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Fairness Opinions and Negligent Misrepresentation: Defining Investment Bankers' Duty to Third-Party Shareholders

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NOTES

FAIRNESS OPINIONS AND NEGLIGENT MISREPRESENTATION: DEFINING INVESTMENT BANKERS' DUTY TO THIRD-PARTY SHAREHOLDERS

INTRODUCTION

The 1980s was a boom decade for corporate mergers and acquisitions. Although the actual number of corporate control transactions changed little from the 1970s, the size of these transactions mushroomed,[1] culminating in the $25-billion leveraged buyout[2] of RJR-Nabisco.[3] Investment bankers[4] were at the center of these enormous deals, which required the involvement of many professional intermediaries.[5]

Although investment bankers may play several roles in these complex deals,[6] use of their fairness opinions is so central to acquisitions of public companies that their non-use "would probably raise eyebrows."[7] A fair-

1. *See* Rosenbloom & Aufses, *On Understanding Investment Banker Liability*, 4 Insights, Apr. 1990, at 3; Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 Yale L.J. 119, 121 n.15 (1986) [hereinafter Note, *Fairness Opinions*].

2. A leveraged buyout is defined as a "takeover of a company, using borrowed funds." Barron's Dictionary of Finance and Investment Terms 209 (1985).

3. For an interesting insider's look at the role of investment bankers in the RJR-Nabisco deal, see B. Burrough & J. Helyar, Barbarians at the Gate: The Fall of RJR Nabisco (1990).

4. This Note refers to investment bankers as institutions, not individuals, and thus substitutes "it" for "investment banker" throughout. When shareholders sue investment banks for negligent misrepresentation, they really seek recovery from the investment banking institution—the deep pocket—not the individual bankers themselves. The exception, however, is when the institution goes bankrupt. *See, e.g.*, *In re* M.D.C. Holdings Sec. Litig., [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,729, at 98,446 (S.D. Cal. Nov. 21, 1990) (shareholders suing individual investment bankers, including Michael Milken, for negligent misrepresentation after Drexel Burnham's bankruptcy).

5. *See* J. Freund, Anatomy of a Merger: Strategies and Techniques For Negotiating Corporate Acquisitions 471 (1975). These intermediaries are important given management's frequent conflict of interest in corporate control transactions. *See id.*

Some commentators, however, look upon the intermediaries' role less favorably—as camouflage for interested directors to achieve their aims. *See, e.g.*, Macey & Miller, Trans Union *Reconsidered*, 98 Yale L.J. 127, 141 (1988) ("[C]orporate boards, aided by a phalanx of sophisticated lawyers and investment bankers, can cloak result-oriented decision-making in the guise of careful deliberation."); Stein, *A New Cloud Over Wall Street? Investment Banking's Dirty Little Secret*, N.Y. Times, June 8, 1986, § 3, at 2, col. 6 ("It is an open secret in the investment community that the writers of 'fairness letters' are paid huge sums to rubber stamp management's offer as 'fair.' ").

6. *See generally* Mancuso, *The Role of the Investment Banker in Public Leveraged Buyouts* in Leveraged Acquisitions and Buyouts 241-61 (1986) (investment bankers may sponsor or advise corporations in public leveraged buyouts).

7. 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, 1442 (1981); *see also* Bebchuk & Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 Duke L.J. 27, 27 (1989) (fairness opinions are often used in major control deals such as "negotiated mergers, freeze-out mergers, hostile tender offers,

ness opinion evaluates whether a transaction is fair to the parties involved from a financial point of view.[8] Corporate directors seek investment bankers' fairness opinions for several reasons,[9] including the assurance of a deal's financial soundness, because ascertaining the fair price of a deal "is an economic and financial determination as to which the investment banker's expertise is particularly fitted."[10]

On occasion, however, an investment banker may fail to apply its expertise properly and opine negligently on a deal's fairness.[11] Such negligence may hurt all who relied on the fairness opinion, including shareholders who lack contractual privity with the investment banker.[12] Recently, some courts have permitted third-party shareholders[13] to raise

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friendly tender offers, self-tenders, leveraged buyouts, negotiated share repurchases, . . . [and] negotiated sales of treasury stock") (footnotes omitted); Steinberg & Lindahl, *The Duty Owed to Minority Shareholders by an Investment Banker in Rendering a Fairness Opinion*, 13 Sec. Reg. L.J. 80, 80 (1985) (use of fairness opinions to influence minority shareholders in tender offers or mergers is widespread), *reprinted in* M. Steinberg, Securities Regulation: Liabilities and Remedies § 15.07, at 15-42 (10th rel. 1990); Winter, *On "Protecting the Investor,"* 63 Wash. L. Rev. 881, 895 n.44 (1988) (obtaining fairness opinion for the valuation of a merger is an "increasingly common practice").

8. *See* Bebchuk & Kahan, *supra* note 7, at 27; Note, *Fairness Opinions*, *supra* note 1, at 120. In particular, however, investment bankers are most concerned that transactions are fair from the perspective of the hand that feeds them—the interested officers and board members. *See infra* notes 48-50 and accompanying text.

9. *See infra* notes 26-30 and accompanying text.

10. M. Lipton & E. Steinberger, 1 Takeovers and Freezeouts § 8.06[2], at 8-24.5 (11th rel. 1990); *see also* J. Freund, *supra* note 5, at 471-72 ("The basic financial terms of a deal . . . are peculiarly the province of the investment banker."); Chazen, *supra* note 7, at 1442 ("Investment bankers have been held to be qualified professionals with regard to the value of securities.").

In reality, however, most corporate directors seek these opinions to help sway shareholders to approve deals and to satisfy their fiduciary duties. *See* Bebchuk & Kahan, *supra* note 7, at 28; *see also* Chazen, *supra* note 7, at 1442 (fairness opinion important because it may help to prove directors exercised reasonable business judgment); Smith v. Van Gorkom, 488 A.2d 858, 876-77 (Del. 1985) (directors might have avoided a breach of their fiduciary duties to shareholders by obtaining a fairness opinion). Furthermore, investment bankers "are sometimes no better equipped to form an opinion as to the fairness of a transaction than are the directors, particularly in transactions involving companies with substantial intangible assets, e.g., patents and trademarks, technological information and other proprietary information." Note, *Fairness Opinions*, *supra* note 1, at 135 n.89.

11. *See, e.g.*, Herskowitz v. Nutri/Sys., Inc., 857 F.2d 179, 182, 189-90 (3d Cir. 1988) (investment banker allegedly rendered fairness opinion negligently), *cert. denied*, 489 U.S. 1054 (1989); Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1124-25 (D.R.I. 1990) (same); Klein v. King, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615 (N.D. Cal. Mar. 26, 1990) (same); Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987) (same), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988); *see also* Schneider v. Lazard Freres & Co., 159 A.D.2d 291, 296-97, 552 N.Y.S.2d 571, 574-75 (1st Dep't 1990) (investment banker provided allegedly negligent advice to special committee on its auction of corporation).

12. *See Herskowitz*, 857 F.2d at 190; *Dowling*, 735 F. Supp. at 1124-25; *Klein*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615 (N.D. Cal. Mar. 26, 1990); *Wells*, 127 A.D.2d at 202-03, 514 N.Y.S.2d at 2.

13. Shareholders are third parties to the contractual relationship between the invest-

state law claims against investment bankers for negligently preparing fairness opinions, notwithstanding the absence of contractual privity.[14] Although under traditional tort principles the lack of privity bars third-party shareholders from suing investment bankers for negligence,[15] most states have nevertheless rejected the traditional privity defense in negligent misrepresentation suits involving professionals.[16]

These states are divided, however, over the appropriate scope of a professional's duty to third parties.[17] Moreover, courts have not given specific guidance on when investment bankers fail to meet this duty. So far,

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ment banker and the officers or directors of the corporation. The corporation's directors are not the agents of the shareholders from the traditional tort law perspective. *See* Continental Sec. Co. v. Belmont, 206 N.Y. 7, 16-18, 99 N.E. 138, 141-42 (1912); H. Henn & J. Alexander, Laws of Corporations § 207, at 562-63 (3d ed. 1983); *infra* note 162 and accompanying text.

14. *See* cases cited *supra* note 12; *see also Schneider*, 159 A.D.2d at 296-97, 552 N.Y.S.2d at 574-75 (investment banker hired by special committee in privity with shareholders and thus liable to them for negligently advising special committee on price's fairness).

15. The privity defense in negligence actions first arose in Winterbottom v. Wright, 152 Eng. Rep. 402, 404-05 (Ex. 1842). As early as 1874, a court in the United States required privity in a cause of action for negligent misrepresentation. *See* Kahl v. Love, 37 N.J.L. 5, 8-9 (N.J. 1874); Bagby & Ruhnka, *The Controversy Over Third Party Rights: Toward More Predictable Parameters of Auditor Liability*, 22 Ga. L. Rev. 149, 153 (1987). The Supreme Court held in 1879 that an attorney could not be liable to third parties for professional negligence, absent special circumstances such as fraud. *See* Savings Bank v. Ward, 100 U.S. 195, 200, 202-03 (1879). The seminal case, however, is Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 174 N.E. 441 (1931), where the New York Court of Appeals limited accountant liability in negligence to a "contractual relation, or even one approaching it." *Id.* at 183, 174 N.E. at 446. For a discussion of *Ultramares*, see *infra* notes 105-109 and accompanying text. "For years, *Ultramares* served to validate the use of the privity defense in nearly all types of professional liability suits based on negligence." Bagby & Ruhnka, *supra*, at 156-57 & n.36; *see infra* note 108 and accompanying text.

16. *See, e.g.*, Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 90-93 (D.R.I. 1968) (accountant liable to foreseen third-party corporation for negligent misrepresentation); Robert & Co. Assoc. v. Rhodes-Haverty Partnership, 250 Ga. 680, 680-82, 300 S.E.2d 503, 503-04 (Ga. 1983) (engineer liable to third-party purchaser for incorrect report on condition of building); Collins v. Binkley, 750 S.W.2d 737, 738-39 (Tenn. 1988) (vendor's attorney found liable to purchaser for preparing defective deed); *see also* Bagby & Ruhnka, *supra* note 15, at 157 n.37 (listing cases).

A professional is one whose work involves labor, skill, education, special knowledge and compensation, but whose labor and skill involve a "high level of training and proficiency." Black's Law Dictionary 1210 (6th ed. 1990). Examples of professionals include accountants, architects, engineers, doctors, lawyers and investment bankers. All of these professionals regularly make representations claiming special knowledge when rendering a service arising from a contract involving pecuniary interest. The recipients of those representations are entitled to expect that the professional will investigate all necessary matters and will have the competence that the particular profession requires when forming an intelligent judgment based upon the data obtained. *See* Restatement (Second) of Torts § 552 comment e (1965).

17. *See, e.g.*, First Nat'l Bank v. Crawford, 386 S.E.2d 310, 313 (W. Va. 1989) (requiring that professional actually foresee the third party's reliance); Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 551, 483 N.E.2d 110, 118, 493 N.Y.S.2d 435, 443 (1985) (requiring that accountant actually foresee the third party's reliance and be linked to the third party via its own actions); H. Rosenblum, Inc. v. Adler, 93 N.J. 324,

courts have addressed investment-banker liability in negligence to third-party shareholders only in pre-trial motions to dismiss for failure to state a claim.[18] Because courts have yet to reach the merits of these cases, the appropriate standard of care that investment bankers owe to third-party shareholders when rendering fairness opinions still awaits judicial definition.

Fairness and justice require that an investment banker's liability reasonably relate to the risks that it assumed in fee negotiations with a board of directors or a special committee.[19] This Note argues that investment bankers owe a duty to third-party shareholders in rendering fairness opinions, but that the scope of that duty should be limited to those shareholders whose reliance was actually foreseen.

Part I briefly explores the role of investment bankers' fairness opinions in corporate control transactions involving public entities and reviews negligent misrepresentation—the most viable third-party cause of action against investment bankers. Part II sets forth the different views on the scope of duty that investment bankers owe to third-party shareholders arising from the negligent preparation of fairness opinions. Part II concludes that negligent bankers owe a duty only to those shareholders whose reliance the bankers actually foresaw. Part III argues for clearer judicial guidelines concerning the standard of care that investment bankers owe to third-party shareholders when rendering fairness opinions. Part III also provides examples of cases in which fairness opinions and proxy statements were sufficiently detailed to warrant a board's reliance upon them in satisfaction of the directors' duties to shareholders. This Note concludes that investment bankers' duty to third-party shareholders requires them to investigate the subject company, reasonably analyze the information retrieved, and thoroughly disclose the bases for their opinions when rendering fairness opinions that third-party shareholders rely upon.

352, 461 A.2d 138, 153 (1983) (requiring that third party's reliance be reasonably foreseeable by accountant).

18. *See, e.g.*, Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1258-59 (D. Del. 1991) (allowing motion to dismiss); Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1125 (D.R.I. 1990) (denying motion to dismiss); Klein v. King, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615 (N.D. Cal. Mar. 26, 1990) (same); Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987) (same), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988); Rosenbloom & Aufses, *supra* note 1, at 6 (discussing motions to dismiss in several investment-banker cases); *see also* Herskowitz v. Nutri/Sys., Inc., 857 F.2d 179, 189-90 (3d Cir. 1988) (denying motion for directed verdict, rejecting scienter standard, and remanding for application of materiality disclosure test), *cert. denied*, 489 U.S. 1054 (1989).

19. A special committee consisting of disinterested directors may be appointed by the board because of a conflict of interest in the subject transaction. The courts consider the use of a special committee as evidence of the board's fair dealing. *See infra* note 24.

I. BACKGROUND: FAIRNESS OPINIONS AND NEGLIGENT MISREPRESENTATION

A. *The Role of Fairness Opinions in Corporate Control Transactions Involving Public Entities: Functions, Preparation and Susceptibility to Abuse*

Fairness opinions are "short letters that state an opinion about whether the consideration in a proposed transaction is 'fair' " to the shareholders from a financial point of view.[20] An investment banker usually addresses this letter to a special committee of the board of directors, which then publishes it in a proxy statement to all shareholders in accordance with securities law.[21] Investment bankers deem a "fair" price to fall "within a range of prices at which informed parties might strike a deal, but not necessarily the highest obtainable price."[22] In corporate control transactions, valuing the stock that is the subject of the transaction is necessary to determine what price is fair;[23] the fairness opinion is a common vehicle to establish the fairness of a price.[24]

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20. *See* Bebchuk & Kahan, *supra* note 7, at 27. If the investment banker opines negatively on a deal, then the fairness opinion states that the consideration is "inadequate" to shareholders from a financial point of view.

21. *See* 17 C.F.R. § 240 14d-9 (1991).

22. Coffee, *New York's New Doctrine of 'Constructive Privity'*, N.Y.L.J., Jan. 25, 1990, at 6 n.1, col. 6; *see* Fleischer, *A 'Fairness Letter' Is Just An Opinion*, N.Y. Times, June 8, 1986, § 3, at 2, col. 5.

23. Whether a deal's financial terms are fair to the acquired company's shareholders is "[a] perennial issue in acquisitions of public companies." Chazen, *supra* note 7, at 1439.

24. *See* Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. Rev. 630, 657 (1985); Winter, *supra* note 7, at 895 n.44; Bagley & Golze, *SEC Contemplates a Requirement of Substantive Fairness*, Nat'l L.J., Feb. 5, 1990, at S9, col. 4; *supra* note 7 and accompanying text.

Another common method to establish fairness is forming a special committee of independent directors. *See* Booth, *supra*, at 657; *supra* note 19; *see also* Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 570, 473 N.E.2d 19, 26-27, 483 N.Y.S. 667, 675 (1984) (special committee would "tend to negate a finding of self-dealing or overreaching"). *But cf.* Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986) (highlighting defects in securing fairness via special committee of outside directors), *rev'd on other grounds*, 481 U.S. 69, 94 (1987).

Both fairness opinions and special committees are indicia of fair-dealing, but neither is required by law. *See, e.g.*, Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 151-52 (S.D.N.Y. 1989) (fairness opinion not required by New York law) (citing Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985)); Oberly v. Kirby, No. 89-467 (Del. Nov. 19, 1990) (1990 Del. LEXIS 351, at *78-79) (fairness opinion not required by Delaware law); Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099, 1106 n.7 (Del. 1985) (declining to hold that absence of special committee constituted unfair dealing); Seagraves v. Urstadt Property Co., No. 10307 (Del. Ch. Nov. 13, 1989) (1989 Del. Ch. LEXIS 155, at *8-9) (Delaware law does not mandate implementation of either fairness opinions or special committees to prevent unfair dealing); *cf.* Cottle v. Storer Communication, Inc., 849 F.2d 570, 578 (11th Cir. 1988) (rejecting requirement of retaining independent financial advisor as prerequisite to invoking business judgment rule).

The ultimate valuation of fair price rests largely within the discretion of the lower courts. *See* Endicott Johnson Corp. v. Bade, 37 N.Y.2d 585, 588, 338 N.E.2d 614, 616, 376 N.Y.S.2d 103, 106 (1975).

Investment bankers limit their evaluations of fairness solely to financial matters.[25] The focus of a fairness opinion is not on the merits of the transaction, but rather the consideration that the shareholders are paid for their stock in the target company.[26]

In addition to determining whether the buyers' offer falls within a range of fair prices, fairness opinions serve several functions in corporate control transactions. From the directors' perspective, fairness opinions (1) offer an independent perspective on a deal's fairness,[27] especially important when directors have conflicts of interest that might hinder them in establishing a fair price;[28] (2) provide directors with possible protection from claims of breach of fiduciary duty;[29] and perhaps (3) convince shareholders to approve or disapprove a merger.[30] From the shareholders' perspective, diligently prepared fairness opinions reduce (1) agency costs by limiting the discretion of opportunistic managers[31] and (2) the

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25. *See* M. Lipton & E. Steinberger, *supra* note 10, § 8.06[4], at 8-28. Most fairness opinions contain the words "from a financial standpoint," by which an investment banker limits the fairness opinion to the transactions' financial considerations. When investment bankers contract to perform a fairness opinion "from a financial standpoint," it is widely believed that they limit their liability and have no duty to consider any non-economic matters, such as the effect on the community, when valuing a security or corporation. *See id.* It should be noted that this belief has never been litigated, "nor is it likely to be effective in cases where the investment banker has an advisory role or otherwise assists in the transaction beyond merely providing [a fairness] opinion." *Id.*

26. *See* Mancuso, *supra* note 6, at 258.

27. *See* M. Lipton & E. Steinberger, *supra* note 10, § 8.02[1], at 8-9.

28. *See* J. Freund, *supra* note 5, at 471-72.

Another common method is the appointment of a special committee of directors to represent the outside shareholders. *See supra* notes 19 & 24.

29. *See* Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 Va. L. Rev. 807, 835 n.74 (1987); Macey & Miller, *supra* note 5, at 134; *see, e.g.*, Cottle v. Storer Communication, Inc., 849 F.2d 570, 578 (11th Cir. 1988) (fairness opinion is factor in finding directors did not abuse discretion); Smith v. Van Gorkom, 488 A.2d 858, 876-77 (Del. 1985) (absence of fairness opinion is factor in court's finding that directors were uninformed); *In re* Radiology Assoc., Inc., No. 9001 (Del. Ch. May 16, 1990) (1990 Del. Ch. LEXIS 58, at *35-36) (same); Danziger v. Kennecott Copper Corp., N.Y.L.J., Dec. 7, 1977, at 7, cols. 1-2 (N.Y. Sup. Ct. Dec. 5, 1977) (fairness opinion is factor in finding directors conducted thorough investigation), *aff'd mem.*, 60 A.D.2d 552, 400 N.Y.S.2d 724 (1st Dep't 1977); *see also* Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 Bus. Law. 1437, 1453 (1985) (discussing the significance of *Van Gorkom*); Note, *The Business Judgment Rule, Due Care and Experts: How Much Information is Enough?*, 7 J.L. & Com. 225, 239 (1987) ("use of . . . outside experts will greatly enhance the probability that a board's action" was adequately informed) [hereinafter Note, *Due Care and Experts*]. Of course, however, the mere existence of a fairness opinion will not protect directors, especially when it is inadequately prepared. *See, e.g.*, Royal Indus. v. Monogram Indus., [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863, at 91,139-40 (C.D. Cal. Nov. 29, 1976) (directors liable despite fairness opinion).

The Model Business Act allows directors to rely in good faith on the evaluations of professionals. *See* Chazen, *supra* note 7, at 1442 & n.17.

30. *See* Note, *Fairness Opinions*, *supra* note 1, at 123.

31. *See id.* at 125-27. Such costs include those "of monitoring and restricting management behavior as well as the lost profits caused by managers' opportunism." *Id.* at 125.

shareholders' information costs in evaluating an offer.[32]

The preparation of a fairness opinion involves numerous variables and financial considerations that may lead two investment bankers to opine differently on the same transaction. The initial variables in the valuation process may include: (1) the type and structure of the transaction involved;[33] (2) the purpose of the opinion;[34] (3) the investment banker's access to data;[35] (4) the time available to prepare the opinion;[36] and (5) the investment banker's familiarity with the subject company and industry.[37]

After reviewing these initial variables, an investment banker must choose one or more valuation techniques. Commonly used techniques include (1) discounted cash flow analysis; (2) evaluation of comparable acquisitions; (3) valuation of comparative companies; (4) breakup analysis; and (5) liquidation analysis.[38] Using one or more of these valuation methods, investment bankers factor into the valuation numerous financial variables:

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32. *See id.* at 126.

33. *See* Chazen, *supra* note 7, at 1443-50.

34. *See* Rosenbloom & Aufses, *supra* note 1, at 8.

35. *See id.*

36. *Cf.* Principles of Corporate Governance: Analysis and Recommendations § 4.01, at 60-61 (Tent. Draft No. 3, 1984) (in determining whether directors acted reasonably, court should consider amount of time board had to acquire information before a decision had to be made).

37. *See* Rosenbloom & Aufses, *supra* note 1, at 8. The more familiar an investment banker is with the subject company, the less the need for an in-depth investigation. If the investment banker is unfamiliar with the subject company, the investment banker and its counsel should investigate the company by reviewing relevant documents concerning the company, visiting principal company facilities, and interviewing key personnel. *See id.* at 8-9; *see also* M. Lipton & E. Steinberger, *supra* note 10, § 8.06[6], at 8-31 ("Independent verification of the key issues should be made."). Visiting a company to evaluate its assets independently becomes more important when the asset values are essential in determining the corporation's value. *See* Bagley & Golze, *supra* note 24, at 10, col. 4.

38. *See* Kahn v. Household Acquisition Corp., No. 6293 (Del. Ch. May 6, 1988) (1988 Del. Ch. LEXIS 64, at *32-34); Rosenbloom & Aufses, *supra* note 1, at 4; *see also* Note, *Fairness Opinions*, *supra* note 1, at 137-39 (listing all but break-up analysis).

> [The] discounted cash flow analysis, which calculates the net present value of the cash flows generated from [the] ownership of the business entity plus a residual or terminal value calculation designed to quantify the theoretical perpetuity of the company's cash flows. [An] evaluation of relevant acquisitions . . . [involves] the banker analyz[ing] the prices paid for companies comparable with the business then under consideration . . . . [The] valuation of comparative companies [is] based on freely traded minority interest value plus a premium for control or a 'going private' premium. Under such an approach, certain financial ratios of the comparatives are assessed and compared to those of the subject company in order to infer a value for the subject company. [A b]reakup analysis . . . assumes that the units of the business will be sold separately and those units are valued. A . . . liquidation analysis[] assumes that the assets of the business will be liquidated piecemeal. The price obtained for these assets less the time value of money and the costs of liquidation are used to determine value under this method.

Rosenbloom & Aufses, *supra* note 1, at 4.

> (1) historical financial results and present financial condition, (2) evaluation of management's projections for the next two to five years, including ability to fund projected capital expenditures, (3) market or replacement value of the assets, (4) evaluation of the management's ability, (5) market information—historical and comparative price-earnings ratios, market trends, comparative premiums for sale of control and general economic conditions, (6) evaluation of the timing of sale of the business—can a better price be obtained later, and (7) can a better price be obtained now.[39]

The investment banker must report its assumptions, methods and conclusions clearly in the fairness opinion.[40] Before a board of directors can reasonably rely on the investment banker's opinion, however, an investment banker must defend its valuation in detail at a board meeting.[41] Following the board's recommendation to proceed with the transaction, the fairness opinion is commonly, if not nearly always, annexed to the proxy statement,[42] which is delivered to all shareholders of record to solicit their approval of the transaction.

The valuation of fairness is, however, prone to abuse and is "[t]he weak link in the protections afforded shareholders in management buyouts."[43] Most importantly, fairness opinions are "judgments, not statements of fact or prophecy,"[44] based on a whole set of contingencies. They differ substantially from audits, which involve evaluations of specific financial indicators at a given place or time in accordance with the standards of the accounting industry. Furthermore, investment bankers rarely opine that a price is unfair; instead, they refuse to render an opinion or withdraw an opinion already rendered.[45] Occasionally, during the

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39. M. Lipton & E. Steinberger, *supra* note 10, § 8.06[3], at 8-25 to -26.

40. *See generally infra* note 185 (listing recommended procedures for disclosing investigation).

41. *See* Bebchuk & Kahan, *supra* note 7, at 27-28; *see also* Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus. Law. 101, 126-27 (1979) (giving an example of investment banker's presentation to board).

42. An investment banker's representation on a deal's fairness reaches the shareholders via the proxy statement. The investment banker should be aware of whether a board intends to use its fairness opinion in the proxy report because the banker crafts its engagement letter to limit its potential liability to the intended recipients of the opinion. *See* Wachtell, Hein, Levene, Chappell, Heins, & Barrows, *Wachtell, Lipton, Rosen & Katz's Drafting of Indemnification Agreements and Engagement Letters for Investment Bankers in Light of Recent Legal Developments* 13 (February 20, 1991) (on file at Fordham Law Review) [hereinafter *Drafting Indemnification Agreements*]. The investment banker's opinion can be a powerful means of persuading shareholders to approve a board's proposal. *See* Note, *Fairness Opinions*, *supra* note 1, at 123.

43. Oesterle & Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 Vand. L. Rev. 207, 249 (1988). Professor Fischel has concluded that the fairness opinion is unreliable at best, and that its cost is little more than a "judicially imposed tax" on control transactions. Fischel, *supra* note 29, at 1453. He has also found that the opinion of those who put their money on the line is more valuable than the opinion of disinterested investment bankers. *See id.* at 1452. *But see* Lipton, *supra* note 41, at 131 (fairness opinions are desirable and useful).

44. Fleischer, *supra* note 22, § 3, at 2, col. 5.

45. *See, e.g.*, Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 696 (2d Cir. 1980)

mergers-and-acquisitions boom of the 1980s, the rendering of a fairness opinion became a mere formality performed after a deal was structured;[46] investment bankers often had to conduct hurried investigations of subject companies to meet the short deadlines that bidders had imposed on target companies for accepting offers.[47]

Another pitfall in the valuation process is an investment banker's tendency to be partial to its client. Not surprisingly, most incentives encourage an investment banker to opine in favor of the interests of the persons who hired it. These persons, often interested board members and officers, seek to garner shareholder support to achieve or prevent a change in corporate control. The investment banker's fee is usually based on a percentage of the deal, with a minimum payment—far less—if the deal folds,[48] unless the banker was hired to block an offer.[49] Refusing

(investment banker unable to opine on deal's fairness); FMC Corp. v. Boesky, 727 F. Supp. 1182, 1187 (N.D. Ill. 1989) (investment banker threatened to withdraw its opinion unless corporation's board increased its offer to match increase in the corporation's stock price).

46. *See* Stein, *supra* note 5, at 2, cols. 4-6; *cf.* Royal Indus. v. Monogram Indus., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863, at 91,139 (C.D. Cal. Nov. 29, 1976) (fairness opinion prepared "virtually overnight and without the necessary time and deliberation for a fair evaluation"); Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983) (not only was fairness opinion prepared over long weekend, but what would be a fair price was left blank until board meeting); EAC Indus. v. Frantz Mfg. Co., No. 8003, slip op. (Del. Ch. June 28, 1985) (LEXIS, States library, Del file, at 9) (investment banker "improvised" fairness opinion), *aff'd*, 501 A.2d 401 (Del. 1985).

47. *See, e.g.*, Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 155-56 (S.D.N.Y. 1989) (directors forced to decide under imminent deadlines); Citron v. Fairchild Camera and Instrument Corp., [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,915, at 90,103-04 (Del. Ch. May 19, 1988) (arm's-length adversary imposed time limit on board), *aff'd* 569 A.2d 53, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,860, at 94,662 (Del. 1989); *In re* RJR Nabisco, Inc. Shareholders Litig., [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,712-13 (Del. Ch. Jan. 31, 1989) (special committee given 30 minutes to accept proposal).

48. *See* Stein, *supra* note 5, at 2, cols. 5-6; Note, *Platinum Parachutes: Who's Protecting the Shareholder?*, 14 Hofstra L. Rev. 653, 669-70 & n.120 (1986); Note, *Outside Directors and the Modified Business Judgment Rule in Hostile Takeovers: A New Test for Director Liability*, 62 S. Cal. L. Rev. 645, 649 & n.10 (1989); *supra* note 197 and accompanying text; *see, e.g.*, Sandberg v. Virginia Bankshares, Inc., 891 F.2d 1112, 1122 (4th Cir. 1989) (in addition to initial $25,000 for opinion, investment banker would receive another $75,000 if merger completed), *rev'd*, Fed. Sec. L. Rep. ¶ 96,036 (June 27, 1991); Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) (Smith Barney would have lost $75,000 bonus had outside company wrested control of board from existing directors), *rev'd on other grounds*, 481 U.S. 69, 94 (1987); Wallerstein v. Primerica Corp., 701 F. Supp. 393, 395 (E.D.N.Y. 1988) (Lazard Freres was to receive additional $9 million if shareholders approved merger); *In re* Appraisal of Shell Oil, No. 8080 (Del. Ch. Dec. 11, 1990) (1990 Del. Ch. LEXIS 199, at *88) (Morgan Stanley received $500,000 flat fee for services rendered and additional $3.5 million for the tender offer's success); Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 201, 514 N.Y.S.2d 1, 2 (1st Dep't 1987) (Shearson Lehman received $750,000 for its opinion and was promised an additional $3.2 million if the deal went through), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988). *But see* Fleischer, *supra* note 22, § 3, at 2, col. 4 (defending the investment banker's objectivity and proficiency in rendering fairness opinions).

Even when the investment banker's fee is not contingent upon the achievement of its to opine on a deal's fairness may cause the investment banker to lose a client, as well as the business of other potential clients who may perceive the investment banker as one who will not tow the line.[50] Even if shareholders later question the investment banker's opinion, indemnification clauses offer an investment banker further protection from the financial harm that might arise from a shareholder suit.[51]

In addition, the board may limit the investment banker's investigation. For example, the board may forbid the investment banker to consider breakup or liquidation values or to shop[52] the company to confirm the adequacy of the buyout price.[53] The investment banker may also render a fairness opinion based on information supplied solely by the corporation's management,[54] which is especially problematic in deals involving a management-led bid. Due to the numerous definitions of fairness[55] and the investment banker's need to consider a broad range of factors,[56] an investment banker has tremendous discretion when opining on the fairness of a price.[57]

Even with these pitfalls in the valuation process, however, some courts and commentators have noted that shareholders tend to rely on financial experts' opinions.[58] Although it is unrealistic to presume that every

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client's interest, the desire to maintain a client for future business or to retain other clients under similar circumstances may still sway an investment banker to render an opinion favorable to its patron's position.

49. *See, e.g., Dynamics Corp.*, 794 F.2d at 257 (investment banker was an interested "blocker" of transaction).

50. *See, e.g.*, Anderson v. Boothe, 103 F.R.D. 430, 436-38 (D. Minn. 1984) (board may have influenced special committee's process of selecting investment banker to avoid fairness opinion contrary to its interests).

51. For a discussion of procedural protections, such as indemnification clauses, that the investment banker may seek to include in its engagement contract with the board, see *infra* notes 174-76 and accompanying text.

52. Shopping constitutes "canvassing dealers for the most favorable price, as in shopping securities dealers for the best bid or offer." Barron's Dictionary of Finance and Investment Terms 379 (1985).

The board may hire a separate investment banker to shop the company for additional offers. For a discussion of investment bankers and shopping, see Mancuso, *supra* note 6, at 258-60.

53. *See* Mancuso, *supra* note 6, at 258; Longstreth, *Fairness of Management Buyouts Needs Evaluation*, Legal Times, Oct. 10, 1983, at 19, col. 3; Comment, *Regulation of Leveraged Buyouts to Protect the Public Shareholder and Enhance the Corporate Image*, 35 Cath. U.L. Rev. 489, 533 & n.260 (1986); *see also* Bagley & Golze, *supra* note 24, at 10, col. 4 (SEC considering whether it is misleading to allow fairness opinions when all procedures have not been completed).

54. *See* cases *infra* note 226.

55. *See supra* note 22 and accompanying text.

56. *See supra* notes 33-39 and accompanying text.

57. *See* Bebchuk & Kahan, *supra* note 7, at 29-37; *see also* Fischel, *supra* note 29, at 1452 ("By assuming sufficiently high future earnings, or a sufficiently low discount rate, it is possible to come up with just about any [real value]."); Macey & Miller, *supra* note 5, at 134-35 (fairness opinions are "notorious" for the degree to which investment bankers can manipulate the valuation process to favor their clients' position).

58. *See* Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 822 (D. Del. 1974); Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984); *see also* Note, *Fairness*

shareholder relies on fairness opinions,[59] the blind reliance that unsophisticated shareholders might have on the opinions of reputable firms compounds the effect of a valuation process that often lacks impartiality because of its dependency upon the discretion of the investment banker and management.

Despite these problems, the Delaware Supreme Court in *Smith v. Van Gorkom*[60] "accentuated the need for fairness opinions and . . . contributed to their ever-widening use" in corporate control transactions.[61] The *Van Gorkom* court did not require directors to seek fairness opinions to fulfill their fiduciary duties,[62] but it did factor the directors' failure to consult an investment banker on the fairness of the cashout[63] price into its determination that the directors were insufficiently informed to invoke the protection of the business judgment rule.[64] *Van Gorkum* reflects the

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Opinions, *supra* note 1, at 123 (investment banker's opinion can have "substantial impact" on shareholders' vote).

Interested directors certainly hope that shareholders will rely on the fairness opinion. *See* Steinberg & Lindahl, *supra* note 7, at 80.

59. Whether all shareholders actually rely on fairness opinions before voting is debatable. For example, arbitragers seek only a premium on the stock and thus care little about the fairness of the price. Other sophisticated shareholders recognize the pitfalls involved in the valuation process and probably put less faith in the opinions. Less sophisticated shareholders, on the other hand, may never even read the proxy statement—they simply may want a deal that offers a premium well over their basis.

60. 488 A.2d 858 (Del. 1985). *Van Gorkum* is often referred to as "*Trans Union*," the name of the corporation that was part of the merger challenged in the case.

61. Stuntebeck & Withrow, *Fairness Opinions Should Offer More Detailed Financial Analysis*, Nat'l L.J., June 13, 1988, at 22, col. 1; *see Van Gorkom*, 488 A.2d at 876-77; Chazen, *supra* note 7, at 1442; Fischel, *supra* note 29, at 1453; Note, *Due Care and Experts*, *supra* note 29, at 237-38.

Van Gorkom did not require that directors seek a fairness opinion; however, it suggested as a general rule that the use of an outside valuation would be given substantial weight in any duty-of-care suit. *See Van Gorkom*, 488 A.2d at 875-78. Still, many have belittled the *Van Gorkom* decision. *See, e.g.*, 1 R. Balotti & J. Finkelstein, The Delaware Law of Corporations and Business Organizations § 4.7, at 101 (1986) ("[t]he decision has sparked harsh criticism, even incredulity"); Fischel, *supra* note 29, at 1455 (describing *Van Gorkom* as "surely one of the worst decisions in the history of corporate law"); Borden, *First Thoughts on Decision in Delaware on* Trans Union, N.Y.L.J., Feb. 25, 1985, at 4, col. 4 (describing *Van Gorkom* as "baffling" and "a distinct threat to the ability of companies to attract responsible directors").

Despite the substantial criticism of *Van Gorkom*, "it is highly unlikely that the Delaware Supreme Court, widely recognized as one of the nation's ablest and most experienced in matters of corporate law, would adopt a rule with such self-defeating consequences." Macey & Miller, *supra* note 5, at 135 (footnote omitted); *see also* Chittur, *The Corporate Director's Standard of Care: Past, Present, and Future*, 10 Del. J. Corp. L. 505, 543 (1985) ("[*Van Gorkom*] is a long-overdue judicial affirmation of the need for better informed directors and, consequently, more responsible corporate behavior.").

62. *See Van Gorkom*, 488 A.2d at 876.

63. " 'Cashout mergers' involve a displacement of minority stockholders by majority stockholders. The minority stockholders are involuntarily divested of their equity interest in return for cash." Note, *Minority Shareholders and Cashout Mergers: The Delaware Court Offers Plaintiffs Greater Protection and a Procedural Dilemma*—Weinberger v. UOP, Inc., *457 A.2d 701 (Del. 1983)*, 59 Wash. L. Rev. 119, 119 n.2 (1983).

64. *See* Smith v. Van Gorkum, 488 A.2d 858, 877-78 (Del. 1985).

weight that courts have given to fairness opinions rendered by reputable firms as long as the opinions have appeared reliable.[65] Only recently have the potential pitfalls in the investment banker's valuation procedures made courts more suspicious of the bankers' impartiality[66] and more open to allowing shareholder actions against them.[67]

B. *Negligent Misrepresentation: The Most Viable Cause of Action Against the Investment Banker*

In 1987, an intermediate New York appellate court in *Wells v. Shearson Lehman/American Express, Inc.*[68] first recognized a third-party shareholders' cause of action against an investment banker for negligently opining on a transaction's fairness.[69] Three other courts have

65. *See* Chazen, *supra* note 7, at 1442; *see, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir.) (directors' actions sufficient under business judgment rule in part because board relied on outside experts including investment banker), *cert. denied*, 454 U.S. 1092 (1981); Treadway Cos. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980) (fairness opinion evaluating merger proposal important factor in showing directors' good faith); Grynberg v. Farmer, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,683, at 98,584 (D. Colo. Oct. 8, 1980) (special committee's failure to consult with independent counsel or financial advisor contributed to rendering sale of stock improper); Consolidated Amusement Co. v. Rugoff, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,584, at 94,484 (S.D.N.Y. Oct. 6, 1978) (defining first step in legitimate private placement as seeking investment banker's advice); Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 572, 473 N.E.2d 19, 27, 483 N.Y.S.2d 667, 676 (1984) (fairness opinion good proof that freeze-out price fair); Danziger v. Kennecott Copper Corp., N.Y.L.J., Dec. 7, 1977, at 7, cols. 1-2 (N.Y. Sup. Ct. Dec. 5, 1977) (seeking independent investment banker's advice before making tender offer important factor in deciding that directors discharged fiduciary duties), *aff'd mem.*, 60 A.D.2d 552, 400 N.Y.S.2d 724 (1st Dep't 1977); *see also* Longstreth, *supra* note 53, at 19, col. 4 (fairness opinions provide strong legal support for management's judgment).

66. *See* Bartlett, *Delaware Courts Get Tough Toward Investment Bankers*, N.Y. Times, May 30, 1989, at D1, col. 1.

67. *See, e.g.*, Herskowitz v. Nutri/Sys., Inc., 857 F.2d 179, 190 (3d Cir. 1988) (denying motion for directed verdict in favor of investment banker in shareholders' negligence-based action against banker), *cert. denied*, 489 U.S. 1054 (1989); Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1124-25 (D.R.I. 1990) (refusing to dismiss shareholders' negligence-based action against investment banker); Klein v. King, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615 (N.D. Cal. Mar. 26, 1990) (same); Schneider v. Lazard Freres & Co., 159 A.D.2d 291, 296-97, 552 N.Y.S.2d 571, 574-75 (1st Dep't 1990) (same); Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987) (same), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988). *But cf.* Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1258-59 (D. Del. 1991) (dismissing plaintiff-shareholder claim of negligent misrepresentation against investment banker because plaintiff-shareholders not part of limited and foreseen class).

68. 127 A.D.2d 200, 514 N.Y.S.2d 1 (1st Dep't 1987), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988).

69. *See id.* at 202-03, 514 N.Y.S.2d at 2. Six years earlier, a Delaware court had rejected a direct cause of action for third-party shareholders against negligent investment bankers. *See* Weinberger v. UOP, Inc., No. 58,1981, slip op. (Del. Feb. 9, 1982), *withdrawn*, 457 A.2d 701 (Del. 1983), *reprinted in* Note, *The Standard of Care Required of an Investment Banker to Minority Shareholders in a Cash-Out Merger:* Weinberger v. UOP, Inc., 8 Del. J. Corp. L. 98, 162-63 (1983) [hereinafter Note, *Standard of Care*].

since followed.[70]

Causes of action other than negligent misrepresentation may be available against investment bankers, but require shareholders to hurdle major procedural and theoretical impediments. For instance, shareholders could raise derivative[71] or federal securities claims[72] against investment bankers. These actions, however, have "encounter[ed] major barriers that substantially inhibit their effectiveness."[73] As an alternative to derivative or federal securities actions, some commentators have suggested that negligent investment bankers owe a fiduciary duty to shareholders.[74]

70. *See Herskowitz*, 857 F.2d at 190; *Dowling*, 735 F. Supp. at 1124-25; *Klein*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615. *But cf. Brug*, 755 F. Supp. at 1258-59 (dismissing plaintiff-shareholder claim of negligent misrepresentation against investment banker because plaintiff-shareholders not part of limited and foreseen class).

Recently, the same New York court that decided *Wells* found an agency relationship between the investment banker and the shareholders, thus avoiding the third-party liability issue. *See Schneider*, 159 A.D. at 296-97, 552 N.Y.S.2d at 574-75.

71. In derivative suits, a "shareholder sues on behalf of the corporation for harm done to it." R. Clark, Corporate Law § 15.1, at 639 (1986). Before bringing the suit, a shareholder first must make a demand on the corporation's board of directors to remedy the alleged problem. *See id.* § 15.2, at 640. Most jurisdictions also require that the shareholder own shares of the subject corporation at the time of the alleged wrongdoing as well as at the time of the suit. *See id.* § 15.4, at 650. In addition, a third of the states authorize courts to require the shareholder to post security for the costs of the defendants. *See id.* § 15.5, at 652.

72. Several civil actions are available to shareholders via the Securities Act of 1933 and the Securities Exchange Act of 1934. For example, the 1933 Act incorporates private rights of action in the general anti-fraud provisions of sections 11, 12(1)-(2), and possibly 17(a), as authorities are split on whether a private action should be implied under this section. *See* Clark, *supra* note 71, § 17.4, at 744-749. Under the 1934 Act, private rights of action include the "catchall anti-fraud provision" of Rule 10b-5. *See id.* § 8.9, at 309, 312.

73. Coffee, *supra* note 22, at 5, col. 1. In particular, Professor Coffee notes that the demand requirement and the business judgment rule, which the courts apply to board decisions to reject derivative suits, effectively offset the effectiveness of the derivative suit. *See id.* at 6 n.3, col 6. *But see, e.g.*, Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 Geo. Wash. L. Rev. 745, 753-54 & n.39 (1984) (describing derivative action as cost-effective means of deterring opportunistic behavior by agents, especially where there is only a one-time breach of fiduciary duty). The professor also points to the shareholders' need to prove scienter in actions under Rule 10b-5 of the Securities Exchange Act of 1934. *See* Coffee, *supra* note 22, at 6 n.3, col. 6. Not all courts require proof of scienter for federal securities violations. *See, e.g.*, Herskowitz v. Nutri/Sys., Inc., 857 F.2d 179, 190 (3d Cir. 1988) (shareholders need not prove scienter under section 14(a) of Securities Exchange Act of 1934), *cert. denied*, 489 U.S. 1054 (1989).

74. *See, e.g.*, Steinberg & Lindahl, *supra* note 7, at 87-89 (banker should be held as a fiduciary to shareholders because its knowledge of facts and skill in reviewing deals are superior to average shareholder, and it expects shareholders to rely upon its opinion); Note, *Standard of Care*, *supra* note 69, at 117-19 (shareholders' confidence in investment bankers' superior knowledge should give rise to fiduciary duty); Note, *Fairness Opinions*, *supra* note 1, at 136 n.94 ("investment banker arguably might owe a fiduciary duty to the shareholders"). *But cf.* Oesterle & Norberg, *supra* note 43, at 252-53 & n.160 (advocating fiduciary duty to corporation when fairness opinion drafted under conflict of interest or without adequate investigation, but rejecting direct fiduciary duty from investment banks

Nevertheless, courts have consistently rejected these suggestions.[75] Shareholders may also argue that they are in privity with an investment banker hired by a special committee and thus allowed to sue the investment banker under its contract with the special committee for negligently advising the special committee on the committee's auctioning of the corporation.[76] Nevertheless, this would require a dubious finding that a special committee of directors is the shareholders' agent—a severe twist of textbook corporate law.[77] Thus, negligent misrepresentation is likely the most viable cause of action for shareholders against investment bankers who negligently prepare fairness opinions upon which the shareholders then rely.[78]

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to shareholders because management-buyout litigation, already rampant, would increase).

75. *See, e.g.*, Lewis v. Leaseway Transp. Corp., No. 8720 (Del. Ch. May 16, 1990) (1990 Del. Ch. LEXIS 69, at *20-21) ("Plaintiffs do not claim, nor could they, that Citicorp or Drexel owed a fiduciary duty to Leaseway shareholders."); *In re* Shoe-Town, Inc. Stockholders Litig., No. 9483 (Del. Ch. Feb. 12, 1990) (1990 Del. Ch. LEXIS 14, at *21-22) (illogical to burden investment bankers with fiduciary duties because fairness opinion not "absolute requirement" under Delaware law); Anderson v. Boothe, 103 F.R.D. 430, 441 (D. Minn. 1984) (noting investment banker "cannot be held liable for breach of fiduciary duty to minority stockholders").

Courts have been less inhibited in finding investment bankers liable for aiding and abetting a parent company's breach of a fiduciary duty to shareholders. *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284 n.33, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,401, at 92,599 n.33 (Del. May 3, 1989) ("Although Wasserstein was not a MacMillan officer or director, it is bedrock law that the conduct of one who knowingly joins with a fiduciary, including corporate officials, in breaching a fiduciary obligation, is equally culpable."); *Anderson*, 103 F.R.D. at 441-42 (refusing to dismiss aiding and abetting claim against investment banker because banker's fee contingent upon success of management's wishes); Richardson v. White, Weld & Co., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,864, at 95,545 (S.D.N.Y. May 11, 1979) (false opinion could make investment banker a co-conspirator, or an aider and abettor, of a parent company's breach of fiduciary duty to shareholders).

76. This argument succeeded in Schneider v. Lazard Freres & Co., 159 A.D.2d 291, 296-97, 552 N.Y.S.2d 571, 574-75 (1st Dep't 1990). For a further discussion of *Schneider*, see *infra* note 162 and accompanying text.

77. The *Schneider* court found this agency relationship between shareholders and a special committee. *See Schneider*, 159 A.D.2d at 296-97, 552 N.Y.S.2d at 574-75. Several commentators have criticized *Schneider*'s agency finding. *See, e.g.*, Coffee, *supra* note 22, at 6, col. 4 (*Schneider*'s finding of privity "seems doctrinally incorrect"); Wachtell, Roth & Houston, *Investment Banker Liability to Shareholders in the Sale-of-Control Context*, N.Y.L.J., Mar. 29, 1990, at 1, col. 1 (*Schneider*'s view of legal relationships "startling"); *cf.* Brodsky, *Investment Banker Liability to Shareholders*, N.Y.L.J., May 3, 1990, at 4, col 5 (*Schneider*'s theory "should be limited to buyouts" and not confused "with well-established principles of accountant and attorney malpractice liability"). For a discussion of *Schneider*'s use of traditional agency principles in viewing the director-shareholder relationship, see *infra* note 162 and accompanying text.

78. *See generally* Steinberg & Lindahl, *supra* note 7, at 89 (investment banker should be liable for negligent misrepresentation); Note, *Standard of Care*, *supra* note 69, at 112-15 (same); *cf.* Coffee, *supra* note 22, at 6, col. 6 (theory of constructive privity would rest on stronger doctrinal grounds and allow state and federal law to interact sensibly).

Only a few courts have allowed this common-law action against investment bankers. *See, e.g.*, Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1125 (D.R.I. 1990) (investment bankers may be liable for negligent misrepresentation); Klein v. King, [1989-

"Negligent misrepresentation is a false representation made by a person who has no reasonable grounds for believing it to be true, though he does not know that it is untrue, or even believes it to be true."[79] The elements of negligent misrepresentation, like all actions in negligence, include duty, breach, actual and proximate cause, and harm.[80] To be liable in a negligence action, the defendant must owe a duty to the plaintiff to exercise reasonable care.[81] Tort law usually requires that this duty be owed to all foreseeable plaintiffs.[82] In negligent misrepresentation involving professionals, however, courts traditionally protected professionals from foreseeable third-party claims by limiting their duty to only those with whom they shared privity.[83] Although most jurisdictions have discarded a privity requirement for imposing liability in negligence,[84] these courts have disagreed on the extent to which a professional's duty should be limited.[85]

After establishing the defendant's duty of care, a plaintiff must prove that the defendant breached this duty of care by misrepresenting a material fact.[86] The Supreme Court has held that under securities laws "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[87]

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90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615 (N.D. Cal. Mar. 26, 1990) (same); Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987) (same), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988). *But cf.* Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1258-59 (D. Del. 1991) (dismissing plaintiff-shareholder claim of negligent misrepresentation against investment banker because plaintiff-shareholders not part of limited and foreseen class).

Such claims are occasionally called "professional malpractice," despite being indistinguishable from other negligent misrepresentation claims. *See* Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 Mich. L. Rev. 1929, 1933 n.19 (1988).

79. Black's Law Dictionary 1152 (4th ed. 1951) (citation omitted).

80. *See* W. Keeton, D. Dobbs, R. Keeton, & D. Owen, Prosser and Keeton on the Law of Torts § 30, at 164-65 (5th ed. 1984 & Supp. 1988) [hereinafter Prosser and Keeton].

81. *See* Prosser, *Misrepresentation and Third Persons*, 19 Vand. L. Rev. 231, 236 (1966).

82. "It is no longer in dispute that one who renders services to another is under a duty to exercise reasonable care in doing so, and that he is liable for any negligence to anyone who may foreseeably be expected to be injured as a result." Prosser and Keeton, *supra* note 80, § 104, at 719 (footnote omitted).

83. *See id.* § 107, at 746-47.

> It should be said that drawing the line between professional and nonprofessional services is not always easy and perhaps in the final analysis the real question is whether or not the service provider is the kind of enterpriser who ought in the public interest to be strictly accountable for harm resulting from the defects in things transmitted in the course of rendering services.

Id. § 104, at 720.

84. *See infra* notes 102-30 and accompanying text. Some courts, however, still require privity. *See infra* note 109 and accompanying text.

85. *See infra* Part IIA.

86. *See* Prosser and Keeton, *supra* note 80, § 108, at 753-54.

87. TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976).

Several state courts have applied this definition to state law claims.[88]

A plaintiff must then demonstrate that the alleged misrepresentation was the actual and proximate cause of the harm by proving that she had reasonably relied on the alleged misrepresentation.[89] Under federal securities laws, a rebuttable presumption of reliance arises when a material omission is found because of the "unreasonable evidentiary burden that would be placed on an investor if he was required to prove a 'speculative state of facts, i.e., how he would have acted if omitted material information had been disclosed . . . or if the misrepresentation had not been made.' "[90] Tort law generally finds such reliance "where special circumstances make it reasonable or probable that the plaintiff should accept the defendant's opinion and act upon it."[91] Some courts have found these special circumstances in the investment banker-shareholder scenario,[92] and have determined that the factual assumptions made within a fairness opinion have such persuasive force that investment bankers should be liable for those statements.[93] Despite these findings, too few courts have addressed shareholder reliance on fairness opinions under negligent misrepresentation claims to conclude that shareholders will not have to prove actual reliance.[94] Ultimately, courts may have to conduct mini-

88. *See, e.g.,* Rose v. Dobras, 128 Ariz. 209, 214, 624 P.2d 887, 892 (Ariz. Ct. App. 1981) (applying *TSC*'s materiality definition to Arizona securities case); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985) (*TSC*'s materiality standard applies in Delaware).

89. *See* Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1120 (D.R.I. 1990).

90. *Id.* (quoting Basic, Inc. v. Levinson, 485 U.S. 224, 245 (1988)). "There is no need to supplement this requirement [of showing materiality] with a requirement of proof of whether a defect actually had a decisive effect on the [shareholders'] voting." Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384-85 (1970).

91. Prosser and Keeton, *supra* note 80, § 109, at 760.

> Further than this, it has been recognized very often that the expression of an opinion may carry with it an implied assertion, not only that the speaker knows no facts which would preclude such an opinion, but that he does know facts which justify it. There is quite general agreement that such an assertion is to be implied where the defendant holds himself out or is understood as having special knowledge of the matter which is not available to the plaintiff, so that his opinion becomes in effect an assertion summarizing his knowledge.

Id. at 760-61 (footnotes omitted).

92. *See Dowling,* 735 F. Supp. at 1120; *see also* CPC Int'l, Inc. v. McKesson Corp., 70 N.Y.2d 268, 286, 514 N.E.2d 116, 125, 519 N.Y.S.2d 804, 813 (1987) (rejecting contention that investment banker's projections were "mere opinions" that could not support claim of fraud).

93. *See Dowling,* 735 F. Supp. at 1124; Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 822 (D. Del. 1974); Joseph v. Shell Oil Co., 482 A.2d 335, 341 (Del. Ch. 1984); *see also* Steinberg & Lindahl, *supra* note 7, at 80 (minority shareholders in cashout mergers undeniably rely on investment banker's opinion); Note, *Fairness Opinions, supra* note 1, at 123 & n.28 (investment banker's opinion can have substantial impact on shareholders' vote).

94. Only the *Dowling* court has addressed this issue to date. *See Dowling,* 735 F. Supp. at 1124. In *Dowling,* Salomon Brothers contended that the shareholders failed to prove actual reliance on its fairness opinion. *See id.* The court, however, found that the vote of the nonplaintiff-shareholders, which forced the plaintiffs to liquidate their stock

hearings on each shareholder's or group of shareholders' contention of reliance or adopt a rebuttable presumption in favor of shareholder reliance.[95]

Finally, a plaintiff must show damages. Courts traditionally hesitated before compensating plaintiffs whose tort claims arose from purely economic losses rather than from physical harm.[96] This convention in negligence-based actions would have completely sheltered investment bankers from liability to shareholders—shareholders rarely suffer anything but financial harm when investment bankers negligently opine on the fairness of transactions. The majority of contemporary courts, however, permit recovery for pecuniary injury arising from negligent misrepresentation.[97] Therefore, because shareholder reliance is expected and neither privity nor non-pecuniary loss is required, investment bankers may be liable to third-party shareholders for negligent misrepresentation when they negligently render fairness opinions that shareholders rely upon.

II. The Scope of the Investment Banker's Duty to Third-Party Shareholders Arising from Negligent Preparation of Fairness Opinions

In 1981, a third-party shareholder's claim against an investment banker for negligently preparing a fairness opinion was rejected as "meritless."[98] Nevertheless, in light of recent holdings that investment bank-

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against their will, satisfied the reliance element of the plaintiffs' negligent misrepresentation claim. *See id.*

95. A rebuttable presumption would avoid the impracticality of having every member in a shareholder class prove actual reliance. Mini-hearings, however, would address the reality that several types of shareholders rarely rely on the investment banker's fairness opinion. *See supra* note 59 and accompanying text.

A presumption of reliance might unfairly burden investment bankers unless courts allowed bankers to defeat the presumption via disclaimers placed prominently within the opinion that alerted shareholders to the opinion's limitations. *Cf.* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 351, 461 A.2d 138, 152 (1983) (involving accountants); Stanton & Dugdale, *Recent Developments in Professional Negligence—II: Accountant's Liability to Third Parties*, 132 New L.J. 4, 5 (1982) (same).

For a discussion concerning disclaimers, see *supra* note 174.

96. *See* Prosser, *supra* note 81, at 232.

97. *See* W. Prosser, J. Wade & V. Schwartz, Torts: Cases and Materials 1024 (8th ed. 1988); *see, e.g.*, Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1124-25 (D.R.I. 1990) (allowing third-party shareholder action in negligence to proceed for recovery of economic loss allegedly caused by negligent investment banker); Klein v. King, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615 (N.D. Cal. Mar. 26, 1990) (same); Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987) (same), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988). *But cf.* Floor Craft Floor Covering, Inc. v. Parma Community Gen. Hosp. Ass'n, 54 Ohio St. 3d 1, 8, 560 N.E.2d 206, 212 (1990) (in absence of privity, no cause of action permitted against architectural designing firm for purely economic damages resulting from negligent drafting of plans); Siliciano, *supra* note 78, at 1941-51 (the economic loss doctrine's concerns about excessive liability and moral hazards are still viable in negligent accounting cases).

98. *See* Weinberger v. UOP, Inc., 426 A.2d 1333, 1348 (Del. Ch. 1981), *rev'd on other*

ers owe a duty of reasonable care to third-party shareholders,[99] investment bankers can no longer expect to be insulated entirely from third-party suits.[100] The issues most likely to divide courts are the scope of the investment banker's duty and the standard of care that the investment banker must meet.[101]

A. *The Scope of a Professional's Duty to Third Parties*

Courts have generally adopted one of three leading views on the scope of a professional's duty to third parties: (1) the *Ultramares* approach; (2)

grounds, 457 A.2d 701, 712 (Del. 1983). The *Weinberger* court noted that no precedent existed for such a cause of action. *See id.*

99. *See* Herskowitz v. Nutri/Sys., Inc., 857 F.2d 179, 190 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054 (1989); *Dowling*, 735 F. Supp. at 1124-25; *Klein*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615; Schneider v. Lazard Freres & Co., 159 A.D.2d 291, 296-97, 552 N.Y.S.2d 571, 574-75 (1st Dep't 1990); *Wells*, 127 A.D.2d at 202-03, 514 N.Y.S.2d at 2. *But cf.* Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1258-59 (D. Del. 1991) (dismissing plaintiff-shareholders' claim of negligent misrepresentation against investment banker because plaintiff-shareholders not part of limited and foreseen class).

100. *See* Rosenbloom & Aufses, *supra* note 1, at 7.

101. Another potential issue is whether the shareholders will have to show actual reliance upon the fairness opinion. Although this Note discusses this issue briefly, *see supra* notes 59 & 89-95 and accompanying text, a full discussion of this issue is beyond the scope of this Note.

In addition, a few commentators have raised free speech questions in the context of other professionals. *See, e.g.*, Siliciano, *supra* note 78, at 1966 & n.179 (raising first amendment concerns in context of accountants); Note, *What Standard of Care Should Govern the World's Shortest Editorials?: An Analysis of Bond Rating Agency Liability*, 75 Cornell L. Rev. 411, 446-58 (1990) (raising first amendment issue in context of bond-rating companies). No court has addressed the freedom of speech issue in the context of an investment banker's fairness opinion.

The first amendment affords special protection to speech of public concern, because such speech "occupies the 'highest rung of the heirarchy [sic] of First Amendment values.'" Connick v. Myers, 461 U.S. 138, 145 (1983) (quoting Carey v. Brown, 447 U.S. 455, 467 (1980)); *see* Dun & Bradstreet, Inc. v. Greenmoss Builders, Inc., 472 U.S. 749, 758-59 (1985) (plurality opinion). For speech on matters of public concern, negligence is constitutionally insufficient to sustain liability. *See* New York Times Co. v. Sullivan, 376 U.S. 254, 279-80 (1964). The Supreme Court distinguishes a public concern from a private concern by examining the speech's "content, form, and context . . . as revealed by the whole record." *Connick*, 461 U.S. at 147-48. *See generally* Note, *supra*, at 450-51 (compiling factors from cases that help distinguish matters of public concern from purely private matters). In the context of large, publicly held corporations, a fairness opinion is arguably of public concern: the economic well-being of a major corporation not only affects its numerous shareholders, but also the nation's economy as a whole. Nevertheless, the investment banker's fairness opinion is generally of greater interest to a limited class than the general public. *Cf. Dun & Bradstreet*, 472 U.S. at 762 (defamatory bankruptcy declaration not a public issue). In addition, the investment banker renders the opinion for a profit—a motive less likely to garner him first amendment protection. *See id.* Thus the fairness opinion is less a news item of public concern and more a private evaluation to which the public is indifferent. *cf.* Note, *supra*, at 460 (drawing a similar conclusion in regards to accountant's audit).

A full discussion of these first amendment concerns is also beyond the scope of this Note. For a more detailed discussion, see Estlund, *Speech on Matters of Public Concern: The Perils of an Emerging First Amendment Category*, 59 Geo. Wash. L. Rev. 1 (1990).

the reasonably foreseeable standard; or (3) the Second Restatement's actually foreseen approach.[102] Even though these three views have developed largely in the context of accountant liability,[103] many courts have applied these standards to other professionals who negligently provide information.[104]

102. *See* Toro Co. v. Krouse, Kern & Co., 827 F.2d 155, 156-57 (7th Cir. 1987); First Nat'l Bank v. Crawford, 386 S.E.2d 310, 311-13 (W. Va. 1989); Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 553 & n.11, 483 N.E.2d 110, 119, 493 N.Y.S.2d 435, 444 (1985).

California courts have recognized a fourth definition of duty that balances policy concerns including

> 'the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct, and the policy of preventing future harm.'

Goodman v. Kennedy, 18 Cal. 3d 335, 343, 556 P.2d 737, 742, 134 Cal. Rptr. 375, 380 (1976) (quoting Biakanja v. Irving, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958)); *see also* Klein v. King, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615 (N.D. Cal. Mar. 26, 1990) (acknowledging *Goodman* and holding financial services firm that allegedly prepared fairness opinion included in proxy statement negligently liable to all plaintiffs who relied on statement); *In re* Worlds of Wonder Sec. Litig., 694 F. Supp. 1427, 1435-36 (N.D. Cal. 1988) (acknowledging *Goodman*, but adopting reasonably foreseeable approach for independent auditors only).

Several courts have rejected this balancing test as too difficult to apply. *See* Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 320-21 (Miss. 1987); Raritan River Steel Co. v. Cherry, Bekaert & Holland, 322 N.C. 200, 214, 367 S.E.2d 609, 617 (1988).

Some courts have also adopted modifications of these three major approaches. *See, e.g.*, Thayer v. Hicks, 243 Mont. 138, 146, 793 P.2d 784, 789 (Mont. 1990) (adopting "modified version" of *Credit Alliance*); Selden v. Burnett, 754 P.2d 256, 260-61 (Alaska 1988) (adopting modified version of Restatement).

103. *See, e.g.*, Ingram Indus. v. Nowicki, 527 F. Supp. 683, 684-85 (E.D. Ky. 1981) (allowing third-party shareholder action in negligent misrepresentation against accountant under Kentucky law); Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91-93 (D.R.I. 1968) (same under Rhode Island law); Badische Corp. v. Caylor, 257 Ga. 131, 132-33, 356 S.E.2d 198, 199-200 (1987) (same under Georgia law); *Raritan River Steel*, 322 N.C. at 214, 367 S.E.2d at 617 (same under North Carolina law).

104. *See, e.g.*, Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1258-59 (D. Del. 1991) (applying Restatement approach to investment bankers); Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1124-25 (D.R.I. 1990) (same); Vereins-Und Westbank v. Carter, 691 F. Supp. 704, 716 (S.D.N.Y. 1988) (applying *Ultramares* rule for accountants to attorney); Guardian Constr. Co. v. Tetra Tech Richardson, Inc., 583 A.2d 1378, 1386 (Del. Super. Ct. 1990) (applying Restatement rule to designing engineer); Robert & Co v. Rhodes-Haverty Partnership, 250 Ga. 680, 680-82, 300 S.E.2d 503, 503-04 (1983) (same); Citizens Nat'l Bank v. Kennedy & Coe, 232 Neb. 477, 480, 441 N.W.2d 180, 182 (1989) (extending privity requirement for attorneys to accountants); Stotlar v. Hester, 92 N.M. 26, 28-29, 582 P.2d 403, 406-07 (N.M. Ct. App.) (applying Restatement rule to appraiser for negligent appraisal), *cert. denied*, 92 N.M. 180, 585 P.2d 324 (1978); Ossining Union Free School Dist. v. Anderson LaRocca Anderson, 73 N.Y.2d 417, 424, 539 N.E.2d 91, 94-95, 541 N.Y.S.2d 335, 338-39 (1989) (applying *Ultramares* rule for accountants to engineer); Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987) (applying *Ultramares* rule for accountants to investment bankers), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988), Cook Consultants, Inc. v. Larson, 700 S.W.2d 231, 236 (Tex. Ct. App. 1985) (applying reasonably foreseeable approach for accountants to surveyor liable

1. The *Ultramares* Approach

The most restrictive approach is derived from the seminal case on professional liability in negligence, *Ultramares Corp. v. Touche, Niven & Co.*.[105] In *Ultramares*, the New York Court of Appeals, speaking through Judge Cardozo, limited the scope of accountant liability for pecuniary harm caused by negligence to those who had a "contractual relation, or . . . one approaching it" with the accountant.[106] Although Judge Cardozo intimated that *actual* privity would not be required,[107] courts later interpreted *Ultramares* to demand strict privity for all types of professional liability suits based on negligence.[108] A few jurisdictions have maintained this interpretation of *Ultramares*, which precludes third-party suits.[109]

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to landowner for negligence in completing survey under contract with building contractor). *But see Klein*, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,615 (N.D. Cal. Mar. 26, 1990) (claiming that under California law, a separate standard exists for independent auditors of financial statements); Donnelly Constr. Co. v. Oberg/Hunt/Gilleland, 139 Ariz. 184, 188-89, 677 P.2d 1292, 1296-97 (Ariz. 1984) (applying Restatement to architects); Hoffman v. Greenberg, 159 Ariz. 377, 380, 767 P.2d 725, 728 (Ct. App. 1988) (limiting professional liability to "that which could have been imposed on contractual basis").

105. 255 N.Y. 170, 174 N.E. 441 (1931).

106. *Id.* at 183, 174 N.E. at 446. With *Ultramares*, the New York Court of Appeals stemmed the deterioration of the privity doctrine that it had initiated in MacPherson v. Buick Motor Co., 217 N.Y. 382, 389, 111 N.E. 1050, 1053 (1916). The *MacPherson* court extended an auto manufacturer's duty of care to all those whom its product could foreseeably have injured. *See id.* at 389, 111 N.E. at 1053.

107. When distinguishing the auditor in *Ultramares* from the public weigher whom the court had held liable to a third party in the earlier decision of Glanzer v. Shepard, 233 N.Y. 236, 135 N.E. 275 (1922), Judge Cardozo noted that the weigher's knowledge of the use of the weight certificates created a "bond . . . so close as to approach . . . privity." *Ultramares*, 255 N.Y. at 182-83, 174 N.E. at 446. Judge Cardozo later declared that the third party in *Glanzer* to whom the accountant owed a duty of care was "in effect, if not in name, a party to the contract." *Id.* at 183, 174 N.E. at 446; *see supra* note 106 and accompanying text.

108. *See* Bagby & Ruhnka, *supra* note 15, at 156-57 & n.36; *see also* Gormley, *The Foreseen, the Foreseeable, and Beyond—Accountants' Liability to Nonclients*, 14 Seton Hall L. Rev. 528, 532 & n.22 (1984) ("*Ultramares* came to symbolize a requirement of privity of contract which in hindsight appears to be a more rigorous requirement than Judge Cardozo may have intended"); Note, *Attorney Liability to Third Parties for Corporate Opinion Letters*, 64 B.U.L. Rev. 415, 430 & n.103 (1984) (courts viewed *Ultramares* "as holding that accountants owe no duty of care to those persons not in privity of contract with them"); *see, e.g.*, O'Connor v. Ludlam, 92 F.2d 50, 53 (2d Cir.) (interpreting *Ultramares* as allowing third-party liability against accountants only in cases of fraud), *cert. denied*, 302 U.S. 758 (1937); Thornton v. Little Sisters of the Poor, 380 A.2d 593, 595 (D.C. 1977) (insurer owed no duty to third parties); Birkenmeyer & Co. v. Homestead Minerals, 32 Colo. App. 258, 262, 510 P.2d 449, 451 (1971) (corporation not liable for losses caused by negligence of its stock transfer agent).

109. *See, e.g.*, Bryant Elec. Co. v. Fredicksburg, 762 F.2d 1192, 1193-96 (4th Cir. 1985) (under Virginia law, in the absence of privity, architectural and engineering firm not liable for purely economic loss resulting from firm's negligence); Investors Tax Sheltered Real Estate, Ltd. v. Laventhol, Krekstein, Horwath & Horwath, 370 So. 2d 815, 817-18 (Fla. Dist. Ct. App. 1979) (accounting firm not liable for negligence to a third-party investment firm), *cert. denied*, 381 So. 2d 767 (Fla. 1980); Citizens Nat'l Bank v. Kennedy & Coe, 232 Neb. 477, 480, 441 N.W.2d 180, 182 (1989) (accounting firm not

One group of courts, led by the New York Court of Appeals,[110] has construed the *Ultramares* view of professional liability less restrictively,[111] requiring only "constructive privity" as a basis for liability.[112] Focusing on *Ultramares*'s "approaching privity" language,[113] these courts impose a duty upon accountants and other professionals when (1) the professional actually foresees the likelihood of the third party's reliance on the representation for a particular purpose,[114] and (2) there is conduct by the professional linking him to the third party.[115] The second requirement—linking conduct—is difficult yet essential to define because it distinguishes the *Ultramares* approach from the Second Restatement's actually foreseen standard. Courts usually require that the parties have some preexisting relationship or nexus that ensures that the professional actually foresaw the third party's reliance.[116] Nevertheless, whether in-

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liable to third party); Floor Craft Floor Covering, Inc. v. Parma Community Gen. Hosp. Ass'n, 54 Ohio St. 3d 1, 8, 560 N.E.2d 206, 212 (1990) (in absence of privity, architectural designing firm not liable for purely economic damages resulting from inaccurate drafting plans).

110. *See* Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985). The *Credit Alliance* court refused to require actual privity to find an accountant liable for negligence causing mere pecuniary damage. *See id.* at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443.

111. *See, e.g.*, Toro Co. v. Krouse, Kern & Co., 827 F.2d 155, 161-62 (7th Cir. 1987) (interpreting Indiana law as following *Credit Alliance*); Colonial Bank v. Ridley & Schweigert, 551 So. 2d 390, 395 (Ala. 1989) (adopting *Credit Alliance* in Alabama); Idaho Bank & Trust Co. v. First Bancorp, 115 Idaho 1082, 1084, 772 P.2d 720, 722 (Idaho 1989) (adopting *Credit Alliance* in Idaho); Thayer v. Hicks, 243 Mont. 138, 146, 793 P.2d 784, 789 (1990) (adopting "modified version" of *Credit Alliance* in Montana); *see also* Ossining Union Free School Dist. v. Anderson LaRocca Anderson, 73 N.Y.2d 417, 424-25, 539 N.E.2d 91, 94-95, 541 N.Y.S.2d 335, 338-39 (1989) (applying *Credit Alliance* to engineers).

Some courts and commentators claim that *Credit Alliance* and its progeny modified the *Ultramares* standard. *See, e.g.*, First Nat'l Bank v. Crawford, 386 S.E.2d 310, 311 (W. Va. 1989) (noting an apparent modification despite the New York Court of Appeals' declaration to the contrary); Bagby & Ruhnka, *supra* note 15, at 163 (acknowledging a modification, but describing it as slight). *But see Credit Alliance*, 65 N.Y.2d at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443 (claiming that court's new test did not depart from the principles of *Ultramares*); Siliciano, *supra* note 78, at 1940 (*Credit Alliance* merely affirmed the continuing validity of *Ultramares*).

112. *Credit Alliance* has been interpreted as requiring "constructive privity." *See* Coffee, *supra* note 22, at 6, col. 6.

113. *See supra* notes 106-07 and accompanying text.

114. This is a combination of the first two prongs of the *Credit Alliance* test: "(1) the accountants must have been aware that the financial reports were to be used for a particular purpose or purposes; (2) in the furtherance of which a known party or parties was intended to rely." *Credit Alliance*, 65 N.Y.2d at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443.

115. *See Toro*, 827 F.2d at 161-62; Colonial Bank v. Ridley & Schweigert, 551 So. 2d 390, 395-96 (Ala. 1989); *Idaho Bank*, 115 Idaho at 1084, 772 P.2d at 722; *Credit Alliance*, 65 N.Y.2d at 551, 483 N.E.2d at 118, 493 N.Y.S.2d at 443; *see also Thayer*, 243 Mont. at 149, 793 P.2d at 791 (conduct not necessary, but must show that third party's reliance relates to particular transaction of which accountant is aware when preparing audit).

116. *See, e.g.*, *Colonial Bank*, 551 So. 2d at 395 (accountant had no previous contact with bank that would indicate his awareness of bank's reliance on audits); Ossining Union Free School Dist. v. Anderson LaRocca Anderson, 73 N.Y.2d 417, 425-26, 539

terpreted as requiring actual or constructive privity, *Ultramares* remains the most restrictive of the three major approaches in defining the scope of professional liability to third parties in negligent misrepresentation.

The *Ultramares* rule aims to prevent excessive liability.[117] This goal stems from two broad policies: (1) applying stricter scrutiny to third-party claims arising from purely economic loss; and (2) allowing private, nonjudicial constraints, such as a profession's self-regulation and a professional's concerns about reputation, to control the risks involved in transactions requiring reliance on a professional's expertise.[118] *Ultramares* protects the professional from unlimited liability by limiting the number of persons that may reasonably rely on the professional's representation to those in privity—or "approaching privity"—with the professional. It also considers broadening professional liability a "matter for legislative rather than judicial reform."[119] *Ultramares*, however, has been criticized for overprotecting the tortfeasor at the expense of the injured.[120]

N.E.2d 91, 95-96, 541 N.Y.S.2d 335, 339 (1989) (consulting engineer's "direct contact" with third-party school district alerted it to school's reliance). Such "conduct" has included a third-party school's authorization to retain defendant sub-contractors, who billed the school directly, *see id.* at 425-26, 539 N.E.2d at 94-95, 541 N.Y.S.2d at 339; and investment bankers rendering fairness opinions that they knew the directors would include in the proxy statement to the shareholders, *see* Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988). In finding that no such conduct existed, the *Credit Alliance* court emphasized that the accountant had neither dealt directly with the plaintiffs, agreed with its client to prepare an audit for the plaintiffs' use, nor provided plaintiffs with a copy of the audit. *See* Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 553-54, 483 N.E.2d 110, 119, 493 N.Y.S.2d 435, 444-45 (1985); *see also Colonial Bank*, 551 So. 2d at 396 (conduct insufficient to alert accountant of third-party bank's reliance, even though accountant gave multiple copies to client and contacted bank as part of standard audit procedures).

For a discussion of the Restatement approach, see *infra* notes 130-35, 164-78 and accompanying text.

117. *See Ultramares*, 255 N.Y. at 179-80, 189, 174 N.E. at 444, 448.

118. *See* Siliciano, *supra* note 78, at 1951-59. *But cf.* Note, *Fairness Opinions*, *supra* note 1, at 127-30 (arguing that existing market and legal controls fail to protect shareholders who rely on negligently rendered fairness opinions).

119. Ossining Union Free School Dist. v. Anderson LaRocca Anderson, 73 N.Y.2d 417, 425, 539 N.E.2d 91, 95, 541 N.Y.S.2d 335, 339 (1989).

120. *See, e.g.*, Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91 (D.R.I. 1968) ("Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional malpractice?"); H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 351-52, 461 A.2d 138, 152-53 (1983) (same) (quoting *Rusch Factors*); Wiener, *Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation*, 20 San Diego L. Rev. 233, 252 & n.95 (1983) (because no undue burden will result from the extension of liability, innocent third parties should not be required to bear disastrous amounts of financial loss) (citing Lucas v. Hamm, 56 Cal. 2d 583, 589, 364 P.2d 685, 688, 15 Cal. Rptr. 821, 824 (1961), *cert. denied*, 368 U.S. 987 (1962)). *But see* Siliciano, *supra* note 78, at 1955-58 (*Ultramares* provides sufficient protection for third party injured by accountant's negligence).

2. The Reasonably Foreseeable Approach

A second view, the reasonably foreseeable approach, is the least restrictive and most recent of the three major standards. First imposed by the Supreme Court of New Jersey,[121] this approach extends a professional's duty to third parties whose reliance on the professional's representation was foreseeable, notwithstanding the professional's lack of actual knowledge of the third parties' reliance.[122] This view rejects the protection that *Ultramares* gave professionals in negligent misrepresentation[123] and suggests that, as long as there is foreseeable harm, all tortfeasors should be responsible for their acts regardless of privity.[124]

The policies underlying the reasonably foreseeable rule focus less on the defendant and more on the interests of the plaintiff and society in recovery by (1) compensating the injured; (2) deterring negligent conduct by forcing the professional to bear the burden of resulting financial losses; and (3) holding professionals to the same scope of duty as other potential tortfeasors.[125] Those advocating the reasonably foreseeable approach suggest that professionals can insure themselves to protect against the overwhelming liability that a class of foreseeable plaintiffs might create.[126] In the context of investment banking, the expansion of liability to

121. In 1983, the New Jersey Supreme Court first adopted the reasonably foreseeable approach in H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 352-53, 461 A.2d 138, 153 (1983). New Jersey's highest court was influenced by California appellate judge Howard B. Wiener, *see id.* at 352, 461 A.2d at 153, who published an article that same year recommending the expansion of an accountant's duty of care to all parties whose reliance was reasonably foreseen at the time of the audit. *See* Wiener, *supra* note 120, at 259-60 (1983); Note, H. Rosenblum, Inc. v. Adler: *A Foreseeably Unreasonable Extension of an Auditor's Legal Duty*, 48 Alb. L. Rev. 876, 890-91 (1984) [hereinafter Note, *Foreseeably Unreasonable*].

122. *See, e.g.*, Touche Ross & Co. v. Commercial Union Ins. Co., 514 So. 2d 315, 322-23 (Miss. 1987) (involving reliance on accountant's audit); *Rosenblum*, 93 N.J. at 352, 461 A.2d 138, 153 (1983) (same); Citizens State Bank v. Timm, Schmidt & Co., 113 Wis. 2d 376, 386, 335 N.W.2d 361, 366 (1983) (same); *cf. In re* Worlds of Wonder Sec. Litig., 694 F. Supp. 1427, 1435-36 (N.D. Cal. 1988) (construing California law as adopting reasonably foreseeable approach for independent auditors only).

123. *See Rosenblum*, 93 N.J. at 333, 352-53, 461 A.2d at 142, 153; Wiener, *supra* note 120, at 260; *see also* Spherex, Inc. v. Alexander Grant & Co., 122 N.H. 898, 903-04, 451 A.2d 1308, 1311-12 (1982) (modern accounting profession no longer in need of judicial protection provided by *Ultramares* to a then "fledgling profession"). *But see* Siliciano, *supra* note 78, at 1950 (arguing that Judge Cardozo's reasoning in *Ultramares* cannot be dismissed simply as "outdated protectionism").

124. *See Rosenblum*, 93 N.J. at 341, 461 A.2d at 146-47; *Citizens State*, 113 Wis. 2d at 386, 335 N.W.2d at 366.

125. *See Rosenblum*, 93 N.J. at 352-53, 461 A.2d at 153; Wiener, *supra* note 120, at 260; *supra* notes 82-83 and accompanying text.

126. *See, e.g.*, H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 349 & n.11, 461 A.2d 138, 151 & n.11 (1983) (reasonably foreseeable approach does not threaten accountant industry because accountants can protect themselves from indeterminate liability by buying insurance).

In the investment banking context, reliance on insurance is unnecessary as investment bankers often have indemnification clauses in their engagement letters. *See infra* notes 175-76 and accompanying text.

all foreseeable parties might enhance the independence of the investment banker's fairness opinion by making an investment banker more concerned about rendering an accurate fairness opinion than securing shareholder support for its clients.[127] The reasonably foreseeable approach, however, has been criticized for analogizing professional liability to product liability[128] and for failing to distinguish between the negligent professional and the deceitful professional.[129]

3. The Second Restatement's Actually Foreseen Approach

The Second Restatement's actually foreseen approach, the majority view,[130] extends a professional's duty to "a person or one of a limited group of persons" whose reliance on the representation the professional could actually foresee.[131] Unlike the reasonably foreseeable approach, the Restatement approach limits a professional's scope of duty for negligent misrepresentations to those whose reliance was foreseen—not merely foreseeable—and retains a broader duty for reckless and intentionally fraudulent misrepresentations.[132]

The Restatement's actually foreseen approach achieves a compromise between the policies of *Ultramares* and the reasonably foreseeable approach. This approach balances "the need to hold accountants to a standard that accounts for their contemporary role in the financial world with the need to protect them from liability that unreasonably exceeds the bounds of their real undertaking."[133] It compensates the injured

127. *See* Note, *Fairness Opinions*, *supra* note 1, at 135; Note, *Standard of Care*, *supra* note 69, at 112; Stuntebeck & Withrow, *supra* note 61, at 23, cols. 2-3. For a discussion of why an investment banker's fairness opinion might be unreliable, see *supra* notes 43-57 and accompanying text.

128. *See* Gormley, *supra* note 108, at 552-54; *see also* Note, *Foreseeably Unreasonable*, *supra* note 121, at 904-09 (noting that not all courts allow for economic recovery under products liability and that misrepresentations of manufacturers differ greatly from those of auditors).

129. *See infra* note 132 and accompanying text.

130. *See* First Nat'l Bank v. Crawford, 386 S.E.2d 310, 312 (W. Va. 1989). The Restatement approach was first adopted in Rusch Factors, Inc. v. Levin, 284 F. Supp. 85, 91-93 (D.R.I. 1968). Many courts have since adopted this approach. *See, e.g.*, *In re* Hawaii Corp., 567 F. Supp. 609, 617-18 (D. Haw. 1983) (applying Hawaii law to accountants); Ingram Indus. v. Nowicki, 527 F. Supp. 683, 684 (E.D. Ky. 1981) (applying Kentucky law to accountants); Robert & Co v. Rhodes-Haverty Partnership, 250 Ga. 680, 680-82, 300 S.E.2d 503, 503-04 (1983) (applying Georgia law to engineers); Spherex, Inc. v. Alexander Grant & Co., 122 N.H. 898, 903-04, 451 A.2d 1308, 1311-12 (1982) (applying New Hampshire law to accountants); Raritan River Steel Co. v. Cherry, Bekaert & Holland, 322 N.C. 200, 214, 367 S.E.2d 609, 617 (1988) (applying North Carolina law to accountant).

131. *See* Restatement (Second) of Torts § 552(2)(a) (1965). *Ultramares* also distinguishes negligent from fraudulent misrepresentations by not limiting professional liability for gross negligence. *See* Ultramares Corp. v. Touche, Niven & Co., 255 N.Y. 170, 188-89, 174 N.E. 441, 448 (1931).

132. *See* Restatement (Second) of Torts § 552 comment a (1965); Gormley, *supra* note 108, at 570.

133. *Raritan River Steel*, 322 N.C. at 215, 367 S.E.2d at 617.

while limiting the number of parties that may rely upon a professional's representations and to which it could potentially be held liable. Nevertheless, although the Restatement approach has the "potential for an optimal balance,"[134] it too has flaws. For example, by requiring the professional to know of the third parties at the time of the representation, but not at the time the client engages the professional, the Restatement approach may subject the professional to liability disproportionate to the risk that it assumes at fee negotiations.[135] On the other hand, the *Ultramares* approach limits the possibility of disproportionate harm by requiring either privity or preexisting conduct between the parties.[136]

B. *The Investment Banker Cases*

Few courts have addressed third-party negligent misrepresentation claims against investment bankers who negligently performed fairness opinions.[137] Three of these courts agreed that an investment banker owed a duty to third-party shareholders when it negligently rendered a fairness opinion upon which shareholders relied, but differed on the scope of that duty.[138]

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134. Bagby & Ruhnka, *supra* note 15, at 190.

135. *See id.* at 190. The authors note that this might be avoided by creating "an exception from liability for uses or users not reasonably identified at the time of the engagement contract." *Id.* at 190-91

136. For a discussion of these two interpretations of the *Ultramares* approach, see *supra* notes 108-16 and accompanying text. For a discussion of the various interpretations of what conduct *Ultramares* requires, see *supra* notes 115-16 and accompanying text.

137. *See* Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1258-59 (D. Del. 1991); Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1124-25 (D.R.I. 1990); Klein v. King, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,602, 95,615 (N.D. Cal. Mar. 26, 1990); Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988).

Two other cases are worth noting. In 1987, the Third Circuit permitted shareholders to recover against an investment banker for a showing of negligence in a federal securities action under Section 14(a) of the Securities Exchange Act of 1934. *See* Herskowitz v. Nutri/Sys., Inc., 857 F.2d 179, 190 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054 (1989). The investment banker had erroneously concluded in its fairness opinion that Nutri/System's income would continue to be taxed for the next five years at the then-existing corporate tax rate of 46%, despite the near certainty that Congress would soon adopt the tax reform legislation before it at the time. *See id.* at 183-84. Following precedent that scienter was not required in actions against management under Section 14(a), Chief Judge Gibbons reasoned

> since an investment banker rendering a fairness opinion in connection with a leveraged buyout knows full well that it will be used to solicit shareholder approval, and is well paid for the service it performs, we see no convincing reason for not holding it to the same standard of liability as the management it is assisting.

Id. at 190.

The other case worth highlighting is Schneider v. Lazard Freres & Co., 159 A.D.2d 291, 296-97, 552 N.Y.S.2d 571, 575 (1st Dep't 1990). For a discussion of *Schneider*, see *infra* note 162 and accompanying text.

138. *See Dowling*, 735 F. Supp. at 1124-25; *Klein*, [1990 Transfer Binder] Fed. Sec. L.

In *Dowling v. Narragansett Capital Corp.*,[139] a federal district court in Rhode Island relied on the Restatement to find that investment bankers owed a duty to shareholders they actually anticipated would rely on their fairness opinion.[140] The court reasoned that the *Ultramares* policy concern with exposing professionals to indeterminable liability was not at issue in the investment banker-shareholder context, because the plaintiffs in this case belonged to a limited class whose reliance was actually foreseen.[141]

In *Wells v. Shearson Lehman/American Express, Inc.*,[142] a New York court applied the *Ultramares* approach and inferred that the shareholder-investment banker relationship, which arose from a special committee's retention of two investment bankers to advise the shareholders, approached one of privity.[143] Not surprisingly, the court offered no policy to justify its extension of the *Ultramares* approach to investment bankers:[144] the New York Court of Appeals had previously applied its *Ultramares* approach to engineers,[145] stating that *Ultramares* might apply to professionals other than accountants.[146]

Rep. (CCH) ¶ 95,002, at 95,602, 95,615; *Wells*, 127 A.D.2d at 202-03, 514 N.Y.S.2d at 2. The fourth case, *Brug*, 755 F. Supp. at 1258-59, did not state that an investment banker would never owe a duty in negligent misrepresentation to third-party shareholders. Recognizing that Delaware courts have followed the Restatement standard to determine the extent of liability for negligent misrepresentation by professionals, the federal court in Delaware applied the Restatement standard to the shareholder-plaintiffs' claim of negligent misrepresentation. It dismissed the shareholder-plaintiffs' cause of action, however, because it held that they were not part of the "limited group" for whose benefit the information in the public statements was intended:

> the only documents which plaintiffs identify as containing the alleged misrepresentations are ones that were released to the public at large. If any member of the public who might choose to invest in [the issuer's] common stock were to qualify as part of a protected class, then the "limited group" requirement [of the Restatement approach] would be meaningless.

Id. at 1259.

139. 735 F. Supp. 1105 (D.R.I. 1990).

140. *See Dowling*, 735 F. Supp. at 1125. The investment banker's assessment of the proposed purchase price "was patently intended to guide shareholders in deciding whether to approve the sale." *Id.*

141. *See id.* The court concluded that the investment banker's duty to exercise reasonable care was extended to its client's shareholders because the banker's "assessment was patently intended to guide shareholders in deciding whether to approve the sale." *Id.*

142. 127 A.D.2d 200, 514 N.Y.S.2d 1 (1st Dep't 1987), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988).

143. *See id.* at 202-03, 514 N.Y.S.2d at 2. The *Wells* court reasoned that the duty the investment bankers owed to their client, a special committee formed to determine the deal's fairness for the shareholders, could be extended to the company's shareholders. *See id.* at 202-03, 514 N.Y.S.2d at 2. The court also noted that the investment bankers must have been aware that their opinion would be used to help shareholders decide on the fairness of the merger offer. *See id.* at 202-03, 514 N.Y.S.2d at 2 (citing Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 551, 483 N.E.2d 110, 118, 493 N.Y.S.2d 435, 443 (1985)).

144. *See id.* at 202-03, 514 N.Y.S.2d at 2.

145. *See* Ossining Union Free School Dist. v. Anderson LaRocca Anderson, 73 N.Y.2d 417, 424, 539 N.E.2d 91, 94-95, 541 N.Y.S.2d 335, 338-39 (1989).

146. *See id.* at 424, 539 N.E.2d at 94-95, 541 N.Y.S.2d at 338-39.

Finally, in *Klein v. King*,[147] a federal district court in California considered both the reasonably foreseeable standard and a policy-balancing test[148] in the evaluation of a shareholder claim of negligent misrepresentation by an investment banker. The shareholders asserted that the investment banker played a substantial role in the business of the corporation and in the publication of the proxy statement.[149] In holding that the investment banker owed a duty to the shareholders under their negligent misrepresentation claim, however, the court did not explicitly adopt either formula.[150]

Dowling, Wells and *Klein* offer little guidance on the appropriate scope of the investment banker's duty to third-party shareholders. These courts merely announce which approach they have chosen without discussing the underlying concerns.

C. *The Appropriate Scope of Duty for Investment Bankers: The Restatement's Actually Foreseen Approach*

Despite the paucity of cases involving shareholders' negligent misrepresentation claims against investment bankers, numerous cases exist that involve negligent misrepresentation actions against other professionals, including accountants, lawyers and engineers.[151] Based on these decisions and the role of the investment banker in corporate control transactions, the appropriate scope of the investment banker's duty in negligence actions brought by third-party shareholders is the Restatement's actually foreseen approach.[152]

The *Ultramares* view imposes unnecessary restrictions on the liability of the investment banker by responding to policy concerns that are less relevant in the investment banker-fairness opinion context than in the accountant-audit context. For instance, third-party shareholder claims theoretically pose less of a threat of indeterminable liability to investment

147. [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,599 (N.D. Cal. Mar. 26, 1990).

148. *See id.* at 95,615. For a discussion of this balancing test, see *supra* note 102.

149. *See id.* at 95,610-11. In *Klein*, a federal court in California refused to dismiss a shareholders' negligent misrepresentation claim against a financial services firm that prepared a fairness opinion attached to the proxy statement in a merger. *See id.* at 95,610, 95,615. The shareholders claimed that the investment banker culpably participated in the dissemination of false information that depicted the potential success of the merger as being overly favorable. *See id.* at 95,602. The court held that all defendants, including the investment banker who participated in preparing the proxy statement, owed a duty to shareholders who relied on the statement. *See id.* at 95,615.

150. On the defendants' motion to dismiss the third-party shareholders' claim of negligent misrepresentation, the court concluded: "Based on the plaintiffs' allegations that all defendants, including [the investment bankers], culpably participated in the preparation of the allegedly false and misleading proxy statement, the Court holds that the defendants owed a duty to all plaintiffs who relied on the statement." *Id.* at 95,615. Whether the court adopted the reasonably foreseeable standard or the balancing test, *see generally supra* note 102 (discussing the balancing test), is unclear from this conclusion.

151. *See supra* notes 103-04 and accompanying text.

152. *See* Restatement (Second) of Torts § 552 (1965).

bankers than do similar claims against accountants. The shareholders compose the class of potential plaintiffs, as they are the group for whose benefit the information was intended.[153] This class is limited and foreseen:[154] even the largest corporation has a finite number of shareholders that the investment banker can identify in advance;[155] further, the investment banker's engagement letter, which its lawyers help craft, mentions whether the investment banker's opinion will appear in communications to shareholders.[156] Although an accountant might know who initially receives its audit, it is more prone to indeterminable liability because an audit has more uses than an investment banker's fairness opinion.[157] Although knowledge of the number of shares is insufficient in and of itself to determine the extent of an investment banker's potential liability,[158] it is one piece of the potential liability puzzle that investment bankers have and accountants lack.

Furthermore, it may be unjust to grant an investment banker the protection that *Ultramares* offered accountants. An accountant's fee is negligible in relation to what a corporation pays an investment banker for its opinion.[159] *Ultramares*'s reliance on private ordering to encourage the

153. *See* Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1258-59 (D. Del. 1991).

154. *See* Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1124-25 (D.R.I. 1990); Note, *Standard of Care*, *supra* note 69, at 114 n.96; *cf.* First Nat'l Bank v. Crawford, 386 S.E.2d 310, 313 (W. Va. 1989) (imposing standard of care only to known users not a "commercially unreasonable rule").

Of course, if the investment banker disseminated information to the public at large, a shareholder could not claim to be part of a limited class for whose benefit the information in the public statements was intended. *See* Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1259 (D. Del. 1991); *supra* note 138.

155. For the huge corporations whose shareholders might number well into the thousands, calling a shareholder class "limited" might seem specious. Nevertheless, even with the largest corporation, an investment banker can technically determine the number of shares that are publicly held and thus the amount of risk assumed. It can then bring its estimate to the fee negotiations. *Cf.* Bagby & Ruhnka, *supra* note 15, at 192-93 (discussing how accounting firms may better control liability when dealing with a known number of recipients). Accountants, however, cannot define their potential liability as easily because an audit has many users, including "government agencies, investors, creditors, unions and other interested parties." Practicing Law Institute, Accountants' Liability 78 (1981); *see also* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 345, 461 A.2d 138, 149 (1983) (discussing numerous uses of audit).

156. Investment bankers normally attempt to limit expressly the persons to whom they owe duties. *See Drafting Indemnification Agreements*, *supra* note 42, at 13.

157. For example, audits help to inform management of potential business problems, to satisfy SEC requirements, to garner funds from banks and other lending institutions, and to acquire credit from suppliers of goods and services. *See Rosenblum*, 93 N.J. at 345, 461 A.2d at 149.

158. Determining the number of shares that an investment banker may be liable for serves little purpose unless an investment banker can also project the price that a judge will later decide falls within a range of fair prices.

159. For a discussion of an investment banker's fees, see *supra* note 48 and accompanying text. Arguably, an investment banker may deserve greater protection than an accountant because its fairness opinion involves numerous presumptions and projections often made under tremendous time pressures. *See supra* notes 33-39 and accompanying text for a discussion of the variables involved in the valuation process. Conversely, an

professional to apply its expertise more carefully is less tenable in the context of investment banking than of accounting, because investment bankers lack the industry standards for performing fairness opinions that accountants have for making audits.[160] Moreover, the resilience of professions such as accounting for almost three decades under the Restatement standard also disproves *Ultramares*'s fear of unlimited liability.[161]

One indication that the *Ultramares* approach may be too restrictive in the investment banking context is a New York court's artful evasion of *Ultramares*'s near-privity requirement to find a duty between an investment banker and shareholders.[162] The Restatement approach, by contrast, allows courts to avoid altering basic corporate law when the "approaching privity" standard of the *Ultramares* approach[163] is not met.[164]

The Restatement approach also satisfies the most fundamental concerns of those advocating the reasonably foreseeable approach: it compensates injured shareholders who form a limited and foreseen class[165] and deters investment bankers from acting negligently. Adopting the reasonably foreseeable approach instead of the Restatement approach

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accountant's audit entails more certain, mathematical calculations. Most investment bankers, however, are so familiar with the routine of valuation that they can perform fairness opinions perfunctorily. *See supra* note 46 and accompanying text.

160. *See* Steinberg & Lindahl, *supra* note 7, at 85.

Courts have also allowed recovery for negligent misrepresentation despite the *Ultramares* concern for limiting recovery for pecuniary loss. *See supra* note 97 and accompanying text.

161. *See* Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1125 (D.R.I. 1990).

162. *See* Schneider v. Lazard Freres & Co., 159 A.D.2d 291, 296-97, 552 N.Y.S.2d 571, 574-75 (1st Dep't 1990). In holding an investment banker liable to the shareholders, this New York appellate court redefined the relationship between a special committee of directors and shareholders as one of agency. *See id.* at 296, 552 N.Y.S.2d at 574-75. The court reasoned that the shareholders were in privity with the investment banker because the investment banker was hired by a special committee whose primary function was to obtain the highest price possible for the shareholders' stock. *See id.* at 296, 552 N.Y.S.2d at 574-75. *Schneider*'s reasoning has startled observers. *See supra* note 77. Its finding of privity fundamentally confuses the legal relationship between directors and shareholders. *See* Wachtell, Roth & Houston, *supra* note 77, at 4, col. 2. "It is well-settled law that directors are not agents of the shareholders, or even the corporation." *Id.*; *see* H. Henn & J. Alexander, Laws of Corporations § 207, at 562-63 (3d ed. 1983); *see also* Continental Sec. Co. v. Belmont, 206 N.Y. 7, 16-18, 99 N.E. 138, 141-42 (1912) (discussing relationship between directors and shareholders); Coffee, *supra* note 22, at 6, col. 4 ("[D]irectors are not agents in the classic master/servant sense, but rather their relationship is *sui generis* and involves a level of discretionary authority that most agents do not posses[s].").

163. For a discussion of this standard, see *supra* notes 105-20 and accompanying text.

164. As some commentators have pointed out: "Are the shareholders, as 'principals', to be deemed personally liable for any 'torts' committed by their 'agents' in the conduct of an auction?" Wachtell, Roth & Houston, *supra* note 77, at 4, col. 2; *see also* Coffee, *supra* note 22, at 6, col. 4 (questioning *Schneider*'s interpretation of shareholder-director relationship).

165. For a discussion of limited and foreseen in the shareholder context, see *supra* notes 154-55 and accompanying text.

places undue burdens on bankers when balanced against the risk they assume. Although investment bankers earn high fees,[166] the reasonably foreseeable approach would expose them to liability that is potentially disproportionate to their wrongdoing if liability is extended to a class of third-party shareholders neither limited nor foreseen by the investment bankers.[167] Admittedly, indemnification agreements, which are commonly found in engagement letters, might limit an investment banker's exposure to liability.[168] Nevertheless, corporations may be less willing in the future to indemnify investment bankers if more courts hold that investment bankers owe a duty to third-party shareholders when rendering fairness opinions on which the shareholders rely.

The Restatement approach also avoids some common criticisms of the reasonably foreseeable approach. Unlike the Restatement approach, the reasonably foreseeable approach's extension of liability creates incentives for *unknown* third parties to make fraudulent or exaggerated claims against investment bankers.[169] In addition, the reasonably foreseeable approach unfairly allocates to the investment banker unbargained-for risks, as the investment banker may be liable to any foreseeable plaintiff that reasonably relies on its fairness opinion, regardless of whether the banker intended to render the opinion for that plaintiff's purpose.[170] The Restatement approach affords investment bankers, especially those who are unable to obtain an indemnification agreement from its client, more of an opportunity[171] to avoid unfair risk allocations by providing them with one variable—the number of shares outstanding—that may help them to negotiate a fee that reflects the added exposure to financial risk when management circulates their opinion to the shareholders.[172]

166. For examples of investment banker fee structures, see *supra* note 48.

167. *Cf.* Siliciano, *supra* note 78, at 1944-48 (merely foreseeable test poses these dangers to accountants); Rabin, *Tort Recovery for Negligently Inflicted Economic Loss: A Reassessment*, 37 Stan. L. Rev. 1513, 1537 n.74 (1985) ("The most persuasive basis for maintaining the limited duty [for accountants] is a proportionality argument").

For an example of how the Restatement approach limits the investment banker's liability to the public at large, see Brug v. Enstar Group, Inc., 755 F. Supp. 1247, 1259 (D. Del. 1991), discussed in *supra* note 138.

168. Indemnification agreements may appear in engagement letters or constitute a separate agreement. *See Drafting Indemnification Agreements*, *supra* note 42, at 23. For further discussion of indemnification agreements, see *infra* notes 175-76 and accompanying text.

169. *Cf.* Siliciano, *supra* note 78, at 1947 (merely foreseeable test poses this "moral hazard[]" to accountants).

170. For a discussion of the justifications and criticisms of the reasonably foreseeable approach's extension of the professional's duty to foreseeable plaintiffs, see *supra* notes 125-29 and accompanying text.

171. This opportunity may be severely limited, however, by the inherent unpredictability of a court holding that retrospectively determines what would have been a fair price, especially given that a court may be deciding this issue years after the actual transaction.

172. *Cf.* Bagby & Ruhnka, *supra* note 15, at 192 (discussing the ability of accountants to negotiate for a fee with knowledge of all intended uses of the audit). The Restatement approach offers the investment banker a better opportunity to measure its potential liability at the time of fee negotiations, because the number of outstanding shares is known.

For further protection from liability disproportionate to their undertaking, investment bankers may attempt to limit those that may reasonably rely on the fairness opinions via express clauses within their engagement letter and, subsequently, their opinions.[173] Express disclaimers may help prove that investment bankers justifiably did not foresee the shareholders' reliance.[174] The investment banker may also negotiate to limit its liability through the use of indemnification provisions and procedural clauses, such as jury waiver or forum selection clauses. All of these devices are common to most investment-banker engagement letters[175] and should be disclosed in the fairness opinion to counter shareholders' claims of reliance most effectively.[176]

Finally, the Restatement approach does not shield investment bankers absolutely; it exposes investment bankers to enough liability to create incentives for them to act as quasi-investigative agents in management

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Few companies perform public offerings—a common method of increasing a corporation's capital—in the midst of a corporate control transaction. If such an offering were to occur, courts could "create, or investment bankers could contract for, an exception for uses . . . not reasonably identified at the time of the engagement contract." Bagby & Ruhnka, *supra* note 15, at 190-91. In this way, an increase in the corporation's capital after fee negotiations would not cause the investment banker undue hardship.

173. For discussions and examples of such disclaimers, see Rosenbloom & Aufses, *supra* note 1, at 10-13; *Drafting Indemnification Agreements*, *supra* note 42, at 15-20.

174. *Cf.* Hoffman v. Greenberg, 159 Ariz. 377, 380, 767 P.2d 725, 728 (Ct. App. 1988) (disclaimer strengthened accountant's contention that it did not actually foresee a third party's reliance, as disclaimer suggested that audit would be used to help client in decision-making process).

A disclaimer within an engagement letter, however, would not automatically protect the investment banker from tort liability to third-party shareholders who relied on a negligently prepared fairness opinion. Tort obligations normally cannot be disclaimed because they are based on policy considerations independent of the parties' manifest intent. *See* Prosser and Keeton, *supra* note 80, § 92, at 656. It follows that competing policy considerations, such as those balanced in the Restatement approach, *see supra* notes 133 & 154-170 and accompanying text, may warrant exceptions to this general bar on disclaiming tort liability. *Cf.* H. Rosenblum, Inc. v. Adler, 93 N.J. 324, 351, 461 A.2d 138, 152 (1983) (in some circumstances, auditor could expressly limit number of persons who could rely on audit); Prosser and Keeton, *supra* note 80, § 92, at 656 (extent to which tort obligations may be impaired by contract depends largely "on the relationship between the parties, the nature of the bargaining transaction, and the type of loss for which liability is disclaimed").

The most effective disclaimer would appear in the fairness opinion and would limit the investment banker's undertaking, not the opinion's dependability, because general disclaimers of reliability are insufficient. *See* First Nat'l Bank v. Crawford, 386 S.E.2d 310, 314-15 (W. Va. 1989); Ryan v. Kanne, 170 N.W.2d 395, 404 (Iowa 1969). If the investment banker sets forth its methods of valuation in its engagement letter and, subsequently, in its fairness opinion, it might limit the basis upon which injured parties could sue it for misfeasance. *See infra* notes 190-93 and accompanying text; *cf. Ryan*, 170 N.W.2d at 404 (concerning accountants).

175. *See* Coffee, *supra* note 22, at 6, cols. 5-6; Brodsky, *supra* note 77, at 4, cols. 5-6; Wachtell, Roth & Houston, *supra* note 77, at 4, col. 2. For a discussion and sample of an investment banker's indemnification agreement, see Rosenbloom & Aufses, *supra* note 1, at 12-13.

176. Courts, however, have historically hesitated before enforcing a party's attempt to limit its liability to third parties. For a discussion of disclaimers, see *supra* note 174.

buyouts that may involve fraud.[177] Thus, investment bankers protect both themselves and shareholders by deterring opportunistic directors and managers from acting inconsistently with the shareholders' interests.[178] Furthermore, courts could prevent an investment banker from merely disclaiming any knowledge of the shareholders' reliance. If the facts suggest that the investment banker should have known of the shareholders' reliance, then courts should hold that the investment banker did foresee this reliance.[179]

In summary, the Restatement approach compensates injured shareholders, deters investment bankers from rendering inaccurate fairness opinions, and protects investment bankers from liability potentially disproportionate to the risk they assumed. It reconciles two conflicting concerns: overprotecting the investment banker at the expense of the shareholder, and underprotecting the investment banker who must render an opinion based on numerous variables and projections.

III. Clarifying the Standard of Care

A. *The Need for a Clear Standard of Care*

Having delineated a duty between investment bankers and shareholders who have relied on the bankers' fairness opinions, courts must clarify the standard of care that the duty mandates. Although third-party shareholders may bring causes of action against negligent investment bankers, shareholders may still lose on the merits. "As a practical matter, it may be difficult for [them] to prove that [the] investment bankers were acting negligently."[180] Generally, a person "who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities."[181] Applying this standard to investment bankers rendering fairness opinions poses problems. The lack of industry guidelines governing the conduct of investment bankers,[182] the numerous variables and financial considerations from which an investment banker may choose when preparing a fairness opinion,[183] and the tremendous time pressures often associated with corporate control transactions make the rendering of a fairness opinion highly discretionary. With this discretion, investment bankers can determine that a widely differing array of bids fall within a range of fair prices,

177. For a discussion of how expanded liability will compel investment bankers to conduct more objective analyses, see *supra* note 127 and accompanying text.

178. *See* Oesterle & Norberg, *supra* note 43, at 250.

179. *See, e.g.*, Wells v. Shearson Lehman/Am. Express, Inc., 127 A.D.2d 200, 202-03, 514 N.Y.S.2d 1, 2 (1st Dep't 1987) (investment bankers must have been aware of the shareholders' reliance), *rev'd on other grounds*, 72 N.Y.2d 11, 24-25, 526 N.E.2d 8, 15-16, 530 N.Y.S.2d 517, 524-25 (1988).

180. Brodsky, *supra* note 77, at 3, col. 1.

181. Restatement (Second) of Torts § 299A (1965).

182. *See* Steinberg & Lindahl, *supra* note 7, at 85.

183. *See supra* notes 33-39 and accompanying text.

"all of which would be reasonable and none of which could be shown to be 'wrong' (or unfair) under objective criteria."[184]

In light of this situation, courts must clarify what a reasonable investment banker would do when rendering a fairness opinion. Delineation of the standard of care would benefit (1) shareholders, because they could identify viable claims and thus avoid fruitless legal costs; (2) investment bankers, because they would know better how to avoid liability; and (3) courts, because clarification would conserve judicial resources by allowing more widespread use of dismissal and summary judgment mechanisms.

B. *Past Attempts at Clarification*

Despite the lack of industry guidelines, few courts have attempted to specify when an investment banker is acting negligently in rendering a fairness opinion.[185] Because the courts that have addressed investment

184. Bebchuk & Kahan, *supra* note 7, at 29; *see* Oesterle & Norberg, *supra* note 43, at 252 n.155; *see, e.g.*, Joseph v. Shell Oil Co., 482 A.2d 335, 339 (Del. Ch. 1984) (estimates ranging from $53 to $85 per share); Kaplan v. Goldsamt, 380 A.2d 556, 566-67 (Del. Ch. 1977) (estimates ranging from $7.25 to $9.50 per share).

185. Curiously, few commentators have tried to fill this judicial void, as most commentators have generally called for increased disclosure. *See, e.g.*, Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich. L. Rev. 1, 107 (1986) (reformers have sought to increase protection of shareholders via several means, including increased disclosure); Oesterle & Norberg, *supra* note 43, at 251-52 (calling for fairness opinions that include price evaluation, detailed explanation of data and assumptions underlying estimate, and methodology used); Stuntebeck & Withrow, *supra* note 61, at 23, cols. 3-4 (bankers must "include a more thorough analysis of the relative weight given to the factors considered in rendering the [fairness] opinion").

Those commentators that have proposed more specific measures have been helpful. In particular, Martin Lipton and Erica Steinberger assert that certain general procedures should be followed:

> (1) The opinion should describe the matters considered, those statements relied upon without investigation, those statements or matters that have been independently verified, and the inherent limitations, if any, of any procedures or standards that have been used.
>
> (2) The opinion should describe the fee being paid, all relations with the client, and any conflicts of interest. If the investment banker participated in the negotiation of the transaction this should be noted in the opinion.
>
> (3) The opinion should be updated to the latest possible date (although, when an opinion is included in a proxy statement, it should be dated approximately the date of such statement; it is not necessary to update it to the actual transaction date, absent a material change in circumstances), and if that date is prior to the date of the transaction the opinion should set forth that it is as of a specific date and does not reflect matters thereafter.
>
> (4) Counsel for the investment banker should assist in the due diligence review and advise as to the kind of backup material which should be prepared.
>
> (5) Independent verification of the key issues should be made.
>
> (6) Where a key issue is legal, the opinion should state that the investment banker has consulted and relied on counsel with respect to such issue.
>
> (7) Where the opinion is to be used in a conflict transaction, the investment

banker liability for negligence misrepresentation to third-party shareholders have yet to reach the merits of these cases,[186] the appropriate standard of care required of investment bankers awaits judicial definition. In addition, in cases not involving negligent misrepresentation, courts that have addressed the standard of care that the banker's duty imposes have been unhelpful. They fail to specify what facts and assumptions the investment banker must consider before rendering an opinion, and what analytical methods it must use when making an opinion. Furthermore, it is unclear what information the investment banker must disclose to avoid negligent misrepresentation liability. For instance, in 1983, the Supreme Court of Delaware declared that, when determining fair value, directors may rely on investment banker opinions that consider all relevant facts except those that are purely speculative.[187] This court, however, never specified what factors were relevant.[188] Similarly, in a 1988 federal securities case involving the possible negligence of investment bankers, the Third Circuit adopted a general, objective test of liability: whether the investment banker's assumptions were "objectively unreasonable in the circumstances."[189] Like the Delaware court, however, the Third Circuit

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> banker should be satisfied as to all the procedures to be used by the client, such as committee of independent directors, vote of minority shareholders, use of appraisers and other experts.
>
> (8) The investment banker generally should not accept compensation which is contingent upon consummation of the transaction or any other arrangement that would impeach its independence in rendering a fairness opinion. The provisions of the customary investment banker-target agreement providing for contingent compensation in the event of improved or White Knight offers do not constitute a contingency impeaching independence, and the customary two-part fee with the second part being paid only if the opinion is used in a disclosure document also does not impeach independence.

M. Lipton & E. Steinberger, *supra* note 10, § 8.06[6], at 8-30 to -31 (footnotes omitted).

Professors Bebchuk and Kahan discourage courts from

> specify[ing] in advance what assumptions bankers should make and what valuation techniques they should use. Rather, courts should weigh an opinion depending on whether it states a range of fair prices and on the extent to which its conclusion is sensitive to its assumptions. Thereby, fairness opinions will convey more information and investment banks will have less discretion.

Bebchuk & Kahan, *supra* note 7, at 47 (footnotes omitted).

Professor Oesterle and Mr. Norberg have suggested that whenever advisors render opinions with an indemnification agreement, specific and conspicuous disclosure should be made to shareholders. *See* Oesterle & Norberg, *supra* note 43, at 254. They also suggest that any indemnification provision should be approved by a shareholders' vote or by a special negotiating committee. *See id.*

Another commentator has suggested that bankers should be liable if they fail to use more than one of the accepted methodologies for determining fairness. *See* Note, *Fairness Opinions*, *supra* note 1, at 139.

186. *See supra* note 18 and accompanying text.

187. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

188. *See id.*

189. Herskowitz v. Nutri/Sys., Inc., 857 F.2d 179, 185 (3d Cir. 1988), *cert. denied*, 489 U.S. 1054 (1989). For further discussion of *Herskowitz*, see *supra* note 137.

provided no specific guidance on what would be objectively reasonable under the circumstances.

Because no court has set specific guidelines for rendering fairness opinions, courts might consider borrowing an approach employed by courts reviewing uncertified audits. In these cases, some courts have recognized that an accountant may affect the parameters of its potential liability by limiting its undertaking in the engagement contract.[190] The accountant, then, would be liable only for any negligently performed task outlined in the contract. It would not be liable for failing to perform an additional procedure not referred to in the contract.[191] Like an accountant performing an uncertified audit, an investment banker lacks official industry guidelines for rendering a fairness opinion.[192] It follows that an investment banker might be able to limit the parameters of its potential liability by describing its intended methods of valuation within its engagement letter and, subsequently, within its fairness opinion. Unfortunately, this approach also has its flaws[193] and is an inadequate alternative to clearer judicial guidelines for the rendering of fairness opinions.

C. *The Duties of an Investment Banker When Rendering a Fairness Opinion*

As an interim substitute to industry and judicial guidelines that specify what investment bankers must investigate, consider and disclose when rendering fairness opinions, courts and practitioners may seek guidance from cases concerning directors' fiduciary and statutory duties of disclosure. Because investment bankers lack the directors' fiduciary duty to shareholders, they should not be held to every requirement that courts have placed upon directors. Nevertheless, these cases best set forth judicial expectations of dealing fairly with shareholders. The cases researched include instances where courts held fairness opinions to be sufficiently detailed to warrant directors' reliance. From these cases, a three-pronged standard of care can be construed for investment bankers who render fairness opinions upon which third-party shareholders rely: (1) a duty to investigate; (2) a duty to perform a reasonable analysis; and (3) a duty to disclose the bases for the opinion.

190. *See* Ryan v. Kanne, 170 N.W.2d 395, 404 (Iowa 1969); First Nat'l Bank v. Crawford, 386 S.E.2d 310, 314-15 (W. Va. 1989).

191. *See Ryan*, 170 N.W.2d at 404.

192. *See* Steinberg & Lindahl, *supra* note 7, at 85.

193. Theoretically, if the investment banker performs these procedures with reasonable care, it should avoid liability even if other methods not referred to in the contract might have rendered a more accurate valuation. This approach, however, assumes that (1) an investment banker will know at the outset of its investigation exactly what methods it will employ, and that (2) it will carefully choose which methods are most appropriate given the information available. The numerous considerations that are associated with the valuation process may often render these assumptions misleading. Nevertheless, most investment bankers are familiar with the routine of valuation and, arguably, as professionals, should be able to determine what procedures are necessary based on the information provided.

1. Duty To Investigate

Generally, an investment banker must merely disclose whether it investigated the subject corporation independently or whether it relied solely on information supplied by management.[194] Nevertheless, some courts have criticized investment bankers who rendered fairness opinions based on data supplied solely by management.[195] Most courts require only that investment bankers disclose their lack of an independent investigation.[196] As a matter of policy, however, courts should demand an independent investigation of any information that an investment banker may obtain from sources other than management, especially when management has an interest in the deal's outcome and the banker is not subject to severe time or management constraints.

2. Duty To Perform A Reasonable Analysis

Courts have criticized fairness opinions that were made under fee arrangements that were contingent upon the deal's outcome[197] or that were either too conclusory,[198] improvised or cursory.[199] Although courts have

194. *See infra* note 226 and accompanying text.

195. *See* Berkman v. Rust Craft Greeting Cards, Inc., 454 F. Supp. 787, 789, 791-93 (S.D.N.Y. 1978).

196. *See infra* note 226 and accompanying text; *see also* Goldstein v. Bear, Stearns & Co., [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,037, at 90,860 (E.D.N.Y. Aug. 15, 1988) (no cause of action for nondisclosure).

Of course, merely reciting that the investment bankers made no independent analysis of the transaction would not protect them from liability if they knew the directors' information was false or if they recklessly rendered the opinion. *See* Richardson v. White, Weld & Co., [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,864, at 95,545 (S.D.N.Y. May 11, 1979).

197. These courts argue that an investment banker on a contingent fee may no longer be an independent evaluator because it is inclined to skew a fairness opinion in favor of satisfying the directors' interests. *See* Sandberg v. Virginia Bankshares, Inc., 891 F.2d 1112, 1122 (4th Cir. 1989), *rev'd on other grounds*, 111 S. Ct. 2749 (1991); *In re* Appraisal of Shell Oil Co., No. 8080 (Del. Ch. Dec. 11, 1990) (1990 Del. Ch. LEXIS 199, at *88); *cf.* Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 257 (7th Cir. 1986) (describing investment banker as an interested "blocker" of transaction), *rev'd on other grounds*, 481 U.S. 69, 94 (1987); Terrydale Liquidating Trust v. Barness, 642 F. Supp. 917, 923 (S.D.N.Y. 1986) (citing *Dynamics Corp.* for appropriately criticizing hiring investment bankers on contingent fee basis); Anderson v. Boothe, 103 F.R.D. 430, 441-42 (D. Minn. 1984) (refusing to dismiss aiding and abetting claim against investment banker because of contingency fee).

Nevertheless, courts generally seem unconcerned about contingent fee arrangements; judicial opinions often fail to mention that a contingent fee was given. *See, e.g.*, Cottle v. Storer Communication, Inc., 849 F.2d 570, 578 (11th Cir. 1988) (no mention of contingent fee along with other transactional fees); Bebchuk & Kahan, *supra* note 7, at 49 & n.112 (same). Moreover, disclosure of an investment banker's contingent fee may sufficiently notify investors of an investment banker's economic interest in a transaction. *See* Radol v. Thomas, 534 F. Supp. 1302, 1314-15 (S.D. Ohio 1982).

198. *See, e.g.*, Howing Co. v. Nationwide Corp., 826 F.2d 1470, 1478-79 (6th Cir. 1987) (proxy statement's laundry list of fairness factors considered by investment bankers in rendering their fairness opinion insufficient disclosure of transaction's fairness), *cert. denied*, 486 U.S. 1059 (1988); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275-76 (2d Cir. 1986) (directors cannot rely on fairness opinion that merely states

recognized that corporations must often act on deals quickly,[200] no court has allowed directors to use time constraints as an excuse to forego their fiduciary duties to their shareholders of diligently investigating the fairness of a deal.[201] Again, however, given the numerous variables involved in the valuation process, most courts have recognized that the mere disclosure of the time constraints sufficiently puts the shareholders on notice of possible problems.[202]

3. Duty To Disclose The Bases For The Opinion

Disclosure of the bases for an investment banker's fairness opinion is necessary to avoid fairness opinions that are too conclusory[203] and may protect investment bankers from allegations that they misrepresented their conclusions. The general rule of disclosure is that all material (or "germane"[204]) facts must be disclosed.[205] To determine what information a court might find material to rendering a fairness opinion, invest-

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option prices were within range of fair value, particularly when quick appraisal unnecessary). *But see* Citron v. E.I. Du Pont de Nemours & Co., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,420, at 97,134 (Del. Ch. June 29, 1990) (allowing directors to rely on an investment banker's financial advice despite lack of "formal opinion placing specific dollar value or range of values" on corporation's stock); Kaplan v. Goldsamt, 380 A.2d 556, 567-68 (Del. Ch. 1977) (allowing directors to confirm their decision to make transaction with two fairness opinions that lacked formality and detail; proxy statement had merely said that both banking firms had approved offer price).

199. *See, e.g.*, Royal Indus. v. Monogram Indus., [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863, at 91,139 (C.D. Cal. Nov. 29, 1976) (defendants cannot rely on fairness opinion prepared "virtually overnight and without the necessary time and deliberation for a fair evaluation"); EAC Indus. v. Frantz Mfg. Co., No. 8003, slip op. (Del. Ch. June 28, 1985) (LEXIS, States library, Del file, at 9) (director may not rely on "improvised" fairness opinion), *aff'd*, 501 A.2d 401 (Del. 1985).

200. *See, e.g.*, Treadway Cos. v. Care Corp., 638 F.2d 357, 384 n.53 (2d Cir. 1980) (refusing to infer bad faith from board's hasty negotiations without other factual support); Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 155-56 (S.D.N.Y. 1989) (directors' decision to act under imminent deadlines not necessarily breach of fiduciary duty); Citron v. Fairchild Camera and Instrument Corp., [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,915, at 90,103-04 (Del. Ch. May 19, 1988) (time limit imposed by arm's-length adversary one factor suggesting board acted with due care), *aff'd* 569 A.2d 53, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,860, at 94,662 (Del. 1989); *In re* RJR Nabisco, Inc. Shareholders Litig., [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,712-13 (Del. Ch. Jan. 31, 1989) (special committee given 30 minutes to accept proposal not liable for its hasty decision).

In the absence of time constraints, however, hasty decisions suggest that a board may have breached its fiduciary duty to shareholders. *See, e.g.*, *Hanson Trust*, 781 F.2d at 275 (paucity of information and swiftness of decision suggested breach of fiduciary duty).

201. *See, e.g.*, *EAC Indus.*, No. 8003, slip op. (Del. Ch. June 28, 1985) (LEXIS, States library, Del file, at 9) (improvised fairness opinion one factor suggesting that attempted ratification of deal was "mere window dressing"); *cf.* Edelman v. Fruehauf Corp., 798 F.2d 882, 886 (6th Cir. 1986) (business judgment rule does not protect independent directors' rubber stamping of management's buyout proposal); *Hanson Trust*, 781 F.2d at 274-75 (directors must make informed decisions).

202. *See* notes *infra* 217-18 & 225 and accompanying text.

203. *See* cases listed in *supra* note 198.

204. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 890 (Del. 1985) ("'germane' means material"); Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977) (defin-

ment bankers may analogize to cases that have held directors liable for failing to disclose material facts. Examples of material facts that might result in liability if undisclosed include:

a. *Information Contradicting The Price's Fairness*: additional information that suggested a price given may have inadequately reflected present market value, such as the value of the company's holdings;[206] the magnitude of a corporation's reserves;[207] a corporation's recent quarterly earnings;[208] the riskiness of the debentures offered;[209] the extraordinary increases in a company's inventory and its short-term debt;[210] an insider's report that higher cash price was a good investment;[211] the management's estimate of value;[212] the majority shareholder's authorization prior to a tender offer of open-market purchases of a target company's shares at a price twenty-five percent higher per share;[213] and the lowest price that the stock had traded in five years, when the directors established the premium at this price;[214]

b. *Information Concerning Other Influential Transactions*: the likelihood of another transaction that would have a financial impact on the subject deal, such as when the directors had information on the status of an impending merger that was likely to affect the company, and when the board claimed that it reviewed the prospective financial conditions of the

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ing germane as information that "a reasonable shareholder would consider important in deciding whether to sell or retain stock").

205. *See, e.g.*, Alpert v. 28 Williams Street Corp., 63 N.Y.2d 557, 571, 473 N.E.2d 19, 27, 483 N.Y.S.2d 667, 675 (1984) (requiring "complete and candid disclosure of all material facts" known to majority shareholder or board members, "including their dual roles and events leading up to merger proposal"); Weinberger v. UOP, Inc., 457 A.2d 701, 711-12 (Del. 1983) (requiring that outside directors and minority shareholders receive "material" information); *Lynch*, 383 A.2d at 281 (rejecting as insufficient lower court's finding that only disclosure of adequate—not material—facts was necessary).

For a discussion of the Supreme Court's definition of when an omitted fact is material in federal securities cases and its adoption by state courts, see *supra* note 88 and accompanying text. Note that federal securities disclosure requirements vary in strictness depending on type of transactions involved. For example, the disclosure requirements for a proxy statement in a freeze-out merger are more extensive than in other types of deals. *See* Radol v. Thomas, 772 F.2d 244, 254-55 (6th Cir. 1985), *cert. denied*, 477 U.S. 903 (1986).

206. *See* Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1119 (D.R.I. 1990).

207. *See* Lockspeiser v. Western Md. Co., 768 F.2d 558, 561 (4th Cir. 1985).

208. *See In re* Worlds of Wonder Sec. Litig., 694 F. Supp. 1427, 1430, 1434 (N.D. Cal. 1988).

209. *See id.*

210. *See* Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 827-28 (D. Del. 1974).

211. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 709 (Del. 1983).

212. *See* Joseph v. Shell Oil Co., 482 A.2d 335, 342-43 (Del. Ch. 1984). In *Joseph*, the court also held that the corporation's oil discovery was a material nondisclosure. *See id.* at 343.

213. *See* Lynch v. Vickers Energy Corp., 383 A.2d 278, 281-82 (Del. 1977).

214. *See* Eisenberg v. Chicago Milwaukee Corp., 537 A.2d 1051, 1060, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,544, at 97,446 (Del. Ch. 1987).

subject company;[215]

c. *Details Of An Investment Banker's Investigation*: a reasonably detailed analysis of the investment banker's valuation methods and the weight it attached to each method;[216]

d. *The Cursory Performance Of A Fairness Opinion*: it is necessary to disclose that a fairness opinion was done over a long weekend,[217] but unnecessary to disclose that investment bankers only had a few days to prepare for their briefing to the board on fairness when they had a month to prepare the written opinion;[218]

e. *Conflicts Of Interest*:[219] such conflicts have included directors who recommended a merger to shareholders after they already had been selected to the prospective company's board,[220] and an investment banker who opined on a deal's fairness while purchasing the subject company's debentures;[221]

f. *Prior Business Relationships Between Investment Bankers And Corporations*: these scenarios include an investment banker who rendered a fairness opinion for the target company and was also a long-time director of the purchasing corporation;[222] an investment banker who had been the advisor of a corporation for two years before rendering a fairness opinion on a merger involving that corporation;[223] and an investment banker who had a prior and continuing advisory relationship with the maker of the tender offer;[224]

g. *The Contingent Nature Of Investment Bankers' Fees*: especially when a large portion of the investment banker's fee was contingent upon shareholder approval of the client's interests[225]—i.e., garnering share-

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215. *See* Weinberger v. Rio Grande Indus., 519 A.2d 116, 125 (Del. Ch. 1986).

216. *See* Howing Co. v. Nationwide Corp., 826 F.2d 1470, 1479 (6th Cir. 1987), *cert. denied*, 486 U.S. 1059 (1988).

217. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983); *Eisenberg*, 537 A.2d at 1060, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,544, at 97,446; Joseph v. Shell Oil Co., 482 A.2d 335, 343 (Del. Ch. 1984).

218. *See* Berg v. First Am. Bankshares, Inc., 796 F.2d 489, 501 (D.C. Cir. 1986).

219. *See* Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557, 572, 473 N.E.2d 19, 27, 483 N.Y.S. 667, 676 (1984).

220. *See* Anderson v. Boothe, 103 F.R.D. 430, 438 (D. Minn. 1984).

221. *See* Berkman v. Rust Craft Greeting Cards, Inc., 454 F. Supp. 787, 791 (S.D.N.Y. 1978).

222. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 706 (Del. 1983).

223. *See* Klein v. King, [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,002, at 95,610-11 (N.D. Cal. Mar. 26, 1990); *see also* Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 95 (E.D.N.Y. 1969) (past rendition of services to corporation involved in deal raised doubts about investment banker's impartiality when opining on fairness), *modified*, 478 F.2d 1281 (2d Cir. 1973).

224. *See* Goldstein v. Bear, Stearns & Co., [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,037, at 90,860-61 (E.D.N.Y. Aug. 15, 1988).

225. *See* Wallerstein v. Primerica Corp., 701 F. Supp. 393, 397 (E.D.N.Y. 1988); Anderson v. Boothe, 103 F.R.D. 430, 436 (D. Minn. 1984); Radol v. Thomas, 534 F. Supp. 1302, 1315 (S.D. Ohio 1982); Schreiber v. Pennzoil Co., 419 A.2d 952, 958-59 (Del. Ch. 1980); *see also* Braunschweiger v. American Home Shield Corp., No. 10755 (Del. Ch. Jan. 7, 1991) (1991 Del. Ch. LEXIS 7, at *17) (omission of "facts surrounding compensa-

holder support to achieve or prevent a change in corporate control.

h. *The Lack Of Independent Investigations By Investment Bankers*: especially when information was supplied solely by an interested board of directors;[226] and

i. *Managements' Limitations On The Scope Of The Investment Bankers' Investigations*: directors have limited the scope of information available to an investment banker concerning the value of the company's assets[227] and the type of buyer that an investment banker may seek when shopping the company.[228]

On the other hand, the following information need not be disclosed:

(a) simple mathematical calculations or deductions;[229]

(b) matters of public knowledge,[230] such as information available in periodicals;[231]

(c) unquantifiable benefits of transactions,[232] although courts are split on a general rule for disclosing "soft information";[233]

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tion of investment banker potentially material in a management-buyout transaction when corporation sold without resorting to public auction"). For examples of contingent fees, see *supra* note 48.

226. Courts have held that directors mislead shareholders when they failed to disclose that their investment bankers relied on information supplied solely by the directors. *See* Kohn v. American Metal Climax, Inc., 458 F.2d 255, 268 (3d Cir. 1972), *cert. denied*, 409 U.S. 874 (1972); Denison Mines Ltd. v. Fibreboard Corp., 388 F. Supp. 812, 821-22 (D. Del. 1974); *see also* Weinberger v. UOP, Inc., 426 A.2d 1333, 1352 (Del. Ch. 1981) (noting that failure to disclose such information would have resulted in liability), *rev'd on other grounds*, 457 A.2d 701, 712 (Del. 1983).

227. *See* Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1119 (D.R.I. 1990); *see also* Joseph v. Shell Oil Co., 482 A.2d 335, 341-42 (Del. Ch. 1984) (holding that directors' failure to disclose tender offeror's withholding from investment banker information about oil reserves was both breach of fiduciary duty and failure to make full disclosure).

228. *See Braunschweiger*, No. 10755 (Del. Ch. Jan. 7, 1991) (1991 Del. Ch. LEXIS 7, at *9-14).

229. *See, e.g.*, Wallerstein v. Primerica Corp., 701 F. Supp. 393, 397 (E.D.N.Y. 1988) (no need to give greater prominence to fee arrangement—shareholders could deduce that investment banker may have favored its clients' interests); Howing Co. v. Nationwide Corp., 625 F. Supp. 146, 152 (S.D. Ohio 1985) ("there may be sound business reasons for not making" certain quantifications in the proxy statement), *rev'd on other grounds*, 826 F.2d 1470, 1477-78 (6th Cir. 1987), *cert. denied*, 486 U.S. 1059 (1988); Richland v. Crandall, 262 F. Supp. 538, 554 (S.D.N.Y. 1967) ("[C]orporations are not required to address their stockholders as if they were children in kindergarten."); *cf.* Eliason v. Hamilton, No. 81-123 (N.D. Ill. Mar. 6, 1987) (1987 U.S. Dist. LEXIS 1826, at *13-14) (reasonable investor could discount any fairness opinion rendered by buying company's investment banker, because it generally seeks to attain lowest price); Spielman v. General Host Corp., 402 F. Supp. 190, 206 (S.D.N.Y. 1975) (investors need not be "spoonfed" information), *aff'd*, 538 F.2d 39 (2d Cir. 1976).

230. *See* Seibert v. Sperry Rand Corp., 586 F.2d 949, 952 (2d Cir. 1978).

231. *See* Beebe v. Pacific Realty Trust, 578 F. Supp. 1128, 1144 (D. Or. 1984).

232. *See* Efros v. Nationwide Corp., [1982-83 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,077, at 95,120 (S.D. Ohio Jan. 17, 1983). Indeed, directors could possibly expose themselves to legitimate charges of misrepresentation if they attempted to quantify the anticipated advantages. *See Howing*, 625 F. Supp. at 152.

233. Soft information is "valuation data based upon 'forwardlooking' information or estimates." Weinberger v. Rio Grande Indus., 519 A.2d 116, 126-27 (Del. Ch. 1986).

(d) events occurring after the issuance of a fairness opinion or proxy statement, unless material changes have occurred;[234]

(e) every approach made by would-be acquirers;[235]

(f) concerns about takeover attempts;[236]

(g) faithless motives, unless they "translat[e] into actionable deeds or omissions both objective and external";[237] and

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Such information includes asset valuations and financial projections. *See* Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1118 (D.R.I. 1990).

Some courts reject soft information as unreliable per se. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 292 (7th Cir.) (no duty to disclose financial projections), *cert. denied*, 454 U.S. 1092 (1981); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1294 (2d Cir. 1973) (no duty to disclose asset appraisals). Other courts, however, require disclosure of calculations that can be made with reasonable certainty. *See, e.g.*, Starkman v. Marathon Oil Co., 772 F.2d 231, 241 (6th Cir. 1985) (no duty to disclose financial forecasts unless they are "substantially certain"), *cert. denied*, 475 U.S. 1015 (1986); Vaughn v. Teledyne, Inc. 628 F.2d 1214, 1221 (9th Cir. 1980) (no duty to disclose unless estimates made with "reasonable certainty"). Yet other courts adopt a case-by-case approach, refusing to reject soft information per se. *See, e.g.*, Flynn v. Bass Bros. Enter., 44 F.2d 978, 988 (3d Cir. 1984) (asset appraisals not immaterial per se, but rather should be disclosed when potential aid of such information outweighs potential harm of undue reliance); *Dowling*, 735 F. Supp. at 1118-19 (adopting *Flynn*'s balancing test); *Rio Grande Indus.*, 519 A.2d at 129-30 (finding that pro forma statements on prospective financial conditions fail *Flynn*'s balancing test).

In the merger context, the Supreme Court has held that the materiality of information "depends on the probability that the transaction will be consummated, and its significance to the issuer of the securities." Basic, Inc. v. Levinson, 485 U.S. 224, 250 (1988). Courts should determine materiality in this context on a case-by-case basis. *See id.*

Soft information must be disclosed if it is curative: management has made partial or erroneous disclosures whose accuracy depends upon further disclosure of soft information. *See, e.g.*, *Dowling*, 735 F. Supp. at 1119 (directors disclosed information on the value of company holdings, but failed to divulge further information showing higher value for holdings).

234. *See* Lewis v. Leaseway Transp. Corp., No. 8720 (Del. Ch. May 16, 1990) (1990 Del. Ch. LEXIS 69, at *19-20); Kahn v. Household Acquisition Corp., No. 6293 (Del. Ch. May 6, 1988) (1988 Del. Ch. LEXIS 64, at *25-27); *cf.* SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1095-96 (2d Cir. 1972) (seller of securities must inform investors of developments subsequent to effective date of registration that render statements contained in prospectus materially false or misleading); Ahern v. Gaussoin, 611 F. Supp. 1465, 1483 (D. Or. 1985) (accountant's audit need only consider subsequent events that render audit false or misleading); Ingenito v. Bermec Corp., 441 F. Supp. 525, 548-49 (S.D.N.Y. 1977) (same).

An investment banker does not have a continual duty to analyze events subsequent to the date of the fairness opinion, although some bankers do withdraw their opinions if subsequent events render their opinions misleading. *See, e.g.*, FMC Corp. v. Boesky, 727 F. Supp. 1182, 1187 (N.D. Ill. 1989) (investment banker threatened to withdraw its opinion unless corporation's board increased its offer to match increase in the corporation's stock price).

235. *See Panter*, 646 F.2d at 296.

236. *See, e.g.*, Rand v. Western Airlines, Inc. [1989-90 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,751, at 94,053 (Del. Ch. Sept. 11, 1989) (no violation for failure to disclose immaterial bid); Braunschweiger v. American Home Shield Corp., No. 10755 (Del. Ch. Jan. 7, 1990) (1991 Del. Ch. LEXIS 7, at *20-21) (must only disclose material bids).

237. Carapico v. Enflo Corp., No. 85-4974, slip op. (E.D. Pa. Dec. 11, 1986) (LEXIS, Genfed library, Dist file, at 5).

(h) purely internal valuations.[238]

Regardless of which assumptions and valuation methods the investment banker ultimately chooses when opining on fairness,[239] the above cases suggest that an investment banker may avoid liability by thoroughly disclosing the suppositions and techniques on which its opinion is based, especially its material assumptions. At times, full disclosure may be difficult, if not impossible, as the valuation may involve material *nonpublic* information, such as an investment banker's trade secrets or information that would endanger a corporation if publicly disclosed. The above lists do suggest, however, that the more thorough the investment banker's investigation and disclosure, the less likely a court finding of negligent misrepresentation liability. It may seem unjust that an investment banker might avoid liability for a shabby investigation of a company or a poor analysis of the relevant factors simply by disclosing these conditions within the fairness opinion. Given the complexity of the valuation process and the time constraints of corporate control transactions, however, this leeway may be a necessary evil in the context of these extraordinary deals. Courts, however, should hold bankers liable for the financial harm that arises from the reasonable reliance on a negligently prepared fairness opinion by an intended recipient of the opinion when neither the complexities of the valuation process nor the time constraints so often associated with corporate control transactions are at issue.

CONCLUSION

Investment bankers owe third-party shareholders a duty of reasonable care in preparing fairness opinions. Courts, however, should limit the scope of this duty to correlate to the risks investment bankers foresee and assume during fee negotiations. This approach would appropriately balance the need to account for investment bankers' current role in the financial world with the need to shield them from liability that unreasonably surpasses the bounds of their actual undertaking. Finally, in the absence of clear judicial or industry guidelines, investment bankers can draw the best guidance on the standard of care that they owe third-party shareholders from cases that have measured whether fairness opinions and proxy statements were sufficiently detailed to warrant a board's reliance upon them.

Michael W. Martin

238. *See* Kademian v. Ladish Co., 792 F.2d 614, 625 (7th Cir. 1986); Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir. 1981). *But see* Lynch v. Vickers Energy Corp., 383 A.2d 278, 280-81 (Del. 1977) (corporation violated duty to disclose its internal valuations that showed target company to be worth more than price paid).

239. For a discussion of the variables inherent in the valuation process and the techniques available to the investment banker, see *supra* notes 33-39 and accompanying text.