THE ASSOCIATION OF THE BAR
OF THE CITY OF NEW YORK
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SPECIAL COMMITTEE ON MERGERS, ACQUISITIONS AND
CORPORATE CONTROL CONTESTS

February 1, 2005

Via e-mail: pubcom@nasd.com

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

Re: Notice to Members 04-83 - Request for Comment on Whether to Propose New Rule That Would Address Conflicts of Interest When Members Provide Fairness Opinions in Corporate Control Transactions (the "Notice").

Dear Ms. Sweeney:

The Special Committee on Mergers, Acquisitions and Corporate Control Contests (the "Committee") of the Association of the Bar of the City of New York ("ABCNY") is pleased to have the opportunity to submit this letter in response to the NASD's request for comment regarding whether the NASD should propose a new rule that would address procedures, disclosure requirements and conflicts of interest when members provide fairness opinions in corporate control transactions.

The Committee is composed of members whose practices focus on mergers & acquisition transactions and related corporate law, corporate governance and securities regulation matters. The Committee includes lawyers in private practice as well as members of corporate law departments and academics.

INTRODUCTION

As recognized by the NASD, following the Delaware Supreme Court's decision in Smith v. Van Gorkom,[1] it has become commonplace for Boards of Directors of public companies to obtain fairness opinions in connection with their consideration as to whether or not to engage in corporate control transactions. The receipt of such opinions, though not determinative, serves as evidence (often strong evidence) that a Board of Directors has fulfilled its fiduciary duty of care

[1] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

in evaluating the financial aspects of a transaction, and directors will generally be protected from liability if they reasonably rely upon such opinions.[2]

Nevertheless, fairness opinions only address the fairness of the consideration (whether cash, stock or other property) to be paid or received in a transaction. In effect, a fairness opinion is simply an opinion that the consideration to be paid or received in a transaction falls within a range of fair values (whether absolute or relative) for the company or business being sold or acquired. To emphasize that point, fairness opinions explicitly state that the opinion addresses fairness "from a financial point of view" and does not address the merits of the proposed transaction versus alternative transactions or business strategies, nor does it address a company's ultimate business decision whether or not to proceed with a transaction. In addition, although focused on value, fairness opinions do not constitute an opinion that the consideration to be paid or received in a transaction is the highest value obtainable by the seller or the lowest price payable by a buyer.

In addition, reflecting their fundamental function as an analytic aid to assist Boards of Directors in evaluating the financial aspects of proposed transactions, fairness opinions are invariably addressed to the Board of Directors (or a committee thereof) of the member's client and are rendered pursuant to the terms of an engagement letter that sets forth the rights and obligations of the parties, including an allocation of risk for any resulting claims or liabilities and limitations on the use of such opinions. In particular, such engagement letters clearly state that such opinions are solely for the use of the Board of Directors of the member's client in evaluating a specific transaction and do not constitute a recommendation to any shareholder as to how to vote or act (e.g., whether or not to tender) on any matter relating to the proposed transaction.

Part I below sets forth the Committee's comments on the possible elements of a new rule regarding which the NASD specifically requests comment in the Notice. Part II below sets forth certain additional observations. We hope that these comments and additional observations are helpful in connection with the NASD's consideration as to whether to propose new rules regarding fairness opinions.

PART I. Comments on Possible Elements of a New Rule

A. Conflicts Disclosure

The Notice specifically requests comment regarding whether the NASD should propose a new rule requiring members to provide in any fairness opinion that will be included in a proxy statement a clear and complete description of any significant conflict of interest by the member, including, if applicable, that the member has served as an advisor on the transaction in question

[2] See, e.g., 8 Del. C. §141(e) ("A member of the board of directors…shall, in the performance of such member's duties, be fully protected in relying in good faith… upon such information, opinions, reports or statements presented to the corporation by…any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation").

and the nature of the compensation that the member will receive upon the successful completion of the transaction (including any variance or contingency in the fee charged for the fairness opinion).

In evaluating the merit of such a new rule, we note that Item 1015(b)(4) of Regulation M-A under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), already provides that, in connection with each report, opinion or appraisal received by a company from an outside party, the company must describe in the relevant filing with the Securities and Exchange Commission ("SEC") "any material relationship that existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of the relationship between … [t]he outside party, its affiliates, and/or unaffiliated representative … and … [t]he subject company or its affiliates." We believe that by requiring the disclosure of all "material relationships" Item 1015(b)(4) already requires disclosure of relationships that are reasonably likely to give rise to an actual or apparent conflict of interest without requiring members and their clients to make largely subjective, and possibly pejorative, judgments regarding the nature of any particular relationship and whether such relationship constitutes an actual conflict of interest – often not a simple determination as many relationships will have a variety of aspects and implications. Nevertheless, subject to certain concerns discussed in Part II below regarding the potential for confusion and inconsistency with the disclosure required of members' clients by Item 1015(b)(4), we would not object to the proposal of a new NASD rule that requires members to disclose to their clients material relationships, including those that are reasonably likely to give rise to an actual or apparent conflict of interest. Although it should be left to members to determine what relationships and other matters would need to be disclosed, we believe that members would, at a minimum, disclose to their client (i) whether or not the member has served as a financial advisor on the transaction in connection with which the member is rendering a fairness opinion and (ii) the amount and nature of the compensation that the member will receive in connection with the transaction (including whether all or any portion of the compensation is contingent upon delivery of a fairness opinion or consummation of the transaction). However, members should not be required to disclose the specifics of current or contemplated future relationships – such as the ongoing negotiation of a material but unrelated transaction – if such disclosure would result in the premature public disclosure of a potential transaction or other material nonpublic information.

In considering this issue of material relationships and potential conflicts, commentators frequently appear to suggest that a fee arrangement pursuant to which the opinion provider receives a substantial portion of its fee upon consummation of a transaction constitutes a per se conflict of interest. We note, first, that such a fee structure is typically the preference of the member's client, not the member, who would generally prefer to be paid a fee whether or not a transaction is ultimately consummated. Clients usually insist that all or a substantial portion of members' fees be contingent on the consummation of transactions. Delaware courts have recognized that, in many circumstances, such an arrangement aligns the interests of the fairness opinion provider with those of shareholders who will only receive a premium if the transaction is consummated.[3] We also note that boards of directors of clients generally expect that firms

[3] *In re the MONY Group Inc. Shareholder Litigation*, 852 A.2d 9, 22 (Del. Ch. 2004) ("This financially sophisticated Board engaged CSFB for advice in maximizing stockholder value. It obtained a fairness opinion from CSFB, itself incentivized to obtain the best available price due

providing financial advice on transactions also provide fairness opinions, in order to have the comfort that the firms are prepared to memorialize the advice and conclusions resulting from their valuation analyses. In that regard, we believe it is important to remember that (i) the fee a member receives for any particular fairness opinion or upon completion of any transaction typically represents a small fraction of such member's overall revenues, (ii) companies will cease to engage the services of a fairness opinion provider that cannot maintain a reputation for objectivity, integrity and sound professional judgment, (iii) fairness opinions are not issued in a vacuum but must be supported by financial analyses that can withstand the scrutiny of a client's management and board of directors and, in some cases, litigation and (iv) the vast majority of members that render fairness opinions have adopted and implemented procedures – such as internal committees ("fairness committees") required to review and approve the issuance of fairness opinions – to assure independent and objective review of the conclusion and analyses underlying each fairness opinion and that such analyses are appropriate in the context of the specific facts and circumstances relating to the relevant transaction.[4]

B. Reliance on Key Information

The Notice also specifically requests comment regarding whether the NASD should propose a new rule requiring members to disclose the extent to which the firm relied on key information supplied by a company or its management, or whether it independently verified certain information

In our experience, members who render fairness opinions clearly and explicitly disclose in their opinions that they do not assume responsibility for independently verifying any information supplied to the member, and thus we are not sure that such a rule is necessary. However, in order to assure uniformity of practice among opinion providers, we would support a new rule that requires a member providing a fairness opinion to specifically disclose (i) those categories of

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to a fee that was set at 1% of transaction value;…"). See also *In re Vitalink Communications Corp. Shareholders Litigation,* Civ. A. No. *12085,* 1991 WL 238816, at *10 (Del. Ch. Nov. 8, 1991) (highlighting a fee agreement as an incentive to seek the best available price).

[4] The Notice states that "the investment bank may find that the transaction is fair from a financial viewpoint if the transaction is favored by the company's management, and, alternatively, opine that the financial terms are not fair if management opposes the transaction." We believe such statement fails to recognize the professionalism members typically exhibit in undertaking the analyses necessary to render a fairness opinion and the longstanding policies and procedures of the vast majority of members that ensure that the substantive analyses and procedures they employ represent the professional view of the member firm as a whole and not just the answer a particular client wants to hear. Furthermore, in our experience, providers of fairness opinions will privately advise their clients if they believe they will not be able to render a fairness opinion with respect to a proposed transaction, and those transactions are typically either renegotiated or abandoned. For obvious reasons, this occurs much more frequently than is generally known or apparent.

key information (e.g., audited and unaudited historical financial information, financial forecasts and forecasts of synergies expected to be achieved as a result of the transaction) that are supplied to the member by or on behalf of the member's client, its proposed counterparty or their respective managements and (ii) whether it assumes any responsibility for independently verifying such information or instead relied on and assumed the accuracy and completeness of such information for purposes of rendering its fairness opinion.

We do not believe that the NASD should seek to fundamentally change recognized and accepted fairness opinion practice by proposing a rule that would require a member to independently verify any information. In many circumstances, such independent verification by opinion providers is not practicable (e.g., because the information is forward-looking and inherently unverifiable in any objective sense or requires accounting or other expertise outside the scope of expertise of the opinion provider), and we believe it is perfectly reasonable for members who render fairness opinions, like boards of directors, to rely on the views of others, particularly management and its auditors and counsel who the member reasonably believes best know the business or (e.g., with respect to its auditors and counsel) certain financial or legal aspects of the business and are in the best position to evaluate the accuracy and completeness of the relevant information.[5]

C. Procedures

The Notice also requests comment on whether the NASD should propose a new rule requiring members to follow specific procedures to guard against conflicts of interest in rendering fairness opinions and sets forth three categories of procedures that might be addressed by such a new rule.

We would generally support a new rule requiring members that render fairness opinions to adopt policies and procedures that address the process by which fairness opinions are approved by a firm and the process to determine whether the valuation analyses used were appropriate for the

[5] See *In re AOL Time Warner, Inc. Securities and "ERISA" Litigation*, No. 1500, 02 Civ. 5575 (SWK), 2004 WL 992991, at *37 (S.D.N.Y. May 5, 2004) ("Put simply, it was not Morgan Stanley's job to independently investigate AOL's accounting; indeed, Morgan Stanley explicitly disclosed this by disavowing any such independent investigation in the fairness opinion itself.") and *Memorandum and Order of Partial Dismissal* at 14-15, *Newby v. Enron Corporation,* No. 01-3624 (S.D. Texas Aug. 5, 2004) (dismissing plaintiffs' claims against Goldman Sachs where the proxy statement "reflected that Goldman Sachs and the Board had agreed that Goldman Sachs could assume that the information that it was given to review was accurate" and "adequately disclosed as potential conflicts of interest that Goldman Sachs had done work for Enron and PGC in the past and might do business with Enron in the future and that part of Goldman Sachs' fee depended on the success of the merger"). See, also, *In re Reliance Securities Litigation*, 135 F. Supp. 2d 480, 513 (D. Del. 2001) (granting summary judgment because financial advisor' engagement letter permitted them to rely without independent verification on information provided to them).

particular transaction. We would not, however, support a rule that mandates the adoption of specific policies and procedures or that requires members to evaluate the amount and extent that compensation from the transaction underlying the fairness opinion benefits any individual or group of officers, directors or employees relative to the benefits to shareholders generally.

1. Approval Process

The Notice suggests that any rulemaking relating to procedures might address the process by which fairness opinions are approved by a firm, including whether the firm uses a fairness committee and, if so, the selection of personnel for the fairness committee, the level of experience of such persons, procedures designed to provide balanced review, and whether steps have been taken to require review by persons whose compensation is not directly related to the underlying transaction of the fairness opinion.

We would support a new rule requiring members that render fairness opinions to adopt policies and procedures regarding the process by which fairness opinions are approved. While we believe that substantially all members that render fairness opinions have already adopted such policies and procedures, we recognize the importance of such safeguards and believe it is useful and appropriate for the NASD to adopt a rule requiring all members to adopt and implement such policies and procedures. As suggested in the Notice, such policies and procedures should address (i) whether or not the member utilizes a fairness committee, (ii) the manner of selection of members of such committee, and (iii) the means employed to ensure that fairness opinions are supported by appropriate analyses and are subject to an independent and objective review. However, we do not believe that it would be in the interests of NASD members or their clients for such a rule to mandate specific procedural requirements, nor do we think it necessary to require members to disclose details regarding such policies or procedures in the text of their fairness opinions. No single approach is suitable for all firms and all transactions. We believe any such rule should allow members to adopt and utilize the policies and procedures they have each developed over time to achieve the desired objectives in a manner best suited to their firms and the characteristics of particular transactions.

The Notice also suggests that such a rule might require members to adopt policies and procedures to ensure that the opinion is reviewed by one or more persons whose compensation is not directly related to the underlying transaction or the fairness opinion. However, given the varying sizes, activities and organizational structures of member firms, we believe it would be very difficult to formulate rules to determine whether a person's compensation is "directly related to the underlying transaction of the fairness opinion." Members of fairness committees generally are selected from amongst a member's most senior and experienced bankers. Although the members of the fairness committee for a particular transaction should not include bankers assigned to perform the related engagement, we do not believe that other experienced bankers whose annual bonuses are affected by the fees earned in connection with a given transaction should necessarily be prohibited from serving as members of a fairness committee. For example, bankers who perform certain management functions or who are members of a relevant industry or product group may receive bonuses from bonus pools directly affected by such fees. Prohibiting such bankers from being members of the fairness committee assigned to evaluate a particular fairness opinion would potentially deprive the fairness committee of some of its most knowledgeable and able bankers, including those with the most relevant industry expertise.

2. Valuation Analyses

The Notice suggests that any rulemaking relating to procedures might also address the process utilized by members to determine whether the valuation analyses used are appropriate for the type of transaction and the type of companies involved in the transaction.

As noted above, we would support the NASD adopting a new rule requiring members that render fairness opinions to adopt policies and procedures to evaluate whether the valuation analyses performed in connection with a particular fairness opinion were appropriate in the context of the transaction and the transaction participants. While we believe that substantially all members that render fairness opinions already have adopted such policies and procedures, we believe that requiring all members to adopt policies and procedures would provide important additional safeguards. Nevertheless, we believe it is important to recognize that the appropriate types of analyses and manner of performing such analyses will vary from transaction to transaction depending on specific facts and circumstances, including those relating to the transaction structure, form and type of consideration and various characteristics and attributes of the transaction participants themselves. As noted above, fairness opinions are not rendered in a vacuum, and the related analyses must withstand the scrutiny of their client's management and board of directors and, in some cases, litigation. Consequently, we do not believe it is practicable or necessary for the NASD to adopt a rule that would mandate or limit the types and manner of analyses that must be performed.

3. Benefits to Individual Officers, Directors or Employees or Classes of Such Persons that Differ from Benefits Received by Shareholders Generally

The Notice suggests that any rulemaking relating to procedures might also address how members evaluate the degree to which the amount and nature of the compensation from the transaction underlying the fairness opinion benefits any individual officers, directors or employees, or class of such persons relative to the benefits to shareholders of the company generally, and thus is a factor in reaching a fairness determination.

While we are generally supportive of many of the suggestions for proposed new NASD rules set forth in the Notice, we believe a proposal to adopt a new rule that required fairness opinions to address such compensation issues misconstrues the purpose and scope of fairness opinions and the roles of members who provide fairness opinions. We strongly urge that the NASD not make any such rule proposal.

As noted above, fairness opinions simply address whether the consideration to be paid or received in a transaction by a company or its shareholders falls within a range (either absolute or relative) of fair values for the company or business being sold or acquired. In reaching their conclusion, opinion providers will typically perform a variety of valuation analyses. The financial analyses performed often will generate absolute or relative valuation ranges for the company or business without regard to capital structure – a so-called enterprise value – from which the investment bank can then infer an equity value by taking into account the actual capital structure and other liabilities of the company or business. This is typically accomplished by subtracting the total amount of debt and other liabilities from the enterprise value indicated by the various valuation analyses. Members typically rely on the financial statements and other information provided by management to determine the amount and nature of existing liabilities and have no ability to unilaterally determine whether certain preexisting liabilities are wise or unwise or appropriate or inappropriate. From an opinion providers perspective, all such preexisting liabilities – whether an employment or severance agreement or any other liability of the company (e.g., a liability for environmental remediation or a broad based employee pension plan) – are liabilities that have priority over the residual equity value and thus must be deducted from enterprise value in determining residual equity value.

It is the province of a company's board of directors (and committees thereof) – not its financial advisor – to determine the amount and terms of any contractual liabilities incurred by the company. Boards exercise their own judgment and routinely obtain the advice of relevant professional advisors in exercising this authority. For example, boards can, and often do, seek the expert advice of employment and management consultants at the time of the adoption or approval (which often occurs months or years before a change of control transaction is entered into or even considered) of a significant employment agreement, severance contract or group of such agreements and contracts. Such advice generally includes analysis and quantification of the costs of such contracts and agreements and data regarding how the costs and terms of such contracts and agreements compare to those entered into by peer companies. An evaluation of the terms of an employment agreement, severance contract or group of such contracts or agreements is within the core competencies of such other consultants and advisors and generally not within the core competencies of most members.

Accepting that fairness from a financial point of view is focused on an analysis of residual equity value relative to the consideration to be paid or received by the company or its shareholders in a transaction – and not a subjective evaluation of whether the transaction is fair in some relative sense as between the company or its shareholders, on the one hand, and the company's officers, directors, employees and other non-shareholder constituencies, on the other hand – it becomes clear that opinion providers cannot be expected to and, in fact, do not consider the degree to which the amount and nature of the compensation from the transaction underlying the fairness opinion benefits any individual officers, directors or employees, or class of such persons, relative to the benefits to shareholders of the company. This does not mean that information regarding the benefits that individual officers, directors or employees will receive from the transaction would be unavailable to boards of directors or shareholders if not specifically addressed by financial advisors in the context of rendering a fairness opinion. As described above, such information generally is presented to boards at the time they adopt the relevant agreements, contracts or arrangements and is presented again to boards in connection with their consideration of a specific change of control transaction. In addition, such information is generally required under applicable SEC rules and regulations to be included in proxy statements sent to shareholders in connection with their vote on change of control transactions.[6] Such disclosure

[6] See Item 5 of Schedule 14A for proxy statements subject to Section 14(a) of the Exchange Act and Item 18(a)(5) of Registration Statement on Form S-4 under the Securities Act of 1933 (the "Securities Act").

enables shareholders as well as boards of directors to evaluate whether any extraordinary payments are justified by the benefits of the proposed transaction.[7]

Although we would not support a rule requiring members to take such relative benefits into account, we would support a rule that requires members to clarify in their fairness opinions that their opinion only addresses the fairness from a financial point of view of the consideration to be received pursuant to the subject transaction and does not address any other aspect or implication of the transaction or of any other agreement, arrangement or understanding entered into in connection with the transaction or otherwise, including, without limitation, agreements entered into by the directors, officers, employees and security holders of the company in connection with their past, current and future employment or other appointment by the company and any termination thereof.

PART II. Additional Observations

A. What Types of Fairness Opinions should be Subject to an NASD Rule

The Notice suggests that a new rule would apply to fairness opinions appearing in any proxy statement in corporate control transactions. We note that in addition to proxy statements filed with the SEC, fairness opinions may also appear in (i) proxy statements for companies whose equity securities are not publicly registered (i.e., so called “private companies”) or are not otherwise subject to Section 14(a) of the Exchange Act (e.g., foreign private issuers), (ii) Solicitation/Recommendation Statements on Schedule 14D-9, (iii) Rule 13e-3 Transaction Statements on Schedule 13E-3, (iv) Registration Statements on Form S-4/F-4, and (v) Information Statements on Schedule 14C. In addition, although practices vary amongst members, fairness opinions may be rendered in connection with transactions that do not involve a “change in control.” If the NASD determines to propose a new rule, such rule should clearly specify the transactions to which it is intended to apply.

B. Disclosure Responsibilities

As already recognized by the NASD, Item 1015(b) of Regulation M-A imposes substantial disclosure requirements on member clients. Any NASD rule would at least partially reallocate the burden of disclosure from members’ clients (as the persons responsible for making filings with the SEC) to the members themselves, at least with respect to the information required by Item 1015(b)(4), and would likely require additional disclosure in each opinion when rendered. Because of the passage of time and intervening events, such disclosure may often differ from the corresponding information required to be disclosed by members’ clients in forms and schedules subsequently filed with the SEC and/or mailed to stockholders, with the consequent potential for confusion.

As stated above, we would not object to the proposal of a new rule requiring members to make disclosures to their clients consistent with the disclosure required by Item 1015(b)(4). However, we remain concerned that the benefits of the NASD adopting a rule requiring members to

[7] See, e.g., *MONY Group Inc., supra* at n. 3 (where the Board resolved not to approve any transaction until it could amend certain management change of control contracts).

disclose in the text of their opinions substantially the same information as SEC regulations already require members' clients to disclose are outweighed by the risk that differing disclosure may result in substantial confusion.

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We appreciate this opportunity to comment on the matters being considered by the NASD, and we would be happy to discuss any questions the NASD or its staff may have with respect to this letter. Questions may be directed to the undersigned at 212-906-1306 or erica.steinberger@lw.com.

Very truly yours,

Committee on Mergers, Acquisitions and Corporate Control Contests

Erica H. Steinberger
Chair