Spring 2006

An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions

Steven J. Cleveland, *University of Oklahoma College of Law*

AN ECONOMIC AND BEHAVIORAL ANALYSIS OF INVESTMENT BANKERS WHEN DELIVERING FAIRNESS OPINIONS

Steven J. Cleveland[*]

In *Smith v. Van Gorkom*, the Delaware Supreme Court suggested that, when a corporation engages in a merger, a fairness opinion from an investment banker would shield any board member from liability for an alleged breach of the duty of care.[1] Following *Van Gorkom*, the demand for fairness opinions increased,[2] spurring scholars to examine fairness opinions and the bankers who deliver them. Those articles implicitly treated bankers as rational actors, indicating that bankers, in a quest for tremendous financial gain, would jeopardize their reputations by delivering opinions that reached the conclusions favored by their clients, even if doing so required bankers to perform subpar analysis. Those earlier articles, however, devoted scant attention to the circumstances in which reputation provides only a weak check on behavior. This Article more fully examines those circumstances, finds them prevalent in the information market regarding fairness opinions, and concludes that bankers would still deliver opinions that reached conclusions favored by their clients, even if the financial gains were not so tremendous.

Although behavioral psychologists have identified deviations away from perfectly rational thought, prior articles have devoted little attention to the cognitive biases to which investment bankers are subject.[3] Such is the case even though authors have penned articles about the cognitive biases of each of the other principal players in the mergers and acquisitions field.[4]

---

* Associate Professor of Law, University of Oklahoma; J.D., Georgetown University; B.A, University of California, Los Angeles.

1. 488 A.2d 858, 874-81 (Del. 1985).

2. *See* Helen M. Bowers, *Fairness Opinions and the Business Judgment Rule: An Empirical Investigation of Target Firms' Use of Fairness Opinions*, 96 NW. U. L. REV. 567, 574 (2002) ("Immediately following the *Van Gorkom* decision, the frequency of use of fairness opinions increased.").

3. *See, e.g.*, Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 38 DUKE L.J. 27, 42-43 (1989) (devoting a short two-paragraph subsection to "Psychological and Social Factors").

4. *See* Stephanos Bibas, *Plea Bargaining Outside the Shadow of Trial*, 117 HARV. L. REV. 2463, 2470 (2004) (prosecutors); Stephen J. Choi & A.C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1 (2003) (SEC); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997) [hereinafter *Organized Illusions*] (corporate managers); Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002) [hereinafter *Taming the Animal Spirits of the Stock Markets*] (investors); Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 NW. U. L. REV. 133 (2000) (accountants). For an analysis of the cognitive biases of enforcement officers at a stock exchange, see my last article. Steven J. Cleveland, *The NYSE as State Actor?: Rational Actors, Beha-*

This Article more closely examines the cognitive biases to which investment bankers may be subject and concludes that those biases enhance the likelihood of delivery of an opinion that reaches the client's favored conclusion, even if to reach such a conclusion, the opinion's analysis must be subpar.

Part I introduces fairness opinions. Part II examines the incentive structure facing rational investment bankers when delivering fairness opinions. Subpart A discusses the significance of reputation to bankers. Subpart B discusses the inefficient information market regarding the quality of bankers' fairness opinions and the weak check that it provides on bankers' behavior. Subpart C discusses bankers' financial incentives when delivering fairness opinions. Subpart D discusses those incentives' impact on a fairness opinion's content. Because behavioral research reveals that we regularly do not act rationally, Subpart A of Part III examines the cognitive biases to which bankers may be subject. Subpart B examines cognitive cures but concludes that they may prove ineffective. Part IV addresses various proposals that may minimize, but not eliminate, the troubling incentives and biases that negatively impact bankers' exercise of discretion when delivering fairness opinions.

I. FAIRNESS OPINIONS

I know many things about my car, but I know virtually nothing about its current value. If I were to sell my car—and if I didn't want to get taken to the cleaners—then I would seek information regarding its current value. I might consult an expert—such as a mechanic—to assess the car's condition and assign a value. Similarly, a potential purchaser of the car, who would recognize that she had less information than the seller, might seek an expert's advice regarding the car's value.

Corporate executives also seek such valuation advice from experts when engaging in fundamental transactions, like the purchase or sale of a company.[5] Such expert financial advice commonly takes the form of a "fairness opinion."[6] Because some companies' stock is traded publicly, one might assume that one could obtain a company's current market value by multiplying the current market price for one share of stock by the number of shares outstanding.[7] The current market price of a company's stock, howev-

vioral Insights & Joint Investigations, 55 AM. U. L. REV. 1 (2005).

5. Samuel C. Thompson, Jr., *A Lawyer's Guide to Modern Valuation Techniques in Mergers and Acquisitions*, 21 J. CORP. L. 457, 459 (1996) ("The starting point for both the buyer and the seller in any merger or acquisition transaction is to determine the value of the target corporation.").

6. *See* Ann Davis & Dennis K. Berman, *Checkup Prompts Search for Second Opinions*, WALL ST. J., Jan. 24, 2005, at C1. "Traditionally, investment bankers have written most of [the fairness opinions], but the high fees and low risks have attracted new competition—consultants and some CPA firms, for example. The new competitors may offer more independence, lower prices and different credentials." Paul Sweeney, *Who Says It's a Fair Deal?*, J. ACCT., Aug. 1999, at 44, 45.

7. For simplicity, assume that a company has only one class of security outstanding: common stock.

er, reflects the value of only one share of that company's stock. For the acquiring company to attain control of the selling company, the acquirer must buy not just one share of stock but a majority of the outstanding shares of stock; with a majority of outstanding shares of stock comes voting control.[8] The current market price does not reflect the per-share price of a block of stock that features voting control. To acquire such control, one must pay a premium.[9]

The concept is not elusive. Consider air travel. One could secure airline tickets through priceline.com, or one could charter a jet. The discounter sells tickets at low cost, but one has little control over the times at which one travels. Alternatively, one could charter a jet and have tremendous control over the times at which one travels, but one can attain such control only if one is willing to pay a premium. The same goes for purchasing a corporation's stock. Even if control does not pass to a single party or related group (such that control remains "in the market"), the acquirer may be required to pay in excess of the market price.[10]

So, each of the purchasers and sellers of a company acknowledge the likelihood that a premium over the market price must be paid. How much of a premium? Here is where financial experts may contribute. Financial experts, such as investment banks, may undertake various analyses and deliver opinions to corporate managers regarding the fairness of consideration offered in connection with contemplated transactions.[11]

A. The Elusive Definition of Fairness

Consideration of any fairness opinion must address the conclusion reached therein, i.e., that the offered consideration is "fair from a financial point of view."[12] There is no single test to assess the fairness of the offered

8. *See* Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 42-43 (Del. 1994).

9. *Id.* at 43 ("The acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price. That price is usually a control premium which recognizes not only the value of a control block of shares, but also compensates the minority stockholders for their resulting loss of voting power."); *see also* JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 1137 (6th ed. 2004) ("Of course, stock market value represented the value of minority shares because controlling shares do not trade.").

10. *See* Thompson, *supra* note 5, at 537-38 (noting that a control premium of 50% was added to the value of Warner based upon a comparable companies analysis). The Time-Warner transaction did not result in control of Warner passing to the hands of a single entity or an affiliated group. *See Paramount Commc'ns*, 637 A.2d at 46-47; Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1149-51 (Del. 1989).

11. *See* Davis & Berman, *supra* note 6.

12. SBC Commc'ns, Inc., Registration Statement (Form S-4), at B-2 (Mar. 11, 2005) ("Based upon and subject to the foregoing, it is our opinion that, as of the date hereof, the Exchange Ratio is fair, from a financial point of view, to the holders of Company Common Stock.") (Fairness Opinion of Credit Suisse First Boston, L.L.C., addressed to the Board of Directors of AT&T Corp., dated Jan. 30, 2005); *id.* at C-3 ("Based upon and subject to the foregoing, we are of the opinion on the date hereof that the Consideration to be received by the holders of shares of Common Stock in accordance with the Merger Agreement is fair from a financial point of view to such holders other than Buyer and its affiliates.") (Fairness Opinion of Morgan Stanley & Co., addressed to the Board of Directors of AT&T Corp., dated Jan. 30, 2005). In addition to being a financial concept, fairness has import under state corporate law.

consideration.[13] Fairness could mean the highest price attainable; fairness could mean the price to which reasonably informed, unrelated parties negotiate; fairness could mean an amount this side of *un*fair; or fairness could incorporate some or none of the preceding concepts.[14] The appropriate definition may turn on a host of factors, including, but not limited to, whether there is one bidder or many bidders, whether the bidder is an insider or an outsider, whether the bidder already has voting control of the target company, and whether the transaction is hostile or friendly.

There does seem to be general agreement that fairness is not a point but a range.[15] And given that a range of prices—rather than a point—defines fairness, it follows that fairness does not mean the best price.[16] Investment bankers are invited to exercise discretion when determining the fairness of offered consideration in a transaction because fairness is not clearly defined and because fairness is indicated not by *a* price but a range of prices.

Investment bankers—who frequently are not lawyers—do not opine on the legal issue of fairness. For a discussion of legal fairness in interested party transactions, see *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1134, 1140 (Del. Ch. 1994), referring to "fairness" as constituted by fair process and fair price. "'Fairness' simply is not a term with an objective referent or clear single meaning. This does not mean its meaning is endlessly elastic and that it therefore constitutes no standard, but that it is a standard which in one set of circumstances or another reasonable minds might apply differently." *Id.*

13. *See* DALE ARTHUR OESTERLE, THE LAW OF MERGERS AND ACQUISITIONS 15 (1999) ("[V]aluation is a very inexact inquiry . . . ."); Bebchuk & Kahan, *supra* note 3, at 30-34 (discussing "The Definitional Problem"); Leonard Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?*, 36 BUS. LAW. 1439, 1439 (1981) (noting that "no single prevailing test of financial fairness" exists).

14. Fairness may take on different meanings in different circumstances. *See* CHOPER ET AL., *supra* note 9, at 127 ("Does fairness to the corporation mean (a) the very best deal obtainable, (b) a transaction that a disinterested board, exercising reasonable business judgment, could (would) have entered into, (c) a contract not so flagrantly one-sided as to come close to appearing dishonest?"); Bebchuk & Kahan, *supra* note 3, at 30-31 ("[T]he suitability of any one definition depends on the kind of transaction at issue and the particular context of that transaction.") (footnote omitted); Chazen, *supra* note 13, at 1440 ("suggest[ing] differing measures of financial fairness" for different types of acquisitions). *See generally* WILLIAM W. BRATTON, CORPORATE FINANCE 1 (5th ed. 2003) ("[A]ll of these (and other) problems in some sense require an answer to the question of how much the firm and its securities are worth. That this question is partly one of definition takes nothing away from its complexity. That this question does not admit of a verifiable answer once the definitional problems are worked out detracts neither from its importance nor its frequency of occurrence.").

15. *See* Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 183 (3d Cir. 1988) (discussing a bank's conclusion that an offer of $7.16 per share is fair when a company was worth between $6.50 and $8.50 per share); CHOPER ET AL., *supra* note 9, at 128 ("[T]he [ALI] Commentary makes clear that fairness is to be judged within a range of reasonableness, rather than a point of reasonableness . . . ." (quoting Marshall L. Small, *Conflicts of Interest and the ALI Corporate Governance Project—A Reporter's Perspective*, 48 BUS. LAW. 1377, 1383 (1993) (internal quotation marks omitted)).

16. *See Cinerama*, 663 A.2d at 1143 ("Goldman [Sachs, an investment banker,] did conclude that a marginally higher price [than $23 per share] might be arranged . . . but even if one assumes that to be the case . . . $23 per share was an entirely fair price."); Chazen, *supra* note 13, at 1453-54 ("[I]f the board of directors is inclined to accept an offer, it does not require an opinion that the offer is the highest or best available (an opinion its banker would probably not give in any event) but merely that the offer is not unreasonably low in relation to the company's other acquisition opportunities."); *Dart Industries Data Brings Up Questions on Proposed Merger*, WALL ST. J., Sept. 3, 1980, at 35 ("We felt the Dart shareholders got a pretty good deal—not the best deal—but a pretty good deal." (quoting an investment banking firm spokesperson) (internal quotation marks omitted)).

B. Computing Fairness

Assuming some accepted definition of fairness, bankers still must reduce the agreed-upon concept to a price or, more likely, a range of prices before concluding that a proposed consideration is fair. In determining fairness, bankers typically perform several valuations and accord different weight to those valuations before reaching a conclusion.[17] The underlying valuation methods may be based on discounted cash flows, comparable transactions, comparable companies, and liquidation, all methodologies that are briefly discussed below.

1. Discounted Cash Flows[18]

"Modern finance theory teaches that the value of [a company] . . . is not determined by accounting conventions, but rather equals the present value of the cash flows expected to be produced by the [company], discounted at a rate that properly reflects the risk associated with the [company]."[19] Valuation experts may prefer to concentrate on cash flow rather than bottom-line earnings because, for example, the income statement includes non-cash expenses (e.g., depreciation) that may negatively impact earnings, even though cash is never expended.[20]

Historic cash flow will provide a starting point, but the market already may reflect historic information.[21] Cash flows must be projected into the future,[22] and though history may provide a guide, future cash flow may reflect the efforts of new management, a new strategy, or old management and an old strategy that gains traction.[23]

Because one dollar in the future is worth less than one dollar today,[24] future cash flows must be discounted to a present value.[25] The appropriate

17. *See* Thompson, *supra* note 5, at 460 (noting multiple valuation techniques and their usage in various situations).

18. *See id.* at apps. C & D (utilizing discounted cash flows (DCF) in connection with the Time-Warner valuation).

19. *Id.* at 460 (citing, among other sources, RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE ch. 2 (4th ed. 1991)); *see* TOM COPELAND ET AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES 70 (2d ed. 1994) ("[A]ccounting earnings is useful for valuation only when earnings is a good proxy for the expected long-term cash flow of the company.").

20. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 864 (Del. 1985) (discussing a corporation with cash flow of hundreds of millions of dollars that generated relatively little net income in its financial statements because of large (non-cash) depreciation expenses).

21. For information regarding the efficient capital market hypothesis, see *Basic, Inc., v. Levinson*, 485 U.S. 224, 246-47, n.24 (1988); BRATTON, *supra* note 14, at 149-71; CHOPER ET AL., *supra* note 9, at 195-203.

22. *See* COPELAND ET AL., *supra* note 19, at 201 ("Once you've analyzed the company's historical performance, you can move on to forecasting its future performance.").

23. *See* Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 298-99 (Del. 1996) (determining, in the context of appraisal rights, that fair value should include value attributable to contemplated improvements by new management).

24. *See* BRATTON, *supra* note 14, at 30-31.

25. *See id.* at 39 ("To fill that framework with substantive content, we need to determine (1) the

discount rate will reflect the risk involved. Any future dollar is worth less and less as it becomes less and less likely that it will be collected, i.e., as the risk becomes greater and greater.[26] The greater the risk involved, the higher the discount rate. The higher the discount rate, the lower the current value of the investment/asset/target company.[27] Experts may derive discount rates using various models, such as the capital asset pricing model, the arbitrage price theory, or the weighted average cost of capital.[28] After cash flows have been predicted into the future and discounted to the present, one has a sense of the company's current value.

2. Comparable Transactions and Comparable Companies[29]

In determining a company's value, one might consider the values assigned to comparable companies recently acquired. By analogy, "if your neighbor's 1975 Chevy Nova [recently] sold for three hundred dollars, your 1977 Chevy Nova should probably sell for about the same amount."[30] Comparability may hinge on a host of factors, some of which follow. When identifying comparable transactions, one should consider the industries of operation of the company to be valued and any comparable transaction.[31] The premia over market value for technology companies may differ substantially from the premia over market value for utility companies. Moreover, because transaction premia fluctuate over time,[32] one should accord greater weight to comparable transactions in close temporal proximity to the contemplated transaction and accord little—if any—weight to transactions distant in time. The valuation generated by the comparable transactions approach already reflects a control premium for the target company.[33]

Bankers also may employ a comparable companies approach.[34] "[A] critical step in applying the direct comparison approach is choosing observ-

quantity and duration of the stream of expected returns to be discounted, and (2) the discount rate.").

26. *See id.* at 55 (discussing risk as an element of valuation).

27. *See id.* at 32 (charting the time value of $1 given various time frames and discount rates).

28. *See* Thompson, *supra* note 5, at 460; *see also* BRATTON, *supra* note 14, at 87 (introducing the concept of CAPM); *id*. at 111-13 (introducing the concept of APT); COPELAND ET AL., *supra* note 19, at 258-71 (discussing CAPM and APT); *id.* at 247 (introducing WACC).

29. *See* Thompson, *supra* note 5, at app. C (excerpting a banker's comparable transaction and comparable companies analyses in the Time-Warner transaction).

30. JOHN ROLFE & PETER TROOB, MONKEY BUSINESS: SWINGING THROUGH THE WALL STREET JUNGLE 123 (2000); *see* BRADFORD CORNELL, CORPORATE VALUATION: TOOLS FOR EFFECTIVE APPRAISAL AND DECISION MAKING 56 (1993) ("similar assets should sell at similar prices").

31. *See* Thompson, *supra* note 5, at 533 (noting that one approach may consider the standard industrial classification (SIC) code published by the federal government while another approach may utilize comparables as defined by securities analysts).

32. *See* Jay E. Fishman et al., *Premiums and Discounts in Business Valuations*, FAIRSHARE, May 1992, at 11, 15 ("Industry and market conditions also affect the level of control premiums that buyers are willing to pay at any given time.").

33. *See* Le Beau v. M.G. Bancorp., No. Civ. A. 13414, 1998 WL 44993, at *7 (Del. Ch. Jan 29, 1998) (addressing a "comparative acquisition approach—in which a control premium is inherent"), *aff'd*, 737 A.2d 513 (Del. 1999).

34. *See* Thompson, *supra* note 5, at 537 (discussing the experts' valuation techniques in the Time-Warner transaction).

able variables . . . that have a consistent relation to value . . . ."[35] Professor Thompson provides a simplified example of this valuation technique. Consider ABC Company of to-be-determined value that earns $10 per share, and assume that a comparable company earns $20 per share and is valued at $100 per share. Solving for the single variable yields a value of $50 per share for ABC. More thorough analysis would require consideration of numerous comparable companies rather than just one. And when considering numerous comparable companies, one must determine whether each of the comparable companies should be weighted equally, whether and why outliers should be excluded, and whether accommodation must be made for the fluctuations that occur in a company's earnings.[36] For example, the emphasis on unadjusted earnings (on which value may hinge, as in the simplified example above) may be misplaced. If earnings fluctuate, perhaps earnings should be smoothed to better approximate value. Bankers exercise discretion throughout the process.

If control of the target company passes to a single party or a group of affiliated parties, then the bankers must add a control premium to the valuation otherwise achieved using the comparable companies approach.[37] Even when control of the target does not pass to the acquirer, experts may deem it appropriate to add a premium over the valuation derived from the publicly traded securities of comparable companies.[38]

3. Liquidation or Break-Up Value

In determining the target corporation's value, one need not assume that the corporation continues in its current form. One may consider, therefore, the value of the corporation if it were liquidated, or if the corporation were broken into pieces and sold to different purchasers.[39] Liquidation, break-up, or segment values may be determined using DCF or comparable analyses.[40]

Depending on the company at issue, a liquidation or break-up value may be higher than the company's value as a going concern. Regarding some of the conglomerates of the 1960s, current thinking suggests that

35. CORNELL, *supra* note 30, at 57; *see also* Thompson, *supra* note 5, at 531-32 (quoting Professor Cornell).

36. *See* Thompson, *supra* note 5, at 533-34.

37. *Cf. Le Beau*, 1998 WL 44993, at *2 (discussing fair value in an appraisal proceeding).

38. *See* Thompson, *supra* note 5, at 537-38 (noting that a control premium of 50% was added to Warner based upon a comparable companies analysis). The Time-Warner transaction did not result in control of Warner passing to the hands of a single entity or an affiliated group. *See* Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1149-51 (Del. 1989); *see also* Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 43 (Del. 1994) (noting that a control premium is the usual price for the sale of control of a company).

39. *See, e.g.*, Goodwin v. Live Entm't, Inc., No. Civ. A. 15765, 1999 WL 64265, at *12 (Del. Ch. Jan. 25, 1999); Joseph v. Shell Oil Co., 482 A.2d 335, 339 (Del. Ch. 1984) (discussing outsider directors' consideration of banker's liquidation value of the target).

40. *See* Thompson, *supra* note 5, at A-4 to A-5 (discussing segment valuation using DCF, comparable transactions, and public and private market analyses).

managers diluted their expertise.[41] Consequently, the value of the whole, under one management team with only generalized expertise, was less than the value of the parts, each under its own management team with specialized expertise. A liquidation or break-up value exceeded the value of the conglomerate as a going concern.[42] Consider Gun Co., which manufactures guns. The management of Gun Co. possesses expertise regarding the design, manufacture, and marketing of guns. Assume that Gun Co. owned Peanut Butter Co. as a subsidiary. Management's expertise regarding guns does not translate well to devising the perfect peanut butter recipe or its production and marketing. Because Gun's management lacks the relevant peanut butter expertise, Peanut Butter Co. may be worth nine units when controlled by Gun Co. Because of relevant synergies, Grape Jelly Co. values Peanut Butter Co. at eleven units. Grape Jelly Co. would be willing to pay ten units to buy Peanut Butter Co., and Gun Co. would be willing to sell Peanut Butter Co. for ten units. Thus, the parts of Gun Co. may be worth more than the whole.[43]

* * *

Each of the valuation methodologies requires bankers to exercise discretion. Such discretion may be cabined by the bankers' concern for their reputations, so that their fairness opinions reflect their genuine beliefs following rigorous, thoughtful analysis.

II. RATIONALITY

Whether we recognize it or not, we commonly act rationally by considering the likely consequences of our actions. For example, virtually no one likes to be doused with water on the way to the office. Nonetheless, we forego the umbrella when the local forecast calls for sunny skies. Why suffer, with 100% certainty, even a minimal inconvenience—lugging an umbrella—when the likelihood of suffering a tremendous inconvenience—getting doused by rain—approaches zero? We do not blindly consider the magnitude of an outcome. We generally consider possible outcomes in light of their expected likelihood of occurrence. We carry umbrellas when rain is

41. *See* Ronald J. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 494 (2001) ("Some transactions drove an industrial movement back to focus—a strategy based on specialization in industries whose demands fit a company's experience and skills . . . by breaking up 1960's conglomerates.") (footnote omitted).

42. *See* Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 913 n.79, 932 n.145 (1988) (discussing conglomerate discounts).

43. On the other hand, a liquidation or break-up value may be less than the company's value as a going concern. Reverse the example above. Assume that Grape Jelly Co. owns Peanut Butter Co. If Grape Jelly Co. was liquidated, another purchaser may be located for Peanut Butter Co., but that purchaser may not be able to put Peanut Butter Co. to as high a valued use as Grape Jelly Co. The purchaser may value Peanut Butter Co. at nine units, whereas Peanut Butter Co. is valued at eleven units by Grape Jelly Co.

likely; we don't carry umbrellas when the forecast calls for sunny skies. We commonly make decisions rationally, based on our self-interest.[44] So do investment bankers.

A. Reputation as Discipline

Attaining a sterling reputation may require time, effort, and money.[45] The reputation of a particular investment banker or a particular investment bank may prove pivotal in securing new clients and retaining existing clients.[46] Because investment banks are profitable[47] and investment bankers are well compensated,[48] those banks and bankers want to preserve or improve upon their reputations. Therefore, rational banks and bankers may be unlikely to gamble with their reputations.[49]

Investments in reputation amount to sunk costs with minimal salvage value.[50] When investment banks and bankers invest in their reputations, those banks and bankers signal to the market their quality of service; if they fail to perform their service with the requisite skill and discretion, they damage their reputations and cannot otherwise recoup on those investments in their reputation.[51] Consequently, we might expect to see banks and bankers exercise the requisite skill and discretion when opining on a particular transaction's fairness to preserve their reputation and future income. We

---

44. Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641, 1661 (2003) ("[T]he claims of law and economics rest on the predictive power of rational choice theory, a theory that assumes individuals choose between competing alternatives based on rational self-interest.").

45. *Cf.* Ted J. Fiflis, *Responsibility of Investment Bankers to Shareholders*, 70 WASH. U. L.Q. 497, 515 (1992) ("[T]he investment-banking industry's stock in trade is its reputation and assets, which provide a valuable bond, already incurred, to assure that the banker will act carefully and skillfully.").

46. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 119 (4th ed. 2004) ("It cannot be overemphasized that stature and prestige are what investment bankers build and retain their business on . . . .").

47. *See, e.g.*, Shanny Basar et al., *Investment Banking Profits Triple at Citigroup*, EFINANCIAL CAREERS, Jan. 20, 2006, http://news.efinancialcareers.com/NEWS_ITEM/newsItemId-5464 ("Citigroup . . . said net profits from its corporate and investment bank more than tripled to $6.9bn last year."); Press Release, Merrill Lynch & Co., Merrill Lynch Reports Record EPS and Net Earnings for Fourth Quarter and Full-Year 2005 (Jan. 19, 2006), http://www.merrilllynch.com/index.asp?id=7695_7696_8149_63464_63466_63662. In 2005, Merrill Lynch's "Global Markets and Investment Banking" unit had record net revenues of over $13 billion and record pre-tax earnings of $5 billion. *Id.*

48. *See, e.g.*, Jeanne Sahadi, *How Much Is Too Much Pay?*, CNN MONEY, Nov. 29, 2004, http://money.cnn.com/2004/11/24/commentary/everyday/sahadi/index.htm ("A typical senior investment banker making $200,000 in salary might get a $700,000 to $750,000 bonus this year. . . . So the banker makes a bonus equal to 375 percent of his salary . . . .").

49. *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 137 (6th ed. 2003) ("[E]ven in the domestic sphere much contract enforcement is decentralized. Most contracts are complied with not out of fear of legal action but out of concern with reputation . . . .").

50. *Cf.* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 617 (1981). *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 97 (1991) (discussing firm-specific investments of human capital).

51. *See* Fiflis, *supra* note 45, at 515 ("The individual banker, her firm, and the whole banking industry suffer when she commits an error or an irregularity . . . ."). *See generally* EASTERBROOK & FISCHEL, *supra* note 50, at 95 ("Consider itinerant vendors. They have no brand name to protect . . . , so they have strong incentives to misrepresent the quality of their wares in order to obtain a higher price . . . .").

might expect that banks and bankers would not opine that a transaction were fair if it were not so, and to a certain extent, we do see banks and bankers refuse to issue fairness opinions when the offered consideration is not fair.[52] However, such refusals are the exception, not the rule,[53] because incentives lead rational bankers to opine that a transaction is fair even when it may not be fair. First, consideration is given to situations in which reputation may provide a weak discipline on rational actors. Second, consideration is given to situations in which the discipline of reputation may be overwhelmed by financial considerations.

B. Reputation as a Weak Check on Behavior

1. Low Likelihood of Detection of Quality

If there is a low likelihood that the market will detect a low-quality fairness opinion, then concern for reputation provides a poor discipline, and rational bankers will issue low-quality opinions more willingly.[54] The information market regarding the quality of fairness opinions seems inefficient. Detecting a fairness opinion's quality proves difficult because of its brevity. A two-page opinion is common, and in those two pages, bankers disclose their conclusion but offer scant analysis.[55] Given scant analysis, the market lacks information to evaluate the opinion's quality. In limited circumstances, federal and state law require disclosure of the analysis underlying the brief fairness opinion's conclusion, but required disclosure is not the general rule.[56]

---

52. *See* Sweeney, *supra* note 6, at 51 ("Rather than say flat out that a deal price is unfair, the more honorable investment bankers and others doing fairness opinion work sometimes turn down an opportunity to earn a fee on a particular fairness opinion or resign from the assignment partway through."); Richard B. Schmitt, *Suspect Opinions: If an Investment Bank Says the Deal Is Fair, It May or May Not Be—Advisers Clear Many Plans That Benefit Everybody Except the Shareholders—The Lure of a Looming Fee*, WALL ST. J., Mar. 10, 1988, at A1 ("Salomon [an investment bank] kills plenty of proposals before they surface, says William Strong, a Salomon Brothers managing director.").

53. Bevis Longstreth, *Fairness of Management Buyouts Needs Evaluation*, LEGAL TIMES, Oct. 10, 1983, at 15, 19 ("Investment bankers do, on occasion, decline to render fairness opinions satisfactory to management. But this is more the exception than the rule.").

54. *See generally* EASTERBROOK & FISCHEL, *supra* note 50, at 96 ("Although the chance of losing business gives doctors some incentive to perform well, it is not much because the disease and treatment will not be perfectly replicated. Disappointed patients cannot look up a physician in *Consumer Reports* or sell shares in a physician short to communicate information to the market."); Amar Bhide & Howard H. Stevenson, *Why Be Honest if Honesty Doesn't Pay*, HARV. BUS. REV., Sept.-Oct. 1990, at 121; Klein & Leffler, *supra* note 50, at 619 n.6 (discussing a quality-assuring price premium model with "interconsumer communication less than perfect").

55. *See generally In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 449 (Del. Ch. 2002) (describing fairness opinion as containing "nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability").

56. Regarding federal law, compare SEC Sched. 14A, Item 14(a)(6), 17 C.F.R. § 240.14a-101 (2006) (citing 17 C.F.R. § 229.1015 (2006)) ("*If* a report, opinion or appraisal materially relating to the transaction has been received from an outside party, *and is referred to in the proxy statement*, furnish [, among other things, a summary of the report, opinion, or appraisal].") (emphasis added), with SEC Sched. 13E-3, Items 8 & 9, 17 C.F.R. § 240.13e-100 (2006) (citing 17 C.F.R. §§ 229.1014-.1015 (2006)) (requiring, among other things, disclosure of a summary of any report, opinion, or appraisal received

Even if the banker's analysis is disclosed, the information market may be otherwise inefficient. The disclosed analysis may be obscured through the use of "abstract, oblique, general language"[57] or the discussion of many factors without specifying their import.[58] These obscuring techniques deny the market information needed to evaluate the bank's analysis. Additionally, some clients "shop" for fairness opinions, refusing to retain any bank that suggests the offered consideration is not fair. When shopping occurs, the market may never learn that some non-retained bankers suggested the offered consideration was not fair.[59] Moreover, as complexity increases, detection of low-quality opinions may become more difficult.[60] As explained above and more fully below, the definition and computation of fairness allow for tremendous discretion, increasing the opinions' complexity and shielding their quality.[61]

Perhaps the low quality of an opinion is not revealed unless a subsequent acquirer offers a significantly higher price than the initial "fair" price.[62] In an effort to encourage the initial bidder to bid, however, targets generally agree to contract provisions that protect the original deal.[63] These

---

from an outside party that is materially related to the going-private transaction). Regarding state law, compare *In re Pure Res*., 808 A.2d at 449 ("Delaware courts have been reluctant to require informative, succinct disclosure of investment banker analyses in circumstances in which the bankers' views about value have been cited as justifying the recommendation of the board.") (footnote omitted), with *id.* at 449-50 (deviating from the general rule of nondisclosure when the acquirer is the target's majority shareholder).

57. OESTERLE, *supra* note 13, at 486.

58. *See id.* ("the laundry list approach").

59. *See* Sweeney, *supra* note 6, at 51 ("Rather than say flat out that a deal price is unfair, the more honorable investment bankers and others doing fairness opinion work sometimes turn down an opportunity to earn a fee on a particular fairness opinion or resign from the assignment partway through. Such actions almost always are very discreet, so investors and financial executives making acquisition decisions are not likely to be told of such demurrals.").

60. *See generally* EASTERBROOK & FISCHEL, *supra* note 50, at 96; Klein & Leffler, *supra* note 50, at 616 ("difficult-to-measure product characteristics"); Scott, *supra* note 44, at 1646 ("Reputation . . . will only work to make promissory commitments credible if other contracting parties can conveniently learn about the reasons why any particular transaction broke down."); Jonathan A. Knee, *Boutique vs. Behemoth*, WALL ST. J., Mar. 2, 2006, at A14 ("When the music stopped in 2000 one might have hoped that the investment banks would loudly apologize and seek to recapture lost reputations. Instead, some denied anything had gone awry . . . .").

61. *See supra* notes 18-43 and accompanying text; *infra* notes 123-132 and accompanying text.

62. Even a higher, subsequent price does not necessarily undermine the original fairness opinion. *See supra* note 16.

63. No bidder wants to be a "stalking horse," *Smith v. Van Gorkom*, 488 A.2d 858, 866 (Del. 1985), so bidders commonly demand contract provisions that protect the deal. Common deal protection provisions include "no shop" clauses, termination fees, stock options, and asset lock-ups. "No shop" clauses prohibit the target from shopping the original bid in quest of a higher bid. Large termination fees are paid to the original bidder if the target walks away from the transaction, presumably to enter into a transaction with another bidder. Stock options entitle the original acquirer to buy a block of stock in the target at an agreed-upon price. The option requires a second bidder to pay more for the target because the original bidder exercises the option at the original transaction price and sells those shares to the second bidder at the higher price. In effect, the second bidder pays a premium for cash. An asset lock-up entitles the original bidder to acquire specified assets of the target if a second bidder purchases the target, possibly making the target less attractive to any second bidder. *See* Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 39-40 (Del. 1994) (discussing a no-shop provision, a termination fee, and a stock option); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182-84 (Del. 1986) (discussing a no-shop provision, an asset lock-up agreement, and a termination fee); OESTERLE, *supra*

deal protection provisions deter subsequent bidders.[64] And if no subsequent bidder offers consideration above the amount that the banker opined to be fair, then there may be little reason to suspect the fairness opinion was of low quality. Even when information may be developed revealing an opinion as being of low quality, the bank may not adequately suffer negative consequences because industry regulation and litigation provide weak checks on banks and bankers.[65]

2. Regulation and Litigation

One's reputation suffers after a public reprimand for deviation from accepted standards or after an adverse court judgment. Industry regulation and litigation, however, provide weak checks on bankers' behavior. Unlike lawyers, who must comply with state bar association rules of practice and ethical conduct codes, and unlike accountants, who must comply with generally accepted accounting principles, investment bankers lack governing standards of conduct.[66] "One of the reasons why there are so many indefensible fairness opinions is the absence of standards to guide investment banks in their . . . fairness opinions."[67] Some have suggested that "best practice" standards be developed by existing organizations—such as the SEC or self-regulatory organizations—but those standards are yet to be developed.[68]

Investment banks and bankers could be disciplined by the threat of litigation. Litigation, however, provides only a weak check on bankers' delivery of fairness opinions. First, banks are likely to escape liability.[69] Even if useful liability standards could be developed,[70] unintended consequences

note 13, at 356-59 (discussing deal protection provisions).

64. *See, e.g.*, *QVC Network*, 637 A.2d at 50 ("[T]he Stock Option Agreement had become 'draconian' . . . and . . . the Termination Fee . . . was similarly deterring the realization of possibly higher bids.").

65. *See generally* Robert J. Giuffra, Jr., Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119 (1986) (proposing enhanced accountability through enhanced liability).

66. *See* Fiflis, *supra* note 45, at 515 ("Bankers have neither an ethics code nor a professional association to administer sanctions for deviations from norms. There is no minimum education or licensing procedure in place. Additionally, some segments of the banking community possess an entrepreneurial ethos very different from that traditionally found in accounting and law.").

67. Charles M. Elson et al., *Fairness Opinions—Can They Be Made Useful?*, 35 SEC. REG. & L. REP. 1984, 1988 (2003).

68. *See, e.g.*, *id.* Though its proposal does not set forth "best practices," the National Association of Securities Dealers (NASD) recently proposed a disclosure rule for its members; as of the date of this printing, the rule is not yet effective. *See* SEC File No. SR-NASD-2005-080, Apr. 4, 2006 (Amendment No. 3), http://www.sec.gov/rules/sro/nasd/2006/34-53598.pdf [hereinafter Proposed NASD Rule 2290] (proposing new NASD Rule 2290 regarding Fairness Opinions).

69. *See* Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?*, 53 OHIO ST. L.J. 951, 970 (1992) ("Traditionally, banker liability for misstatements or omissions to the shareholders whose decisions were impacted by the faulty opinions was highly restricted."); Sweeney, *supra* note 6, at 51 ("[A] firm writing an unwarranted positive opinion . . . is unlikely to face much legal liability.").

70. Professor Carney has "little hope that American courts can develop a reasonable set of due-diligence standards that will allow them to impose liability for negligent preparation of fairness opinions without creating such [excessive] costs." William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 537 (1992) (also referencing Delaware

may follow.[71] Second, banks *quietly* settle any lawsuits that might have merit, minimizing any negative impact on their reputations.[72] Third, banks commonly negotiate for indemnification rights from corporate clients in the event such liability does arise, lessening any incentive for those corporations' shareholders to initiate lawsuits.[73]

3. Provision of Additional Services

Reputation may provide poor discipline when one is asked to criticize oneself. Some banks provide multiple services to their clients. A bank that represents a target may assist in identifying the acquirer and negotiating the transaction before being called upon to opine on the fairness of the offered consideration.[74] Banks may be hesitant to criticize a transaction for which they participated in the negotiations.[75] Certainly, the market need not rely solely on such self-evaluation, but as mentioned above, the information market may be inefficient.[76] Moreover, the bank may be concerned with its overall reputation rather than its reputation regarding the provision of a specific service.[77] If such is the case, then a bank may be able to sustain a sterling reputation overall even if one of its services may be delivered in subpar fashion.

4. Young Bankers and Turnover

Banks must act through individuals. An individual acting on behalf of an investment bank may face a different incentive structure than the collection of individuals working for the bank. Certain individuals may suffer

courts' "obtuseness" in developing valuation guidelines for appraisal).

71. "[B]anks [will] say less and charge more." Elson, *supra* note 69, at 1001.

72. Sweeney, *supra* note 6, at 46 ("According to John C. Coffee, Jr., . . . most legal disputes contesting fairness opinions are settled quietly and out of court.").

73. *See* Elson et al., *supra* note 67, at 1985 n.16 ("[E]xcept for the bank's gross negligence or willful misconduct, [the client shall] indemnify[] [the bank] against damages from claims by third parties asserted incident to the bank's fairness opinion engagement."); SBC Commc'ns, Inc., Registration Statement (Form S-4), at 33 (Mar. 11, 2005) ("In addition, AT&T has agreed to indemnify CSFB [the opining investment bank] and its affiliates, their respective directors, officers, agents and employees and each person, if any, controlling CSFB or any of its affiliates against certain liabilities and expenses, including certain liabilities under the federal securities laws, related to or arising out of CSFB's engagement and any related transactions.").

74. *See* Elson et al., *supra* note 67, at 1985 ("[O]ften as part of a number of M&A advisory services to be performed in the same engagement, the investment bank agrees to provide a fairness opinion . . . .") (footnote omitted). Banks also may provide fairness opinions to acquirers, *id*. at 1985, and provide additional services to those clients, *id.* at 1985 n.13 ("obtaining . . . financing . . . and, in tender offers, acting as . . . dealer managers"). An acquirer's bank may be hesitant to withhold a fairness opinion from the acquirer because the bank may stand to earn significant fees for the provision of those other services.

75. Sweeney, *supra* note 6, at 47 ("[I]nvestment bankers have little incentive to second-guess their first analyses.").

76. *See supra* notes 54-61 and accompanying text.

77. *See* Bebchuk & Kahan, *supra* note 3, at 44 ("Furthermore, to the extent that courts *do* pay attention to professional reputation, they are likely to evaluate fairness opinions on the basis of a bank's general reputation rather than on the basis of its reputation with respect to fairness opinions.").

from a last-period problem.[78] Individuals whose tenure at a particular bank will be short may not be sufficiently concerned with the bank's long-term reputation. Bankers may believe that by the time the bank suffers harm to its reputation, they will be long gone. Concern for the bank's reputation provides only a weak check on the behavior of those people whose tenure at the bank may be short. Many individuals at investment banks have short tenures.[79]

Even though bankers may not be concerned with the bank's reputation, bankers' concern about their own reputations seemingly would provide adequate discipline. Maybe not. The information market may be inefficient. A fairness opinion is signed in the bank's name, without identifying any individual who worked on the transaction, so the target's public disclosure to its shareholders will not identify individual bankers who worked on the transaction.[80] Additionally, the bankers performing the valuation may be relatively young and inexperienced.[81] To preserve their reputations, these young bankers may attribute to others any shortcomings in the fairness opinion or the underlying analysis.[82]

C. Financial Considerations

The incentive to preserve reputation may lead banks to deliver opinions untainted by factors that do not speak directly to the fairness determination. Rational actors, however, may be influenced by factors that do not speak directly to the fairness determination. Where the rewards justify the risk, rational banks and bankers may jeopardize their reputations by skewing their fairness analyses. The structure by which bankers are compensated and the competitive nature of the banking business may provide the motive and opportunity for bankers to skew their analyses. Banks and bankers may deliver fairness opinions that further the clients' preferred course of action, even if the contents of those opinions deviate from what would be expected for the preservation or enhancement of one's reputation.

---

78. *See* CHOPER ET AL., *supra* note 9, at 566-67 ("In this 'end game,' there is greater reason for managers to act opportunistically . . . . Economists call this a 'final period' problem, referring to the fact that the agent no longer has the same incentives to serve the principal faithfully."); Robert Prentice, *Enron: A Brief Behavioral Autopsy*, 40 AM. BUS. L.J. 417, 438-39 (2003) ("Thus, Lou Pai made (up) his numbers, took $350 million in compensation, and walked out the door leaving Enron with numerous projects that in reality were losing money.").

79. *See* Lisa Valentine, *Making an Informed Exit*, A.B.A. BANKING J., Oct. 2005, at 72, 72 ("Reducing high employee turnover is a challenge for most banks."); Charles Gasparino, *Analysts' Contracts Link Pay to Deal Work*, WALL ST. J., May 6, 2002, at C1 (noting an analyst contract length of two years); Interview by Janice Chan with Linda Lee, Senior HR Prof'l, http://hr.monster.com.hk/jobqanda/hrprofessional (last visited Oct. 29, 2006) ("What's the turnover rate in an investment bank? Around 20-30% annually.").

80. Individual bankers may, however, be identified in other publications. For purposes of comparison, the *American Lawyer* identifies attorneys who work on significant corporate transactions. *See, e.g.*, *Big Deals*, AM. LAW., Mar. 2006, at 43-46.

81. *See* Elson et al., *supra* note 67, at 1988 ("[T]he very young bankers who perform these engagements are often not well supervised.").

82. For a discussion regarding senior bankers, see *infra* notes 113-116 and accompanying text.

1. Fee Structure

Investment banks collect significant fees for opining on the fairness of transactions.[83] Even though the fee for a fairness opinion may seem large in the abstract, such a fee may constitute only a small fraction of the overall amount that the investment bank collects upon the consummation of a friendly transaction.[84] Consequently, a significant portion of the overall fee may be contingent on the transaction's success.[85] Moreover, the success fee's magnitude may be linked to the transaction's value.[86] Success fees may align the bank's interests with the target's interests. The bank's and the target's interests, however, may not be aligned perfectly.

This imperfect alignment of interests may be made more readily apparent by examining a familiar transaction. Let's say we want to sell our house.[87] We can retain a real estate agent who will work hard to assist us in the process and who will collect a fee that is a percentage of our house's sales price. We may think that, because the agent will collect a fee that is tied to the sales price, the agent will want to obtain the highest selling price for the house, perfectly consistent with our preference. Our agent may locate a buyer willing to pay $300,000, an amount on which we'd pay a standard 6% fee to the agent, which comes to $18,000. Our agent, however, likely will share the fee with the buyer's agent. So now she's down to $9,000. Moreover, the agent likely will share half of her take with the real estate agency. Now, she's down to $4,500, or 1.5% of the home's purchase price. Maybe the agent could identify another buyer willing to pay $310,000. We'd be happy because we'd collect virtually all of the extra $10,000, but she'd collect only an extra $150. Suddenly, our interests and

83. *See* Anderson v. Boothe, 103 F.R.D. 430, 435 (D. Minn. 1984) ($250,000 fee); Davis & Berman, *supra* note 6 ("as much as several million dollars each"); Robert McGough, *Fairness for Hire*, FORBES, July 29, 1985, at 52 ("Morgan Stanley received a hefty $500,000 up front for giving Royal Dutch its opinion."); *id.* at 54 ("Bear, Stearns earned . . . $750,000, by sprinkling holy water on [the acquirer's] bid . . . .").

84. *See* SBC Commc'ns, Inc., Registration Statement (Form S-4), at B-2 (Mar. 11, 2005) ("We have acted as financial advisor to the Board of Directors in connection with the Merger and will receive a fee for our services, a significant portion of which is contingent upon the consummation of the Merger.") (Fairness Opinion of Credit Suisse First Boston, L.L.C., addressed to the Board of Directors of AT&T, dated Jan. 30, 2005); Bebchuk & Kahan, *supra* note 3, at 39-40; Elson et al., *supra* note 67, at 1985 n.14 ("[F]airness opinion fees were on average, less than 10% of the sum of fairness opinion fees plus success fees."); Davis & Berman, *supra* note 6 ("[B]ankers make the lion's share of their fees only if a deal gets done.").

85. *See, e.g.*, Bebchuk & Kahan, *supra* note 3, at 39 ("Morgan Stanley was to receive $3.794 million if the companies actually merged, but only $350,000 otherwise.").

86. For example, in the 1980s, one bank charged target companies a success fee of 1% for transactions valued at $100 million; in a $500 million transaction, the success fee was 0.5%; and in a $1 billion transaction, the success fee was 0.4%. *See* Peter Petre, *Merger Fees that Bend the Mind*, FORTUNE, Jan. 20, 1986, at 18. When representing acquirers, banks commonly negotiate flat fees that are not linked to increases or decreases in the offered consideration. *See id. But see* Bebchuk & Kahan, *supra* note 3, at 41 n.83 (noting that *sometimes* the bank that an acquirer retains will collect a fee linked to the transaction's value).

87. The example set forth in the text is taken from STEVEN D. LEVITT & STEPHEN J. DUBNER, FREAKONOMICS: A ROGUE ECONOMIST EXPLORES THE HIDDEN SIDE OF EVERYTHING 7-9 (2005).

her interests do not seem well-aligned, particularly because the agent will do virtually all of the work to secure the higher offer, but she will collect only a pittance for her extra effort.

Our real estate agent would be hesitant to advise us against accepting the initial offer of $300,000, unless she was confident of locating a higher bidder who would follow through with the purchase, or was confident that the cost of locating that higher buyer would be minimal, or was confident that the original bidder would remain interested over time. As long as the offered price is in the ballpark, the agent favors the sale—and the quicker, the better.[88]

Should we expect investment bankers to behave differently? Maybe not. Unlike a real estate agent, a bank will collect a fee for its efforts (the flat fee for the opinion) regardless of whether a transaction occurs.[89] As the disparity widens between a bank's overall fees (the flat fee plus the success fee) for a successful transaction and the bank's flat fee for a fairness opinion (or advisory services), the bank's incentive structure more closely resembles the incentive structure that a real estate agent faces. Ten-to-one disparities between overall success fees and flat fees may be the norm.[90]

With such success fees overhanging the fairness determination, a rational bank retained by a *willing* target may opine that the offered consideration is fair, even if the bank believes the offered consideration is unfair or inadequate.[91] The negative consequences that a bank experiences by bucking a target's management may dwarf the negative consequences that a bank experiences by delivering a low-quality opinion, as examined in the next section.

2. Retaining and Recruiting Clients

Evolutions in law and technology have reduced opportunities for profit in connection with services commonly provided by investment banks. Banks may provide brokerage and advisory services to investors, underwriting services to companies issuing securities, and consultation services to

88. *See id.* at 73 ("[T]he seller lost at least $20,000. The [seller's] agent, meanwhile, only lost $300—a small price to pay to ensure that she would quickly and easily lock up the sale . . . .").

89. *See also* sources cited *supra* note 84 (explaining that banks receive a fee merely for issuing an opinion).

90. *See* Bebchuk & Kahan, *supra* note 3, at 39-40 (discussing two transactions—one where the banker would receive a flat fee of $350,000 but would collect $3.794 million upon consummation of a merger, and a second transaction in which the bank would collect a flat fee of $1 million but an estimated $13 million upon consummation of the deal); Elson et al., *supra* note 67, at 1985 n.14 (indicating a ratio of nine-to-one).

91. *See* Schmitt, *supra* note 52 ("The problem is that investment banks that are asked for a fairness opinion have incentives to deliver the one management wants. Most obvious is the prospect of a fat fee."). *See generally Organized Illusions*, *supra* note 4, at 115 ("[I]t would not be surprising to find situations in which trading off credibility with (perhaps even the risk of liability to) investors for some profit-enhancing gain in some other area could be a rational choice.") (footnote omitted); Prentice, *supra* note 4, at 210 ("Firms that do cater to client pressure risk tarnish to their reputations, but . . . for big firms, the risk may seem worthwhile in light of substantial potential rewards.").

companies engaged in significant transactions. As banks' profits fall in other services, rational bankers may ensure the collection of fees in connection with the delivery of fairness opinions.

Brokerage and Advisory Services. Profitability in brokerage services was reduced by the abolition of fixed brokerage commissions.[92] Moreover, the Internet has given rise to a bevy of discount brokerages that feature low-cost trading.[93] Profit derived from the provision of investment advice also may be on the decline.[94] Recently promulgated by the Commission, Regulation FD generally prohibits companies from selectively disclosing material information to bank analysts.[95] The informational advantage banks once enjoyed is on the decline, and the Internet has reduced dramatically an element of the cost of voluntary disclosure.[96] These developments negatively impact banks' bottom lines.

Underwriting Services. Investment banks also profit from underwriting securities, but developments in law and technology have negatively impacted banks' profits. In 1983, the Commission promulgated Rule 415 that permitted shelf offerings,[97] in which banks play a lesser role than traditional offerings and for which they receive less compensation.[98] Additionally, the Internet may revive dutch auctions, a means by which securities are offered to the public and for which bankers' traditional role (pricing) is minimized, lessening their compensation.[99]

---

92. *Cf.* Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified throughout 15 U.S.C.) (ending fixed trade commissions, which had been the practice for over 150 years, on May 1 ("May Day"), when negotiated trade commissions became the rule).

93. *See, e.g.*, Kate Bonamici, *Book 'em*, FORTUNE, Jan. 12, 2004, at 42, 42 (TD Waterhouse billed itself as "[t]he alternative to higher-priced brokers").

94. Investment banks do not "sell" their analysis to institutions. Instead, banks freely provide institutions with analysis. Banks receive indirect compensation when institutions execute trades with the banks that provide the most beneficial analysis. *See* DAN REINGOLD, CONFESSIONS OF A WALL STREET ANALYST 15 (2006).

95. *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,599, 65 Fed. Reg. 51,716 (Aug. 24, 2000).

96. The Internet allows delivery of information at a very low cost. The widespread availability of information lessens the informational advantages previously enjoyed by banks. *See* Thomas Gilroy & Crescent Muhammad, *Disclosure Regarding Audit Committees*, *in* 1 PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2002, at 275, 324 (Practising Law Institute 2002).

97. *See* 17 C.F.R. § 230.415 (2005); Shelf Registration, Securities Act Release No. 6499, Exchange Act Release No. 20,384, 48 Fed. Reg. 52,889 (Nov. 23, 1983).

98. *See* COX ET AL., *supra* note 46, at 201 ("Rule 415 . . . has reduced [the banker's] share of the pot. . . . Rule 415 leads to more competition among underwriters, so that lower underwriting fees are incurred than are experienced outside of the shelf registration rule.").

99. Google bucked tradition, going public by way of a dutch auction. Although Google employed investment bankers for the offering, those bankers received about three-quarters of their standard compensation for a traditional offering. *See* Gary Rivlin, *After Months of Hoopla, Google Debut Fits the Norm*, N.Y. TIMES, Aug. 20, 2004, at C1. Following the auction, Google's stock price climbed steadily, suggesting Google may have been able to sell its shares for a higher price. Perhaps, by foregoing the assistance of bankers on the issue of pricing, Google left money on the table. On the other hand, traditionally underwritten securities commonly rise following an initial public offering, so bankers are not immune from underpricing securities. *See* COX ET AL., *supra* note 46, at 132-34 (discussing the underpricing of IPOs).

Transaction Consultation Services. Evolutions in law and technology also may negatively impact the bottom lines of banks' investment banking units. In 1933, in the wake of the stock market crash of 1929, Congress passed the Glass-Steagall Act, which required the separation of investment and commercial banking, and which, in the process, decreased competition in the investment banking industry.[100] In 1999, Congress passed the Gramm-Leach-Bliley Act, which repealed portions of the Glass-Steagall Act that had prohibited commercial banks from engaging in the business of investment banking.[101] More and more firms have entered the field; more and more firms provide fairness opinions.[102] Further, the competition for business is without borders.[103]

Such evolutions in the law and technology have resulted in even greater pressure to maintain relations with existing clients and establish relations with new clients.

> Historically, . . . [t]he investment banker was a confidant to the company's highest executives, and the relationship between a CEO and his banker spanned an entire career. . . . Bankers didn't have to spend a whole lot of time chasing new business . . . .
>
> . . . .
>
> [Today, however,] the advisory side of the business has become much more commoditized. The banker no longer has the lock on relationships. The banker's information is no longer highly proprietary. Information on companies is now so widespread that there's very little company-specific knowledge that bankers can truly call their own. . . . This shift in the nature of the bankers' advisory business is illustrated by what, today, is a much more typical advisory assignment—an exclusive sale. In an exclusive sale a company that wants to sell its business calls up every investment banker that it knows. . . .
>
> . . . .
>
> As the bankers' competitive information advantage has waned, the bankers have gradually been forced to change their approach. . .

100. Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162 (codified in various sections of 12 U.S.C.) (commonly known as the Glass-Steagall Act); *see* Note, *Restrictions on Bank Underwriting of Corporate Securities: A Proposal for More Permissive Regulation*, 97 HARV. L. REV. 720, 731 (1984).

101. Pub. L. No. 106-102, 113 Stat. 1338 (1999); *see* COX ET AL., *supra* note 46, at 120.

102. "Traditionally, investment bankers have written most of [the fairness opinions], but the high fees and low risks have attracted new competition—consultants and some CPA firms, for example." Sweeney, *supra* note 6, at 45.

103. *See* COX ET AL., *supra* note 46, at 121.

> . They now have to spend a much larger portion of their time scrambling to find new clients and new business.[104]

Certainly, a stellar reputation may keep clients in the fold and attract new clients, but "[t]he reality is that reputation means precious little if a firm has no clients."[105] Giving clients what they want preserves existing relationships and attracts new clients.[106] A client may want a high-quality fairness opinion, but the client may be willing to trade a high-quality opinion that contradicts its position for a low-quality opinion that supports its position. From the bank's perspective, delivering a high-quality opinion that contradicts the client's preferences may do more harm than good.[107] Low-quality opinions may result.[108]

Representation of Willing Targets. If target management favors a transaction and requests that a bank deliver a fairness opinion, the bank will collect a flat fee, and by delivering the requested fairness opinion, the bank increases the likelihood it will collect a success fee.[109] If target management favors a transaction and requests that a bank deliver a fairness opinion, and the bank refuses, negative consequences follow. First, the bank may lose out on subsequent business from that particular client. Rather than walk away from the contemplated transaction, the client may seek a fairness opinion from a different bank; any bank that refuses to deliver a fairness opinion when requested may not be retained in the future.[110] To preserve its reputa-

---

104. ROLFE & TROOB, *supra* note 30, at 97-100; *see also* Petre, *supra* note 86, at 18 ("Less important than a decade ago are long-term associations in which a corporation depended on one Wall Street firm for discreet help and advice in a range of financial affairs, of which mergers were only a minor part. Today's relationships are shorter lived, sometimes breaking up after a single transaction, and the investment bankers must ceaselessly stalk new business.").

105. Prentice, *supra* note 4, at 204.

106. *Cf.* ROLFE & TROOB, *supra* note 30, at 125-26 ("At the end of the day, there's only one immutable goal. The [investment banking] team has to reach the valuation target that the company will be happy with."); Schmitt, *supra* note 52 ("The banks also may have a long relationship with the client, one they would just as soon keep.").

107. *See* Fiflis, *supra* note 45, at 518 ("Bankers are unlikely to bite the . . . hand that feeds them."); Sweeney, *supra* note 6, at 51 ("[I]nvestment bankers don't like writing a negative fairness opinion. A well-deserved negative fairness opinion doesn't earn them enough to outweigh the soured business relationships that are likely to result.").

108. *See* Knee, *supra* note 60 ("During the [1990s technology] boom even the very best investment banks radically lowered their standards . . . [out of a] fear of losing market share . . . . Transactions using grossly inflated stock were routinely deemed 'fair.'"); *see also* Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983) ("cursory preparation . . . when . . . speed was the hallmark"); Joseph v. Shell Oil Co., 482 A.2d 335, 344 (Del. Ch. 1984) (banker originally lacked significant information and later reaffirmed its fairness opinion quickly and cursorily).

109. *See* Longstreth, *supra* note 53, at 20 ("The [opiner's] fee may vary, depending upon who ultimately succeeds in a contested buyout, creating economic pressures to support management's judgment."); Schmitt, *supra* note 52.

110. *See* Schmitt, *supra* note 52 ("At the last minute, . . . a San Francisco investment banker . . . rescinded an opinion supporting 3Com Corp.'s plan[ned acquisition, killing] . . . the deal. . . . But the process discourages nay-saying. Spoilsports often end up on the street. When 3Com planned another acquisition [the following year], it went to a different investment bank for an opinion."); *see also* McGough, *supra* note 83, at 52 ("Dean Witter Reynolds refused to reaffirm its opinion that $39 a share was a fair price [because] . . . [t]hree months had passed since the original opinion, and the stock market was up sharply. . . . Did that stop Levitz management . . . ? No way. For $200,000, E.F. Hutton declared

tion, the bank may forego future revenue. However, no one is likely to learn about the refusal to deliver the requested opinion, so the bank has not actually bolstered its reputation with its refusal; it simply has avoided the possibility of tainting its reputation.

By refusing to deliver a fairness opinion, a bank may hope to spur renegotiations to better serve the target (and perhaps to collect a higher success fee). The refusing bank, however, runs the risk that the initial bidder will walk away or that a different bidder cannot be located, in which case the refusing bank has missed the opportunity to collect a success fee.[111] Why would a bank risk losing a bonus unless the original offer was exceptionally low? Will the original offer seem exceptionally low if, as we would expect, the acquirer offers more than the public trading price to attain the target?

Representation of Unwilling Targets. If the deal is hostile, then the target may seek an opinion that the offered consideration is inadequate. If the bank delivers an opinion that supports target management, then the bank may collect additional fees in connection with fending off the hostile bidder. If a bank delivered a *fairness* opinion to a target *unwilling* to deal with the acquirer, then the bank would miss the opportunity to collect fees for defensive work, which could include the identification of a white knight. Identifying a white knight could lead to a friendly transaction involving its own success fee.[112]

Senior Bankers. As referenced above, the interests of individual bankers may differ from the interests of the bank itself. Each senior banker may be willing to trade the bank's reputation for personal benefit. A senior banker's income is tied to the revenues generated by that particular banker.[113] By delivering a low-quality fairness opinion to secure business from the target, a senior banker will collect greater income because of that relationship. If the senior banker refuses to deliver the low-quality opinion, then the banker preserves the bank's reputation, which may help that banker in the long run, but the banker foregoes the immediate benefit of increased compensation. Individual senior bankers may trade uncertain long-term benefits of unknown magnitude for the certain short-term benefits of increased compensation.[114] Corporate managers, accountants, and lawyers behave in this man-

---

that the very same merger terms were fair.").

111. *See infra* notes 151-161 and accompanying text (discussing risk aversion); *cf. supra* notes 87-88 and accompanying text (exploring the incentive structure for real estate agents).

112. This Article focuses on transactions when management is not conflicted. When management is on both sides of the transaction, there may be even more reason for the bank retained to opine consistent with management's preferences. *See* Bebchuk & Kahan, *supra* note 3, at 40 & n.78; McGough, *supra* note 83, at 52 ("The need for real independence is never more acute than in a management buyout. Management has everything to gain and nothing to lose from lower valuations.").

113. *See* Avital Louria Hahn, *Fine-Tuning*, INVESTMENT DEALERS' DIG., Mar. 20, 2006, at 24, 26-28 (discussing how investment banks made a more focused effort in 2005 to reward those senior bankers who brought in business).

114. *Cf.* Garrett Hardin, *The Tragedy of the Commons*, 162 SCIENCE 1243, 1244-45 (1968) (explaining that absent defined property rights, the common asset will be depleted).

ner.[115] Depending on the magnitude of the costs and the likelihood of detection, rational bankers may follow suit.[116]

D. Impact of Incentives on Rational Bankers

Discretion pervades the valuation process. Given that (1) reputation may provide a weak check on investment bankers in their delivery of fairness opinions, and/or (2) investment bankers may trade reputation for financial gain, investment bankers may be incentivized to exercise discretion in a manner that favors their clients. The following Parts discuss areas in which bankers may exercise their discretion to achieve management's preferred valuation.

1. Definition of Fairness

Given the varying definitions of fairness, bankers could reach different conclusions based upon the chosen definition. One definition may lead a bank to conclude that the offered consideration is "fair,"[117] while another definition may lead a bank to conclude that the offered consideration is not "fair."[118] When banks issue their fairness opinions, however, banks do not define fairness.[119] This definitional confusion, coupled with the general agreement that fairness is a range (not a point),[120] leads to scenarios that clearly exemplify the discretion enjoyed by bankers. For example, when delivering an opinion to a willing target, the target's banker may conclude that the offered consideration is "fair," even if the offered consideration is low in the range and the banker genuinely believes the target could draw a higher price through alternative means.[121] On the other hand, when a target opposes a hostile transaction, the target's banker may conclude that the offered consideration is "inadequate," even if the offered consideration is high in the range, so long as the banker believes the target could draw a higher price through alternative means.[122] Low in the range may be "fair," and high

115. *See* Prentice, *supra* note 4, at 184 (accountants); Prentice, *supra* note 78, at 438-40 (corporate managers); *cf.* Ted Schneyer, *Reputational Bonding, Ethics Rules, and Law Firm Structure: The Economist as Storyteller*, 84 VA. L. REV. 1777, 1790 (1998) (arguing that firm size does not insulate lawyers at large firms from the economic effects of withdrawing from representation of a client).

116. *Cf.* Prentice, *supra* note 4, at 184 (discussing a similar incentive structure for auditors).

117. *See* CHOPER ET AL., *supra* note 9, at 127 ("Does fairness to the corporation mean . . . a contract not so flagrantly one-sided as to come close to appearing dishonest?").

118. *See id.* ("Does fairness to the corporation mean . . . the very best deal obtainable . . . ?").

119. *See* Bebchuk & Kahan, *supra* note 3, at 30.

120. *See supra* note 15 and accompanying text.

121. *See* Chazen, *supra* note 13, at 1453-54 ("[I]f the board of directors is inclined to accept an offer, it does not require an opinion that the offer is the highest or best available . . . ."); *Dart Industries Data Brings Up Questions on Proposed Merger*, *supra* note 16 ("We felt the Dart shareholders got a pretty good deal—not the best deal—but a pretty good deal." (quoting an investment banking firm spokesperson) (internal quotation marks omitted)).

122. *See* Chazen, *supra* note 13, at 1454 ("[A] board seeking back up for its decision to turn an offer down does not require an opinion that the offer is unreasonably low (*i.e.*, an 'unfairness opinion') but only that the company would have a substantial chance of doing better if it sought other offers. An offer

in the range may be "inadequate"—a word that, rightly or wrongly, one might construe as "unfair."

2. Computation of Fairness

Even assuming agreement as to the definition of fairness, the means by which banks compute fairness allow the exercise of discretion to reach the outcome preferred by their clients. Discretion is exercised in any valuation technique.

DCF and the Strategic Projection of Revenues and Expenses. Although based upon historical performance, projections amount to best guesses,[123] which may not be grounded in reality.[124] Accountability may be weak because no one can predict the future.[125] Accountability also may be weak because of the extraordinarily high number of variables involved in projections. Because the information market may be inefficient regarding the quality of bankers' fairness opinions, rational bankers may skew their projections, or their choices of others' projections, in the direction favored by their clients.[126]

DCF and the Strategic Selection of Discount Rates. Even if there were agreement regarding the projections, different discount rates can yield dramatically different current values.[127] Bankers have various models from which to choose when determining the discount rate.[128] Various models enable financial gurus to select the model that generates the result that the

---

that is within the range of fairness may still be low enough that a banker can advise its client that the client has a substantial chance of obtaining higher offers.").

123. *See* Fiflis, *supra* note 45, at 518 ("[I]n using discounted cash flows, estimating the amount and timing of all future cash flow—with such variables as changes in tax and inflation rates, technology, and the risks of the particular company and industry—approaches *mere guesswork*.") (emphasis added).

124. *See* ROLFE & TROOB, *supra* note 30, at 125 ("The [investment banker] has a quick rule of thumb—reality is irrelevant."); Laura Jereski, *Fiction in, Fiction out*, FORBES, Dec. 9, 1991, at 292, 294 ("[M]anagement's projections . . . were almost laughable."); *id*. ("[T]he management group figured out how much they would have had to increase cash flow in order to handle the deal and then worked backwards to find the money. The company's chief financial officer and the controller took forecasts received from the operating subsidiaries and massaged the numbers until they came up with $75 million in savings.").

125. *See generally* The Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (providing a statutory safe harbor from securities liability for certain forward-looking statements).

126. *See* Le Beau v. M.G. Bancorp., No. Civ. A. 13414, 1998 WL 44993, at *10 (Del. Ch. Jan. 29, 1998) (contrasting plaintiff's cash flow projection that increased at a constant rate over a ten-year period with defendant's cash flow projection with a growth rate that decreased after five years), *aff'd*, 737 A.2d 513 (Del. 1999); ROLFE & TROOB, *supra* note 30, at 125 ("The projections should always show revenues going up and expenses going down. That makes the DCF model spit out a big fat value for the business. Big fat values make CEO's happy."). Rather than make projections, bankers may accept management's projections. *See infra* Part II.D.3.

127. *See* Bebchuk & Kahan, *supra* note 3, at 35-36.

128. Usage of the Capital Assets Pricing Model is widespread. Though a Westlaw search of "ALLCASES" yielded only two hits for "arbitrage pricing theory," APT accounts for multiple factors while the CAPM ignores them; "a multi-factor model is probably more reflective of reality." BRATTON, *supra* note 14, at 112. For more on APT, see Stephen A. Ross, *The Arbitrage Theory of Capital Asset Pricing*, 13 J. ECON. THEORY 341 (1976).

client favors. Even if there were only one model, bankers exercise discretion with respect to the variables included in that model.[129]

Comparables Chosen Strategically. Consider an investment banker's comments:

> The problem with the comp analysis is that most of the time the banker wants to have a group of comps with the highest multiples possible and that, in turn, means that the bank may have to use companies as comps that are completely different from the company being valued. The associate's job then becomes figuring out a way to make all the companies seem similar, even though they're not. I once worked on an IPO for an engineering company that had a lot of clients in the broadcasting industry. Broadcasting companies were selling at huge premiums to engineering companies in the market, so we convinced the buyers that the company going public was actually a *broadcasting* company that just happened to employ a lot of engineers. . . . On the comp analysis, any company with even the slightest justification for inclusion is considered.[130]

Bankers choose "comparables" based less on factors that evince comparability and more on factors that support any analysis that generates a result consistent with the client's position.[131] Similarities may be emphasized, while disparities are explained away.

Relevant Time Frame Chosen Strategically. Even assuming agreement regarding the identities of the comparable companies/transactions, bankers must choose the relevant time frame during which to examine those companies/transactions to determine the target's value. One could utilize a time frame when the comparable companies had high valuations or when the comparable transactions generated high premia; one also could utilize a time frame that generated low valuations or low premia. The relevant time frame is malleable, inviting bankers to exercise discretion to achieve the client's favored ends.[132]

3. Nonaction

Just as rational bankers may exercise discretion in a fashion that enables them to deliver fairness opinions consistent with their clients' preferences,

129. *See* ROLFE & TROOB, *supra* note 30, at 122 ("In an investment bank, the managing director figures out what reasonable valuation number he is going to need to tell the client . . . . It then becomes the associate's job to work backward to figure out a way to display analysis that will validate the target value.").

130. *Id.* at 123-24.

131. *See Le Beau*, 1998 WL 44993, at *8 ("A primary issue dividing the parties concerns the companies chosen as 'comparable' to the corporation being appraised.").

132. *See id.* at *9 (expressing a willingness to depart from the norm when justified).

rational bankers also may refuse to exercise discretion, enabling them to deliver fairness opinions consistent with clients' preferences.

Acceptance of Management's Projections and Synergies. Rather than make projections regarding the future, rational bankers may accept the projections offered by management.[133] Bankers commonly assume the accuracy of management's projections.[134] If a banker assumes that management's projections are accurate, then management exerts tremendous control over the valuation generated by that banker. Control over the inputs amounts to control over the output. Bankers are bound to generate results consistent with management's preferences.

No Market Test. When a target seeks a banker's opinion, the banker may opine on the transaction's fairness but indicate that she did not test the price in the market.[135] There may be good reasons for a bank's failure to have tested the market. The agreement with the original bidder may have prohibited the target from soliciting third-party interest.[136] If bankers do not shop the target,[137] then it becomes that much easier for rational bankers to

133. The NASD's proposed Rule 2290 would require the disclosure of categories of information supplied by the client that formed a substantial basis for the opinion, if the fairness opinion is provided, described, or referenced to public shareholders. *See* Proposed NASD Rule 2290, *supra* note 68. Bankers also may utilize projections generated by independent third parties, but even those projections may be influenced heavily by information provided by the company being valued. The point is not that bankers should create their own projections but that accepting management's projections facilitates reaching management's preferred valuation.

134. *See, e.g.*, SBC Commc'ns, Inc., Registration Statement (Form S-4), at B-1 (Mar. 11, 2005) ("With respect to the financial forecasts of the Company for 2005 prepared by the management of the Company, we have discussed such forecasts with the management of the Company and we have been advised by them, and we have assumed, that such forecasts represent the best currently available estimates and judgments of the management of the Company as to the future financial performance of the Company. With respect to the publicly available research analyst estimates concerning the Company for 2006 through 2009 that we reviewed and discussed with the Company, the management of the Company has advised us, and we have assumed, that such estimates represent reasonable estimates and judgments as to the future financial performance of the Company.") (Fairness Opinion of Credit Suisse First Boston, L.L.C., addressed to the Board of Directors of AT&T Corp., dated Jan. 30, 2005); *id.* at C-2 ("With respect to the financial projections of the Company for 2005 and the estimates of cost savings and synergies prepared by the management of the Company, we have discussed such projections and estimates with the management of the Company and we have been advised by them, and we have assumed, with your consent, that such projections represent the best currently available estimates and judgments of the management of the Company as to the future financial performance of the Company.") (Fairness Opinion of Morgan Stanley & Co., addressed to the Board of Directors of AT&T Corp., dated Jan. 30, 2005).

135. *See, e.g.*, *id.* at B-2 ("In addition, we have not been requested to make, and have not made, an independent evaluation or appraisal of the assets or liabilities (contingent or otherwise) of the Company or the Acquiror, nor have we been furnished with any such evaluations or appraisals.") (Fairness Opinion of Credit Suisse First Boston, L.L.C., addressed to the Board of Directors of AT&T, dated Jan. 30, 2005); *id.* at C-2 ("In arriving at our opinion, we were not authorized to solicit, and we did not solicit, interest from any party with respect to any acquisition, business combination or other extraordinary transaction involving the Company.") (Fairness Opinion of Morgan Stanley & Co., addressed to the Board of Directors of AT&T, dated Jan. 30, 2005).

136. "No shop" clauses regularly appear in transaction documents. *See supra* note 63.

137. *See* Schmitt, *supra* note 52 ("How do you know the price is fair if you haven't tested the market?" (quoting Bevis Longstreth, a New York lawyer and former SEC Commissioner) (internal quotation marks omitted)).

conclude that the offered consideration—an amount undoubtedly in excess of the market price prior to the announced transaction—is fair.[138]

Acceptance of Accounting Figures. Valuation techniques commonly start with numbers taken from financial statements. In the first instance, the company generates financial statements internally under the guidance of its management. Company accountants may feel real or imagined pressure from management to ensure that the financial statements reflect management's preferences.[139] Even absent such pressure, company accountants exercise discretion when accounting for the company's business.[140] Accounting is an art.[141] Periodically, independent accountants may audit internally generated financial statements. Theoretically, an independent audit ultimately will lead the company's financial statements to reflect accurately the company's financial condition. Auditing, however, is also an art.[142] Moreover, rational auditors may face incentive structures that negatively impact the quality of their audits,[143] and auditors themselves may be subject to cognitive biases that negatively impact their audits' quality.[144]

The numbers contained in the financial statements are created internally and accepted without independent verification by bankers who then value

---

138. Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1453 (1985) ("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.'").

139. *See generally* Prentice, *supra* note 78, at 431 ("Of course, we know now that Enron *was* pulling these profits out of thin air, but no Enron employee would want to believe this, nor be prone to question when their CEOs were repeatedly telling them that nothing was wrong.").

140. *See* Longstreth, *supra* note 53, at 20 ("Large discretion is accorded management in the application of accounting principles, particularly if one seeks to be conservative."); *Former SEC Chairmen Advise Commission on Various Topics*, CORP. COUNSEL WKLY., Jan. 11, 2006, at 13 ("Roderick M. Hills, a former chairman of the Securities and Exchange Commission . . . counseled current Chairman Christopher Cox . . . to lead the SEC to give more consideration to acknowledging the ambiguity of financial numbers and promoting the use of nonfinancial indicators. . . . Harvey L. Pitt, who served [as Chairman] between 2001 and 2003, agreed with Hills that the relevance of financial statements as they exist today is questionable.") (internal punctuation omitted). *See generally* LEOPOLD A. BERNSTEIN & JOHN J. WILD, FINANCIAL STATEMENT ANALYSIS: THEORY, APPLICATION, AND INTERPRETATION 63 (6th ed. 1998) ("Preparation of financial statements requires judgment. Judgment is imperfect, yielding variability in the quality and reliability of accounting numbers. Since financial statements are general-purpose presentations, preparers' judgments are affected by their view of a typical user's requirements and expectations. These requirements and expectations do not necessarily coincide with those of a user with a specific task in mind. Accounting is also a *social science* and, therefore, is at least partially determined by human factors, including incentives.").

141. *See* PETER J. EISEN, ACCOUNTING THE EASY WAY 1 (4th ed. 2003) ("Accounting is the art of organizing, maintaining, recording, and analyzing financial activities.").

142. *See* Robert A. Prentice, *Can the Contributory Negligence Defense Contribute to a Defusing of the Accountants' Liability Crisis?*, 13 WIS. INT'L L.J. 359, 394 (1995) ("The auditing process is as much art as science."); Scott Vick, Note, Bily v. Arthur Young & Co.*: Is Limiting Auditor Liability to Third Parties Favoritism or Fair Play?*, 26 LOY. L.A. L. REV. 1335, 1345 (1993) ("In reality, an audit is more akin to art than science.").

143. *See* Prentice, *supra* note 4, at 212-13 ("[A] firm that violates the rules may not get caught. Any temptation to fudge is bolstered by the fact that the quality of an audit is nearly impossible to observe. . . . The ability of an audit firm to trade on its reputation 'depends ultimately on the perception rather than the fact of independence.'" (quoting Randolph A. Shockley, *Perceptions of Auditors' Independence: An Empirical Analysis*, 56 ACCT. REV. 785, 785 (1981))).

144. *See id. passim*.

the company under examination.[145] And of course, valuation is an art.[146] So, we have an inexact science (accounting), which is monitored by an inexact science (auditing), which forms the foundation for an inexact science (valuation). Discretion and the potential for inaccuracy are inherent in the process. By accepting, without independently verifying, the client's financial statements, rational bankers are better able to deliver the opinion their clients requested.

III. COGNITIVE BIASES AND CURES

A. Cognitive Biases

Though we generally may make decisions as rational actors, evidence makes plain that we suffer from cognitive biases that cause us to deviate from purely rational decision-making processes.

"[E]ven the most avid adherents to law and economics theory now admit that the rational actor model 'seems contradicted by the experiences and observations of everyday life.'"[147] Work remains, as no one has measured all of the cognitive biases across settings nor has anyone accounted for such biases in an overarching theory with predictive force. Nonetheless, cognitive "biases are sufficiently well-accepted in both the theoretical and empirical literature that we should take them seriously as behavioral risks, even if we cannot determine their exact role in any given setting or estimate how often they will apply in general."[148] So, even if we assume good faith on the part of investment banks and bankers,[149] cognitive biases may infect their decision-making processes and negatively affect the quality of their fairness opinions.[150] Some of these cognitive biases enhance banks' concern about their reputations—thereby bolstering their credibility and the worth of their fairness opinions—and other cognitive biases may lessen banks' concern

145. *See In re* AOL Time Warner, Inc., Sec. & "ERISA" Litig., 381 F. Supp. 2d 192, 244 (S.D.N.Y. 2004) ("Put simply, it was not Morgan Stanley's job to independently investigate AOL's accounting . . . .").

146. *See* William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1092 n.74 (2002) ("art of valuation").

147. Prentice, *supra* note 4, at 140 (quoting RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 17 (5th ed. 1998)).

148. *Organized Illusions*, *supra* note 4, at 134 (footnote omitted).

149. *See* Longstreth, *supra* note 53, at 19 ("I [former SEC Commission Longstreth] do not question the good faith or professionalism brought to fairness opinions."). *See generally* Russell Hardin, *The Psychology of Business Ethics*, *in* CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS 342, 359 (David M. Messick & Ann E. Tenbrunsel eds., 1996) ("As a first cut, it is plausible that there is far more failure of rationality than of morality in organizations . . . .").

150. *See* Prentice, *supra* note 78, at 428 ("It is not just that people consciously say: 'I'm looking out for me; screw the other guy,' although they sometimes do. Rather, a menu of cognitive biases and limits on rationality affect how people perceive, process, and remember information, and, consequently, how they choose among alternative actions, assess risk, and make many other types of decisions." (quoting Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1603 (2000) (internal quotation marks omitted)).

about their reputations—thereby undermining their credibility and the worth of their fairness opinions. Several cognitive biases are examined below.

1. Risk and Loss Aversion

Generally, people are averse to risks and losses.[151] A loss deflates more than a gain of equal magnitude elates.[152] Risk aversion and loss aversion seemingly enhance the disciplinary effect (provided by reputation) on banks in the delivery of fairness opinions.[153] A low-quality opinion may draw the ire of the client and deter potential clients from retaining that bank to opine on a transaction's fairness or provide other services. Aversions to risk and loss may lead a banker to ensure that the job is well done as recognized by the current client, any potential clients, and anyone in the market concerned with the reputations of the bank or banker. "The evidence indicates that the pressures of accountability and personal responsibility increase . . . manifestations of loss aversion."[154]

Moreover, people generally are risk-averse to small probabilities of loss.[155] As discussed in Part II.B., there may be only a small probability that a bank's (and less so, a banker's) reputation suffers from the delivery of a low-quality opinion. Because people generally are risk-averse to small probabilities of loss, one would expect bankers to behave in a manner to avert such low-probability risk, which would be consistent with the delivery of high-quality fairness opinions (regardless of clients' preferences).

The impact of aversions to risk and loss may be susceptible to problems of framing or of drawing baselines. What if the baseline for measuring loss is not one's reputation last year but one's bottom line last year? The baseline may be the status quo; we might view anything inferior to the status quo as a loss.[156] (Of course, failure to maintain the status quo could also

151. *See* Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1326 (1990); Roger G. Noll & James E. Krier, *Some Implications of Cognitive Psychology for Risk Regulation*, 19 J. LEGAL STUD. 747, 752 (1990); Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1179 (1997). People are not only loss averse but also risk averse—preferring a sure thing to a gamble that offers an equal expected value. *Id.* There are exceptions to the general preference for risk aversion. *Id.* The purchase of lottery tickets is a prime example. *Id.* at 1185-86.

152. *See* Jennifer Arlen, *Comment: The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1771 (1998) (observing "the disutility associated with giving up an object is greater than the utility gained by acquiring it"); Bibas, *supra* note 4, at 2508 ("I hate to lose more than I like to win." (quoting tennis great Jimmy Connors) (internal quotation marks omitted)); Kahneman et al., *supra* note 151, at 1326; Sunstein, *supra* note 151, at 1179; Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453, 454 (1981) ("The displeasure associated with losing a sum of money is generally greater than the pleasure associated with winning the same amount, as is reflected in people's reluctance to accept fair bets on a toss of a coin.").

153. *See* Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17, 22 (1993) ("Decision makers become more risk averse when they expect their choices to be reviewed by others . . . .").

154. *Id.*

155. *See* Bibas, *supra* note 4, at 2508 n.189.

156. *See generally* Editorial, *Solich Deserves the Boot After 9-3 Regular Season*, DAILY NEBRASKAN, Dec. 3, 2003, http://www.dailynebraskan.com/media/storage/paper857/news/2003/12/03

damage one's reputation.) Expectations may require the bank or the banker to produce profits on a par with the prior year.[157] In an effort to preserve the status quo and achieve those profits, one may take excessive or irrational risks.[158]

For example, the loss of a long-term client may significantly alter the status quo, particularly in light of the competitive pressures in the investment banking industry and the constant pressure to attract new clients and maintain relations with existing clients.[159] The cognitive bias regarding loss aversion may lead a bank or a banker to deliver to a long-term client an opinion with content pleasing to the client—even if the opinion is of low-quality—to preserve the relationship with that client.[160] Rather than being averse to risk, banks and bankers may be risk-seekers to avoid loss. Even absent a long-term relationship with a client, bankers must achieve increasing profit targets by attracting new clients or new business from existing clients.

Just as certain cognitive biases seemingly enhance the disciplinary effect of reputation on investment banks and bankers, there are cognitive biases that may lessen the disciplinary effect of reputation. Such behavioral biases include the overconfidence bias, the availability bias, and the self-serving bias. Groups may perpetuate, magnify, or minimize these individual biases.[161]

/Sports/Solich.Deserves.The.Boot.After.93.Regular.Season1739880.shtml?norewrite200609152009&sourcedomain=www.dailynebraskan.com. The termination of Nebraska football coach Frank Solich, after a season in which his team won 75% of its games, "reinforced the mantra of 'meet expectations, or get out.'" *Id.* Solich followed Hall of Fame coach Tom Osbourne whose teams between 1993 and 1997 went 60-3 and won two national championships. *See Big Shoes to Fill*, SPORTS ILLUSTRATED, Dec. 27, 1998, http://sportsillustrated. cnn.com/football/college/1998/bowls/holiday/news/ 1998/12/27/nebraska_solich.

157. *See generally* Prentice, *supra* note 78, at 435 ("Those [at Enron] who didn't make their numbers were demoted and destroyed, and those who did make their numbers received bonuses so fabulous that Houston luxury car dealers knew to come to Enron to exhibit their wares every bonus period.").

158. *See* Noll & Krier, *supra* note 151, at 752 ("[P]eople are risk averse as to gains but risk taking as to losses."); *id.* at 758 ("[W]hen faced with the certainty of some loss, they may be excessively prone to take actions involving a reasonably large chance of a catastrophic outcome.").

159. *See generally* COX ET AL., *supra* note 46, at 118, 121 (Legal and technological developments "have contributed to an environment that encourages . . . risk taking among American investment banking firms.").

160. *See* Collins v. SEC, 532 F.2d 584, 599 n.28 (8th Cir. 1976) (quoting the SEC's Division of Investment Management Regulation) ("[T]rue independence of financial advisers where fairness is at issue would preclude a situation where the advisers are made aware of their clients' thinking as to proper terms and *consciously or not*, are likely to tailor their opinions, to some degree, to the results desired.") (internal quotation marks omitted) (emphasis added), *rev'd on other grounds*, 432 U.S. 46 (1977); McGough, *supra* note 83, at 52 ("The more incestuous the relationship between investment bank and client, the more suspect the fairness opinion.").

161. Chip Heath et al., *Cognitive Repairs: How Organizational Practices can Compensate for Individual Shortcomings*, 20 RES. ORG. BEHAV. 1 (1998) (minimize); Cass R. Sunstein, *What's Available? Social Influences and Behavioral Economics*, 97 NW. U. L. REV. 1295, 1305-08 (2003) (perpetuate or magnify).

2. Overconfidence

A banker may deliver a high-quality fairness opinion to avoid any risk that the delivery of a low-quality opinion would damage her reputation. If, however, the banker is overconfident in her fairness opinion, the banker may not accurately perceive the risk to her reputation. Overconfidence could cause a banker to underestimate the risk from delivering a (low-quality) fairness opinion. Studies suggest that individuals are overconfident in their assessments regarding risk. For example, ninety percent of a polled group believed that, relative to the others in the group, they were above-average automobile drivers.[162] Additionally, studies suggest that people underestimate the likelihood that they will be involved in an auto accident if they perceive themselves as having some control over the situation.[163] One's perception of control may be misplaced, which can heighten the degree of overconfidence.[164]

Bankers may be overconfident in their assessments regarding risk and may improperly view themselves as in control.[165] Certainly, bankers do not control the operations of their client's businesses. Bankers, however, may perceive themselves as in control if they structured the transaction or if they conducted the search for an acquirer. Having structured the transaction or having identified the acquirer, a banker may be overconfident that the offered consideration is fair. In such scenarios, the banker may misperceive the risk of issuing a low-quality opinion which asserts that the offered consideration is fair.

Bankers may feel overconfident and under-perceive the risk attendant to issuing a low-quality opinion because those opinions contain little substance. The banker says only that the offered consideration (almost certainly an amount in excess of the public trading price) is fair, not that the offered consideration is the highest price attainable. Additionally, the exceptions, qualifications, and carve-outs set forth in a fairness opinion emasculate the conclusion reached therein.[166] Given the relatively modest opinion, the opining banker is hardly sticking out her neck.[167] Moreover, evidence indicates that overconfidence bias is stronger with regard to complex tasks; the complexity of the valuation process provides fertile ground for overconfi-

162. Sunstein, *supra* note 151, at 1183.

163. *See* David M. DeJoy, *The Optimism Bias and Traffic Accident Risk Perception*, 21 ACCIDENT ANALYSIS & PREVENTION 333, 336-37 tbl.2 (1989); *id.* at 336 tbl.1; *see also* Bibas, *supra* note 4, at 2501 ("Overconfidence is . . . exceptionally strong when people have some control: they are overly optimistic about how well they can exercise that control to avoid bad outcomes.").

164. Cass R. Sunstein, *Cognition and Cost-Benefit Analysis*, 29 J. LEGAL STUD. 1059, 1081 (2000) (noting that drivers may not be at fault but still be injured in an accident and that passengers and pedestrians who may be injured in car accidents exercise little, if any, control).

165. Kahneman & Lovallo, *supra* note 153, at 27 ("[A] pervasive optimistic bias [is] . . . an illusion of control. . . . People . . . exaggerate their control over events . . . .").

166. *See* Schmitt, *supra* note 52 ("virtually worthless") (quoting attorney Harvey Kronfeld).

167. *See* City Capital Assocs., L.P. v. Interco, Inc., 551 A.2d 787, 792 (Del. Ch. 1988) ("The so-called reference ranges do not purport to be a range of fair value; but just what they purport to be is (deliberately, one imagines) rather unclear.").

dence, increasing the likelihood that low-quality opinions may result.[168] Consequently, the banker may be overconfident in reaching the conclusion preferred by the client, may perform sub-par analysis in support of that conclusion, and may misperceive the risk of issuing a low-quality opinion. Finally, experts are more overconfident than lay persons when predictability is low.[169] Relative to John Q. Public, an investment banker is an expert and operates in a realm where predictability is low,[170] where the overconfidence bias undermines the delivery of a high-quality fairness opinion.

3. Availability Bias

A rational decision-making process generally involves the consideration of the likelihood and magnitude of each of the benefits and costs related to the contemplated action. Consideration of the magnitude of a certain consequence isolated from its likelihood of occurrence would be irrational.[171] Evidence suggests that individuals do not rationally assess the likelihood of events. One tends to overestimate the likelihood of an event when similar events are readily available for the mind to recall.[172] One tends to underestimate the likelihood of an event when similar events are not readily available for the mind to recall.[173]

The availability bias may negatively influence the decision-making processes of bankers as they opine on the fairness of transactions. Assume a client is contemplating a friendly transaction with a third party for which the client seeks an opinion from a banker confirming the fairness of that transaction. If the fairness of the transaction is genuinely at issue, a rational banker may compare the perceived negative impact that would follow the refusal to deliver the requested opinion against the perceived negative impact that would follow the delivery of a fairness opinion for a transaction that was actually unfair.[174]

---

168. *See* Prentice, *supra* note 4, at 154 ("unacceptable task performance" (quoting Jane Kennedy & Mark E. Peecher, *Judging Auditors' Technical Knowledge*, 35 J. ACCT. RES. 279, 279 (1997) (internal quotation marks omitted)). *See generally* Baruch Fischhoff, *The "Public" Versus the "Experts": Perceived Versus Actual Disagreements About Risks*, *in* CODES OF CONDUCT, *supra* note 149, at 275, 277 ("[A]s the role of judgment increases in any of these operations, the results become increasingly subjective.").

169. *See* Dale Griffin & Amos Tversky, *The Weighing of Evidence and the Determinants of Confidence*, 24 COGNITIVE PSYCHOL. 411, 427 (1992).

170. *See generally* Fiflis, *supra* note 45, at 518 ("mere guesswork").

171. *See* Tversky & Kahneman, *supra* note 152, at 454.

172. *See* Amos Tversky & Daniel Kahneman, *Extensional Versus Intuitive Reasoning: The Conjunction Fallacy in Probability Judgment*, 90 PSYCHOL. REV. 293, 311 (1983) (According to one study, individuals believed that a page of text would include more words ending with the letters "ing" than words having "n" as the second to last letter. Gerunds and words that rhyme with "sing" are readily available for the mind to recall. On the other hand, one tends not to categorize words by the second-to-last letter, leaving words with "n" as the second-to-last letter less available for recall. Researchers concluded that one's ability to recall similar words affected one's prediction of the likelihood of the appearance of such words. Of course, the number of words having "n" as the second-to-last letter must equal or exceed (but never be less than) the number of words that end with "ing").

173. *See id.*

174. Commentators have termed such a decision-making process as "error-cost analysis." *See, e.g.*,

A banker may overestimate the negative impact resulting from the refusal to deliver the requested opinion because the negative consequences may be readily available for the banker's mind to recall. Failure to deliver the requested opinion may cost the bank a success fee on the transaction, may cost the bank its client, and may jeopardize the bank's ability to attract future clients. Failure to generate sufficient revenue for the bank may cost the banker her job. Bankers know of their employers' high turnover rate. Bankers know that those who do not produce are not retained. The availability to the banker's mind of the negative consequences of refusing to deliver the opinion requested by a client may cause the banker to overestimate the likelihood that those negative consequences will be realized, increasing the likelihood that the banker delivers the requested opinion.

A banker may underestimate the negative impact resulting from the delivery of a fairness opinion for a transaction that was actually unfair. The negative consequences may be both uncertain and distant. The negative consequences of delivering a low-quality opinion could damage the reputation of the bank and the banker, but because the information market regarding the quality of opinions is inefficient, prior instances of reputation damage are not readily available for the banker's mind to recall. Moreover, there is no industry monitor, decreasing instances of repercussion for the delivery of inferior opinions, and leaving such instances less available for the mind to recall. Because of the rarity of the imposition of civil liability for the delivery of inferior opinions, those instances are less available for bankers to recall. And those to whom bankers might be liable are unknown investors.

Studies suggest that individuals care more for identified individuals (even if not known personally) than unidentifiable (statistical) individuals.[175] To bankers, the investors that may suffer from a low-quality opinion are simply unknown, unidentifiable statistics (unlike the known client). Bankers may accord those investors inadequate weight when deciding whether to deliver the low-quality opinion.[176]

Moreover, the information market may be inefficient at attributing the low-quality opinion to a particular banker, increasing the uncertainty that

---

Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 S. CAL. L. REV. 657, 679 (2001). Courts have employed this error-cost analysis. *See* Mathews v. Eldridge, 424 U.S. 319, 334-35 (1976) (holding that, when determining whether a pre-deprivation hearing is required, courts should consider, among other things, the private interest at stake and the risk of erroneously depriving that interest); Am. Hosp. Supply Corp. v. Hosp. Prods. Ltd., 780 F.2d 589, 593 (7th Cir. 1986) ("A district judge asked to decide whether to grant or deny a preliminary injunction must choose the course of action that will minimize the costs of being mistaken [, in part,] [b]ecause he is forced to act on an incomplete record . . . .").

175. *See generally* George Loewenstein, *Behavioral Decision Theory and Business Ethics: Skewed Trade-offs Between Self and Other*, *in* CODES OF CONDUCT, *supra* note 149, at 214, 217 ("Many commentators have lamented the public's tendency to show more concern for identifiable victims than for statistical victims.").

176. *See generally id.* at 226 ("[T]he people who will be hurt by any misrepresentation of information are statistical. Many of them might lose a small amount of money; it isn't clear who will do so; and there is some chance that no one will be adversely affected by a minor misrepresentation. In contrast, the auditor is likely to be intimately acquainted with those who would be hurt by a negative ('qualified') opinion on an audit.").

the banker will suffer negative consequences from delivering such an opinion. While the negative consequences from refusing to deliver the requested opinion may be relatively swift, the negative consequences from delivering a low-quality opinion seemingly would be relatively delayed.[177] Moreover, an individual banker—whose tenure at the bank may be short—may discount future harms at an excessively high rate, minimizing the impact of reputation on current decision-making.[178]

4. Self-Serving Bias[179]

"One of the most important nonobjective influences on information processing is self-interest . . . ."[180] When confronted with ambiguity, one sees what one wants to see, and what one wants to see is something consistent with one's self-interest, "not a threat to . . . career prospects."[181] Although the unambiguous may not be ignored, ambiguity abounds when bankers conduct valuations. Therefore, "predictions of the value . . . are . . . biased in a self-serving manner."[182]

Rational bankers likely deliver the opinions requested by their clients; the self-serving bias increases that likelihood.[183] The self-serving bias complicates resolving the incentives that rational bankers confront because the "self-serving inferences are pervasive and hard to disentangle from business justifications . . . ."[184]

---

177. *See generally id.* ("[T]he negative consequences of a[n auditor's] qualified opinion are likely to be immediate—loss of the client's friendship, likely loss of the contract, and possible unemployment—whereas the effects of a false negative (an unqualified report where qualification is merited) are likely to be delayed in time.").

178. *See generally* Richard A. Posner, Op-Ed, *The Probability of Catastrophe . . .* , WALL ST. J., Jan. 4, 2005, at A12 ("Politicians with limited terms of office and thus foreshortened political horizons are likely to discount low-risk disaster possibilities . . . . The officials, given the variety of matters to which they must attend, are likely to have a high threshold of attention below which risks are simply ignored.").

179. When the authors of the articles cited in this section reference "fairness," they refer to the general concept of "fairness," not specifically to bankers' opinions or corporate transactions. Nonetheless, the analogy to bankers' opinions and corporate transactions does not seem inappropriate.

180. Loewenstein, *supra* note 175, at 221.

181. *Organized Illusions*, *supra* note 4, at 144; *see* Max H. Bazerman et al., *Environmental Degradation: Exploring the Rift Between Environmentally Benign Attitudes and Environmentally Destructive Behaviors*, *in* CODES OF CONDUCT, *supra* note 149, at 256, 266 ("Ambiguity enables individuals to make self-serving interpretations of the situation and to judge as fair distributions of resources that favor themselves.").

182. George Loewenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135, 139 (1993); *see* Bazerman et al., *supra* note 181, at 265 ("When people are personally involved in a situation, judgments of fairness are likely to be biased in a manner that benefits themselves."); Arlen, *supra* note 152, at 1776 ("self-serving assessment of what is fair"); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1095 (2000) ("[T]he self-serving bias suggests that individuals are likely to estimate the value of property rights differently depending on which side of the transaction they find themselves.").

183. *See* Bazerman et al., *supra* note 181, at 265 ("Individuals first determine their preference for a certain outcome on the basis of self-interest and then justify this preference on the basis of fairness by manipulating the importance of attributes affecting what is fair.").

184. *Organized Illusions*, *supra* note 4, at 145.

B. Cognitive Cures

Cognitive biases may be minimized (or eliminated) by learning and by competition. Additionally, an organization may take steps to minimize (or eliminate) the cognitive biases of individuals through the adoption of cultural norms and a decision-review process. First, expertise may mute cognitive biases.[185] Bankers develop expertise through extensive training and by repeatedly conducting valuations. "[R]epeat players . . . can spot and offset some of these psychological biases and heuristics . . . [but those who are] overburdened . . . may not."[186] Bankers work incredibly long hours;[187] overburdened bankers may struggle to identify and overcome cognitive biases.

One might also argue that the market will weed out those suffering from cognitive biases.[188] The market, however, may be inefficient.[189] Despite large economic effects resulting from irrational decision-making by individuals, the market may not weed out such irrationality if the decision errors have little effect on those individuals.[190] As already discussed, the individual banker may not suffer the negative consequences stemming from decision

185. *See* Arlen, *supra* note 152, at 1768-69; Bibas, *supra* note 4, at 2502 ("[K]nowledge and experience[] may limit . . . overconfidence." (citing Douglas A. Hershey & Jo A. Wilson, *Age Differences in Performance Awareness on a Complex Financial Decision-Making Task*, 23 EXPERIMENTAL AGING RES. 257, 268-69 (1997))). Nonetheless, experts may suffer from the same cognitive biases as lay people. *See* Arlen, *supra* note 152, at 1784. In one study, seven internationally renowned civil engineers predicted (and set a 50% confidence interval around) the height at which a structure would cause its foundation to fail. Heath et al., *supra* note 161, at 4. "The results were quite sobering: not one engineer correctly predicted the true failure height within his or her confidence interval. Evidently, the civil engineers thought they knew more than they did . . . ." *Id.*

186. Bibas, *supra* note 4, at 2498. Skill, however, may only come with time. High turnover rates at investment banks may inhibit the acquisition of the relevant expertise.

187. *See* ROLFE & TROOB, *supra* note 30, at 87-88 ("[Y]ou stay up all night [preparing] the pitch . . . . If you get the deal, then you and your team have lots of work to do. You may as well cancel all of your plans for the next six weeks because you're in for some long nights and hectic days. . . . [O]nce training's over you guys won't see the light of day again." (quoting an investment banking associate) (internal quotation marks omitted)).

188. *See generally Organized Illusions*, *supra* note 4, at 148 ("[S]hould we not expect those firms with unrealistic belief systems that do not learn from their errors to disappear, leaving only those that have successfully countered the problem of cognitive bias?"); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, S275 (1986) ("[I]t is sometimes argued that failures of rationality in individual decision making are inconsequential because of the corrective effects of the market.").

189. Though competition in the fairness opinion business is on the rise, the market may not be competitive yet. *See* Petre, *supra* note 86, at 18 ("oligopoly of investment firms"); *id.* ("[I]nterlopers and lesser fry have . . . a tough time winning a piece of the . . . business."). The market has not eliminated cognitive biases in other arenas. *See* Tversky & Kahneman, *supra* note 188, at S275. For example, when bettors play the ponies, the market that a favorite will "win" is efficient, but the market that the favorite will "place" or "show" is inefficient as bettors underestimate the likelihood of such outcomes. *See id*. One would expect, given the level of expertise at the tracks and given the arbitrage opportunity for profits, that the market would move towards efficiency, but it does not. *Id*.; *see also* Richard H. Thaler & Cass R. Sunstein, *Market Efficiency and Rationality: The Peculiar Case of Baseball*, 102 MICH. L. REV. 1390, 1401 (2004). *See generally* Lynn A. Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 639-40 (1995) (arguing that some portion of new participants in the market are overconfident).

190. *See* George A. Akerlof & Janet L. Yellen, *Can Small Deviations from Rationality Make Significant Differences to Economic Equilibria?*, 75 AM. ECON. REV. 708, 709 (1985); Tversky & Kahneman, *supra* note 188, at S275.

errors associated with the fairness opinion, increasing the likelihood that the banker may deliver the opinion requested by the client, even if of low quality. "The claim that the market can be trusted to correct the effect of individual irrationalities cannot be made without supporting evidence, and the burden of specifying a plausible corrective mechanism should rest on those who make this claim."[191]

Organizations may cure the cognitive biases of individual decision-makers.[192] First, the bank may institute cultural norms that lead to better decision-making,[193] and hire people that behave consistent with those norms.[194] When a bank signals that a trait is valued, its employees will take the hint. If coworkers signal adherence to a particular norm, then others, who otherwise might have deviated from that norm, sense pressure to conform and do conform.[195]

Second, because an organization may acquire, retain, and retrieve information better than an individual,[196] banks may review initial or preliminary decisions of individual low-level bankers, who may be more subject to cognitive biases.[197] Banks commonly require senior bankers to review the valuation work initiated by low-level bankers,[198] which may eliminate or minimize the cognitive biases of low-level bankers. Such a review process may educate low-level bankers of their own biases and help them eliminate or minimize the impact of those biases in future exercises of discretion.[199] Additionally, banks commonly create fairness opinion review committees

191. Tversky & Kahneman, *supra* note 188, at S275.

192. *See* Arlen, *supra* note 152, at 1769.

193. *See Organized Illusions*, *supra* note 4, at 132 ("[T]hese belief systems are powerful normative influences once a coherent culture evolves."). *But see* Fiflis, *supra* note 45, at 515 ("Bankers have neither an ethics code nor a professional association to administer sanctions for deviations from norms. There is no minimum education or licensing procedure in place. Additionally, some segments of the banking community possess an entrepreneurial ethos very different from that traditionally found in accounting and law.").

194. *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 83 ("Supervisors should, by all accounts, hire agents carefully . . . . There is a crudely accurate assumption that good compliance starts with good hiring."). When hiring, however, a bank may find it difficult to discern the ability to appropriately exercise discretion. *See, e.g.*, *id.* (noting applicants may have "no observable experience in a sufficiently similar setting"). Screening devices may prove helpful but will not be foolproof. Moreover, once applicants learn of the sought-after characteristics, applicants may feign those traits. *Id.* at 84 (recognizing it is "not hard for clever people to mimic" these traits).

195. *See id.* at 104.

196. *See* Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 CORNELL L. REV. 549, 579 (2002) ("[C]areer staff provide an ongoing repository not only of substantive knowledge but also of decisionmaking experience, so that agencies . . . need not reinvent the wheel . . . ."); James P. Walsh, *Managerial and Organizational Cognition: Notes from a Trip Down Memory Lane*, 6 ORG. SCI. 280, 292, 295 (1995).

197. As part of a review process, an organization may provide its low-level employees with feedback that is clear, frequent, and quick; such reviews provide fertile ground for learning. *See* Colin F. Camerer, *Comment on Noll and Krier, "Some Implications of Cognitive Psychology for Risk Regulation,"* 19 J. LEGAL STUD. 791, 794 (1990).

198. *See generally* ROLFE & TROOB, *supra* note 30, at 131-40 (describing the review process of a pitch originally drafted by a low-level banker and subsequently reviewed by increasingly senior bankers).

199. *See* Cleveland, *supra* note 4, at 68-69.

comprised of senior bankers who are familiar with valuation theories and who did not work on the transaction under consideration.[200] Before a bank delivers a fairness opinion, the committee reviews the transaction, the analysis and supporting documentation, and the proposed opinion.[201]

Even if organizational review minimizes the cognitive biases of individuals, it may not eliminate such biases because organizations are also subject to cognitive biases. The low-level banker initiating the valuation process controls a mountain of information and selectively reports information upward for review by a supervisor.[202] In certain respects, the upward flow of selected information may inhibit effective decision-making.[203] Moreover, the low-level banker may find the information at her disposal to be malleable. Consistent with her training, the low-level banker will assemble, from a mountain of information, a mosaic that leads others to see what she sees.[204] In so doing, the low-level banker may, without any nefarious intent, unduly emphasize the good (anything favorable to the valuation reached by that low-level banker) and de-emphasize the bad (anything unfavorable to that valuation).[205] True, senior bankers—who likely possess greater experience and expertise—may identify flaws (cognitive or otherwise) in the valuation reached by the low-level banker. Nonetheless, senior bankers may recognize that they lack familiarity with the mountain of information regarding the valuation under review.[206] And, because those se-

200. *See* Bebchuk & Kahan, *supra* note 3, at 44-45, 45 n.97; Comment Letter from Marjorie Bowen & Robert Hotz, Houlihan Lokey Howard & Zukin Inv. Banking Servs., to Barbara Z. Sweeney, Senior Vice President and Corporate Sec'y, NASD (Feb. 1, 2005), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013245.pdf (commenting on Proposed NASD Rule 2290 regarding Fairness Opinions). The NASD has proposed a rule requiring any member to have procedures regarding the issuance of a fairness opinion, including the transactions for which a committee must approve the issuance of an opinion (as well as procedural requirements regarding the selection of committee members), procedural requirements regarding the analyses employed in fairness opinions, and procedural requirements to identify conflicts between insiders and shareholders of the client. Proposed NASD Rule 2290, *supra* note 68.

201. *See* Proposed NASD Rule 2290, *supra* note 68; Comment Letter from Gerard M. Creagh, Executive Managing Dir., Standard & Poor's, to Barbara Z. Sweeney, Office of the Corporate Sec'y, NASD (Jan. 10, 2005), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013220.pdf (commenting on Proposed NASD Rule 2290 regarding Fairness Opinions).

202. *See generally* Edward J. Joyce & Gary C. Biddle, *Anchoring and Adjustment in Probabilistic Inference in Auditing*, 19 J. ACCT. RES. 120, 120 (1981) ("[Auditors] use their professional judgment to determine the type and amount of information to collect . . . ."); *Organized Illusions*, *supra* note 4, at 119 ("Information is highly decentralized in business organizations.").

203. *See Organized Illusions*, *supra* note 4, at 119 n.60. In other respects, the upward flow of selected information may encourage effective decision-making. *Id.* For example, executives cannot be saddled with every decision nor inundated with every datum. *See generally* DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by *or under the direction of* a board of directors . . . .") (emphasis added); *West Wing: Life On Mars* (NBC television broadcast Apr. 30, 2003), http://www.westwingtranscripts.com/search.php?flag= getTranscript&id=88&keyword=crazy%20stuff%20out%20of%20his%20office#thequery ("[G]ive me a quick hit just so you can learn how to keep the crazy stuff out of his office.").

204. Martha S. Feldman & James G. March, *Information in Organizations as Signal and Symbol*, 26 ADMIN. SCI. Q. 171, 176 (1981) ("Often information is produced in order to persuade someone . . . .").

205. *See generally Organized Illusions*, *supra* note 4, at 122 (quest for advancement may lead one to "accentuate the positive and to distort bad news").

206. *See id.* at 121 ("The employees with the most immediate access to basic information are almost always line personnel . . . ."); *see also* Walsh, *supra* note 196, at 280 ("The most fundamental challenge

nior bankers have additional monitoring and operational responsibilities,[207] those senior bankers may defer to the reasoned judgment of those most intimately familiar with that information—the lower-level banker.[208] Moreover, to protect the morale of the low-level banker, a senior banker may face incentives against intrusive review.[209] The quest for favorable working environment and the avoidance of confrontations may render the review process less valuable.[210]

Furthermore, the perceptions of a bank supervisor may be colored by the initial conclusions of the lower-level banker. The initial conclusion of a lower-level decision-maker may serve as an anchor from which a supervisor experiences difficulty freeing himself. Experiments indicate that "an original 'anchor' . . . may be hard to dislodge."[211] Once an initial valuation is reached, it may be altered inadequately.[212]

Although a bank's supervisor may be slow to question the low-level banker's exercise of discretion when performing the valuation, when questioned, those lower-level bankers may defend their discretionary decisions in suboptimal fashion. "When there is accountability for decisions, people tend to construe information in ways that bolster their prior commitments. . . . [W]hen a decision has been made and the decision-maker has to answer for it, there tends to be a shift toward rationalization, both to oneself and

---

faced by managers, however, is that their information worlds are extremely complex, ambiguous, and munificent.").

207. *See* Langevoort, *supra* note 194, at 93 ("[I]t is possible to get inadequate monitoring from even professional auditors. Particularly if the monitors are given too much work . . . ."); *see also Organized Illusions*, *supra* note 4, at 137-39 ("These tendencies are strengthened when managers work in teams or share decisionmaking responsibility. Because of the demands of communication and negotiation, groups can attend to even less information than individuals . . . . [E]ven if a group member privately wonders whether some bit of information is troubling, the very fact that other group members do not appear to be concerned is a reason to let the matter drop . . . [and resort to] 'groupthink' . . . [in order] to preserve internal solidarity . . . ."). Bankers work in teams. *See* ROLFE & TROOB, *supra* note 30, at 87.

208. *See* Langevoort, *supra* note 194, at 88 ("A supervisor with many team members and a host of other line responsibilities can readily fall prey to [a bias in favor of the status quo] even if not inclined toward wishful thinking."); *id.* at 87-88 ("Once an impression is gained, it is insufficiently revised to reflect new information.").

209. *See* Kahneman & Lovallo, *supra* note 153, at 26 ("[F]acing the facts can be intolerably demoralizing. . . . [T]he [unfavorable] forecast was quietly dropped from active debate . . . ."); *Organized Illusions*, *supra* note 4, at 123; *id.* at 138-39 (describing how "senior managers . . . unconsciously deflect[] threatening information to preserve internal solidarity").

210. *See* CHRIS ARGYRIS, OVERCOMING ORGANIZATIONAL DEFENSES: FACILITATING ORGANIZATIONAL LEARNING 14-31 (1990).

211. Sunstein, *supra* note 151, at 1188 ("Often people make probability judgments on the basis of an initial value, or 'anchor,' from which they make insufficient adjustments. The initial value may have an arbitrary or irrational source.") (footnote omitted). For example, in one experiment, one group of accountants was asked two questions: (1) Does the incidence of significant management fraud exceed 1%?, and (2) What is your estimate of the percentage of firms that have significant management fraud? A second group of accountants was asked the same questions except that the first question set the anchor at 20%. In response to the second question, the first group placed the estimate at 1.6%; the second group placed the estimate at 4.3%. *See* Joyce & Biddle, *supra* note 202, at 123-25.

212. *See generally* ROLFE & TROOB, *supra* note 30, at 131-40 (discussing an investment bank's review process of a pitch, which review process involved numerous stylistic changes but little substantive change).

others."[213] Because of a commitment bias, the low-level banker may resist a change in, or adaptation of, her original position.[214]

IV. PROPOSALS

In this Part, I focus on friendly acquisitions of publicly held corporations by unrelated third parties of the sort in which the *Van Gorkom* court provided the impetus for targets to solicit fairness opinions.[215] Incentives and biases seemingly lead bankers to deliver the opinions requested by clients, even if those opinions are of low-quality. We could craft rules to limit the impact of those incentives and biases. Such rules might prohibit certain conduct or require additional disclosure. General prohibitions seem overbroad. Disclosure seems ineffective. Instead, closer scrutiny by directors and judges seems more promising. Prohibition, disclosure, and scrutiny are addressed below.

A. General Prohibition

We could, to minimize certain troubling incentives and biases, prohibit an investment bank from (1) collecting a success fee, or (2) delivering a fairness opinion while also providing advisory services to a particular client. The federal government has imposed such restrictions on accountants. Fearing that their independence would be compromised, the Commission generally prohibited accountants from collecting contingent fees from auditing clients.[216] In the Sarbanes-Oxley Act of 2002, Congress generally prohibited a public accounting firm from delivering a fairness opinion to a client for which the accounting firm performed auditing services.[217]

Perhaps, investment bankers should be treated like accountants. In fact, other countries have pursued solutions that require governmental participation in connection with the delivery of fairness opinions. The European Un-

213. Langevoort, *supra* note 194, at 87. After making a commitment, one tends to resist evidence that the chosen course of action was worse than alternatives.

214. *See Organized Illusions*, *supra* note 4, at 142; Langevoort, *supra* note 194, at 87; Rachlinski & Farina, *supra* note 196, at 605 ("People find it difficult to come to believe that their initial decisions were mistaken."). *But see Organized Illusions*, *supra* note 4, at 142 n.142 ("[O]ne cannot be sure that commitment is necessarily a bias; a rational actor might remain committed to a course of action if she fears that discovery of the mistake will lead to termination.").

215. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). The discussion still applies to other transactions but possibly with less force. Additionally, in other transactions, factors not addressed here could loom large.

216. *See* Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008 (Dec. 5, 2000).

217. *See* The Sarbanes-Oxley Act, 15 U.S.C. § 78j-1(g) (Supp. III 2003). And prior to Congress, the Commission generally prohibited such behavior. *See* Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,008. Though Congress's prohibition may seem sound in theory, Professor Romano surveyed studies on the subject and concluded audit quality is not jeopardized by the provision of non-audit services. *See* Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1535-37 (2005); *id*. at 1536 ("legislating away a nonproblem").

ion calls for governmental appointees to opine on the fairness of offered consideration.[218] The United States is unlikely to follow suit. In crafting the federal securities laws, Congress expressed its preference for regulation via disclosure rather than governmental regulation of the merits of particular investments.[219]

Even absent a rule prohibiting a bank from providing services in addition to a fairness opinion, the market may be responding. Some clients implicitly acknowledge the potential conflict that an investment bank confronts when, after advising on a transaction, the bank also is asked to deliver a fairness opinion, so those clients seek a second fairness opinion from a different investment bank. And, in those circumstances, some banks recommend that clients seek a second fairness opinion.[220] One leading investment bank reportedly refuses to deliver a fairness opinion to a target if that bank also is assisting the acquirer to finance the transaction.[221]

B. Disclosure

1. Disclosing the Definition of Fairness

The phrase employed by bankers when delivering fairness opinions is that the offered consideration is "fair from a financial point of view."[222] Bankers, however, do not define this critical term. Because the offered consideration may be fair under one definition of fairness but unfair under a different definition, bankers retain discretion that may be exercised—subject to the influences of incentives and biases—to deliver the opinion favored by the client. To lessen such influences, bankers should disclose their definition of fairness in the opinion[223] but should remain free to define fairness as they see fit. For example, the opinion could state that "the price is fair compared to the pre-merger-announcement stock price or fair compared to the price the company would carry in an auction."[224] Bankers' exercise of discretion when defining fairness would be disciplined by the reac-

218. *See* Council Directive, 78/885, art. 10, Ch. II, 1978 O.J. (L295) (EC); Carney, *supra* note 70, at 537.

219. *See* COX ET AL., *supra* note 46, at 3-7. Some states engage in merits regulation, *see id*. at 15, but the significance of state regulation may be on the decline. *See generally* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 (exempting certain securities offerings from state requirements regarding registration and reporting); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 126 S. Ct. 1503, 1514-15 (2006) (holding that federal legislation preempts state-law holder class actions); Edgar v. MITE Corp., 457 U.S. 624, 646 (1982) (holding that federal legislation regarding disclosure preempted state statute that permitted state to adjudicate the fairness of certain acquisition offers).

220. *See* Davis & Berman, *supra* note 6.

221. *Id.*

222. *See, e.g.*, SBC Commc'ns, Inc., Securities Registration (Form S-4), at C-3 (Mar. 11, 2005) (Fairness Opinion of Morgan Stanley & Co., addressed to the Board of Directors of AT&T, dated Jan. 30, 2005).

223. *See In re* Staples, Inc., S'holders Litig., 792 A.2d 934, 955 (Del. Ch. 2001) ("[I]t is important that the Staples stockholders know how the Staples board defined its approach to value.").

224. Bebchuk & Kahan, *supra* note 3, at 46-47.

tions of the market and the judiciary. The disclosure of a definition is hardly demanding.[225] Nor would disclosure of the definition have unintended consequences in the way that disclosure of a bank's financial analysis might.[226]

Perhaps, the nondisclosure of the definition suggests that the market does not value the information. On the other hand, perhaps bankers have not disclosed the definition to retain discretion, which is exercised to further their self-interest.

2. Disclosing Fees and Other Potential Conflicts

To quiet the influence of troubling incentives and biases, disclosure of fees and other conflicts could be required. The federal government required such disclosures of accountants.[227] Prior to Congress prohibiting accountants from providing both auditing services and fairness opinions, the Commission generally required the disclosure of fees paid to an accountant that provided both auditing and non-auditing services to a particular client.[228]

Even absent a rule requiring disclosure, banks generally disclose the fact that they will collect a success fee, contingent on the consummation of the transaction.[229] Such voluntary disclosures, however, do not set forth the magnitude of the success fee or the ratio of the success fee to the flat fee for issuing the fairness opinion.[230] Disclosure of such facts would not only be valuable to investors but also could lessen the troubling incentives and biases to which banks are subject. Such disclosure may have been valuable at some point in the past but seemingly would be of less value today. It is no longer a secret that an investment bank commonly collects a sizeable fee that is contingent on the successful completion of a transaction on which that bank has opined. So, if we know that banks commonly collect success fees, then unless we are instructed otherwise, won't we assume that the target's bank will collect a success fee and that the success fee will be as large as similar transactions? The failure to disclose the details allows the market

225. *See id.* at 47.
226. *See infra* note 281 and accompanying text.
227. *See* Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 76,008 (Dec. 5, 2000).
228. The Sarbanes-Oxley Act, 15 U.S.C. § 78j-1(g) (Supp. III 2003); Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 76,008.
229. *See, e.g.*, SBC Commc'ns, Inc., Registration Statement (Form S-4), at B-2 (Mar. 11, 2005) ("We have acted as financial advisor to the Board of Directors in connection with the Merger and will receive a fee for our services, a significant portion of which is contingent upon the consummation of the Merger.") (Fairness Opinion of Credit Suisse First Boston, L.L.C., addressed to the Board of Directors of AT&T Corp., dated Jan. 30, 2005). Although commonly disclosed voluntarily, the NASD has proposed a rule that would require its members to make descriptive (not quantitative) disclosures regarding the existence of contingent fees. *See* Notice of Filing of Proposed Rule Change and Amendment Nos. 1, 2 and 3 thereto to Establish New NASD Rule 2290 Regarding Fairness Opinions, 71 Fed. Reg. 18,395, 18,398 (April 11, 2006) [hereinafter NASD Notice of Filing].
230. *See, e.g.*, NASD Notice of Filing, *supra* note 229, at 18,398.

to wonder about the magnitude of the success fee, and the market will not wander to a conclusion that the success fee is minuscule.[231]

Aside from contingent fees, banks commonly disclose certain facts that could influence a bank's independence when opining on the fairness of a transaction. In the short opinion letter, banks voluntarily disclose the existence of prior engagements by the client receiving the opinion letter.[232] Such voluntary disclosures may enable others to determine whether those prior relationships will taint the bank's judgment regarding its fairness determination. Voluntary disclosures also acknowledge the possibility of future engagements by the target or by the acquirer.[233] Moreover, a bank commonly acknowledges that another division of that bank may trade in the securities of the target or the acquirer.[234] An ethical wall separates those divisions to prevent the activities of one division from influencing the activities of another division.[235]

3. Disclosing the Range

Requiring the public disclosure of the range of prices deemed fair may lessen the troubling incentives and biases to which bankers are subject, but ultimately, disclosure of the ranges may be unnecessary or counterproduc-

231. Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 683 (1984) ("Silence means bad news."). As opposed to targets, banks may be hesitant to disclose their fees for any number of reasons.

232. *Compare* Bell Atl. Corp., Registration Statement (Form S-4), at f-1 (Apr. 13, 1999) ("We . . . acted as financial advisor to the Company in connection with the Company's acquisition of BBN Corporation in 1997; . . . acted as financial advisor to the Company in connection with the Company's attempted acquisition of MCI Communications Corporation in 1997; . . . acted as managing underwriter of a public offering of $2.1 billion of debentures issued by the Company on April 22, 1998; and . . . acted as financial advisor to the Company in connection with the Agreement.") (Fairness Opinion of Goldman Sachs & Co. addressed to the Board of Directors of GTE Corp., dated July 27, 1998), *with* SBC Commc'ns, Inc., Registration Statement (Form S-4), at B-2 (Mar. 11, 2005) ("From time to time, we and our affiliates have in the past provided and in the future we may provide, investment banking and other financial services to the Company and the Acquiror, for which we have received, and would expect to receive, compensation.") (Fairness Opinion of Credit Suisse First Boston, L.L.C., addressed to the Board of Directors of AT&T Corp., dated Jan. 30, 2005). Although commonly disclosed voluntarily, the NASD has proposed a rule that would require its members to make descriptive (not quantitative) disclosures regarding past and contemplated future material relations. *See* NASD Notice of Filing, *supra* note 229, at 18,398.

233. *See* SBC Commc'ns, Inc., Registration Statement (Form S-4) at B-2 (Mar. 11, 2005) ("[I]n the future we may provide[] investment banking and other financial services to the Company and the Acquiror . . . .") (Fairness Opinion of Credit Suisse First Boston, L.L.C., addressed to the Board of Directors of AT&T, dated Jan. 30, 2005).

234. *Id.* ("In the ordinary course of business, CSFB and its affiliates may acquire, hold or sell, for their own accounts and the accounts of customers, equity, debt and other securities and financial instruments (including bank loans and other obligations) of the Company, the Acquiror and any other company that may be involved in the Merger, as well as provide investment banking and other financial services to such companies.").

235. The ethical wall may be permeable. For discussion of certain conflicts within investment banks recently brought to life by New York Attorney General Eliot Spitzer, see DONNA M. NAGY ET AL., SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS 755 (2003) and Robin Sidel, *Sorry, Wrong Number: Some Untimely Analyst Advice on WorldCom Raises Eyebrows*, WALL ST. J., June 27, 2002, at A12, but few doubted the existence of such conflicts prior to those enforcement actions.

tive. If there is a range of prices that is fair to selling shareholders, then the offered consideration theoretically would fall within one of five general categories—below the range, low in the range, middle of the range, high in the range, or above the range.

Below the Range or Low in the Range. If the target's banker determines that the offered consideration is below the range, then the banker will refuse to deliver a fairness opinion.[236] We might be concerned that, given the troubling incentives and biases to which bankers are subject, the banker exercises discretion to enlarge the range to capture a low offer or to skew the range downward to improve the appearance of a low offer.

A rule that requires banks to disclose the range of prices deemed to be fair would lessen (but not eliminate) banks' discretion when conducting their fairness analyses. Lessening their discretion would lessen the troubling incentives and biases to which banks are subject. Armed with the range of prices deemed fair by target's banker (rather than just a hollow conclusion of fairness), target shareholders and the market would be better able to assess whether the bank expanded or skewed the range to deliver the opinion requested by management. For example, extremely large ranges invite skepticism of the underlying analysis.[237] Also inviting skepticism of the underlying analysis are ranges skewed to improve the appearance of the offered consideration.

The failure of banks to disclose a price range may be alleviated to a certain extent by the market. Once the transaction price is announced, the media commonly compare the premium offered by the acquirer to the premia offered in comparable transactions. For example, the *New York Times* recently reported that Wachovia would acquire SouthTrust Corporation for at least (the then-current market capitalization of) $11.5 billion.[238] The *Times'* article indicated that "[b]ank acquisitions typically carry a 20 percent to 30 percent premium over the market value of the acquired entity—meaning

236. In a hostile setting, the concern is that the unwilling target's banker will opine that the offered consideration is inadequate. Incentives and biases remain at play and may lead the banker to deliver the opinion favored by target's management. Armed with an opinion that the offered consideration is inadequate, target's management is better able to counsel target's shareholders against selling for too little.

237. *See, e.g.*, *In re* Genentech, Inc., S'holders Litig., Civ. A. No. 11377, 1990 WL 78829, at *8 (Del. Ch. June 6, 1990) (noting a range of $10-$47 per share is "of little or no help to a shareholder trying to determine the value of a company" and "[t]he breadth of the ranges are not surprising when one examines the highly speculative information upon which they were calculated"); Paramount Commc'ns, Inc. v. Time, Inc., Civ. A. Nos. 10866, 10670, & 10935, 1989 WL 79880, at *13 (Del. Ch. July 14, 1989) ("In the longer term, Time's advisors have predicted [a] trading range[] of . . . $208-$402 for 1993[;] . . . a range that a Texan might feel at home on."). Courts may unintentionally and implicitly encourage banks to generate overly large ranges because they are deemed of little help or speculative, rendering them immaterial and not subject to disclosure. Requiring disclosure of the range would better discipline banks, but required disclosure still seems ill-advised for the reasons discussed in the text. The NASD's proposed Rule 2290 Regarding Fairness Opinions does not require disclosure of the price range. *See* NASD Notice of Filing, *supra* note 229, at 18,399-400.

238. Timonthy L. O'Brien & Andrew Ross Sorkin, *Wachovia Moves to Buy Big Lender in Alabama*, N.Y. TIMES, June 21, 2004, at C1; *see also* Robin Sidel, *Modest Premium for Bank One May Give Other Buyers a Signal*, WALL ST. J., Jan. 16, 2004 , at C3 ("Bank deals sported . . . premiums, on average: 21.3% [in 2003] and 15.3% in 2002.").

that SouthTrust may be sold for more than $14 billion."[239] Regardless of the content of any investment banker opinion regarding the transaction, shareholders of SouthTrust might expect that an acquisition price of $14 billion (twenty percent premium) would be low in the range and $15 billion (thirty percent premium) would be high in the range. If, following such disclosure by the media, the deal price were announced at $12 billion and a banker disclosed a range of $12-$14 billion, then the market would view the bank and its analysis skeptically. Aside from transaction premia, the media may identify other comparable data to enlighten shareholders.[240] Extensive media coverage of acquisitions of publicly held companies seemingly alleviates certain nondisclosures by banks of price ranges, weakening the argument of compelled disclosure.[241]

Middle of the Range. If the bank's analysis suggests that the offered consideration is in the middle of the range, then the opinion says what it should say: The transaction is fair. Requiring disclosure of the range adds little, if anything, to the mix.[242]

High in the Range. If the offered consideration falls high in the range identified by target's bankers and if the bankers disclose the range, then target shareholders may benefit. Those shareholders are comforted that they are selling for relatively high consideration and can vote/tender on an informed basis. When the offered consideration falls high in the range, however, the disclosure of that range may have unintended consequences.

Rather than assist selling shareholders, disclosure may harm them. The acquirer wants to pay as little as possible for the target. Once the target's banker opines to the public that the offered consideration is high in the range, then the acquirer reasonably will believe that it could have offered less and still succeeded with the acquisition. It may seem that the acquirer has learned of the range too late—only after the acquirer and target reached an agreement regarding the acquisition price. The problem is that target will "inevitably breach"[243] the transaction agreement. In the typical transaction agreement, the target will make representations and warranties about itself and its business, which presumably will be true at the time made. The typical transaction agreement will also require the target to reaffirm those repre-

239. O'Brien & Sorkin, *supra* note 238.

240. *See, e.g.*, Dennis K. Berman & Christopher J. Chipello, *Kinder Morgan to Buy Terasen For $3.1 Billion*, WALL ST. J., Aug. 2, 2005, at C5 ("Kinder is paying about 23.8 times Terasen's estimated 2005 earnings, . . . compared with 17.7 times recent Canadian pipeline deals.").

241. Some believe that, when the offered consideration falls low in the range, the disclosure of that range may harm target shareholders. Arnold v. Soc'y for Savs. Bancorp., Inc., 650 A.2d 1270, 1282-83 (Del. 1994). Those shareholders, the argument goes, will refuse to sell for a premium price because of an unrealistic belief that a subsequent higher bid may be forthcoming. *Id.* ("Disclosing an overly optimistic per share figure may be harmful because it might induce stockholders to hold out for an elusive, higher bid."). Withholding the range from shareholders solely for paternalistic reasons does not seem compelling.

242. *See* Goodwin v. Live Entm't, Inc., No. Civ. A. 15765, 1999 WL 64265, at *11 (Del. Ch. Jan. 25, 1999) (noting that the range is immaterial when it simply affirms the board's recommendation).

243. OESTERLE, *supra* note 13, at 288.

sentations and warranties at the time that the transaction is closed.[244] "[B]ecause of the delay between [signing and closing] and the complexity of most businesses[,] . . . sellers . . . sign[] an agreement that they will, in most cases, inevitably breach."[245] A breach by the target invites renegotiation, at which point the acquirer is now armed with the range of the target's banker. The disclosure of the range, which was intended to benefit target shareholders, may work to their detriment. Courts have counseled against required disclosure that hampers the disclosing parties' ability to negotiate.[246] Disclosure of the range seemingly hampers the disclosing parties' ability to negotiate.

Above the Range. Presumably, once an unrelated third party offers consideration, then the offered consideration could be at the top of the range but could not exceed the range. Even if the offer could exceed the range, requiring disclosure of the range could unintentionally harm target shareholders for the reasons in the previous paragraph.

4. Disclosing Analysis

The investment bank typically delivers to the target's board of directors a short opinion letter, a detailed written analysis,[247] and an oral presentation regarding that detailed analysis. A copy of the bank's short opinion letter commonly will be forwarded to shareholders.[248] None of the detailed analysis, the assumptions underlying that analysis, or a summary of that analysis may be forwarded to shareholders.[249] Nor are they generally required by

244. *Id.* at 264 ("One of the important conditions [to closing the transaction] is a *'bring down' clause* in which the seller reaffirms all of the representations as accurate as of the closing date.") (emphasis added).

245. *Id.* at 288.

246. *See In re* Pure Res., Inc., S'holders Litig., 808 A.2d 421, 450 (Del. Ch. 2002) (opining that the "desire to conceal the bankers' work during ongoing negotiations might make some sense . . . [so as to preserve the confidentiality of their] reserve price"); Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 289-90 (Del. Ch. 1989). In *Shamrock*, the target had won a judgment of liability against a patent infringer and was about to commence the damages portion of the trial, when acquirer made a tender offer to acquire shares of target. *Id.* at 279. The target opposed the tender offer as inadequate because the acquirer undervalued the amount to be recovered in the upcoming damages suit, but the target refused to disclose "the likely amount of any recovery or when such a recovery may be obtained." *Id.* at 290. The court counseled against requiring disclosure of such matters because if disclosure were required, then the target's "bargaining position with [the patent infringer] could be seriously weakened." *Id*.

247. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 357 n.20 (Del. 1993) (describing analysis as a "78-page 'board book,'" that "included median and mean values for other similar companies, a comparison of acquisitions in the motion picture business, a common stock comparison for other retailing companies, the financial performance of [target] and its constituent businesses, a profit and loss statement for each of [target]'s major divisions, projections for [target] through 1989, projections on [acquirer]'s ability to consummate the transaction, and a Standard and Poor's tear sheet on [acquirer]"); *In re* Genentech, Inc., S'holders Litig., Civ. A. No. 11377, 1990 WL 78829, at *4 (Del. Ch. June 6, 1990) (including "a binder with some 110 pages of financial analyses based on share price analyses, discounted cash flow analyses, purchase price ratio analyses and comparable company valuations"); Thompson, *supra* note 5, at 467 n.64 ("The 'blue book' contains the analysis which serves as the basis of the fairness opinion [delivered to the board].").

248. *See In re Genentech*, 1990 WL 78829, at *8.

249. Thompson, *supra* note 5, at 467 (noting the data underlying the fairness opinion is presented to

statute or rule to be made available to shareholders.[250] Shareholders may be asked to sell their shares but lack the valuation information resting in the hands of the board of their corporation.[251]

Perhaps the bank's analyses and underlying assumptions should be made available to shareholders. Consider the impact on various groups effected by a rule requiring disclosure. Requiring disclosure of banks' analysis and assumptions would better discipline banks and directors by arming investors with helpful information. Arming third-party acquirers with such information may work to the detriment of the shareholders intended to benefit from such disclosure.

Target's Directors. Requiring disclosure of a bank's analysis and assumptions would deter directors from relying on shoddy fairness opinions. Perhaps the most significant reason that directors seek fairness opinions can be traced to *Van Gorkom* in which the Delaware Supreme Court suggested that a fairness opinion shields a director from an allegation that she breached her duty of care.[252] Disclosure of the analysis (on top of the short opinion letter) may further evidence the information gathered. Disclosure could reduce litigation. Disclosure could also increase litigation. Unless the board always negotiates to the price at the top of the range, disclosure may suggest (frequently wrongly) that the board negotiated poorly.[253] Unless the board always negotiates to the price at the top of the range, dissatisfied shareholders will sue, and they will be armed—at no cost—with expert fi-

---

the board of directors).

250. *See* Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1173-74 (Del. 2000); *In re Pure Res.*, 808 A.2d at 449 ("Delaware courts have been reluctant to require informative, succinct disclosure of investment banker analyses in circumstances in which the bankers' views about value have been cited as justifying the recommendation of the board."); Abbey v. E.W. Scripps Co., Civ. A. No. 13397, 1995 WL 478957, at *3 (Del. Ch. Aug. 9, 1995) ("While the role and opinion of a banker may usually be claimed material to a shareholder, all of the work and consideration that enter into the ground leading to that opinion will, in my opinion rarely if ever be material."). Federal rules generally do not require such disclosure in transactions with unrelated parties but do require disclosure in going-private transactions. *Compare* SEC Sched. 14A, Item 14(7)(b)(6), 17 C.F.R. § 240.14a-101 (2005) ("*If* a report, opinion or appraisal materially relating to the transaction has been received from an outside party, *and is referred to in the proxy statement*, furnish [, among other things, a summary of the report, opinion, or appraisal].") (emphases added), *with* SEC Sched. 13E-3, Items 8 & 9, 17 C.F.R. § 240.13e-100 (2005) (requiring, among other things, disclosure of a summary of any report, opinion, or appraisal received from an outside party that is materially related to the going-private transaction). Despite the apparent absence of statute or rule, the Commission reportedly may require the disclosure of a summary of the banker's analysis. NASD Notice of Filing, *supra* note 229, at 18,395. Proposed NASD Rule 2290 would not require members to disclosure their analysis when issuing opinions but would require the disclosure of categories of information that formed a substantial basis for the opinion that were supplied by the client and whether the member verified that information (if the fairness opinion is provided, described, or referenced to public shareholders). *See id.* Requiring such disclosure may lose import because members may respond by disclosing the "laundry list." *See* Sweeney, *supra* note 6, at 48.

251. *Abbey*, 1995 WL 478957, at *3.

252. *See* Smith v. Van Gorkom, 488 A.2d 858, 886, 890-93 (Del. 1985) (discussing the board's failure to obtain an internal or external valuation).

253. Parties negotiate over many terms, with price being only one of those terms. Consider the purchase of a car. Paying a little more than your neighbor does not necessarily indicate you are a poor negotiator if (unlike your neighbor) you also received an extended warranty, a GPS system, and Bluetooth capabilities.

nancial analysis indicating that the board left money on the table. Shielding the board from meritless litigation may counsel against requiring disclosure.

Other rules—such as section 102(b)(7) of the Delaware General Corporation Law[254] and counterparts in other states[255]—may allow for solutions more tailored to the problem than simply refusing to require disclosure, but even Section 102(b)(7) can be circumvented.[256]

The Opining Investment Bank. The bank may oppose disclosure of its underlying analysis and assumptions because disclosure could reveal the analysis as poorly reasoned or the assumptions as unjustified. Disclosure could harm the bank even if the bank's opinion (that the offered consideration is fair) is correct. Requiring disclosure would better discipline banks and would lessen the troubling incentives and biases to which banks are subject. On the other hand, requiring such disclosures of banks may lead banks to include even more qualifications to their analyses, making those analyses even less worthwhile.[257]

Target's Institutional Shareholders. Institutional shareholders generally find the bank's short opinion letter to be of "little value"[258] and the bank's analysis and assumptions to be "helpful."[259] Compared to small shareholders, institutional shareholders are much more likely to read and understand a bank's analysis and assumptions, if disclosed. Denied such disclosures, institutions may undertake their own analyses or rely on their own experts, such as Institutional Shareholders Services, Inc.[260] Perhaps, a rule requiring

254. DEL. CODE ANN. tit. 8, § 102(b)(7) (2005) authorizes the inclusion in the certificate of incorporation a provision eliminating directors' personal liability to the corporation or shareholders for money damages for breach of the duty of care. *See* CHOPER ET AL., *supra* note 9, at 112-13.

255. Shortly after Delaware adopted D.G.C.L. § 102(b)(7), "more than 40 states had adopted some form of legislation designed to reduce the risk of directors' personal liability for damages, and almost all presently have some type of provision directed to this end." CHOPER ET AL., *supra* note 9, at 112 n.49.

256. *See* Alidina v. Internet.com Corp., Civ. A. No. 17235-NC, 2002 WL 31584292, at *8 (Del. Ch. Nov. 6, 2002) ("I cannot dismiss plaintiffs' duty of care claim based upon an exculpatory provision contained in the [corporation's] charter. As [precedents] instruct, when a duty of care breach is not the *exclusive* claim, a court may not dismiss based upon an exculpatory provision. Because the duty of loyalty is implicated in this case, the § 102(b)(7) provision cannot operate to negate plaintiffs' duty of care claim on a motion to dismiss.") (footnotes omitted).

257. *See In re* Genentech, Inc., S'holders Litig., Civ. A. No. 11377, 1990 WL 78829, at *9 (Del. Ch. June 6, 1990) ("To minimize such potential harm the [information] sought by plaintiffs would necessarily have to be qualified so heavily that [its] already marginal value would decrease.") (footnote omitted).

258. Comment Letter from Ann Yerger, Executive Dir., Council of Institutional Investors, to Barbara Z. Sweeney, Office of the Corporate Sec'y, NASD (Jan. 12, 2005), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013221.pdf (commenting on Proposed NASD Rule 2290 regarding Fairness Opinions). "During a 2002 meeting with the Delaware Chancery Court, Council members complained that fairness opinions were of little value to shareowners and that additional information—projections, assumptions, discount rates, information about who provided the estimates and the date of the projections used—would be helpful." *Id*.

259. *Id*. Current federal and state disclosure requirements generally hinge on the information being material, not helpful. *See, e.g.*, Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1174 (Del. 2000) ("Omitted facts are not material simply because they might be helpful."). Nonetheless, regulators may require disclosure of information, even if the bar seems to be set at a point that captures a large quantity of immaterial information. *See generally* Regulation S-K, Item 404(a), 17 C.F.R. § 229.404(a) (2006) (requiring disclosure of $120,000 interests).

260. *See* Hewlett v. Hewlett-Packard Co., No. Civ. A. 19513-NC, 2002 WL 818091, at *8 (Del. Ch. Apr. 30, 2002) ("[I]t was widely known that Institutional Shareholder Services, Inc. ('ISS') played a

banks to disclose their analyses would be of value because each institution might not need to conduct its own analysis (which would be redundant to that undertaken by the opining bank)[261] and because there would be less need for an institution to retain its own expert.

Most institutions, however, "have incentives to keep corporate managers happy . . . [and] conflicts of interest . . . tilt the voting calculus to some extent away from maximizing share value,"[262] depending on the degree of the conflict and depending on the nature of the transaction. Given such conflicts, institutions may place lower value on the analysis and assumptions that undergird the bank's fairness opinion, lessening the benefit of required disclosure.

Moreover, institutional shareholders are subject to cognitive biases. When making a decision, an individual recognizes that she lacks perfect information.[263] Studies suggest that individuals follow the lead of the herd—thinking that those in the herd possess knowledge that the individuals lack—even if the individuals possess some knowledge suggesting that the herd may be following the wrong course.[264] Investors exhibit herd behavior, and so do those that advise investors.[265] Following the herd may yield profits in the short-run.[266] Other forces may countervail the herding tendency. [267] If the herd has headed in the wrong direction, deviating from the herd will yield profits eventually.[268] The catch may be that deviating from the herd may not be profitable until others learn the truth. Sometimes, the truth comes quickly; other times, the truth is slow to emerge.[269] Responding to

---

critical role, because several institutions usually follow ISS recommendations . . . .").

261. EASTERBROOK & FISCHEL, *supra* note 50, at 287 ("Investors produce too much information . . . if several create the same . . . bit of information (redundant production). Mandatory disclosure will prevent redundant production of information, the argument concludes.").

262. Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 606 (1990); *see* CHOPER ET AL., *supra* note 9, at 562; Black, *supra*, at 595-604 (describing the conflicts of various institutions).

263. *See* Herbert A. Simon, *Rationality as Process and as Product of Thought*, 68 AM. ECON. REV. 1 (1978); Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 117-18 (1955).

264. Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 Q.J. ECON. 797, 798 (1992). *See generally* Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683, 685-86 (1999) (describing "informational cascades"); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 465, 466, 477 (1990).

265. Werner F.M. De Bondt & Richard H. Thaler, *Do Security Analysts Overreact?*, 80 AM. ECON. REV. 52 (1990); *see* Scharfstein & Stein, *supra* note 264, at 477 (discussing herd behavior by money managers); Ivo Welch, *Sequential Sales, Learning, and Cascades*, 47 J. FIN. 695 (1992).

266. *See* Yahoo Financial Education Center, *Gaining Speed: Momentum Investing*, http://biz.yahoo.com/edu/st/ir_st3.ir.html (last visited Oct. 30, 2006) (describing momentum investing).

267. *See* Scharfstein & Stein, *supra* note 264, at 475.

268. *Id.*

269. The truth may be slow to emerge if analysts neglect to study a company's public disclosures or fail to understand them. *See generally* John R. Emshwiller & Gary McWilliams, *Executives on Trial: Enron Testimony Focuses on Disclosure Timing*, WALL ST. J., Feb. 24, 2006, at C3 ("[B]ased on her [Paula Rieker, Enron's former corporate secretary and deputy investor-relations chief] experience in investor relations few analysts closely read SEC filings."); Sheila McNulty, *Enron Lawyers Diverge on Defense Tactics*, FIN. TIMES, Jan. 26, 2006, at 28 ("[E]ven Wall Street analysts who covered the company admitted they did not understand its books . . . .").

clients, institutional shareholders may place excessive emphasis on the short-term.

Decision-makers fear the negative consequences of their decisions. For example, one thinks—would I rather be the only one who is wrong, or would I rather be wrong in the company of others? "[A]n unprofitable decision is not as bad for reputation when others make the same mistake . . . ."[270] Consequently, investors may place too little weight on private information and too much weight on the behavior of others.[271] Recall that, due to conflicts of interest, institutions may vote in a value-maximizing manner for the institution qua institution but in a non-value-maximizing manner for the institution qua shareholder.[272] Herding tendencies may compound the problem, and, because information in one's possession may be ignored to follow the herd, disclosure may not provide a cure.

Furthermore, just like small shareholders, certain institutions suffer from collective action and free-riding problems.[273] Mutual funds, for example, compete for investment dollars on the basis of their bottom lines.[274] Funds may be hesitant to expend resources analyzing transactions involving companies in which the funds have an interest and instead wait for voting cues from other institutions.

Small Shareholders of Target. The disclosure of the short letter opinion in proxy materials suggests that directors include the information to persuade shareholders.[275] The conclusion in the opinion may persuade, but shareholders may place undue emphasis on that conclusion when denied the opinion's underlying analysis and assumptions. Disclosure of the underlying analysis and assumptions may prevent misleading disclosures. This argument seemingly suffers from a critical flaw. Small shareholders do not read the proxy materials nor the target's Schedule 14D-9,[276] much less any complicated analysis that might be included therein. Faced with difficult decisions that require the digestion of complex information, people commonly seek shortcuts.[277] For example, most of the populace does not pour over the

---

270. Scharfstein & Stein, *supra* note 264, at 466.

271. *See id.* at 468.

272. Black, *supra* note 262, at 606.

273. *See* CHOPER ET AL., *supra* note 9, at 560-61. As the cost of gathering information increases, investors will be encouraged to free-ride on others, "exacerbat[ing] the herding problem." Banerjee, *supra* note 264, at 816.

274. *See generally* William Francis Galvin, Sec'y of the Commonwealth of Mass., *What You Should Know About Mutual Funds*, http://www.sec.state.ma.us/sct/sctprs/prsamf/amfidx.htm (last visited Oct. 30, 2006).

275. *See* Herskowitz v. Nutri/System, Inc., 857 F.2d 179, 184 (3d Cir. 1988) ("The fairness opinion had independent significance to shareholders, for it was obtained by the disinterested directors for the purpose of determining whether the offer from management was fair. It was, moreover, an opinion of an expert on valuation."); Elson, *supra* note 69, at 951 (identifying "securities holders whose actions [*e.g.*, sales in a tender or votes in a merger] these [fairness] opinions are designed to influence").

276. *See* CHOPER ET AL., *supra* note 9, at 560-61. A Schedule 14D-9 is an information document sent by a company (that is subject to a tender offer) to its shareholders, which includes the company's recommendation to accept or reject the tender offer. *See* 17 C.F.R. § 240.14e-2 (2005); 17 C.F.R. § 240.14d-101 (2005).

277. *See generally* JOHN G. MATSUSAKA, FOR THE MANY OR THE FEW: THE INITIATIVE, PUBLIC

details of political candidates' healthcare plans, even though healthcare is important to those same voters.[278] Instead, voters use shortcuts (such as political party affiliation) when voting their preferences.[279] When shareholders vote or decide to tender, they may seek shortcuts to make their decision. Where, as assumed here, the directors are disinterested and favor the transaction and where the shareholders have an expert's conclusion (even if not the expert's underlying analysis), the shareholders have the information that they want.[280] While others may benefit from disclosure of the analysis and assumptions undergirding a fairness opinion, small shareholders do not benefit directly.

Third Party Acquirers. Third party acquirers may be the most significant beneficiaries of a rule requiring the disclosure of a bank's analysis and assumptions. If the disclosure regarding the bank's work is limited to its conclusion that the offered consideration is fair, then third party acquirers must expend resources to determine their ability and willingness to top the original offer. If rules required the disclosure of the bank's analysis and assumptions, then third parties could free-ride on expenses borne by the target, which may enable a third party bidder to top the original bid. As a first pass, target shareholders may rejoice over a rule requiring disclosure of the analysis of its bank if the rule breeds subsequent higher bids. If such disclosures, however, decrease the likelihood that the original bidder actually acquires the target, those required disclosures may deter the original bidder from making the initial bid. If the original bidder never appears, then there may never be any subsequent bidders, and the disclosure rule, which was intended to benefit target shareholders, actually prevents value-creating transactions that would benefit target shareholders.[281]

POLICY, AND AMERICAN DEMOCRACY 10 (2004) ("Voters may not need a detailed (or 'substantive') understanding of a measure in order to accurately register their preferences in the voting booth. They may be able to cast a 'competent' vote (meaning a vote that reflects their underlying interests and values) by using information cues or shortcuts, such as recommendations from trusted organizations or individuals.").

278. *Id.*

279. *Cf. id.* ("[A]n environmentalist can cast the 'right' vote (that is, a vote consistent with his or her values) on an environmental ballot proposition simply by learning whether the Sierra Club is for or against the measure, without reading or understanding anything in the voter's handbook.").

280. *See generally* Matador Capital Mgmt. Corp. v. BRC Holdings, Inc., 729 A.2d 280, 297-98 (Del. Ch. 1998) ("I am unable to conclude that this case presents the unusual circumstances in which the disclosure [of the banker's methods and assumptions] would be material to stockholders in determining whether or not to tender their shares. The [banker's] analysis is consistent with the opinion it gave and supportive of the directors' recommendation. . . . [W]hile stockholders might find it of interest to know . . . the ranges of value reflected in [the banker's] work, I am unable to conclude that a reasonable stockholder would consider such information important in deciding whether or not to tender his or her stock.").

281. *See* OESTERLE, *supra* note 13, at 486; Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 DUKE L.J. 945, 969-71 (1993) (discussing required disclosures in the context of tender offers). Although disclosure by the media may educate third-party acquirers, which disclosures may be sufficient for the decision confronting shareholders, such disclosures may be insufficient for the decision confronting third-party acquirers.

C. Directorial and Judicial Scrutiny

No reasonable rule can eliminate the exercise of discretion by bankers when examining the fairness of offered consideration. For example, no rule should require bankers to utilize a particular valuation technique. Continuing the example, why accord much, if any, weight to the value derived from a comparable transactions analysis if there have been no recent comparable transactions? Instead, before directors should be able to give any weight to the fairness opinion, directors should be expected to scrutinize more closely the banker, the target's relationship with the banker, and the banker's analysis and assumptions. And courts should scrutinize more closely the directors' scrutiny. Because of the difficulty of developing broad rules that speak to the valuation process, enforcement on a case-by-case basis seems appropriate.[282] Enforcement of existing rules may achieve that end.

Section 141(e) of the Delaware General Corporate Law permits directors to rely in good faith upon the opinion of one who is selected with reasonable care and whose opinion is reasonably believed to fall within their professional competence.[283] Directors should scrutinize the terms of the bank's engagement letter. The compensation scheme may render any reliance on the banker's opinion unreasonable. This is not to say that success fees should be impermissible, but as the success fees become larger and larger or as the success fee dwarves the flat fee for the opinion, then reliance on the banker's opinion becomes less and less reasonable. At some point, such reliance does not seem in good faith or suggests that the directors did not select the banker with reasonable care. Although directors may not be able to eliminate bankers' incentive to secure new clients and retain existing clients, directors may witness behavior that evidences bankers' anxiousness to deliver requested opinions without firm foundation. For example, when a banker comes to a meeting of directors with a draft fairness opinion where the price is left blank,[284] directors' suspicions should be aroused, possibly rendering unreasonable any reliance on the conclusions reached in that opinion. Furthermore, directors should scrutinize the banker's underlying analysis. Blind reliance is not reasonable;[285] directors should question bankers regarding their analysis, their assumptions, and the impact of those assumptions on the bankers' conclusions.[286] And in scrutinizing the bankers' conclusion that the transaction was "fair," directors should understand the

282. *See* Comment Letter from Peter R. Douglas, Davis Polk & Wardwell, to Barbara Z. Sweeney, Office of the Corporate Sec'y, NASD (Feb. 1, 2005), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013247.pdf (commenting on Proposed NASD Rule 2290 regarding Fairness Opinions).

283. DEL. CODE ANN. tit. 8, § 141(e) (2005); *see also* MODEL BUS. CORP. ACT § 8.30(e) (1984).

284. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983).

285. *See* Smith v. Van Gorkom, 488 A.2d 858, 875 (Del. 1985) (calling for "good faith, not blind, reliance," recognizing a "duty . . . to make reasonable inquiry," and noting that if the board had made a reasonable inquiry, "the inadequacy of that upon which they now claim to have relied would have been apparent").

286. *See* Bebchuk & Kahan, *supra* note 3, at 47-49.

bankers' definition of "fair" and how a different definition would impact the bankers' conclusion.

In addition to courts re-scrutinizing the directors' scrutiny, courts should ensure that directors actually relied on the fairness opinion.[287] If fairness opinions are simply "make weight" or rubber stamps for decisions already made by directors, then directors may not have actually relied on those opinions.[288] Enforcement of existing rules on a case-by-case basis seems appropriate.[289]

CONCLUSION

Investment bankers act rationally when delivering fairness opinions, but, like other players in the mergers and acquisitions field, investment bankers may be subject to cognitive biases that distort their decision-making processes. The incentives and biases to which bankers are subject increase the likelihood that those bankers will deliver an opinion consistent with their clients' preferences, even if the quality of the opinion suffers in the process. Prohibiting conflicted bankers from issuing opinions or requiring additional disclosure may mute the troubling incentives and biases but could also create unintended problems. By enforcing existing rules—by permitting only reasonable reliance on bankers' opinions—on a case-by-case basis, the troubling incentives and biases may be lessened, if not eliminated.

287. *See* Ash v. McCall, No. Civ. A. 17132, 2000 WL 1370341, at *9 (Del. Ch. Sept. 15, 2000) ("[P]laintiffs have not alleged particularized facts . . . that . . . the directors in fact did not rely on the expert, or . . . that their reliance was not in good faith, or . . . that the directors were at fault for not selecting experts with reasonable care . . . .").

288. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) ("[I]t is apparent that the insiders on the board . . . decided from the start to block the tender offer, before its ramifications for shareholder welfare were considered; judgment first, trial later, as the Queen of Hearts said in *Alice in Wonderland*."), *rev'd on other grounds*, 481 U.S. 69 (1987); Schmitt, *supra* note 52 ("rubber stamps").

289. *See* Comment Letter from Peter R. Douglas, Davis Polk & Wardwell, to Barbara Z. Sweeney, Office of the Corporate Sec'y, NASD (Feb. 1, 2005), http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013247.pdf (indicating that thousands of opinions are issued annually and suggesting that the NASD proposal reveals only a small number of problematic opinions).