

Court reverses finding of financial adviser aiding and abetting liability

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Introduction

On October 1 2015 in *In re Zale Corporation Stockholders Litigation*(1) the Delaware Court of Chancery refused to dismiss a claim against Zale Corporation's financial adviser asserting that the adviser had aided and abetted an alleged breach of the duty of care by Zale's board. However, following the Delaware Supreme Court's decision in *Corwin v KKR Financial Holdings, Inc.*, which held that a transaction approved by uncoerced and fully informed shareholders results in business judgment rule review, the court reversed its earlier decision and dismissed the claim against the adviser, concluding that the court had incorrectly applied the *Revlon* enhanced scrutiny standard of review in the initial decision, rather than the business judgement rule standard of review mandated by the *KKR Financial* decision.

Facts

The plaintiffs' complaint alleged that Zale's directors had breached their duty of care by retaining its financial adviser in connection with Zale's sale to Signet Jewelers without conducting an adequate investigation into its potential conflicts, and further alleged that the adviser had aided and abetted those breaches. The Zale board had engaged the adviser after the adviser had represented that it had no conflicts and a limited relationship with Signet. However, the adviser had received \$2 million in fees from Signet in the previous two years and a managing partner on the Zale engagement had made a presentation to Signet concerning a possible acquisition of Zale – including a maximum price that Signet should be willing to pay in such a transaction – shortly before being engaged by Zale. The Zale board did not learn about that presentation until after the merger agreement was signed.

The Delaware Court of Chancery initially determined that *Revlon* was the appropriate standard of review under which to evaluate the plaintiffs' claims against Zale's directors. Under a *Revlon* analysis, the court found it reasonably conceivable that the Zale directors' reliance on the adviser's representations about its relationship with Signet without further investigation "could constitute a breach of their duty of care in this *Revlon* context". The court stated that board members have a duty to detect a pre-existing conflict when engaging a financial adviser, which they could satisfy by asking probing questions about prior relationships and negotiating for representations and warranties in the engagement letter. The court further determined that it was reasonably conceivable that the adviser's alleged failure to disclose its presentation to Signet, where it proposed making a bid to acquire Zale for a purchase price in the range of \$17-\$21 per Zale share, adversely affected the adviser's, and consequently the board's, ability to seek a higher price per share.

The court ultimately determined that the exculpatory provision in Zale's certificate of incorporation shielded its directors from monetary liability for any breach of their duty of care; however, the court held that the plaintiffs had adequately stated a claim against the adviser for aiding and abetting those breaches.

AUTHORS

[Jason
Freedman](#)



[Zachary R
Blume](#)



Immediately following the Delaware Supreme Court's ruling in *KKR Financial*, the adviser moved for reconsideration of the Delaware Court of Chancery's decision, claiming that, consistent with *KKR Financial*, the court should have applied the business judgement standard of review rather than *Revlon* enhanced scrutiny when determining, for purposes of a motion to dismiss, whether the Zale directors had breached their duty of care.

Decision

On reconsideration, the court determined that in light of *KKR Financial*, the business judgement rule was the appropriate standard of review because a majority of Zale's disinterested stockholders had approved the merger in a fully informed vote. The court concluded that:

"when reviewing a board of directors' actions during a merger process after the merger has been approved by a majority of disinterested stockholders in a fully informed vote, the standard for finding a breach of the duty of care under [the business judgment rule] is gross negligence."

The court then applied the gross negligence standard to the allegations presented in the complaint and determined that it was not reasonably conceivable that the Zale directors breached their duty of care by acting in a grossly negligent manner with respect to their engagement of the financial adviser. With "no basis for a predicate fiduciary duty breach", the court held that the plaintiffs had not adequately pled that the adviser had aided and abetted any breach by the Zale directors.

For further information on this topic please contact [Jason Freedman](#) at Ropes & Gray LLP's San Francisco office by telephone (+1 415 315 6300) or email (jason.freedman@ropesgray.com). Alternatively, contact [Zachary Blume](#) at Ropes & Gray LLP's Boston office by telephone (+1 617 951 7000) or email (zachary.blume@ropesgray.com). The Ropes & Gray website can be accessed at www.ropesgray.com.

Endnotes

(1) *In re Zale Corporation Stockholders Litigation*, CA No 9388-VCP (Del Ch October 29 2015).

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