bankers' fairness opinions warrants reexamination of the premises on which they are based. The traditional fairness opinion evolved primarily from arms-length merger transactions in which the investment banker acted for the "deal". Recently, fairness opinions have become significant in a wide range of transactions:

1. Minority shareholder freezeouts;
2. Repurchases from insiders;
3. Second step acquisitions following tender offers;
4. Conflict mergers; and
5. Arms-length mergers.

Lawyers and management of corporations recognize that an investment banker's opinion can be a major factor in sustaining a corporate transaction against attack. Indeed, in Harriman v. E.I. duPont de Nemours & Co., CCH Fed. Sec. L. Rep. ¶ 95,386 (D.Del. 1975) it was argued that it would be a violation of Rule 10b-5 for the controlled party in a conflict merger to negotiate the terms without the assistance of an investment banker, and, although the court rejected the argument, it is clear that the court reached its conclusion, sustaining the

duPont-Christiana merger there in issue, primarily on the basis that the parties did in fact obtain investment bankers' fairness opinions.

Where a fairness opinion is used in a proxy statement for a business combination governed by Rule 145, the investment banker probably has the status of an expert within Section 11(a)(4) of the 1933 Act.* As such the investment banker will be held liable for any misleading statement, opinion or valuation made by it unless it can show that (except for statements made on the basis of other experts) it conducted a reasonable investigation and had reasonable grounds to believe that its statements were true and not misleading.

Where a fairness opinion is used in a proxy or information statement not governed by Rule 145 or where a fairness opinion is not communicated to shareholders, the liability standards may differ somewhat from the expert's liability under the 1933 Act. However, as Sanders v. John Nuveen & Co., 524 F.2d 1064 (7th Cir. 1975), vacated

---

* From time to time a theory has been advanced that an investment banker's fairness opinion in a business combination proxy statement may make the investment banker a participant in the distribution and therefore an underwriter with full due diligence responsibility for the proxy statement. While we think that this theory is not well grounded, it must be recognized as a potential liability and taken into account in determining the form of the fairness opinion and the review procedures used in connection with the fairness opinion.

and remanded, 96 S. Ct. 1659 (1976) and Chris-Craft Industries, Inc. v. Bangor Panta Corp., 480 F.2d 341 (2d Cir. 1975), cert. granted, 96 S. Ct. 1505 (1976) demonstrate, the possibility that the courts may impose 1933 Act type due diligence standards in other contexts must be kept in mind.

Accordingly, a specific due diligence program should be developed for each fairness opinion. In this connection counsel should be consulted in each case for advice as to whether the usual procedures should be changed. Recent cases have changed substantially the standards which may apply in reaching fairness opinions and this is an evolving area of the law. See, e.g., Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585 (1975) and Del Noce v. Delyar Corp., CCH Fed. Sec. L. Rep. ¶ 95,670 (S.D.N.Y. 1976).

For many years it has been assumed that if a fairness opinion was qualified by use of "from a financial standpoint" or similar words, the investment banker limited its liability and had no duty to inquire into any aspect of the transaction other than the traditional economic matters taken into account in valuing a security or a business. Whether or not this assumption would stand up

in actual litigation has not been tested.* However, we believe that it would not be effective in cases where the investment banker has an advisory role or otherwise assists in the transaction beyond merely providing an opinion. To the extent that such assumption limits due diligence or limits the factors taken into account in reaching the opinion, it may be counterproductive and subject both the investment

---

* In Green v. Santa Fe Industries, Inc., 533 F.2d 1283 (2d Cir. 1976) cert. granted, 95 S.Ct. 54 (1976) a short-form cash merger freezeout transaction was found to violate Rule 10b-5 on the basis of substantial undervaluation, lack of corporate purpose and failure of Delaware law to provide prior notice to minority shareholders. The statutory notice of the effectuation of the short-form merger had appended to it an investment banker's opinion as to "the price at which [the stock of the merged subsidiary] would trade under current market conditions." The investment banker was alleged to have participated in the parent's Rule 10b-5 violation. On the basis that the investment banker's engagement was limited to valuation of the stock and compilation of a report on the subsidiary's financial status and on the basis that the investment banker was not involved in the planning or the effectuation of the short-form merger and had no knowledge of lack of corporate purpose, the court held that the investment banker was not a participant in the parent's Rule 10b-5 violation. However, the case arose on a motion to dismiss the complaint and the decision was premised on the absence of allegations as to the investment banker's participation. As a practical matter the investment banker does and should participate in the decision making with respect to this type of transaction and it is rarely possible to remain so removed from the transaction as to meet the criteria on which the court relied. Therefore it is better for the investment banker to participate, use due diligence and insist that the client obtain and follow well founded legal advice, than to rely on having expressed only a "financial" opinion. If the investment banker had indeed concerned itself with both substantive and procedural fairness for a freezeout transaction, in all probability its client as well as it would have escaped liability.

banker and its client to needless liability exposure. For example, in certain states such as New Jersey there is a substantial question whether a minority shareholder freezeout may be effected no matter what the financial terms.* Fairness from a financial standpoint may be only one element necessary to sustain such a transaction and the investment banker should take that into account. There are cases where the investment banker has no connection with the transaction other than responding to a request for an economic or market valuation. In such cases the investment banker may properly limit its function, but it should be specially careful to describe its limited role and to guard against its opinion being misused.

The broad spectrum of types of transactions in which fairness opinions may be used makes it not feasible to provide useful general guidelines. Each fairness opinion should be designed specially for the specific transaction. The client requesting the opinion should be asked to present an engagement letter which defines precisely the purpose of the opinion and the legal standards that govern the transaction. The engagement letter should be reviewed by counsel for the investment banker. The engagement should not be accepted unless there is agreement as to the scope of the work and the

* See Berkowitz v. Power/Mate Corp., 137 N.J. Super. 36 (Sup. Ct. Ch. Div. 1975).

applicable standards. Indemnification, including legal expenses, should be obtained for each engagement. The engagement letter should reserve the investment banker's control over the use of the opinion and any summary or description of the opinion.

The following additional procedures should be followed:

1. The opinion should describe the matters considered, those statements relied upon without investigation, those statements or matters that have been independently verified, and the inherent limitations, if any, of any procedures or standards that have been used.

2. The opinion should set forth any conflicts of interest and the fee and describe all relations with the client. If the investment banker participated in the negotiation of the transaction this should be noted in the opinion.

3. The opinion should be updated to the latest possible date and if that date is prior to the date of the transaction the opinion should set forth that it is as of a specific date and does not reflect matters thereafter.

4. Counsel for the investment banker should assist in the due diligence review and advise as to the kind of back-up material which should be prepared.

5. Independent verification of the key issue (e.g., limitation on future growth of the business in a repurchase; liquidation value in a minority shareholder freezeout) should be made.

6. Where a key issue is legal, the opinion should state that the investment banker has consulted counsel and relied on counsel with respect to such issue.

7. Where the opinion is to be used in a conflict transaction, the investment banker should be satisfied as to all the procedures to be used by the client, such as committee of independent directors, vote of minority shareholders, use of appraisers and other experts, etc.

8. The investment banker should not accept contingent compensation or any other arrangement that would impeach its independence in rendering a fairness opinion.

If properly structured and supported by a fairness opinion from an independent investment banker, there is virtually no corporate transaction, no matter how many or strong the conflicts of interest, that cannot be accomplished.

The foregoing provides a basis for tailoring a fairness opinion for any situation. The cardinal point is that the fairness opinion must be tailored to each situation -- standard forms will not work.

Martin Lipton