

Corporate Finance/M&A - USA

Financial adviser liable for aiding and abetting board breach of fiduciary duties

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[Introduction](#)
[Facts](#)
[Key takeaways](#)

Introduction

On March 7 2014 the Delaware Court of Chancery published a post-trial opinion in *In Re Rural/Metro Corporation Stockholders Litigation*,⁽¹⁾ finding Rural/Metro's financial adviser RBC Capital Markets liable for aiding and abetting the Rural/Metro 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 sale transactions. It demonstrates the importance of good process and evidences Delaware's continuing scepticism regarding staple financing.

Facts

In March 2011 Rural/Metro Corporation was acquired by Warburg Pincus for \$17.25 per share in cash, representing a total deal value of approximately \$440 million. The sale process was led by a special committee of the Rural/Metro board of directors. The special committee was initially instructed by the full board 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 as its financial adviser 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 targets' shareholders to share in the synergies of putting these two companies together by virtue of a buyer being willing to pay a higher price for both companies than for each company in isolation. 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. Additionally, while the Rural/Metro board approved of RBC offering staple financing to the buyer of Rural/Metro, it failed to monitor the provision of such financing and was unaware of the vigour with which it was pursued by RBC in an attempt to obtain additional fees.

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 divert resources away from the already active EMS process.

In addition, the special committee, acting on advice from RBC, refused to extend the Rural/Metro sales process to allow Clayton, Dubilier & Rice, which won the auction to acquire 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 (which 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. Meanwhile, RBC aggressively pitched buy-side financing to Warburg Pincus.

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 RBC's fairness opinion. In terms of the fairness opinion itself, the court found that RBC had engineered the fairness opinion to make the \$17.25 a share offer appear

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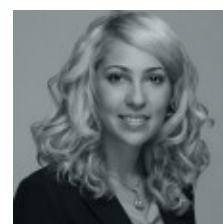
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reasonable by misrepresenting how market analysts treated certain one-time expenses and by manipulating other aspects of its financial analysis. During these crucial moments leading up to signing – and without the knowledge of the Rural/Metro board – RBC 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 a 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 advisers, but the claims against RBC for aiding and abetting proceeded to trial.

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

Ultimately, on August 4 2013 - just over two years after the closing of the acquisition by Warburg Pincus - Rural/Metro filed for bankruptcy. Rural/Metro's bankruptcy plan was confirmed on December 17 2013 and the company emerged from bankruptcy on December 31 2013.

On April 23 2014 RBC filed a post-trial brief asking the court to reduce its damages by 87.5% - the percentage that RBC contends to be the aggregate *pro rata* share of aiding and abetting liability for each of the directors and the company's secondary financial advisers, each of whom had previously settled claims with the plaintiffs.⁽²⁾

Key takeaways

Aider and abettor liability

Aider and abettor liability can attach to an agent which knowingly causes a breach of a fiduciary duty by a director, regardless of whether the director himself or herself knows of the breach. In this case, the court concluded that RBC had 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 information gaps between the Rural/Metro board and its financial adviser (eg, 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 had perpetuated this information 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. Further, Vice Chancellor Laster found such metrics to be intentionally engineered to mislead the Rural/Metro directors to conclude that the acquisition price was fair. The decision serves as a reminder to financial advisers and their counsel that they are at risk of being held responsible for their clients' sale process and must monitor it actively. That said, the recent Delaware Court of Chancery decision in *Aaron Houseman v Eric S Sagerman*⁽³⁾ emphasises that the benchmark for aiding and abetting breach of fiduciary duty remains high – the non-fiduciary must knowingly participate in the breach. Merely providing limited services will not be enough to meet the pleading standard for this type of aider and abettor liability.

Statutory limitations on liability do not extend to third-party 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 the 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.

Staple financing

Although acknowledging the appropriateness of staple financing in certain contexts and with suitable constraints, the decision exemplifies how the Delaware courts remain highly sceptical of staple financing. Laster was critical of both the vigour of RBC's desire to participate in buy-side financing (and the conflict of interests it created in this instance) and the Rural/Metro board's failure to monitor RBC in the process – for example, 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 maximise its fees.

This scepticism of unconstrained staple financing echoes Laster's critique of financial advisers in the February 2011 ruling in *In re Del Monte Foods Company Shareholders Litigation*,⁽⁴⁾ where financial advisers similarly made efforts to steer the sale process towards buyers that might have provided a financing role (and a portion of financing fees) for the investment bankers. Given the scepticism of the Delaware courts, in instances where staple financing provides a benefit to the target, boards of Delaware

corporations should nevertheless exercise diligent oversight to ensure that appropriate checks are in place on the perceived conflicts that such staple financing creates.

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 adviser 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 to render even the decision to start the process unreasonable.

Engagement letter did not suffice to waive RBC conflicts

Laster rejected RBC's arguments that a generic conflicts acknowledgement in its engagement letter precluded aiding and abetting claims. The court found that RBC had 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 carry out diligence on the sale process

Although challenging because target companies are understandably reluctant to share non-public details of sale processes prior to signing a definitive agreement, *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's actions relating to the sale transaction.

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, 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.

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Endnotes

- (1) *In re Rural Metro Corp Stockholders Litig*, CA No 6350-VCL (Del Ch March 7 2014).
- (2) RBC Capital Markets, LLC's Post-Trial Contribution Brief, *In re Rural Metro Corp Stockholders Litig*, CA No 6350-VCL (Del Ch April 21 2014).
- (3) CA No 8897-VCG (Del Ch April 16 2014).
- (4) CA No 6027-VCL (Del Ch February 14 2011).

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