Emerging Issues in Working with Financial Advisors

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- Identifying and Addressing Material Investment Banker Relationships
- What’s on the Football Field?
- Selected Projections Issues
Emerging Issues in Working with Financial Advisors

Identifying and Addressing Material Investment Banker Relationships
Disclosure of Material Financial Advisor Relationships

The Focus on Disclosure

- Disclosure of material relationships and actual and potential conflicts of interest has received increased attention given the number of breach of fiduciary duty claims and aiding and abetting breach of fiduciary duty claims based in whole or in part on alleged inadequate disclosure of material relationships and conflicts to the board.

- Boards need to consider the implications of material relationships between prospective financial advisors and potential counterparties and other interested parties (which may include management):

  “But what is critical is that banks have a sensible and defensible disclosure policy that tracks and helps surface potential material conflicts .... It is also vital that there not be a partial approach to conflict disclosure, which leaves open the possibility for “oh by the way” moments that were foreseeable. Disclosure is comforting to clients and the courts, as it suggests a forthright attempt to grapple with self-interest in principled, ethical way. . . . If conflicts were surfaced, contained, and addressed, and a strong hand was given to the impartial members of the board, the plaintiffs’ ability to suggest that those conflicts infected the why [certain decisions were made] is impaired. It will therefore be more difficult for the plaintiffs to get the deal enjoined or to press a damages case.” Strine, Leo E., “Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-Making and Reduce the Litigation Target Zone,” Business Lawyer, Vol. 70 No. 3 (Summer 2015).
Disclosure of Material Financial Advisor Relationships (cont’d)

But Chief Justice Strine has also noted that:

“Banks with the least number of potential conflicts (i.e., boutique banks) are not necessarily the best advisors for a target company...”

“[T]here is a difference between the typical conflicts that involve a bank or lawyer working semi-regularly on engagements for key players, such as private equity firms, and more unusual, more material conflicts.” Strine, Leo E., “Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-Making and Reduce the Litigation Target Zone,” Business Lawyer, Vol. 70 No. 3 (Summer 2015).

And others have observed that:

“The Delaware courts are undoubtedly cognizant and respectful of the fact that the most effective advisory services are often rendered by bankers with relationships that run broadly and deeply in the relevant industry. In general, the courts are not seeking to dictate the choice of adviser, but rather are promoting transparency and supervision.”
http://blogs.law.harvard.edu/corpgov/2012/05/31/delaware-decisions-data-points-not-doctrine/.
Disclosure of Material Financial Advisor Relationships (cont’d)

Examples of What May Need to be Disclosed

- Material investment banking relationships – aggregate fees or revenues received for providing material investment banking advice and services (M&A advisory, capital markets, financing) to most likely buyers during past two years
- Material financial interests – i.e., material amounts of equity, debt and other securities and financial instruments held by the financial advisor and senior deal team members in the most likely buyers
- Loans to or participations in credit facilities of most likely buyers
- Interest in seeking other roles in transaction, such as financing potential buyers
- Recent targeted pitches to potential buyers concerning a potential transaction involving the client (e.g., Zale)
- Material relationships between senior members of the investment banking team (including as a recent employee at other investment banks) and most likely buyers
Disclosure of Material Financial Advisor Relationships (cont’d)

**Mechanics of Disclosure**

- When and how to disclose relationships/actual and potential conflicts of interest:
  - Outset of engagement
    - Single bidder process
    - If limited number of most likely buyers believed to be known
  - Once limited number of likely buyers identified
    - E.g., prior to second round of bids if broad auction)
- How to disclose to the board:
  - Verbally
    - Evidentiary concerns if recollections differ
  - Writing
    - Creates contemporaneous written record
- Where to disclose:
  - Memo to Board of Directors/Board book
  - Engagement letters
Disclosure of Material Financial Advisor Relationships (cont’d)

Board Disclosure Memoranda

- “Board Disclosure Memoranda” are typically provided at a relatively early stage in the sales process, so that the board can make an informed decision with respect to whether the financial advisor will be able to provide the board with the objective financial and strategic advice that the board needs.

- The forms of Board Disclosure Memoranda typically focus on the range of aggregate fees received during the past two years for providing investment banking advice and services (e.g., M&A advisory, capital markets and financing) to the most-likely buyers and any material financial interests the financial advisor has in those most-likely buyers.

- Board Disclosure Memoranda also typically disclose whether any of the senior investment banking professionals assigned by the financial advisor to perform the sellside advisory engagement have material relationships with or financial interests in the most-likely buyers.

- To the extent facts and circumstances warrant, the forms of Board Disclosure Memoranda being used by financial advisors can be modified to provide additional information requested by the board or as otherwise may be appropriate.
Disclosure of Material Financial Advisor Relationships (cont’d)

Engagement Letter Provisions

Disclosure of Material Financial Advisor Relationships (cont’d)

Requirements for Effective Disclosure

Consistent with the theme of Chief Justice Strine’s article, the primary goal of counsel and financial advisors should be to assist boards in making informed business decisions.

- Effective disclosure for purposes of informed board decision making requires three things:
  - **Content** – the disclosure of adequate information regarding the financial advisor’s material relationships with prospective buyers;
  - **Timing** – the disclosure of information at the beginning or at a relatively early state in the sales process; and
  - **Access** – board access and attention to the disclosed information.

- Though not the primary objective, additional benefits of effective disclosure that assists boards in making informed business decisions include the increased likelihood that a board’s decisions will survive legal challenge and the reduced likelihood that a company’s board or its financial advisor will be found liable for any damages resulting from the board’s business decisions.
Disclosure of Material Financial Advisor Relationships (cont’d)

Board Disclosure Memorandum v. Engagement Letter Provisions - Content

- **Content** – The delivery of a Board Disclosure Memorandum to a client’s or prospective client’s board at a relatively early stage in the sale process that discloses the range of aggregate fees received during the past two years (e.g., less than $X million; between $X and $Y million; between $Y million and $Z million; more than $Z million) for providing investment banking advice and services to the most-likely buyers, as well as any material financial interests the financial advisor has in those most-likely buyers, will generally provide the board with adequate information to assess the benefits and risks associated with relying on the financial advisor’s advice when making key decisions.

- Attempting to address the need for adequate disclosure regarding a financial advisor’s material relationships with potential buyers by means of contractual provisions in an engagement letter often results in demands for detailed disclosure that takes a long time to negotiate and prepare (and, to the extent verifiable, adequately verify) and that may require the consent of third parties (e.g., the financial advisor’s other clients) who may not be willing to provide consent in a timely manner, if at all.
Disclosure of Material Financial Advisor Relationships (cont’d)


- **Timing** – Proponents of Board Disclosure Memoranda believe that once a limited number of the most-likely buyers has been identified, information regarding the financial advisor’s material relationships with the most-likely buyers can and should be promptly provided to a client’s or prospective client’s board and periodically updated as facts and circumstances warrant – e.g., to reflect additional likely buyers or material changes in the previously disclosed information regarding the financial advisor’s material relationships with the most-likely buyers.

- Delaying the selection of a financial advisor and/or board action upon its financial advisor’s advice until the detailed disclosure provisions in an engagement letter have been finalized and the resulting disclosures regarding the financial advisor’s material relationships with potential buyers have been reviewed by the board, risks delay that could adversely affect the timing (and potentially even the likelihood) of a successful transaction.
Disclosure of Material Financial Advisor Relationships (cont’d)


- **Access** – Providing a Board Disclosure Memorandum to the board at a relatively early stage in a sales process also significantly increases the likelihood that the board will be better positioned to make informed judgments regarding the selection of a financial advisor and/or the weight to be given to the financial advisor’s advice, the need for additional information regarding those relationships and the possible need for a second advisor.

- Given that contractual provisions in an engagement letter relating to the disclosure of a financial advisor’s material relationships with potential buyers would form only a part of the broader contractual relationship established by a financial advisor’s engagement letter and that engagement letters are often negotiated concurrently with the performance of an engagement, the board may not have adequate time to address the resulting disclosures regarding a financial advisor’s material relationships with potential buyers if the contractually required disclosures are not received until late in the sales process.
Disclosure of Material Financial Advisor Relationships (cont’d)

Board Disclosure Memorandum v. Engagement Letter Provisions - Other

- Other Considerations – In addition, if a primary goal of detailed contractual provisions in an engagement letter relating to the disclosure of the financial advisor’s material relationships with potential buyers is to allocate risk and liability, it is far from clear that such provisions will provide an effective remedy to the company retaining the financial advisor or that company’s stockholders.

- Given that, despite alleged conflicts, virtually all negotiated mergers still close, any contractual claims for breach of provisions in an engagement letter brought by a target company will inure to the benefit of the buyer as the new owner of the target.

- Even if the target becomes aware of such claims prior to the execution of the merger agreement, attempts by the target to negotiate for additional consideration from the buyer reflecting the value of such claims will not likely succeed since buyers will be unlikely to attribute much value to claims against the target’s financial advisor that allegedly resulted in the buyer obtaining a favorable purchase price.
Disclosure of Material Financial Advisor Relationships (cont’d)

*Board Disclosure Memorandum v. Engagement Letter Provisions*

- In practice, it appears that, as a result of the issues and concerns discussed above, the Board Disclosure Memorandum has become the predominant market approach for addressing the need for disclosure of a financial advisor’s material relationships with the most-likely buyers to a client’s or prospective client’s board.
Emerging Issues in Working with Financial Advisors

What’s on the Football Field?
Financial Analyses Underlying Fairness Opinions – What’s on the football field

- **Purpose of the Football Field**
  - Summarizes the financial analysis performed in connection with preparation of a fairness opinion but may include other considerations
  - Format typically tracks the transaction structure
    - dollar values in cash or fixed value transactions
    - exchange ratios in stock-for-stock/fixed exchange ratio mergers
  - As a summary, should be reviewed and considered in the context of the more detailed underlying analysis
    - “All analyses are not created equal” - each reflects a different focus and perspectives and needs to be considered in the context of the specific facts and circumstances presented
    - Different analyses have unique advantages and limitations, and as such, differ in informational value under the facts and circumstances presented
Financial Analyses Underlying Fairness Opinions – What’s on the football field (cont’d)

- Most Common Financial Analyses
  - Selected Companies Analysis
  - Selected Transactions Analysis
  - Discounted Cash Flow Analysis
  - Contribution Analysis (Stock Consideration)

- Other Potential Analyses and Considerations (whether or not on the football field)
  - Historical Stock Trading Analysis (i.e., 52 week high/low)
  - Wall Street Research Price Targets
  - Premiums Paid Analysis
  - Leveraged Buyout (LBO) Analysis
  - Merger Consequences – accretion/dilution
  - Illustrative Future Stock Trading Analysis
Financial Analyses Underlying Fairness Opinions – Selected Considerations

- Choice of Analytical Methodologies, Assumptions and Inputs
  - Exercise of professional judgment taking into account relevant facts and circumstances
  - Precedent, convention and consistency plays an important role in establishing the analytic parameters of the valuation
  - Certain common analyses may be excluded if significant limitations impair their value/utility
Financial Analyses Underlying Fairness Opinions – Selected Considerations (cont’d)

- Choice of Methodologies, Assumptions and Inputs (cont’d)
  - Discounted cash flow analysis
    - Projections are the critical input to the analysis and should reflect management’s current best estimates with respect to the future financial performance of the Company
    - Financial advisors rely upon the Company for the preparation of projections and approval to use/rely upon the projections for purposes of their dcf and other analyses
      - Multiple forecasts endorsed by management can create issues
  - Treatment of synergies, NOLs
  - Other dcf considerations:
    - cost of capital discount rates
      - Equity risk premia, betas and other inputs
    - approaches to terminal valuation
      - multiples vs. perpetuity growth rates
      - terminal value multiples based on selected companies analysis vs. selected transactions analysis
Financial Analyses Underlying Fairness Opinions – Selected Considerations (cont’d)

- Choice of Methodologies, Assumptions and Inputs (cont’d)
  - Selected companies analysis
    - How comparable are the companies relative to each other and to the subject company – business profile, operating and financial metrics
    - Addressing material changes in the subject company’s business- historical and/or projected
    - Relevant metrics for assessing value – industry/company specific
    - Selection of reference ranges: mathematical/fixed criteria vs. exercise of professional judgment (median vs. selected multiple ranges that may not be centered on median)
Financial Analyses Underlying Fairness Opinions – Selected Considerations (cont’d)

- Choice of Methodologies, Assumptions and Inputs (cont’d)
  - Selected transactions analysis (additional considerations to those for selected companies)
    - Timeframe of completed transactions included in the analysis
    - Changes in market conditions over time for the transactions considered
    - Different forms of consideration (cash, cash/stock, all-stock)
    - Different transaction structure terms – 338 (h)(10), acquired NOLs
    - Unique considerations of particular acquirer which impact price paid – quantum of synergies, strategic imperative
Financial Analyses Underlying Fairness Opinions – Selected Considerations (cont’d)

- Selected Discussion Topics
  - Must financial analyses underlying fairness opinions follow case law regarding statutory appraisals?
  - What if management projections generate DCF valuation ranges significantly in excess of the proposed purchase price?
  - What if not all of the analyses support a fairness conclusion?
  - How do inadequacy opinions rendered in response to unsolicited offers differ from fairness opinions?
Emerging Issues in Working with Financial Advisors

*Selected Projections Issues*
Selected Projections Issues

- Do financial advisors prepare projections?
- When and on what basis are projections prepared by management?
  - What is the role of the board and company counsel in supervising the preparation and approval of projections?
- Dealing with unrealistic projections or projections that change or are updated during a sale process.
  - What should a buyer be told and when?
- What if a board/special committee or a financial advisor has reservations regarding a counterparty’s projections?
  - Which are more relevant:
    - counterparty management’s projections for counterparty; or
    - client management’s projections for counterparty?
Selected Projections Issues

- Avoiding disputes regarding the projections on which financial advisors were authorized to rely.

- What if a counterparty won’t provide internal projections?
  - Criteria for determining whether to press for buyer projections?
  - Under what circumstances can you consider relying on publicly available analyst estimates in lieu of internal management projections?

- How should multiple projections cases be considered by the board/special committee and financial advisors?
  - What if management cannot or will not identify a single set of projections representing its best estimates as to the future financial performance of the company?