Corporate Finance/M&A - Italy

Conflicts of interest: how many fingers can you put in one pie?

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Introduction

In 2012 the $21 billion Kinder Morgan bid for El Paso was challenged before the Delaware Court of Chancery due to alleged breach of fiduciary duties by both advisers and company executives. A billion-dollar deal, a chief executive officer with underlying motives and conflicted investment banks are the perfect elements of a modern play with plenty of drama and plot twists for the international legal community. But what if this deal had happened in Italy?

This update briefly analyses the Italian laws applicable to financial advisers' and directors' conflicts of interest that would apply to an Italian equivalent of the El Paso/Kinder Morgan deal.

In brief: the El Paso/Kinder Morgan deal

El Paso, a pipeline energy company, was targeted by fellow competitor Kinder Morgan's initial public offering in 2011. At the time, Goldman Sachs was advising both the bidder and the target on different matters. Kinder Morgan had entertained a long-term business relationship with the investment bank, which resulted in Goldman Sachs:

- acquiring a 19.1% ownership interest in Kinder Morgan (although indirectly through Goldman Sachs's private equity arm);
- gaining the right to appoint two members of Kinder Morgan's board; and
- advising Kinder Morgan during its privatisation process in 2006.

On El Paso's side, Goldman Sachs was assisting the company in the evaluation process of the pros and cons of a spin-off of its exploration and production business. Moreover, El Paso's chief executive, Mr Foshee – while negotiating with Kinder Morgan on the advice of Goldman Sachs – apparently intended to buy personally from Kinder Morgan the exploration and production business to be spun off following completion of the deal.

The love triangle soon became clear and unsustainable; this caused Goldman Sachs to step back by leading the two directors on Kinder Morgan's board to recuse themselves from discussion on the hypothetical bid for El Paso. On the El Paso front, Goldman Sachs disclosed the potential conflict and requested to retain Morgan Stanley as additional adviser on the bid; under Goldman Sachs' intentions, the co-adviser should have given El Paso impartial advice. This was not enough to prevent El Paso shareholders from challenging the merger.

The *In re El Paso* shareholder litigation was a shareholder class action lawsuit in the Delaware Court of Chancery challenging the merger between El Paso and Kinder Morgan mainly on the grounds that it was the product of breaches of fiduciary duty by El Paso's board, supported by Kinder Morgan and El Paso's financial adviser, Goldman Sachs.

The story came to an end in December 2012 with the execution of a $110 million settlement agreement approved by the Delaware court in which the main players (Goldman Sachs, Kinder Morgan and Foshee) declared that they had "diligently and scrupulously complied with all of their legal duties and obligations". In addition, Goldman Sachs waived the $20 million fee it had accrued to demonstrate its good faith in the deal. The purpose of the settlement was to avoid costly and time-consuming litigation for Kinder Morgan and El Paso.

Financial advisers' conflicts of interest

In several non-EU jurisdictions, shareholders' interests are protected by financial advisers or other auditing bodies that must be hired by bidders on a mandatory basis. In Italy, neither the financial adviser's activity nor its possible conflict of interest are regulated by any statute other than those governing the contractual relationship between the client and the adviser. Even with respect to public companies, there is no obligation for the offeror's board to appoint a financial adviser; however, in practice, financial advisers are often retained by the offeror to advise on the legality and feasibility of bids, which is done mainly to avoid or minimise directors' liabilities.

This legal framework does not directly protect third parties that may be indirectly damaged by advisers' breach of the terms of the engagement letters governing the relationship with their clients. In an era in which "we are all totally conflicted – get used to it" (according to Robert A Kindler, vice chairman of Morgan Stanley), advisers usually try to deal internally with conflicts of interest, and this is also the case in Italy. Internal guidelines on management of conflicts of interest are in fact quite common in Italy. However, such guidelines create no duties with respect to third parties (eg, public companies' shareholders) and therefore give shareholders no right to request their enforcement in a courtroom in case of breach.

Under certain conditions, advisers could be held liable for extra-contractual (ie, tort) liability. This type of liability would allow shareholders to claim for the direct damages they suffered as a consequence of the financial advisers' actions. However, shareholders will bear the burden to prove:

- the fraudulent or grossly negligent conduct of the financial advisers; and
- the causation of damages by the financial advisers' conduct.

Finally, an additional and unsolved problem is how to deal with conflicts of interest in an economy where everyone knows everyone, and where each major adviser has certainly dealt with one party or another, directly or indirectly, in an earlier deal (particularly in smaller jurisdictions). Goldman Sachs's idea of appointing a co-adviser on the target's side appeared to be a good idea, but it was deemed faulty, as other conflicting interests were deemed to have prevailed; the same probably would have applied in Italy.

Directors' conflicts of interest

From an Italian legal standpoint, a different scenario opens with reference to directors' liability for breach of loyalty and conflict of interest. As in many other jurisdictions, Italian law requires directors to abide by several 'fiduciary duties' towards the company and directors should always act in the best interest of the company that they represent.

The Civil Code sets forth the duty of each director to disclose any interest – both direct and indirect, regardless of whether such interest is in conflict – in all transactions involving the company. In such case, the 'interested' director must inform the board of directors, as well as the panel of statutory auditors (roughly similar to an audit committee), about the nature, terms, origin and magnitude of his or her interest. If the interested director has executive authority, he or she must not perform the transaction. The board approving a transaction in which there is an interested director must adequately justify the reasons for approving the transaction.

In general, a director's liability under the law to the company, the creditors and each individual shareholder (or even other parties) can be claimed before a court where the director:

- does not comply with the duties provided for by law or by the company's articles of association with

the diligence required by the nature of his or her office (eg, executive director, as opposed to non-executive or independent director) andhis or her specific expertise (eg, a lawyer, as opposed to an accountant or a medical doctor on the board of a pharmaceutical company), and his or her conduct causes damages to the company;
- causes damage to the integrity of the company's assets, where they are insufficient for the satisfaction of creditors; or
- commits fraudulent or grossly negligent conduct that causes direct damage to the individual shareholders or to third parties.

In light of the above, the law governing directors' liability has a strict framework that allows market players to explore different solutions in structuring a deal without the board of directors jeopardising shareholders' rights of due diligence and loyalty.

Comment

First and foremost, directors should always ensure that formal requirements are strictly complied with in any transaction – they must make sure that:

- every necessary or useful piece of paperwork is duly drafted and executed;
- the terms of the deal are strictly complied with and any departure from the agreed terms is appropriately documented; and
- all required or advisable resolutions are carefully considered and, if possible, lawfully adopted.

Furthermore, directors are jointly liable for the unlawful conduct of other directors if they have failed to monitor the other directors' activities. Complying with such formal requirements could go a long way towards demonstrating compliance with the duty of care and due diligence before a court.

Had the El Paso/Kinder Morgan deal occurred in Italy, Foshee should have disclosed any interest in the transaction and recused himself from negotiating the deal. Failure to do so could not only result in a court order blocking the corporate resolution adopted due to the vote of the 'Italian Foshee', but could also trigger his liability to the company for the damages deriving from his action or omission and arising from the use of company information or business opportunities for his personal benefit.

The other directors should ensure that when selecting advisers, evaluating the deal and approving the transaction, appropriate reporting and monitoring systems are in place to enable the directors to make informed decisions. Furthermore, if informed of a conflict or if they would have been aware of the conflict had they used the care required of them, the other directors should clearly indicate their disapproval of the transaction.

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