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Everybody's Got a Hungry Heart: Navigating Conflicts in Change of Control Transactions

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The Delaware Court of Chancery recently decided a series of high-profile cases involving conflicts of interest in change of control transactions.[1] The conflicts the Court addressed took a number of forms, including conflicts involving controlling stockholders, directors, officers and advisors, and their volume and variety has led some to observe that conflicts have become "a cost of doing business on Wall Street these days."[2] While we agree that conflicts in the context of change of control transactions may be inevitable, they have always been a part of the deal-making process and the Chancery Court's focus on efforts to navigate them is not new. The same scrutiny of self-interest among transaction participants that guided the Court's analysis in *Revlon* shapes the analysis of change of control transactions and the efforts of directors, advisors and others to manage them today. These recent cases have not changed our guidance for handling conflicts: identify them early, disclose them appropriately, determine whether they are disqualifying or can be mitigated and, when mitigation is possible, mitigate them effectively.

Conflicts Are Inevitable

The Delaware Supreme Court finds conflicts of interest where participants have an interest on both sides of a transaction or expect to derive personal financial benefit from a transaction in a way that does not flow to the corporation or all other stockholders generally.[3] As Chancellor Leo E. Strine, Jr. explains in *El Paso*, succumbing to one's self-interest at the expense of a company's stockholders is and has been a risk inherent in change of control transactions:

> **As *Revlon* itself made clear, the potential sale of a corporation has enormous implications for corporate managers and advisors, and a range of human motivations, including but by no means limited to greed, can inspire fiduciaries and their advisors to be less than faithful to their contextual duty to pursue the best value for the company's stockholders.[4]**

In *Revlon*, the Delaware Supreme Court found that the directors violated their fiduciary duties by allowing "considerations other than the maximization of shareholder profit to affect their judgment."[5] Only a year before *Revlon*, the Delaware Supreme Court in *Unocal* referred to the possibility of board members placing their own interests above the interests of the stockholders they represent as an "omnipresent specter"[6] in change of control transactions.

The *El Paso* decision, in which Chancellor Strine "reluctantly" declined to enjoin the proposed acquisition of El Paso Corporation by Kinder Morgan, Inc. despite what he referred to as the "disturbing" behavior of certain actors involved in brokering and evaluating the deal, illustrates the myriad conflicts that can arise in change of control transactions. In May 2011, El Paso, which was being advised by Goldman, Sachs & Co., publicly announced that it would spin off its exploration and production business. Soon after, Kinder Morgan approached El Paso and expressed an interest in purchasing the company as a whole, but with the intent to sell off the exploration and production business prior to closing to help finance the purchase. Goldman had close ties to Kinder Morgan: it owned 19% of the company (an investment valued at approximately $4 billion), controlled two of Kinder Morgan's board seats and had previously served as financial advisor to Kinder Morgan. As a result of this known conflict, El Paso engaged a second financial advisor, Morgan Stanley & Co., LLC, to handle negotiations with Kinder Morgan.

The Court noted several facts that potentially compromised the financial advisors' ability to advise the board effectively. First, the Court found that Goldman's continuing role as exclusive adviser on the spin-off, the most logical strategic alternative to the merger, enabled it to implicitly advise on the merger. Second, Morgan Stanley's fee was entirely contingent on successfully selling the company as a whole, which the Court found gave it little incentive to consider strategic alternatives other than a sale to Kinder Morgan. Lastly, the lead Goldman banker advising El Paso did not disclose that he personally owned approximately $340,000 of stock in Kinder Morgan.

Separately, the Court took issue with the actions of El Paso CEO Douglas L. Foshee, who spearheaded the negotiations for El Paso, but kept secret from the El Paso board his interest in teaming with members of El Paso's management to acquire the exploration and production business Kinder Morgan planned to sell to finance the acquisition. The Court found that Foshee's interest in this undisclosed deal created a conflict: while having a duty to "squeeze the last drop of the lemon out for El Paso's stockholders,"[7] he also had a motive to keep the price of the overall transaction low and maintain friendly relations with the counterparty. The Court concluded Foshee did not negotiate aggressively enough with Kinder Morgan, and provided the following colorful description of one incident:

> **[On] Sept. 23, 2011, Kinder said "Oops, we made a mistake. We relied on a bullish set of analyst projections in order to make our bid. Our bad. Although we were tough enough to threaten going hostile, we just can't stand by our bid."**
>
> **Instead of telling Kinder where to put his drilling equipment, Foshee backed down.[8]**

Conflicts Need Not Be Fatal

While certain conflicts are inevitable, they need not draw the ire of the Chancery Court as Foshee's conflicts did in *El Paso*. At the earliest stage of a transaction, and throughout its evolution, directors and their advisors must identify and closely scrutinize all real and potential conflicts of interest for the parties involved. Boards should thus be directly engaged in the process and continuously evaluate whether their decisions regarding the process, and the interests and actions of the parties involved, are aligned with the best interests of the company's stockholders. Just as importantly, boards and their advisors must document these efforts appropriately in the board's minutes to ensure that the directors can demonstrate that they have discharged their duties appropriately.

The timing of when a conflict is identified is critical to the board's ability to take appropriate steps to effectively mitigate or eliminate it. Certain conflicts may require structural changes to how a board goes about evaluating the transaction. For instance, if a person serves on the boards of both the target and the acquirer, ideally the conflicted director would not participate in any of the target's consideration of the transaction or available alternatives. In *Southern Peru*, for example, a director appointed to the Southern Peru board by a large founding stockholder served on the special committee of the board charged with evaluating and negotiating a proposal to purchase a large business from Southern Peru's controlling stockholder. The large founding stockholder had wanted the ability to sell its Southern Peru shares freely on the open market and, in connection with the proposed transaction, Southern Peru agreed to give it the registration rights it needed to do so. The existence of this conflict was not identified to the board or the special committee until just before the special committee was to vote on the transaction. Even though the conflicted committee member ultimately abstained from the final vote, his inclusion throughout the negotiation of the deal cast suspicion on his (and the committee's) effectiveness.[9]

Like the conflict affecting the special committee member in *Southern Peru*, the ownership of an interest in Kinder Morgan by El Paso's lead banker illustrates the fact that the significance of a conflict will be compounded if it is discovered too late and by the existence of other conflicts. A recent decision found that an independent director could remain independent even if he owned stock in the selling company as long as the stock ownership is "not material" to the director.[10] Presumably, the same materiality test ought to apply to the personal stock ownership of a banker advising the company. In *El Paso*, however, the Court noted that the lead banker advising El Paso

did not disclose his ownership of approximately $340,000 of stock in Kinder Morgan, which deprived the board of the opportunity to consider whether it would compromise his advice. Against the background of the multitude of conflicts that arose in connection with the transaction, the Court did not even consider whether the amount that the banker personally stood to gain was immaterial; it simply took note of yet another undisclosed conflict and added it to the list of reasons to question the actions of the El Paso board in its negotiations with Kinder Morgan.[11]

Once a conflict has been identified, it must be mitigated effectively if it cannot be avoided entirely. In *El Paso*, Goldman's conflicts of interest stemming from its ownership and management stake in Kinder Morgan were well known. Goldman even took steps to address the conflicts, including setting up a wall between the Goldman advisors to El Paso and the Goldman representatives responsible for the firm's Kinder Morgan investment. Further, El Paso retained Morgan Stanley ostensibly to provide unconflicted advice in connection with the transaction. Nevertheless, as noted above, the Court found the steps taken to mitigate the conflict were not sufficiently effective, because Goldman continued to have influence over the board's consideration of the proposed sale to Kinder Morgan and Morgan Stanley's fee was entirely contingent on successfully selling the company as a whole, giving it little incentive to consider strategic alternatives other than a sale to Kinder Morgan.

In some cases, however, even taking appropriate steps to mitigate a conflict is not enough. Compare the special committee in *Southern Peru*, which the court found was not "well-functioning,"[12] with the special committee formed to evaluate a transaction advocated by Delphi Financial's CEO, Robert Rosenkranz, the sole holder of Delphi's Class B stock, which provided him with 49.9% of the voting power but only 12.9% of the equity of the company. In *Delphi Financial*, the Court noted that the committee's membership was limited to independent directors with business and industry experience and, as confirmed through interviews the committee's independent legal counsel conducted with the committee members, no economic or social connection with Rosenkranz.[13] Further, the Delphi special committee was given a broad mandate, including the authority to reject or pursue any transaction it deemed to be in the best interests of the holders of Delphi's Class A stock, whereas the special committee in *Southern Peru* was given only the authority to evaluate the transaction proposed by Southern Peru's controlling stockholder. As a result, the Delphi special committee had leverage in its negotiations with Rosenkranz, who wanted a premium for his Class B stock at the expense of the consideration payable to holders of the Class A stock despite the fact that Delphi's charter prohibited the payment of different consideration. While the special committee did not reject the proposed transaction when it was unable to get Rosenkranz to drop his demand for a premium for his Class B stock, it negotiated the premium down to what its independent financial advisor indicated was the low end of the range for similar transactions. The court found that while the special committee was motivated by a desire to give the holders of Delphi's Class A stock an opportunity to vote on a transaction that would give them a substantial premium for their shares, Rosenkranz may have violated his duties to Delphi's stockholders by insisting on the differential consideration. Thus, despite a well-functioning special committee, the holders of the Class A stock lost (perhaps temporarily) a portion of the consideration they otherwise would have received to Rosenkranz.

Delphi Financial also illustrates that effectively managing conflicts often includes disclosing to stockholders the existence of the conflict and the actions the board and its advisors have taken to mitigate them. Such disclosure enables stockholders to make their own independent judgments about the nature of the conflicts, the board's efforts to manage them and any impact the conflicts may have had on the proposed terms of the transaction. In *Delphi Financial* specifically, the robust public disclosure of Rosenkranz's many conflicts and the actions he and the special committee took in connection with the proposed sale of Delphi Financial (as well as the right of the stockholders to pursue a damages claim) enabled the Court to let the transaction proceed to a vote of the stockholders.

Conflicts are an inherent part of change of control transactions. It is up to boards and their advisors to ferret them out and take appropriate steps to manage and disclose them in order to effectively discharge their duty to the corporation's stockholders.

NOTES

1. *See In re S. Peru Copper Corp. S'holder Derivative Litig.*, 30 A.3d 60 (Del. Ch. 2011); *In re El Paso Corp. S'holder Litig.*, 2012 WL 1232608 (Del. Ch. Feb. 29, 2012); *In re Delphi Fin. Group S'holder Litig.*, 2012 WL 729232 (Del. Ch. Mar. 6, 2012). These cases come on the heels of *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).
2. *See Peter J. Henning, How Wall Street Deals With Conflicts, New York Times* (March 19, 2012), http://dealbook.nytimes.com/2012/03/19/how-wall-street-deals-with-conflicts.
3. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).
4. *El Paso*, at *5.
5. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).
6. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954.
7. *El Paso*, at *7.
8. *El Paso*, at *3.
9. *Southern Peru*, at *19.
10. *LC Capital Master Fund v. James*, 990 A.2d 435, 453 (Del. Ch. 2010) (analyzing whether personal stock investment is material to directors and specifically considering that directors are generally wealthier than the average person). Although the plaintiffs alleged multiple conflicts, the court did not find any of them compelling.
11. *See also In re Micromet, Inc. S'holders Litig.*, 2012 WL 681785 (Del. Ch. Feb. 29, 2012) (issued on the same day as El Paso and providing that not all such interests of the target's financial advisor in an acquiror are of a "size and nature" that "would be likely to impede [the financial advisor's ability] effectively and loyally to perform its assignment.").
12. *Southern Peru*, at *7.
13. *Delphi Financial*, at *6.