

Financial Advisor Liable for Aiding and Abetting Buyout Target Board's Breach of Fiduciary Duty

On March 7, the Delaware Court of Chancery published a post-trial opinion in *In Re Rural Metro Corporation Stockholders Litigation (Rural Metro)* finding Rural/Metro's financial advisor RBC liable for aiding and abetting the Rural/Metro's board of directors' breach of its fiduciary duties in connection with the acquisition of Rural/Metro by Warburg Pincus. The decision is the latest in a series of Delaware opinions concerning conflicts of interest of banks and investment firms in advising companies in buy-out transactions.

BACKGROUND

In March 2011, Rural/Metro Corporation was acquired by Warburg Pincus for \$17.25 per share in cash, a total deal value of approximately \$440 million. The sale process was led by a special committee of Rural/Metro's board of directors. The special committee was initially instructed to evaluate strategic alternatives available to the company and report back to the full board on those alternatives, but the special committee exceeded that mandate and hired RBC Capital Markets as its financial advisor to conduct a sale process. RBC recommended running a sale process in parallel with the ongoing sale of competitor Emergency Medical Services Corporation (EMS), suggesting that it would set up potential bidders to acquire both EMS and Rural/Metro and allow the target companies to share the synergies of putting these two companies together. However, RBC never disclosed to Rural/Metro that one of its primary goals in representing Rural/Metro was to obtain a role in financing bids for EMS in order to generate fees far in excess of its expected advisory fee from Rural/Metro.

The sale process did not unfold as RBC had hoped. Bidders for EMS, including many large private equity funds that would have been potential bidders for Rural/Metro, were generally reluctant to participate in the Rural/Metro sale process out of concern about violating use restrictions in EMS's confidentiality agreement and because participating in the Rural/Metro process would require diverting resources away from the EMS process (which was much further along). Additionally, the special committee, acting on advice from RBC, refused to extend the Rural/Metro sales process to allow Clayton, Dubilier & Rice, which had acquired EMS, to prepare a bid even though the sales process had ostensibly been designed to allow the acquirer of EMS to bid. Eventually, Warburg Pincus (who did not seriously participate in the EMS process) emerged as a potential acquirer of Rural/Metro, in part because Warburg Pincus perceived there to be a lack of competition for Rural/Metro.

During the process, RBC failed to provide the Rural/Metro board of directors with any formal valuation analysis of the company until one hour and 18 minutes before the board meeting approving the Warburg Pincus deal in connection with the delivery of its fairness opinion. In terms of the fairness opinion itself, the Court found that RBC engineered the fairness opinion to make the \$17.25 per share offer appear reasonable by misrepresenting how market analysts treated certain one-time expenses and manipulating other aspects of their financial analysis. During these crucial moments leading up to signing — and without the knowledge of the Rural/Metro board — RBC met with and continued its push to convince Warburg Pincus to use RBC for its buy-side financing needs in connection with the acquisition of Rural/Metro, including sharing details regarding the internal dynamics of the Rural/Metro board. Despite those efforts, RBC ultimately failed to obtain any role in financing the transaction.

Shortly after the announcement of the Rural/Metro acquisition, various shareholders filed lawsuits objecting to the transaction. The plaintiffs ultimately settled with Rural/Metro directors and the company's secondary financial advisors, but the claims against RBC for aiding and abetting proceeded to trial.

At trial, the Court found that the Rural/Metro directors breached their fiduciary duties by failing to conduct a reasonable sale process and that RBC failed to serve its proper role as an advisor to the board. As a result, the Court found that RBC was liable for aiding and abetting breaches of the Rural/Metro directors' fiduciary duties.

KEY TAKEAWAYS

Aider and Abettor Liability. Aider and abettor liability can attach to an agent who knowingly causes a breach of a fiduciary duty by a director, regardless of whether the director herself knows of the breach. In this case, the Court concluded that RBC aided and abetted the Rural/Metro directors' breach of their fiduciary duty of care and disclosure obligations to Rural/Metro stockholders by creating an unreasonable sale process and informational gaps between the Rural/Metro board and its financial advisor (e.g., omitting disclosure on the extent of its conflicts resulting from attempts to gain a place in the buy-side financing for EMS and Rural/Metro). The Court found that RBC perpetuated this informational gap by failing to provide any formal valuation metrics on Rural/Metro until a little more than an hour before the board meeting at which the deal was approved, which metrics Vice Chancellor Laster found to be intentionally engineered to mislead the Rural/Metro directors to conclude the acquisition price was fair.

Statutory Limitations on Liability Do Not Extend to Aiders and Abettors. Section 102(b)(7) of the Delaware General Corporation Law, which allows corporations to absolve directors from personal liability to stockholders for monetary damages for breaches of duty of care, does not apply to non-directors who aid and abet a breach of fiduciary duty, even when the directors themselves are otherwise exculpated by a Section 102(b)(7) provision.

The Delaware Courts Remain Highly Skeptical of Staple Financing. Vice Chancellor Laster was critical of both the vigor of RBC's desire to participate in buy-side financing (and the conflict of interests it created) and the Rural/Metro board's failure to monitor RBC in the process (such as failing to inquire about the financing and its associated process, provide guidance on when staple financing discussions should begin or end, and impose practical checks on RBC's interest to maximize its fees). This skepticism of staple financing echoes Vice Chancellor Laster's critique of financial advisors in the February 2011 ruling in *In re Del Monte Foods Company Shareholders Litigation*, where financial advisors similarly made efforts to steer the sale process towards buyers that might have provided a financing role for the investment bankers (and therefore, a slice of financing fees). Given the skepticism of the Delaware Courts, boards of Delaware corporations should exercise diligent oversight to ensure that appropriate checks are in place on the inherent conflicts that such staple financing creates.

The Process is Paramount. As should be well-understood by now, the process by which boards of directors evaluate major transactions is vitally important to good outcomes. Even actions that one might expect to be routinely defensible become highly problematic when the integrity of the process is effectively called into question. In this case, the Court found that the threshold decision to initiate the sale process itself did not satisfy the standard of care as a fiduciary duty matter. This extraordinary result flowed from the Court's finding that the decision to initiate the process was undertaken unilaterally by a special committee chairman who lacked the authority to put the company in play and who, in doing so, acted on the advice of a financial advisor that was motivated by self interest. As the Court acknowledged, a well-informed board might have

considered a variety of pros and cons to the timing of the sale process, but the fact that this basic step in the process was omitted helped render even the decision to start the process unreasonable.

Engagement Letter Did Not Suffice to Waive RBC Conflicts. Vice Chancellor Laster rejected RBC's arguments that a generic conflicts acknowledgement in its engagement letter precluded aiding and abetting claims. The Court found that RBC failed to disclose the degree of its conflict to the Rural/Metro board, and Delaware law requires that any conflict waiver be knowing and unambiguous, including with respect to the degree of the conflict. Generic boilerplate signed at the outset of a deal (and before the actual conflict exists) will not suffice.

Buyers Should Diligence the Sale Process. Rural/Metro provides another illustration of the importance for buyers to diligence sale processes in M&A transactions in order to understand what (if any) sale-related liabilities they may inherit or become subject to in connection with the target company's actions relating to the sale transaction and to incorporate those potential costs into valuation models.

Not All Shareholder Litigation Settlements Will Be Approved by the Court. The case was on the brink of a supplemental disclosure-only settlement in January 2012. However, following an objection to the settlement by a Rural/Metro stockholder who had filed a parallel lawsuit in Arizona, Vice Chancellor Laster rejected the disclosure-only settlement as inadequate, serving as a reminder that proposed settlements need to pass a hearing on fairness before the matter can be resolved. In Delaware, the depth of the fairness inquiry has tended to vary, slightly complicating the predictability of the sufficiency of a disclosure-only settlement in any particular litigation before the Delaware Courts.