The Advocate
FOR INSTITUTIONAL INVESTORS

Goldman Sachs and the Art of the Deal

Heads: We Win! Tails: You Lose!

By Mark Lebovitch and Jeremy Friedman

Delaware Court Chastises Goldman for Indifference to Conflicts of Interest in Landmark *El Paso* Decision

On February 29, 2012, Chancellor Leo Strine of the Delaware Court of Chancery issued a landmark ruling in *In re El Paso Corporation Shareholder Litigation* that promises to change the way Wall Street banks handle potential conflicts of interest when advising their clients on corporate transactions. Wall Street firms are regularly paid tens of millions of dollars to advise their corporate clients on whether potential transactions are in the best interests of shareholders. Most professionals, like attorneys or auditors, are subject to well-established ethical obligations to recuse themselves from providing advice when their personal financial interests are adverse to the interests of their clients. Chancellor Strine's opinion in *El Paso* highlights the disturbing fact that, even following the recent financial crisis and a consistent stream of stunning revelations and corporate scandals, some Wall Street firms and corporate executives still think these basic rules do not apply to them.

Kinder Morgan is an energy pipeline operator. In 2006, Goldman Sachs assisted Rich Kinder, the founder of Kinder Morgan, in taking the company private in one of history's largest private equity buyouts. Goldman Sachs acquired a $4 billion equity stake in the company and control of two seats on Kinder Morgan's Board of Directors.

Five years later, in August 2011, Kinder Morgan's CEO privately approached El Paso Corporation's CEO, Douglas Foshee, about buying El Paso. Despite Goldman's massive ownership interest in Kinder Morgan (the potential buyer), Goldman sought and obtained a key role advising El Paso (the target) on whether the sale was in the best interests of El Paso's shareholders. The conflict of interest was plain, as Goldman would profit if Kinder Morgan paid the lowest possible price to acquire El Paso. Making matters worse, Goldman demanded a fee of $20 million for its "advisory services" and staffed the

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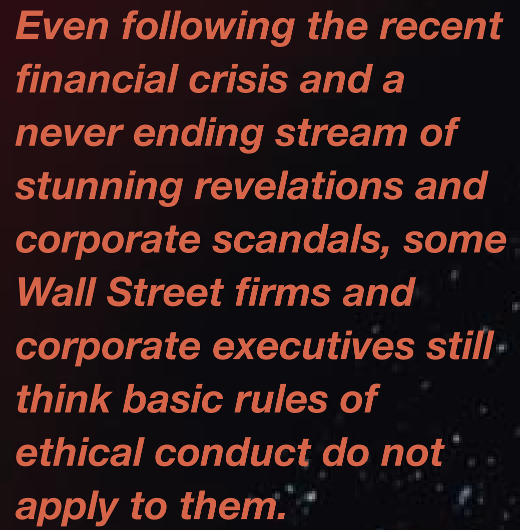

Even following the recent financial crisis and a never ending stream of stunning revelations and corporate scandals, some Wall Street firms and corporate executives still think basic rules of ethical conduct do not apply to them.

assignment with a banker who personally owned more than $300,000 in Kinder Morgan stock.

Rather than remove Goldman from the transaction to avoid this blatant conflict of interest, El Paso retained Morgan Stanley as a second financial advisor. The retention of Morgan Stanley did nothing to cleanse Goldman's conflict of interest. In fact, Morgan Stanley's entire $38 million advisory fee for the transaction was contingent on a sale to Kinder Morgan — exactly what Goldman Sachs wanted. In other words, Morgan Stanley, which was supposed to provide El Paso's Board with unbiased advice, was given a $38 million incentive to justify a sale to Kinder Morgan (and its owner, Goldman Sachs) regardless of whether this was the best option for El Paso's shareholders.

Corporate insiders also had misaligned personal incentives. While negotiating the terms of a potential sale with Rich Kinder, El Paso's CEO Foshee and other members of El Paso's senior management learned that Kinder planned to sell off one of the company's core businesses after acquiring El Paso. Foshee and his senior managers saw an opportunity to profit by acquiring these assets from Kinder Morgan. If these managers tried to buy these assets from El Paso while it remained a public company, they would face harsh scrutiny from El Paso's investors and the courts. As a result, it was in the El Paso CEO's personal interest to complete a deal with Kinder Morgan even if it was at a less than ideal price for El Paso's shareholders. Remarkably, CEO Foshee did not tell the Board about his conflict of interest. Instead, he served as the deal's primary negotiator and aggressively advocated for the deal to the El Paso Board, even at prices below the Board's clearly stated "floor" price for any deal.

Each of these conflicts of interest came to the forefront when Kinder Morgan, after initially agreeing to pay $27.55 per share of El Paso stock, informed El Paso that the deal had to be renegotiated. Citing an "error" in its valuation model, Kinder Morgan claimed that it would not complete the deal unless El Paso accepted less money per share. Instead of calling out Kinder Morgan's gamesmanship, El Paso's Foshee and his financial advisors readily agreed to recut the deal at a lower price for El Paso shareholders and to accept stock warrants of speculative value.

On October 21, 2011 a group of public pension fund shareholders filed a class action lawsuit alleging, among other things, that the El Paso Board breached its fiduciary duties in connection with the sale to Kinder Morgan and that Goldman Sachs aided and abetted the Board's breaches. After hearing the evidence, Chancellor Strine expressed concerns "that Goldman [would] seek to maximize the value of its multi-billion dollar investment in Kinder Morgan at the expense of El Paso." In fact, documents uncovered during the discovery process revealed that even Goldman's co-advisor, Morgan Stanley, expressed dismay at Goldman's willingness to enmesh itself into the deal, writing internally that Goldman's behavior was "shameless."

Chancellor Strine concluded that "Foshee's velvet glove negotiating strategy — which involved proffering counter-offers at levels below the level he was authorized by the Board to advance — can now be viewed as having been influenced by an improper motive." As a result of Goldman and Foshee's misconduct, the Chancellor held that "plaintiffs have a probability of showing [at a full trial on the merits] that more faithful, unconflicted parties could have secured a better price from Kinder Morgan." It appears that Goldman Sachs has learned nothing from its role in the 2008 financial crisis, the $550 million SEC fine and high-profile public rebuke it received for betting against its own clients in 2010, or the various other scandals that have tarnished Goldman's reputation in recent years.

Chancellor Strine's opinion is a wake-up call to Goldman and other corporate fiduciaries and gatekeepers who are entrusted with investors' money, as well as a significant statement by one of the nation's most important judges.

Without the efforts of the public pension fund investor plaintiffs in this instance, these facts would not have come to light. It is essential that institutional investors continue to play a significant role in ensuring that Goldman, other Wall Street firms, and corporate titans finally play by the rules.

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