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Refining The Adviser Disclosure Dance In Del.

Law360, New York (August 13, 2012, 12:22 PM ET) -- In recent years, the Delaware courts have delivered numerous decisions focusing on the disclosure of issues and information relating to acquisition targets' financial advisers in change of control transactions. On initial consideration, rationalizing the case law appears challenging at best. However, when considered as a whole, and with a view toward the underlying transaction process, it may be possible to anticipate how the court might react, and plan accordingly.

Since the landmark 1983 Delaware Supreme Court Weinberger v. UOP Inc. decision, target boards have been advised that receipt of a fairness opinion is a practical necessity in any change of control transaction. While this resulted in new business for financial advisers, it also exposed them to challenge from various commentators and more importantly, an active plaintiff's bar.

Boards counseled to obtain the protections offered by a fairness opinion were anxious to make that opinion and the underlying analysis available to their shareholders. Opinions referenced in public filings were subject to U.S. Securities and Exchange Commission disclosure obligations, including the requirements now set forth in Item 1015 of Regulation M-A and FINRA Rule 2290. These rules mandated that various disclosures be made about financial adviser compensation and past or expected relationships between the adviser and transaction parties.

Such disclosure highlighted an inherent conflict of interest: Traditionally sell side advisers received the bulk of their fee based upon a percentage of the consideration received by their client at a transaction's closing. Because a transaction was unlikely to close without a "positive" fairness opinion, plaintiffs alleged that the analyses underlying fairness opinions, and the related delivery, reflected the result of the adviser's desire to obtain a fee as opposed to professional financial analysis and unbiased advice.

Other challenges centered on inaccurate or incomplete disclosure of analyses underlying opinions. These challenges were separate and apart from any SEC requirements and often focused on a board's duty of candor under Delaware law. Thus, even after disclosure had been vetted by the SEC through the comment process, it was still subject to challenge in a strike suit, which often sought to enjoin the process required to approve the change of control transaction. In several recent cases, suits have been successful in obtaining injunctive relief, which is not only detrimental to the transaction process, but likely extremely embarrassing to the boards and advisers involved.

In other cases, injunctive relief was not granted, but defendants' motions to dismiss were denied, creating a likelihood of potential damages and giving plaintiffs concrete leverage in related settlement discussions. Many of the underlying opinions contain significant criticisms of financial advisors, individual bankers and the boards they were engaged to protect. At times, it is difficult to rationalize the principles behind the court's decisions. However, a reading of the cases and related transcripts can at least provide some guidelines on how to avoid unfavorable outcomes.

It is absolutely imperative to disclose the financial adviser's fee arrangements as well as any relationships the adviser or individual bankers have with the transaction parties. These relationships should have been made known and evaluated in connection with selecting the financial adviser with reasonable care (see DGCL 141(e)). Furthermore, it is advisable to make specific, rather than general, disclosures about these fee arrangements and relationships.

For example, it is better to note that the financial adviser had received in excess of a specific revenue amount from the buyer and its affiliates in the last three years rather than simply stating that the buyer received significant fees. The same specifics should be included with respect to the fees received for the transaction at hand. Five years ago, public filings often referenced "customary" fees, whereas now specific dollar amounts are standard. If stapled finance is contemplated, disclosure of the potential conflicts that it presents should be clear, as should any other transaction-specific conflicts.

Any specific conflict that might influence individual bankers' behavior should also be investigated and disclosed as appropriate. Taking these steps will not only reduce the risk of embarrassing censure in a publicly filed opinion, but also will allow financial advisers to minimize potential liability, including the risk of their actions being found to be outside typical engagement letter indemnification and exculpation provisions. These measures will also greatly reduce the chance that the transaction will be enjoined.

Boards should be mindful that the court will examine whether the opinion-related disclosure is fulsome enough to facilitate the shareholders' decision to accept the merger consideration being offered or to reject it in favor of a standalone option or appraisal rights. It is critical that the advisor include sufficient facts to enable a shareholder to assess whether the key assumptions underlying the analyses were justified.

This does not imply that the court will substitute its own judgment for that of the financial adviser's, but that it wants shareholders to be granted the ability to make an informed judgment based upon a fair summary of the financial adviser's analysis. To make that possible, the disclosure must include projections provided to the bankers, the discount rate and other key assumptions. It should also include information about specific comparative companies and transactions to enable the shareholders to assess whether those employed were appropriate in their own judgment.

In determining the level of detail to include regarding the analyses underlying the fairness opinion, thought should be given to the overall transaction process and any existing "risk factors." Questions to ask include:

- Does the entire fairness standard apply to the transaction or is it the product of a fully shopped auction with an unrelated third-party buyer?
- Do the facts present support a plaintiff's allegation that management or board members are not fully independent? For example, are they being offered the opportunity to participate in the equity of the surviving company while other shareholders are being cashed out?
- How attractive is the premium and how does the transaction measure up on the financial adviser's football field?
- Did the financial adviser rely on management's longstanding projections and were specific protections developed in the context of the transaction, or was it necessary to develop a related sensitivity analysis in connection with "getting" to fairness?

The cases granting injunctions based on lack of opinion-related disclosure often seem to deal with some of these issues. Many transactional lawyers, and judges, based on an interpretation of their opinions, would consider the underlying transaction "risky" in some form.

More risk mitigates toward more disclosure as demonstrated by a Schedule 13e-3's "going private" transaction requirements where full disclosure of the adviser's opinion-related presentations is mandated. However, in most other cases, the deal parties and their advisers will conclude that this level of disclosure is not needed and might give rise to undue confusion or distraction as the approval process goes forward. This conclusion also reflects any related settlement negotiations with regard to the plaintiff strike suits that seem to arise in the bulk of change of control transactions.

Heightened disclosure should ultimately result in less risk to the process, the financial advisers and their clients. In any case, it is highly recommendable that projections and other key assumptions and facts be included so that shareholders are provided a fair summary of the financial analyses. And any potential conflict should be disclosed. Once disclosed, the board and/or shareholders can make an informed decision and no argument can be made that relevant facts were hidden for self-serving purposes.

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