

The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2006

PHILADELPHIA, MONDAY, MAY 22, 2006

VOL 234 • NO. 98 \$3.00

ALM

VOL P. 3589

MONDAY, MAY 22, 2006

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SECURITIES LAW

Investment Bank Accountability for the Issuance of Fairness Opinions

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Special to the Legal

A fairness opinion is a professional opinion of a paid consultant, usually an investment bank with expertise in financial valuation, about the fairness of the price of a proposed material transaction.

The Delaware Supreme Court's 1985 landmark decision in *Smith v. Van Gorkom* required members of boards of directors to inform the exercise of their business judgment by obtaining fairness opinions for such transactions. The decision institutionalized fairness opinion practices in the United States and spurred a great deal of commentary. The function of fairness opinions included in enterprises' public disclosures — particularly proxy statements soliciting a shareholder vote — and the responsibility of those who provide them, have been addressed by the courts. Courts have ruled, albeit sometimes grudgingly, that those who issue fairness opinions must do so within the legal framework of the securities and proxy laws.

While commentators generally agree that transactions often require a fairness opinion that is based on well-reasoned, honest and properly performed processes, consensus in the commentary breaks down thereafter. Some commentators believe that investment



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banks issuing fairness opinions should be held liable for their knowing, reckless or negligent misrepresentations and omissions. Others believe that the risk of misstatements in fairness opinions should be borne by those who rely on them, usually the directors of an enterprise and its owners, the shareholders.

What is troublesome about the latter group of commentators, as exemplified in an article titled "Fairness Opinions: Are They Fair or Should We Care?" by Stetson University Law Professor Charles Elson, is that they would seek to legitimize a philosophy of caveat emptor — let the buyer beware — even where a fairness opinion functions as the vehicle for the dissemination of financial

information. That is troubling because it runs contrary to long-cherished United States capital market policy manifested in the securities laws that replaces the philosophy of caveat emptor with the philosophy of transparency through disclosure.

Commentators aside, the courts have ruled, like the Southern District of New York in the *Livent Securities* litigation, that an investment bank may be liable under the anti-fraud provisions of the federal securities laws for making a misstatement in a fairness opinion with scienter, that is, with an intent to deceive or with knowing disregard of red flags raising questions about the basis of the conclusions in the opinion.

Courts following the seminal decisions by the 3rd U.S. Circuit Court of Appeals in *Herskovitz v. Nutri/System Inc.* and by the New York Appellate Division in *Walls v. Shearson Lehman/American Express Inc.*, have also recognized investment bank liability for negligence under the federal proxy laws and at common law for issuing a misleading fairness opinion without exercising due professional care. These cases stand for the proposition that a fairness opinion disseminated to the market acts as a vehicle for disclosing financial information and is subject to the laws, policies and standards that govern dissemination of financial information to market participants.

These decisions are targets for the champi-

ons of caveat emptor. They, like Elson, argue that investors should know better than to rely on fairness opinions. They observe that investors know that banks providing fairness opinions may use varying appropriate valuation methodologies, enjoy latitude of professional judgment and receive substantial fees, even fees contingent on the success of a transaction.

The caveat emptor argument ignores generally accepted principles governing dissemination of financial information to the market that harness those responsible for making representations about financial matters to the yolk of accountability. These principles, often generally accepted accounting principles (GAAP), were promulgated by the American Institute for Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB), and govern the dissemination of all financial information. Moreover, these principles were adopted by Securities and Exchange Commission rules and judicial decisions under the securities laws. Even though investment banks do not have an AICPA equivalent for self-regulation, they may not disclaim liability with impunity, in the small print, when they make knowing, reckless or negligent misstatements in fairness opinions.

Because there no longer is a question of whether investment banks face liability to

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shareholders when issuing fairness opinions — they do, the question now is what are banks doing to prevent the dissemination of materially false financial information in the guise of fairness opinions? This columnist, allied with the champions of transparency through disclosure, argues that the banking industry should regulate itself through compliance with and promotion of the standards generally accepted in the United States for the dissemination of financial information to the market.

A bank issuing a fairness opinion opines that the underlying transaction is fair “from a financial point of view.” In doing so, the bank performs procedures using relevant financial and accounting information. As Practising Law Institute’s Michael Kennedy explains, by issuing its opinion “from a financial point of view” the bank is concerned with numbers. “They look at historical and projected balance sheets, income statements and cash flow. Armed with these numbers, they compute ratios, multiples and make comparisons. Thus, the average reader concludes, and probably intuitively knows, that ‘from a financial point of view’ means from a numbers perspective.” These numbers represent the financial information about the underlying transaction and enterprises, and must be grounded in the standards generally

accepted for disseminating such information.

By holding itself out as an expert, consenting to the inclusion of its opinion in proxy materials sent to shareholders, and offering its opinion that a transaction is fair “from a financial point of view,” the investment bank places itself at the heart of financial reporting in the proxy statement, and injects itself into shareholders’ decision-making processes. For this reason, it is incorrect to argue that no standards exist for investment banks to regulate their fairness opinion practices.

The cases above and their progeny stand for the proposition that the securities laws prohibit investment banks from knowingly, recklessly or negligently disseminating an opinion “from a financial point of view” that violates generally accepted standards for the dissemination of financial information. Those standards are often GAAP, and, at the very least, include the most basic of GAAP’s fundamental precepts: Statements of Financial Accounting Concepts (FASCON), most especially FASCON Numbers 1 and 2.

FASB promulgated the FASCONs to set forth fundamentals on which financial reporting standards are based. When read together, FASCONs 1 and 2 require investment banks providing fairness opinions to use their power to obtain information about the subject of the fairness opinion to resolve any uncertainty as to what is being reported, address uncertainty with skepticism, and provide reasonable assurance that what is reported actually represents what it purports to represent.

In 1978 FASCON 1 established the objectives of financial reporting. The “function of financial reporting is to provide information that is useful to those who make economic decisions about business enterprises and about investments in or loans to business enterprises.” While it may seem axiomatic, FASCON 1 explains that information provided by financial reporting is primarily “financial” in nature; it is generally quantified and expressed in units of money, exchanges or numbers. While FASCON 1 recognizes that “financial analysts and advisers” such as investment banks are potential users of financial reporting, among others (including investors), in it FASB recognized that investment banks “have the power to obtain information” as needed. FASCON 1 explains that a bank “can often obtain desired information by making the information a condition for completion of the transaction.”

FASCON 1 also contrasts investment banks, which enjoy a gatekeeper role wielding a power of inquiry, with investors, who are “the most obvious” group using reported financial information, but who “lack the authority to prescribe the information they want.” FASB recognized in FASCON 1 that banks that have the power to get answers upon inquiry should, in fact, exercise that power.

In 1980 FASB promulgated FASCON 2 to examine the characteristics of financial information that make the information “useful.” Building on FASCON 1, FASCON 2 codified

“a convention of conservatism” — or “prudence” — in the standards for reporting financial information to the market. FASB explains that “conservatism is a prudent reaction to uncertainty to try to ensure that uncertainties and risks inherent in business situations are adequately considered.” FASCON 2’s “conservatism” requires skepticism where, as in the issuance of fairness opinions, financial information about a pending transaction is being disclosed:

“The best way to avoid the injury to investors that imprudent reporting creates is to try to ensure that what is reported represents what it purports to represent. The reliability of financial reporting may be enhanced by disclosing the nature and extent of the uncertainty surrounding events and transactions reported to stockholders and others. In assessing the prospect that as yet uncompleted transactions will be concluded successfully, a degree of skepticism is often warranted. The aim must be to put the users of financial information in the best possible position to form their own opinion of the probable outcome of the events reported. Prudent reporting based on a healthy skepticism builds confidence in the results and, in the long run, best serves all.”

Thus, FASCON 2 serves transparency through disclosure by providing that “judgments [are] properly ... made only by those who have all the facts.”

Columbia University Law Professor John

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Coffee includes investment banks in his definition of “gatekeepers” because they act as “reputational intermediaries” and enjoy a power over management of inquiry into the underlying enterprise. University of Colorado Law Professor Ted Fafilis explains, a banker’s veto power is at least

as great as the auditor’s opinion in a registered offering or the lawyer’s opinion as a condition to closing a merger.

Fafilis echoes Judge Henry Friendly’s observation, in *United States v. Benjamin*, that in “our complex society the accountant’s certificate and the lawyer’s opinion or, we may add, the banker’s fairness opinion, can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.”

Investment banks must be cognizant that

they face liability for their knowing, reckless or negligent issuance of materially misleading fairness opinions. Indeed, the legal precedent is grounded in sound principles derived from generally accepted standards for financial reporting. Rather than contradict or undermine the persuasiveness of the precedent or the veracity of the standards, it would be good for investment banks to emulate them.

By exercising their gatekeeper role with

professional skepticism as appropriate during the procedures involved in issuing a fairness opinion and obtaining reasonable assurance that it is properly based on competent, verifiable financial information, investment banks are in the best position to regulate themselves. By doing so, investment banks would better serve their role as gatekeeper and function to ensure transparency of disclosure in our capital markets. •