BANKING ON CORPORATE

BY NEILL MAY

A healthy rationalization

Sometimes you just need rules . . . and corporate lawyers. That is just the way it is, in the view of this completely unbiased observer. However, it took me a while to attain that view.

Years ago I read one of those seemingly often-featured commentaries comparing the number of lawyers per capita in the West to the numbers in Japan. My reaction to that commentary was to imagine Japan as a much more efficient society of bridge builders, and Canada as a community of talking heads. How I ended up as a lawyer, given this perspective, I prefer not to consider, and just blame my parents. However, I have come to find that lawyers, and legal systems, are critical in many ways.

Anyone working on international transactions with jurisdictions having less-developed legal systems has witnessed the tremendous efficiencies that rule of law helps provide. The dynamic is not geographically or geopolitically limited. A recent line of cases out of Delaware shows that even in economies with highly developed systems, there are gaps that rules and lawyers must fill.

The Delaware cases deal with questionable behaviour by financial advisers. My point is not that financial advisers are uniquely culpable in this regard; that is obviously not so. Rather, what is notable is the cases clearly demonstrate there are serious limits on the effectiveness of reputational discipline — which, one would have thought, would powerfully affect professional firms in their conduct of business.

To be fair, it has always been understood that there are limits to reputational discipline. For example, it's only effective (a) where there's competition and (b) where the relevant deal is not the party's last one. Unfortunately, these recent cases seem to indicate that market actors are treating many deals as if they're the last.

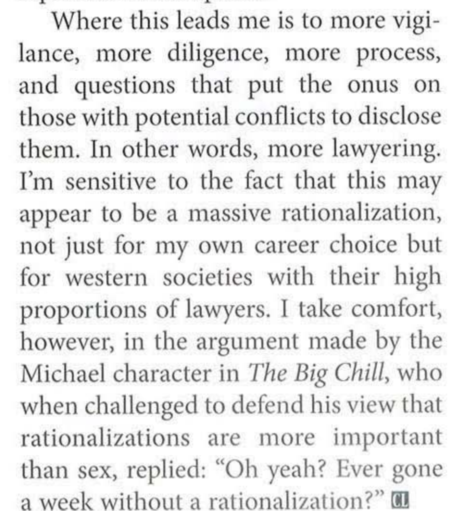
In the first case, *Re Del Monte Foods Co. Shareholder Litigation*, the financial adviser acting for Del Monte in its strategic sale process put two of the potential bidders together (without disclosing to Del Monte, and contrary to the instructions and best interests of Del Monte in that it eliminated competitive tension from the auction). Remarkably, the adviser had historically advised one of those bidders about acquiring Del Monte and stood to earn a financing fee from one of the bidders.

In the second case, *Re Southern Peru Copper Corp. Shareholder Derivative Litigation*, which dealt with a sale by Grupo Mexico of an asset of its controlled subsidiary, Southern Peru, the court found Southern Peru's financial adviser (as well as its own board) went to "strenuous lengths," and relied entirely on "unconventional methods" to equalize values in its financial advice so as to facilitate completion of the transaction on terms that appeared profoundly contrary to the interests of the adviser's client (the purchaser).

Most recently, in *Re El Paso Corp. Shareholder Litigation*, both El Paso's chief executive officer and its financial adviser were cited for conflicts. The CEO was allegedly more concerned with buttering up the potential buyer, Kinder Morgan, in order to make a subsequent purchase of El Paso's pipeline business, than with seeking other bidders. The financial adviser, though advising El Paso, had through its private equity business a significant investment in the bidder (and two appointees on the bidder's board). Though steps were taken to create walls to manage the conflicts, the court determined the financial adviser, by continuing to advise El Paso on alternatives to the deal (with a deal team led by a banker with a significant personal investment in the bidder), and by working with El Paso to bias the terms of engagement of other firms engaged, affected the deal though tainted by clear conflicts.

It's clear that risks to professional reputation are not comprehensively deterring reaches for short-term financial gain. Perhaps the phenomenon results to some degree from the professional firm construct, where individuals within the firm stand to reap large personal gains and do not fully bear the risk borne by the firm (shades of Arthur Andersen in the Enron era). Whatever the reason, reputational discipline alone doesn't cut the mustard.

To be very clear, professional firms in all disciplines are clearly, and properly, firmly focused on their professional integrity and reputation. But there are bad actors, or at least questionable decisions at the margin, and it's not clear that even in a smaller marketplace like Canada blind faith can be placed in reputational discipline.



Where this leads me is to more vigilance, more diligence, more process, and questions that put the onus on those with potential conflicts to disclose them. In other words, more lawyering. I'm sensitive to the fact that this may appear to be a massive rationalization, not just for my own career choice but for western societies with their high proportions of lawyers. I take comfort, however, in the argument made by the Michael character in *The Big Chill*, who when challenged to defend his view that rationalizations are more important than sex, replied: "Oh yeah? Ever gone a week without a rationalization?"

Neill May is a partner at Goodmans LLP in Toronto. His practice focuses on all aspects of securities law, with an emphasis on M&A and corporate finance. E-mail him at nmay@goodmans.ca. *The opinions expressed in this article are those of the author alone.*