King & Spalding

Client Alert

Corporate Practice Group

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In re El Paso Corporation Shareholder Litigation[1]

Another Black Eye for Investment Banks and a Warning Shot – Be Ready to Aggressively Defend their Role in Your Next M&A Transaction

In a case that adds more ammunition to those who question the motives of Wall Street investment bankers, last week the Delaware Chancery Court issued yet another stinging opinion strongly chastising sell-side bankers who were allegedly conflicted in the M&A advice they provided to a board of directors that was considering a takeover bid. Chancellor Strine's warnings to investment bankers in his decision in *In re El Paso Corporation Shareholder Litigation* are perhaps the strongest-worded admonitions issued by the Delaware Chancery Court to date.

The decision is the latest in a string of recent Delaware Chancery opinions where the Court has carefully focused on the role of the investment bankers in an M&A transaction.[2] What it means is that M&A bankers and those that hire them – boards of directors and management – should be very sensitive to banker conflicts (be they real or perceived) and be ready to aggressively defend their role when the deal is announced.

Background

It should be noted at the outset that the facts alleged in the *El Paso* litigation are based only on a preliminary record which was developed from truncated, expedited discovery. If one assumes the statements of the Court as true, the case provides further guidance on the role of sell-side investment bankers in an M&A transaction. The case also provides a cautionary tale for Boards that allow senior members of the management team to negotiate a sale transaction without active and direct oversight from the Board. However, in light of the salacious allegations made against the bankers in *El Paso*, we believe the views expressed by Chancellor Strine regarding their role will receive the greatest attention from commentators and the courts and, therefore, are likely to have important implications for companies engaged in sale of control transactions and their advisors. Accordingly, this client alert focuses only on those implications and provides our views on how best to address them going forward.

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The *El Paso* litigation stemmed from the proposed $21.1 billion acquisition of El Paso Corporation by Kinder Morgan, Inc. The plaintiffs in the case alleged a number of conflicts of interest, including that Goldman Sachs & Co. was on both sides of the transaction due to its ownership of approximately 19% of Kinder Morgan stock (worth approximately $4 billion) and control of two Board seats at the same time as it was advising the El Paso Board on a proposed spin-off of El Paso's oil and natural gas exploration and production business. To make matters worse, unknown to El Paso's Board, the lead Goldman banker advising El Paso failed to disclose that he personally owned approximately $340,000 of Kinder Morgan stock. Although Morgan Stanley & Co., LLC was hired by El Paso as a second banker to advise the Board because of Goldman's perceived conflicts, Chancellor Strine concluded that Goldman continued to cast a heavy influence over El Paso – so much so that it was able to accomplish the "remarkable feat" of arranging for Morgan Stanley to be paid a fee only if the sale to Kinder Morgan was completed.[3] Moreover, at one point in the negotiations when Kinder Morgan threatened to go hostile and take its interest in buying El Paso public, it appeared to Chancellor Strine from the limited factual record that Goldman was able to prevail on El Paso that it should placate Kinder Morgan (allowing Kinder Morgan to avoid a longer and potentially more expensive fight).[4] At no time during the negotiations, did El Paso or its bankers conduct even a soft market check to determine whether Kinder Morgan's price was appropriate.

Taken together, these facts and others led Chancellor Strine to the conclusion that the plaintiffs have "a reasonable likelihood of success in proving that the [El Paso acquisition] was tainted by disloyalty"[5] – meaning that he felt the plaintiffs have a reasonable chance of prevailing on the merits of the case. Even though Chancellor Strine felt he could not grant the preliminary injunction requested by the plaintiffs (and the acquisition will therefore now proceed to a stockholder vote on March 9)[6], the case is not over. It now turns into a damages action and Chancellor Strine hinted at the end of his opinion that he believes exposure could be in the half billion dollar range and that Goldman could be liable for part of it.[7] However, we expect Kinder Morgan ultimately would be responsible for most if not all of any damages since, if the transaction is completed, Kinder Morgan would own El Paso and likely have indemnity obligations to nearly all of the prospective defendants, including Goldman. Whether Goldman will be forced to pay any amounts in the event the litigation is settled remains to be seen.

What El Paso Means – Key Takeaways

In the aftermath of *El Paso*, we expect a number of commentators (and perhaps even a few law firms) will breathlessly call for conflict-free bankers, claiming that the risks of an investment banker with interests on both sides of a transaction are just too great. We think this is the wrong response.

The Delaware courts have never said that bankers have to be free from conflicts and even Chancellor Strine is on record for the principle that a conflict should not automatically result in disqualification.[8] This is a recognition that companies, their boards, their management teams and their stockholders are best served by an investment banker who knows the client and its industry and, most importantly, one whom the board and management *trusts*. After all, relationships with a history foster candid dialogue and sound advice; one-time special engagements do not. It is also a recognition that in large deals – where top flight banking experience is critical (and the ability to tap into a large bank's balance sheet is even more important) – there are simply not enough independent, full service banks to go around. In a large transaction, it is a fact of life that every bank will have a tangled conflict of some sort.

Accordingly, post *El Paso*, our advice is as follows:

- Not Only Should Real and Potential Conflicts be Accurately Assessed, the Board Should Understand their Potential Impact. It goes without saying that Boards and management should fully vet and question all appearances that may give rise to a cloud over a banker's independence. To do this, they will need the bank's help – meaning that the bank should be fully transparent (to the extent consistent with any confidentiality obligations) about any other roles or positions that may be viewed as being inconsistent with acting in the best interests of its prospective client.[9] Avoiding surprises should be the number one goal. This requires critical forward thinking beyond the mere completion of a questionnaire. As described below, directors, management and the bankers need to be realistic as to how conflicts (both real and potential ones) will be viewed in hindsight, recognizing that just about everyone has a jaundiced eye when it comes to these types of relationships.

  It does no good for the management team to be aware of a conflict if the Board is not similarly apprised of it. Counsel for the company should spend sufficient time with the Board reviewing potential areas of banker conflicts and directors should actively question their impact. The minutes of the meeting in which this discussion takes place should reflect this full and comprehensive review. We are constantly amazed by the number of directors who will state in a deposition that they did not fully appreciate the risks of a potential conflict. It is in everyone's best interest – including the bank's – that every director fully understands the impact.

- The Banker's Role Should be Clearly Defined and Actively Enforced. In short, to the extent there is or appears to be a conflict, the conflict must be appropriately managed. El Paso and Goldman Sachs did take some remedial steps to manage the conflict, such as bringing in Morgan Stanley to provide the fairness opinion, and Goldman erected internal walls to separate Goldman's El Paso bankers from those who managed the Kinder Morgan investment. However, Chancellor Strine found those efforts to "cabin" Goldman's role inadequate and ineffective.[10] For example, Goldman continued to advise the El Paso Board in connection with the threat by Kinder Morgan to go hostile even though El Paso's own management team was suspicious of Goldman's advice.[11]

  So whose job is to police the bankers and make sure that they are abiding by the terms of the engagement? At the end of the day, the "buck stops with the Board"[12] and even though El Paso's directors largely avoided Chancellor Strine's wrath in the opinion, it appears they only did so because they were given reason to believe that Goldman's alleged conflicts had been addressed. Going forward, directors should not count on the Delaware Chancery Court being so kind.[13] Boards will need to show substantive oversight and supervision during all phases of the sale process and give their bankers clear instructions regarding their role during the transaction.

- Banker Fees Should be Structured to Avoid "All or Nothing" Payouts When Conflict Questions Already Abound. The Delaware Chancery Court clearly recognizes that contingent fees in M&A transactions are routine.[14] However, where the contingency fee can readily be seen as providing an extraordinary incentive for the banker to support the transaction, the Board, management and the bankers are well advised to structure a fee that will mitigate that risk – particularly when they are already attempting to manage difficult conflict questions.

The fact that Morgan Stanley – which was brought in to cleanse the Goldman conflict in the first place – would only get paid if the El Paso/Kinder Morgan deal closed (an all or nothing approach), clearly tainted Morgan Stanley's role and created significant concerns in the mind of Chancellor Strine regarding the reliability of Morgan Stanley's fairness opinion.[15]

The amount of the contingent component in a banker's fee is a matter of the Board's business judgment. We recognize that most leading banks are unwilling to accept engagements for flat fees and boards are correctly reluctant to obligate themselves to a large fee if the likelihood of a transaction is unknowable. The point here, however, is that in situations where there is already evidence of banker conflicts, the Delaware Chancery Court is likely to review the banker's fee structure with increased scrutiny.

- Be Ready to Play Defense. In the current environment, bashing Wall Street and – by extension – investment bankers has become wildly popular. Plaintiffs and, perhaps most importantly, the courts are not immune to this influence. Accordingly, the entire deal team – the Board, management and the investment bankers – should expect the bankers to come under intense scrutiny when a deal is announced. Get ahead of the curve and do not allow allegations of banker conflicts to go unanswered. Be ready to respond aggressively and show that, notwithstanding the alleged conflict, the integrity of the sale process was not compromised.

We believe one last bit of caution is in order. At some point, having a conflicted banker on the deal team may simply cause too much drag on the transaction, creating an albatross draped around the neck of the company, its board and management team – necessitating that the banker either not be considered at all for the engagement or be removed from the transaction if it has already commenced. It is obviously better that this realistic and honest assessment be completed on the front end before the banker is engaged. However, in those instances when that is not possible, our experience is that it is far better to cut the cord early rather than to string out the engagement and jeopardize the deal – and possibly the reputations of the Board, the management team and the bankers. Just because an engagement may be "legally" permissible, does not mean that it is advisable, particularly in light of the continuing, if not increased, suspicion with which Delaware courts are viewing sell-side banker relationships.

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[1] *In re El Paso Corporation Shareholder Litigation*, C.A. No. 6949-CS, at 1 (Del. Ch. Feb. 29, 2012).
[2] *See, e.g., In re S. Peru Copper Corp.*, C.A. No. 961-CS (Del. Ch. Dec. 20, 2011); *In re Atheros Commc'ns. Inc.*, C.A. No.6124-VCN, at 1 (Del. Ch. Mar. 4, 2011); *In re Del Monte Foods Co. S'holders Litig.*, Consol. C.A. No. 6027-VLC, at 13 (Del. Ch. Feb. 14, 2011); *In re Netsmart Tech., Inc. S'holders Litig.*, C.A. No. 2563-VCS, at 1 (Del. Ch. Mar. 6, 2007); *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975 (Del. Ch. 2005).
[3] *El Paso*, C.A. No. 6949-CS, at 1.

[4] *Id.* at 12.
[5] *Id.* at 2.
[6] The El Paso stockholder vote on the acquisition was originally scheduled for Tuesday, March 6, but was postponed until Friday, March 9, to give stockholders time to consider the Court's opinion.
[7] *Id.* at 26, 32.
[8] In the context of stapled financing and the running of a go shop process, Chancellor Strine said "the idea that what you do is you go get an unconflicted person who has absolutely no experience and capability to do the job is an idiotic notion and it's not embraced by our law … I question the idea of bringing in a Mickey Mouse-sized bank to run a go shop process and then try and tell me that that's better than having, you know, a really good bank with disclosed conflicts, knowing its role … and I think we can't take the route in Delaware law of hyerfetishizing independence the same way we've done for directors, or you do double violence to the stockholders." *The LBO Panel In Their Own Words*, THE M&A JOURNAL, May 2007, at 13.
[9] We note that there are clearly levels at which a bank's relationship with another party to a transaction are of a size and nature that would likely impede the financial advisor's ability to effectively perform its assignment. *See, e.g.* Vice Chancellor Parson's opinion in *In re Micromet S'holders Litig.*, C.A. No. 7197-VCP (Del. Ch. Feb. 29, 2012), which was issued on the same day as the *El Paso* opinion. *See also In re John Q. Hammonds Hotels Inc. S'holder Litig.*, C.A. No. 758-CC (Del. Ch. July 14, 2011).
[10] *El Paso*, C.A. No. 6949-CS, at 1, 12.
[11] *Id*. at 5, n. 30.
[12] *Del Monte*, Consol. C.A. No. 6027-VLC, at 19 (quoting *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989)).
[13] For example, Vice Chancellor Laster was sharply critical of the banker oversight provided by the Board of Directors of Del Monte and concluded that the Board had breached its fiduciary duties by "failing to provide the serious oversight that would have checked the investment banker's misconduct" – in spite of the fact that the banker's negotiations with the acquiror to put the company in play had been kept secret from the Board. C.A. No. 6027-VLC, at 19.
[14] *See, e.g., Atheros*, C.A. No. 6124-VCN, at 8 ("Contingent fees are undoubtedly routine").
[15] *El Paso*, C.A. No. 6949-CS, at 15.