KIRKLAND & ELLIS LLP

KIRKLAND **M&A UPDATE**

October 28, 2009

Avoiding Liability Pitfalls in Financial Advisory Assignments

A recent motion to dismiss in the U.S. District Court for the District of Massachusetts brings to light the importance of wording in engagement letters for advisory services, and conduct during the time advice is being offered, in preserving advisory expectations and mitigating adviser liability.

Recent case law on potential liability of investment bankers for advice given in connection with M&A advisory roles has focused on the contractual nature of the relationship between the adviser and the recipient of the advice. Courts have been generally unwilling to find an extracontractual duty owed to shareholders of a target, the likely harmed parties in the event of alleged faulty advice, particularly if the engagement letter and/or fairness opinion itself is clear as to whom advice is being offered and the nature of the relationship between the adviser and the recipient parties. As the case law has developed, standard language in engagement letters has continued to evolve in a manner designed to further clarify the nature of the banker/company relationship, reduce the likelihood that extracontractual claims against an investment bank would survive court scrutiny and minimize the damages that may be asserted by aggrieved parties.

However, a recent decision on a motion to dismiss in the U.S. District Court for the District of Massachusetts should cause parties to banker engagement letters to sharpen their focus on the specific wording of engagement letters as well as their conduct during the period in which advice is being offered, particularly in cases where the engaging company is privately held. The case involves claims by the principal shareholders of Dragon Systems, which in 2000, with the advice of Goldman Sachs, completed a sale of the speech recognition company to Lernout & Hauspie (L&H). Shortly after the completion of the sale, L&H collapsed in a massive fraud, rendering worthless the $300 million of L&H shares received by the Dragon shareholders. The shareholders brought a claim against Goldman seeking recompense for its allegedly faulty advice in not properly assessing the risks of accepting shares of L&H, making claims based in contract, tort and state statute. The court, consistent with precedent described above, dismissed the basic breach of contract claims based on a reading of the engagement that showed that Dragon, and not its shareholders, was the only party to the engagement letter. However, the court declined to dismiss claims based on theories of contractual third party beneficiary, negligence, negligent misrepresentation, the Massachusetts unfair trade practices statute and an implied covenant of good faith and fair dealing.

The court focused on the combination of the following provisions in the engagement letter, as well as Goldman's post-engagement conduct, to reach its conclusion:

- the addressees of the engagement letter included one of the principal shareholders in her individual capacity (notwithstanding the fact that, with one irrelevant exception, she did not sign the letter in such capacity and therefore was not in direct privity of contract with Goldman);
- the use of the phrase "you," rather than the "company," in the text of the engagement letter to describe to whom Goldman's obligation to provide "financial advice and assistance" is directed;
- the inclusion of the fairly standard phrase that any advice provided "is exclusively for the information of the Board of Directors … of the Company" showing the intent to benefit members of the board, which included one of the principal shareholders, without clearly specifying that the benefit was limited to such person's capacity as a director;
- Goldman's dealing "directly and persistently" with the shareholders during the course of the engagement and the fact that the shareholders were "central players" in the transaction as opposed to being "mere bystanders" as is the case in public company engagements, and
- the absence of a specific waiver of extracontractual fiduciary duties being owed by Goldman, as well as Goldman's active solicitation and "specific knowledge" of the shareholders' "faith, confidence and trust."

While the court's decision was only on a motion to dismiss, parties to investment bank engagement letters would be well-advised to heed its lessons. Especially when there are significant losses, courts may critically assess the specific words of the engagement letter and fairness opinion and the course of conduct of the adviser during the engagement period. Particularly (but not exclusively) in cases of private companies or where individuals fill multiple roles at the target company, the risk of liability for an adviser may increase if careful attention is not paid, in words and practice, to preserving the expectation that the advisory relationship is solely between the investment bank and the target company (and its board solely in that capacity).

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland author or your regular Kirkland contact.

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