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M&A Update

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Two cases currently are getting a lot of attention in legal circles. The first is *MFW*, a Delaware Supreme Court decision that clarifies the legal standards in controlling stockholder transactions. The second, *Rural Metro*, involves an entertaining catalogue of bad behavior by investment bankers. Many investment bankers will question whether *Rural Metro* is instructive for them, given the extreme facts involved, but the case yields useful reminders for all bankers about fundamental aspects of the job.

I. Controlling Stockholder Transactions

Under Delaware law, the default standard of review applicable to directors' decisions is the business judgment rule, under which directors enjoy a favorable presumption that they have fulfilled their fiduciary duties unless a plaintiff proves that the directors acted disloyally, in bad faith or with gross negligence. Traditionally, director actions in controlling stockholder transactions have been reviewed under the "entire fairness" standard, a more rigorous test requiring proof of both a fair process and a fair price. Before *MFW*, it was an open question what, if anything, a controlling stockholder could do to ensure that a merger between the controlling stockholder and the controlled company would be reviewed under the business judgment rule. The *MFW* case provides a path to the business judgment rule for controlling stockholder transactions, but it is a path with some obstacles and it remains to be seen how well traveled it will become.

A. Case Law

Kahn v. M&F Worldwide, No. 334, 2013 (Del. March 14, 2014)

MacAndrews & Forbes proposed to take M&F Worldwide Corp. ("MFW") private by acquiring by merger the 57% of MFW shares it did not already own. The acquisition proposal was conditioned from the outset on the transaction being (i) negotiated and approved by a special committee of independent MFW directors and (ii) approved by a majority of the 43% of MFW stockholders not affiliated with MacAndrews & Forbes. The conditions were met and the deal closed in December 2011. Claimants (minority stockholders) sued for post-closing damages and relief, including against MFW's directors for breach of fiduciary duty. At trial, the Delaware Court of Chancery granted summary judgment to the defendant directors, after determining that the business judgment rule standard of review should apply rather than the more demanding entire fairness standard. The Delaware Supreme Court affirmed the ruling in March, holding that, "in controller buyouts, the business judgment standard of review will be applied *if and only if*: (i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority."

B. Lessons

- To secure business judgment rule treatment, the required procedural protections must be in place **from the beginning**. When advising a controlling stockholder, investment bankers need to be aware of *MFW* and consider the pros and cons in early strategy sessions. Once any overture is made or discussions commence it may be too late.
- In some situations, the *MFW* criteria may be impractical. Are there independent directors on the board of the controlled subsidiary who are qualified to run a transaction process? What is the stockholder census—will there be adequate minority stockholder participation and will a majority of the minority condition disproportionately empower certain active members of the minority stockholder group?
- The court admitted that it would not be difficult for a plaintiff to allege facts indicating that the process or disclosure were deficient, which would allow the case to proceed from the pleading stage to the discovery stage, thus increasing the cost of litigation and defeating an important benefit of the business judgment rule standard.
- Even if attempting to fit within the requirements of *MFW*, the parties should proceed as if the entire fairness standard will apply. If the case survives the pleadings stage, the discovery stage and motions, and proceeds to trial, the entire fairness standard would apply.

II. Advisor Conflicts

The relationships and financial incentives of financial advisors have come under increasing scrutiny in recent deal litigation. Most recently, in the *Rural Metro* case, RBC Capital Markets was found liable for aiding and abetting directors' breaches of fiduciary duties. The case could encourage plaintiffs to name financial advisors as defendants with the hope of uncovering undisclosed actual or apparent conflicts, thus turning RBC's bad day into a bad day for all financial advisors. The facts of *Rural Metro* are unusually troublesome, but advisor conflicts are a continuing theme. The court's opinion includes numerous cites to the *El Paso* case described below, where Goldman was taken to task for inadequately managing its conflicts of interest in a sale transaction.

A. Case Law

In re Rural Metro Corporation Stockholders Litigation, Consol. C.A. No. 6350-VCL (Del. Ch. March 7, 2014)[1]

In June 2011, Warburg Pincus acquired Rural/Metro Corporation. Rural/Metro stockholders alleged (and the court agreed) that Rural/Metro directors breached their fiduciary duties by approving the deal and that RBC aided and abetted those breaches.

In 2010, RBC first pitched Rural/Metro on acquiring American Medical Response, a subsidiary of publicly traded Emergency Medical Services Corporation. Rural/Metro approached EMS in August 2010, but EMS was not interested.

In October 2010, Rural/Metro received an indication of interest from a consortium of private equity buyers. Those talks apparently stalled, but ultimately galvanize certain directors and management of Rural/Metro in favor of a sale.

In December 2010, rumors emerged that EMS was for sale. RBC informed Rural/Metro that private equity investors were interested in EMS and that those interested in separating AMR from EMS might view Rural/Metro as a potential partner in a deal. In response, the board reactivated its special committee to retain advisors and evaluate strategic alternatives. RBC won the engagement with a pitch centered on selling Rural/Metro in coordination with the EMS process.

RBC realized that a buyer of EMS might prefer to buy Rural/Metro rather than sell AMR to Rural/Metro. RBC surmised that, if it led a sale process for Rural/Metro, the buyers who might be interested in both EMS and Rural/Metro would be more likely to include RBC in their financing trees for the EMS acquisition, in the hope that doing so would give those buyers an advantage in pursuing Rural/Metro. In its pitch, RBC noted its willingness to provide staple financing to potential buyers of Rural/Metro, but it did not disclose its plans to use its engagement as Rural/Metro's advisor to pursue financing work for the EMS bidders.

The sale process was flawed and RBC never explained to its client that bidders for EMS, the most likely buyers of Rural/Metro, could not meaningfully participate in a Rural/Metro sale process due to confidentiality restrictions imposed in the EMS process, which involved Rural/Metro's direct competitor. The defective

[1] The portions of the opinion that relate to the underlying breaches of fiduciary duty are omitted here in favor of the portions of the opinion that relate to the behavior of the financial advisors.

process ended with Warburg as the lone final bidder, at which point RBC's drive for buy-side financing work intensified to such a degree that RBC appears to have changed its valuation analysis to make the Warburg bid look more attractive.

The deal ultimately closed without RBC getting any buy side work in the Rural/Metro sale or the EMS sale, but that did not make up for the damage done by RBC's obvious conflict of interest and the behavior it engendered. The court has yet to set the damage award against RBC. The court's 91-page opinion, which largely shows a financial advisor who did everything but protect the best interests of its client, suggests something more than a slap on the wrist is coming.

In re El Paso Corporation Shareholder Litigation, C.A. No. 6949-CS (Del. Ch. February 29, 2012)[2]

Stockholders sought to enjoin a merger between El Paso Corporation and Kinder Morgan, Inc. They did not get the injunction—Chancellor Strine let the matter proceed to a stockholder vote, mainly because no other bidders were in the picture—but the opinion suggests breaches of fiduciary duty likely occurred due to conflicts of interest of management and Goldman Sachs, who served as financial advisor to El Paso.

After El Paso announced that it would spin off a line of business, Kinder Morgan made a bid to buy the whole company. Goldman, already engaged as the financial advisor to El Paso, owned approximately 19% ($4bn) of Kinder Morgan stock and controlled two Kinder Morgan board seats. Goldman's lead banker working for El Paso personally owned about $340,000 of Kinder Morgan stock.

Goldman disclosed to El Paso its interest in Kinder Morgan (but not the banker's personal stock ownership) and attempted to cabin the conflict with internal ethical walls. Goldman stayed on as financial advisor to El Paso on the original spin-off, but was not supposed to provide any advice on the Kinder Morgan transaction. Goldman never really left the scene and appears to have continued to exert influence on the decision-making for the Kinder Morgan transaction, including through its analysis of the viability of the spin-off option, which was the only other transaction for the board to consider against the merger.

Morgan Stanley was hired separately to advise El Paso on the proposed Kinder Morgan merger. Goldman insisted, however, that it continue to be the exclusive advisor on the spin-off. That meant Morgan Stanley would be paid upon consummation of the Kinder Morgan merger but would not receive a fee if the El Paso board elected instead to pursue a spin-off. Morgan Stanley thus had incentives to pursue the very transaction that tainted Goldman in the first place—a

[2] The opinion covers the conflicts of interest of El Paso management but that topic is omitted here in favor of the discussions that focus on the financial advisors.

merger with Kinder Morgan. In the court's view, the addition of Morgan Stanley actually made the situation worse, because it increased the likelihood of Kinder Morgan's acquisition of El Paso (probably at a lower price), an outcome more favorable to Goldman than to El Paso's other stockholders.

The transaction ultimately did close and spawned additional stockholder litigation that required Kinder Morgan to pay $110 million to El Paso stockholders. Goldman had to disgorge a $20 million fee it received in the transaction and plaintiffs' lawyers received $26 million in legal fees and expenses.

B. Lessons

- Big investment banks that invest as principal and lend money or are affiliated with lenders have a different conflicts profile than stand-alone boutique advisory firms. But it is not financing relationships alone that pose risks. A plaintiff can make a big deal out of any conflict.
- To the extent that a firm has fewer conflicts of interest than its large investment banking competitors, could this be a selling point?
- The financial advisor can be held liable for aiding and abetting a breach of fiduciary duty even where the director is relieved of liability for the breach under state law or the corporation's governing documents.
- Financial advisors, like lawyers, are viewed as "gatekeepers" who protect the integrity of the process. The threat of aiding and abetting liability is seen as an incentive to gatekeepers to provide sound advice.
- All participants in a sale process need to be mindful of relationships and how they might appear to others. Disclosure (usually earlier is better) must be considered carefully, and in some cases disclosure alone may not be enough.
- On the buy side, be wary of approaches from sell-side advisors who want to provide buy-side financing. The Delaware courts have been careful not to say that staple financing is a *per se* conflict, but even staple financing can create conflict issues. The buy-side advisor would see its closing risk increase significantly in a situation where the sell-side advisor is pursuing work on both sides.
- When asked to give a second opinion, understand the reason for the second opinion and evaluate whether the engagement is consistent with that reasoning. Will the second opinion help to resolve or alleviate a conflict?

III. Valuation Analysis

Courts are showing an increasing willingness to wade into the particulars of a financial advisor's valuation analysis. A disorderly process or changes to methodologies or underlying assumptions are viewed with skepticism.

A. Case Law

In re Rural Metro Corporation Stockholders Litigation, Consol. C.A. No. 6350-VCL (Del. Ch. March 7, 2014)

The handling of conflicts is not the only area where RBC fell short in the *Rural Metro* case (see II.A. above). The court also was very critical of RBC's valuation work, in terms of both process and substance.

For three months the Rural Metro board received no valuation information from RBC. The first valuation information of any kind was delivered at 9:30 p.m. on a Sunday night, about 12 hours before Warburg's bid was set to expire, and three hours before the meeting to approve the deal. The board thus had no meaningful opportunity to understand the analysis, let alone understand it in the context of alternatives to the transaction it was evaluating.

In parsing through the DCF analysis and questioning certain assumptions, the court essentially assessed the work as ranging in quality from poor to outright false. The court assigned blame for the poor valuation work not only to the conflict of interest that was driving RBC but also to RBC's internal approval processes. A quote from the opinion: "Many leading investment banks have a standing fairness committee staffed by senior bankers who oversee the opinion process and review opinions to ensure their quality and consistency. The RBC fairness committee is different. Its members consist of any managing directors who happen to be available and willing at the time a request for review goes out. At least two managing directors must respond and be willing to serve as the *ad hoc* fairness committee."

For the Rural/Metro deal, the call for committee volunteers went out at 10:00 p.m. the Friday before the Sunday board meeting. The *ad hoc* committee consisted of two volunteers, one of whom had never served before. It met Saturday morning and signed off on a revised fairness presentation the following day, Sunday, after making changes arguably intended to make the Warburg bid look better. In this context, the court's description of the RBC fairness opinion review process as "different" was a euphemism for "inferior."

In re El Paso Corporation Shareholder Litigation, C.A. No. 6949-CS (Del. Ch. February 29, 2012)

In the course of describing Goldman's conflicts of interest in the *El Paso* case (see II.A. above), then-Chancellor Strine took a time out to review Goldman's valuation analysis of the spin-off. His point was that some of the decisions that resulted in a downward revision to the value of the spin-off appear suspect in light of Goldman's conflict of interest. The interesting aspects of Strine's aside on valuation are the willingness of the court to challenge the work of investment bankers and whether the increasing displays of that willingness will embolden stockholders (and plaintiffs' lawyers) to pick apart the valuation analysis in the same way.

Kahn v. M&F Worldwide, No. 334, 2013 (Del. March 14, 2014)

The court in *MFW* cast the investment banking work in a more favorable light. In reaching its conclusion that the MFW special committee exercised due care, the court noted the committee's financial advisor (Evercore) (i) requested new projections reflecting management's most current thinking in the summer of 2011, even though it already had projections prepared in April and May 2011; (ii) employed a range of valuation methods, including a DCF model; (iii) even through the price offered fell within the range of values produced by each methodology, Evercore, at the committee's request, explored strategic alternatives, like asset divestitures; and (iv) investigated the possibility of other buyers, even though MacAndrews & Forbes, as the controlling stockholder, had indicated that it would not consider alternative transactions. The overall picture is one of a diligent, orderly process with reasonable explanations for each action taken.

B. Lessons

- Courts, stockholders and plaintiffs' lawyers are becoming more sophisticated in financial matters and are more willing to question a financial advisor's valuation analysis.
- Every communication with the client is an opportunity to build the record. Will the record show that the directors were well informed, that they had sufficient information and understood it in its full context?
- Things do change. People reconsider projections and events occur in the market and within the transaction that require adjustments. Will the record show why changes were made to projections and other assumptions and why those changes made sense at the time?