Mitigating Financial Adviser Conflicts With Second Adviser

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Financial adviser conflicts, whether arising from prior relationships or from the financial adviser's interest in providing buy-side financing, have been a focus in M&A litigation for several years. A second or backup fairness opinion from an independent financial adviser is commonly used to offset the effect of such conflicts, but the Court of Chancery has expressed skepticism as to the value and effectiveness of a second adviser's opinion in conflict situations, as in *Ortsman v. Green*, C.A. No. 2670-N (Del. Ch. Feb. 28, 2007) (ordering expedited discovery where the target's financial adviser participated in buy-side financing despite the company's retention of a separate financial adviser to render a fairness opinion). However, a recent Court of Chancery opinion, *In re Morton's Restaurant Group Shareholders Litigation*, C.A. No. 7122-CS (Del. Ch. July 23, 2013), demonstrates that a second financial adviser, when properly engaged and actively involved, can help to overcome a merger challenge based upon a primary financial adviser's alleged lack of independence.

BACKGROUND OF THE CASE

In *Morton's*, the Court of Chancery dismissed fiduciary duty claims challenging the merger between Morton's Restaurant Group Inc. and Landry's Inc. The plaintiffs argued that the merger should be subject to entire-fairness review, alleging, among other things, that the board of directors of Morton's acted in bad faith by permitting the company's financial adviser, Jefferies, to provide financing to Landry's and that the second fairness opinion issued by KeyBanc was merely a "rubber stamp." The court found that entire fairness was not the appropriate standard of review and, applying intermediate scrutiny, concluded that the board acted reasonably in addressing Jefferies' conflict.

In contrast to previous decisions that called into question the benefit of a second fairness opinion, the court credited the fairness opinions from both advisers and concluded that the board's decision to permit Jefferies to provide financing and to retain KeyBanc as a second independent financial adviser was reasonable. In rejecting the plaintiffs' argument that certain differences between the two fairness opinions established an inference of impropriety, Chancellor Leo E. Strine Jr. found that the differences were much less disturbing than if "somehow two advisers generated by some sort of harmonic convergence, exact replicas of each other's reasoning."

The opinion emphasized the deliberative process followed by the board in response to Jefferies' request to provide buy-side financing and KeyBanc's active role in the sales process, as opposed to it being retained merely to issue an after-the-fact fairness opinion. The court noted that Jefferies' potential buy-side financing arose late in the sales process and only after Landry's had encountered difficulty obtaining financing from other sources. Additionally, an independent M&A committee had recommended to the board that Jefferies be permitted to finance the transaction, provided that Jefferies agreed (as it did) to (1) recuse itself from further negotiations, (2) reduce its fee to partially offset KeyBanc's fee, and (3) opine on whether the resulting transaction was fair to Morton's once the terms were set. The opinion stated that these facts, among others, outweighed any conflict that arose from Jefferies' involvement with the bidder's financing.

Past Delaware opinions have cited the use of a second financial adviser to bolster the credibility of a conflicted primary financial adviser: *Parnes v. Bally Entertainment*, C.A. No. 15192-CC (Del. Ch. Feb. 23, 2001), and *S. Muoio & Co. LLC v. Hallmark Entertainment Investments*, C.A. No. 4729-CC (Del. Ch. Mar. 9, 2011). But, until *Morton's*, the Court of Chancery's more recent decisions have reflected a more skeptical view of the value of a second fairness opinion: *In re Transatlantic Holdings Shareholders Litigation*, C.A. No. 6547-CS (Del. Ch. Aug. 2011) (rejecting the second fairness opinion where the primary adviser controlled the sales process and advised the board and the second adviser merely issued a "post-game" fairness opinion); *In re El Paso Shareholder Litigation*, 41 A.3d 432, 434 (Del. Ch. 2012) (denying "reluctantly" a motion for preliminary injunction and noting as particularly problematic that the conflict-cleansing bank only got paid if the conflicted bank obtained its best-case scenario); and *City of Monroe Employees' Retirement System v. Capps*, C.A. No. 7788-CS (Del. Ch. Jan. 16, 2013) ("The second banker has nothing to do with Delaware judicial decisions. ... The key thing remains for the board to decide: Can that first adviser, who is doing all the cool and important stuff, do they have a real conflict that makes you suspect that their advice would be tainted? If you suspect it, you probably shouldn't hire them.")

BEST PRACTICES IN RETAINING SECOND FINANCIAL ADVISER

Morton's reflects that the Court of Chancery remains concerned about financial adviser conflicts and will examine the role of a second banker contextually in determining what weight, if any, to give to the second adviser's involvement. The mere receipt of a second fairness opinion, standing alone, may not be sufficient to cure a material conflict of interest on the part of the primary financial adviser. Rather, for a second financial adviser's opinion to have a meaningful effect, the board of directors should carefully consider how best to address the conflict and take steps to ensure that the second financial adviser has a meaningful role beyond merely issuing a confirmatory fairness opinion.

Factors that the Court of Chancery may consider in evaluating the effectiveness of a second financial adviser include, but are not limited to, the following:

- The degree to which the board was actively involved in assessing the impact of and response to the primary adviser's conflict, including whether the conflict was, or should have been, anticipated at the outset.

- The degree to which the second financial adviser was actively involved in the sales process and provided substantive, independent advice to the board during the sales process.

• Whether and to what extent the situation giving rise to the conflict can objectively be viewed as providing a benefit to the company and its stockholders, rather than benefiting only the financial adviser.

• The relative compensation arrangements of the first and second adviser, including the degree to which the compensation is contingent, the relative magnitude of each adviser's fee weighted against the efforts and risk undertaken by each adviser, and whether the conflicted adviser's fees were adjusted to account for the increased expense incurred to retain a second adviser.

Financial adviser conflicts are certain to remain a focus in M&A litigation. It remains important for boards to carefully consider potential conflicts of interest at the outset to ensure that the board's financial advisers truly are independent. But where unanticipated conflicts of interest arise, Morton's demonstrates that the retention of a second financial adviser, if properly managed by a well-counseled and actively engaged board, can be effective to minimize the impact of the conflict.

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