December 11, 2013

Financial Advisory Update

A number of recent cases highlight the increasing risks for financial advisors and the lawyers who represent them. Financial advisors, and the lawyers who represent them, should be cognizant of these recent developments and heed their lessons as they work on transactions.

1. CVR

A case just filed in a federal district court highlights the need to make sure that clients are fully aware of the material terms of an engagement letter with an investment bank. CVR Energy Inc. (CVR) is suing its lawyers for legal malpractice because they allegedly did not adequately inform the board of the payment structure for CVR's financial advisors. At issue were the investment bank engagement letters regarding CVR's defense against a hostile tender offer. The engagement letters allegedly specified that the financial advisors would each receive a $9 million fee if CVR stayed independent, but a higher fee if there was a "sales transaction." CVR was allegedly not aware of the fact that a sales transaction included the consummation of the hostile tender offer and that the financial advisors would, therefore, receive a higher fee if the client's takeover defense failed than if it succeeded. In its suit, CVR alleged that its legal advisors were negligent and breached their duties to CVR because they failed to fully inform CVR of the various definitions of a sales transaction, even though the lawyers knew that CVR had no experience defending against hostile tender offers and specifically solicited legal advisors based on their expertise in similar matters. It is optimal, in our view, to ensure that financial advisors are equally incentivized, regardless of the outcome. But it is not uncommon, in our experience, that the financial advisors are entitled to a higher fee in the event of a sales transaction because of the liquidity event occasioned by such transaction.

2. Red Zone

A recent case decided in the Civil Branch of the Supreme Court of the State of New York, New York County illustrates the risk lawyers face when they do not carefully draft investment bank engagement letters. The trial court found Red Zone LLC's legal advisor guilty of legal malpractice because of its work on an amendment to an engagement letter with an investment bank. Red Zone sought legal advice in connection with its consent solicitation for three of the seven seats on the target's board. The financial advisor and Red Zone entered into an engagement letter. The financial advisor argued that a successful consent solicitation would constitute an "acquisition transaction" pursuant to the terms of the engagement letter; thus, the financial advisor would be entitled to a $10 million success fee. Red Zone disagreed with this interpretation and indicated that it would not proceed unless it was assured that it would not owe such a fee. The parties entered into an oral agreement that the proposed consent solicitation would not constitute an acquisition transaction, that the fee owed to the financial advisor in the event such consent solicitation was successful would be only $2 million and that a $10 million success fee would not be payable unless Red Zone controlled greater than 51 percent of the target's common stock. The oral agreement was later memorialized as an amendment to the engagement letter. The amendment stated that the definition of an acquisition transaction would not include Red Zone's proposed consent solicitation, but it made no mention of the 51 percent control requirement. After the initial consent solicitation was successful, Red Zone eventually gained nine of the 10 board seats of the target and effectively controlled the target. Red Zone's financial advisor sued Red Zone to recover its $10 million success fee pursuant to the acquisition transaction language in the engagement letter. Red Zone lost its case against the financial advisor and then sued its legal advisor for legal malpractice in drafting the amendment. The trial court ruled that Red Zone's legal advisor was guilty of legal malpractice because the amendment, as drafted, did not accurately memorialize the oral agreement. The court ordered the legal advisor to pay damages.

3. Bioclinica

Turning from investment bank engagement letters to fairness opinions, in a recent case in Delaware, *In Re Bioclinica, Inc.*, Vice Chancellor Glasscock clarified one of his earlier decisions, *Koehler v. NetSpend Holdings Inc.*, in which he referenced what he termed a “weak” fairness opinion. By way of background, certain of Bioclinica’s stockholders sued to stop the sale of the company, alleging a breach of the board’s Revlon duties for failing to procure the highest reasonably available sales price. In support of their contention, the plaintiffs cited the vice chancellor’s earlier decision, in which he found that the plaintiffs had a likelihood of success on the merits of their Revlon claim because the sale process was not designed to achieve the highest reasonably available sale price for stockholders. He made this determination by pointing to various factors, such as the lack of a pre-agreement market canvas, various stringent deal protection devices, the one-off negotiated nature of the sale and the NetSpend board’s reliance on, what he termed, a weak opinion. The opinion was weak, in his view, because he discounted the validity of the comparisons in the selected public companies and precedent transactions methodologies. The final price agreed to by the NetSpend board was below the financial advisor’s discounted cash flow analysis, which was based on management projections that were higher than those forecasted by the street, although the price was within the range of the selected companies and precedent transactions valuation methodologies. Distinguishing *NetSpend* from *Bioclinica*, the vice chancellor noted that the Bioclinica sale involved an auction process and, thus, had a market check on its pricing, unlike the NetSpend sale, which was a single-bidder negotiated transaction. The key take away from these opinions is that not all fairness opinions carry the same weight in the court’s view. Lawyers who advise financial advisors should be aware of the overall process of the sale, especially if the sale is pursuant to a negotiated transaction with a single bidder instead of a broader auction process.

4. Gerber

Lastly, given the requirement in some limited partnerships, especially master limited partnerships, that they must obtain a fair and reasonable opinion before an interested party transaction can be entered into, we closely monitor developments in this area. Another recent Delaware case, this one involving a limited partnership, clarified which fiduciary duties a limited partnership could contract away. *Gerber v. Enterprise Products Holdings, LLC* involved a challenge to two transactions, a sale of assets and a merger involving Enterprise GP Holdings L.P., on conflict grounds. Before the transactions were consummated, an independent committee of the board sought the opinion of an independent financial advisor. This was done in accordance with the “special approval” process, which was defined in the limited partnership agreement as approval by a committee of three or more independent directors. In upholding the defendant’s motion to dismiss, the Delaware Court of Chancery held that the special approval process in the limited partnership agreement displaced any common law fiduciary duties regarding the approval of conflicted transactions. The court went one step further, however, when it addressed the plaintiff’s claim regarding the breach of the implied covenant of good faith and fair dealing. First, the court noted that the implied covenant of good faith and fair dealing binds only the named parties to the limited partnership agreement. Thus, the only colorable claim was against the general partner. In assessing the claim against the general partner, the court, again, looked back to the limited partnership agreement, which provided for a “conclusive presumption” of good faith if the general partner relied on the opinion of experts, such as the opinion provided by the financial advisor in this instance. Under the Delaware Limited Partnership Act, however, a partnership agreement may not eliminate the implied covenant of good faith and fair dealing. The court reasoned that the covenant is a gap filler, and, in this case, there was no gap, due to the express language of the agreement. In reversing and remanding the case on this issue, the Delaware Supreme Court held that the court erred by conflating two distinct principles: the contractual fiduciary duty regarding good faith and the implied covenant of good faith and fair dealing that applies to every provision in an agreement. As the Delaware Supreme Court noted, there could be many instances in which the good-faith language of the agreement was followed, but the implied covenant was not. The lesson of *Gerber* is that, while the limited partnership form allows for the contracting away of many fiduciary duties and liabilities, such contractual provisions must be specific and explicit to be effective and, if there is only a general waiver, the implied covenant of good faith and fair dealing, which will always be in effect, could work to undercut the waiver.

Jeffrey Lee Rothschild
T: +1 212 548 7086
jrothschild@mcguirewoods.com

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