

# A MORE CRITICAL USE OF FAIRNESS OPINIONS AS A PRACTICAL APPROACH TO THE BEHAVIORAL ECONOMICS OF MERGERS AND ACQUISITIONS

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## I. INTRODUCTION

In his essay *The Behavioral Economics of Mergers and Acquisitions*,<sup>1</sup> Don Langevoort accurately describes the state-of-play in a somewhat broken system of corporate governance in the context of business combinations (a.k.a. mergers and acquisitions or, as referenced here, “M&A”). The law (in both its regulatory and enforcement forms), as described by Professor Langevoort, fails to effectively curb observed behavioral biases in the M&A transactional environment. As a result, Professor Langevoort ultimately urges that law practice—rather than legal principles and constraints arising from legislation, regulation, and judicial review—holds the answer to important unresolved questions at the intersection of behavioral economics and corporate governance. Specifically, he contends that:

corporate law is about more than strategies of judicial or regulatory intervention. The *practice* of corporate law and corporate governance—in which lawyers are centrally involved—requires a great deal of psychological as well as economic astuteness, and the rich body of behavioral M&A research can and should inform how deals are negotiated, structured and approved, even in setting of minimal judicial review.<sup>2</sup>

He goes on to say that:

[t]he most important message . . . applies to those individuals trying to manage the deal process in the shareholders’ best interest. Those individuals, including the lawyers, bankers, and accountants, should recognize the pressures driving members of the deal team and be demanding and critical, even when they genuinely believe in doing the deal.<sup>3</sup>

Finally, consistent with the foregoing, he concludes that:

the greatest use for this [behavioral] research is mainly for participants in the transactional process itself, who very much need to better understand

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<sup>1</sup> Donald C. Langevoort, *The Behavioral Economics of Mergers and Acquisitions*, 12 *TRANSACTIONS: TENN. J. BUS. L.* 65 (2011).

<sup>2</sup> *Id.* at 76.

<sup>3</sup> *Id.* at 78.

not only that human nature poses a risk to the deal, but how, why, and under what circumstances there is reason to worry.<sup>4</sup>

Some may find Professor Langevoort's conclusions in this regard obvious because legislative and regulatory rulemaking and judicial intervention have, indeed, proven unworkable, seemingly leaving only practical solutions on the table. Others may find them counterintuitive in that flaws of human nature exist in both M&A dealmakers and those responsible for M&A practice, making it difficult for us to fathom how one may meaningfully check the behavioral biases of the other. Both views may be valid critiques of the conclusions he draws in his essay. So be it. But neither takes away from the simple elegance (and, I believe, validity) of his idea. Professor Langevoort's description of legal and practical considerations in M&A transactions is accurate, and his solution rings true to me as a former M&A practitioner. A major question exists, however, as to whether his idea is practicable. I maintain that it is and hope, through this response to his essay, to demonstrate that promising practical tactics exist to achieve his strategic objectives.

Professor Langevoort encourages us to educate transactional participants about both the nature of observed behavioral norms that impact M&A transactions and the effects of the observed norms on those transactions so that transactional participants may engage in activities that reinforce desirable behavioral norms and counteract undesirable norms. I stand ready to join in this effort and the overall charge toward practice-based responses to behavioral critiques of corporate governance in the M&A context.

Accordingly, as a means of further effectuating the educational mission suggested and commenced by Professor Langevoort in his essay, this paper expresses preliminary thoughts on one potential component of the practice-based answer Professor Langevoort seeks. Specifically, this paper asserts that fairness opinions, nearly ubiquitous in M&A transactions, can be better used in the M&A transactional process to mitigate or foreclose the negative effects of prevalent adverse behavioral norms. Like Professor Langevoort's conclusions excerpted above, the idea that fairness opinions may offer opportunities to neutralize behavioral norms in M&A transactions is both obvious (because fairness opinions are designed to serve a gatekeeping function, protecting both sellers and buyers against biased or otherwise inaccurate management price determinations) and counterintuitive (in that the investment bankers who typically author fairness opinions, and the corporate managers who retain them, have been accused of acting in accordance with behavioral biases in rendering and accepting those opinions). The core idea motivating this paper is that fairness opinions, when properly constructed and used, have the potential to provide effective gatekeeping in spite of the operation of countervailing behavioral biases.

Accordingly, this paper begins by briefly reviewing the nature (attributes, benefits and detriments), regulation, and utilization of fairness opinions in the M&A transactional process, including the ways in which fairness opinions manifest, support, and attempt to counteract behavioral norms. Next, the paper suggests best practices in the construction and use of fairness opinions that take into account our knowledge of behavioral psychology as it relates to M&A transactions. The net effect of these best practices is to transform what may be unconscious behavioral norms into conscious biases that, once exposed, can be confronted and, as desired, mitigated. The paper ends with a summary conclusion.

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<sup>4</sup> *Id.* at 79.

## II. FAIRNESS OPINIONS IN M&A PRACTICE

Fairness opinions typically are provided to corporate management by an outside financial advisor, such as an investment bank or valuation firm,<sup>5</sup> to provide assurance that the pricing of a transaction is fair—specifically, that the transaction is fair “from a financial point of view.”<sup>6</sup> In M&A transactions, these opinions may be provided to the board of directors or a committee of the board of directors for the acquiror or the target or both, depending on the context. Fairness opinions tend to have a particular, predictable structure and form.<sup>7</sup>

When used as part of management’s deliberative process, fairness opinions have the capacity to increase the amount of information available to executives and the board of directors, especially independent directors.<sup>8</sup> The price verification provided by fairness opinions may be critical where a market-based price is unavailable or unreliable.<sup>9</sup> In addition, fairness opinions represent a way for officers and directors to ensure compliance with their fiduciary duties of care (informing themselves of all material information reasonably available) and loyalty (including good faith) in M&A transactional decision-making. Fairness opinions are not legally mandated, but since the Delaware Supreme Court’s 1985 decision in *Smith v. Van Gorkom* (in which a target’s board of directors was criticized for, among other things, its perfunctory assessment of the pricing of a merger in the absence of a fairness opinion),<sup>10</sup> they have become omnipresent in M&A transactions of

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<sup>5</sup> For ease of reference, I will often refer to the authors of fairness opinions as investment banks, although I acknowledge that valuation firms and other financial advisors also may render fairness opinions. I note here, however, that the range of services provided by investment banks may make them more likely to have a conflicting interest than more narrowly tailored financial services firms. See *infra* notes 23-25 and accompanying text.

<sup>6</sup> See ROBERT F. REILLY & ROBERT P. SCHWEIHS, HANDBOOK OF ADVANCED BUSINESS VALUATION 310 (2000) (“A fairness opinion is a letter, prepared by a knowledgeable financial advisory firm (generally an investment banking firm or an entity specializing in valuations), that states whether or not a transaction—or the consideration or financial terms of a transaction—is fair. Fairness is assessed from a financial point of view.”); Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557, 1558 (2006) (“A fairness opinion is an opinion provided by an outside advisor, usually, though not necessarily, an investment bank, that a transaction meets a threshold level of fairness from a financial perspective.”). The concept of fairness from a financial point of view is imprecise and is not defined in the opinions themselves. See Steven J. Cleveland, *An Economic and Behavioral Analysis of Investment Bankers When Delivering Fairness Opinions*, 58 ALA. L. REV. 299, 336 (2006); Michael B. Rizik, Jr. & Matthew M. Wirgau, *Fairness Opinions: No Longer a Laughing Matter*, 25 T.M. COOLEY L. REV. 233, 239 (2008). The clear importance of the “financial point of view” qualifier is to limit the scope of the opinion to matters within the expertise of the firm rendering the opinion. See REILLY & SCHWEIHS, *supra*.

<sup>7</sup> See Rizik & Wirgau, *supra* note 6, at 251-56.

<sup>8</sup> See generally Matthew D. Cain & David J. Denis, *Do Fairness Opinion Valuations Contain Useful Information?* (Am. Fin. Ass’n 2008 Meetings, Working Paper, Oct. 4, 2010), available at <http://ssrn.com/abstract=971069> (finding evidence that fairness opinions provide information useful to directors and investors). See also Cleveland, *supra* note 6, at 300-01 (explaining in simple terms the information-enhancing role of a fairness opinion in corporate transactions); Davidoff, *supra* note 6, at 1589 (“[A]n unconflicted valuation conducted with rigor and discipline in accordance with current academic precepts and without biased manipulation of subjective inputs can materially inform as to value.”); Melissa B. Frye & Weishen Wang, *Boards, Uncertainty, and the Use of Fairness Opinions*, 18 CORP. GOV.: AN INT’L REV. 49 (2010) (showing, among other things, that boards with more independent directors may seek fairness opinions to enhance their knowledge).

<sup>9</sup> Jeffrey B. Bede, *Are Fairness Opinions . . . Fair?*, CHESIECAP, at 3, <http://www.chessiecap.com/pdfs/Fairness-Opinions.pdf> (last visited March 21, 2011).

<sup>10</sup> 488 A.2d 858, 876-78 (Del. 1985).

a certain size.<sup>11</sup>

A secondary function of fairness opinions is to provide shareholders with transaction pricing information, enabling them to better determine how to exercise rights to tender or vote (or dissent and exercise statutory appraisal rights, if available).<sup>12</sup> The opinions are disclosed and described as part of the publicly available materials for certain public company tender offers and for mergers and sales of all or substantially all of a corporation's assets.<sup>13</sup> Some empirical evidence suggests that the existence of a fairness opinion in an M&A transaction protects the shareholders of acquiror firms by keeping the premium over market prices relatively low.<sup>14</sup> Target fairness opinions may be more important than acquiror fairness opinions in this regard. A recent study indicates that voting shareholders of an acquiror value the fairness opinion rendered by the target's advisor (which typically is less biased) more than the fairness opinion of the acquiror's advisor in making their voting decisions.<sup>15</sup>

As a general matter, fairness opinions are designed to ensure that there are effective procedural checks on potential managerial and institutional deviations from normative wealth maximization. If, as Professor Langevoort's essay suggests, individual cognitive traits or biases threaten to impair rational individual and institutional decision-making in M&A transactions and neither regulation nor the courts provides fully effective checks on the potential for irrational behavior, then a third-party opinion from a reliable source seems like a sensible response. This is a weighty responsibility for the firms that write fairness opinions because they serve as reputational intermediaries.<sup>15</sup> Both management and shareholders may

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<sup>11</sup> Professor Frank Partnoy makes this point particularly well:

[T]he directors in *Smith v. Van Gorkom* did not follow the then relatively common practice of soliciting a fairness opinion from an investment bank. The court in *Van Gorkom* suggested that although such fairness opinions were not required by law, the directors would have obtained some advantage in the case if they had obtained a fairness opinion. Thus, *Van Gorkom* created a regulatory entitlement related to fairness opinions.

Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491, 523 (2001) (footnote omitted).

<sup>12</sup> See Bede, *supra* note 9, at 3 (“[T]he fairness opinion serves an important role in providing useful information to shareholders....”).

<sup>13</sup> See PETER A. HUNT, *STRUCTURING MERGERS & ACQUISITIONS: A GUIDE TO CREATING SHAREHOLDER VALUE* 338 (4th ed. 2009) (“In transactions that require shareholder approval, the fairness opinion is often included in the proxy statement or prospectus that is sent to shareholders seeking their vote in favor of the deal”). Securities and Exchange Commission disclosure rules may mandate disclosure. See, e.g., Sec's & Exch. Comm'n, Reg. M-A, Reports, Opinions, Appraisals and Negotiations, 17 C.F.R. § 229.1015 (2010) (requiring disclosure of the existence of and certain information about fairness opinions); Sec's & Exch. Comm'n, Reg. M-A, Exhibits, 17 C.F.R. § 229.1016 (2010) (requiring that fairness opinions disclosed under Item 1015 be included as exhibits). Interestingly, cash tender offers that do not constitute going-private transactions do not invoke these requirements. See Davidoff, *supra* note 6, at 1590.

<sup>14</sup> See, e.g., Darren J. Kisgen et al., *Are Fairness Opinions Fair? The Case of Mergers and Acquisitions*, 91 J. FIN. ECON. 179 (2009).

<sup>15</sup> See SERGEI PARIJS, *FAIRNESS OPINIONS AND LIABILITY: A LEGAL AND ECONOMIC ANALYSIS OF FAIRNESS* 88-89 (2005) (classifying those who offer fairness opinions as “gatekeepers” and stating that “gatekeepers are also called ‘reputational intermediaries’”); Jonathan M. Barnett, *Certification Drag: The Opinion Puzzle and Other Transactional Curiosities*, 33 IOWA J. CORP. L. 95, 100 (2007) (describing the theory explaining reputational intermediaries and citing to investment banker roles in corporate transactions as an example); John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301, 308-09 (2004) (discussing gatekeepers

view the perceived stature of these firms and their willingness to render an opinion as a seal of approval on the transaction on which the opinion is given.<sup>16</sup>

But the proposition that fairness opinions could be important, independent, practice-based checks on biased decision-making by officers and directors in M&A transactions flies in the face of a substantial body of academic literature questioning the actual role and value of fairness opinions in M&A transactions. The critiques are many and varied.<sup>17</sup> For example, empirical evidence indicates that acquirors using fairness opinions underperform in the short term.<sup>18</sup> Acquiror fairness opinions may have a tendency to overvalue the target.<sup>19</sup> In addition, fairness opinions have been described as subjective, indeterminate, and inconsistent in approach and in the weighting of valuation factors; they are not always rendered in accordance with the best practices advocated in practical and academic literature.<sup>20</sup> Knowledgeable non-scholarly commentary is consistent with these findings.<sup>21</sup> Overall, questions remain as to whether the benefits of fairness opinions are outweighed by their high cost.<sup>22</sup>

Perhaps the critique with the most traction relates to the possible effect of conflicting interests on the quality of a fairness opinion. The potential conflicts range from those arising from a lack of independence (given that many of the authors of fairness opinions are financial advisors to the firm in connection with the transaction for which the opinion is written and also have provided and plan to continue providing other financial advisory services to the firm) combined with an overall compensation scheme for the transaction in the form of a sizable success fee (based on the aggregate transaction value) to the existence of actual or possible business interests on both sides of the M&A transaction.<sup>23</sup> The capacity for divided loyalties in this environment seems great. Yet, there is some

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as reputational intermediaries and listing investment bankers as among those gatekeepers who serve as reputational intermediaries).

<sup>16</sup> I am not, of course, the first to make this observation. See, e.g., Rizik & Wirgau, *supra* note 6, at 237 (“A fairness opinion is the issuer’s ‘Good Housekeeping Seal of Approval’ for the constituency seeking it.”).

<sup>17</sup> See Yasuhiro Ohta & Kenton K. Yee, *The Fairness Opinion Puzzle: Board Incentives, Information Asymmetry, and Bidding Strategy*, 37 J. LEGAL STUD. 229, 232-33 (2008) (describing three bases for bias in the rendering of fairness opinions).

<sup>18</sup> See Kisgen et al., *supra* note 14, at 180-81; Lucy Huajing Chen & Heibatollah Sami, Does the Use of Fairness Opinions Impair the Acquirers’ Abnormal Returns? The Litigation Risk Effect 4 (Aug. 2007) (unpublished manuscript, available at [http://www.af.polyu.edu.hk/jcae\\_af/paper2008/concurrent/S.2a%20Sami.pdf](http://www.af.polyu.edu.hk/jcae_af/paper2008/concurrent/S.2a%20Sami.pdf)).

<sup>19</sup> See Cain & Denis, *supra* note 8, at 17 (“[T]he valuations of acquirer advisors exceed those of matched target advisors by 29%, on average.”).

<sup>20</sup> Davidoff, *supra* note 6, at 1573-85. To the subjectivity point, one industry professional aptly describes fairness opinions as involving “both art and science.” Bede, *supra* note 9, at 2.

<sup>21</sup> See, e.g., ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES 374 (2010) (“A fairness opinion is usually touted as an independent, unconflicted seal of approval for a deal. But on Wall Street, they are often seen as little more than paid rubber stamps.”).

<sup>22</sup> See Barnett, *supra* note 15, at 146 (“[E]ven routinely employed certification practices may convey little new information to contracting parties, thereby doing nothing more on a net social basis than imposing a costly ‘drag’ on market transactions.”).

<sup>23</sup> See Davidoff, *supra* note 6, at 1586-88; see also *Fairness Opinions and Advisor Independence*, AM. APPRAISAL, 2 (Winter 2010), <http://www.american-appraisal.us/userfiles/file/Fairness%20opinions%203222010.pdf> (describing potential conflicts of interest for financial advisors).

dispute about whether conflicts of interest have actual detrimental effects on fairness opinions.<sup>24</sup> Regardless, research confirms that shareholders may discount the value of fairness opinions because they know the advisors rendering the opinions are conflicted.<sup>25</sup>

Even assuming the potential or actual existence of conflicts of interest in some situations, the benefits of fairness opinions may exceed their costs. For example, asking for a valuation from a financial advisor who is familiar with the firm may provide some offsetting benefits, e.g., in the form of a more accurate valuation.<sup>26</sup> Advisors with pre-existing relationships with a firm should have more information about the firm, enabling a more accurate (and, potentially, more efficient) valuation. In addition, certain authors of fairness opinions may be more accurate than others. For example, support exists for the contention that fairness opinions authored by top-tier financial advisors signal a higher quality transaction.<sup>27</sup>

In 2007, in an effort to address the conflict of interest issue, the Financial Industry Regulatory Authority (“FINRA”) imposed new requirements on member firms that render fairness opinions.<sup>28</sup> These requirements, embodied in FINRA Rule 5150 (originally proposed as NASD Rule 2290), comprise disclosure obligations relating to both the member firm rendering the fairness opinion and the opinion itself (operative only when “the member issuing the fairness opinion knows or has reason to know that the fairness opinion will be provided or described to the company's public shareholders”) and mandate that any member

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<sup>24</sup> Compare Cain & Denis, *supra* note 8, at 4 (“We conclude, therefore, that there is little evidence that fairness opinion valuations are driven by conflicts of interest.”) with Kisgen et al., *supra* note 14, at 181 (“We find . . . evidence that conflicts of interest . . . affect the objectivity and quality of F[airness] O[pinion]s.”). Specifically, the Cain and Denis paper finds “no evidence . . . that opinion providers provide less accurate valuations for mergers in which they are paid contingent fees” and “no evidence that unaffiliated third-party investment banks provide valuations that are more accurate than affiliated advisors.” Cain & Denis, *supra* note 8, at 4. Kisgen et al., on the other hand, “find that acquirers with F[airness] O[pinion] providers that also receive a fee contingent on deal completion have significantly lower announcement-period returns” and that in cases involving financial opinion advisors “otherwise *unaffiliated* with the transaction . . . the market does not react negatively to the use of these advisors.” Kisgen et al., *supra* note 14, at 181.

<sup>25</sup> Anil K. Makhija & Rajesh P. Narayanan, *Fairness Opinions in Mergers and Acquisitions* 4 (Fisher Coll. of Bus., Working Paper No. 2007-03-108; Charles A. Dice Ctr., Working Paper No. 2007-11, 2007), available at [http://www.terry.uga.edu/finance/docs/narayanan\\_fairness\\_opinions.pdf](http://www.terry.uga.edu/finance/docs/narayanan_fairness_opinions.pdf) (“Shareholders, aware of the conflict of interest facing the advisor, thus rationally discount their valuation of the deal when the advisors provide the fairness opinions.”).

<sup>26</sup> See Cain & Denis, *supra* note 8, at 4 (“advisors with a pre-established relationship with the target” “produce significantly lower absolute valuation errors”).

The results . . . provide some evidence that both acquirer and target advisors produce significantly lower absolute valuation errors for transactions in which they have had previous business experience with either the target only or both the acquirer and target. This evidence supports the view that prior business relationships produce information that is useful in the producing more precise fairness opinion valuations.

*Id.* at 22.

<sup>27</sup> See Kisgen, *supra* note 14, at 181 (“The use of top-tier F[airness] O[pinion] advisors on the acquirer side reduces the deal premium, while the use of lower-tier FO advisors is associated with a higher probability of completing the deal, higher premiums paid, and significantly lower announcement returns.”); Cain & Denis, *supra* note 8, at 4 (“We further find that top-tier investment banks produce significantly lower absolute valuation errors.”).

<sup>28</sup> FINRA R. 5150, Fairness Opinions, FINRA Manual, available at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=6832](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6832).

firm rendering the opinion have written procedures regarding the approval of fairness opinions.<sup>29</sup> The required disclosures, some of which were formerly voluntary or included only in the text of public filings describing the opinion, must be included in the fairness opinion itself.<sup>30</sup> Admittedly, these new requirements fall short of ensuring the efficacy of fairness opinions that may be tainted by a conflict of interest.<sup>31</sup> Mandatory disclosure may be a necessary yet insufficient response to self-interest,<sup>32</sup> and weak process regulation is similarly unlikely to have much effect.<sup>33</sup>

Finally, even if the critiques regarding fairness opinions can be overcome or substantially offset by their positive attributes, it is important to note that investment bankers authoring fairness opinions may be subject to the same cognitive biases—the risk and loss aversion, overconfidence, availability, and self-serving biases—that operate on corporate officers and directors.<sup>34</sup> Other biases also may impact the behavior of investment banks rendering fairness opinions.<sup>35</sup> The existence of these biases may have effects on the ability of a fairness opinion author to resist the tug of self-interest or to properly assess the reputational risk associated with delivering a “low-quality opinion.”<sup>36</sup> Learning, competition, monitoring, and other activities and structures may counteract these individual behavioral tendencies, but one still must account for the possibility that cognitive biases impact fairness opinion decision-making at the institutional, as well as individual, level (Professor Langevoort’s third of the four tall steps that must be climbed to incorporate insights from psychology into corporate and securities law) in establishing any remedial measures.<sup>37</sup>

In sum, fairness opinions have an entrenched place in the M&A process that makes them well positioned to mitigate the effects of cognitive biases on decision-makers. However, as currently constituted and regulated, fairness opinions fail to live up to their potential. They may have certain predictable and unpredictable inaccuracies resulting from the norms of fairness opinion practice, conflicting interests, and processing errors. In other words, fairness opinions, as a possible check and balance on flawed decision-making in the M&A process, exhibit some of the same defects Langevoort and others observe in the M&A decision-making context generally. Yet, there may be ways to enhance the prospect that

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<sup>29</sup> *Id.*

<sup>30</sup> See Rizik, Jr. & Wirgau, *supra* note 6, at 262.

<sup>31</sup> *Id.* at 265.

<sup>32</sup> See Langevoort, *supra* note 1, at 67 (“[C]orporate and securities law’s favorite strategy—more disclosure—often fails when up against a well-ingrained, institutionally favored behavioral bias.”).

<sup>33</sup> See Davidoff, *supra* note 6, at 1595-98 (citation omitted) (commenting on the proposed NASD Rule 2290, later codified as FINRA Rule 5150, and concluding that “[t]he rule in its current proposed form is largely uneventful and a disappointment given the NASD acknowledgement of the issues before it.”).

<sup>34</sup> See Cleveland, *supra* note 6, at 324 (citations omitted).

<sup>35</sup> See *infra* notes 50-57 and accompanying text (describing dependent gatekeepers, characterizing fairness opinion authors as dependent gatekeepers, and identifying biases to which dependent gatekeepers likely are subject).

<sup>36</sup> Cleveland, *supra* note 6, at 326 (describing how “[t]he cognitive bias regarding loss aversion may lead a bank or a banker to deliver to a long-term client an opinion with content pleasing to the client—even if the opinion is of low quality—to preserve the relationship with that client” and that the overconfidence, availability, and self-serving biases “may lessen the disciplinary effect of reputation”).

<sup>37</sup> *Id.* at 330-34; Langevoort, *supra* note 1, at 66-67.

fairness opinions could have a meaningful role in diminishing the effects of behavioral biases on M&A decision-making. The remainder of this paper is dedicated to that proposition.

### III. ADDING VALUE TO FAIRNESS OPINIONS AS A RESPONSE TO BEHAVIORAL BIASES

It remains for us to determine how to mold this rather promising, yet flawed, device—the fairness opinion—into a tool that can be used more effectively to curb cognitive biases in the M&A decision-making process. I posit that a multi-pronged attack on existing fairness opinion practice may yield results in this regard. Two main avenues exist for reforming the use of fairness opinions in the M&A process: (1) modifications can be made to the form of fairness opinions and the process that creates them or (2) adjustments can be made to the way that fairness opinions are employed and reviewed in the M&A decision-making process. A number of scholars have addressed the first of these two avenues for reform, but not many have approached the latter. This Part preliminarily outlines a series of proposed changes in the contents, construction, use, and assessment of fairness opinions that, when taken together, hold promise to enhance the value of fairness opinions as a response to cognitive bias in the M&A context.

#### *A. Further Changes to the Form of Fairness Opinions*

As earlier noted,<sup>38</sup> FINRA Rule 5150 imposes content requirements on fairness opinions written by member firms.<sup>39</sup> However, it represents a somewhat limited approach, catered only to specific aspects of the potential for conflicting interests (and not cognitive bias). Why not, then, consider a similar approach to counteracting bias? That is precisely what Professor James Fanto suggested ten years ago.

The SEC might consider a disclosure rule that would hold investment bankers to a higher standard in their opinions by requiring them to consider the potential negative consequences and costs arising from the transaction and to quantify the likely negative results of the merger. In the same vein, investment bankers could be required to give an opinion that explicitly addresses the rationality of the deal from both the acquirer's and target's perspective as opposed to their current limited focus on the fairness of the exchange ratio. After all, since they are so involved in promoting the mega-mergers, it is appropriate for them to be enlisted in the effort to achieve a comprehensive rationality on the part of boards and shareholders. In addition, by expanding their opinions to address the evidence on the negative results of mega-mergers, investment bankers would enhance the comprehensive rationality of merger decision-making. They would also present a stronger scientific rationale than that contained in the watered-down, self-interested version of financial economics currently used to justify their fairness opinions.<sup>40</sup>

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<sup>38</sup> See *supra* notes 28-30 and accompanying text.

<sup>39</sup> FINRA R. 5150, Fairness Opinion, FINRA Manual, available at [http://finra.complinet.com/en/display\\_main.html?rbid=2403&element\\_id=6832](http://finra.complinet.com/en/display_main.html?rbid=2403&element_id=6832).

<sup>40</sup> James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333, 1398 (2001) (footnote omitted).



In his 2001 article, Professor Fanto offers this content-based proposal as one among a number of reforms targeted to combat behavioral bias in M&A decision-making.<sup>41</sup> As Professor Langevoort notes in his essay, it is Professor Fanto who demonstrated many years ago, in the study presented in that article, that psychological factors impair rationality in M&A decision-making.<sup>42</sup> Professor Fanto's proposal is nicely tailored to the biases he and Professor Langevoort observe, and I endorse it. I would suggest that in the current regulatory environment, however, FINRA, rather than (or perhaps in addition to) the SEC, may be the appropriate author of the rule and that, in fact, the requirements proposed by Professor Fanto be added to FINRA Rule 5150. In this regard, consideration should be given to counteracting bias in fairness opinions rendered by both investment bankers and others in both public and private transactions.

*B. Changes in the Way Fairness Opinions are Made*

Changing the form of fairness opinions will necessarily involve modifications in the process used to construct those opinions. To support the content-based changes proposed by Professor Fanto and increase the overall accuracy of fairness opinions in combating cognitive bias in M&A decision-making, what might a good process look like? Best practices used in other professions in rendering opinions may provide useful guidance.

Various other reputational intermediaries (gatekeepers)<sup>43</sup> issue opinions in connection with business transactions, including principally lawyers and accountants. Lawyers are not subject to externally imposed restrictions on the form and content of their opinions (although custom and practice guidance provide important, yet nonbinding, parameters and regulatory authorities, including the SEC, and stock exchanges may require the coverage of specified items in specific transactional circumstances),<sup>44</sup> and the effect of a legal opinion on the M&A decision-making process is negligible.<sup>45</sup> Auditors, on the other hand, must comply with significant rules that dictate the form and substance of their audit opinions,<sup>46</sup> and their opinions carry great weight in M&A decision-making.<sup>47</sup> Before the

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<sup>41</sup> *Id.*

<sup>42</sup> Langevoort, *supra* note 1, at 68.

<sup>43</sup> See *supra* note 15 and accompanying text.

<sup>44</sup> Jonathan C. Lipson, *Price, Path & Pride: Third-Party Closing Opinion Practice Among U.S. Lawyers (A Preliminary Investigation)*, 3 BERKELEY BUS. L.J. 59, 71 (2005) ("Although closing opinion letters are not generally regulated, they have become fairly standardized in forms that are widely available."). Practice conventions are important to legal opinion practice. See John C. Coffee, Jr., Comment, *Can Lawyers Wear Blinders? Gatekeepers and Third-Party Opinions*, 84 TEX. L. REV. 59, 62 (2005) (referencing bar association activities relating to the form of third-party legal opinions and opinion committee practice).

<sup>45</sup> See Steven L. Schwarcz, *The Limits of Lanyering: Legal Opinions in Structured Finance*, 84 TEX. L. REV. 1, 29 (2005) ("[C]lients generally have more and better information about the consequences of a transaction, other than the transaction's legality. The clients therefore are better positioned to make business decisions."). Professor Schwarcz also writes:

[N]either third-party legal opinions nor legal opinions addressed to clients purport to evaluate a transaction's inherent business wisdom. At least heretofore, an opining lawyer has had no duty to evaluate the business merits of the underlying transaction beyond the obvious ethical and legal obligations of not knowingly furthering a fraudulent transaction.

*Id.* at 11 (footnotes omitted). Undoubtedly, however, because they are conditions to closing transactions (including M&A transactions), legal opinions facilitate completion of the transaction. *Id.* at 28.

<sup>46</sup> See *id.* at 20. Professor Schwarcz succinctly describes those rules: "[T]he criteria for fair presentation of a company's financial condition and results of operations are already dictated by generally accepted accounting

advent of FINRA Rule 5150, the opinion process for investment banks rendering fairness opinions looked much like that for lawyers issuing legal opinions. Perhaps the audit process is a better model for fairness opinion practice.

A 2006 article written by Professor Arthur Laby supports this notion.<sup>48</sup> In his article, Professor Laby divides the world of gatekeepers into two categories: dependent and independent.<sup>49</sup> Under Laby's taxonomy, investment banks authoring fairness opinions (like lawyers issuing legal opinions) historically would have been classified as dependent gatekeepers—reputational intermediaries that “provide advice and recommendations to assist a client in meeting its goals.”<sup>50</sup> Dependent gatekeepers are distinguishable from independent gatekeepers (which generally include auditors) by their fiduciary duties, which bind them to their clients through trust and confidence.<sup>51</sup> Professor Laby observes that gatekeepers are subject to unconscious bias in performing their roles (although he does not focus on the M&A context and does not discuss fairness opinions).<sup>52</sup>

A dependent gatekeeper is accountable to its client and knows what the client wants.<sup>53</sup> As a result, the advice of dependent gatekeepers tends to be directional, and dependent gatekeepers tend to be committed to a particular outcome that is beneficial for the client.<sup>54</sup>

People generally are motivated to seek approval from their audience and are biased in favor of conclusions that conform to the audience's views. When the views of the audience are known to the decision maker before she forms an opinion, she will redirect her opinion to conform to them. Directional goals take over. People adopt positions that are likely to be pleasing to those to whom they are accountable.<sup>55</sup>

This approach decreases accuracy in the gatekeeper's decision-making. “[A]fter committing to a decision, if called upon to justify the choice, people are highly motivated to avoid self-criticism and justify their original decision.”<sup>56</sup> Moreover, “[d]ependent gatekeepers are likely

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principles (GAAP). GAAP comprises a set of standards for financial accounting and reporting, officially recognized as authoritative by the SEC, that provide the ‘credibility, transparency, and comparability’ needed for “the efficient functioning of the economy.” *Id.* (footnotes omitted).

<sup>47</sup> See Patricia A. McCoy, *Realigning Auditors' Incentives*, 35 CONN. L. REV. 989, 991 (2003) (“[A]uditors act as gatekeepers. Certain major transactions involving potentially large information asymmetries cannot get off the ground without audit opinions, either as a matter of business necessity or of law.”).

<sup>48</sup> Arthur B. Laby, *Differentiating Gatekeepers*, 1 BROOK. J. CORP. FIN. & COM. L. 119 (2006).

<sup>49</sup> *Id.* at 122.

<sup>50</sup> *Id.* at 127.

<sup>51</sup> *Id.* at 124-26 & 128-32 (comparing and contrasting the attributes and roles of auditors and lawyers).

<sup>52</sup> *Id.* at 135-40. See also Cleveland, *supra* note 6, at 324-30.

<sup>53</sup> Laby, *supra* note 48, at 142.

<sup>54</sup> *Id.* at 144.

<sup>55</sup> *Id.* at 141.

<sup>56</sup> *Id.* at 143-44. “Psychologists refer to this as *retrospective rationality* or *defensive bolstering*.” *Id.* at 144 (footnotes omitted).

to be more prone to bias through anchoring and adjustment than independent gatekeepers.”<sup>57</sup>

Conversely, independent gatekeepers are principally accountable to a greater public outside of the client—an audience the gatekeeper does not know.<sup>58</sup> “When the audience’s views are unknown, conformity is not possible and accuracy goals predominate. In that case, opinion authors are more likely to consider multiple objectives and engage in a more thoughtful, deliberate, self-critical analysis.”<sup>59</sup> Independent gatekeepers are committed to processes rather than outcomes.<sup>60</sup> “Process accountability . . . leads to a better decision making process, such as more consideration of alternatives and less self-justification.”<sup>61</sup>

It is important to acknowledge that even independent gatekeepers may not be able to maintain complete independence from their clients in performing their work. Certain scholars, for example, question the ability of auditors to be truly independent.

How realistic is the assumption that auditors—even those of high integrity—can provide impartial judgments that respond to the interests of creditors, stockholders, and the general public, rather than to the interests of the companies that hire them? Psychological research points to an inescapable conclusion: such impartiality is impossible . . . .<sup>62</sup>

Specifically, auditors manifest a self-serving bias that is enhanced by, among other things, the faceless, “statistical,” nature of the shareholders their opinions serve.<sup>63</sup> As a result, auditors may have an interest (conscious or subconscious) in adopting positions that are favorable to their clients in a manner similar to the interest (even if not the obligation) of lawyers, especially given the fact that auditors are paid by clients—not by the government, third parties, shareholders, or the general public—for the audits they perform.<sup>64</sup>

Nevertheless, Professor Laby does describe an important structural difference between the type of gatekeeping performed by dependent gatekeepers (like lawyers), on the one hand, and independent gatekeepers (for example, auditors), on the other. The disparate fiduciary duties that Professor Laby identifies appear to be the key factor. A lawyer, as a

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<sup>57</sup> *Id.* at 146.

<sup>58</sup> *Id.* at 142.

<sup>59</sup> *Id.* at 141 (footnote omitted).

<sup>60</sup> *See id.*

<sup>61</sup> *Id.* at 146 (footnote omitted).

<sup>62</sup> Max H. Bazerman et al., *The Impossibility of Auditor Independence*, 38 SLOAN MGT. REV. 89, 90 (1997). *See also* Sean M. O’Connor, *Be Careful What You Wish for: How Accountants and Congress Created the Problem of Auditor Independence*, 45 B.C. L. REV. 741, 820-21 (2004) (noting the capacity of consulting engagements and other non-accounting work to detract from auditor independence); Sean M. O’Connor, *The Inevitability of Enron and the Impossibility of “Auditor Independence” under the Current Audit System* (Mar. 1, 2002), available at <http://ssrn.com/abstract=303181> (“[T]he accounting firms are supposed to be ‘independent’ of the audit client and act on behalf of the public, not the audit client. The problem is that, however well this audit system worked at its inception, it is fundamentally flawed now, such that as a practical matter it is impossible for auditors to be ‘independent’ of their audit clients.”); Robert A. Prentice, *The SEC and MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1637-53 (2000) (summarizing scholarly studies and commentary relating to accountant and auditor independence).

<sup>63</sup> *See* Bazerman et al., *supra* note 62, at 91-92.

<sup>64</sup> *See* O’Connor, *supra* note 62, at 2-3; Prentice, *supra* note 62, at 1629-37.

dependent gatekeeper, has a duty of loyalty to his or her client and an obligation to represent the client zealously.<sup>65</sup> An auditor, as an independent gatekeeper,

performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>66</sup>

Surely, these distinct operative client duties are meaningful; they clearly belie different gatekeeping roles. The differences in these roles may not be adequately considered and weighed in corporate decision-making (including M&A negotiations and deliberations). While the opinions of neither a dependent nor an independent gatekeeper are free from inaccuracies, the broad-based loyalties and process orientation of independent gatekeepers seemingly have a greater propensity to create accurate opinions.

How do investment banks issuing fairness opinions fit into Professor Laby's system of categorization in light of FINRA Rule 5150? Do they continue to be classified most accurately as dependent gatekeepers? There has been and is some dispute as to whether an investment bank issuing a fairness opinion does or should owe a fiduciary duty to the shareholders of its client.<sup>67</sup> It may nevertheless owe a fiduciary duty to its client.<sup>68</sup> Moreover, FINRA Rule 5150 may be interpreted to reflect the existence of or create a duty of trust that is fiduciary in nature. The investment bank knows what its client wants and is committed to an outcome that gives the client what it wants. In other words, there is a commitment to finding that the subject transaction is fair from a financial point of view in order to facilitate consummation of that transaction. Thus, despite the advent of FINRA Rule 5150, the investment bank that renders a fairness opinion still appears to be more of a dependent gatekeeper, as categorized by Professor Laby.

The observations made by Professor Laby in his article indicate that it may be possible to enhance the accuracy of fairness opinions by making investment banks more accountable to shareholders, an audience the banker does not know (as opposed to the

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<sup>65</sup> See MODEL RULES OF PROF'L CONDUCT R. 1.3 (2010); *id.* at R. 1.7.

<sup>66</sup> *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-818 (1984).

<sup>67</sup> Compare *Baker v. Goldman Sachs & Co.*, 656 F. Supp. 2d 226, 236-37 (D. Mass. 2009) (finding "that special circumstances existed to create a fiduciary relationship apart from the terms of the contract") with *Joyce v. Morgan Stanley & Co.*, 538 F.3d 797, 800-03 (7th Cir. 2008) (finding no fiduciary duty owed to shareholders by an investment bank issuing a fairness opinion). See also *CIBC Bank & Trust Co. (Cayman) Ltd. v. Credit Lyonnais*, 270 A.D.2d 138 (N.Y. App. Div. 1st Dep't 2000) (finding no fiduciary duty to investors where the terms of the contracts between the parties "flatly contradicted" the existence of one); *Fulco v. Cont'l Cablevision, Inc.*, No. 89-1342 S, 1990 WL 120689, at \*3 (D. Mass. June 19, 1990) (indicating that an investment bank did not owe a fiduciary duty to a selling corporation's shareholders); PARIJS, *supra* note 15, at 153-57 (describing legal actions involving fiduciary duty claims by shareholders against investment banks issuing fairness opinions); Park McGinty, *The Twilight of Fiduciary Duties: On the Need for Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 192 n.40 (1997).

<sup>68</sup> See *Bear Stearns & Co. v. Daisy Sys. Corp.* (In re Daisy Sys. Corp.), 97 F.3d 1171, 1177-79 (9th Cir. 1996); *Fulco*, 1990 WL 120689, at \*4; M. Breen Haire, Comment: *The Fiduciary Responsibilities of Investment Bankers in Change-of-Control Transactions*: In Re Daisy Systems Corp., 74 N.Y.U. L. REV. 277 (1999).

client's board of directors), and by better insuring that the investment banks rendering fairness opinions are committed to processes rather than outcomes.<sup>69</sup> Under current law, given the lack of a clear duty of investment banks to shareholders and the absence of a direct contractual relationship between the investment bank and the shareholders, "the exact scope of an investment bank's liability to stockholders for the rendering of an 'incorrect' fairness opinion is still uncertain and subject to much judicial and academic debate."<sup>70</sup> Some have proposed that investment banks that issue faulty fairness opinions be held strictly liable for inaccuracies in their fairness opinions.<sup>71</sup> While this approach does make fairness opinion authors accountable to shareholders, it would result in increased transaction costs to cover the increased risk of litigation and may encourage investment banks to be committed to conservative outcomes. Liability for negligence may create fewer perverse incentives and better align accountability of investment banks in fairness opinion practice with the liability of accountants in audit practice.<sup>72</sup> In general, the idea would be to refrain from treating effects on shareholders as externalities and to implement practices that take investment banks further away from being dependent, directional, outcome-committed reputational intermediaries. The goal would be to mitigate undesirable biases and increase information quality in fairness opinions by fostering independence through accountability to shareholders and process commitment.

### C. *Changes in the Way Fairness Opinions are Used and Assessed*

Finally, a comprehensive resolution to issues associated with bias in M&A decision-making also should focus on how to improve the process relating to the boards of directors' use and assessment of fairness opinions in M&A transactions. Boards of directors should be both "demanding and critical" in their review of fairness opinions.<sup>73</sup> This focus may be difficult to implement, however, since it means changing the way the board of directors does business—and doing that pervasively. But, as Professor Langevoort suggests, lawyers and accountants can help.<sup>74</sup> A board of directors, under the guidance of its advisors, can institute better overall cultural norms and provide a more rigorous analysis of the fairness opinion and the materials supporting that opinion. Professor Davidoff offers a statement of best practices in this regard.

A fairness opinion delivered orally or in writing by the preparer at a board meeting is almost always, at least in a corporate control transaction, accompanied by a "board book." The board book details the underlying analyses conducted by the opiner to arrive at and conclude financial fairness. It is here that the meat of the investment banker's work lies. A well-advised board will review this book in connection with their [sic] receipt of a fairness opinion and question the bankers as to their derivation

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<sup>69</sup> See *supra* notes 48-61 and accompanying text.

<sup>70</sup> See Davidoff, *supra* note 6, at 1568 n.38.

<sup>71</sup> See PARIJS, *supra* note 15, at 88.

<sup>72</sup> See C. Richard Baker & Deborah Prentice, *The Evolution of Auditor Liability Under Common Law*, 8 J. FORENSIC ACCT. 183 (2007); Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17 (2003); J. Keaton Grubbs & Jack R. Ethridge, Jr., *Auditor Negligence Liability to Third Parties Revisited*, 10 J. LEGAL, ETHICAL & REG. ISSUES 75 (2007).

<sup>73</sup> See *supra* text accompanying note 3.

<sup>74</sup> See *supra* text accompanying note 3.

of fairness. It is in these actual analyses that the meaning and worth, if any, of a fairness opinion lies.<sup>75</sup>

In order for a board of directors to ascertain methodically the “meaning and worth”<sup>76</sup> of a fairness opinion, legal and other advisors to the board of directors should develop and evolve a useful set of questions for assessing the accuracy and integrity of fairness opinions. Because fairness opinions are expert opinions, I suggest that an appropriate model for these questions derives from a checklist of five basic questions assembled and recommended by one of my colleagues for use by judges in evaluating the admission of expert testimony in proving lost profits—a situation in which similar biases may operate on the opinion author.<sup>77</sup> In a 2007 article,<sup>78</sup> Professor Bob Lloyd offered the following questions as a nonexclusive list for use by judges in that context:

- Is the expert qualified for this analysis?
- How reliable is the underlying data?
- Are the expert's assumptions supported by the record?
- Does the expert deal adequately with facts inconsistent with the expert's theory?
- Has the expert considered alternative scenarios?<sup>79</sup>

These inquiries are consistent with the intents and purposes of FINRA Rule 5150 (which focuses on disclosure and process), Professor Fanto’s proposed disclosure rule, and a re-framing of fairness opinion authors as independent gatekeepers. Moreover, the answers to these questions should help “participants in the transactional process . . . to better understand . . . how, why, and under what circumstances there is reason to worry.”<sup>80</sup>

### 1. Expert Qualifications

In asking the first of the five questions, boards of directors should look for evidence of specialized skills that may be applicable to the transaction and valuation methodology at issue. Although the overall qualifications of an investment bank rendering a fairness opinion generally are not an issue (since valuation is a general skill in the toolkit of financial advisors), certain types of valuation—particularly asset-based valuation techniques—may benefit from more focused expertise. It is important that boards of directors assess the type and relative size of the transaction, as well as the types of valuation methods used by the author of the opinion, to determine whether the substance of all or part of the fairness opinion extends beyond the author’s areas of expertise and to meaningfully question that expertise in light of the amount of money at issue.

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<sup>75</sup> Davidoff, *supra* note 6, at 1568-69 (footnotes omitted).

<sup>76</sup> *Id.* at 1569 (footnote omitted).

<sup>77</sup> See Prentice, *supra* note 62, at 1625-27 (describing the operation of the self-serving bias in this context). Douglas R. Richmond, *Expert Witness Conflicts and Compensation*, 67 TENN. L. REV. 909, 940-47 (2000) (discussing compensation-related bias in expert witness testimony).

<sup>78</sup> Robert M. Lloyd, *Proving Lost Profits After Daubert: Five Questions Every Court Should Ask Before Admitting Expert Testimony*, 41 U. RICH. L. REV. 379 (2007).

<sup>79</sup> *Id.* at 380.

<sup>80</sup> Langevoort, *supra* note 1, at 79.

Where the amount at stake is relatively small, it is not fair to require a party to conduct a nationwide search to find the individual best qualified to opine on the particular issue, especially when there may be several distinct areas . . . that might call for different areas of expertise and thus require different experts. On the other hand, where there are tens or hundreds of millions of dollars at stake and the party clearly has the resources to find and hire the people best qualified to testify, a court should not accept less. The fact that counsel chose someone not among the top people in the field should lead the court to suspect that the better-qualified experts would have given less-favorable testimony.<sup>81</sup>

Ideally and typically, boards of directors would make this assessment before engaging a firm to render a fairness opinion for an M&A transaction. It would behoove the board to revisit the issue, however, at the time the opinion is rendered and being considered by the board.

## 2. Data Reliability

The second question, regarding the reliability of the data underlying the fairness opinion, enables the board of directors to explore where the factual information supporting the opinion came from. Did the client provide the information? Which personnel of the client participated in the gathering, distillation, and synthesis of the data needed? How knowledgeable is each about the data that was supplied? Was any of the data independently verified by an audit or other similar means of certification that could be obtained cost-effectively? Is the “data . . . ‘of a type reasonably relied upon by experts in the particular field’”?<sup>82</sup> Members of the board of directors could use the answers to these questions to assess the integrity (completeness and accuracy) of, and potential for bias in, the data used to generate the opinion. The board of directors may want to arrange to interview the personnel involved in assembling and generating the applicable data or to otherwise test its accuracy and completeness.

## 3. Support for Assumptions

Additionally, the board of directors should inquire whether the assumptions the fairness opinion authors make are fair based on the underlying data and other facts. Fairness opinion assumptions not founded in fact may mislead the board of directors.<sup>83</sup> In addition, “testimony that relies on multiple assumptions should be viewed with extreme skepticism. Where one estimate is piled on another, the uncertainty is magnified . . . .”<sup>84</sup> The board of directors must be careful, however, to assess the relative importance of different assumptions to the opinion before condemning an opinion due to faulty assumptions.

[U]nsupported assumptions should not be fatal if the assumptions were not necessary to the expert's testimony or if the effect of their not being correct would not have had a major impact. The American Institute of Certified Public Accountants has dealt with the question of assumptions in the context of auditors' reports on financial statements: “[T]he attention

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<sup>81</sup> Lloyd, *supra* note 78, at 391 (footnotes omitted).

<sup>82</sup> *Id.* at 391-92 (footnote omitted).

<sup>83</sup> *Cf. id.* at 399-400 (describing the need to exclude expert testimony based on faulty assumptions because of its propensity to mislead).

<sup>84</sup> *Id.* at 409.

devoted to the appropriateness of a particular assumption should be commensurate with the likely relative impact of that assumption on the prospective results. Assumptions with greater impact should receive more attention than those with less impact.”<sup>85</sup>

Through this process of testing and weighing assumptions, the board of directors can better understand and assess the overall validity of the fairness opinion.

#### 4. Treatment of Inconsistent Facts

The fourth question asks the board of directors to challenge the opinion giver’s analytical integrity. “Where there are facts inconsistent with the expert’s theory or model, the expert cannot just ignore them. Sometimes the expert will be able to make a reasonable argument that the contrary data is wrong or that it does not apply to the question he or she is addressing.”<sup>86</sup> But where the investment bank or valuation firm cannot either identify or explain data inconsistent with its valuation analysis or opinion or where it hides or inappropriately discounts inconsistent data, the board of directors should be skeptical of the opinion’s accuracy and overall integrity.

#### 5. Consideration of Alternatives

Directors can learn a lot about a fairness opinion by inquiring about what is *not* in the opinion. Thus, the fifth question focuses on the investment bank’s consideration of alternative scenarios. There are many different ways to ask about “the road not taken.”<sup>87</sup> Which valuation methods were considered and not used? Why were they excluded? What data and assumptions were considered and then discarded in the valuation and opinion drafting process? What happens to the analysis reflected in the opinion when certain assumptions are relaxed or altered? The content of these questions on alternatives necessarily overlaps with that in preceding questions, but it provides necessary completeness and closure to the board’s analysis of the fairness opinion author and the opinion itself. If the board of directors is empowered with alternatives, then it can better assess, for example, whether the assumptions the fairness opinion author made are fair.<sup>88</sup> Moreover, exploring alternative scenarios “alleviates the false impression of certainty”<sup>89</sup> that a fairness opinion may give, revealing the true nature of the opinion as “both art and science.”<sup>90</sup> A firm rendering a fairness opinion may, however, offer only the alternative scenarios that bolster

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<sup>85</sup> *Id.* (footnote omitted).

<sup>86</sup> *Id.* at 410-11 (footnote omitted).

<sup>87</sup> This is an obvious, shameless reference to the famous poem of the same name. ROBERT FROST, *The Road Not Taken*, in MOUNTAIN INTERVAL 9, 9 (1916). For those who may not have read this literary work recently, in the poem, the traveler comes to a fork in the road and stops to take a long look down one path before taking the other. *See id.*

<sup>88</sup> *Cf.* Lloyd, *supra* note 78, at 421-22 (“[W]hen the assumptions underlying the more extreme scenarios have been shown to be doubtful, [the board can] choose a scenario based upon a more supportable assumption.”).

<sup>89</sup> *Id.* at 422.

<sup>90</sup> *See* Bede, *supra* note 9, at 2.



its original opinion. So, it is important not to rely on this singular line of inquiry when assessing the accuracy and integrity of the opinion.<sup>91</sup>

#### IV. CONCLUSION

In his essay, Professor Langevoort presents a convincing picture of the many roles that cognitive biases play in M&A decision-making. As he notes, scholars have written precious little on behavioral finance in this context; they—we—could and should do more theoretical and empirical work on the effect of bias on individual and institutional decision-making in the M&A context. Additional empirical work especially should add meaningful information and analysis to the existing story that Professor Langevoort tells. Yet, even in the absence of further scholarly work to support Professor Langevoort's conclusions, his observations about behavioral biases in M&A practice and the difficulty in applying behavioral psychology in this context make important scholarly contributions to behavioral and corporate finance.

However, in assessing the fourth tall step in his quest to plausibly apply behavioral science to M&A decision-making—i.e., determining appropriate interventions to address the possibility of non-rational decision-making—Professor Langevoort makes another significant contribution. He suggests that we turn to elements of practice and process and to the actions of transaction participants to supplement an existing legal and regulatory system that offers an inadequate response to observed biases in M&A decision-making. This paper picks up that thread running through Professor Langevoort's essay and begins exploring the potential for individual and team (as well as, potentially, organizational) learning curves described by Professor Eric Sundstrom in his responsive paper<sup>92</sup> by suggesting that fairness opinion practice, a part of almost every public company M&A transaction, can be reformed to better respond to the cognitive biases that plague M&A.

Specifically, this paper suggests that changes in the contents, construction, use, and assessment of fairness opinions may better enable fairness opinions to counteract the potential and actual biases of corporate management and shareholders in M&A decision-making. This is, avowedly, a very limited thesis; changes to fairness opinions and related practices are not sufficient in and of themselves to implement Professor Langevoort's vision. Rather, the changes to fairness opinion practice set forth here represent only one possible approach among many potential practice-oriented interventions. One might say that it is an incremental step toward full achievement of the fourth tall step described in Professor Langevoort's essay.

In concluding his 2001 article on behavioral psychology and M&A decision-making, Professor Fanto stated the following about his own ideas for modifying M&A decision-making:

With more detailed empirical research, the reform proposals should make board members focus on negative consequences of the transaction and should stimulate more debate in the board room. Board members will then be more likely to address better the influence of specific psychological

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<sup>91</sup> Cf. Lloyd, *supra* note 78, at 422 (“Presenting alternative scenarios is of course no cure-all. . . . Experts can still present several extreme scenarios, giving the least outrageous of them an appearance of plausibility by labeling it the ‘conservative’ scenario.”).

<sup>92</sup> Eric Sundstrom, *Tall Steps, Slippery Slopes & Learning Curves in the Behavioral Economics of Mergers and Acquisitions*, 12 TRANSACTIONS: TENN. J. BUS. L. 99 (2011).

factors. Moreover, much legal improvement may naturally result if those who make legal decisions become more aware of the influences of psychological and behavioral factors on merger decision-making.<sup>93</sup>

Although I cannot speak for Professor Langevoort, in my view, this is the essence of what we (he, together with Professor Sundstrom and me) are building toward in our papers. I hope that others will add to these ideas as time advances and enable us to finish climbing Professor Langevoort's fourth tall step.

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<sup>93</sup> Fanto, *supra* note 40, at 1401.