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DELAWARE COURT SHARPLY CRITICIZES CONFLICTS OF INTEREST IN HIGH-PROFILE CORPORATE MERGER

Despite misgivings with M&A process, Court refuses to issue injunction and allows stockholder vote to proceed

In a colorful opinion authored by Chancellor Strine, the Delaware Court of Chancery recently addressed management and financial advisor conflicts of interest in the context of an M&A transaction. Although the Court ultimately declined to preliminarily enjoin a highly-publicized merger in *In re El Paso Corporation Shareholder Litigation*[1] in favor of allowing target company stockholders "a chance to turn down the Merger at the ballot box", the Court went to great lengths to explain how a process tainted by conflicts of interest on the part of both the target's CEO and financial advisor could, under the right circumstances, lead a court to find that the transaction does not pass muster under an enhanced *Revlon*[2] analysis.

It should be noted at the outset that the Court's opinion in *El Paso* was issued in the context of a motion for preliminary injunction filed by a group of stockholders seeking to delay the transaction on the basis that the merger process was "tainted by disloyalty" due to alleged conflicts of interests on the part of El Paso's CEO and financial advisor. As a result, any factual statements in the Court's opinion are subject to being proven at trial, if any, and the Court made no definitive findings of fact. However, if one assumes that the statements of fact relied on by the Court prove to be accurate, the opinion provides helpful guidance for boards of directors and their advisors in conducting M&A transactions.

1 2012 WL 653845 (Del. Ch. February 29, 2012).

2 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

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Background

El Paso Corporation is a publicly-held energy company "composed of two main business segments: a pipeline business, which transports natural gas throughout the United States, and the E&P business, which looks for and exploits opportunities to drill and produce oil and natural gas." On May 24, 2011, El Paso announced a plan to spin-off its E&P business and retained its "longtime advisor", Goldman Sachs, to provide financial advice. The market reacted favorably to this announcement and El Paso's stock price increased.

On August 30th, Kinder Morgan, Inc., another publicly-held energy company, sought to derail the proposed spin-off (and thereby prevent the pipeline business from being put into play once separated from the E&P business) by making a non-public bid for all of El Paso's outstanding shares, offering $25.50 per share in cash and stock. After the El Paso board of directors rejected this overture on the basis of both inadequacy of price and inopportune timing, on September 9 th Kinder Morgan "threatened to go public with its interest in buying El Paso." In the face of this threat, El Paso entered into negotiations with Kinder Morgan.

Because Goldman owned 19% of Kinder Morgan (a $4 billion investment) and controlled two Kinder Morgan board seats, Morgan Stanley was retained by the El Paso board "for financial and tactical advice" and "developing its negotiating strategy" with respect to the Kinder Morgan proposal. Notably, Morgan Stanley's compensation was structured as a contingency fee payable *only if* a merger with Kinder Morgan was consummated; Morgan Stanley would receive no fee if El Paso proceeded instead with the previously announced spin-off proposal. Goldman also continued to provide advice to El Paso but, to "cabin" these potential conflicts of interest, it established an internal "Chinese wall" and arranged for the Goldman directors on Kinder Morgan's board to recuse themselves from all merger-related discussions. Unbeknownst to the El Paso board, however, the Goldman lead banker on the El Paso engagement personally owned approximately $340,000 of Kinder Morgan stock.

On September 16th, El Paso CEO Doug Foshee, who was deployed by the board "as its sole negotiator," asked Kinder Morgan to increase its bid to $28 per share. Foshee and Rich Kinder, Kinder Morgan's CEO and controlling stockholder, reached an agreement in principle two days later for a deal "at $27.55 per share in cash and stock, subject to due diligence by Kinder Morgan." Within a week, however, Kinder Morgan withdrew its bid on the ground that it had mistakenly "relied on a bullish set of analyst projections." Foshee ultimately communicated to Kinder Morgan (without El Paso board approval) that he would consider accepting a reduced bid of $26 per share in cash and stock.

Finally, on October 16th, the El Paso board accepted a Kinder Morgan offer of $26.87 per share, comprised of $25.91 in cash and stock and a warrant indicatively valued at $0.96 per El Paso share. This price represented a 37% premium to market and the El Paso board was separately advised by Morgan Stanley and Goldman Sachs that "the offer was more attractive in the immediate term than doing the spin-off and had less execution risk …."

The merger agreement signed by Kinder Morgan and El Paso contained several deal protections, including (1) a "no shop" provision, (2) a match right for Kinder Morgan with regard to any "Superior Proposal", defined as a sale of "more than 50% of El Paso's equity securities or consolidated assets," and (3) a $650 million termination fee payable to Kinder Morgan upon El Paso's acceptance of a Superior Proposal. Because the E&P business constituted less than 50% of El Paso's consolidated assets, its sale could not

qualify as a Superior Proposal. Further, if El Paso undertook a sale of the larger pipeline business in response to a Superior Proposal, the $650 million termination would amount to a daunting 5.1% of the equity value of that segment. The combined impact of these deal protections was, in the Court's words, to "effectively preclude a post-signing market check for bids for the separate divisions."

Following the signing of the merger agreement, Foshee approached Rich Kinder (once again, without El Paso board approval) "to try to get Kinder interested in letting El Paso management bid" on the E&P business. Kinder rejected this approach. In the meantime, the market price of Kinder Morgan stock continued to increase, resulting in an increase in the nominal value of Kinder Morgan's offer to $30.37 per El Paso share, representing a 47.8% premium.

Prior to the scheduled El Paso stockholders meeting to approve the merger, a group of El Paso stockholders sought a preliminary injunction of the vote, alleging "that the Merger is tainted by the selfish motivations of both Doug Foshee and Goldman Sachs." As the basis for their suit, plaintiffs pointed to several "questionable" decisions of the El Paso board, including (1) "[t]he failure of the Board to shop El Paso as a whole or its two key divisions separately … despite knowing that although there would be a number of bidders for the company's two key divisions if marketed separately, there was unlikely to be any rival to Kinder Morgan willing to purchase El Paso as a whole," (2) "[t]he failure of the Board to reject Kinder Morgan's initial overtures and force it to go public and face the market pressure to raise its offer," (3) allowing Foshee to handle all negotiations "without any presence or close supervision by an independent director or legal advisor," (4) "[a]llowing Kinder Morgan … to renege on an agreement in principle to pay cash and stock equal to $27.55" and (5) the various deal protection mechanisms "that would effectively preclude a post-signing market check for bids for the separate divisions …."

The Court's Analysis

The Court addressed plaintiffs' motion for an injunction by applying the traditional three-prong test under which plaintiffs must demonstrate "(1) a reasonable probability of success on the merits; (2) that they will suffer irreparable harm if an injunction does not issue; and (3) that the balance of equities favors issuance of an injunction."

Probability of Success on the Merits: Impact of Conflicts of Interest

Chancellor Strine began by stating that, "[a]bsent a conflict of interest," the tactical decisions of the El Paso board challenged by plaintiffs provided "little basis for enjoining a third-party merger approved by a board overwhelmingly comprised of independent directors, many of whom have substantial industry experience." Further, the Chancellor explained that "[t]he *Revlon* doctrine, after all, does not exist as a license for courts to second-guess reasonable, but arguable, questions of business judgment in the change of control context, but to ensure that the directors take reasonable steps to obtain the highest value reasonably attainable and that their actions are not compromised by impermissible considerations, such as self interest." On the other hand, "when there is a reason to conclude that debatable tactical decisions were motivated . . . by a fiduciary's consideration of his own financial or other personal self-interests," more stringent judicial review is required.

Turning first to the role of Goldman Sachs, Chancellor Strine pointed to several alleged facts that if true would evidence that Goldman may have "had financial motives adverse to the best interests of El Paso's stockholders." First, despite Goldman's $4 billion investment in Kinder Morgan and the retention of Morgan Stanley "to address Goldman's economic incentive for a deal with, and on terms that favored, Kinder Morgan," Goldman "still played an important role in advising the [El Paso] Board by suggesting that the Board should avoid causing Kinder Morgan to go hostile and by presenting information about the value of pursuing the spin-off instead of the Kinder Morgan deal." This ability "to continue to exert influence over the Merger," along with the undisclosed $340,000 personal investment of Goldman's lead banker in Kinder Morgan, led the Court to note that "there were questionable aspects to Goldman's valuation of the spin-off … that could be seen as suspicious in light of Goldman's huge financial interest in Kinder Morgan." Second, Chancellor Strine expressed concern that Goldman's continued retention as "the exclusive advisor on the spin-off" and "refus[al] to concede that Morgan Stanley should be paid anything if the spin-off, rather than the Merger, was consummated" effectively "tainted the cleansing effect of Morgan Stanley …." In sum, "[a]lthough Goldman's conflict was known, inadequate efforts to cabin its role were made."

The Court next turned to the role of Foshee, pointing out that "the supposedly well-motivated and expert CEO entrusted with all the key price negotiations kept from the Board his interest in pursuing a management buy-out of the Company's E&P business." Chancellor Strine explained that this put Foshee in the awkward position of being an "interested . . . buyer of a key part of El Paso at the same time he was charged with getting the highest possible price as a seller of that same asset." This, in the Chancellor's view, gave Foshee an undisclosed incentive to keep the merger consideration low and to avoid "a fist fight of a negotiation" that "might leave a bloodied Kinder Morgan unreceptive to" a smaller subsequent buy-out for the E&P asset.

With these elements in mind, Chancellor Strine explained that the "numerous debatable tactical choices" of the El Paso board outlined in plaintiffs' complaint, which otherwise "could be seen as the sort of reasonable, if arguable, ones that must be made in a world of uncertainty," "now must be viewed more skeptically …." Specifically, the Chancellor noted that "[t]he concealed motives of Foshee, the concealed financial interest of Goldman's lead banker in Kinder Morgan, Goldman's continued influence over the Board's assessment of the spin-off, and the distortion of Morgan Stanley's incentives … leave me persuaded that the plaintiffs have a reasonable probability of success on a claim that the Merger is tainted by breaches of fiduciary duty" and "that more faithful, unconflicted parties could have secured a better price from Kinder Morgan."

Irreparable Harm: Inadequacy of Monetary Damages

Next, Chancellor Strine found "a likelihood of irreparable injury if the Merger is not enjoined" because "the adequacy of monetary damages as a remedy … is not apparent." The independent directors of El Paso were "protected by an exculpatory charter provision" and their "reliance upon Foshee seems to have been made in good faith," making it unlikely that they "could be held liable in monetary damages for their actions." Moreover, the Chancellor noted the difficulty plaintiffs would encounter in proving "an aiding and abetting claim" against either Goldman or Kinder Morgan. Finally, the Chancellor recognized the obvious difficulty that Foshee would have in satisfying a judgment of sufficient magnitude to compensate plaintiff stockholders if they were successful on the merits of their claims.

Balancing of Equities: Let the Stockholders Decide

For the Chancellor, the balancing of equities was "the hardest question." Issuing an injunction would have the effect of "interven[ing] when the El Paso stockholders have a chance to turn down the Merger at the ballot box" at a time when "no rival bidder for El Paso exists." Thus, this was "[u]nlike a situation when this court will enjoin a transaction whose tainted terms are precluding another available option that promises higher value …."

Chancellor Strine inferred that plaintiffs shared this concern because, rather than seeking an outright injunction of the merger, they proposed "an odd mixture of mandatory injunctive relief" that would "permit El Paso to shop itself in parts or in whole" free of the negotiated deal protections, but "force Kinder Morgan to consummate the Merger if no superior transactions emerge." Recognizing that the "traditional tools of equity may not provide the kind of fine instrument that enables optimal protection of stockholders" absent "a trial and a careful evaluation of Kinder Morgan's legitimate interests," the Chancellor concluded that "the El Paso stockholders are well positioned to turn down the Kinder Morgan price if they do not like it." With the balance of equities favoring allowing the transaction to proceed, the Chancellor "reluctantly" denied plaintiffs' motion "despite the disturbing nature of some of the [parties'] behavior."

Conclusion

Like the *Del Monte*[3] case decided just one year ago, *El Paso* is a reminder to boards of directors and their legal and financial advisors of the extent to which conflicts of interest can taint even the most promising M&A transactions offering stockholders a significant premium. *El Paso* also highlights the degree to which financial advisors must carefully police themselves to avoid giving plaintiffs' counsel weaknesses in the deal process to dissect. For, as has been emphasized since the days of *Revlon*, Delaware courts will not hesitate to abandon their inclination to practice judicial restraint where there is an appearance of an effort to sacrifice stockholder value for the benefit of management and/or their advisors.

Postscript

Although Chancellor Strine strongly criticized the process by which the El Paso/Kinder Morgan merger was negotiated, El Paso stockholders ultimately approved the transaction. Following a self-imposed delay of the special meeting for a few days to allow its stockholders to digest this decision, on March 9, 2012, amongst chanting and protests at the stockholders meeting, El Paso stockholders overwhelmingly voted in favor of the merger.

3 *In re Del Monte Foods Co. Shareholders Litigation*, 2011 WL 532014 (Del. Ch. 2011). In contrast to the result in *El Paso*, the *Del Monte* court actually enjoined the stockholder vote for 20 days and suspended the deal protections to allow the target company to seek out (unsuccessfully, as it turned out) a superior transaction. For a discussion of the *Del Monte* decision, please see our Client Alert entitled "*Delaware Court Imposes 20-Day Delay In Merger Vote Due To Challenged Board Process*," dated March 22, 2011.

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