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Modification of Investment Banker Fairness Opinions and Indemnification Agreements in Light of Recent Arbitration Award

To Our Clients:

Recent press reports of a substantial arbitration award against a major investment banker for a merger fairness opinion that was allegedly negligently or knowingly false have raised questions regarding whether the standard fairness opinion language should be changed. While this arbitration underscores the importance of careful due diligence procedures and appropriate fairness opinion disclaimers, it does not appear that the award turned on particular language in the fairness opinion such that a change in the language would have altered the result.

Nevertheless, we would suggest that, where appropriate, fairness opinions state that the investment banker has not assumed any responsibility for independent verification of data provided to it, rather than making the statement that the investment banker has not made any independent verification. Thus, we would suggest including the following language in a typical fairness opinion:

> In rendering our opinion, we have assumed and relied upon the accuracy and completeness of [specified information provided by the corporate client], and <u>we have not assumed any responsibility for</u> independent verification of such information or any independent valuation or appraisal of any of the assets of the [corporate client].

This sentence would replace the following frequently used sentence:

> In rendering our opinion, we have assumed and relied upon the accuracy and completeness of [specified information provided by the corporate client], and we have not undertaken any independent verification of such information or any independent valuation or appraisal of any of the assets of the [corporate client].

This suggested phraseology recognizes that in many cases the normal due diligence conducted by the investment banker may include steps that may be characterized as independent verification of data even though the investment banker has not assumed the obligation to do this. Engagement letters should continue to provide that the investment banker is not undertaking responsibility for independent verification.

In addition, the fact that a claim predicated on an allegedly negligent or fraudulent fairness opinion can be asserted against an investment banker by individual shareholders or a group of shareholders in an NYSE arbitration -- rather than in the more customary judicial action -- suggests the need to review indemnification agreements to determine whether they adequately protect the investment banker in the arbitration context.

In the recent arbitration, the shareholders of the investment banker's client, even though not in privity with the investment banker, were able to choose arbitration because NYSE rules provide that, "upon the demand of [a] customer or non-member" any claim by that customer or non-member against a member arising in connection with the business of the member shall be arbitrated (NYSE Rule 600(a)). That rule has apparently been interpreted very broadly. While there is a prohibition against bringing a class action claim in arbitration (*see* NYSE Rule 600(d)(i)), the possibility of future arbitration claims by individual shareholders or groups of shareholders against investment bankers cannot be discounted.

The typical indemnification agreement covers expenses or losses in any actions or proceedings -- language broad enough to encompass an arbitration. However, one concern posed by a shareholder arbitration against an investment banker is that a particular arbitration case may involve multiple claims, some of which may not qualify for indemnification either as a legal matter or because of exclusions in the indemnity agreement. Yet often the arbitration award will simply grant a recovery to the claimant without specifying which claims were resolved in the claimant's favor. We believe the following

addition to indemnification agreements is appropriate to clarify that, in the case of an arbitration involving both indemnifiable and non-indemnifiable claims, an award will be conclusively deemed to be based on claims for which indemnification is permitted, unless otherwise specified in the award:

> If multiple claims are brought against you in an arbitration, with respect to at least one of which indemnification is permitted under applicable law and provided for under this agreement, we agree that any arbitration award shall be conclusively deemed to be based on claims as to which indemnification is permitted and provided for, except to the extent the arbitration award expressly states that the award, or any portion thereof, is based solely on a claim as to which indemnification is not available.

Another concern is that an arbitration pursuant to NYSE rules will almost always involve only the investment banker, not its corporate client, since there will usually be no basis upon which the typical corporate client, which is not an exchange member, may be named as a respondent in the arbitration. Thus, whereas in a judicial proceeding against both the corporate client and the investment banker the corporate client will generally assume the lead role in defense and settlement of a claim, in an arbitration the investment banker will most likely find itself on its own. We have focused on this issue and have concluded that there is not any practical way to avoid this problem. We therefore do not recommend changing indemnification agreements to add a provision to attempt to achieve joinder of the corporate client in arbitration.

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SUMMARY OF THE RIEGEL-NEAL INTERSTATE BANKING AND BRANCHING EFFICIENCY ACT OF 1994

- Repeal of the Douglas Amendment. Commencing one year after passage of the new law, bank holding companies that are "adequately capitalized and adequately managed" will be permitted to acquire banks in any state. (§ 101)

  - No Opt-Out. States may not "opt out" of the interstate banking provisions. State laws prohibiting interstate banking or discriminating against out-of-state banks are preempted by the new law.

  - States May Set "Minimum Age" For Targets. States may set a "minimum age" (up to five years) for banks that are targets of mergers or acquisitions. New shell banks established for acquisitions will be deemed to have the age of acquired banks.

  - Deposit Caps Apply. At the federal level, interstate bank acquisitions and mergers that would give a company 10+% of insured deposits in the U.S. or 30+% of a state's insured deposits (other than in connection with an initial entry into a state) will generally not be permitted unless the target state (including by regulatory order) has approved a **higher** cap. States may impose lower caps on a nondiscriminatory basis.

  - Community Reinvestment Compliance. In determining whether to approve an interstate acquisition, the Federal Reserve Board must take into account the applicant's record under the Community Reinvestment Act (CRA) and any applicable state community reinvestment laws.

  - Acquisitions of Troubled Banks. The modest restrictions that remain on interstate expansion may be preempted by the Federal Reserve Board in connection with the acquisition of banks in default or in danger of default.

- Interstate Branching Permitted In 1997. On June 1, 1997, "adequately capitalized and adequately managed" banks will be able to engage in interstate branching by merging banks in different states. After an interstate merger, a bank will retain all branching rights of the merging banks. (§ 102)

- States May Opt Out. States may opt out of interstate branching by enacting specific legislation before June 1, 1997. If a state opts out, out-of-state banks will generally not be able to branch into that state, and banks headquartered in that state will generally not be permitted to branch into other states.

- States May Opt In Early. States may opt into interstate branching earlier than 1997 with specific legislation. Early opt-in legislation must apply equally to all out-of-state banks and permit interstate merger transactions with all out-of-state banks.

- Compliance with State Filing Requirements. A state may impose filing requirements in connection with interstate bank mergers that are nondiscriminatory and are no broader than requirements imposed on out-of-state nonbanking corporations seeking to engage in business in such state.

- Initial Entry Subject to CRA Scrutiny. Interstate bank mergers that provide a company with an initial entry into a state will be subject to full CRA scrutiny, taking into account an institution's compliance with both federal and state community reinvestment statutes. However, other transactions will remain subject to existing CRA regulations and practices.

- Exclusive Means of Interstate Branching. Once the new interstate branching provisions are effective, headquarter relocations across state lines (as done by NationsBank and First Fidelity) will not be permitted.

- De Novo Branching/Branch Acquisitions Generally Barred. Interstate de novo branching and branch acquisitions will not be permitted unless the state specifically authorizes the activity. However, the new law does not appear to bar the use of a tiny acquisition (if otherwise legal) as a springboard for further branching in a target state. (§ 103)

° Affiliated Banks May Take Deposits Etc. for One Another. (§ 101(d))

- Effective one year from enactment, the new law permits subsidiaries of the same bank holding company to act as "agents" for one another in receiving and renewing deposits, closing and servicing loans, and

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accepting loan payments.

- Affiliated banks will continue to not be able to originate or approve loans or open deposit accounts for one another without being deemed branches.

- Ban on "Deposit Production Offices." Federal regulators are directed to adopt uniform regulations effective June 1, 1997 banning the use of interstate branching "primarily for the purpose of deposit production." These regulations will include guidelines to "ensure that interstate branches . . . are reasonably helping to meet the credit needs of the communities which the branches serve." (§ 109)

  - If an interstate bank's ratio of in-state loans in a particular state to in-state deposits is less than half the state average, federal regulators are directed to review the bank's loan portfolio to determine whether the bank is "adequately addressing the needs of the community" in such state.

  - If the agency determines that an out-of-state bank is not reasonably helping to meet the credit needs of the community, the agency may order that an interstate branch or branches of such bank be closed and/or prohibit the bank from opening new branches in such state unless the bank submits an acceptable plan to meet such needs.

- Public Comment and Hearings for Certain Branch Closures. Before closing a branch in low or moderate income neighborhoods, a bank must notify federal agencies, and the notice must provide for public comment. The new procedures also require the regulators to consult with community leaders before branches in low- or moderate- income neighborhoods are closed. These procedures are not meant to change the substantive grounds upon which an interstate bank may close a branch or the timing of such closing. (§ 106)

- CRA Examinations. The Federal agencies are required to provide separate written evaluations and ratings of an interstate bank's CRA performance in each state in which it operates on an ongoing basis, along with separate evaluations for each metropolitan and nonmetropolitan area in which the bank maintains one or more branches. (§ 110)

- State Regulatory Authority Remains. The general regulatory authority of the states would remain in place.

(§§ 101, 102, 105) States can continue to:

- regulate intrastate branching in a nondiscriminatory way,
- examine branches operated in the state by out-of-state banks, including pursuant to cooperative agreements designed to facilitate coordinated or joint examinations,
- impose nondiscriminatory notification and reporting requirements on branches of out-of-state banks,
- adopt laws regarding community reinvestment, consumer protection and fair lending, subject to current principles of federal preemption (and preemption determinations are subject to additional notice procedures), and
- exercise existing taxing authority, including by taxing branches as if they were in-state banks.

° <u>No Impact on Existing Antitrust Authority</u>. The new law is meant to have no impact on existing antitrust laws, and the applicability, if any, of state antitrust laws which are not currently preempted by federal statute is likewise preserved.

° <u>Application to Foreign Banks</u>. Generally, foreign banks would be allowed to engage in interstate banking without being required to establish U.S. bank subsidiaries. The new law provides that foreign bank branches must comply with CRA and fair lending and consumer protection laws, and directs the FDIC and the OCC to review and revise their regulations restricting a foreign bank's ability to accept retail deposits. The Federal Reserve Board or the OCC are also granted the authority to require a foreign bank to establish a separate U.S. subsidiary if necessary to verify that the foreign bank is adhering to capital requirements that are equivalent to those applicable to U.S. banks. (§§ 104, 107)

° <u>Federal Reserve Board Study on Bank Fees</u>. The Federal Reserve Board is required to conduct an annual survey of the fees charged by banks for retail banking services. (§ 108)

° <u>Financial Services Commission</u>. The Secretary of the Treasury is directed to establish a commission to study the strengths and weaknesses of the U.S. financial ser-

vices system in meeting the needs of the system's users. (§ 210)

- GAO Report on Data Collection. The GAO is directed to report on the adequacy of existing requirements for insured depository institutions to collect and report deposit and lending data to meet regulatory and congressional oversight needs in connection with the new statute. (§ 112)

- Statute of Limitations. The FDIC and the RTC, as conservator or receiver of a failed depository institution, are permitted to revive certain tort claims that had expired under a state statute of limitations within five years of the appointment of the conservator or receiver. The conference committee limited this provision to claims arising from fraud, intentional misconduct resulting in unjust enrichment and intentional misconduct resulting in substantial loss to the institution. The OTS, however, has indicated that it will exercise its existing authority to bring claims against S&L directors and officers in an effort to mitigate the impact of the conference committee restrictions. (§ 201)

- Texas Homestead Protection. The controversial provision reversing the authority of the federal regulators to preempt a provision in the Texas Constitution protecting homesteads of consumers in the state remains in the new Act. (§ 102(b)(5))