

Client Alert

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Two Delaware Decisions Address CEO Conflicts in M&A Transactions

Two recent Delaware decisions reflect the potential pitfalls of having an interested chief executive officer lead a sale process. These decisions offer an important reminder to boards of directors and officers to identify and manage conflicts of interest. Among other things, the board should identify actual and potential conflicts early and provide for appropriate oversight of the sale process in light of such conflicts.

In re El Paso Corporation Shareholders Litigation

The first decision, *In re El Paso Corp. Shareholders Litigation*, involved a third party's acquisition of El Paso Corporation. During the merger negotiations, the buyer indicated an intent to spin-off one of El Paso's divisions following the merger. After the merger agreement was signed but before the merger closed, El Paso's chief executive officer approached the buyer to discuss a potential management buyout of that division, to be led by the CEO and several other El Paso managers.

The court was highly critical of the CEO for failing to disclose this interest to El Paso's board of directors, since he was El Paso's lead negotiator in the merger. "When anyone conceals his self-interest," the court wrote, "it is far harder to credit that person's assertion that that self-interest did not influence his actions." The court explained that "the reality is that [the CEO] was interested in being a 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." It elaborated that "[a]t a time when [the CEO's] and the Board's duty was to squeeze the last drop of the lemon out for El Paso's stockholders, [the CEO] had a motive to keep juice in the lemon that he could use to make a financial Collins for himself and his fellow managers interested in pursuing an MBO of the E&P business." In the court's view, the CEO had a potential incentive not to maximize the value of the corporation, since that might increase the price the buyer might seek in selling the division. The court also suggested the CEO might want to avoid a "fist fight" in negotiating the merger with the buyer in order to preserve a friendly relationship for the later buyout negotiations.

In re Delphi Financial Group Shareholder Litigation

The second case, *In re Delphi Financial Group Shareholder Litigation*, involved the sale of a company that had dual classes of stock. The company's public shareholders held one class, while the founder and CEO held the other high-vote class, which entitled him to 49% of the company's voting power. When the company was first approached about a potential transaction, the CEO did not disclose to the board of directors that he intended to seek a control premium for his shares. There were also allegations that the CEO had reached a separate agreement relating to the sale to the buyer of certain other businesses owned by the CEO that provided services to the company. The revelation during the litigation of the alleged side agreement caused the company's special committee to revise the company's proxy materials to explain the potential arrangement.

The court was critical of the CEO for conferring first with other senior managers about his ability to seek a control premium and not promptly informing the directors, noting that "[d]espite using Delphi resources in procuring this advice, [the CEO] did not inform the Board of his desire for disparate consideration until a [later] Board meeting." The court also reviewed the CEO's negotiations with the board, saying that his

“gamut of emotions confirmed that the Kübler-Ross Model [i.e., the five stages of grief] indeed applies to corporate controllers whose attempts to divert merger consideration to themselves at the expense of the minority stockholders are rebuked by intractable special committees.” The court voiced its concern that “the process by which [the CEO] negotiated both as a fiduciary for Delphi and, at the same time, for himself as a controlling stockholder, is troubling.” Ultimately, however, the court concluded that the CEO likely had an incentive to obtain the best aggregate price possible for the company in order to maximize his sale proceeds.¹

Takeaways

El Paso and *Delphi* are reminders that boards of directors and their advisors should assess potential conflicts of interest early in the M&A process. The failure to identify a conflict in the early stages of a sale process may haunt the directors later. As the *El Paso* court noted, the board of directors may have conducted the process differently had the directors been aware of various conflicts of interest. In addition, both cases found that the stockholder-plaintiffs had a reasonable probability of success in pursuing claims after the closings against the respective CEOs, albeit for different reasons.

These cases are also a reminder about dealing specifically with senior management's potential conflicts of interest in a sale process. Delaware courts have expressed concerns where potentially conflicted managers have negotiated transactions without adequate oversight from independent directors or have gotten too far in front of their boards of directors.² Although this is by no means a new issue, it received significant attention between 2005 and 2007, as numerous companies were acquired by private equity firms. Referring to those transactions, the *El Paso* court observed that some of them “might have been good for investors, but the suspicion that they were not on the ‘best’ terms available lingers for rational reasons.” Thus, boards need to exercise proper oversight of the process in a manner that is commensurate with any conflicts of interest.

In some cases, the board's oversight may lead it to form a special committee. Historically, special committees have been composed of a subset of the company's disinterested and independent directors. In *Delphi* and another recent Delaware case, however, the special committees were composed of all the outside directors.³ In both cases, furthermore, the special committees formed smaller subcommittees to provide for more active oversight or to address specific issues.

¹ The court held that the plaintiff had a reasonable probability of success in pursuing a different claim — namely, that the CEO had breached a contractual or fiduciary duty in seeking a control premium for his shares. Delphi's certificate of incorporation provided that both classes of stock would be treated equally in a merger. The court reasoned that stockholders had purchased Delphi stock with the understanding that the CEO could not seek a control premium. Thus, the court found that the plaintiff was reasonably likely to show that the CEO's insistence that the certificate of incorporation be amended in connection with the merger to permit a control premium for his shares constituted a breach of a legal duty. Importantly, both *El Paso* and *Delphi* were issued on preliminary records on the plaintiffs' motions to preliminarily enjoin the mergers.

² See *In re SS&C Techn., Inc. S'holders Litig.*, 911 A.2d 816, 820 (Del. Ch. 2006) (questioning the effect of a CEO's negotiations without the special committee's involvement); see also *In re Zenith Nat'l Insur. Corp. S'holders Litig.*, C.A. No. 5296-VCL, Transcript ruling (Del. Ch. Apr. 22, 2010) (“[A] CEO-directed process always carries risks which is that somebody like me will schedule an injunction proceeding so that plaintiffs can find out what really happened.”).

³ The other case was *In re Smurfit-Stone Container Corp. S'holder Litig.*, C.A. No. 6164-VCP, mem. op. (Del. Ch. May 24, 2011).

None of these cases should be read as to preclude a company's CEO from leading merger negotiations.⁴ To the contrary, this is common and the chief executive officer is typically best situated to represent the corporation. Rather, the issue typically is the extent to which the board oversees the CEO's role in the negotiations. The directors may be able to fulfill their duties by obtaining regular updates from the CEO and other senior management, by establishing management's negotiating authority, and by imposing restrictions on management's ability to negotiate post-closing employment terms.⁵ In other situations, it may be advisable for the special committee's or board's advisors to be present in key negotiations.⁶ The lesson, therefore, is to identify actual and potential conflicts promptly and decide how best to address them under the circumstances.

Finally, boards should remain sensitive to conflicts of interest with outside advisors, an issue highlighted in last year's decision in *In re Del Monte Foods Co. S'holders Litigation*. In *El Paso*, the company's financial advisor had a significant equity interest in the buyer. For that reason, the company engaged a second financial advisor on a customary contingency fee basis, but it did not authorize that second financial advisor to consider other strategic alternatives. The court found that the second banker's limited engagement failed to cleanse the conflict of its first financial advisor. The court also criticized the company's decision to allow the first financial advisor to consider advising the board of directors on its strategic alternatives. Thus, *El Paso* is another reminder that boards should continue to review potential conflicts of interest with their financial advisors and to consult counsel in addressing any material conflicts.

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⁴ See *Alidina v. Internet.com, Corp.*, 2002 Del. Ch. LEXIS 156 (Nov. 18, 2002) ("There is nothing inherently wrong with allowing an interested CEO to negotiate a transaction."); *In re NYMEX S'holder Litig.*, C.A. No. 3621-VCN, mem. op. at 20 (Del. Ch. Sept. 30, 2009) ("It is well within the business judgment of the Board to determine how merger negotiations will be conducted, and to delegate the task of negotiating to the Chairman and the Chief Executive Officer."); *In re the MONY Group Inc. S'holder Litig.*, 852 A.2d 9, 20 (Del. Ch. 2004) ("A board appropriately can rely on its CEO to conduct negotiations...."); see also *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007) (finding that, although the CEO negotiated the terms of the merger agreement "outside the presence of Special Committee supervision, there is no evidence that that decision adversely affected the overall reasonableness of the board's efforts to secure the highest possible value.").

⁵ See, e.g., *In re Dollar Thrifty S'holder Litig.*, C.A. No. 5458-VCS, mem. op. at 60 (Del. Ch. Sept. 8, 2010) (stating that "throughout the negotiation process, [the CEO] kept the independent directors, particularly ... the Board Chairman, informed through frequent emails and other communications").

⁶ See, e.g., *In re Netsmart Techn., Inc. S'holders Litig.*, 924 A.2d 171, 194 (Del. Ch. 2007) (stating that the special committee "was also less than ideally engaged" and left the CEO "unattended to bandy [post-closing employment] issues around with the invited bidders").