
NACD BOARD LEADERSHIP CONFERENCE
NATIONAL HARBOR, MARYLAND

OCTOBER 15, 2012
The Issue

- Court of Chancery has increasingly focused on disclosure of financial advisor analysis in M&A transactions
- Guidance from DE case law is divergent
- One proposal is for a “model disclosure”
  - “Have you . . . thought about getting together with the . . . deans of the Delaware bar and coming up with a model banker disclosure that would, you know, talk about how you put in a reasonable summary of what’s in the board book?” *Turberg v. ArcSight, Inc.* (Laster, V.C., 9/20/11)
The Financial Advisor Task Force (includes M&A counsel, counsel to banks and financial advisors) continues to discuss the pros and cons of a model disclosure. At this point, no consensus opinion has emerged. Additional efforts under consideration include:

- Further dialog between plaintiff and defense counsel, bankers and the DE bench
- Educative materials that demonstrate and annotate common analytical frameworks used in M&A transactions

Task Force discussions have highlighted a few key issues:

- Divergence of current DE case law
- Impact on M&A litigation risk and resolution
- Impact on substantive analysis and analytical process
Can the current debates regarding financial advisor disclosures be, simply, reduced to Skeen versus Pure Resources?

Has Skeen versus Pure Resources ever been definitively answered? Will it be?
Framing The Debate

  - Cash-out merger following first-step tender offer.
  - Information Statement included:
    - a copy of the fairness opinion given by target’s investment banker
    - target’s audited and unaudited financial statements through January 31, 1998 (day before signing)
    - target’s quarterly market prices and dividends through the year ended January 31, 1998
**Framing The Debate**

  - Plaintiffs alleged the following, among other things, should have been included in Information Statement:
    - Summary of “methodologies used and range of values generated” by target’s banker
    - Management’s projections of target’s financial performance for the next five years
    - More current financial statements
Framing The Debate


- Supreme Court holds:
  - Plaintiffs’ argument “ignores settled law.”
  - Standard is “substantial likelihood that the undisclosed information would significantly alter the total mix of information already provided.”
  - Plaintiffs unsuccessfully advocated for “a new disclosure standard” requiring “stockholders [to] be given all the financial data they would need if they were making an independent determination of fair value.”
Framing The Debate

• *McMullin v. Beran* (Del. 2000)
  - Controlling stockholder negotiated acquisition of company by third party.
  - Plaintiff alleged the following information, among other things, omitted from 14d-9:
    - Indications of interest from other potential acquirers;
    - The handling of these potential offers;
    - The restrictions and constraints imposed by the controlling stockholder on the potential sale of the company
    - The information provided to Merrill Lynch, the company’s financial advisor
    - The valuation methodologies used by Merrill Lynch
  - Court of Chancery finds no disclosure violation.
Framing The Debate

**McMullin v. Beran (Del. 2000)**

- Supreme Court reaffirms *Skeen*:
  - “In *Skeen*, it was argued that the minority shareholders should have been given all of the financial data they would need if they were making an independent determination of fair value. We declined to establish ‘a new disclosure standard where appraisal is[s] an option.’ We adhere to our holding in *Skeen*.”

- Nevertheless, the Supreme Court, as part of its overall remand, remands disclosure allegations, finding that “[t]he disclosure violations alleged in McMullin’s Amended Complaint are, if true, sufficient to withstand a motion to dismiss.”
In re Pure Resources, Inc. S’holders Litig., (Del. Ch. 2002)

- S-4 and/or 14d-9 contain:
  - Financial advisor opinions
  - Historical financial information
  - Projections
- Court addresses whether bankers’ underlying financial analyses should be disclosed
In re Pure Resources, Inc. S’holders Litig., (Del. Ch. 2002)

Court observes competing policies:
- Against disclosure:
  - Fear of “stepping on the SEC’s toes”
  - Worry of “encouraging prolix disclosures”
- In favor of disclosure:
  - “Utility of such information”
  - DE case law encourages banker analyses for board
Framing The Debate

- *In re Pure Resources, Inc. S’holders Litig.*, (Del. Ch. 2002)
  - Court cites *Skeen* and *McMullin* as manifesting the “conflicting impulses”
  - Key quote:
    - “In my view, it is time that this ambivalence be resolved in favor of a firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely.”
Framing The Debate

• In re Pure Resources, Inc. S’holders Litig., (Del. Ch. 2002)
  • Court suggests following is material:
    • Basic valuation exercises that bankers undertook
    • Key assumptions used by bankers
    • Range of values generated by bankers
• *In re Pure Resources, Inc. S’holders Litig.*, (Del. Ch. 2002)

  - Court offers additional policy reason for its analysis:
    - “When controlling stockholders make tender offers, they have large informational advantages that can only be imperfectly overcome by the special committee process, which almost invariably involves directors who are not involved in the day-to-day management of the subsidiary. The retention of financial advisors by special committees is designed to offset some of this asymmetry, and it would seem to be in full keeping with that goal for the minority stockholders to be given a summary of the core analyses of these advisors in circumstances in which the stockholders must protect themselves in the voting or tender process. That this can be done without great burden is demonstrated by the many transactions in which meaningful summary disclosure of bankers’ opinions are made, either by choice or by SEC rule.”
  
  - After *Pure*, some question as to whether the “fair summary” standard applies outside of a controlling stockholder squeeze out.
M&A practice has evolved to reflect a Pure standard.
  - Netsmart cites Pure, not Skeen.

But, is Pure or Skeen the law?
  - Skeen last Supreme Court word on the subject
  - Justice Berger wrote Supreme Court opinion in Skeen; then-Vice Chancellor Jacobs wrote Court of Chancery opinion in Skeen; Justice Holland wrote Supreme Court opinion in McMullin; then-Vice Chancellor Steele wrote Court of Chancery opinion in McMullin
  - McMullin remand focused on all omissions, not just financial advisor-related omissions

In practice, will the Supreme Court get to weigh in again?
Significant Increase in M&A Litigation in the Past Five Years

- **More Deals Subject to Litigation**
  - In 2011, 96% of transactions over $500 million were subject to litigation, up from 53% in 2007.

- **More Litigation Per Deal**
  - In 2011, the litigated deals attracted on average 6.2 separate suits, up from 2.8 suits per deal in 2007.

- **More Litigation In Multiple Jurisdictions**
  - In 2011, 72% of transactions over $500 million resulted in litigation in Delaware and at least one other jurisdiction, up from 37% in 2007.
Disclosure Claims Often Focus on the Financial Advisor’s Analyses

- A colorable disclosure claim provides a hook for expedited proceedings and a preliminary injunction.
- Thus, a “Denny’s buffet” of disclosure claims is included in almost every complaint.
- The amorphous concept of a “Fair Summary” has proved to be fertile ground for disclosure claims.
The Rise of the Disclosure Only Settlement

• Of 202 reported settlements in connection with transactions announced in 2010 and 2011, 166 – or 83% – settled for supplemental disclosures and nothing more.

• Though there is no clear benchmark for comparison, one study suggests that only 10% of all settlements of M&A litigation in Delaware in 1999 and 2000 were based on disclosures alone.

• The motivation for entrepreneurial plaintiffs is clear, but what is driving the increase in disclosure only settlement on the defense side?
A Troubling “Cycle of Supplementation” or Something Else?

- **Kahn v. Chell** (Laster, V.C., 6/7/11)
  - “I think it’s continuing to be somewhat surprising that despite now years of opinions, particularly from Vice Chancellor Strine, explaining that we expect these things to be disclosed, people don’t disclose them. But as I’ve said in another transcript, what I think that speaks to is the desirability of getting releases as opposed to an actual desire to follow what the Delaware courts have said in terms of what’s material information. And so, to the extent that people are consciously or can be inferred to have been consciously leaving things out that are covered by prior decisions, that’s something we’re going to have to take into account on an ongoing basis; not just me, but obviously my colleagues. But it is something that’s somewhat troubling.”

- **Stourbridge Investments LLC v. Bersoff** (Laster, V.C., 3/13/12)
  - “[T]he increase in disclosure-only settlements is troubling. Disclosure claims can be settled cheaply and easily, creating a cycle of supplementation that confers minimal, if any, benefits on the class.”
The Impact of Increased M&A Litigation & Disclosure Only Settlements

- Inconsistent Rulings
- Accretive Changes In The Law?
But for *Pure*, Would Things be Different?

- Less M&A Litigation?
- Fewer Disclosure Only Settlements?
How Disclosure Impacts Substantive Analysis

- Fundamental valuation analysis
  - No change in fundamental methodologies but additional conversations about omitting methodologies and/or using non-traditional methodologies

- Better contemporaneous documentation of subjective, professional judgments (e.g., comp sets, etc.)

- Board books (draft and final)
  - Greater recognition that books need to function as stand-alone documents in litigation

- Responsibility for M&A litigation risk management extends from solely legal to financial teams. Now, not just sales process, but analytical process risk
Arguments in favor of more Delaware-mandated disclosure:

- Utility of such information
- DE case law encourages banker analysis
- Evolving stockholder base (institutions)
- Really is material to view banker analysis
- 13e-3 Transactions already require board books; what is harm in disclosing in other transactions?
- ???
Revisiting *Pure* – Your Thoughts...

- **Arguments against more Delaware-mandated disclosure:**
  - Fear of stepping on SEC’s toes – or the reverse
  - Worry of encouraging prolix disclosures
  - **Not really moving needle on stockholder vote**
    - *In re Art Technology Group, Inc. S’holders Litig.* (Laster, V.C., 5/16/11)
      - “I do think it’s quite striking that not a single stockholder changed their vote. And I think it does call into question some of what these disclosure cases do.” (p.89)
  - **Slippery Slope–When Does It End?**
    - *In re Icagen, Inc. S’holder Litig.* (Strine, C., 4/5/12)
      - Argument over value of additional disclosures regarding beta used by financial advisor
    - Creates “Cycle of Supplementation”
Returning To Question Posed

• *Turberg v. ArcSight, Inc.* (Laster, V.C., 9/20/11)
  - “Have you . . . thought about getting together with the . . .
deans of the Delaware bar and coming up with a model banker
disclosure that would, you know, talk about how you put in a
reasonable summary of what’s in the board book?”

• Your thoughts?
Background

El Paso had two primary businesses — pipelines and E&P (exploration and production).

To increase value to stockholders, the El Paso Board determined to spinoff El Paso’s E&P business and engaged Goldman Sachs, a long time financial advisor to El Paso, as its exclusive financial advisor in connection with the spinoff.

After El Paso publicly announced its planned spinoff, Kinder Morgan made a proposal to acquire El Paso, accepting the risk that it would be able to sell the E&P business, which it didn’t want, at an acceptable price.

Goldman owned 19% of Kinder Morgan (worth approximately $4 billion), which it helped take private and then public again, and has two representatives on the Kinder Morgan Board.

Goldman’s representatives on the Kinder Morgan board advised Kinder Morgan that Goldman had a conflict and recused themselves from discussions regarding a potential acquisition of El Paso by Kinder Morgan.

Goldman advised El Paso to engage an independent financial advisor but continued to attend board meetings at which, among other things, the Kinder Morgan proposal was discussed.

Morgan Stanley was engaged to advise El Paso on potential sale to Kinder Morgan.

Morgan Stanley requested that it be a co-advisor on the proposed spinoff and/or be entitled to receive a fee if El Paso consummated a spinoff of the E&P business in lieu of a sale.

Goldman, as exclusive financial advisor on the proposed spinoff, refused a request that Morgan Stanley be a co-advisor on the proposed spinoff and/or be entitled to receive a fee if El Paso consummated a spinoff of the E&P business in lieu of a sale.

Goldman requested and was granted the right to receive a $20 million fee if a sale was consummated in lieu of spinoff.

Later, Goldman requested that the press release announcing the proposed sale to Kinder Morgan reference it as an advisor in connection with the sale so that it could obtain league table credit.

After agreement on price, the CEO of El Paso, who was El Paso’s lead negotiator with Kinder Morgan, contacted the CEO of Kinder Morgan and inquired as to whether, following Kinder Morgan’s acquisition of El Paso, Kinder Morgan might be interested in selling the E&P business to El Paso management.

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1. Based on allegations and statements in the hearing transcript and the decision on motion for preliminary injunction, neither of which constitute findings of fact.
What did the Financial Advisor allegedly do wrong?

- Despite conflict, Goldman continued to attend El Paso Board meetings at which the Kinder Morgan proposal was discussed for a brief period and continued to advise on a spinoff, the primary alternative to a sale
  - **Court’s Concern:** Goldman’s financial interest in Kinder Morgan may have influenced its advice
  - **Potential Remedy:** If conflicted, should have more quickly and completely removed itself from any board meetings at which a potential sale to Kinder Morgan were discussed
  - **Open Issue:** Given the nature of Goldman’s conflict, should the El Paso Board have engaged an independent financial advisor on the proposed spinoff alternative as well? Did unforeseeable circumstances effectively “require” El Paso to replace or at least supplement the advisor most knowledgeable about El Paso and pay two advisors in the event of a spinoff?

- Refused to permit Morgan Stanley to earn a fee if El Paso implemented the originally contemplated spin off in lieu of a sale but requested that it receive a $20 million fee if sale occurred (lack of symmetry)
  - **Court’s Concern:** Skewed Morgan Stanley’s incentives to encourage a sale, perhaps at a price that would have benefited Goldman as a substantial investor in Kinder Morgan
  - **Potential Remedy:** If conflicted, either permit Morgan Stanley to earn an “alternative transaction” fee covering spin-off or not request that Goldman be paid an alternative transaction fee if sale occurs
  - **Open Issue:** Were Morgan Stanley’s incentives different than in other contingent fee engagements?
What did the Financial Advisor allegedly do wrong (cont’d)?

- Requested that it be named a financial advisor on a sale to Kinder Morgan to obtain league table credit
  - **Court’s Concern**: Goldman’s financial interest in Kinder Morgan influenced it’s advice
  - **Potential Remedy**: If conflicted and not advising on sale, don’t seek league table credit inconsistent with actual role

- Did not disclose that the lead banker on its El Paso team had a $340,000 investment in Kinder Morgan
  - **Court’s Concern**: Lead banker’s financial interest in Kinder Morgan may have influenced his advice
  - **Potential Remedy**: Disclose lead banker’s financial interest, involve other senior banker’s to supervise and/or, if requested by El Paso, replace lead banker
  - **Open Issues**: Monitoring, tracking and reporting — how broad and how deep?

What did the Financial Advisor do right?

- Representatives on Kinder Morgan Board recused themselves from all discussions regarding Kinder Morgan’s potential acquisition of El Paso

- Recognized El Paso’s need to engage an independent financial advisor to advise the El Paso Board on a potential sale to Kinder Morgan
What else?

- Boards should interview potential financial advisors and make appropriate inquiries regarding potential conflicts and how they will be addressed.
- As circumstances change, Board’s should revisit prior inquiries and seek updated responses.
- Boards need to be active and involved in supervising management and advisors, regardless of whether there are potential conflicts but particularly in light of potential conflicts.
- Continuing importance of contemporaneous board minutes or other written records to help demonstrate that the Board carefully considered the pros and cons of various alternatives, particularly those relating to conflicts.

  — Board decisions regarding potential conflicts may be subject to enhanced scrutiny rather than protected by the business judgment rule.
On the Financial Advisor’s Alleged Conflict

“The Board and management of El Paso relied in part on advice given by a financial advisor, Goldman, Sachs & Co., which owned 19% of Kinder Morgan (a $4 billion investment) and controlled two Kinder Morgan board seats. Although Goldman’s conflict was known, inadequate efforts to cabin its role were made. When a second investment bank was brought in to address Goldman’s economic incentive for a deal with, and on terms that favored, Kinder Morgan, Goldman continued to intervene and advise El Paso on strategic alternatives, and with its friends in El Paso management, was able to achieve a remarkable feat: giving the new investment bank an incentive to favor the Merger by making sure that this bank only got paid if El Paso adopted the strategic option of selling to Kinder Morgan. In other words, the conflict-cleansing bank only got paid if the option Goldman’s financial incentives gave it a reason to prefer was the one chosen. On top of this, the lead Goldman banker advising El Paso did not disclose that he personally owned approximately $340,000 of stock in Kinder Morgan.”

[...]

“The fact that Goldman continued to have its hands in the dough of the spin-off is important, because the Board was assessing the attractiveness of the Merger relative to the attractiveness of the spin-off. That was critical because the Board, at the recommendation of Foshee, Goldman, and Morgan Stanley, decided not to risk Kinder Morgan going hostile and not to do any test of the market with other possible buyers of El Paso as a whole, or of either or both of its two key business segments separately. Thus, the Board was down to two strategic options: the spin-off or a sale to Kinder Morgan. Therefore, because Goldman stayed involved as the lead advisor on the spinoff, it was in a position to continue to exert influence over the Merger. The record suggests that there were questionable aspects to Goldman’s valuation of the spin-off and its continued revision downward that could be seen as suspicious in light of Goldman’s huge financial interest in Kinder Morgan.”

[...]
On the Financial Advisor’s Alleged Conflict (cont’d)

“Even worse, Goldman tainted the cleansing effect of Morgan Stanley. Goldman clung to its previously obtained contract to make it the exclusive advisor on the spin-off and which promised Goldman $25 million in fees if the spin-off was completed. Despite the reality that Morgan Stanley was retained to address Goldman’s bias toward a suboptimally priced deal with Kinder Morgan and thus Morgan Stanley’s work in evaluating whether the spin-off was a more valuable option was critical to its integrity enforcing role, Goldman refused to concede that Morgan Stanley should be paid anything if the spin-off, rather than the Merger, was consummated. Goldman’s friends in El Paso management — and that is what they seem to have been — easily gave in to Goldman. This resulted in an incentive structure like this for Morgan Stanley:

- Approve deal with Kinder Morgan (the entity of which Goldman owned 19%) — get $35 million; or
- Counsel the Board to go with the spin-off or to pursue another option — get zilch, nada, zero.

This makes more questionable some of the tactical advice given by Morgan Stanley and some of its valuation advice, which can be viewed as stretching to make Kinder Morgan’s offers more favorable than other available options. Then, despite saying that it did not advise on the Merger — a claim that the record does not bear out in large measure — Goldman asked for a $20 million fee for its work on the Merger. Of course, by the same logic it used to shut out Morgan Stanley from receiving any fee for the spin-off, Goldman should have been foreclosed from getting fees for working on the Merger when it supposedly was walled off from advising on that deal. But, Goldman’s affectionate clients, more wed to Goldman than to logical consistency, quickly assented to this demand.”
On the Significance of the Alleged Conflicts

“The record is filled with debatable negotiating and tactical choices made by El Paso fiduciaries and advisors. Absent a conflict of interest, these debatable choices could be seen as the sort of reasonable, if arguable, ones that must be made in a world of uncertainty. After discovery, however, these choices now must be viewed more skeptically, as the key negotiator on behalf of the Board and a powerfully influential financial advisor each had financial motives adverse to the best interests of El Paso’s stockholders. In the case of the CEO, he was the one who made most of the important tactical choices, and he never surfaced his own conflict of interest. In the case of Goldman, it claimed to step out of the process while failing to do so completely and while playing a key role in distorting the economic incentives of the bank that came in to ensure that Goldman’s conflict did not taint the Board’s deliberations. This behavior makes it difficult to conclude that the Board’s less than aggressive negotiating strategy and its failure to test Kinder Morgan’s bid actively in the market through even a quiet, soft market check were not compromised by the conflicting financial incentives of these key players. The record thus persuades me that the plaintiffs have a reasonable likelihood of success in proving that the Merger was tainted by disloyalty.”
Goldman’s Potential Liability

“Given that Goldman’s largest conflict was surfaced fully and addressed, albeit in incomplete and inadequate ways, whether the plaintiffs could ultimately prove Goldman liable for any shortfall is, at best, doubtful, despite Daniel’s troubling individual failure of disclosure.”