COMMENT

THE FIDUCIARY RESPONSIBILITIES
OF INVESTMENT BANKERS IN
CHANGE-OF-CONTROL TRANSACTIONS:
IN RE DAISY SYSTEMS CORP.

M. BREEN HAIRE*

INTRODUCTION

In Spring 1998, the business magazine Barron's alerted its readers to a forthcoming verdict that "could be a landmark, because it touch[es] on the issue of whether investment bankers have a fiduciary duty to the clients they advise."1 The jury rendered its verdict that May, concluding that although investment bank2 Bear Stearns owed a fiduciary duty to its client, Daisy Systems Corporation, that duty had not been breached.3

The jury's conclusion should provide the financial community little comfort. The real battle had been fought, and lost, by Bear Stearns two years earlier in an appeal to the Ninth Circuit, in which the court held that the existence of a fiduciary relationship between a bank and its client was an issue of fact inappropriate for summary judgment disposition.4 That decision, In re Daisy Systems Corp.,5 marked a significant departure from previous authority holding that bankers' relationships with their clients were merely contractual in nature.6

---

* I am grateful to Lewis Bossing, Michael Gat, Melanie Hochberg, Deb Stein, and the entire staff of the New York University Law Review for all they have done to make this Comment better. Most of all, thank you to my wife, Holly Haire.


2 This Comment uses the terms "investment bank(er)" and "bank(er)" interchangeably.


4 See In re Daisy Sys. Corp., 97 F.3d 1171, 1177-79 (9th Cir. 1996).

5 97 F.3d 1171 (9th Cir. 1996).

This Comment examines the mischief that the *Daisy* ruling could make. Though advisors such as attorneys and auditors have previously been held to be fiduciaries of their clients, the *Daisy* court's broad application of these duties to investment bankers poses unique problems. The first Part begins with a brief survey of pre-*Daisy* cases dealing with the responsibilities owed by bankers to their clients, and then turns to *Daisy* itself. The second Part discusses the *Daisy* court's broad conception of the role of bankers in change-of-control transactions. The final Part is a policy and doctrinal critique of the *Daisy* rule, focusing especially on the undesirable incentives provided to bankers as a result of the holding. The Comment concludes that the court's decision in *Daisy* promulgates a liability regime desirable neither as a matter of corporate governance nor as a shareholder-protection device.

---


8 This Comment uses the term "change-of-control transactions," or simply "control transactions," to refer not only to actual mergers and acquisitions but also to corporate actions that frequently arise as a result of such a transaction, such as acquisition financing or the implementation of defensive tactics. The term does not include many services provided by investment bankers, including the underwriting of securities offerings. Underwriting activities are closely regulated by the Securities and Exchange Commission pursuant to the Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994), and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78jj (1994). See generally Samuel N. Allen, A Lawyer's Guide to the Operation of Underwriting Syndicates, 26 New Eng. L. Rev. 319 (1991) (discussing federal regulation of underwriting activities).
I

INVESTMENT BANK LIABILITY IN THE COURTS

The courts have not spoken with unanimity on the liability of investment bankers. Plaintiffs have several different liability theories on which they may choose to proceed, including claims of negligent misrepresentation,9 violation of federal securities laws,10 and aiding and abetting directors in breaching their fiduciary duties.11 The Daisy court, however, took the novel step of validating a claim of fiduciary


10 Investment bankers are vulnerable to claims grounded on section 14(a) of the Securities Exchange Act, the antifraud provision regarding proxy solicitations and tender offers. See, e.g., Herskowitz, 857 F.2d at 189-90 (recognizing section 14(a) claim). But see Adams v. Standard Knitting Mills, Inc., 623 F.2d 422, 428-31 (6th Cir. 1980) (demanding proof of scienter in section 14(a) claim against auditor). Scienter will often be difficult to prove in such cases, making a section 14(a) claim an unattractive strategy for many plaintiffs. See Robert J. Giuffra, Jr., Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L.J. 119, 129 (1986) ("Plaintiff shareholders rarely, if ever, can prove that directors and investment bankers acted with scienter.").

breach against the bankers themselves. This Part discusses the often contradictory holdings of cases involving bankers’ fiduciary responsibilities to their clients, and then proceeds to examine the Daisy case in detail.

A. Pre-Daisy Authority

A fiduciary relationship can be characterized generally as one in which a party reposes confidence in another party willing to accept such confidence, to such an extent that the latter party exercises domination or control. The paradigmatic example of fiduciary relations in the corporate context is that between the board of directors and shareholders. Because of the potential for abuse of their broad powers over the corporation, directors are not permitted to set their own interests ahead of those of the shareholders, as would be typical in a commercial relationship. Instead, they assume duties beyond those of simple fairness and honesty; in the words of Chief Judge Cardozo, “[T]he punctilio of an honor the most sensitive is... the standard of behavior.” Should the directors’ performance fail to satisfy this high standard, they could be held liable to shareholders for breach of their fiduciary duty.

Courts have dealt with the application of such duties to investment bankers only sporadically. An analysis of the case law must begin with the opinions of the Delaware Chancery and Supreme Courts in Weinberger v. UOP, Inc. The plaintiffs, minority shareholders
complaining that the consideration offered in a freezeout merger was insufficient, alleged that the company's investment banker had collaborated with management in rendering a biased fairness opinion (a brief letter stating that the purchase price was fair). Their claim against the bank was founded on a breach of fiduciary duty theory.

The Vice-Chancellor concluded that the investment bank did not owe the plaintiffs a fiduciary duty merely because it was retained by the company's management. On appeal, the Delaware Supreme Court affirmed, reasoning that the relationship between the banker and client could not be characterized "as anything but contractual." The court noted that the bank was hired solely to render a fairness opinion in the time allotted by the board, and thus concluded that it had fulfilled "its duties and obligations under the agreed upon contractual terms."

Since that time, the Delaware courts have grown more skeptical of hastily prepared or biased fairness opinions but have not held a banker liable for breach of fiduciary duty. Indeed, in two cases the Chancery Court stated explicitly that such a theory was not supported of an Investment Banker to Minority Shareholders in a Cash-Out Merger: Weinberger v. UOP, Inc., 8 Del. J. Corp. L. 98 (1983). Though the precedential value of the opinion is minimal, it remains an important theoretical touchstone in the application of fiduciary doctrines to bankers. See id. at 123 (discussing importance of withdrawn opinion).

A freezeout merger occurs when the controlling party of a corporation forces non-controlling shareholders to sell their interests in the firm. See Robert Charles Clark, Corporate Law § 12.1, at 499-500 (1986).

Fairness opinions are discussed in detail in Part I.A.2, infra.

See id. at 1348 ("[P]laintiff has offered no authority to indicate that an investment banking firm rendering a fairness opinion as to the terms of a merger owes [a] fiduciary duty to the minority shareholders.").

Weinberger II, reprinted in Haight, supra note 18, at 162-63.

Id. at 163.

For example, in a 1996 case the Chancery Court criticized a banker who had revised his fairness opinion so that a bid by management would fall within the banker's range of fairness. See Kahn v. Dairy Mart Convenience Stores, Inc., No. 12489, 1996 WL 159628, at *9 (Del. Ch. Mar. 29, 1996); see also Joseph v. Shell Oil Co., 482 A.2d 335, 344 (Del. Ch. 1984) (noting that bankers' fairness opinions were "quick and cursory"). In a New York Times article, former Delaware Chancellor William T. Allen was openly critical of investment bankers. See Sarah Bartlett, Delaware Courts Get Tough Toward Investment Bankers, N.Y. Times, May 30, 1989, at D1 (quoting Allen's comment that "courts are suspicious and will no longer accept blindly the advice of bankers").

In Anderson v. Boothe, 103 F.R.D. 430 (D. Minn. 1984), the court, applying Delaware law, held that "in light of the Chancery Court's opinion in Weinberger, this court is constrained to hold that [investment bank] Salomon, as a matter of law, cannot be held liable for a breach of fiduciary duty to the minority shareholders." Id. at 441. In Rubin v. Posner, 701 F. Supp. 1041 (D. Del. 1988), the district court held that the investment bank defendant's "status as [plaintiff] PEC's investment banker does not necessarily give rise to an owing of a fiduciary duty. Plaintiffs cite no authority to support their contention that
by law. In *Lewis v. Leaseway Transportation Corp.*,27 the court noted that the plaintiffs "[did] not claim, nor could they, that [investment bank Drexel Burnham Lambert] owed a fiduciary duty to Leaseway shareholders."28 And in *In re Shoe-Town, Inc.*,29 the court reasoned that the imposition of a fiduciary duty would be illogical because fairness opinions are not absolutely required under Delaware law.30

One New York court, however, has employed starkly different reasoning. In *Schneider v. Lazard Freres & Co.*,31 a case arising from the leveraged buyout of RJR Nabisco, the plaintiff shareholders alleged that the investment bank defendant had negligently opined that two competing bids in the auction for the company were "substantially equivalent."32 The bank argued that because the fairness opinion was addressed to the special committee of the Nabisco board of directors, it owed no duty to the shareholders directly.33

The court responded with a novel theory based on agency doctrine: It held that the special committee was, in effect, an agent of the shareholders, and thus the bank was a subagent of the shareholders.34 As such, the bank inherited the fiduciary duties owed by the directors.35 The court rejected the bank's argument that, as *sui generis* decisionmaker, the board's function could not be characterized as one of agency.36 Instead, the court concluded, the board's function was that of an agent charged with obtaining the highest price for the shareholders.37

[defendant] Drexel owed a fiduciary obligation on account of its limited role in arranging financing." Id. at 1053; see also infra note 59 (noting *Daisy* court's reference to *Rubin*).

28 Id. at *21 (emphasis added).
30 See id. at *21-*22; see also infra note 100 (discussing Delaware cases holding that fairness opinions are not absolutely required by law).
32 See id. at 572 (internal quotation marks omitted). Instead, they claimed, the bank should have recognized that the bid offered by management was higher than that made by LBO firm Kohlberg Kravis Roberts (who prevailed in the auction). See id.
33 See id.
34 See id. at 574-75.
35 See id. at 574 ("Viewing the relationship between the shareholders and the Special Committee . . . as one of principal and agent, we do not see how it can be said that a duty of care owed by the bankers was not intended for the benefit of the shareholders.").
36 See id. at 575 (noting that "the question is not . . . one approaching privity, but whether the relationship between the shareholders and the Special Committee was one governed by the law of agency or the law of corporations"). For a discussion of the decisionmaking function of the board of directors, see infra notes 84-86 and accompanying text.
37 See *Schneider*, 552 N.Y.S.2d at 575 (acknowledging that board *is sui generis* decisionmaker of corporation's affairs but reasoning that "sale of the control of a corporation is not corporate business of the type governed by traditional principles of corporate govern-
Schneider marked the first time a bank had been held liable to its client or its clients' shareholders as a fiduciary, albeit by the circuitous route of agency law.\(^\text{38}\) The Daisy court's approach, discussed in the following Section, would be more direct.

B. In re Daisy Systems Corp.

In 1988, Daisy Systems Corporation (Daisy) was a highly successful and economically healthy software company possessing the top market share in the computer aided design (CAD) industry.\(^\text{39}\) Daisy's CEO, Norman Friedman, sought to expand the company's product line by acquiring a firm with expertise in producing printed circuit boards for semiconductor chips.\(^\text{40}\) He found a suitable target in Cadnetix. When Friedman approached Cadnetix to discuss a friendly deal, however, he was rebuffed.\(^\text{41}\)

At this point, Friedman concluded that Daisy should explore hostile acquisition strategies and contacted Michael Tennenbaum, a managing director at the prominent Wall Street investment bank Bear Stearns & Co., Inc. (Bear Stearns), for advice.\(^\text{42}\) Tennenbaum agreed to advise the company under the terms of an engagement letter stating that Bear Stearns would act as Daisy's "exclusive financial advisor," which would include "advice on valuation and structuring of the [Cadnetix] transaction, and assisting [Daisy] in negotiations with Cadnetix."\(^\text{43}\)
Tennenbaum advised that Daisy adopt a “bear hug” strategy, in which Daisy would purchase a toehold equity interest in Cadnetix on the open market to place pressure on the Cadnetix board.44 Once Daisy acquired 4.9% of Cadnetix’s common stock, Friedman approached the Cadnetix board again, and was again rejected.45 A public tender offer46 ensued, to be financed with high-yield debt underwritten by Bear Stearns.47 The Cadnetix board subsequently agreed to resume friendly negotiations,48 and the merger was consummated to form a new entity named “Dazix.”49

Dazix subsequently encountered serious operational difficulties as a result of a costly computer system conversion and problems arising from the postmerger transition.50 The company was unable to make its first interest payment to the holders of the debt issued in the

44 See id.; see also Professional Negligence, supra note 3, at A8 (calling Bear Stearns' strategy “bear hug” (internal quotation marks omitted)). A bear hug strategy is so named because it is an aggressive means of placing the target board under pressure to accept the bidder's offer, while maintaining a (nominally) “friendly” deal. See generally Martin Lipton & Erica H. Steinberger, 1 Takeovers & Freezeouts §1.06[1] (1997) (discussing bear hug strategy).

45 See Professional Negligence, supra note 3, at A8.

46 In a public tender offer, an entity or individual “invites or solicits shareholders of a target company to tender their shares for sale at some specified consideration.” Clark, supra note 19, at 531. By offering to purchase the securities at a premium price, the offeror can accumulate a control stake in the firm and effectuate a change of control. See id.

47 See Daisy, 97 F.3d at 1173-74. A dispute arose between the parties as to the precise nature of Bear Stearns’ agreement to provide financing. Friedman claimed that Bear Stearns agreed to provide financing at any stage of the acquisition if it could not be arranged otherwise, while Bear Stearns claimed that the bank’s commitment extended only to the first step of the two-step acquisition. See id. The misunderstanding over the financing for the second step created delays that, according to Daisy, caused the company to lose customers and key employees. See id. at 1175. In its decision to remand on the fiduciary duty claim, the Ninth Circuit panel held that questions of material fact existed on these issues. See id. at 1179-80.

48 The Cadnetix board believed that once financing for the transaction was assured, it had a duty to consider seriously Daisy’s offer. Garrett L. Cecchini, counsel for Daisy’s bankruptcy trustee in the Bear Stearns lawsuit, stated that

At that time, the state of the law in the U.S. was . . . that you had a duty to resist a takeover, even if they were offering you the best price for your stock, as long as their ability to finance the transaction was still contingent . . . . But now, it was no longer contingent . . . . At this point, the hostile takeover turned friendly because we were offering so much money per share.

Professional Negligence, supra note 3, at A9. Presumably, the Cadnetix board suspected that Daisy’s securing of financing would be construed by a reviewing court to have triggered the board’s Revlon duties, discussed infra note 85.


50 See Professional Negligence, supra note 3, at A9.
merger.51 Many key employees then left the company, hastening the downward spiral.52

The debtholders immediately petitioned for the appointment of a Chapter 11 bankruptcy trustee.53 The trustee, Jack Kenney, inherited a company in a critical cash crisis, and after substantial (and expensive) cash infusions failed to rehabilitate Dazix, he concluded that the company would have to be sold or liquidated.54 A buyer was found and Dazix was sold, but the proceeds were so small that the company's six thousand creditors and seven thousand shareholders pressured Kenney to investigate potential lawsuits.55

Kenney instituted a lawsuit against Bear Stearns alleging breach of fiduciary duty, negligent misrepresentation, and other claims for relief.56 The United States District Court for the Northern District of California, applying California state law, granted summary judgment on all claims in favor of Bear Stearns.57

Regarding the claim for breach of fiduciary duty, Judge Lowell Jensen applied a test articulated in the leading California case Beery v. State Bar of California:58 To prove the existence of a fiduciary relationship, the plaintiff must show "that the parties do not deal on equal terms, because the 'person in whom trust and confidence is reposed and who accepts that trust and confidence is in a superior position to exert undue influence over the dependent party.'"59 Judge Jensen

51 See id. (noting that "[i]t quickly became clear [that] the company was not going to make the payment").
52 See id.; see also Daisy, 97 F.3d at 1175 (discussing competitors' attempts to lure away Daisy employees).
53 See Professional Negligence, supra note 3, at A9; see also Daisy, 97 F.3d at 1175 (discussing appointment of Jack S. Kenney as Chapter 11 trustee).
54 See Professional Negligence, supra note 3, at A10.
55 See id. ("Counsel convinced Kenney that Bear Stearns had been professionally negligent and had breached its fiduciary duty to its client. A lawsuit was filed. Clearly, any kind of return for the company's 6,000 creditors and 7,000 shareholders hinged on its success.").
57 See Daisy, 97 F.3d at 1175 (discussing district court's grant of summary judgment). Prior to granting summary judgment for Bear Stearns, Judge Jensen had dismissed several portions of Daisy's claims, including that for breach of fiduciary duty. See Daisy, 1993 WL 491309, at *5.
58 43 Cal. 3d 802 (1987).
59 Daisy, 1993 WL 491309, at *4 (quoting Beery, 43 Cal. 3d at 813, but misquoting "unique" as "undue"). Judge Jensen noted that "[b]usiness relationships do not in general give rise to the level of a fiduciary relationship." Id. He cited recent Delaware authority for the proposition that even though a client may place trust in its investment banker, a fiduciary relationship cannot be presumed to exist: "'[A] contract, in itself, does not impose fiduciary duties on the contracting parties. Even if the contract shows that plaintiff
concluded that the requisite "superiority" could not be found to exist on the facts alleged: 60 "Merely because Bear Stearns was hired as an expert consultant to render financial services does not mean it was in a position of superiority in this relationship between two sophisticated business entities." 61

The trustee appealed to the Ninth Circuit, which reversed and remanded on the fiduciary duty claim. 62 The court reasoned that the sophistication of Daisy's management and directors 63 did not end the "superiority" inquiry; rather, the district court should have considered "the fact that Bear Stearns was retained to advise Daisy in a type of transaction with which Daisy had no experience." 64 The difference in practical experience between banker and client, "even though both parties were sophisticated corporations . . . suggests that the requisite degree of 'superiority' may have existed." 65 The panel considered the placed a "quantum of trust" in a defendant that the defendant accepted, no fiduciary relationship can exist without superiority on the part of the defendant." Id. (citing Rubin v. Fosner, 701 F. Supp. 1041, 1053 (D. Del. 1988)).

60 Kenney alleged that Daisy "placed substantial trust and confidence in Bear Stearns and in its superior knowledge, sophistication and expertise." Daisy, 1993 WL 491309, at *4 (citing Plaintiff's Second Amended Complaint ¶ 118). He explained that the relationship between Daisy and Bear Stearns was much more than one of acting as an "investment banker" in a transaction . . . Bear Stearns understood that Daisy was completely relying on Bear Stearns to provide all of the financial advice, structuring and financing necessary to successfully complete the LBO, and that Bear Stearns' position as exclusive financial advisor meant that Daisy was completely dependent on the expertise, integrity and superior knowledge of Bear Stearns with respect to the matters of its engagement. Id. at *4-*5 (quoting Plaintiff's Opposition to Bear Stearns' Motion to Dismiss, at 4 (emphasis omitted)). The court held that these assertions alone were "insufficient to give rise to any rational inference that Bear Stearns was in a superior position with regard to Daisy." Id. at *4.

61 Id. at *5 (emphasis added). Judge Jensen reasoned further: "Daisy's 'complete' dependence on Bear Stearns, even if it is true, is unjustified and does not render Bear Stearns liable for an arms-length business transaction that has gone sour." Id.

62 See In re Daisy Sys. Corp., 97 F.3d 1171, 1181 (9th Cir. 1996). The court also reversed the grant of summary judgment on the professional negligence claim but affirmed summary judgment on the negligent misrepresentation claim. See id. The court dealt with the fiduciary duty claim in two steps: first determining that there were material issues of fact as to whether a fiduciary duty existed, and then determining that issues of fact existed as to whether that fiduciary duty had been breached. See id. at 1177-80.

63 There is ample reason to believe that Daisy's management and directors were, in fact, sophisticated businesspersons. Friedman, Daisy's president and a board member, was the former head of the Titan missile program, and the board also included a director of Intel and one of the founders of Xerox. See Professional Negligence, supra note 3, at A8, A10.

64 Daisy, 97 F.3d at 1178.

65 Id.
issue one of fact, inappropriate for disposition on summary judgment.66

The court pointed to two factual issues that should influence the factfinder's inquiry. First, because "confidentiality is an element of a fiduciary relationship," the panel reasoned that the question should turn in part "on whether Daisy reposed confidences in Bear Stearns."67 Second, the court held that, "[s]hould a factfinder determine from the record that an agency relationship existed between the parties, then a fiduciary relation should be presumed to exist."68

As a final matter, the court held that issues of fact existed as to whether Bear Stearns had breached its fiduciary duty (if one was found to exist).69 An expert for Bear Stearns testified that the bank's duties were circumscribed by the terms of the engagement letter and that its primary function was to "advise on valuation and structuring and assist in negotiations."70 Daisy's expert, on the other hand, interpreted the bank's designation as "exclusive financial advisor"71 in the engagement letter to mean that Bear Stearns should have assessed the risks and benefits of alternative structures for the transaction and the probable impact of the transaction on the market for the companies' stock, analyzed the effects of the transaction on Daisy and Cadnetix's business operations, determined financing alternatives and sources, analyzed operational im-

---

66 See id. The court cited California authority holding that ordinarily the "existence of a confidential or fiduciary relationship depends on the circumstances of each case and is a question of fact for the fact trier." See id. at 1178 (citing Kudokas v. Balkus, 26 Cal. App. 3d 744, 750 (Cal. Ct. App. 1972)). Bear Stearns, on the other hand, insisted that the relationship between a banker and client "is not a fiduciary relationship as a matter of law," a determination justifying summary judgment. See id. (emphasis added) (internal quotation marks omitted). The Ninth Circuit rejected this argument. See id.

67 Id.

68 Id. (citation omitted). The court was careful to point out, however, that the agency question is not dispositive: "[E]ven where the relationship between an agent and principal cannot generally be classified as fiduciary, a fiduciary obligation may exist with respect to those matters falling within the scope of the agency." Id. at 1178-79.

The court's use of agency doctrine differs from that in the Schneider case, discussed supra notes 31-38 and accompanying text. The Schneider court reasoned that the special committee of the board of directors acted as agent to the firm's shareholders, and thus the committee's investment banker acted as subagent to the shareholders. See Schneider v. Lazard Freres & Co., 552 N.Y.S.2d 571, 574-75 (App. Div. 1990). The Daisy court, on the other hand, was concerned only with the question of whether the banker acted as an agent to Daisy's board. See Daisy, 97 F.3d at 1178. The difference is due to the fact that the Daisy court did not have to face the troublesome issues of privity that arise when shareholders sue the firm's investment bank, as was the case in Schneider. See supra note 9 (discussing privity issues in Schneider). Schneider used agency doctrine to construe such privity, while Daisy's treatment merely creates a presumption of fiduciary duties.

69 See Daisy, 97 F.3d at 1179-80.

70 Id. at 1176.

71 Id. at 1175 (internal quotation marks omitted).
The court accepted Daisy's expert's testimony as establishing "the appropriate duty of care in the investment banking community."73 With this formulation in mind, issues of fact clearly existed as to whether Bear Stearns' performance was deficient, even though the bank's hostile strategy succeeded in forcing Cadnetix to negotiate a friendly deal.74 The advice rendered, the court concluded, "resulted in Daisy making stock purchases with the intention of pursuing a transaction which Daisy contends the market would under no circumstances support."75

Judge Fernandez dissented from the court's decision to remand on the fiduciary duty claim. After citing the district court's reasoning with approval, Fernandez pointed out that "it is only in conditions of litigation that Daisy's high-powered executives would be willing to say that they were mere lambs under the protection of the shepherds at Bear Stearns."76 In strong language, he characterized Daisy's attempt "to clothe [itself] in the weeds of a poor put-upon consumer" as one that "borders on the ludicrous."77

The Ninth Circuit's decision, and its holding on fiduciary duty in particular, attracted a significant amount of attention from the press78 and commentators.79 On remand, a jury found that (1) a fiduciary

---

72 Id. at 1175-76. Daisy faulted Bear Stearns for failing to recognize that hostile mergers were disfavored in the high-tech industry in general. See id. at 1176. The trustee's counsel explained in an interview that such a takeover had never occurred before in the industry, and that

there was a reason why strategists believed this could not be done. The intellectual property is in the heads of the engineers. It's common knowledge [on Wall Street] that you could fight and win a hostile takeover and badly lose the war when the engineers walked out the next day.

Professional Negligence, supra note 3, at A8.

73 *Daisy*, 97 F.3d at 1176.

74 See id. at 1180.

75 Id.

76 Id. at 1182 (Fernandez, J., concurring in part and dissenting in part).

77 Id.

78 See, e.g., Robert Ablon, Ninth Circuit Ruling May Expand Banks' Liability, The Recorder, Sept. 25, 1996, at 1, available in LEXIS, LegNew File (quoting Robert Forgnone, counsel for Bear Stearns, as saying, "[t]he relationship of an investment banker to its client had never been held by any circuit that I'm aware of to be a fiduciary relationship as a matter of law"); Professional Negligence, supra note 3, at A1, A8, A12 (discussing Daisy holding); David E. Rovella, Business Acumen Not Determinative of Duty, Nat'l J., October 14, 1996, at B3 (same).

duty did exist between Bear Stearns and Daisy; (2) Bear Stearns did not breach that duty; and (3) Bear Stearns committed professional negligence. The jury awarded Daisy $108 million, or 39% of the $277 million in damages that Daisy claimed to have incurred. Garrett L. Cecchini, counsel for Daisy, claimed that, had the jury found that Bear Stearns had breached its fiduciary duty, "the award could have approached the billion dollar mark. It will happen, perhaps in the next case."

II

THE INTERSECTING ROLES OF INVESTMENT BANKERS AND CORPORATE DIRECTORS IN CHANGE-OF-CONTROL TRANSACTIONS

The Daisy court took an exceptionally broad view of the investment banker's role in change-of-control transactions. Daisy's expert testimony, which the court accepted, proposed a standard in which bankers could be held responsible for the most fundamental decisions in such a transaction, including whether to complete the acquisition at all.

 Fundamental corporate law precepts, on the other hand, allocate functional responsibilities for corporate enterprises very differently. Delaware, for example, is typical in providing by statute that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors.” Such provisions make

The effect that the Daisy decision will have on the financial community is uncertain. The rule of the court is controlling, of course, only in the Ninth Circuit, and then only when the federal court applies California state law. Nevertheless, the state law that the Daisy court applied is not unique. For example, Delaware courts, like California courts, have held "superiority" to be a necessary prerequisite to the existence of a fiduciary relationship. See, e.g., Rubin v. Posner, 701 F. Supp. 1041, 1053 (D. Del. 1988); see also supra note 59. At the time of preparation of this Comment, no court had followed, applied, or discussed Daisy's holding in any published opinion.


See Norton, supra note 1, at 13.

Professional Negligence, supra note 3, at A1, A8. Cecchini claimed that the verdict was "the largest professional negligence verdict against a major Wall Street player in history." Id. at A1.

See supra notes 72-73 and accompanying text. The expert for Daisy argued that Bear Stearns should have analyzed the "probable impact of the transaction on the market for the companies' stock," as well as "operational impacts" and "the feasibility of alternatives." Daisy, 97 F.3d at 1175-76.

clear that the plenary decisionmaking function in change-of-control transactions resides in the board, subject only to the approval of shareholders when a vote is required.

The conflict between this axiomatic rule and Daisy's expansive conception of the banker's role forms the most critical flaw in the court's reasoning. This Part argues that the court's characterization of the role was one that encompassed many of the elements of the decisionmaking function, and therefore intruded on what should be the exclusive domain of the board of directors.

A. The Functions of Investment Bankers

To properly evaluate the Daisy court's formulation of investment bankers' duties, one must first understand precisely what purposes bankers serve in change-of-control transactions. The functions of bankers in this context can be broadly categorized into three parts: (1) facilitating the transaction, (2) delivering fairness opinions, and (3) advising on general strategy.

1. The Facilitatory Function

The investment banker's role as transaction facilitator may be further subdivided into two components. First, and perhaps most important, is the arrangement of acquisition financing.

85 The nature of the decisionmaking function may change in certain situations in control transactions. For example, Delaware case law states that once a company is "for sale," the director's primary duty is to obtain the highest price possible for the shareholders. See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986). For a thorough discussion of the board's so-called Revlon duties, see Steven G. Bradbury, Note, Corporate Elections and Directors' Fiduciary Duties: A Third-Generation Business Judgment Rule, 87 Mich. L. Rev. 276, 289-92 (1988). Alternatively, directors may employ defensive tactics (such as the so-called "poison pill") to ward off a hostile bidder who poses a legitimate threat to shareholders, provided that the tactics are a reasonable response to the threat posed. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

86 A shareholder vote is required for the execution of certain fundamental changes not in the ordinary course of business, such as a change of control or a sale of all assets of the corporation. See Del. Code Ann. tit. 8, § 251(c), (f) (Supp. 1997) (requiring shareholder approval of mergers); id. § 271(a) (requiring shareholder approval of asset sales). Shareholders cannot, as a general matter, order directors to adopt particular business practices. See, e.g., Automatic Self-Cleansing Filter Syndicate Co. v. Cunningham, 2 Ch. 34 (Ch. App. 1906) (holding that shareholders cannot command directors' decisions in ordinary course of business) (cited in Clark, supra note 19, § 3.1.1, at 94 n.8); see also Clark, supra note 19, §3.1.1, at 94 (discussing lack of shareholder control over most actions of directors).

87 It should come as no surprise that large acquisitions usually require the raising of substantial amounts of capital. In 1998, for example, the six largest U.S. deals of the year all involved more than $50 billion. See Paul M. Sherer, The Lesson From Chrysler, Citicorp and Mobil: No Companies Nowadays Are Too Big to Merge, Wall St. J., Jan. 4, 1999, at R8.
oped a sophisticated industry in the design, underwriting, marketing, and brokerage of corporate securities.\textsuperscript{88} Bankers are skilled in the design of complex financial instruments that can be structured to meet the needs of the particular issuer.\textsuperscript{89} In addition, bankers are experienced underwriters of securities,\textsuperscript{90} possessing both knowledge of the underwriting process and the ability to accept the risk involved in distribution.\textsuperscript{91} Finally, bankers possess a valuable network of contacts within the community of securities buyers, and thus can efficiently market and distribute the securities.\textsuperscript{92}

The second important component of the bank's facilitatory function is its role as auctioneer. Before the purchase or sale of a business entity can occur, an orderly auction process must be instituted to maximize shareholder value, minimize transaction costs, and ensure a speedy consummation.\textsuperscript{93} Investment bankers possess a unique expertise in conducting these often complex auctions.\textsuperscript{94} For example, in a typical multibidder auction, the banker may be called upon to oversee

\textsuperscript{88} See Arthur H. Rosenbloom, Investment Banker Liability: A Panel Discussion, 16 Del. J. Corp. L. 557, 576-77 (1991) (noting investment bankers' expertise in securities distribution); see also id. at 577 ("Investment bankers' activities in the market for corporate control are really an add-on to those [securities distribution] skills.").

\textsuperscript{89} During the wave of mergers and acquisitions in the 1980s, bankers developed dozens of innovative new financial instruments, including high yield bonds, spread-adjusted notes, asset-backed securities, medium term notes, variable rate preferred stock, and preferred equity redemption cumulative stock. See Elson, supra note 9, at 966 n.50 (listing examples of new financial products); see also Tom Pratt, How Percs Became the Year's Hottest Product: The Inside Story of Morgan Stanley's Three-Year Wait to Revive a Hybrid, Inv. Dealers Dig., Dec. 2, 1991, at 20, available in LEXIS, NEWS Library, IDD File (discussing development of preferred equity redemption cumulative stock).

\textsuperscript{90} An underwriter is "a firm that specializes in the marketing of new issues of securities or secondary offerings of securities by selling shareholders." Richard W. Jennings et al., Securities Regulation 88 (7th ed. 1992).


\textsuperscript{92} See Rosenbloom, supra note 88, at 576-77 (noting bankers' sophistication in marketing financial products).

\textsuperscript{93} Such a process is a matter not only of smart business but also of legal duty; for example, under Delaware law, once a company is "for sale" the selling company's directors' role is that of an "auctioneer[ ] charged with getting the best price for the stockholders at a sale of the company." Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986). This is known as the board's "Revlon duty." See supra note 85 (discussing Revlon duty).

multiple rounds of bidding and closely guarded releases of confidential information about the parties.\textsuperscript{95} Furthermore, the bank is frequently required to draw upon its network of contacts to find participants in the auction.\textsuperscript{96}

2. The Fairness Opinion Function

One of the most controversial aspects of the investment bank's role in control transactions is the delivery of fairness opinions.\textsuperscript{97} Since the 1985 case \textit{Smith v. Van Gorkom},\textsuperscript{98} in which the Delaware Supreme Court criticized a corporate board for failing to obtain a banker's opinion as to the fairness of an acquisition bid,\textsuperscript{99} such opin-

\textsuperscript{95} See Randall S. Thomas & Robert G. Hansen, A Theoretic Analysis of Corporate Auctioneers' Liability Regimes, 1992 Wis. L. Rev. 1147, 1152-58 (describing auction process for private and public companies).

\textsuperscript{96} See Rosenbloom, supra note 88, at 577 (noting bankers' abilities to develop prospective bidders in auctions). Bankers performing this service are sometimes called "finders." See John W. Herz et al., Broker and Finder Agreements, in The Mergers & Acquisitions Handbook, supra note 91, at 135, 136 (defining finder as party who introduces buyer and seller in change-of-control transaction).

\textsuperscript{97} Fairness opinions are brief letters stating the bank's opinion as to whether, upon examination of specified data supplied by management, the transaction is "fair from a financial point of view." Lucian Arye Bebchuk & Marcel Kahan, Fairness Opinions: How Fair Are They and What Can Be Done About It?, 1989 Duke L.J. 27, 30; see also Lipton & Steinberger, supra note 44, at 3-91 to 3-98, 3-105 to 3-106, 3-109 to 3-110 (reprinting several fairness opinions).

Fairness opinions serve the dual purpose of aiding directors in the fulfillment of their \textit{Van Gorkom} duty of care, see infra text accompanying note 99, and of persuading shareholders to approve a transaction, see Bebchuk & Kahan, supra, at 28. Shareholders may be influenced by the opinion letter because, although it is usually addressed to the corporation's board of directors, it is often published in the proxy statement the directors send out to obtain shareholder approval for the transaction. See Martin, supra note 9, at 137; see also James C. Freund, Anatomy of a Merger 470 (1975) (suggesting that directors include opinion letter in proxy materials). Few boards of directors will approve a transaction that has been labeled unfair in such a letter (and thus invite a \textit{Van Gorkom} lawsuit, discussed infra notes 98-101 and accompanying text). Conversely, directors are reluctant to adopt aggressive tactics to defend against a hostile acquiror whose bid had been labeled "fair" by a banker.

\textsuperscript{98} 488 A.2d 858 (Del. 1985).

\textsuperscript{99} See id. at 876-77. The court suggested that the company's directors could have rebutted the allegation that they did not exercise informed business judgment by showing that they relied on a fairness opinion. See id. at 876.
ions have become a practical necessity; in fact, the failure to obtain one in a major transaction today would be deemed exceptional.

Fairness opinions have been criticized a great deal. Much of the criticism focuses on the potential for conflicts of interest between the shareholders, the purported beneficiaries of the opinion, and the investment banker. Because bankers are usually compensated in large part by fees contingent on the completion of the transaction, they have a strong incentive to approve deals too readily. Moreover, even if a contingency fee is not in place, bankers have an incentive to preserve their relationships with the managers who hire them by approving their proposals. These incentives, critics maintain, have resulted in a system in which directors can satisfy their fiduciary

---


103 See, e.g., Bebchuk & Kahan, supra note 97, at 38-39 (discussing effects of incentive compensation on bankers rendering fairness opinions); Elson, supra note 9, at 968 (same); Michael Schuld, A Statutory Proposal for the Regulation of Fairness Opinions in Corporate Control Transactions, 56 Mo. L. Rev. 103, 110 (1991) (same). On the other hand, some have pointed out that incentive compensation schemes can produce positive results; because bankers are often compensated by fees calculated as a percentage of the value of the deal, they have an incentive to maximize the price obtained. See Arthur Fleischer Jr., A “Fairness Opinion" Is Just an Opinion, N.Y. Times, June 8, 1986, § 3, at 2.

104 See Bebchuk & Kahan, supra note 97, at 41-43 (discussing desires of bankers to attract and retain clients, as well as “psychological factors” of loyalty toward management, which undermine objectivity).
duties by hiring a banker who will rubber-stamp the transaction without regard to its substantive fairness. To deter such behavior, critics argue, bankers must face increased liability in the courts for their faulty opinions.

Whatever the intuitive appeal of these arguments, one must consider them in the context of how bankers arrive at their opinions. There are no objective guidelines or systematic criteria for use in determining whether a control transaction is “fair.” An initial problem lies in the varying conceptions of what is, in fact, fair; for example, a fair price might be the value of the firm if it were to continue to operate independently, the price that would be obtained in a competitive auction, or the price that would be derived in a two-party arms-length negotiation. Secondly, use of different valuation techniques can yield significantly disparate results. Finally, bankers must consider innumerable variables in their analysis, including the synergies, cost savings, and economies of scale realized by particular bidders; consequently, it is unrealistic to suppose that any two bankers would ever consider identical variables with equal weight. This goes to suggest

---

105 See, e.g., Longstreth Says Federal, State Laws Are Not Assuring Fairness in Buyouts, 15 Sec. Reg. & L. Rep. (BNA) 1908, 1909 (Oct. 14, 1983) (citing former SEC Commissioner Bevis Longstreth’s characterization of fairness opinions as “boiler-plated passkeys . . . inadequate to give shareholders full value for their shares”); Bartlett, supra note 25, at D1 (quoting former Delaware Chancellor William T. Allen’s comment that “courts are suspicious and will no longer accept blindly the advice of bankers”).

106 See, e.g., Giuffra, supra note 10, at 135 (arguing that bankers will not always follow proper procedures if only directors are subject to liability for faulty opinions). Although Daisy’s reasoning did not include a discussion of fairness opinions per se, one could plausibly argue that the fervent and frequent attacks on them at least contributed to the court’s ultimate decision to expand liability.

107 See Bebchuk & Kahan, supra note 97, at 30-32 (discussing “definitional” problem of fairness); Schuldt, supra note 103, at 105-07 (same).

108 Four valuation techniques predominate in this context: discounted cash flow analysis, comparable company analysis, comparable acquisition analysis, and liquidation analysis. See Brian H. Saffer, Touching All Bases in Setting Merger Prices, Mergers & Acquisitions, Fall 1984, at 42, 42 (listing valuation techniques). All four techniques have their advantages and disadvantages, and no single method is popularly viewed as authoritative. See id. In Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), the Delaware Supreme Court rejected a rigid, systematic approach to valuation, opting instead for a “more liberal” approach. See id. at 704; see also Bebchuk & Kahan, supra note 97, at 34-37 (discussing “measurement problem” inherent in use of different valuation techniques); Fiflis, supra note 9, at 518 (noting that use of discounted cash flow analysis, because of variables such as tax savings, technology, and risk, “approaches mere guesswork”).

109 In order to derive a definitive valuation, if such a thing exists, the valuator would need to know the identity of the buyer in order to properly quantify synergies, tax benefits, labor savings, etc. See Carney, supra note 100, at 533 (noting that bankers “can only specify a range of prices that reflect their educated guesses about the probable range of synergies available to various buyers”); Rosenbloom, supra note 88, at 578 (observing that bankers do not know value of businesses to particular buyers); see also Fiflis, supra note 9, at 518 (“[N]o two analysts in a blindfold test would ever arrive at identical figures.”).
that valuation in fairness opinions is an inexact science at best. The subjectivity of the process makes the ex post evaluation of an allegedly faulty fairness determination difficult, perhaps entirely unadministrable.\footnote{Professor Charles M. Elson writes:
If a uniform definition of fairness or a uniformly accepted process for testing and determining fairness existed, the bankers' task would be relatively straightforward and criticism of any deviation from that definition or process would be easily formulated. As a number of commentators have noted, however, no such uniform approach exists.

Elson, supra note 9, at 959; see also Harris Trust & Sav. Bank v. Ellis, 810 F.2d 700, 706 (7th Cir. 1987) (Easterbrook, J.) (noting that "'[f]airness' is a range, not a point"). Courts have frequently noted the imprecise nature of valuation in fairness opinions and have expressed reluctance to second-guess bankers' judgments. See, e.g., Pinson v. Campbell-Taggart, Inc., No. 7499, 1989 WL 17438, at *8 (Del. Ch. Nov. 28, 1989) ("By their very nature, appraisals normally tend to present difficult questions."); Kaplan v. Goldsamt, 380 A.2d 556, 567 (Del. Ch. 1977) (noting imprecise nature of valuations). Moreover, some have noted the judiciary's lack of institutional competence to evaluate such discretionary judgments. See infra notes 147-48 and accompanying text.}

3. The Strategic Advisory Function

The most undefined and variable aspect of the investment bank's role in control transactions is its position as strategic advisor. While the tasks performed as such may take many forms, most of bankers' advisory functions are closely related to the two functions discussed above. For example, in the course of arranging for acquisition financing, the banker may be asked to advise the managers on the appropriate balance of debt and equity that the firm should maintain; while conducting an auction, the banker may be able to offer special insight into particular bidders as a result of prior dealings;\footnote{See Marren, supra note 94, at 488 (noting that one reason to hire bankers is to access their contacts and market knowledge); Rosenbloom, supra note 88, at 577 (noting that bankers typically seek bidders in corporate auctions from their "network of contacts").} and after performing analyses for a fairness opinion, the banker may be able to offer important forecasts and financial estimates.\footnote{For example, comparable market valuations performed during the analysis may provide insights into the value of particular subsidiaries or business segments, or the value of intangibles such as intellectual property and goodwill. See Rosenbloom, supra note 88, at 577 (quoting comments by investment banker Carl Ferenbach on usefulness of valuation estimates, "an area of the banker's expertise").}
B. Daisy's Intrusion on the Decisionmaking Function of Corporate Directors

In *Daisy*, Bear Stearns argued that its responsibilities included aspects of, but were limited to, the facilitatory,113 fairness opinion,114 and strategic advisory115 functions.116 In rejecting this argument,117 the court failed to distinguish the numerous purposes bankers serve during the course of a control transaction from the board's role as decisionmaker, which entails far greater authority118 and fiduciary responsibilities.119

Many of the functions investment banks perform are quite distinct from the usual responsibilities of the board. For example, directors will often leave to the bank's discretion the marketing and distribution of any securities issued to finance the transaction.120 Likewise, the board typically does not (and should not) participate in the bank's performance of its fairness opinion function.121 For some facets of the bank's role, however, there will be some amount of overlap with the role of the board. For example, both the directors and bankers will usually be intimately involved in designing the structure of the bid and the financing.122 More important, both will actively take part in the administration of the auction and the strategy involved in negotiations throughout the bidding process.123

This overlap of responsibilities should not, however, be understood as a division of authority challenging the primacy of the

113 Bear Stearns argued that it was obligated to assist in negotiations, see *In re Daisy Sys. Corp.*, 97 F.3d 1171, 1176 (9th Cir. 1996), a service encompassed in this Comment's definition of the facilitatory function. See supra notes 93-96 and accompanying text.

114 Bear Stearns acknowledged that Daisy had requested its assistance in valuation. See *Daisy*, 97 F.3d at 1176. Presumably this valuation data would eventually form the basis for a fairness opinion. See supra Part II.A.2.

115 Bear Stearns recognized that it was to assist in structuring the transaction and in negotiations, see *Daisy*, 97 F.3d at 1175, the performance of which would fall within this Comment's definition of the strategic advisory function. See supra Part II.A.3.

116 See *Daisy*, 97 F.3d at 1176.

117 See id. at 1177 (rejecting Bear Stearns's characterization of bankers' role).

118 See supra notes 84-86 and accompanying text.

119 See supra notes 13-17 and accompanying text.

120 See supra notes 88-92 and accompanying text (noting banks' unique expertise in securities distribution).

121 The integrity of the bank's conclusion in the fairness opinion would be compromised if the firm's management participated in or influenced the evaluation process. See supra notes 102-06 and accompanying text (discussing criticisms of biased fairness opinions).

122 See Herz et al., supra note 96, at 136 (discussing cooperation between management and advisors in structuring transactions).

123 Compare supra Part II.A.3 (discussing bank's strategic advisory function) with supra notes 84-86 and accompanying text (discussing board's decisionmaking authority in change-of-control transactions).
Fundamental corporate law instructs, without equivocation, that when the judgment of the board and that of its advisors conflict, the board’s decision trumps. For instance, in the auction context, in which the functional overlap between the banker and board is probably most significant, the bank may run the proceedings; it will not, however, "wield a gavel." This point may seem obvious, but it bears reinforcement: It is the board, not the board’s advisors, who have been conferred with general decisionmaking authority by law and by the shareholders themselves. It follows, of course, that with this conferral of power on the board.

124 But see Fiflis, supra note 9, at 512 (arguing that “bankers are often in a control position with their expertise, superior access to information because of their staff facilities, and the confidence and trust placed in them”). Indeed, investment bankers are influential participants in change-of-control transactions. Professor Fiflis overlooks the fact, however, that whatever the influence an investment banker exerts in a given transaction, the actual authority to make decisions will remain vested in the board. See supra notes 84-86 and accompanying text (discussing statutory grant of decisionmaking authority to board of directors).

Moreover, a conception of the banker’s role in the decisionmaking function as subordinate to that of the board is surely closer to reality. See Rosenbloom, supra note 88, at 573 (“Even in a world of personable and persuasive investment bankers, companies and managements call the shots.”). In fact, in many transactions the client’s management has already decided to pursue the acquisition before consulting with the banker. See Marren, supra note 94, at 488 (noting that management typically retains banker after decision to complete transaction has been made). This is, of course, precisely what occurred in Daisy. See supra notes 40-42 and accompanying text (noting that Daisy’s CEO decided to pursue hostile strategies to acquire Cadnetix before consulting Bear Stearns). Professor Fiflis’s other arguments are curious, especially his claim that bankers have superior access to information. It is hard to imagine a banker having superior access when, as is typical, access is provided to the banker by the permission of the board. See, e.g., supra note 43 (discussing Daisy board’s agreement to provide Bear Stearns access to requested information).

125 For example, Delaware law provides that a corporation’s business affairs should be managed by the board of directors. See Del. Code Ann. tit. 8, § 141(a) (1991); see also supra notes 84-86 and accompanying text (discussing grant of decisionmaking authority to directors in corporation statutes); Rosenbloom, supra note 88, at 577 (arguing that in change-of-control transactions, “the board has to be held fully accountable and has to make its own judgments”); Thomas & Hansen, supra note 95, at 1160 (noting that bankers’ primary responsibility in corporate auctions “is to solicit bids and transmit them to the board of directors. The board retains all authority to accept a bid.”).

126 Thomas & Hansen, supra note 95, at 1159; see also id. at 1164 (“The directors’ duties in managing the corporation’s affairs include, if they choose to auction their company, conducting the auction. Responsibility for the proper conduct of an auction cannot be removed from the board, although the actual conduct of the auction can be delegated to an agent . . . .”).

127 Professor Fischel, discussing the Van Gorkom case, argues:

In the final analysis, the issue facing the directors in [Van Gorkom] was whether to accept the deal . . . . This is the classic type of decision in which corporate law has long recognized that the directors, in light of their superior information and incentive to maximize the value of the firm, are better able to assess this trade-off than individual shareholders, plaintiffs’ attorneys, or courts.
board comes responsibility; because the decisions are, ultimately, theirs to make, the directors must be the ones to take responsibility for any consequences, fortunate or unfortunate.\textsuperscript{128}

The Daisy court's "startlingly broad"\textsuperscript{129} definition of the bank's role evinces a lack of clear understanding on this fundamental issue. The court held that the bank was duty-bound to advise on the overall financial prudence of the acquisition, a decision solely in the board's discretion, and held the bank liable when its advice proved unwise.\textsuperscript{130} The ruling holds banks responsible for the consequences of decisions \textit{that were not theirs to make}—a dubious proposition at best.\textsuperscript{131}

To conclude, the Ninth Circuit's reasoning suggests that the investment banker's role encompasses the responsibility for, and the authority to make, the most fundamental decision in any transaction—whether to undertake the transaction at all.\textsuperscript{132} The banker's functional duties, of course, are far more limited. In its struggle to understand exactly what investment banks do in control transactions, the Daisy court crafted a rule founded on fundamental misconceptions of the banker's role.

III

A Doctrinal and Policy Critique of the Daisy Rule

The Daisy court ruled that the existence of a fiduciary relationship between an investment bank and its client is an issue of fact, and proposed a test for the factual determination based on the relative experience of the parties and on agency law.\textsuperscript{133} While the preceding Part discussed a key misunderstanding in the reasoning used to arrive at this rule (namely, the court's overestimation of the banker's role),

\textsuperscript{128} See infra notes 136-40 and accompanying text (discussing directors' fiduciary responsibilities and consequent liability exposure).

\textsuperscript{129} Mundiya, supra note 79, at 16.

\textsuperscript{130} See In re Daisy Sys. Corp., 97 F.3d 1171, 1175-79 (9th Cir. 1996).

\textsuperscript{131} See Mundiya, supra note 79, at 16 ("Indeed, the Ninth Circuit's standard would only seem appropriate if the investment banker was in effect replacing the board of directors rather than simply assisting it."); see also infra Part III.B.2 (arguing that, in wake of Daisy, bankers will demand decisionmaking authority over transactions on which they advise, thereby unseating directors as exclusive decisionmakers).

\textsuperscript{132} See Mundiya, supra note 79, at 16-17 (arguing that Daisy court defined bankers' duties as going beyond mere facilitation to stopping clients from pursuing objectives that might prove imprudent ex post). To Mundiya, such a standard "would require the banker to assume the board's expertise in the business of the company, a skill that investment bankers ordinarily do not pretend to possess." Id. at 17.

\textsuperscript{133} See supra Part I.B (discussing Daisy rule and test).
this Part critiques the rule itself from both a doctrinal and a policy perspective. The first Section argues that bankers are inappropriate bearers of the risk of enterprise failure that Daisy places upon them. The second Section goes on to examine the likely responses of investment banks as they attempt to reduce their increased liability exposure.

A. Investment Banks as Inappropriate Risk-Bearers

In holding that banks can be held liable for the consequences of advice that does not meet the high standards of fiduciary duty, the Daisy court shifted a significant amount of the risk of failure of a transaction from directors to bankers. If shareholders or other parties with standing to bring suit discover that a corporation's fortunes have turned, they need no longer look solely to the management and directors for recompense; Daisy has put investment banks in play. This risk-shifting poses particular problems for investment bankers that the court may not have considered.

This Section discusses these problems in a two-step fashion: first, by examining bankers' unsuitability for risk-bearing relative to directors, because of the lack of offsetting doctrinal protections afforded bankers' discretionary judgments, and second, by examining bankers' unsuitability for risk-bearing relative to shareholders, because of their inability to diversify their risk.

1. Investment Banks' Unsuitability for Risk-Bearing Relative to Corporate Directors

As discussed above, directors are given broad decisionmaking authority over corporate enterprises, and as reciprocation for this power they accept fiduciary obligations to shareholders. To counterbalance these enormous responsibilities, courts have applied the business judgment rule in evaluating directors' actions: Provided that directors can demonstrate they exercised careful, disinterested judgment, courts will not second-guess their decisions. As an additional

134 See supra notes 16-17 and accompanying text (discussing high standard of behavior expected of fiduciaries).
135 See infra note 189 (discussing availability of bankers as "deep pocket" to whom shareholders can look when transactions fail); see also supra text accompanying note 82 (noting that future fiduciary claims against investment bankers could bring recoveries of over $1 billion).
136 See supra notes 84-86 and accompanying text.
137 See supra notes 13-17 and accompanying text.
138 See, e.g., Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (holding directors' decisions protected unless plaintiff can prove failure to meet duty of care or duty of loyalty).
protection, directors are also permitted by law to rely in good faith on advice rendered by competent, unbiased experts.\textsuperscript{139}

These doctrinal protections grant directors the breathing room to perform their decisionmaking function effectively, despite their heavy burden as fiduciaries. The business judgment rule in particular protects the board from potentially onerous liability resulting from its unsuccessful, but honest, choices. Without such insulation from liability, directors would be forced to manage the firm in a way that creates the fewest opportunities for failure (and thus liability).\textsuperscript{140}

The \textit{Daisy} court essentially viewed the investment banker’s fiduciary responsibilities in control transactions as coterminous with the board’s, including responsibility for the overall financial prudence of the deal.\textsuperscript{141} In so doing, however, it did not provide the offsetting protections that directors are afforded. There is no business judgment for business judgment rule). The duty of care requires that directors exercise “that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances.” Clark, supra note 19, § 3.4, at 123; see also American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.01 (1994) (discussing duty of care). The duty of loyalty prohibits directors from abusing shareholders in transactions in which they have a self-interest or a conflict of interest. See Clark, supra note 19, § 4.1, at 141 (discussing duty of loyalty). If these duties are satisfied, in most cases the business judgment rule will apply. See AC Acquisitions Corp. v. Andersen, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (noting that rule is so protective of directors that its application is virtually outcome determinative.)

\textsuperscript{139} The Delaware statute provides:

\begin{quote}
A member of the board of directors . . . shall . . . be fully protected in relying in good faith upon . . . such information, opinions, reports or statements presented . . . 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.
\end{quote}


\textsuperscript{140} Professor Fischel acknowledges that “[i]nformed decision making is necessary for corporate managers to maximize the value of the firm.” Fischel, supra note 100, at 1440-41. Nevertheless, rational investors would desire that managers “spend an additional dollar on information acquisition only to the point where there is an additional dollar generated from better decision making.” Id. at 1441. He explains that “[i]t would make no sense, for example, for a manager who has to decide whether to give his or her secretary a $10-a-week raise to commission a $100,000 study of secretarial compensation in the United States.” Id. The example illustrates the absurd dilemma facing the risk-averse corporate manager who operates without the protection of the business judgment rule. Because the consequences of an incorrect decision are so severe to the manager who operates in a regime without judicial deference to her decisions, she may misallocate firm resources to protect herself from even relatively minor errors.

\textsuperscript{141} See supra Part II.B (discussing \textit{Daisy} court’s view of bankers’ responsibilities relative to board of directors).
rule for bankers.\textsuperscript{142} Similarly, bankers cannot avail themselves of the expert reliance protections granted to directors.\textsuperscript{143} They are therefore placed in the inequitable position of being saddled with tremendous liability risk without the courts' usual shield.

The customary response of advisors to liability risk, regardless of the applicability of doctrinal protections, is to obtain contribution and indemnification agreements from the client.\textsuperscript{144} Such arrangements provide that the client will partially contribute to, or fully indemnify, the advisor's litigation costs and remedy costs. Their effectiveness, however, is questionable for a bank facing a \textit{Daisy} lawsuit, because it is unclear whether advisors can be indemnified for remedy costs arising from a breach of fiduciary duty.\textsuperscript{145} Moreover, if a bank is to be indemnified, its client must be solvent—a contingency, as \textit{Daisy} illustrates, on which the bank cannot rely.\textsuperscript{146}

It is important to note additionally that \textit{Daisy}'s failure to entitle bankers' business judgment to deference in the courts places pressure on the competence of the judiciary. Delaware Vice-Chancellor Carolyn Berger points out that judges do not hold themselves out as financial experts; consequently, "if a non-expert is to decide whether

\textsuperscript{142} See Rosenbloom, supra note 88, at 591 (quoting Delaware Vice-Chancellor Carolyn Berger's statement that "[n]o court that I know of has applied the business judgment rule to investment bankers"). This is not to say, of course, that the business judgment rule could not be applied to bankers. To do so, however, would not remedy the problems \textit{Daisy} raises. See infra note 168 (discussing effects of application of business judgment rule to bankers).

\textsuperscript{143} See, e.g., Del. Code Ann. tit. 8, § 141(e) (1991) (limiting expert reliance protection to corporate directors). These provisions have never been extended to investment bankers, logically avoiding the absurd and costly incentive to hire experts to check the experts (who checked the experts who checked the experts, ad infinitum). Regardless of its strange fit in this context, the unavailability of the expert reliance protection further illustrates the disparate doctrinal treatment of directors and bankers.


\textsuperscript{145} At a minimum, directors cannot indemnify advisors, such as attorneys and auditors, for a breach of their duty of loyalty. See, e.g., Rev. Model Bus. Corp. Act § 8.31 (1984). The law is not clear on whether advisors can be indemnified for breach of the duty of care, though the trend is toward the allowance of indemnification. See Dale Arthur Oesterle & Jon R. Norberg, Management Buyouts: Creating or Appropriating Shareholder Wealth?, 41 Vand. L. Rev. 207, 253-54 (1988) (arguing that indemnification should be allowed under certain conditions). Courts have held in a similar context, however, that allowing indemnification for advisors' violations of the federal securities laws would flout the policies promoted in the statutes. See, e.g., Globus v. Law Research Serv., 418 F.2d 1276, 1288 (2d Cir. 1969). Additionally, if the recovery by the shareholders is large, full indemnification may not be easy to obtain. See Giuffra, supra note 10, at 140-41 (expressing doubt that corporations will fully indemnify large judgments against investment banks).

\textsuperscript{146} See In re \textit{Daisy Sys. Corp.}, 97 F.3d 1171, 1175 (9th Cir. 1996) (noting that \textit{Daisy} entered bankruptcy prior to commencement of lawsuit against Bear Stearns).
an expert's conclusion was valid or not, it seems . . . you are always running the risk that the non-expert judge (or jury) will not fully understand the appropriateness of the method that was chosen by the investment banker.” Moreover, even assuming that judges possess the expertise to assess bankers' performances effectively, the subjective nature of much of what bankers do makes evaluation difficult. Valuation estimates, for example, are based on largely discretionary decisions and can vary widely from banker to banker.148

2. Investment Banks' Unsuitability for Risk-Bearing Relative to Shareholders

Implicit in the extensive protections afforded directors is the assumption that they are poorer bearers of the risk of failure of corporate enterprises than the firm's shareholders. Were the directors superior risk-bearers, courts would be less willing to effectuate such broadly protective doctrines as the business judgment rule. This assumption is further borne out in the reality of modern corporate management: Even though directors' exposure to liability is minimized by the courts, shareholders in most major corporations willingly offer their directors and officers insurance for whatever risk remains (with the premia paid from the corporate fisc).149

The explanation for this hypothesis is that shareholders can diversify their investment portfolios to minimize the effect of a single failed enterprise.150 Directors and officers, however, face much greater repercussions, including loss of reputation or even their jobs. Because of the already dire consequences of unsuccessful enterprises to managers, liability for such mistakes will exacerbate a tendency toward

147 Rosenbloom, supra note 88, at 592. The limits of judicial competence are often cited as a reason for application of the business judgment rule. See, e.g., Bradbury, supra note 85, at 281 (noting that courts “will not substitute their inexpert judgment” for board's judgment in most cases). Professor Fischel notes that judges make their business judgments, if they are called upon to do so, in very different circumstances from corporate managers. While managers who make poor decisions are often penalized or fired, judges are generally immune from such consequences. See Fischel, supra note 100, at 1443 (“The much-heralded independence of judges . . . makes judges particularly poor candidates to make business decisions because it frees them from the contractual and market mechanisms that encourage sound decision making.”).

148 See supra notes 107-10 and accompanying text.


150 See Fischel, supra note 100, at 1442 (“Shareholders, because of their ability to invest in many firms, are better able to bear business risk than corporate managers.”).
risk-averse decisionmaking. Shareholders who are more tolerant of risky projects because of their ability to diversify may find such an approach undesirable.

As discussed earlier, the effect of the Daisy rule is to saddle investment bankers with many of the responsibilities, and consequent liability exposure, of the board’s decisionmaking function. The arguments for shareholders as superior risk-bearers to management are no less applicable to bankers; like directors, bankers cannot diversify away their risk and thus will face identical risk-aversion incentives. Daisy failed to recognize this analogy, and shifted the risk of unsuccessful enterprises from shareholders to the investment bankers involved.

B. Investment Banks’ Reactions to the Daisy Rule

The natural reaction of a party facing increased exposure to liability is to take steps to reduce that exposure; indeed, this is precisely what the law contemplates. After Daisy, investment banks face expected liability \( L \) that can be summarized in a simple equation: \( L = DFS \), where \( D \) represents the damages recoverable if a subsequent Daisy-type lawsuit is successful, \( F \) represents the probability of trans-action failure of a kind and to a degree sufficient to give rise to a Daisy lawsuit, and \( S \) represents the probability that the reviewing court would determine the bank to be an agent of or superior to its

---


152 See Fischel, supra note 100, at 1442 (arguing that shareholders usually desire managers to take more risk than they are willing to assume without business judgment rule protection). The doctrinal protections and insurance coverage, therefore, more closely align the interests of management with risk-tolerant investors by allowing the managers more room for error.

153 See supra text accompanying notes 129-32.

154 At first blush, this claim appears to be susceptible to an appealing counterargument: Banks, unlike directors, can diversify their risk by varying their “portfolio” of clients. This does not, however, put bankers on equal footing with shareholders, because corporate law limits shareholders’ potential loss to their original investment. See, e.g., Rev. Model Bus. Corp. Act § 6.22 (1984).

Suppose an investor spreads $100 evenly over 10 firms. Each firm has a 10% risk of insolvency; if insolvency does not occur, the firms will each yield a 20% return. Thus the investor can expect to earn $18 from the nine successful firms and sustain a loss of $10 from the insolvent firm, for a net of $8, or 8%. Compare the investment banker who allocates $100 of firm resources evenly over 10 clients. Each client has an insolvency risk of 10% and will return fee profits of 20%. The banker can expect to earn $18 from the nine solvent clients, but the loss from the insolvent client, under a Daisy regime, will not be limited to the $10 investment—in fact, it will surely be far greater.
This section analyzes the ways banks can be expected to reduce each of the factors $D$, $F$, and $S$, and thus reduce their expected liability $L$. The first subsection explains how banks will reduce $S$ by screening their clients. The second subsection argues that banks will seek to reduce both $D$ and $F$ by demanding greater control over the transactions on which they advise and exercising this control to adopt risk-averse, liability-minimizing strategies. Finally, the third subsection explains how banks will offset their expected liability $L$ as a cost of business passed on to their client base.

1. Client Screening

_Daisy_ institutes a test to determine a bank’s status as a fiduciary which turns on a factual determination as to whether the bank was its client’s agent (the bank’s “agency risk”), or whether it was “superior” to its client (“superiority risk”). Investment banks will, from the outset of their retention, seek to minimize the chance that they could be found to be either by a reviewing court.

The _Daisy_ court gave little guidance regarding the nature of the factfinder’s agency inquiry. Nevertheless, a bank should have little difficulty in minimizing agency risk by carefully structuring its relationship to its client to be that of an “independent contractor,” rather than an agent.

Agency law provides well-defined guidelines to aid

---

155 To illustrate: If a bank estimated there existed a 20% chance that an enterprise for which it may be retained would fail and give rise to _Daisy_ damages of $50 million, and that there was a 65% chance that it would be found to be “superior” to the client, the equation would yield an expected liability of $6.5 million. The bank would probably wish to analyze the expected liability under several different scenarios. For example, for the bank above there may also be a 10% chance that the project would fail to an extent that would give rise to _Daisy_ damages of $75 million, in which case the expected liability would be $4.875 million.

Presenting these variables so systematically is not meant to suggest that their values are easily predicted. In fact, each is stochastic; the bank can only hope to derive the closest of various ballpark estimates. This uncertainty will in turn lead banks to demand an even greater risk premium for bearing the risk that their estimate of expected liability will prove incorrect. For discussion on risk premia that banks will demand in a _Daisy_ regime, see infra Part III.B.3.

156 Indeed, because the potential liability $L$ could be so large as to pose a risk of insolvency to the bank, bankers would likely take precautions that are greater than necessary to simply offset the expected liability. See generally Thomas & Hansen, supra note 95, at 1172 (discussing incentives for bankers to take excessive precautions against liability).

157 See _In re Daisy Sys. Corp._, 97 F.3d 1171, 1178 (9th Cir. 1996). The court also reasoned that the factfinder should consider whether the client reposed confidences in the banker. See id. at 1178. This factor, however, was not deemed to be a determinative one by the court. See id.; see also supra note 67 and accompanying text.

158 The court did, however, emphasize the fact that the engagement letter provided that Bear Stearns “would be acting on _Daisy’s_ behalf.” Id.

159 A “servant,” or agent, is defined as one who is “employed by a master to perform service in his affairs whose physical conduct in the performance of the service is controlled...
courts in distinguishing "servants" from independent contractors, and bankers can conform their relationships to these standards.160

The superiority inquiry, on the other hand, creates powerful and troubling incentives. Because banks are unlikely to reduce superiority risk by deliberately employing personnel who are less sophisticated than particular clients, they will seek to minimize the risk by screening their clients. Banks will face a regrettable, but inevitable, incentive to agree to be retained only by clients who are likely to be characterized as equal or superior to their own personnel.

This incentive is regrettable, even perverse, because it places the services of investment banks out of the reach of entities who need their services most: those which previously have not conducted a transaction of the type for which the banker would be retained. In contrast to the firm with practical expertise, which may need bankers for little more than the delivery of a fairness opinion, unseasoned firms may depend significantly on the advice of bankers to complete a sophisticated transaction. However, because of the increased superiority risk involved in the engagement, banks will be hesitant to help or will, at least, demand a substantial risk premium.162

---

160 The Restatement offers the following guidelines for courts to consider in their determination of whether a party is an agent or independent contractor:
(a) the extent of control which, by the agreement, the master may exercise over the details of the work;
(b) whether or not the one employed is engaged in a distinct occupation or business;
(c) the kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision;
(d) the skill required in the particular occupation;
(e) whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work;
(f) the length of time for which the person is employed;
(g) the method of payment, whether by the time or by the job;
(h) whether or not the work is a part of the regular business of the employer;
(i) whether or not the parties believe they are creating the relation of master and servant; and
(j) whether the principal is or is not in business.

Id. § 220.

161 See Carney, supra note 100, at 529 (noting that agency is consensual relationship and that shrewd bankers will not agree to characterize their client relationships as such).

162 See infra Part III.B.3 (discussing bankers' demand for payment of risk premia). Client screening that results in client rejection or risk premia will impose wide-ranging opportunity costs, because transactions that would otherwise be economically desirable will be deterred by the parties' inability to obtain bankers' services or by the additional expense.
2. Demand for Control and Risk-Minimizing Strategies

While directors face considerable liability risk as corporate decisionmakers, as discussed earlier, this risk is mitigated by important doctrinal protections. Another important mitigating factor is the degree of control over corporate enterprises that directors exercise. Clearly, directors would not accept the liability risk of corporate management if their fate rested in another party’s hands; for this reason, corporate statutes confer broad general power on directors subject only to shareholder vote in special circumstances.

Investment bankers do not enjoy the broad decisionmaking powers directors are afforded; nevertheless, Daisy places much of the liability risk facing directors on the bankers they engage. Since bankers presumably can do nothing to force courts to provide them with doctrinal protection, they must focus their efforts on reducing the risk of failure of the enterprise (“failure risk”) and the consequent damages by seeking to obtain greater control over the course of the transaction. It is manifestly reasonable for bankers to expect, like directors, to hold their liability “fate” in their own hands.

Therefore, to agree to advise a client on a transaction, the banker will demand contractual provisions requiring the board to share its authority to perform the decisionmaking function. This displacement of the board as plenary decisionmaker is plainly inconsistent

Such deterrence negatively affects not only investment banks' clients, but also the parties who are unable to obtain services or do not seek services because of their prohibitive cost. See infra text accompanying notes 181-82 (discussing opportunity costs).

163 See supra notes 136-40 and accompanying text.
164 See supra notes 84-86 and accompanying text.
165 See supra note 86.
166 Failure risk is represented by the factor $F$ in the equation discussed supra notes 155-56 and accompanying text.
167 Such damages are represented by the factor $D$ in the equation discussed supra notes 155-56 and accompanying text.
168 This point should not be understood to suggest that, were investment bankers to be provided with doctrinal protection, they would cease to demand control over their clients’ enterprises. Despite the importance of the Daisy court’s failure to afford bankers discretionary deference, see supra notes 142-44 and accompanying text, infra note 173, correcting this oversight would not solve the problems raised in this Comment—it would merely place bankers on equal footing, from a liability exposure standpoint, with directors. Bankers would therefore continue to demand enterprise control that is at least equal to that provided to directors in order to protect themselves from liability. This eventuality would produce the same consequence discussed in this subsection, namely the usurpation of the board’s position as plenary decisionmaker despite its superior ability to exercise such authority. See infra notes 169-71 and accompanying text.
169 Cf. Thomas & Hansen, supra note 95, at 1169 (questioning whether bankers will allow board to choose among bidders if bankers are subject to direct liability to shareholders).
with the spirit of state corporate law. It is also unwise as a matter of corporate governance; the board, which is intimately involved in the operations, prospects, and long term goals of the firm, is the most suitable entity to make fundamental corporate decisions.

A further problem lies in the way bankers will wield their decisionmaking power. As suggested earlier, were it not for doctrinal protections such as the business judgment rule, directors would have an irresistible incentive to adopt unrisky strategies even though riskier enterprises may be desirable. Bankers are not afforded such protections and, as a result, will face the same risk-averse incentives feared in the director context. Because their decisions are not enti-

---

170 See supra notes 84-86 and accompanying text (discussing corporate statutes on directors' authority).

171 See Rosenbloom, supra note 88, at 579 (quoting Carl Ferenbach as asking "are we in a world where we want the banker to determine who comes to the auction, how long the auction runs and what the auction rules are? Do we not rather want a world in which the board takes that responsibility?"); Thomas & Hansen, supra note 95, at 1169 (expressing same concern). One commentator points out that the risk-averse investment banker, when faced with the specter of Daisy liability, will perform (and bill for) tasks that duplicate work already performed by the board in the course of its analysis. See Rosenbloom, supra note 88, at 577-78 (statement of Carl Ferenbach). Bankers are typically provided with information on their clients by the board, accompanied with a representation that all information so provided is accurate. See, e.g., 3 Lipton & Steinberger, supra note 44, at E-233, E-234 (reprinting fairness opinion with representation of reliance on accuracy of information provided by management). In a Daisy regime, however, the banker may not be satisfied with such a representation and will independently verify the data. See Rosenbloom, supra note 88, at 577-78.

172 See Bradbury, supra note 85, at 281 (noting that imposing judicial review of directors' decisions may deter directors from undertaking desirable, but risky, projects).

173 The absence of business judgment rule protection is critical. Assume that risks can be divided into three overlapping categories: desirable risks, which are enterprises whose payoff, after discounting for risk of failure, provides a positive net present value; tolerable risks, which are enterprises that perfectly informed corporate decisionmakers are willing to undertake under the current liability regime (i.e., after consideration of the applicability of business judgment rule protection); and actionable risks, which are enterprises so ill-advised that the decisionmakers can be held liable to shareholders. The business judgment rule has the effect of conflating the categories of desirable risks and tolerable risks, because the judgment of the decisionmaker will be protected if the enterprise is legitimately determined to have a positive net present value. When the business judgment rule is not applied, however, many desirable risks will not be tolerable risks because they may also be actionable risks. Stated graphically:

---

**BUSINESS JUDGMENT RULE**

Desirable Risks

Tolerable Risks

Actionable Risks

**NO BUSINESS JUDGMENT RULE**

Desirable Risks

Tolerable Risks

Actionable Risks
tled to deference by a court reviewing their actions ex post, bankers will exercise their discretion to choose strategies that pose minimal failure risk.\(^\text{174}\)

Investors, with their ability to diversify their holdings, may be willing to bear the risk of uncertain projects in the hopes of obtaining a potentially large reward.\(^\text{175}\) After Daisy, however, directors wishing to employ such a strategy may find themselves hamstrung by the unwillingness of bankers to go along. If bankers have obtained sufficient decisionmaking control to veto a risky strategy, directors will face the decision to either (1) adopt an alternative, less risky strategy, (2) compensate the banker for the assumption of additional failure risk, or (3) forego the services of the banker altogether. Given the necessity of fairness opinions in contemporary change-of-control transactions, among the other services bankers provide, the third option will be very unattractive. This leaves options (1) or (2), neither of which benefits the firms' shareholders, the ostensible beneficiaries of the Daisy holding.\(^\text{176}\)

The overlap between actionable risks and desirable risks occurs because the court is permitted to substitute its ex post judgment in analyzing the decisionmaker's performance. Many enterprises may fail and yet be beneficial risks from an ex ante perspective because their net present value is positive even after discounting for risk. The reviewing court is not forced to adopt this perspective, however, in its evaluation. The decisionmaker will thus adopt a risk-averse strategy by confining its choices to those that are tolerable risks instead of those that are desirable risks.

\(^\text{174}\) See Fischel, supra note 100, at 1442:

It is always possible to argue that a bad outcome could have been avoided (or a good outcome would have been better) if managers had obtained more information. . . . But if managers can be sued whenever decisions, even if desirable when made, turn out poorly, they will respond by avoiding risk . . . .

\(^\text{175}\) See supra notes 150-52 and accompanying text.

\(^\text{176}\) If the additional risk premium demanded by the bank amounted to less than the incremental benefit to be gained by the riskier enterprise, it would be beneficial for the client firm to pay the premium. This Comment argues, however, that any premium paid is counter to shareholder interests because shareholders would prefer to bear the risk of enterprise failure themselves. See infra notes 184-89 and accompanying text.

Some commentators have argued that there may be a net benefit for shareholders nevertheless. Professor Reinier H. Kraakman offers the valuable insight that advisors can operate as efficient "gatekeepers," or monitors of the board's activity. See Reinier H. Kraakman, Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857, 888-96 (1984); Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. Econ. & Org. 53, 71-78 (1986). Some have sought to apply this theory as justification for the increased liability of bankers. See, e.g., Fiflis, supra note 9, at 513-16; Giuffra, supra note 10, at 135 (arguing increased liability would promote banker vigilance, hinder banker-director collusion, and ensure compliance with legal rules). The costs of gatekeeping are high, however. See infra Part III.B.3 (discussing increased costs resulting from risk premia). Additionally, because directors' judgments are so often a matter of discretion and not obviously incorrect, their errors may be difficult to detect ex ante. See supra notes 84-86 and accompanying text (discussing broad discretionary authority of board of directors).
Daisy's rule, in sum, creates a serious conflict of interest between client and banker: the client's to maximize shareholder value by engaging in enterprises that may contain risk, and the banker's to minimize failure risk. To the extent that bankers prevail over their clients (whether by adoption of a less risky strategy or by payment of a risk premium), shareholders' interests are compromised.

3. Increase in the Costs of Change-of-Control Transactions

The increase in expected liability for investment bankers represents, as all litigation risk does, an additional cost of doing business. Besides the obvious remedy costs, banks will plan for increased litigation expenses, transaction costs, and insurance premia. Such costs must be passed on to clients if banks are to remain profitable. The increase in price of bankers' services will be paid from the corporate coffers of their clients, and thus the clients' shareholders. Moreover, these costs must be viewed alongside the more subtle opportunity costs Daisy forces shareholders to bear: Because of bankers' incentives to screen their clients and veto risky enterprises, many transactions shareholders would wish to undertake may be deterred.

Conceivably, shareholders could saddle corporate directors with unlimited liability for enterprise failure and compensate them, in the form of (likely enormous) salary increases, for the costs of bearing the risk. They have never done so, however, as reflected in the general acceptance of the business judgment rule and the common use of corporate-funded liability insurance. As discussed earlier, this phe-
nomenon stems from the fact that directors are inferior bearers of risk.¹⁸⁵

Bankers are no more appropriate risk-bearers. Shareholders would therefore prefer to bear the risk of failure themselves and pay less for bankers’ services, as they have done for directors.¹⁸⁶ The Daisy rule, of course, does not allow shareholders this option; instead, bankers are by judicial fiat the de facto insurers of a transaction’s success if the elements of the test are met.¹⁸⁷

This observation asks and answers the penultimate question: Given the fact that the costs of insuring the success of a transaction will always be passed on to the firm’s shareholders, would shareholders prefer to pay in the form of higher fees for bankers’ services instead of simply bearing the risk themselves? The answer is surely no; if shareholders did prefer to compensate a third party for bearing such risk, they would have done so long ago by placing the risk on corporate directors.¹⁸⁸ The unfortunate irony is apparent; though the Daisy opinion has a distinct shareholder protectionist flavor, the court failed to substantiate its rationale by considering whether shareholders would prefer to leave well enough alone.¹⁸⁹ This oversight resulted in a rule which compromises the very interests it was intended to further.

¹⁸⁵ See supra notes 150-52 and accompanying text (discussing directors’ unsuitability for risk-bearing relative to shareholders).

¹⁸⁶ Shareholders may also wish to hold bankers immune from liability to attract the highest-quality and most experienced advisors. This is certainly another motivating factor behind the protections afforded directors. See Robert B. Robbins & Mandy S. Cohen, Ensuring Mandatory Indemnification of Corporate Officers and Directors, Insights: The Corporate and Securities Law Advisor, Oct. 1994, at 14 (noting that protections assist company in attracting high quality management); see also Fischel, supra note 100, at 1439 (arguing that failure to protect directors would “result in fewer talented people being willing to serve as directors”).

¹⁸⁷ See Elson, supra note 9, at 995 (noting that liability will effectively make banker “an insurer of the fairness of the transaction”). The problem of preempting shareholder choice is heightened by the fact that shareholders are unlikely to receive considerably better or more competent services in exchange for the higher prices bankers will demand. As discussed in the preceding sections, bankers will be more cautious in the performance of their functions, but will also demand control over decisions that are better left to the board’s discretion. See supra notes 162-71 and accompanying text.

¹⁸⁸ Besides the point that shareholders are superior risk bearers, one must consider the fact that in order to claim the benefits of the insurance provided by bankers under the Daisy rule, shareholders must resort to litigation, which is costly.

¹⁸⁹ See supra note 186 and accompanying text (discussing reasons shareholders would prefer to bear risk of enterprise failure themselves). One commentator supporting the extension of fiduciary duties to investment bankers suggests that such a rule would be desirable because shareholders are often left without recourse when a transaction fails and management is judgment-proof. See Fiflis, supra note 9, at 511 (arguing that fiduciary cause of action “restores the shareholders’ right to have someone responsible” for substantive fairness of transaction). Indeed, the Daisy rule does provide a deep pocket to which shareholders may resort, but Professor Fiflis (like the court itself) bypasses the predicate
CONCLUSION

The *Daisy* court, in a rather cavalier opinion, created a liability regime for investment bankers that is justified neither by corporate governance principles nor as a means of protecting shareholders. By conferring responsibility for fundamental corporate decisionmaking on bankers without providing corresponding doctrinal protections, the court produced an irresistible incentive for bankers to demand decisionmaking control, seriously undermining the authority of the board of directors. Moreover, the court’s shift of enterprise failure risks to bankers creates costs, in the form of increased fees and lost opportunities to undertake risky but profitable projects, that shareholders would contract to avoid if left to their own devices. The consequences of the *Daisy* decision should not be underestimated—if left unchecked, bankers and their clients face significantly increased costs in change-of-control transactions, costs made necessary only by that court’s failure to recognize them as such.