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Corporate Law

ALERT

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Delaware Chancery Court Reluctantly Declines to Stop Stockholder Vote

Notwithstanding questionable board decisions and significant management and financial adviser conflicts of interest, court allows stockholders to decide whether to approve merger.

The Delaware Chancery Court denied an application for preliminary injunction to stop a stockholder vote on a merger, in *In re El Paso Corporation Shareholder Litigation*, Consolidated CA No. 6949-CS.

El Paso, which has both a natural gas pipeline and a gas and oil exploration and production (E&P) business, announced its intention to spin off the E&P business. The announcement prompted Kinder Morgan, Inc., to make a nonpublic offer to El Paso to acquire El Paso in its entirety. El Paso understood that Kinder Morgan intended to keep only the pipeline business, but wanted to acquire El Paso before the spin-off, to discourage other bidders for the pipeline business.

After El Paso's board declined Kinder Morgan's initial $25.50 per share bid, Kinder Morgan threatened to go public with a hostile takeover. El Paso's exclusive financial adviser with respect to the spin-off recommended against tempting Kinder Morgan to commence a hostile bid. Rather than open the field to competitive bidding, the El Paso board authorized the company's CEO alone (without "supervision" from any independent director or legal counsel) to continue private negotiations with Kinder Morgan.

The CEO hadn't disclosed to the board, however, that he wanted to acquire the E&P business from Kinder Morgan, which hoped to dispose of the E&P business before the merger was consummated. Although he withheld his personal overture to Kinder Morgan until after principal merger terms were agreed upon, the CEO would have had a number of reasons to refrain from negotiating the best possible deal for stockholders.

El Paso's financial adviser also owned 19 percent of Kinder Morgan and, as a member of Kinder Morgan's control group, was entitled to designate two of its board members. Due to this obvious conflict of interest, El Paso engaged a second financial adviser to advise the company regarding Kinder Morgan's bid, but the conflict was not entirely ameliorated. The original financial adviser continued to advise El Paso in comparing the value to stockholders of the spin-off relative to the Kinder Morgan bid. Given its interest in seeing the merger completed (although on terms most favorable to Kinder Morgan), the first firm had incentive to undervalue the spinoff. The second financial adviser would receive a $35 million fee upon completion of the merger, but nothing from the $25 million fee if the spin-off was consummated. The second firm was faced with the choice of recommending either the merger and getting paid, or recommending the spin-off and receiving no fee. To ensure that its first firm would receive a fee even if a transaction with Kinder Morgan precluded the spin-off, El Paso's board agreed to pay the firm $20 million upon consummation of the merger, notwithstanding the firm's claim that it was not giving El Paso merger advice. (The firm also sought credit as a financial adviser to El Paso when the merger agreement was announced.) In addition, the firm's lead adviser to El Paso did not inform El Paso that he personally owned $340,000 of Kinder Morgan stock.

In the negotiations, Kinder Morgan increased its offer to $27.55, in cash and stock, per El Paso share. A few days later, claiming it had made a mistake, Kinder Morgan replaced the bid with an offer of $25.91, in cash and stock, and a Kinder Morgan stock purchase warrant, for total consideration of $26.87 per El Paso share, which El Paso accepted. The merger agreement contained a no-shop clause that precluded El Paso from separately selling the E&P business and a termination fee likely to foreclose bids on the pipeline business.

Notwithstanding the 37 percent premium to market that the merger consideration represented, plaintiff stockholders contended that the conflicts of interest prevented stockholders from receiving more and cited a number of questionable decisions made by the board to support their view. Agreeing that “more faithful, unconflicted parties [probably] could have secured a better price from Kinder Morgan,” the court nonetheless declined the stockholders’ application for injunctive relief.

Although stockholders might not be made whole by money damages, the court reasoned that the value of the merger consideration was sufficiently attractive that reasonable stockholders might want - and therefore should be allowed - , to accept it. No other bidder had emerged, and enjoining the merger might result in its termination. The court believed that the unusual mandatory relief plaintiffs requested reflected this quandary. Acknowledging that “[t]he kind of troubling behavior exemplified here can result in substantial wealth shifts from stockholders to insiders,” the court concluded that more injury probably would result from granting plaintiffs’ motion than denying it. The court ventured, however, that for the financial adviser, El Paso’s CEO, and perhaps other El Paso managers, “the likely prospect of a damages trial is no doubt unpleasant.”

For more information about the content of this alert, please contact David Fischer or Giovanni Caruso.

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Corporate Group

DAVID P. ANSEL	DANSEL@LOEB.COM	212.407.4837
CURTIS W. BAJAK	@LOEB.COM	310.282.2377
ROBERT S. BARRY JR.	RBARRY@LOEB.COM	310.282.2258
KENNETH R. BENBASSAT	KBENBASSAT@LOEB.COM	310.282.2340
NORWOOD P. BEVERIDGE, JR.	NBEVERIDGE@LOEB.COM	212.407.4970
GREGORY J. BLASI	GBLASI@LOEB.COM	212.407.4236
KARL E. BLOCK	KBLOCK@LOEB.COM	310.282.2225
JENNIFER BOROW	JBOROW@LOEB.COM	310.282.2311
GIOVANNI CARUSO	GCARUSO@LOEB.COM	212.407.4866
ERIK W. CHALUT	ECHALUT@LOEB.COM	312.464.3182
GERALD M. CHIZEVER	GCHIZEVER@LOEB.COM	310.282.2121
MIRIAM L. COHEN	MCOHEN@LOEB.COM	212.407.4103
STEPHEN H. COHEN	SCOHEN@LOEB.COM	212.407.4279
WALTER H. CURCHACK	WCURCHACK@LOEB.COM	212.407.4861
JOSEPH F. DANIELS	JDANIELS@LOEB.COM	212.407.4044
ANGELA M. SANTORO DOWD	ADOWD@LOEB.COM	212.407.4097
ALLAN B. DUBOFF	ADUBOFF@LOEB.COM	310.282.2141
KEVIN M. EISENBERG	KEISENBERG@LOEB.COM	212.407.4123
DAVID C. FISCHER	DFISCHER@LOEB.COM	212.407.4827
HAROLD A. FLEGELMAN	HFLEGELMAN@LOEB.COM	310.282.2394
JEFFREY S. FRIED	JFRIED@LOEB.COM	212.407.4987
SCOTT J. GIORDANO	SGIORDANO@LOEB.COM	212.407.4104
CHELSEA A. GRAYSON	CGRAYSON@LOEB.COM	310.282.2188
JAMES V. INENDINO	JINENDINO@LOEB.COM	312.464.3148
MICHAEL W. JAHNKE	MJAHNKE@LOEB.COM	212.407.4285
CHANNING D. JOHNSON	CJOHNSON@LOEB.COM	310.282.2322
STAN JOHNSON	SJOHNSON@LOEB.COM	212.407.4938
CHRISTOPHER J. KELLY	CKELLY@LOEB.COM	310.282.2263
ARASH KHALILI	AKHALILI@LOEB.COM	310.282.2282
ROBERT B. LACHENAUER	RLACHENAUER@LOEB.COM	212.407.4854
FRANK LEE	FLEE@LOEB.COM	212.407.4825
ELIZABETH L. MAJERS	EMAJERS@LOEB.COM	312.464.3142
FRANK J. MARINARO	FMARINARO@LOEB.COM	+86 10 5954 3588
COREY N. MARTIN	CMARTIN@LOEB.COM	212.407.4841
BARRY T. MEHLMAN	BMEHLMAN@LOEB.COM	212.407.4812
MITCHELL S. NUSSBAUM	MNUSSBAUM@LOEB.COM	212.407.4159
BRYAN G. PETKANICS	BPETKANICS@LOEB.COM	212.407.4130
THOMAS ROHLF	TROHLF@LOEB.COM	310.282.2240
ANDREW M. ROSS	AROSS@LOEB.COM	212.407.4838
LLOYD L. ROTHENBERG	LROTHENBERG@LOEB.COM	212.407.4937
DAVID S. SCHAEFER	DSCHAEFER@LOEB.COM	212.407.4848
PETER G. SEIDEN	PSEIDEN@LOEB.COM	212.407.4070
PAUL W. A. SEVERIN	PSEVERIN@LOEB.COM	310.282.2059
FRAN M. STOLLER	FSTOLLER@LOEB.COM	212.407.4935
LAWRENCE VENICK	LVENICK@LOEB.COM	310.282.2318
TAHRA T. WRIGHT	TWRIGHT@LOEB.COM	212.407.4122