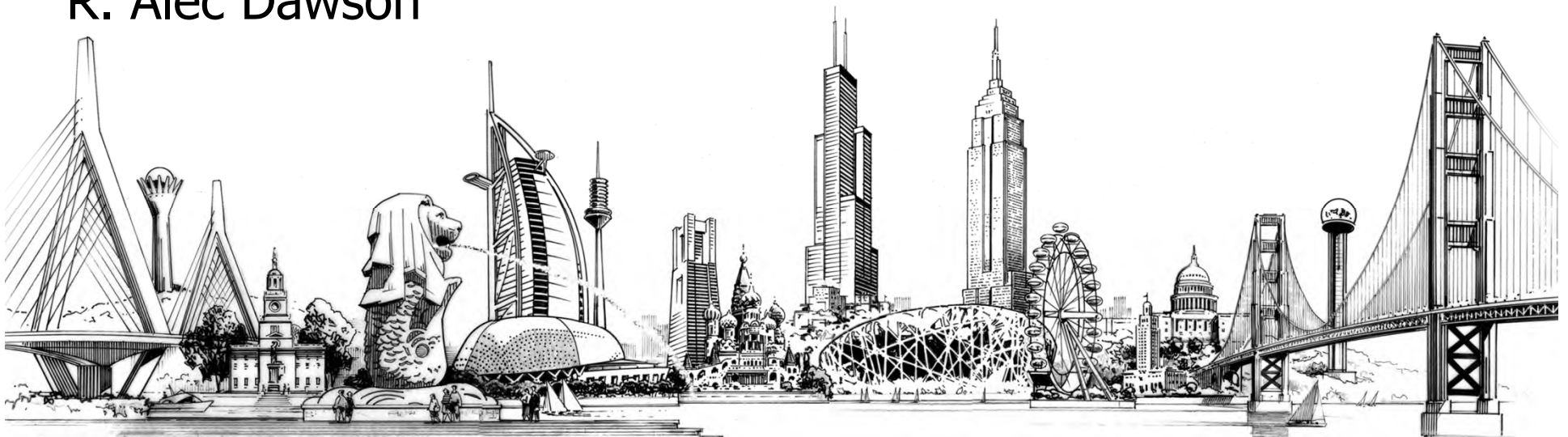


Morgan Lewis

PUBLIC COMPANY M&A - PART II

**FAIRNESS OPINIONS AND
BANKER CONFLICT OF INTEREST
ISSUES**

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Investment Banker Engagements – Some Basics – Fee-Related Issues

- What are the services to be provided?/What is the “Transaction”?
- Consider the type of fee:
 - fixed fee
 - contingent success fee
 - opinion fee
 - expense reimbursement, including legal fees
- When will the fee be paid?
 - initial engagement fee
 - monthly retainer
 - upon board presentation or opinion request
 - upon signing/consummation of a transaction

Investment Banker Engagements – Some Basics – Fee-Related Issues

- Other considerations:
 - contingent consideration/break-up fees
 - equity participation
 - breadth of definition of “Consideration” if fee is a percentage of transaction value (i.e. non-competes, options, debt, etc.)
 - carve-outs for certain acquirors?
 - right of first refusal to provide other banking services
 - tail period

Investment Banker Engagements – Some Basics – Indemnification

- Indemnification
 - standard of care: gross negligence vs. negligence; aiding and abetting
- Exculpation
 - not available for securities law liability
- Contribution
 - Carve-outs or flat
- Arbitration vs. Litigation

Investment Banker Engagements – Some Basics – The Board Presentation

- Be sure management understands the presentation before it is presented to the board
 - assumptions are correct
 - projections are correct (and any sensitivity analysis is reasonable)
- The board will expect management to develop and explain the projections/specifics
- Ask outside counsel to review in light of engagement letter and draft opinion – in public deals SEC rules require detailed descriptions
- Be prepared with questions for the banker
- Review valuation methodologies:
 - discounted cash flow
 - comparable company and transaction values
 - liquidation
 - LBO/MBO
 - contribution analysis (stock-for-stock deals)

Investment Banker Conflicts of Interest – Recent Developments

- Bankers “are all totally conflicted – get used to it” (former Vice Chair of Morgan Stanley)
- Types of banker conflicts:
 - banker has business relationship with the other party to the deal
 - seller’s banker provides buy-side financing (“stapled finance”)
 - banker has a financial interest in the other party
 - banker’s compensation structure (i.e. contingency, or “success” fees)
 - banker ties to management, especially in special committee situations

Investment Banker Conflicts of Interest - Recent Developments

- Why do banker conflicts matter?
 - if the banker is conflicted, the board should know and should consider and address the conflict, or risk a finding that the board has breached its fiduciary duty
 - can board address conflicts in the engagement letter?
 - should board consider need for an additional banker to give a second fairness opinion?
 - disclosure to shareholders is critical to the process and a board can't disclose what it doesn't know
 - the deal could be delayed
 - buyer's deal protections could be compromised
 - buyer may inherit the liability and the headache
 - disclosure and an informed vote will cleanse duty of care violations under KKR holding

Investment Banker Conflicts of Interest - Recent Developments

- The bottom line:
 - Seller should care if its banker is conflicted as it could result in a finding that the board has breached its fiduciary duty
 - Buyer should care if a target's banker is conflicted and should do diligence with this issue in mind as it could impact deal and timing, and buyer could inherit liability
 - Banker should care as it could become liable

Investment Banker Conflicts of Interest - Recent Developments

- Some Recent Cases:
 - Del Monte (Del. Ch. Feb. 2011/Laster)
 - El Paso (Del. Ch. Feb. 2012/Strine)
 - Rural/Metro (Del. Ch. Mar. and Oct. 2014/Laster; Del. S. Ct. Dec. 2015)
 - PLX (Del. Ch. Sept. 2015/Laster)
 - Zales (Del. Ch. Oct 2015/Parsons)
 - Tibco (Del. Ch. Oct. 2015/Bouchard)

Investment Banker Conflicts of Interest - Recent Developments

- Del Monte:
 - the poster child for banker conflicts in Delaware
 - Bank (i) put the company in play, (ii) maneuvered to get the buy-side financing (and a big fee), and (iii) allowed potential buyers to club together to reduce competition, in violation of Del Monte's confidentiality agreement and with no benefit to Del Monte
 - del Monte board was in the dark; when the board told the banker to stand down, it kept at it

Investment Banker Conflicts of Interest - Recent Developments

- Del Monte cont'd:
 - Revlon transaction in which Del Monte adopted a single-bidder strategy with a go-shop run by the banker
 - Del Monte spent \$3M on a second banker for a second fairness opinion
 - the court found that there was a reasonable probability that plaintiff would succeed on the merits of a Revlon claim because the board failed to oversee the conflicts
 - board was passive in its oversight; it did not question the club arrangement or the bank providing financing

Investment Banker Conflicts of Interest - Recent Developments

- Del Monte cont'd:
 - the court found that the banker was so conflicted that the entire process was tainted; “for purposes of equitable relief, the Board is responsible”
 - the court delayed the shareholder vote for 20 days to allow a topping bid to arise
 - during that delay, the buyer’s deal protections (no-shop, match rights, and breakup fee) could not be enforced
 - no topping bid arose, and the case settled postclose for \$89.4M with about \$20M in attorney fees (split between Del Monte and Barclays)

Investment Banker Conflicts of Interest - Recent Developments

- El Paso:
 - El Paso hired a financial advisor to help with a spin-off of a portion of its business
 - banker had a \$4B (19%) equity position and two board seats in Kinder Morgan, the party that offered to buy the entire company
 - a second banker was brought in, but with a fee only if the whole company was sold
 - as a result, both bankers were incentivized to push for a sale of the whole company to the counterparty

Investment Banker Conflicts of Interest - Recent Developments

- El Paso cont'd:
 - neither El Paso nor its bankers did a soft market check on the Kinder Morgan price
 - the board knew of the first banker conflict, but according to the court did not deal with it because it allowed that banker to continue to analyze whether a spin-off was an appropriate alternative
 - Strine was highly critical of the first banker, and found that plaintiffs had a reasonable likelihood of success in prevailing on the merits

Investment Banker Conflicts of Interest - Recent Developments

- El Paso cont'd:
 - Strine did not enjoin the deal because no other bid was on the table, and blocking the deal would ultimately harm El Paso shareholders more than letting the offer go to vote
 - Kinder Morgan (as owner of El Paso) ultimately settled for \$110M, and did not pay the first banker its \$20M fee or any indemnity payments

Investment Banker Conflicts of Interest - Recent Developments

- Rural/Metro:
 - Warburg Pincus purchased Rural/Metro
 - Rural/Metro banker offered staple financing for the buyer; the board knew, and brought in a second banker to deliver a second fairness opinion
 - Warburg's first bid did not use the first banker's financing, but behind the scenes the first banker continued to try to get that business (and the associated large fee)
 - the day before the board approved the merger, the first banker was working on its fairness opinion analysis to make the Warburg offer look more attractive

Investment Banker Conflicts of Interest - Recent Developments

- Rural/Metro cont'd:
 - Rural/Metro's board received written valuations from both bankers at 9:42 p.m. for an 11 p.m. board meeting to approve the deal
 - this was the first valuation information the board received in the entire process
 - plaintiff brought claims against the directors for breach of fiduciary duty, and against the bankers for aiding and abetting the breach
 - the directors and the second banker settled before trial, leaving the first banker to defend the aiding and abetting claim

Investment Banker Conflicts of Interest - Recent Developments

- Rural/Metro cont'd:
 - Vice Chancellor Laster applied a “reasonableness” standard in determining whether the Rural Metro board had breached its duty of care
 - prior decisions suggest that the right standard is gross negligence
 - Laster focused on the fact that plaintiffs are not seeking to recover from disinterested, independent directors with relatively low fees, but rather against an advisor paid \$60M by inducing the board to sell when and how it did
 - importantly, he called the bankers “gatekeepers”
 - this comment has attracted extensive attention of commentators

Investment Banker Conflicts of Interest - Recent Developments

- Rural/Metro cont'd:
 - “the prospect of aiding and abetting liability for investment bankers who induce boards of directors to breach their duty of care creates a powerful financial reason for the banks to provide meaningful fairness opinions and to advise boards in a manner that helps ensure that the directors carry out their fiduciary duties when exploring strategic alternatives and conducting a sale process, rather than in a manner that falls short of established fiduciary norms.”
 - are lawyers next?
 - takes a different view of the world than seeing boards as the sole fiduciaries and decisionmakers

Investment Banker Conflicts of Interest - Recent Developments

- Rural/Metro cont'd:
 - the first banker was found guilty of aiding and abetting and ordered to pay \$76M in damages to former Rural/Metro shareholders
 - should the banker, as a gatekeeper, have said it was too conflicted and the board shouldn't hire it?
 - can a board's actions be unreasonable if based on partially hidden information?
 - on appeal, the Chancery Court was affirmed, although the gatekeeper analysis was disavowed

Investment Banker Conflicts of Interest - Recent Developments

- PLX:
 - bank (i) engaged to represent PLX in sale to Avago because of existing tail; (ii) had significant past and current ties with Avago including: \$56 million of fees in last three years, member of Avago deal team sat on opinion committee approving PLX sell side opinion, and internal announcement regarding deal stressed ties to Avago; and (iii) did not disclose conflicts until late in the process
 - PLX Management prepared three successive sets of deal-only projections for purpose of fairness opinion, bringing deal price within fairness range

Investment Banker Conflicts of Interest - Recent Developments

- PLX cont'd:
 - bank held to have aiding and abetting liability by failing to disclose conflicts
 - bank left alone as last defendant standing, without benefit of indemnification because board not monetarily liable for duty-of-care breach

Investment Banker Conflicts of Interest - Recent Developments

- PLX cont'd:
- Lessons
 - blind reliance/assumption of accuracy with respect to projections no longer viable even if prepared by management and vetted by board
 - late disclosure will not present aiding and abetting liability (although KKR might)
 - banks need to take care with internal communications and opinion committee composition

Investment Banker Conflicts of Interest - Recent Developments

- Zales:
 - bank pitched Signet to buy Zales, with banker recommending a price not in excess of \$21 per share
 - Signet engaged a different bank, but the same banker won a sell side mandate from Zales, although did not disclose Signet pitch
 - Signet ultimately purchased Zales for \$21 per share
 - bank found liable for aiding and abetting duty-of-care breach; however, because the conflict was disclosed in the proxy, the underlying duty-of-care breach was cleansed and thus the aiding and abetting claim failed

Investment Banker Conflicts of Interest - Recent Developments

- Zales cont'd:
- Lessons
 - disclose early and often
 - consider conflicts created by multiple pitches and specific information shared
 - companies in auctions should consider depth and breadth of conflict procedures regarding bankers

Investment Banker Conflicts of Interest - Recent Developments

- Tibco:
 - bank represents Tibco in sale to Vista (a fund founded by bank alumni)
 - Vista calculates overall price based on LBO analysts and converts to per-share price, but the cap table employed double-counted certain shares
 - when correct cap table was discovered, a new purchase price based on a per share analysis was determined reducing the overall purchase price by \$100M
 - Vista informed bank it perceived the reduction as a windfall after the contract was signed
 - board was never informed until ensuing plaintiff strike suit, although Bank claimed it informed Company counsel orally
 - bank found liable for aiding and abetting in an embarrassing opinion, which suggested intentional creation of an information vacuum and malpractice

Investment Banker Conflicts of Interest - Recent Developments

- Tibco cont'd:
 - bank exposed to both plaintiff liability and a potential malpractice claim from buyer
 - key disclosures must be in writing
 - liability would have been easily avoided with proper disclosure and board deliberation
 - bank is appealing and initial papers indicate that discovery backs up bank's position regarding disclosure to lawyers

Conflict Implications - for Engagement Letters

- Boards must be active participants in the banker engagement process and in reviewing and dealing with conflicts; they should ask questions, perform diligence, and interview multiple bankers
- Sellers are pushing harder in engagement letters for some or all of:
 - representations that banker has not had prior discussions with any other parties about the deal within the two to three years
 - representations about any current or past discussions or relationships between the banker and certain potential counterparties
 - representations about stock ownership by the bank or certain individuals of potential counterparties
 - banker's agreement to not communicate with any other party about the transaction, except as directed by the board

Conflict Implications - for Engagement Letters

- banker's covenant not to provide financing or other financial advisor services to buyers without board consent
- banker's agreement to share the fee if another banker is necessary due to a conflict
- prohibitions on banker assisting in a clubbing arrangement without board permission
- banker's covenant to advise the board of any expression of interest
- banker's covenant to promptly advise the board of any future perceived conflict
- elimination of any tail fee if the financial advisor has materially breached any such representation or covenant

Conflict Implications - for Merger Agreements

- Buyers are starting to push for:
 - express provision that if there is an injunction that limits the buyer's rights under the no-shop and matching provisions, or that eliminates or reduces the termination fee, buyer can terminate the agreement
 - but seller's response is that in Del Monte, the buyer's collusion with the banker was a big part of the problem, and that misconduct is avoidable by buyer

Conflict Implications - for Stockholder Disclosure

- Full and accurate disclosure to stockholders is critical and governed by various SEC and FINRA rules:
 - of banker's compensation arrangement
 - dollar amount not necessarily required, but structure, magnitude, and ratio of advisory vs. opinion fees is important
 - of prior relationships between seller and the bankers, and past fees paid
 - of any banker conflicts, how the board considered them, and what the board did to address
 - Be vigilant in making sure board books, opinions and analyses are accurately described in proxy statement

Conflicts - Other Lessons to be Learned

- Banker conflicts are not per se impermissible (with some exceptions)
- A second fairness opinion doesn't automatically fix a conflict; a conflict is not cured by layering on another fairness opinion
- Boards that don't have full information can't meet their fiduciary duties; boards must be informed and involved
- Board should carefully review:
 - engagement letter(s)
 - fairness opinion(s)
 - board books and changes along the way; be questioning
 - Strine would require blacklined board books if possible, but summary change pages are becoming prevalent

Conflicts - Other Lessons to be Learned

- board minutes (which should be contemporary and detailed enough to provide a record of the process, including conflicts)
- sanitized minutes don't actually help anyone; understand your approach to minutes
 - See Strine's Harvard Discussion Paper which encourages detailed, fulsome minutes as the best way to illustrate the board's actions and care
- Counsel must focus the board on the proxy statement disclosure; directors are responsible for that disclosure
- Don't stop at SEC disclosure requirements
- Lawyers and bankers may be on the way to being held to a higher standard than ever before

Conflicts - Other Lessons to be Learned

- As Strine has noted, “[y]ou and your clients get to write the play...If the play is one where your clients appear to have made sensible, good faith judgments for legitimate, well-documented reasons, those judgments are likely to withstand judicial scrutiny”
- A strong process is the best defense

Biographies



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Laurie A. Cerveney is an accomplished corporate, M&A, and securities lawyer. She has extensive experience counseling US and foreign issuers and their boards on mergers and acquisitions and the ongoing disclosure and reporting requirements of public companies, corporate governance matters, annual meeting and proxy-related issues, securities laws, SEC rules, stock exchange listing requirements, executive compensation, and various other matters affecting public companies and their officers and directors. Laurie is a deputy practice leader of the M&A practice area and a member of the firm's Advisory Board and of the steering committee for ML Women, the firm's women's initiative.



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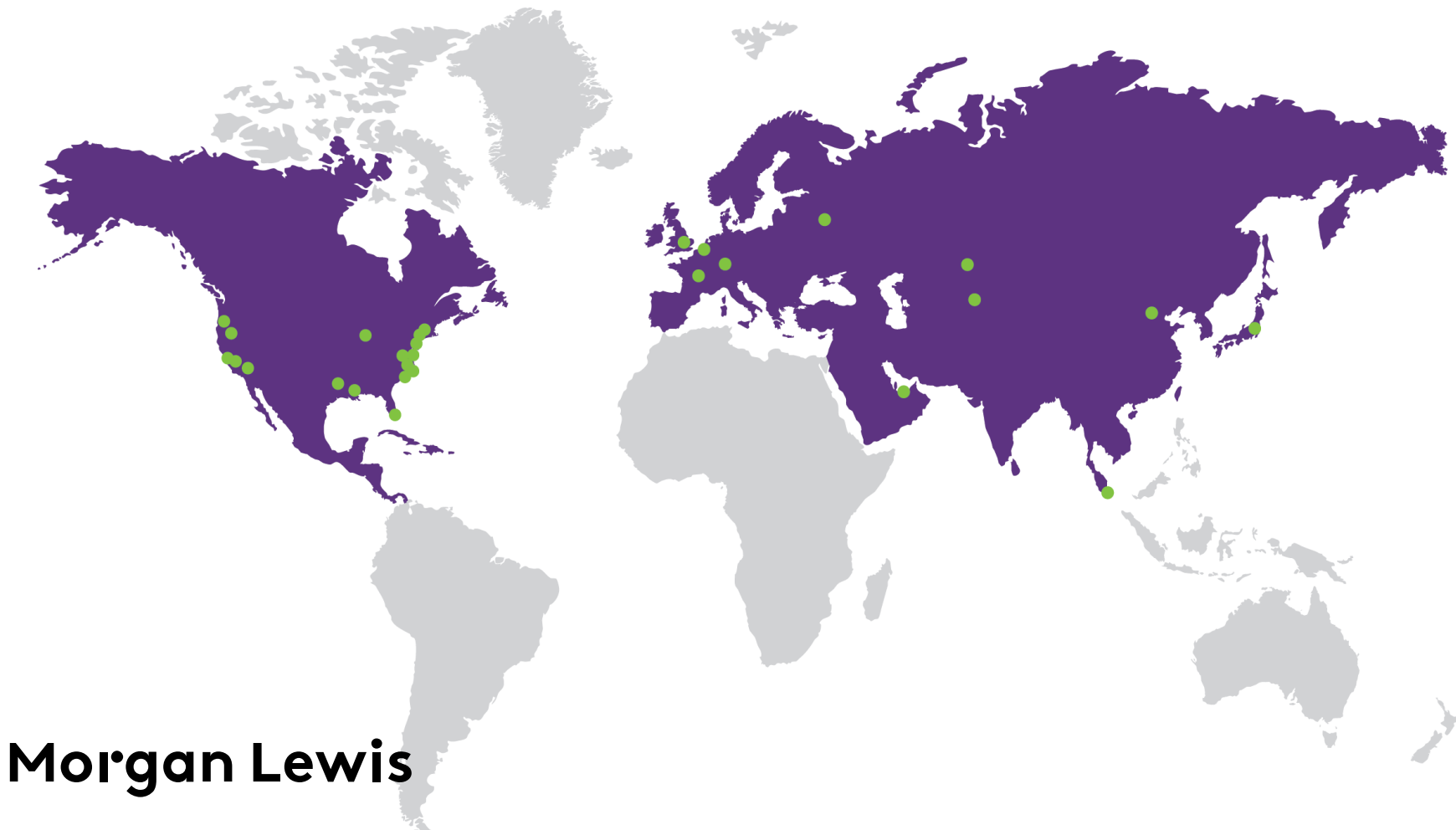
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