The El Paso/Kinder Morgan Opinion: Further Delaware Guidance on Sell-side Conflicts

In its recent decision regarding the acquisition of El Paso Corporation by Kinder Morgan, Inc.,[1] the Delaware Chancery Court concluded that El Paso's sale process may have been tainted by conflicts of interest affecting the company's CEO and financial advisors. The court nevertheless denied plaintiffs' request for a preliminary injunction on the grounds that enjoining the deal in the absence of a competing bid would pose a significant risk for El Paso shareholders who would have their own chance to judge the merits of the deal at a shareholder meeting. The opinion, authored by Chancellor Strine, provides guidance, and simultaneously raises a number of questions, regarding how to approach relationships and interests that risk giving rise to conflict of interest allegations against directors, officers and financial advisors involved in a sale of control.

The Opinion

After El Paso announced that it would spin-off its exploration and production ("E&P") business and retain its pipeline business, it received an unsolicited bid for the entire company from Kinder Morgan. In the course of the subsequent negotiations, the El Paso board made numerous decisions that, based on a preliminary record, Chancellor Strine found "could be seen as questionable." These included the failure to shop the company or either of its two businesses after receiving the Kinder Morgan bid; the failure to forcefully reject the initial overture and force Kinder Morgan to go public with its bid; charging El Paso CEO Doug Foshee with handling all the negotiations without close supervision by an independent director or legal advisor; continuing to negotiate after Kinder Morgan lowered its bid from a preliminarily agreed upon price; agreeing to deal protections that prohibited accepting an alternative bid for less than 50% of El Paso's assets thereby precluding a separate sale of the E&P business; agreeing to matching rights; and agreeing to a break-up fee that, in the context of a hypothetical sale of El Paso to an interloper interested in the pipeline business alone, would likely represent a relatively high percentage of the purchase price in such a transaction. Chancellor Strine noted, however, that these decisions alone would not provide the basis for enjoining the merger as Delaware law does not permit courts to second guess reasonable, even if debatable, steps taken by a board to obtain the highest value available.

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

But on his review of the preliminary record, the Chancellor concluded that plaintiffs had established a reasonable likelihood of success on their claim that the deal was tainted by breaches of fiduciary duty. The basis for this conclusion was his determination that there was evidence that Mr. Foshee and El Paso's financial advisors had conflicts of interest which may have led to the board's "questionable" tactical decisions.

In particular, the opinion focuses on the fact that Foshee never informed the El Paso board that he was considering bidding for El Paso's E&P business after the closing of an acquisition of the entire company by Kinder Morgan. Although Foshee did not mention his interest in the E&P business to Kinder Morgan until after the merger agreement was executed, he had discussed it with other members of El Paso management during the negotiation of the deal. This led Chancellor Strine to conclude that Foshee may not have been motivated to get the highest price from Kinder Morgan as that would tend to cause Kinder Morgan to seek a higher price from any subsequent purchaser of the E&P assets, and he may not have vigorously negotiated as "a fist fight . . . might leave a bloodied Kinder unreceptive to a bid from Foshee and his team." The Chancellor noted that, at the very least, Foshee should have disclosed his interest in a post-acquisition purchase of the E&P assets to the El Paso board.

The court also found, based on a preliminary record, potential conflicts relating to the board's financial advisors. Goldman Sachs & Co. was El Paso's long-time financial advisor and had been advising El Paso on the spin-off. When the Kinder Morgan bid was made, an issue arose because private equity funds affiliated with Goldman Sachs owned approximately 19% of Kinder Morgan and had two representatives on the Kinder Morgan board. The El Paso board was fully aware of these circumstances, and several steps were taken by the board and Goldman to address the situation: Morgan Stanley & Co. was retained by El Paso as an independent advisor for the potential Kinder Morgan transaction; Goldman Sachs put a firewall in place between the El Paso advisors and the individuals responsible for the Kinder Morgan investment; the Goldman affiliated directors on the Kinder Morgan board recused themselves from the transaction; and the El Paso board and Goldman agreed that Goldman would not advise the board on the Kinder Morgan deal. The Chancellor, however, found that these remedial measures may have been insufficient. He noted that, despite the attempt to wall Goldman off from the Kinder Morgan transaction, Goldman advised the El Paso board regarding the offer in the first days after it was made, including recommending, as is quite common, that the board take steps to avoid a potentially expensive and disruptive hostile bid by Kinder Morgan. In addition, as a result of its continuing advice regarding the E&P spin-off, the primary alternative to a sale of the company, the Chancellor concluded that Goldman necessarily had an impact on the board's view of the relative merits of the Kinder Morgan deal. Finally, the court expressed concern that the El Paso board was unaware that the senior Goldman banker working on the spin-off transaction owned an interest in approximately $340,000 of Kinder Morgan stock.

The court also questioned whether the retention of Morgan Stanley cured Goldman's potential conflict. In particular, the Chancellor found that the structure of the agreement between El Paso and Morgan Stanley regarding Morgan Stanley's fee may have created a distinct conflict of its own. According to the court, because Morgan Stanley would not receive a fee if the El Paso board decided to pursue the spin-off instead of the Kinder Morgan deal, Morgan Stanley -- brought on for the purpose of remedying any potential effect of Goldman's interest in Kinder Morgan -- may itself have been biased toward seeing that the Kinder Morgan deal was completed.

Despite finding that there was sufficient evidence in the preliminary record to support a reasonable likelihood plaintiffs would succeed on their fiduciary duty claims, the court denied plaintiffs' request that it grant a preliminary injunction modifying the merger agreement to allow El Paso to pursue alternatives for a specified period while still requiring Kinder Morgan to acquire El Paso in the event such pursuit proved fruitless. Chancellor Strine concluded that it would be inequitable for Kinder Morgan to remain bound by the terms of the merger agreement while El Paso was freed from the bargained-for deal protections. More importantly, he noted that, although the process may have been flawed, an injunction would have put the deal -- which was at a substantial premium -- at risk. It was a risk he was unwilling to take in light of the ability of the El Paso stockholders to decide whether to approve or reject the Kinder Morgan deal at the upcoming shareholder meeting.

Implications for Boards and Financial Advisors

While differing facts and circumstances will undoubtedly affect the analysis in any particular transaction, the opinion has several significant implications for companies and their advisors in change of control transactions:

- The opinion serves as a reminder to boards and executives that potential conflicts of interest faced by directors and senior management should be explored at the outset of the transaction process and, if necessary, remedial measures should be implemented. In addition, if circumstances that may give rise to allegations of conflicts subsequently arise they should promptly be brought to the attention of the board and its counsel. Instructive in this regard is Chancellor Strine's oft repeated assertion that the El Paso board may have approached the negotiations differently had the directors known of Foshee's interest in buying the E&P assets from Kinder Morgan.

- It is not entirely clear from the opinion, which was based on a preliminary record, how closely Foshee's negotiations were supervised by the El Paso board. In any event, if management is tasked with leading negotiations on behalf of the board, as Foshee did for El Paso, the board or a subset of the board including independent directors, should consider implementing a mechanism for regularly monitoring the course of the negotiations. This may be as simple as receiving regular updates from management as the process unfolds.

- If one of the principal alternatives to a sale of control is a break-up of the company, the board should carefully consider whether a "fiduciary out" in a transaction agreement should provide the flexibility to accept an alternative "superior" transaction that involves the sale of separate businesses and/or a spin-off of certain businesses to shareholders. In this regard it is instructive that in *El Paso* Chancellor Strine found it "questionable" that the board did not have a "fiduciary out" to accept an alternative transaction that involved a separate sale of the E&P assets. In addition, he implied that the magnitude of the break-up fee should be evaluated not only relative to the purchase price for the entire company, as is customarily done, but also relative to the purchase price for the separate business that a topping bidder might want to acquire.

- At the beginning of a sale process, a board should ask its financial advisor about interests it may have in potential bidders, and financial advisors should be instructed to keep the board updated during the transaction process. However, as Vice Chancellor Parsons observed in *In re Micromet Shareholders Litigation*,[2] issued on the same day as the *El Paso* decision, 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." In addition, due to institutional informational barriers, the holdings and interests of many parts of an investment bank will, by necessity, be unknown by the team providing financial advice. Although boards should make inquiries about a financial advisor's interests in potential bidders, *El Paso* should not be read in most situations to require concern about holdings and interests that fall below the thresholds required for public filings and that the financial advisory team would be unaware of due to firewalls.

- The *El Paso* opinion suggests that, in addition to inquiring into its financial advisor's investments, the board should also consider inquiring as to whether the senior bankers who will be advising the board have significant ownership stakes in potential bidders. Again, however, not all such interests will be material or raise potential conflicts, and the board should recognize that there may be legitimate practical limitations on the ability to conduct such an inquiry.

- A board should carefully consider the incentives created by the fee arrangements agreed to with its financial advisor. Certainly, as the Chancery Court has repeatedly recognized, there are legitimate reasons for a board to agree to a pure

[2] C.A. No. 7197-VCP (Del. Ch. February 29, 2012).

success-based fee or for an engagement to provide that no fee or perhaps a nominal fee be payable in the event a transaction is not consummated. Many potential transactions are explored with the assistance of financial advisors, and no board wants to pay a substantial fee if a transaction is not completed. However, in circumstances in which a second financial advisor is retained to address a potential conflict, *El Paso* counsels that a board should be particularly mindful of the potential impact of fee arrangements agreed to with that financial advisor.

- For financial advisors, already on guard after Vice Chancellor Laster's opinion last year in the *Del Monte* case, the *El Paso* opinion counsels continued caution in considering sell-side conflicts. The Delaware Chancery Court judges appear to be subjecting financial advisors' potential conflicts and the customary measures used to address those potential conflicts to increased scrutiny. It is therefore important that a financial advisor carefully vet potential conflicts with its own counsel and keep its counsel updated on developments in the transaction process. In addition, at the outset or in advance of an engagement, financial advisors and their counsel should work with boards and their advisors to put the financial advisors' relationships and interests in perspective and to permit appropriate and well-informed deliberation by the board with the objective of arriving at sensible and practical approaches to the engagement.

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