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LEGAL UPDATE

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Who's in Charge – Is the Board Responsible to Monitor Its Financial Advisor or Vice Versa?

Background

The recently decided case of *In re Rural Metro Corporation Stockholders Litigation* follows in the footsteps of cases such as *In re Del Monte Foods Company Shareholder Litigation* and *In Re El Paso Corporation Shareholder Litigation* regarding allegedly conflicted financial advisors. In *Rural Metro*, Vice Chancellor J. Travis Laster of the Court of Chancery of the State of Delaware held that the primary financial advisor retained by Rural/Metro Corporation aided and abetted the board in breaching its fiduciary duty of care.

Rural/Metro merged with an affiliate of Warburg Pincus LLC, with Warburg paying $17.25 for each share of Rural/Metro for total consideration of approximately $440 million. The primary financial advisor was chosen after a presentation in which the financial advisor proposed that the sale of Rural/Metro be pursued in parallel with the sale of Emergency Medical Services Corporation (EMS), which was a competitor of Rural/Metro. The Court of Chancery found that the primary financial advisor pushed for this course of action because it recognized that it could use its position as Rural/Metro's sell-side advisor to secure a buy-side financing role with the bidders for EMS (and thus secure significantly higher fees). However, while the primary financial advisor had disclosed in its engagement letter that it might seek to provide stapled and/or acquisition financing, it did not disclose during the process the efforts it was making to convince Warburg to use it for the stapled financing, nor did it disclose its efforts to secure its role in buy-side financing a bid for EMS. The EMS sales plan did not work in part because of standard confidentiality agreements signed by the EMS bidders, which such bidders feared could be breached by bidding on Rural/Metro, and what the court described as the readily apparent difficulty many potential buyers would have in bidding on the two companies at the same time. Stockholder litigation commenced soon after the Rural/Metro-Warburg deal closed, with the Rural/Metro board and the secondary financial advisor ultimately settling without admitting or denying any wrongdoing. The primary financial advisor did not settle and was sued under a theory of aiding and abetting the board's breach of its fiduciary duty of care during the sales process and misconduct that led to disclosure violations.

In examining whether the board breached its fiduciary duty of care during the sales process, the Court of Chancery reviewed the transaction under enhanced scrutiny, the intermediate level of review pursuant to *Revlon* under Delaware law, in order to determine whether the board made any unreasonable decisions. The court ruled that the board breached its fiduciary duty of care because it engaged in a sales process without having asked its financial advisor to fully inform the board of the company's valuation, and because it did not engage in proper oversight of its primary financial advisor. The court also noted that the special committee of the board only had authority to analyze strategic alternatives and relay those alternatives to the board, not to retain a financial advisor and initiate a potential sales process as it did in this case. The court held that this unauthorized initiation of a sales process fell short under the enhanced scrutiny standard of review. From the facts of this case, it does not seem that the primary financial advisor knew that the special committee of the board was operating without proper authorization. The board eventually passed a resolution "restating and ratifying" the special committee's authority to retain a financial advisor, but the court noted that the conduct of the sales process up to that point already represented a breach of the board's fiduciary duty of care; the court did not delve into why the resolution was a "restatement." It also determined that the board breached its fiduciary duty because its decision was based in part on a flawed financial fairness analysis.

The court went on to hold that the primary financial advisor knowingly aided and abetted the board's breach of its fiduciary duty of care because it "*created* the unreasonable process and informational gaps that led to the Board's breach of duty" (emphasis in original). Key examples of this information gap cited by the court include that the primary financial advisor did not provide the board with valuation materials until approximately one hour before the board meeting to approve the sale to Warburg (although the record is devoid of any request by the board for the primary financial advisor to furnish it with any valuation materials, and we are unaware of any prior requirement that the financial advisor do so) and that the valuation supporting the fairness opinion was tainted because the primary financial advisor misrepresented how analysts treat certain one-time adjustments in order to lower the valuation and make Warburg's bid appear relatively higher to the board. While the court did not impose a duty to update valuation materials on the primary financial advisor, the court held that the fact that the primary financial advisor only provided valuation materials at such a late stage in the process coupled with the faulty calculations rendered the information defective and reliance on it by the board unreasonable.

The court also took issue with the fact that while the primary financial advisor was running the sales process, it was also privately conferring with Warburg in order to offer it stapled financing. Vice Chancellor Laster stated that this presented a conflict for the primary financial advisor because it would stand to gain much higher fees from financing the transaction than from merely advising on it. In its defense, the primary financial advisor noted that Warburg ultimately did not use it for the financing of the bid, but Vice Chancellor Laster dismissed this fact by noting that just because the primary financial advisor never received the fees from such stapled financing does not mean it "did not act consciously to obtain [the fees]." The court noted, "[t]here was no conceivable upside for Rural from [the primary financial advisor's] last-minute lobbying of Warburg. The downside for Rural was to accentuate [the primary financial advisor's] desire to generate good will with Warburg and close the deal." The court found that such downside was evidenced in the faulty valuation discussed above.

In its defense, the primary financial advisor also argued that its engagement letter precluded a claim for aiding and abetting liability based on its attempt to provide stapled financing because the engagement letter contained language that the primary financial advisor may arrange for stapled financing for potential buyers of Rural/Metro. Vice Chancellor Laster rejected this argument because the boilerplate language "did not amount to a non-reliance disclaimer that would waive or preclude a claim against [the financial advisor] for failing to inform the Board about specific conflicts of interest." He stated that under Delaware law, a non-reliance disclaimer must be clear and unambiguous in order to be enforceable, and it wasn't in this case. As an aside, the court also dismissed the primary financial advisor's defense that Delaware General Corporation Law Section 102(b)(7) exculpation should apply to a party charged with aiding and abetting the board's breach of its fiduciary duty of care by noting that the exculpatory provision in Rural/Metro's certificate of incorporation does not protect aiders and abettors, only the directors of the corporation.

Lastly, the court also discussed the issues of contribution and fee shifting. The primary financial advisor raised the defense of contribution, arguing that any monetary liability it may owe should be lessened by either the defendants' share of liability or the amount the other defendants paid to settle the case, whichever is greater. The court ordered supplemental briefing on this question. The court was sympathetic to the plaintiff's claim of fee-shifting (*i.e.*, having the defendants pay plaintiffs' legal fees) but withheld reaching a conclusion on this issue until a proper motion was made at a later date. The court noted instances that would support fee-shifting (*e.g.*, alleged misrepresentations in the primary financial advisor's court testimony and changes in its position), such as when the primary financial advisor stated in pre-trial that it did not have meetings with Warburg without Rural/Metro's consent and that the team handling the stapled financing was separate from the team that was handling the Rural/Metro sales process, seemingly pushing the defendants to reach a settlement.

Holding

The four elements of a claim of aiding and abetting a breach of fiduciary duty are as follows: the existence of a fiduciary relationship, a breach of a fiduciary duty, knowing participation in that breach, and damages caused by that breach. Vice Chancellor Laster found that all four elements were satisfied here. In sum, he found that because the board (a fiduciary) acted in an unreasonable way (a breach), and the primary financial advisor was found to have acted with *scienter* (knowing participation) that caused the directors to sell Rural/Metro for less than its fair value (damages), the primary financial advisor is liable under a theory of aiding and abetting the board's unreasonable actions. This holding goes beyond the conflict relating to stapled financing. Much of Vice Chancellor Laster's decision focuses on the fairness opinion that aided and abetted the board's breach of its duty, but it is equally applicable to a financial advisor not offering stapled financing or to one merely rendering a secondary and independent fairness opinion. This is evident from a footnote in which Vice Chancellor Laster also criticizes the secondary financial advisor for its fairness opinion, but does not proceed further because the secondary financial advisor had already settled. Vice Chancellor Laster in many ways has put responsibility for properly running a sale process on the financial advisor, rather than on the board of directors, where such responsibility has traditionally rested, and, given that he has found the primary financial advisor liable despite no apparent finding of gross negligence by the board of directors, his holding is unclear on whether he has lowered the standard of liability for investment banks going forward.

Takeaways

Bad facts make bad law. As Vice Chancellor Laster noted in the first page of his opinion, the managing directors of the primary financial advisor who testified at trial provided testimony that "at times strained credulity, and the plaintiffs successfully impeached their testimony on multiple occasions." Previously it was understood that it was the board's responsibility to monitor the financial advisor and oversee the sales process, but this decision seems, at least partially, to have turned that paradigm on its head. The following are recommendations for best practices for financial advisors following the *Rural Metro* decision:

1. Engage in additional due diligence before agreeing to become a joint advisor, particularly when engaged after the initial financial advisor, because a joint or secondary advisor may be held accountable for information previously provided to, and work done previously by, the initial financial advisor. As an aside, joint presentations are less likely after this decision, and are less advisable.
2. Request and review the board minutes forming the special committee to confirm that the committee has the requisite legal authority and broad mandate, or at least ask for confirmation that the committee has such authority and mandate.
3. Create a clear record that valuation materials were available upon request, and, in certain circumstances, consider periodically providing updated valuation materials during the sales process, even when not asked to do so by the board. In anticipation of litigation, financial advisors should also explain in their presentations all differences in their valuations as they evolve over time and ensure that they are always reviewed by outside legal counsel representing the financial advisor. If possible, all presentations regarding valuation should be vetted by internal committees at the financial advisory firm (or a designated member of the committee) to ensure that significant changes are not requested by such committees after preliminary views on valuation have already been presented.
4. Solicit both strategic and financial buyers in a sell-side process, unless explicitly directed not to do so by the board of directors (and the board had made an informed decision on why any of such potential buyers should be excluded), given the court's criticism of the primary financial advisor for having only solicited potential financial buyers and for being unable to show that the board made a well-informed decision in this regard.
5. Conspicuously note which analyses were relied upon, and which, although included in the presentation, were presented for informational purposes only and not relied upon in reaching a conclusion regarding financial fairness, given the court's statement, albeit in a footnote, that the primary financial advisor "misleadingly" left its comparable company analysis in its presentation despite the fact that it did not rely upon it in reaching its conclusion. The determination of whether these informational analyses should be presented as annexes or separate supplemental materials depends on the particular facts and circumstances.
6. Supplementally specify exactly what conflicts the client is requested to waive once these conflicts are known, instead of merely relying on boilerplate language in the engagement letter itself.
7. Make the record clear that it was suggested that the board meet at least twice before it approves the sale of a public company given Vice Chancellor Laster's criticism that the board only had a single meeting to approve the merger and did not have enough time to properly evaluate Warburg's bid.
8. Have standing fairness committees or *ad hoc* committees composed of senior officers with significant opinion and valuation experience given the court's criticism of the primary financial advisor's *ad hoc* fairness committee, which was made up of two managing directors who happened to be available at that time, regardless of their fairness opinion experience, one of whom had never served on a fairness committee before, and which met for the first time the day before the Rural/Metro board approved the merger. Financial advisors should also consider precluding individuals from serving on a particular fairness committee, regardless of their seniority and experience, if those individuals report to members of that particular deal team.
9. Ensure complete and careful labeling in any and all presentations, and pay close attention to the drafting of the description of analyses in the proxy statement or other public filing given the court's finding of false disclosure relating to the valuation analysis in Rural/Metro's proxy statement.
10. Spend significant time considering potential business conflicts beyond those that have required consideration in the past. FINRA Rule 5150 requires disclosure of engagements by the financial advisor with any party to the transaction in the prior two years or anticipated in the future. In addition to the conflict regarding the stapled financing, which involved another party to the transaction, Vice Chancellor Laster criticized the primary financial advisor for not disclosing to the board that it initially wanted to run the sale process concurrently with the sale process of EMS because it could then try to garner buy-side financing fees from the bidders for EMS. This business conflict is beyond the types of conflicts courts have

required to be disclosed in the past, and similar business conflicts should be thoroughly vetted by the financial advisor before the financial advisor becomes engaged.

11. Exercise caution and great care when making statements, particularly in writing, about valuations given that they can be taken out of context.

Financial advisors must take heed of Vice Chancellor Laster's prescriptions if they wish to avoid aiding and abetting liability. It appears that the risk of providing stapled financing may now potentially outweigh the benefits. This is likely to further the trend to look to boutique investment banks for independent M&A advice. Query whether acquisition financing is the next targeted practice on the Court of Chancery's docket.

Postscript

Although judges are not supposed to consider after-the-fact events during the course of their decision-making, observers may do so. Consider the following: (1) the court noted that the primary financial advisor was retained with the mandate to sell the company, as it spent the bulk of its time during the beauty contest focused on this alternative; (2) Rural/Metro was trading at $12.55 before Warburg offered $17.25 per share, and Warburg's offer came about after an auction that produced six offers; (3) although this was not a simultaneous sign and close transaction, and the court did not find that the deal protections were preclusive, no higher bidders emerged; and (4) Rural/Metro filed for bankruptcy in 2013. Had the deal not gone through, the stockholders of Rural/Metro may have been wiped out in the bankruptcy process. Instead, they received a 37 percent premium and are suing for a windfall in damages, which are yet to be determined.

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