The Legal Intelligencer

How to Negotiate a Merger: Delaware Case Presses for Answer

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To date, the most significant judicial consequence of the litigation has been a candid, almost pained, decision by Chancellor Leo E. Strine Jr. declining to enter a preliminary injunction to block the merger. Although Strine declined to grant an injunction, he lustily criticized El Paso's board and management for their unsavory conduct and disregard of basic conflicts principles. As such, the Chancery Court's opinion provides a stern warning about conduct appropriate in merger negotiations while, at the same time, preserving Delaware's tradition of deference to corporate decision-making consistent with shareholder interests. Moreover, the case has this interesting procedural twist: Despite the denial of a preliminary injunction and an overwhelming shareholder vote approving the merger, the case continues.

Prior to its merger with Kinder Morgan, El Paso was an energy company with two main businesses: a pipeline business, which transported natural gas throughout the country, and an exploration and production business, which discovered and exploited opportunities to drill and produce oil and natural gas. In 2011, Kinder Morgan, another pipeline company, approached El Paso about a possible acquisition. El Paso rejected Kinder Morgan's initial bid. Kinder Morgan responded with a threat to go public with its interest, according to the opinion in *In re El Paso Shareholder Litigation*. Instead of using this opportunity to generate bids through a public struggle, El Paso's board entered into private negotiations with Kinder Morgan.

El Paso's board entrusted the merger negotiations to El Paso's CEO, who quickly reached an agreement with Kinder Morgan to sell at $27.55 per share. Term sheets were exchanged. Days later, however, Kinder

Morgan recanted its agreement, claiming its bid was based on "bullish" analyst projections. Rather than threatening to seek other offers at that point, El Paso authorized its CEO to return to the negotiating table and demand nothing less than $26.50 per share. The CEO returned to the board with a deal valued at $25.91 in cash and stock, which was below what the board had authorized. Nevertheless, the El Paso board approved the merger on those terms.

The board's decision to recommend the merger caused shareholders to sue to enjoin the shareholder vote. In addition to the lower price, the shareholder plaintiffs took issue with several other decisions made by El Paso's board. Why didn't El Paso test the market for higher bids prior to or during negotiations with Kinder Morgan? Why didn't the board force Kinder Morgan to go public? Why didn't the board better supervise the CEO charged with negotiating the deal? Even more importantly, wasn't the entire process tainted by profound conflicts of interest affecting both the investment bank (Goldman Sachs) advising El Paso and the CEO negotiating on behalf of El Paso and its shareholders?

Numerous conflicts of interest resounded throughout the negotiation of this sale. First, and "worst of all," according to Strine, was that El Paso's CEO, who conducted all of the negotiations with Kinder Morgan, had a personal interest in purchasing the exploration and production business from Kinder Morgan after the sale to Kinder Morgan was completed. Rather than disclosing to El Paso's board his interest in buying that business, however, the CEO kept this information to himself. Once the merger was finished, he then approached Kinder Morgan's CEO twice to express his interest. Thus, the court observed, while El Paso's CEO should have been negotiating to get the highest price possible for El Paso, he actually had an interest in doing the exact opposite — because the less Kinder Morgan had to pay El Paso for that business, the less it would demand in a sell-off to a subsequent buyer, such as El Paso's own CEO.

But that wasn't the only conflict. El Paso had long used Goldman Sachs as its adviser, and it continued to use Goldman Sachs here. Goldman Sachs, however, had a major financial interest in Kinder Morgan. It owned approximately 19 percent ($4 billion worth) of Kinder Morgan's stock, and it controlled two of Kinder Morgan's board seats, according to the opinion. Despite that conflict, it played a material role in advising El Paso throughout the negotiations with Kinder Morgan. The defendants argued that Goldman had disclosed its interest in Kinder Morgan and had been walled off from the merger negotiations by El Paso's hiring of Morgan Stanley to advise on the merger transaction. Strine, however, was not convinced. He noted that Goldman continued to act as the board's primary adviser regarding certain alternatives to the merger, i.e., a spin-off of the exploration business. In this position, Goldman continued to exert influence over the board, which was deciding between two options: a spin-off strategy or a merger. As evidence of Goldman's continued involvement in the overall merger discussions, the court noted that Goldman insisted on receiving a $20 million fee for its work on the merger and would not agree to share a fee with Morgan Stanley if El Paso rejected Kinder Morgan in favor of the spin-off alternative. To muddy the waters even more, Goldman's lead partner advising El Paso's board failed to disclose that he personally had an interest in the outcome by way of his sizable ($340,000) stock holding in Kinder Morgan, according to the opinion.

Thus, the negotiations with Kinder Morgan were tainted by conflicts affecting both El Paso's chief negotiator and its strategic adviser. As a result, the negotiations with Kinder Morgan could be construed as soft and as tilted toward getting a sale made to Kinder Morgan, even if at a lower than necessary price. Under these circumstances, Strine concluded that the plaintiffs had "a reasonable probability of success on a claim that the merger [was] tainted by breaches of fiduciary duty," the first element required to secure an injunction.

Addressing the second prong of equitable relief, Strine concluded that the plaintiffs would suffer irreparable harm if the injunction were not issued. Money damages, according to the court, would be difficult to recover. The economic difference between Kinder Morgan's original bid and the one agreed to totaled $534 million, and it would be unlikely for the plaintiffs to recover that amount because: (1) El Paso's independent directors are protected by an exculpatory provision in the bylaws and likely acted in good faith throughout the process; (2) El Paso's CEO, who likely did not act in good faith, probably does not have this sum of money in his personal capacity; (3) Goldman may not be held liable because it disclosed its conflict and shared advisory responsibility with Morgan Stanley; and (4) co-defendant Kinder Morgan had no reason to believe conflicts were not adequately addressed and, in any event, was not responsible for them.

Thus, the court found that the shareholder plaintiffs had satisfied two of the three elements needed for a preliminary injunction: irreparable harm and likelihood of success on the merits. Normally, that is enough to sustain preliminary relief, because the third element — the balance of harm — is a logical consequence of the first two. If plaintiffs were injured, and a money award is likely to be inadequate recompense, then, as a matter of sheer logic, the denial of an injunction would cause more harm than the granting of one.

But the court found otherwise. In an unusual twist, the court concluded that despite the defendants' likely breach of fiduciary duty, and the inadequate remedy at law, it would be unfair to deny El Paso's shareholders the opportunity to vote on the deal and decide for themselves whether it was a good one. Indeed, the price negotiated by El Paso presented shareholders with a 37 percent premium over the prenegotiation price. The court also observed that there was no other deal available to the shareholders and, in the absence of competing bids (as was the case in *Revlon*), it seems unfair to deny shareholders the chance to vote on the only proposal being made to them. (Note the paradox here: The reason there was only one bidder was — at least as alleged by plaintiffs — the inadequate effort made by El Paso's board to attract competing bids.)

The court's opinion, thus, is an implied declaration that democracy can cleanse a transaction of impurities. Let the shareholders vote and they can decide for themselves if the deal is sufficiently accretive as to override whatever procedural deficiencies may have tainted the process. There is great power in that reasoning. For, at the end of the day, the rules of fiduciary conduct are designed to protect shareholder interests, and, given the primacy of shareholder interests, aren't the shareholders themselves best situated to declare if a deal is in or against those interests?

But the "democracy model" only works if the vote is a fully informed one based on accurate information. Interestingly, here the court did not order enhanced disclosures to the shareholders before the voting was concluded. Perhaps the court concluded that its very opinion — as clear as it was on the conflicts issues — was itself adequate disclosure. Indeed, the shareholder vote was delayed a short time to allow shareholders to review and evaluate the court's opinion and its commentary about possible breaches of fiduciary duty.

And if the proof is in the pudding, then one need look only to the shareholder vote to see if the board's conduct offended its shareholder constituency. After all was said and done, El Paso's shareholders voted overwhelmingly (95 percent) to accept the merger deal negotiated by the El Paso board with Kinder Morgan.

What conclusions does one draw from this experience? There are several possibilities. One conclusion may be that, with appropriate disclosure to shareholders, there is virtually no reason to enter an injunction that would deprive shareholders of the chance to vote on a board-approved deal. But the court itself hinted that may not be true in a *Revlon* situation, where a second or third bidder has interests of its own that may not be protected by a shareholder vote of the target company. Also, even where there is only one bidder, is it clear that a fully informed vote protects the shareholders? Or are they simply put to an unenviable Hobson's choice: If they accept the deal, they may be selling too low, but if they reject the deal, they get nothing.

Interestingly, the El Paso shareholders' case is still going on. The case has not collapsed after the denial of a preliminary injunction and the consummation of the merger. What are the plaintiffs hoping to accomplish at this point? At first blush, it all seems to be a moot point by now. But perhaps the plaintiffs wish to test the notion that even where there is only one bidder, shareholders can be injured by the very deal they approve — because the deal was negotiated and presented in a way that left them no real option. "Take it or leave it" may be OK, but doesn't the "it" have to be a deal that was negotiated fairly, in good faith and with shareholder interests foremost in mind? This case is still worth watching, if just to see whether that question gets resolved.

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