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LEGAL UPDATE

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Financial Advisor Conflicts Update

In recent cases the Delaware Court of Chancery has increasingly scrutinized financial advisor conflicts in the mergers and acquisitions context. The court has emphasized in various opinions the sentiment that financial advisors play a valuable role, but that disclosure of potential conflicts is crucial and, in the *Atheros* decision (discussed below), specifically stated financial advisors "serve a critical function by performing a valuation of the enterprise upon which its owners rely in determining whether to support a sale. Before shareholders can have confidence in a fairness opinion … the conflicts and arguably perverse incentives that may influence the financial advisor in the exercise of its judgment and discretion must be fully and fairly disclosed."

This newsletter examines recent Delaware cases focusing on financial advisor conflicts in the areas of stapled financing, contingent fee arrangements, prior work and the financial advisor's interest in the transaction, and concludes with some recommended best practices.

Stapled Financing

In February 2011 the court halted a stockholder vote on the proposed buyout of Del Monte Foods Company because it found that the merger agreement between Del Monte and a group of private equity firms resulted from collusion between Del Monte's financial advisor and those firms in *In re Del Monte Foods Company Shareholders Litigation*. Vice Chancellor Laster criticized the financial advisor for its conflicting roles in bringing together competing bidders, thus limiting the competition, and seeking to provide buy-side financing while simultaneously acting as the financial advisor assisting the board of Del Monte in its potential sale. Del Monte's board of directors allowed the financial advisor to run the 45-day go-shop process, despite the advisor's expectation of earning a fee for providing financing in the deal. The financial advisor stood to earn $21 million to $24 million from the financing and approximately $23 million for its advisory role, and Del Monte paid an additional $3 million by engaging another financial advisor to provide a second opinion.

The court enjoined the stockholder vote for 20 days and found that Del Monte's board of directors breached its fiduciary duty of care to stockholders even though the court found that the board was misled by the financial advisor. "Although the blame for what took place appears at this preliminary stage with the [financial advisor], the buck stops with the Board," the court stated, and emphasized, "[T]he role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management [and here I add other contingently compensated professionals like investment banks] may not necessarily be impartial."

Del Monte follows a 2005 decision by then-Vice Chancellor Strine criticizing the board of Toys "R" Us for creating "an appearance of impropriety" by allowing its financial advisor to finance the winning bidder of the company. In that opinion, however, Strine also noted in a footnote that he was not making a bright-line statement and could "imagine a process when a board decides to sell an entire division or the whole company, and … obtains a commitment from its financial advisor to provide a certain amount of financing to any bidder, in order to induce more bidders to take the risk of an acquisition," that would be wholly consistent with the best interests of the primary client company.

Contingent Fee Arrangements

In 2007, in *Globis Partners v. Plumtree*, the court dismissed *inter alia* plaintiffs' claims that the defendants breached their disclosure obligations pursuant to a merger between two software companies by failing to provide details about their financial advisor's compensation in the proxy statement to stockholders. Specifically, that such compensation was partially based on the successful completion of the merger. The proxy statement stated the financial advisor's fees were "customary" and partially contingent, with no further details. Vice Chancellor Parsons found that without an "allegation of exorbitant or otherwise improper fees, there is no basis to conclude the additional datum of the [advisor's] actual compensation, *per se*, would significantly alter the total mix of information available to stockholders."

In contrast, in March 2011, in *In re Atheros Communications, Inc. Shareholder Litigation* the court enjoined the target, Atheros Communications, Inc., from holding a stockholders meeting to approve a merger with Qualcomm, Inc. pending curative proxy disclosure of the amount of contingent fees to be paid to the financial advisor, among other issues. Like *Globis*, the original proxy statement did not disclose the exact amount of the financial advisor's fee nor the exact percentage of the fee that was contingent upon closing of the merger. The proxy statement did state, as many that are not reviewed by the U.S. Securities and Exchange Commission (SEC) do, that the financial advisor would "be paid a customary fee, a portion of which is payable in connection with the rendering of its opinion and a substantial portion of which will be paid upon completion of the [m]erger." The financial advisor was to be paid a flat fee, of which approximately 98 percent was contingent upon the closing of the transaction. Though declining to announce a bright-line rule, Vice Chancellor Noble reasoned "it is clear that an approximately 50:1 contingency ratio requires disclosure to generate an informed judgment by the shareholders as they determine whether to rely upon the fairness opinion in making their decision to vote for or against the [t]ransaction." Also, the amount of fees paid to the financial advisor was required to be disclosed.

Prior Work

In December 2010 the court enjoined the acquisition of Art Technology Group, Inc. (Art) by Oracle Corporation, requiring the financial advisor to Art to disclose a description of the type of services it had performed for Oracle and the aggregate compensation paid by Oracle to the financial advisor for the prior four years in *In re Art Technology Group, Inc. Shareholders Litigation*. Such enhanced disclosure exceeds the disclosure requirements of 1015(b)(4) of Regulation MA under the Securities and Exchange Act of 1934, which requires disclosure of material relationships in the past two years between the financial advisor and the parties, and any compensation received as a result of that relationship, and the two-year look-back period required by FINRA Rule 5150. Vice Chancellor Laster enjoined the merger for 10 days while the disclosures were made in a public filing with the SEC.

In a ruling from the bench in April 2010, the court denied a preliminary injunction motion seeking to block a merger between Zenith National Insurance Corp. and Fairfax Financial Holdings Ltd. based on *inter alia* allegedly inadequate disclosures regarding the financial advisor's work for both sides. While the proxy disclosure regarding the advisor's role in advising Fairfax on an unrelated engagement before the Zenith deal was disclosed along with the total compensation received, the disclosure did not mention that the "day-to-day" banker advising Zenith on the Fairfax transaction was the same person who represented Fairfax on the earlier engagement. Vice Chancellor Laster reasoned that in large investment banking firms the implication is the same professionals are not working on both sides of the transaction. The court ultimately found that due to a number of factors—including the fact that this was an all-cash merger between unaffiliated parties, the advisor was not directly involved in negotiations and no one took the deposition of the particular banker in question, which the court viewed as a "critical omission"—that the additional disclosure would not be material nor required. In stressing that this was a "very close issue," the court stated that "nobody should cite this transcript as saying 'Court of Chancery blesses same banker working for target side, having six months ago worked for bidder side.'"

Financial Advisor's Interest in the Transaction

The court granted a preliminary injunction in 2008 based on inadequate disclosures regarding the nature and amount of the financial advisor's interest in the success of an acquisition of a software company in *David P. Simonetti Rollover IRA v. Margolis*. The proxy statement disclosed that, as of the date of the financial advisor's opinion, the advisor and its affiliates held convertible notes and warrants in the company. Upon consummation of the merger, the advisor would be entitled to cancellation payments relating to the warrants and the conversion value and certain make-whole payments relating to the notes. Requiring the benefits to the advisor to be disclosed, Vice Chancellor Noble stated, "it is imperative for the stockholders to be able to understand what factors might influence the financial advisor's analytical efforts. … It is not simply the magnitude of the [financial advisor's note and warrant] holdings, but how those obligations will be treated as a result of the [m]erger."

Financial advisor conflicts have also threatened to derail the recent proposed $38 billion buyout of rival El Paso Corporation by Kinder Morgan Inc. In *El Paso Corp. Shareholders Litigation*, plaintiffs' lawyers alleged El Paso's financial advisor improperly stood on both sides of the deal because it advised El Paso while its affiliates held a 19 percent stake in Kinder and had two representatives on the Kinder board. El Paso's board accepted Kinder's bid of $25.91 per share, which represented a 37 percent premium to shareholders, but plaintiffs' lawyers argued that was inadequate. The financial advisor's "conflict of interest was obvious from the outset: With a stake in [Kinder] worth over $4 billion, every dollar shaved off the buyout price represented approximately $150 million of savings" for the financial advisor, plaintiffs' lawyers stated in a February 3, 2012, court filing. In its defense, the financial advisor stated in court filings it took "reasonable measures" to mitigate any conflicts, including disclosing its stake in Kinder, having its affiliates' directors recuse themselves from considering the deal and having bankers from a separate financial advisory firm also serve as financial advisors to El Paso. Plaintiffs' lawyers contend this was not enough and that the financial advisor still steered the El Paso directors toward the sale instead of the alternatives of remaining independent or spinning off El Paso's exploration and production business. On February 29, 2012, Chancellor Strine declined to issue an injunction, but did indicate he was concerned in general about the deal process, and in particular about the financial advisor's alleged conflicts, and allowed the possibility of the plaintiffs continuing to pursue the case to seek monetary damages.

Recommended Best Practices

In general, concerns regarding conflicts may arise when the financial advisor has potential incentives outside of the transaction in question. For example, in the sale of a company, its sell-side investment bank could be perceived to favor a leveraged buy-out due to relationships with management or a sale to another client of the investment bank. The investment bank could also be perceived to favor a private equity fund or a particular strategic buyer that requires financing. Conversely, on the buy-side, a contingent fee structure could create what may be perceived as incentives for the financial advisor to encourage its client to overpay for a target, and the more heavily weighted the contingent fee, the greater the potential perceived conflict.

In order to solve or mitigate such conflicts, different steps may be taken. The sell-side investment bank may be restricted from having any role in financing, and an additional or separate financial advisor (whose fees may be credited to the success fees owed to the initial financial advisor) could be hired to provide an independent opinion, to advise on the sale process or to run the go-shop process, if one is used. The buy-side investment bank's fee structure could be revised so it is less contingent on completion of the sale and the buy-side investment bank may similarly be restricted from having any role in financing.

If a financial advisor has existing or prior relationships with the target or the acquiror, there may be similar potential concerns over the financial advisor's impartiality and confidentiality. These may be mitigated or solved by the financial advisor disclosing prior and existing engagements with the counterparty, obtaining the consent of the company's board of directors to act as financial advisor in light of such disclosures and/or establishing ethical walls to ensure the financial advisor's deal team is not exposed to information from previous engagements. Still, ethical walls may be of limited usefulness. For example, despite establishing such ethical walls, the role of the financial advisor in *El Paso* was still subject to challenge.

When a financial advisor is advising on the fairness of the consideration changing hands in a transaction, the role of, and the fees received by, the financial advisor should be carefully structured so that the financial advisor is as ambivalent to the ultimate outcome of the transaction as possible.

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