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January 26, 2005

By Electronic Mail (pubcom@nasd.com) and First Class Mail

Barbara A. Sweeney
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Office of the Corporate Secretary
1735 K Street NW
Washington, D. C. 20006-1500

Re: NASD Notice to Members 04-83
<u>Fairness Opinions Issued by Members</u>

Dear Ms. Sweeney:

The Committee on Securities Regulation (the "Committee") of the Business Law Section of the New York State Bar Association appreciates the invitation in NASD Notice to Members 04-83 (the "Notice") to comment on the National Association of Securities Dealers, Inc. ("NASD") proposal relating to fairness opinions issued by its member firms.

The Committee is composed of members of the New York State Bar, a principal part of whose practice is in securities regulation. The Committee includes lawyers in private practice and in corporation law departments. A draft of this letter was reviewed by certain members of the Committee, and the views expressed in this letter are generally consistent with those of the majority of members who reviewed and commented on the letter in draft form. The views set forth in this letter, however, are those of the Committee and do not necessarily reflect the views of the organizations with which its members are associated, the New York State Bar Association or its Business Law Section.

<u>Summary</u>

The Notice reflects some of the same concerns that have been and are being addressed in case law and current litigation. Many of the proposals in the Notice appear to be within the NASD's authority. An NASD rule mandating disclosure with respect to conflicts, while unobjectionable, would overlap with existing SEC disclosure requirements and the practice developed in response to state corporate law concerns. Furthermore, adopting proposals prescribing procedures for giving fairness

opinions could:

1. Have an adverse effect on developing standards for fairness opinions under state corporate law;

2. Impose duties upon NASD member firms that render fairness opinions that are not relevant to the duties imposed upon a corporation's board of directors that is retaining the member firm to render a fairness opinion; and

3. Impose duties on NASD member firms that are not similarly imposed on other advisers that render fairness opinions.

Given the disclosures already required by the SEC's proxy rules relating to methodology and the somewhat unique nature of each corporate control situation, the Committee questions whether further rule-making is warranted relating to the substantive preparation of fairness opinions. State corporate law is well developed and has addressed issues arising in the preparation of fairness opinion, as demonstrated by the survey below. State corporate law also has addressed issues of conflicts of interest in the context of fairness opinions. However, if the NASD feels it must act in this area we urge it to limit its actions to requiring disclosure of conflicts of interest.

Comments

The proposed rules contemplated by the Notice would directly impose a structure and disclosure duties on member firms in how they supervise preparation of a fairness opinion and handle the attendant conflicts of interest. The Committee has concerns that a rule-based prescription for managing conflicts of interest may unduly hamper firms' efforts to adapt conflicts management to their particular and unique structures. For example, mandating a fairness opinion committee and the process or criteria by which members of a firm's fairness committee are selected could deprive firms of opportunities for experimentation and innovation in their conflicts management process. Similarly, firms may take a variety of approaches towards ensuring balanced review procedures for the fairness opinions themselves. Further, the duties imposed on a board and its advisers, as interpreted by case law, may require that they obtain, as part of the fairness opinion process, disclosures and actions by the NASD member firms that may go beyond or be inconsistent with an NASD rule.

The substantive content of any firm's process for preparing, reviewing and rendering fairness opinions will be driven in large part by the requirements of state corporate law - which may change dynamically through the legislative process as well as judicial interpretation over time, as evidenced by the discussion of fairness opinion developments later in this letter. A fixed prescription for such fairness opinion processes may not adequately respond to these changing requirements. We have similar concerns that a rule-based process might not accommodate the particular circumstances of a transaction or the relevant relationships of the involved parties.

For your information we have summarized below a number of cases dealing with fairness opinions. As you can see, the standards in this area are developing. Further, the duties of directors and their ability to rely upon a fairness opinion vary from case to case. An NASD rule mandating various procedures and disclosures in the case of fairness opinion may be inconsistent with the statutory duties of directors and the requirements that state corporation law and case law may impose upon them and they, in turn, impose upon their financial advisers, including NASD member firms. We are concerned that it could be argued that an NASD rule, approved by the SEC, may preempt state law in the area or affect, in unpredictable ways, the development of state law in this area.

The NASD specifically requested comment on whether additional procedures should be mandated to address "the degree to which the amount and nature of the compensation [to be received by] ... any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company, is a factor in reaching a fairness determination." The Committee believes such mandated procedures would be inappropriate. The fairness opinion addresses the fairness to shareholders, as a financial matter, of the entire transaction; pre-existing liabilities (e.g., to managers) are but one component of the complete information to be taken into account in that overall analysis. It would be inappropriate to require a firm rendering a fairness opinion to comment on the fairness of specific aspects of a corporate control transaction, particularly ones that may have been in place before the transaction was contemplated.

Finally, a number of firms that are registered investment advisers also render fairness opinions on corporate control transactions. These firms are not registered as broker-dealers and are not members of the NASD. Even if these firms are affiliated with NASD member firms the proposed NASD rules would not govern their conduct or relationship with the issuers in rendering their fairness opinions.

Survey of State Law

Ability to Rely on a Fairness Opinion: The NASD correctly notes that since the Van Gorkum decision (488 A. 2d 858 (Del. 1985)) there has been an increase in the use of fairness opinions in corporate control transactions. However, the courts do not view a fairness opinion as automatically or necessarily discharging directors' duty of care. Rather, courts have held that a board of director's reliance on fairness opinions may constitute a "reasonable basis" in coming to the conclusion that it obtained the best offer for the sale of their corporation. See In re Vitalink Communications Corp. Shareholders Litigation, 1991 WL 238816 at *12 (Del. Ch. 1991). Directors will be considered to have acted within the duty of care, "when the directors reasonably believe the information upon which they rely has been presented by an expert 'selected with reasonable care' and is within that person's professional or expert competence." In re Cheyenne Software, Inc. Shareholders Litig., 1996 Del Ch. LEXIS 142 (Nov. 7, 1996).

Duty to have Adequate Data for a Fairness Opinion: Courts have found directors in breach of their fiduciary duty even when they have acted in reliance on a fairness opinion.

Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264(2nd Cir. 1986). In Mills Acquisition Company v. MacMillan, Inc., 559 A 2d 1261, 1280 (1990), the court held that "while a board of directors may rely in good faith on information, opinions, reports or statements, presented by experts selected with reasonable care, it may not avoid its active and direct duty of oversight." The directors of the company were found to have breached their fiduciary duty, despite the fact that they obtained a fairness opinion as to a proposed tender offer, due to their failure to provide the investment bank "essential facts necessary . . . to arrive at a fair and accurate opinion as to the value." Jane Joseph, et al. v. Shell Oil Company, et al., 482 A.2d 335, 341 (May 1984) (holding that withholding crucial information from the financial advisor, such as the value of probable oil reserves, constituted a breach of fiduciary duty). In Alidina v. Internet.com Corporation, 2002 Del. Ch LEXIS 156 (2002), the court found that the board of directors had breached their duty of care in not acting with informed judgment. In Alidina the corporation underwent a two-step transaction consisting of a tender offer followed by a merger. Although a fairness opinion was obtained from an independent investment bank in regard to the merger transaction, there was no separate fairness opinion as to the advisability of the tender offer. The court found the lack of a separate fairness opinion to be evidence that the directors were not truly "informed" when making their business judgment concerning the overall transaction. See id. at *25.

Conflicts of Interest in Fairness Opinions: State courts have recognized that under state corporate law conflicts of interest may arise between the board of directors and the investment bank, particularly when the investment bank both structures the deal and prepares the fairness opinion. See, e.g. Radol v. Thomas, 103 F.R.D. 430, 436 (D. Minn. 1984) ("a contingent fee arrangement between the target company and its investment banker could have the potential to taint the fairness opinion of the investment bank"). The Delaware Chancery Court has addressed the issue of conflicts of interest that arise when investment banks are hired to give fairness opinions. In an appraisal action to determine the fair value of shares after a short-form merger, the court noted that the corporation's investment bank was not disinterested in giving a fairness opinion. See In the Matter of the Appraisal of Shell Oil Co., 1990 Del Ch. LEXIS 199, *88. The court noted that because the investment banker was dealer-manager for the 1984 Tender Offer and would receive a large contingent fee if the offer was successful, the investment banker "clearly had an incentive to skew its analyses" and the "existence of such an obvious conflict of interest does diminish the credibility" of the investment banker's opinions. See id. This conflict of interest, along with the fact that the bank withheld several documents dealing with the valuation, led the court to conclude that less weight should be given to the investment banker's fairness opinion. See id * 92. The court also stated that both side's opinions as to valuation must be "scrutinized and evaluated with considerable caution." See id. Courts have held that an investment bank rendering a fairness opinion was lacking in independence in cases when it was retained by and consulted with company's management that was financially interested in the proposed transaction. Mills Acquisition Company v. Mac Millan, Inc. 559 A. 2d 1261 (1990).

Conflict of Interest Due to Fee: Courts have found a conflict of interest where investment bankers receive a contingent fee for their services. See e.g., Joseph v. Shell Oil Co.,

Del. Ch., 482 A.2d 335, 334 (1984); Sandberg v. Virginia Bankshares, Inc., 891 F.2d 1112, 1122 (4th Cir. 1989).

Substantive Duties Imposed Upon Investment Banks Rendering Fairness Opinions: Courts have imposed substantive duties under state law upon investment bankers rendering fairness opinions. Investment banks issuing fairness opinions have been held accountable for negligent misrepresentation in cases where the analysis was "patently intended to guide shareholders in deciding whether to approve the sale." Daniel K. Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105 (1990). In Dowling, the plaintiff shareholders brought suit to recover damages for the sale of Narragansett Capital Corp.'s assets for what they claimed was a "grossly inadequate price." See id at 1125. The shareholders claimed that the investment bank had been negligent in delivering its "fairness opinion" of the value of NCC's assets for the asset sale. The court ruled that the investment bank could be held liable for negligent misrepresentation because they "held themselves out as experts in valuing stock and made it appear as if they had all the relevant information, when in fact they did not." See id at 1125. Courts have also addressed the issues of fraud by investment bankers in the context of fairness opinions. See Stuchen, et al., v. Duty Free International, Inc., et al., 1996 Del. Super. LEXIS 187 (September 11, 1985). In Stuchen, the court granted the defendant, Goldman Sachs' motion to dismiss the fraud, breach of contract, and negligence claims in relation to their fairness opinion. As to the fraud claim, the court found that there was no indication that the opinions or analysis of Goldman Sachs were false, or made in bad faith or without a reasonable basis.

Duty to Disclose Analysis Underlying Fairness Opinion: Courts have also addressed the duty of disclosure of analyses used in rendering a fairness opinion. In Goodwin v. Live Entertainment, Inc., 1999 Del. Ch. LEXIS 5*17 (1999), plaintiff shareholders claimed that the directors of the corporation breached their 'duty of care' because of certain omissions in the proxy statement, one in particular relating to valuation analysis. The Delaware Court of Chancery held that disclosure of the analysis underlying a fairness opinion is not ordinarily required. See id. *34. The court stated that "the decision about disclosure in this context requires a careful balancing of the potential benefits of disclosure against the possibility of resultant harm." Id; See Arnold v. Society for Sav. Bancorp, Del. Supr. 650 A.2d 1270, 1279 (1984); See Skeen v. Jo-Ann Stores, Inc., 750 A2d 1170 (Del. 2000).

Disclosures in the Fairness Opinion: Courts have held that the reasons for a corporation's retention of a competent investment bank does not need to be disclosed, stating that, "the reason why a competent banker was selected over other competent bankers will rarely be of material interest to investors, unless the reasons suggests that the integrity of the Special Committee has been compromised by self-interest or a lack of independence." Clements v. Robert D. Rogers, et al., 790 A.2d 1222, 1245 (August 14, 2001). The same court also ruled that disclosure of the fee arrangement, whereby the investment bank would receive a fee regardless of whether the fairness opinion supported the transaction, is not required. See id. The fact that the investment bank was required to update a positive fairness opinion did not indicate that the fee was a "contingency" fee, but rather the court found that it was "natural that such a clause would exist as to a positive opinion, but not a negative one. Id.; See Also, Matador Capital Management Corp. v. BRC

Holdings, Inc., 729 A.2d 280 (1998) (stating that "our law rejects the proposition that disclosure of the detailed facts and specific analyses underlying a financial advisor's valuation methodology is automatically mandated in all circumstances"). However, the law in Delaware is not settled as to disclosure requirements in regard to fairness opinions. In re Pure Resources, Inc., Shareholders Litigation, 808 A.2d 421, 449 (October 1, 2002).

Other court decisions have stated that the valuation analysis in a fairness opinion should be disclosed. The Delaware Court has stated that "Stockholders are entitled to a fair summary of the substantive work performed by the investment bankers, upon whose advice the recommendations of their board as to how to vote on a merger or tender rely . . . disclosure of the banker's 'fairness opinion' alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability." Id. at 449.

Fairness opinions are sought, and delivered, to address issues arising under state corporations statutes. The state courts have developed a body of law with respect to fairness opinions that reflects the underlying state law purposes sought to be advanced by those corporations statutes. NASD rules specifying procedures for delivery of fairness opinions would introduce a new and potentially troublesome element into this area of state law.

We hope the NASD finds these comments useful. We would be happy to discuss these comments further.

Respectfully submitted,

COMMITTEE ON SECURITIES
REGULATION

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