

Investment Banking Briefing

How Financial Advisors Can Reduce

October 1997

Their Legal Exposure in Leveraged Transactions

HEALTHCO ATTACK ON LBOS

Two published decisions by Bankruptcy Judge James F. Queenan in the case of *In re Healthco International, Inc.* have caused concern in the financial community. The decisions arose from the 1991 leveraged buyout of Healthco, once the world's leading dental supply company, and its Chapter 7 liquidation two years later. The first decision denied certain defendants' motions to dismiss various fraudulent transfer and related claims asserted by Healthco's Chapter 7 trustee.¹ The second decision denied motions of those same defendants for summary judgment dismissing breach of fiduciary duty claims against the directors who voted to approve the LBO, aiding and abetting and breach of contract claims asserted against the financial professionals who advised the board and aiding and abetting claims against the buyer.² On June 6, 1997, following a seven-week trial in federal court in Worcester, Massachusetts,

all of the defendants in the *Healthco* case were vindicated by a ten person jury. On September 11, 1997, the District Court issued its decision endorsing the jury's verdict with respect to the board's financial advisor³ and entered judgment in favor of all defendants. Unfortunately the jury verdict and the District Court decision do not constitute a "reversal" of the legal rulings in the Bankruptcy Court decisions.⁴ The reasons for the jury's verdict are not a matter of public record, and the District Court's decision, in essence, finds that the plaintiff trustee produced "no credible evidence" to support his claims.

FUTURE ATTACKS LIKELY

As a result, it can be expected that, despite the defendants' complete victory at trial, Judge Queenan's pre-trial decisions will be cited by future plaintiffs to support claims against directors who approve LBOs that subsequently fail and against the professionals who advise those boards. The risk remains that other courts may follow Judge Queenan's statements of law, thereby subjecting financial professionals and directors to the risks of trial whenever a leveraged transaction fails. The purpose of this paper is not to debate Judge Queenan's state-

ments of the law, which are highly questionable, but to offer practical advice to avoid problems in the first place.

RE-EXAMINE YOUR PRACTICES

One of the surprising, and frightening, features of the *Healthco* case was the extent to which plaintiff's claims were an attack on commonplace and customarily accepted practices. At trial, the trustee's counsel repeatedly read from the minutes of board meetings and quoted statements allegedly made by the board's professionals to support his case. For this reason, professionals involved in leveraged transactions should use the decisions in the *Healthco* case as an opportunity to re-think some of their practices. While there may be no iron-clad way to protect against lawsuits, there are steps that can be taken to minimize risk. In the case of investment banks in particular, engagement letters should be reviewed to make certain that they clearly define what the investment banker is to do (or not do) and from whom he is to take instruction. Attention must also be paid to the manner in which engagements are carried out and the record of the investment banker's participation in board meetings.

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CLAIMS AGAINST THE FINANCIAL ADVISOR

Healthco's investment banking firm was sued by the Chapter 7 trustee for \$250 million for alleged breach of contract, breach of fiduciary duty and for aiding and abetting the directors' alleged breach of their fiduciary duties. The essence of the trustee's claims was that, due to the breadth of the undertakings in its engagement letter, the investment bank had a duty to analyze the reasonableness of the buyer's projections and detect and warn against the risks of insolvency created by the proposed capital structure.

The trustee's case was based principally on the investment bank's engagement letter, which provided that the investment bank was to act as Healthco's "exclusive financial advisor." The engagement letter provided that the investment bank, among other things, would "consider the appropriateness of various financial and acquisition alternatives" and "evaluate any transaction . . ." Despite the fact that the investment bank had never before provided any services to Healthco, the engagement letter acknowledged the investment bank's "familiarity" with the company's financial condition and stated that this would enable it "to approach various situations not simply on a transactional basis but rather from a long-term perspective." All of this verbiage, unnecessary to the contract from a legal perspective, formed the basis for the trustee's claims.

RISK OF OVERBROAD ENGAGEMENT LETTER

Because of the actual language

of the engagement letter, the Bankruptcy Judge rejected the investment bank's arguments that its engagement was limited to finding a willing buyer and issuing a fairness opinion. The Bankruptcy Judge noted that the engagement letter did not even mention a fairness opinion, let alone narrow the investment bank's obligation to merely the issuance of a "rather innocuous fairness opinion." Because of the exclusivity provision and the other broad and general undertakings, the Bankruptcy Court rejected the argument that solvency issues were the exclusive domain of the appraisal firm retained to give a solvency opinion. The Chapter 7 trustee had alleged that "based upon information [the investment bank] knew or should have known from available financial statements, that [the investment bank] was derelict in its contractual obligations when it failed to advise Healthco against effecting the transaction and, indeed, encouraged it." The Bankruptcy Court let go to trial the complaint's allegation that the investment bank "knew, or should have known, the transaction would leave Healthco insolvent or with unreasonably small capital."

GROSS NEGLIGENCE EASILY PLEADED

Moreover, the Bankruptcy Court ruled that the contractual provision exculpating the bank from liability for negligence—which the Court described as "tacky"—provided no protection. The Bankruptcy Court found that the investment bank's "encouragement" of the

board to close a transaction, which should have been reasonably foreseen as leading to failure, could be characterized as gross negligence rather than mere negligence. According to the Bankruptcy Judge, the investment bank's failures included:

- failing to analyze "the critical cash flow projections made by the buyer and the buyer's appraisal firm";
- failing to advise "Healthco on the effect of the proposed leveraged buyout on the transaction";
- facilitating the transaction by confirming the obvious, that it was fair to the stockholders; and
- acting like a "cheerleader" in telling the board that it thought the buyer could make the transaction work.

The jury ultimately found, and the District Court agreed, that the Chapter 7 trustee failed to prove his case by credible evidence. This may have been due, in part, to the fact that the director-defendants, who were highly sophisticated, and included two investment bankers, testified at trial that the investment bank had properly done everything expected of it. The directors praised the investment banker rather than engaging in finger pointing in an effort to shift blame from themselves to their advisors—contrary to what the trustee had expected. In a case where the directors testify that they were relying on the investment banker to ana-

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lyze cash flows and consider the solvency questions, the outcome might be very different. The fact that the evidence in the Healthco trial was favorable to the investment bank is no assurance that the same will occur in other cases. Judge Queenan's decisions are authority for the proposition that when allegations of the type made in Healthco are proved at trial, then the investment bank will be liable. Foresight and planning by financial professionals at the time of the engagement is infinitely preferable to hoping the witnesses at trial confirm the investment bank's version of events.

ENGAGEMENT LETTERS— DON'T UNDERTAKE MORE THAN YOU INTEND

It is time for investment bankers to review their form of engagement letter. First, these documents may have become formulaic and encrusted with verbiage more appropriate for a sales brochure than for a contract specifying the investment bank's duties. All of the language broadly describing the extensive services that will be provided is ammunition for a lawsuit complaining that those services were not provided. Second, the meaning of the undertaking to be the company's "exclusive financial adviser" should be made clear. It does not mean that the financial advisor undertakes sole responsibility for all financial matters. What is really meant by "exclusivity" is that the advisor gets its fee if a deal closes, regardless of its, or any one else's, involvement in the deal.

That is what should be stated.

Third, in most leveraged buyouts and recaps, an appraisal firm will be retained to give a solvency opinion. While virtually all engagement letters disclaim any responsibility on the investment bank's part for performing appraisals of assets, Judge Queenan found that this is not a disclaimer of responsibility for opining on solvency issues.

ENGAGEMENT LETTERS— STEER CLEAR OF SOLVENCY ISSUES

The solvency opinion is financial advice that an investment banker may be competent to give, but it is advice which an investment banker cannot appropriately give, due to the lack of independence arising from its contingent fee arrangement. But what role will the investment bank have in the solvency opinion process? Will it review the buyer's or management's projections? Will it review the appraiser's independent projections, if any are prepared? Obviously, the farther away the investment banker stays from evaluating projections, or other involvement in the solvency opinion process, the better. If that is the agreement, then the engagement letter should make clear that the investment bank will have no responsibility in these areas. If the investment banker's job is to find buyers and render a fairness opinion, then the engagement letter should make plain that this is the extent of its responsibility.

It also should be clear from whom the investment banker is

to take instructions and that additional services will be provided only upon request or only upon further mutual agreement. This makes it much simpler for the bank to prove, in light of instructions actually received, that it did its job or that its failure to do things is attributable to the company's not requesting such services rather than to negligence on the banker's part.

In sum, engagement letters should be reviewed to make certain they clearly define what the investment bank has been retained to do and to make clear that it is not expected to do anything else unless it is requested to and so agrees.

LIMIT YOUR ROLE TO THE ENGAGEMENT

Aside from appropriate disclaimers in the engagement letter, investment bankers need to be alert to the risks that arise during the free-for-all that may occur when a board is making decisions under pressure. The excitement of the moment can lead to advisors' being called upon to express, or even volunteering, opinions on matters that they are not fully prepared to address or that are beyond the scope of their engagement. In retrospect, this can become a basis for negligence or breach of fiduciary duty claims. This is particularly true when the advisor's compensation is tied to the closing of a deal. It is in precisely this circumstance that the investment bank opens itself to the charge made in *Healthco*, that it became a "cheerleader" for the transaction.

The investment banker should keep firmly in mind the scope of his engagement and not be tempted to become an all purpose expert advisor to the board. This can happen when the banker is asked for advice on matters beyond the scope of his retention. But there is also risk when the banker merely gets in the middle of the paper flow, receiving copies of projections or drafts of solvency opinions, which are filed away without attention. That paper trail can later be used as evidence that the investment banker was expected to do more than was done.

The investment bank is generally retained to identify transactions providing the greatest value to shareholders. Its compensation arrangement usually creates incentives to promote the transaction whose value, multiplied by the probability of closing, yields the greatest amount for shareholders. Given both his role and his incentives, it is unrealistic to expect investment bankers to protect the interests of creditors. Not only should the engagement letter clearly state the investment bank's role, but bankers should limit their activities and advice to matters within their engagement, i.e., the evaluation of competing transactions for the shareholders.

Finally, the materials presented to the board by the bankers and the draft minutes of meet-

ings at which bankers make presentations should be reviewed for accuracy and to ensure that they do not support the claim that advice was given beyond the scope of the engagement.⁵

Alan Kolod and Mark N. Parry
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BIOGRAPHICAL NOTE

Moses & Singer LLP, founded in 1919, is a general practice firm with substantial experience in bankruptcy matters, fraudulent transfer litigation and litigation involving director fiduciary duties. In the area of director litigation, in addition to representing defendants in the Healthco trial, Moses & Singer's attorneys have been involved in such cases as: *Friedman v. Benington*, *Forum v. Classic*, *In re York Research Corp.*, *Trinidad & Tobago v. Tesoro Petroleum Corp. et al.*, *Bolton v. Tesoro Petroleum Corp. et al.*, *Atlas Van Lines v. Contrans Acquisition, Inc.* and *Chris Craft v. Bangor Punta*.

Alan Kolod is the managing partner of the firm and chair of the Bankruptcy and Reorganization Department. Mark Parry is a partner in the Litigation and Bankruptcy and Reorganization Departments.

This Briefing is intended as a general comment on certain recent proposed developments in the law. It does not contain a complete legal analysis or constitute an opinion of Moses & Singer LLP or any member of the Firm on the legal issues herein described. It is recommended that readers not rely on this general guide in structuring or analyzing individual transactions but that professional advice be sought in connection with any such transaction.

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¹ 195 B.R. 971 (Bankr. D. Mass. 1996).

² 208 B.R. 288 (Bankr. D. Mass. 1997).

³ The investment bank, alone among the defendants, waived its right to a jury and, as a result, the jury's verdict was only advisory with respect to the claims against the investment bank. This required the District Court to make binding findings of fact and render a decision, which it did on September 11, 1997.

⁴ In fact, the District Court did repudiate the Bankruptcy Court's legal conclusions in many respects. A recent article in the *National Law Journal*, August 18, 1997, p. B4, ch. 1, has pointed out numerous examples in which District Judge Gorton's jury instructions differed from Bankruptcy Judge Queenan's statement of the law in his summary judgment decision. Furthermore, in an unreported pre-trial ruling, the District Court held that Judge Queenan's grant of summary judgment to the trustee dismissing the directors' "business judgment rule" defense, and his finding that certain directors were interested parties as a matter of law, were merely advisory and refused to adopt those rulings, instead requiring that those questions be submitted to the jury.

⁵ In *Healthco*, the Board minutes reflected that the banker had told the Board that "the deal was tight" but the buyer "probably could make it work." The banker explained at trial that he was talking about the buyer's ability to obtain financing commitments prior to an imminent deadline. The trustee argued that the banker was commenting on the company's ability to service debt post-closing. A great deal of the trustee's case relied upon statements in the minutes of board meetings. This is just one instance where review and correction of the draft minutes could have obviated the problem.