A Shareholder May Bring a Direct Action Against Investment Bankers for Giving Negligent Advice in a Sale of Control Transaction

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DEVELOPMENTS IN THE LAW

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In recent years, the role of investment bankers in corporate decision making has increased dramatically. In the context of any major corporate control transaction, an investment banker's fairness opinion is a regular and indispensable component. In theory, the fairness opinion is investment banker's opinion on deal's value. A fairness opinion is based on the results of an investment banker's analysis of the financial value of the corporations involved in a particular transaction. Although the value of a publicly-held company is quantified best by the market price of its shares, "acquirors have been willing to pay substantial premiums for the shares of target companies." The use of junk bonds became popular to many institutional investors willing to take positions in highly leveraged companies because "deregulation had permitted new forms of investment and low demand by traditional borrowers had increased the search for high-yield lending opportunities." On a technical level, fairness opinions have been severely criticized because the lack of uniformity in the financial models used by investment bankers in arriving at their estimate of fair price frequently yield disparate results. Even when bankers employ the identical techniques, because they "simplify, assume, and estimate in different ways that are all reasonable and justifiable, they often arrive at different estimates of fair price." In addition to the increase in the number of sale of control transactions, courts have directly aided the proliferation of fairness opinions by declaring such opinions relevant and sometimes even dispositive of whether a director has fulfilled his fiduciary duty.

1 Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 YALE L.J. 119, 121-22 (1986). This increase is largely attributable to the "heightened level of merger and acquisition activity." Id. at 121. In addition to the increasing number of transactions, the size and complexity of each deal has made investment banker participation an indispensable component. See id. at 121 n.15 (from 1975 to 1985, value of transactions increased from $14 billion to $180 billion and number of $100 million deals rose from 14 to 270).

The major factor behind the rising level of mergers and acquisitions has been the growth of leveraged buyouts, financed through high-yield junk bonds. See Oesterle & Norberg, Management Buyouts: Creating or Appropriating Shareholder Wealth?, 41 VAND. L. REV. 207, 208 (1988). The use of junk bonds became popular to many institutional investors willing to take positions in highly leveraged companies because "deregulation had permitted new forms of investment and low demand by traditional borrowers had increased the search for high-yield lending opportunities." Id. at 208 n.3.

2 See Note, supra note 1, at 122-25 (fairness opinion is investment banker's opinion on deal's value). A fairness opinion is based on the results of an investment banker's analysis of the financial value of the corporations involved in a particular transaction. Id. at 122. Although the value of a publicly-held company is quantified best by the market price of its shares, "acquirors have been willing to pay substantial premiums for the shares of target companies." Id.; see also Easterbrook & Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1165-67 (1981) (share price best represents true value of company under efficient capital market theory). Thus, the purpose of a fairness opinion is "to determine the difference between the market price of a company's shares and the value of the shares in a transaction where corporate control is being sold." Note, supra note 1, at 122.

On a technical level, fairness opinions have been severely criticized because the lack of uniformity in the financial models used by investment bankers in arriving at their estimate of fair price frequently yield disparate results. See Bebchuk & Kahan, Fairness Opinions: How Fair are They and What can be Done About It?, 1989 DUKE L.J. 27, 30 (1989) (defining "fair price" usually leads to significantly different estimates between investment bankers). Even when bankers employ the identical techniques, because they "simplify, assume, and estimate in different ways that are all reasonable and justifiable, they often arrive at different estimates of fair price." Id. at 34 (footnotes omitted); see also Note, supra note 1, at 124 (modern valuation techniques cannot determine with precision fair price).

3 Bebchuk & Kahan, supra note 2, at 27. In addition to the increase in the number of sale of control transactions, courts have directly aided the proliferation of fairness opinions by declaring such opinions relevant and sometimes even dispositive of whether a director has fulfilled his fiduciary duty. Id. at 28; see, e.g., Treadway Cos. v. Care Corp., 638 F.2d 357, 384 (2d Cir. 1980) (obtaining fairness opinion evidenced good faith); Smith v. Van Gorkom, 488 A.2d 858, 876-78 (Del. 1985) (directors' failure to obtain fairness opinion significant in finding violation of duty of care); Alpert v. 28 Williams St. Corp., 63 N.Y.2d 557,
an investment banker's fairness opinion is intended to protect shareholders by presenting an independent, third party assessment of the financial fairness of a merger or buyout proposal. As a result of the crucial role of investment bankers in the decision-making process affecting the financial affairs of shareholders, courts recently have indicated a willingness to extend the liability of investment bankers to shareholders. However, third-party liability of investment bankers is only an emerging concept and most courts, finding a lack of contractual privity, have denied direct actions by shareholders against investment bankers for negligence in supplying a fairness opinion. Recently, however, in Schneider v. 572, 473 N.E.2d 19, 27, 483 N.Y.S.2d 667, 676 (1984) (dictum indicated retention of investment bank would be “good means” to demonstrate fair price).

See Note, supra note 1, at 120 (fairness opinion is investment banker's judgment of quality of transaction). An impartial, third-party assessment becomes crucial in a merger or buyout context because conflicts of interest, arising from the inevitable intertwining of their personal futures with that of the outcome of the transaction, may influence management. Id. at 125-26.

See Wells v. Shearson Lehman/American 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, 526 N.E.2d 8, 530 N.Y.S.2d 517 (1988). In Wells, the Appellate Division, First Department, allowed a direct action against the investment bankers who allegedly were negligent in preparing a fairness opinion. Id. Among the findings of the court, were that management had retained the bankers solely as a service to the shareholders, and that the bankers were aware the shareholders would use their opinion. Id. Crucial to the court's determination was the fact that the proxy materials sent to the shareholders, on the basis of which they approved the buyout, contained the opinion prepared by the bankers. Id. at 201, 514 N.Y.S.2d at 1.


See generally H. HENR & J. ALEXANDER, LAWS OF CORPORATIONS 1045-46 (3d ed. 1983) (distinction between direct and derivative actions). A derivative action is brought on behalf of a corporation against third parties or corporate fiduciaries, whereas a direct action is brought on a shareholder's own behalf against the corporation or its fiduciaries. Id. at 1045. Since a shareholder must show that the act of the wrongdoer injured the corporation, a derivative action may be unavailable in the sale of control transaction context because the purchase price runs directly to the shareholders without affecting the corporation. See id. at 1045-46; Brodsky, supra note 6, at 3, col. 1.

See Weinberger v. UOP, Inc., 426 A.2d 1333, 1348 (Del. Ch. 1981), rev'd on other grounds, 457 A.2d 701 (Del. 1983); Note, supra note 1, at 128-30. The Weinberger court found no authority to support the allegation that an investment banker owes a fiduciary duty to minority shareholders merely because management had retained him. Weinberger, 426 A.2d at 1348.

Although courts have not extended third-party liability to investment banks on a negli-
Lazard Freres & Co., the Appellate Division, First Department, held that in the context of a sale involving the control of a corporation, the relationship between the shareholders and a special committee of the board of directors was that of principal and agent, thus placing the bankers in contractual privity with the shareholders for whose benefit their advice was rendered.

In Schneider, former shareholders of RJR Nabisco, Inc. ("RJR") brought a direct action against the investment bankers retained by the Special Committee of RJR's Board of Directors for allegedly giving negligent advice in evaluating competing bids for the company. In particular, the shareholders alleged that the bankers were negligent when they advised the Special Committee that the final bids were substantially equivalent when, in fact, the bid from the Management Group was superior. The bankers moved to dismiss the complaint for failure to state a cause of action, arguing that their advice was intended for the Special Committee, not the shareholders. They contended, therefore, that they owed no duty of care to the shareholders to render non-negligent advice. The Supreme Court, New York County, denied the motion.

gence theory, they have allowed direct shareholder actions in cases of fraud. See Note, supra note 1, at 128-30. However, in order to establish liability, the shareholder must prove scienter, a difficult burden due to a lack of shareholder access or knowledge of the actual negotiations. Id. at 129.

10 Id. at 297, 552 N.Y.S.2d at 575.
11 See id. at 292, 552 N.Y.S.2d at 572. The Special Committee was comprised of a group of disinterested RJR Nabisco, Inc. ("RJR") directors. Id. A "disinterested" committee is intended to protect the shareholders by reducing the potential for conflicts of interest when a management group is a participant in the sale of control. See Oesterle & Norberg, supra note 1, at 242; see also infra note 24 (requirement of disinterestedness for application of business judgment doctrine). One pair of commentators has expressed a concern that such committees may actually harm shareholders if the formation of a committee causes a relaxation of scrutiny by the courts. See Oesterle & Norberg, supra note 1, at 242.
12 Schneider, 159 A.D.2d at 292, 552 N.Y.S.2d at 572. The auction of RJR's stock was conducted between the successful bidder, Kohlberg, Kravis, Roberts & Co., and a management-led group. Id.
13 Id. The shareholders argued in the alternative that, if the bid from the Management Group was inferior, the bankers should have advised the Special Committee to request another bid from the Management Group, or, if the bids were financially equivalent as the bankers claimed, the bankers should have instructed the Special Committee to solicit tie-breaking bids from both groups. Id.
14 Id. In the alternative, the bankers moved to dismiss the action upon the condition that they be allowed to intervene in the earlier commenced action in Delaware, or stay the New York action pending final determination of the Delaware action. Id.
15 Id.
tion and the defendants appealed.\(^{18}\)

In upholding the sufficiency of the complaint,\(^{17}\) the Appellate Division, First Department, ruled that the traditional principles of corporate governance do not apply in a buyout context since the purpose of the transaction is not to benefit the corporation, but rather for the protection of the shareholders.\(^{18}\) In expanding its previous ruling in *Wells v. Shearson Lehman/American Express, Inc.*,\(^{19}\) the First Department rejected the bankers’ assertion that privity was lacking, and found that the board of directors had created the Special Committee solely to act as the agent of the shareholders in order to obtain the highest possible price for their stock.\(^{20}\) Thus, the court held that the shareholders could bring an action in negligence against the bankers for advice given to the Special Committee under established principles of agency, notwithstanding that the bankers had never directly dealt with the shareholders.\(^{21}\)

Although the *Schneider* court’s extension of third-party liability to negligent investment bankers advances desirable policy objectives,\(^{22}\) the court’s utilization of agency theory appears misplaced in the corporate setting and seems to promote divergent standards of professional liability. It is suggested that the standards applied to other professionals, such as accountants, should determine the basis of liability for investment bankers.

Traditional corporate law generally has declined to treat directors as agents of either the corporation or the shareholders.\(^{23}\)

\(^{16}\) See id. at 291, 552 N.Y.S.2d at 571.

\(^{17}\) See id. The First Department modified the order of the Supreme Court, New York County, by granting the defendant’s motion to stay the New York action pending final determination of the Delaware proceeding. Id.

\(^{18}\) Id. at 297, 552 N.Y.S.2d at 575.

\(^{19}\) 127 A.D.2d 200, 203, 514 N.Y.S.2d 1, 2 (1st Dep’t), rev’d on other grounds, 72 N.Y.2d 11, 526 N.E.2d 8, 530 N.Y.S.2d 17 (1988); see supra, note 5. In *Wells*, a direct action was allowed against the investment bankers for negligence in preparing a fairness opinion. *Wells*, 127 A.D.2d at 202-03, 514 N.Y.S.2d at 2. The investment bankers were hired by a committee, which was created by the officers of the corporation to determine the fairness of the buy-out. Id. The court held that “[a]nynbody hired by the committee, aiding in its endeavor, was actually retained to advise the shareholders.” Id.

\(^{20}\) *Schneider*, 159 A.D.2d at 297, 552 N.Y.S.2d at 575.

\(^{21}\) Id. In a traditional agency relationship, a third party is liable for negligent statements made to an agent who relied upon the statements to the detriment of the principal. See H. Reuschlein & W. Gregory, The Law of Agency and Partnership 184 (2d ed. 1990).

\(^{22}\) See infra notes 31-34 and accompanying text.

\(^{23}\) See H. Henn & J. Alexander, supra note 7, at 611 n.3 (directors are neither agents
commonly, the law has viewed the role of directors as that of trustees, who have a fiduciary obligation to discharge their duties with reasonable care, as measured by the "business judgment rule." This fiduciary duty rests solely with the directors and is not delegable to an investment banker. No decisional law exists indicating a change in the role of directors in a buyout or merger context, and in fact, courts have reaffirmed that the duty remains unchanged.

Moreover, it is suggested that the doctrine of agency is facially nor trustees); see, e.g., New York Dock Co. v. McCollom, 173 Misc. 106, 109, 16 N.Y.S.2d 844, 847 (N.Y. Sup. Ct. 1939) (director not agent of corporation or stockholders); see also Brudney, Corporate Governance, Agency Costs, and The Rhetoric of Contract, 85 Colum. L. Rev. 1403, 1428 (1985) ("contours of the traditional agency relationship do not delineate the relationship between investors and management of large public corporations"). An agency exists when a principal appoints an agent, the agent accepts, and the principal has control over the agent's actions. Id. "[T]he relationship between corporate management and stockholders does not follow that conventional doctrine." Id.

24 See N.Y. Bus. Corp. Law § 717 (McKinney 1986 & Supp. 1990). "A director shall perform his duties ... in good faith and with that degree of care which an ordinarily prudent person in a like position would use under similar circumstances." Id. New York has interpreted the business judgment rule as:

Bar[ring] judicial inquiry into actions of corporate directors taken in good faith... ."[T]heir powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient."


25 See Auerbach, 47 N.Y.2d at 633, 393 N.E.2d at 1002, 419 N.Y.S.2d at 928. But see In re The Richmond Corp., 41 S.E.C. 398, 405 (1963) (in dictum, SEC indicated that investment banker who issues general prospectus may have duty of care to investing public commonly required of fiduciaries (citing H. Rpt. No. 85, 73rd Cong., 1st Sess., at 5 (1933))).

26 See Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1287 (Del. 1989). In the context of a sale of control transaction, the directors must meet the "requirement of fairness for the purpose of enhancing general shareholder interests ... [and] the board's primary objective, and essential purpose, must remain the enhancement of the bidding process for the benefit of the stockholders." Id. at 1286-87. Although the Mills court recognized an enhanced duty requirement of directors in the sale of control context, the court also noted that the nature of their relationship with the shareholders does not change. See id. at 1287 (discussing enhanced duty requirement set out in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).
inapplicable to the facts of Schneider. Although the characterization of a director as a fiduciary does not preclude the existence of an agency,\(^{27}\) the functional relationship between directors and shareholders warrants against such a portrayal.\(^{28}\) An agency relationship implies control by the shareholders over the acts and decisions of the Special Committee, which the court contradicted with its finding that the shareholders "were not to do anything other than passively follow the recommendation of the Special Committee."\(^{29}\) It also appears doubtful that the shareholders would be held personally liable to third parties for contracts entered into by the Special Committee as would a principal in a true agency relationship.\(^{30}\)

Despite the theoretical weaknesses of the Schneider court's reliance on an agency relationship, the extension of third-party liability to investment bankers in a sale-of-control transaction is a desirable result, which garners support from various policy considerations.\(^{31}\) For example, the prevalence of contingent fee arrangements and the intimate business relationship between

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\(^{27}\) See Easterbrook & Fischel, Corporate Control Transactions, 91 YALE L.J. 698, 700-703 (1982). Professors Easterbrook and Fischel have stated that fiduciary principles govern agency relationships and that the entire structure of a corporation is itself a series of agency relationships. Id. at 700. Although a description of corporate relationships as a series of agencies may facilitate the theoretical delegation of authority from the investors to the directors, the characterization becomes attenuated when extended to impose third-party liability to those contracting with directors. See Brudney, supra note 23, at 1427-28. In attempting to apply agency theory to corporate relationships, the analysis "focuses more on th[e] commonalities than on the differences," resulting in a flawed conception that "normative consequences appropriate for one such relationship are appropriate for others in totally different contexts." Id. at 1428.

\(^{28}\) See Brudney, supra note 23, at 1428-30 (relationship between corporate management and shareholders does not follow conventional doctrine of agency).

\(^{29}\) Schneider, 169 A.D.2d at 296, 552 N.Y.S.2d at 574. An agency is a consensual relationship in which the agent acts on behalf of the principal and is subject to the control of the principal. RESTATEMENT (SECOND) OF AGENCY § 1 (1958) [hereinafter RESTATEMENT]; see also Brudney, supra note 23, at 1429 (characterization as agency imports concepts of control by investors over management activities and actual consent to what management does).

\(^{30}\) See generally RESTATEMENT, supra note 29, § 26 (principal liable to third party as result of act of principal's agent); Wachtell, Roth & Houston, Investment Banker Liability to Shareholders in the Sale-of-Control Context, N.Y.L.J., Mar. 29, 1990, at 4, col. 5 (in criticizing Schneider, authors queried whether "the shareholders, as 'principals,' [are] to be deemed personally liable for any 'torts' committed by their 'agents' in the conduct of an auction").

\(^{31}\) See generally Note, supra note 6, at 110-11 (not extending liability allows directors to fulfill their duty with lower standard of care as long as they obtain banker's opinion); Oesterle & Norberg, supra note 1, at 249-50 (misuse of fairness opinions is weak link in protecting shareholders).
bankers and directors have raised serious questions as to the impartiality of fairness opinions.\(^3\) In addition, if investment bankers remain insulated from liability, the shareholders may be without an adequate remedy in the buyout context since courts typically construe the “business judgment rule” to protect directors when they have sought and obtained an investment banker’s advice.\(^3\) Finally, the argument has been made that extending the liability of investment bankers, would force the entire profession to become more standardized and demonstrate greater competence, as has occurred in the accounting field.\(^4\)

It is proposed that investment bankers be subject to the same standard of liability as are other professionals. New York has extended the liability of a negligent accountant to non-contractual third parties who were the known and intended beneficiaries of the accountant’s contractual performance.\(^5\) Applying such a standard

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\(^3\) See Bebchuk & Kahan, supra note 2, at 37-45. Although a banker’s fee for preparing a fairness opinion is often fixed, a banker is frequently involved in other aspects of the deal for which substantial fees are contingent on the consummation of the transaction and the eventual price obtained, thus creating substantial incentives to characterize proposals or bids to further their own pecuniary interests. Id. at 38-39; see also Anderson v. Boothe, 103 F.R.D. 430, 436 (D. Minn. 1984) (contingent fees may bias fairness opinion). In addition to fees, a banker’s objectivity is questionable since he frequently knows the directors that hire him and usually has an ongoing business relationship that he is inclined to protect by favoring the interests of management over those of shareholders. Bebchuk & Kahan, supra note 2, at 42-43. The argument also has been posed that a bank’s interest in protecting its professional reputation promotes unbiased opinions. See id. at 43. However, courts have not distinguished fairness opinions on the trustworthiness of a specific bank and shareholders generally do not have detailed information on the quality of a bank’s opinion other than the general reputation of the investment bank. See id. at 43-44; Note, supra note 1, at 127-28.

\(^3\) See supra note 23 (director not liable as agent and therefore only liable to corporation if business judgment rule violated). In Schneider, a derivative action would have been unavailable to the shareholders since the court expressly stated that the injury, if any, was sustained by the shareholders and not the corporation. Schneider, 159 A.D.2d at 297, 552 N.Y.S.2d at 578; see also Fifty States Management Corp. v. Niagara Permanent Sav. and Loan Ass’n, 58 A.D.2d 177, 179, 396 N.Y.S.2d 925, 927 (4th Dep’t 1977) (shareholder has no separate right of action apart from right of corporation); supra note 7 (distinction between direct and derivative suits).

\(^3\) See generally Mess, Accountants and the Common Law: Liability to Third Parties, 52 Notre Dame L. Rev. 838, 855-56 (1977) (increased reliance upon and central role of accountants require clearer standard of liability which will enhance and strengthen profession); Note, supra note 1, at 137 (“accountants have responded to increased legal liability by improving their standards and techniques”).

\(^3\) See 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). The Credit Alliance court established that, in New York, the criteria for extending third-party liability to a negligent accountant requires reliance by a third party and some conduct on the part of the accountant that links the accountant to that party. Id. The court rejected the broader standard applied by other juris-
to investment bankers would hold them directly liable to shareholders in the buyout context, given that the shareholders are the primary beneficiaries of their fairness opinions. The standard established by the First Department in Schneider, however, imposes liability regardless of whether the bankers knew that the shareholders would potentially rely on their advice. On the other hand, use of a more traditional framework of third party liability, that does not improperly superimpose agency theory on a corporate relationship, furthers the policy considerations favoring the extension of liability without unreasonably expanding the scope of an investment banker's liability.

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*Defense barred under New York State Constitution from racially discriminating through exercise of peremptory challenges*

New York Criminal Procedure Law section 270.25 affords both prosecutors and criminal defendants the right to exercise per-