Delaware Court of Chancery Finds Financial Advisor Liable for Aiding and Abetting Fiduciary Duty Breaches

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On March 7, 2014, Vice Chancellor Travis Laster of the Delaware Court of Chancery found a financial advisor liable for aiding and abetting breaches of fiduciary duties by the board of Rural/Metro Corporation in connection with the company's 2011 sale to an affiliate of Warburg Pincus LLC. In its 91-page, post-trial opinion, the Court concluded that the financial advisor allowed its interests in pursuing buy-side financing roles in both the sales of Rural/Metro and Emergency Medical Services ("EMS") to negatively affect the timing and structure of the company's sales process, that the board was not aware of certain of these actual or potential conflicts of interest, and that the valuation analysis provided to the board was flawed in several respects. Both the Rural/Metro board of directors and a second financial advisor to Rural/Metro settled before trial for $6.6 million and $5.0 million, respectively.

This opinion is the latest example of the Court of Chancery's focus on conflicts of interest involving sell-side financial advisors, as most recently demonstrated in the *Del Monte* and *El Paso* decisions. *Rural Metro* thus underscores the very real and potentially significant liabilities to financial advisors. It also serves as a salient reminder that the actions of advisors, including those carried out unbeknownst to the board, may be imputed to boards that fail to exercise reasonable oversight of their so-called informational "gatekeepers" in a sale process.

Background of the Transaction

In late 2010, the financial advisor discussed with Rural/Metro the possibility that Rural/Metro could participate in a sales process under way at EMS and possibly partner with a private equity firm to combine Rural/Metro and AMR, a subsidiary of EMS and one of Rural/Metro's primary competitors. The Court found that the financial advisor believed that, if it were able to lead a sales process for Rural/Metro, then it could (a) seek to provide financing to potential acquirors of Rural/Metro and (b) use its position as the sell-side advisor to secure significant buy-side financing fees from the private equity firms bidding for EMS.

Rural/Metro reinstated a three-person special committee, previously formed to explore prior, inbound inquiries received by the company, to review the company's potential strategic alternatives, including whether to participate in the EMS sales process, and then to provide a recommendation to the board.

The special committee engaged the financial advisor as its principal financial advisor and another bank as a second advisor. The Court found that, during its pitch for the Rural/Metro engagement, the financial advisor noted that it hoped to provide stapled financing to potential acquirors of Rural/Metro but did not disclose its intent to seek a buy-side financing role with potential acquirors of EMS.

The special committee and the financial advisor contacted 28 private equity firms, of which six firms submitted preliminary bids. Warburg Pincus was the only bidder to submit a final bid, although another firm (which won the EMS auction) had requested an extension of the bid deadline. The Court concluded that the financial advisor favored Warburg Pincus, due to, among other things, the potential opportunity to provide financing. The special committee declined to extend the deadline for the other bidder and proceeded with Warburg Pincus. According to the Court's factual findings, the financial advisor continued to try to secure a role in the buy-side financing but, ultimately, did not succeed.

Shortly before the board meeting at which the transaction was approved, the financial advisor prepared its fairness opinion. An *ad hoc* fairness committee at the financial advisor comprising two managing

directors approved the opinion, which was delivered to the board. That was the first time that valuation materials were presented to the board. The Court was critical of both the internal process that led to the fairness opinion and the substance of that opinion, which the Court concluded had been skewed to make the deal look more favorable.

Rural/Metro's second financial advisor also delivered its opinion and the board approved the deal with Warburg for $17.25 per share.

The Court's Ruling

Addressing the claims against the financial advisor, the Court confirmed that an aiding and abetting claim requires (a) the existence of a fiduciary relationship (e.g., the fiduciary duties of care and loyalty by a director to the company's shareholders); (b) a breach of the fiduciary's duty; (c) knowing participation by the non-fiduciary; and (d) damages proximately caused by the breach. Notably, the Court held that Rural/Metro's 102(b)(7) exculpatory charter provision (which would eliminate damages for a director's breach of the duty of care) provides no defense to non-directors. Vice Chancellor Laster indicated that the plain language of the Delaware statute does not protect non-fiduciaries and explained the public policy reasons for exculpating directors who act in good faith but not the "highly compensated advisors" on whom the directors are entitled and encouraged to rely. The Court explained that the "threat of liability helps incentivize gatekeepers to provide sound advice, monitor clients and deter client wrongs."

The Court held that the board breached its fiduciary duties of care in the sale process. It found that the special committee's initial decision to run a sale process in parallel with the EMS process was not reasonable because it was (a) not authorized by the board (the mandate of the special committee was limited); (b) influenced by a financial advisor that was also pursuing buy-side financing roles in the EMS sale and leveraging its role as sell-side advisor to obtain those engagements; and (c) made by decision-makers who the Court concluded suffered from these undisclosed conflicts of interest. Absent the apparent conflicts and abdication of the board's power, the Court said that the decision to launch the sales process would have been a close call. However, the "totality of the evidence" showed that the pursuit of a sale was not well-informed and therefore fell outside the range of reasonableness.

In addition, the Court held that the board's decision to approve the merger was not reasonably informed, particularly given the board's failure to "act reasonably to identify and consider the implications of the investment banker's compensation structure, relationships and potential conflicts." The Court also noted the board's lack of earlier valuation information and the limited opportunity the board had to examine and understand the valuation materials used at the board meeting approving the merger. The Court concluded:

> "The combination of [the financial advisor]'s behind the scenes maneuvering, the absence of any disclosure to the Board regarding [the financial advisor]'s activities, and the belated and skewed valuation deck caused the Board decision to approve Warburg's offer to fall short under the enhanced scrutiny test. Because [the financial advisor] misled the Board, this is not a case where a Board's independent sense of the value of the company is sufficient to carry the day."

The Court also found that the directors breached their duties of disclosure by failing to disclose certain of the banker's material conflicts of interest and because of issues with the financial advisor's valuation analysis as presented in the proxy statement.

On the element of "knowing participation," the Court held that the financial advisor misled the directors into breaching their fiduciary duties by (a) creating the unreasonable process and informational gaps that led to the breach; (b) knowing that the board and special committee were uninformed about Rural/Metro's value when making their critical decisions; (c) failing to disclose to the board its continued interest in buy-side financing and last minute lobbying of Warburg to participate in the financing; and (d) at the same time, revising its valuation of Rural/Metro downward to comport with the fairness opinion on the sell-side.

The Court noted that the fact that the financial advisor ultimately did not provide the financing did not change or affect the Court's analysis.

The Court further found that the financial advisor's actions proximately resulted in the shareholders receiving less than fair value for their shares.

The Court was not prepared, based on the record at trial, to determine the appropriate remedy and therefore asked the parties to submit additional evidence concerning the company's DCF value and whether any monetary liability that the financial advisor bears should be reduced by the greater of the defendants' share of liability or the amount the other defendants paid to settle the case.

Principal Takeaways

- While the Court did not find that sell-side advisors providing financing to a bidder is per se impermissible—and the Court will continue to review such engagements on a case-by-case basis—the *Rural Metro* opinion underscores the risks where sell-side financial advisors also provide or seek to provide buy-side financing. The opinion further confirms that simply engaging a conflict-free second financial advisor to issue a fairness opinion does not cure any actual or perceived material conflicts of interest involving another financial advisor, particularly when those conflicts are not disclosed to the board.
- Financial advisors must be diligent in disclosing actual or potential material conflicts of interests to their clients and in applicable SEC filings. Indeed, *Rural Metro* likely will only amplify the already significant spotlight on investment banking conflicts of interest in M&A litigation. A troubling implication of the opinion is that it may encourage shareholder-plaintiffs to add investment banks as aider and abettor defendants at the outset, with the hopes that document discovery will uncover a previously undisclosed material conflict of interest. Such a development would compound the already difficult and complex judgments that investment banks and their advisors—and the Court of Chancery—wrestle with in determining what is a material conflict of interest that needs to be disclosed.
- The *Rural Metro* opinion is another sobering reminder of the need by boards to be active and reasonably informed participants in the sales process, including with respect to the board's obligation to identify, consider, and proactively respond to actual or potential material conflicts of interest involving financial advisors. These conflicts issues need to be addressed in the sales process and cannot be cured entirely through robust disclosure in the SEC filings relating to the transaction.
- Consistent with long-standing Delaware law, it is important for boards of directors to issue clear mandates of authorities to the special committees they create and to ensure that special committees do not overstep such mandates. Throughout the *Rural Metro* opinion, the Court relied on the lack of the special committee's authority to pursue a sale to establish the board's underlying fiduciary breach.
- The Court appeared skeptical of the *ad hoc* fairness committee employed by the financial advisor to deliver its fairness opinion. The fairness committee was permitted to consist of any two or more managing directors who were available to review and approve the proposed opinion, which in this case included a managing director who had never sat on a fairness committee. The Court contrasted this with the process employed by some other investment banks, which have standing fairness committees staffed by designated senior bankers who oversee the opinion process and review opinions to ensure quality and consistency. Advisors may consider reviewing their fairness committee and opinion processes in light of the Vice Chancellor's analysis of this committee's level of quality control.

See a copy of **In re Rural Metro Corporation Stockholders Litigation**, Consol. C.A. No. 6350-VCL.

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