Conflicted advisors causing trouble

Directors are at risk of not being fully informed.

BY DOUG RAYMOND

We recently were reminded that boards of directors must be watchful for potential conflicts of interest, and not just those involving directors; it is equally important to be sensitive to conflicts involving their advisors. This was highlighted by two recent cases in the Delaware Court of Chancery involving investment banks in M&A transactions. In these cases, the price of failing to avoid the conflict was expensive litigation and a temporary injunction that delayed the shareholder vote and risked scuttling the transactions involved.

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In *In re Art Technology Group, Inc. Shareholders Litigation*, the Court of Chancery enjoined a deal because it was concerned about an undisclosed relationship between the target's financial advisor and the proposed buyer. In its original proxy disclosure to shareholders, the seller, Art Technology Group (ATG), explained that its financial advisor, Morgan Stanley, would collect a fee only if the proposed sale was approved. However, the proxy did not disclose that Oracle, the proposed buyer, and Morgan Stanley had a pre-existing relationship dating back years.

Ruling from the bench, Vice Chancellor J. Travis Laster expressed skepticism that ATG's shareholders would be able to appropriately determine the level of credibility to assign to Morgan Stanley's fairness opinion without knowing exactly how much Oracle had previously paid to the bank. In order to remedy this, he enjoined the shareholder vote until the parties had made supplemental disclosure regarding: (i) the services Morgan Stanley had provided Oracle throughout their relationship and (ii) the annual fees Oracle paid to Morgan Stanley during that time. This went well beyond current practice and any federal disclosure requirements.

In the second case, *In re Del Monte Foods Company Shareholders Litigation*, the court enjoined the sale of Del Monte Foods Co. to a buyout group led by Kohlberg, Kravis, Roberts & Co. (KKR) and temporarily prohibited the enforcement of KKR's deal protection measures. This was due to its finding, based on a preliminary record, that the board had likely breached its fiduciary duties by failing to provide the oversight needed to detect its financial advisor's misconduct.

During the sale process, Barclays Capital, Del Monte's financial advisor, worked behind the scenes to favor its handpicked buyer, KKR, evidently so that it could provide buy-side financing in addition to serving as the sell-side advisor. This conflict did not come to light until the litigation, but the court found the board had ignored two prominent warning signals. First, KKR had asked Del Monte to waive the "no teaming" provision in its confidentiality agreement so that it could work with another private equity firm who was a potential competing bidder to make a joint bid (when in fact Barclays had secretly put the two firms together long before the request was made). Then, in the middle of negotiations, Barclays requested permission to provide buy-side financing to KKR (which apparently it had always intended to do) even though alternative sources of financing were available and Barclays was still negotiating the purchase price with KKR on behalf of Del Monte.

According to Vice Chancellor Laster's opinion, even though the board appeared to be acting in good faith, it acted unreasonably by failing to give either request meaningful consideration before acquiescing, and without seeking any benefit to Del Monte in return. Additionally, the court held the deal was further tainted by the board's decision to allow Barclays, who by this time was clearly conflicted, to manage the post-signing market check.

There are a number of steps a board can take to minimize the risk that its decisions will be undermined by the conflicts of its advisors, including:

- Taking precautions to assure that its advisors disclose all potential conflicts and provide full details regarding any request for a waiver.
- Requiring advisors to disclose relationships with potential counterparties. If the relationship is significant, consider the potential impact on the work being undertaken by the advisors, and on the advisor's credibility.
- Being wary of contingent fee structures where advisors are hired for the purpose of providing a fairness or valuation opinion. Contingent fee arrangements may appear to be economical, but can create a bias towards the outcome that will generate the fee.
- Giving meaningful consideration to all decisions being made, not just relying upon the advice of advisors.

While completely eliminating conflicts of interests among advisors may not be possible, following the steps outlined above can minimize the negative impact these conflicts can have on the board's decisions. ■

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