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Gatekeepers No More: Del. Defines M&A Adviser Liability

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On Nov. 30, 2015, the Delaware Supreme Court issued a 107-page opinion affirming the Court of Chancery's post-trial decisions in In re Rural/Metro Corp. Stockholders Litigation. In the lower court, Vice Chancellor J. Travis Laster found a seller's financial adviser (the "Financial Adviser") liable in the amount of $76 million for aiding and abetting the Rural/Metro Corp. board's breaches of fiduciary duty in connection with the company's sale to private equity firm Warburg Pincus LLC. See RBC Capital Markets LLC v. Jervis, No. 140, 2015, slip op. (Del. Nov. 30, 2015). The court's decision reaffirms the importance of financial adviser independence and the courts' exacting scrutiny of M&A advisers' conflicts of interest. Significantly, however, the court disagreed with Vice Chancellor Laster's characterization of financial advisers as "gatekeepers" whose role is virtually on par with the board's to appropriately determine the company's value and chart an effective sales process. Instead, the court found that the relationship between an adviser and the company or board primarily is contractual in nature and the contract, not a theoretical gatekeeping function, defines the scope of the adviser's duties in the absence of undisclosed conflicts on the part of the adviser. In that regard, the court stated: "Our holding is a narrow one that should not be read expansively to suggest that any failure on the part of a financial advisor to prevent directors from breaching their duty of care gives rise to" an aiding and abetting claim. In that (albeit limited) sense, the decision offers something of a silver lining to financial advisers in M&A transactions. Equally important, the decision underscores the limited value of employing a second financial adviser unless that adviser is paid on a noncontingent basis, does not seek to provide staple financing and performs its own independent financial analysis.

Background

Rural/Metro arose out of the March 2011 sale of Rural to a financial buyer, Warburg Pincus. Almost one year earlier, in May 2010, Rural was considering potential acquisition targets, including its primary competitor, American Medical Response Inc. (AMR), which was a subsidiary of Emergency Medical Services

Corp. (EMS). In August 2010, the Rural board appointed a three-member committee of nonmanagement directors to oversee Rural's strategy regarding an acquisition of AMR. Then, in early December 2010, after EMS announced that it was exploring strategic alternatives, the Rural board issued a new charge to the committee to explore potential strategic alternatives generally; however, the board did not authorize the committee to pursue a sale.

In late December 2010, the committee interviewed three potential candidates to serve as financial adviser and ultimately retained the Financial Adviser as its primary adviser. The committee also retained another firm as its secondary adviser (the "Secondary Adviser"). The Financial Adviser scheduled first-round bids for Rural in January 2011, which was timed to coincide with EMS's sale process. Several firms submitted indications of interest, including Warburg, which had withdrawn from the EMS bidding process. Ultimately, in March 2011, the Rural board approved a sale to Warburg.

Rural's shareholders sued the company's directors for breaching their fiduciary duties and also asserted aiding and abetting claims against the Financial Adviser and Secondary Adviser. The Rural directors and the Secondary Adviser settled near trial, and at trial, the Financial Adviser did not argue that the other defendants engaged in wrongdoing. After trial, without objection from the Financial Adviser, the lower court approved the proposed settlements, which barred all claims for contribution against the settling defendants but provided that damages against the Financial Adviser would be reduced to the extent of the pro rata liability on the part of the settling defendants.

In March 7 and Oct. 10, 2014, post-trial opinions, Vice Chancellor Laster found the Financial Adviser liable in the amount of nearly $76 million, representing 83 percent of the total damages of $91,323,544.61 sustained by the class. Vice Chancellor Laster also found that the Financial Adviser was barred from claiming a settlement credit under the Delaware Uniform Contribution Among Tortfeasors Act (DUCATA) to the extent it perpetrated a "fraud upon the board," which it characterized as a "failure of insiders to come clean" about their own or others' wrongdoing. The Financial Adviser appealed various aspects of the Chancery Court's post-trial decisions.

Takeaways

Revlon applies when the company in fact commences a sales process. The Delaware Supreme Court held that Revlon-enhanced scrutiny applied as soon as the committee initiated the sale process and retained the Financial Adviser in connection with exploring a sale of the company, even though the board had not authorized the committee to do so at that time and did not ratify those actions until several months later. There was no dispute on appeal that Revlon was the applicable standard of review, but the Financial Adviser argued that Revlon-enhanced scrutiny should not have applied until March 2011, at the very end of the sale process, when the board ratified the committee's initiation of the sale process and a sale of the company became "inevitable."

The court disagreed, explaining that, although simply "being in play" is not enough to trigger Revlon, the committee initiated an active bidding process in December 2010 and, on March 15, 2011, the full board "restated and ratified" those actions, thus rendering them retroactively approved and triggering Revlon from the outset. According to the court, "[t]o sanction an argument that Revlon applies only at the very endpoint of the sale process — and not during the course of the overall sale process — would afford the Board the benefit of a more lenient standard of review where the sale process went awry, partially due to the Board's lack of oversight. Such a result would potentially incentivize a board to avoid active engagement until the very end of a sale process by delegating the process to a subset of directors, officers, and/or advisors." The court contrasted the situation with Lyondell Chemical Co. v. Ryan, where the court

held that Revlon did not apply until Lyondell began negotiating with a potential acquirer because, unlike in Rural, the Lyondell board made a decision not to put the company up for sale and not to enact defensive measures, adopting instead a "wait and see" approach.

The court's decision makes clear that there is no bright-line test for determining when Revlon duties attach. Rather, courts will consider whether in fact a sales process was commenced in determining whether and when Revlon applies. Even where a special committee is alleged to have "gone rogue" in initiating a sale process, Revlon-enhanced scrutiny will still apply during that "rogue" period if in fact a sales process was initiated and the board later ratifies the special committee's conduct or there is evidence that the special committee's actions were sanctioned by the board.

A board's failure to discover a financial adviser's undisclosed conflict threatens to undermine — to the point of being meaningless — a market check conducted under those circumstances. The court affirmed the Chancery Court's ruling that the transaction failed to pass muster under Revlon because Rural's committee and the full board were unaware of, and did not meaningfully attempt to inquire into, the Financial Adviser's conflict of interest in seeking to obtain a buy-side financing role. According to the court, "[b]ecause a conflicted advisor may, alone, possess information relating to a conflict, the board should" have, but failed to, "require disclosure of, on an ongoing basis, material information that might impact the board's process." Here, the Financial Adviser was motivated to recommend that the board commence a sale process by its interest in leveraging its role as Rural's sell-side adviser to secure a role in buy-side financing with bidders for EMS (because an acquirer of EMS might decide to buy Rural rather than sell EMS's subsidiary, AMR). The court found that the maximum financing fee for the Financial Adviser was $55 million, "more than ten times the advisory fee."

The court further explained the harm caused by the board's failure to uncover that conflict: because the board was unaware of the Financial Adviser's conflict of interest, it also remained unaware of and did not explore the impediments to generating the highest reasonably attainable price for Rural given the competing EMS process. Specifically, running a competing sales process was likely to, and in fact did, preclude bids by potential financial buyers, which generally lacked the resources to pursue both companies at once, and strategic buyers, which were "preoccupied with" the EMS process. This fact was noted contemporaneously by private equity firm KKR and observed privately by the Financial Adviser itself. "Because Warburg had withdrawn from the EMS process, it was able to pursue Rural aggressively, thus giving Warburg an advantage over others who were still involved in evaluating EMS." The trial court found that "RBC's faulty design prevented the emergence of the type of competitive dynamic among multiple bidders that is necessary for reliable price discovery." Instead, the sales process was "structured and timed in a manner that impeded interested bidders from presenting potentially higher value alternatives" due to the simultaneous EMS sales process.

While a board will not be liable any time it fails to discover conflicts of interest on the part of its financial advisers, the court's decision reaffirms that a board has an affirmative duty to take sufficient steps to uncover any conflicts of its advisers, including by requesting ongoing disclosure of material information that might impact the board's decision-making process. Further, while the court agreed that "the reasonableness of initiating a sales process to run in tandem with the EMS auction, absent conflicts of interest, would be one of the many debatable choices that fiduciaries and their advisors must make ... and it would fall within the range of reasonableness," such decisions must be "viewed more skeptically" where undisclosed conflicts exists. And, although a board can waive certain conflicts while retaining the protection of 8 Del. C. § 141(e) (permitting presumption that information provided by experts is both accurate and complete when experts are "selected with reasonable care"), that protection is unavailable where the board fails to "manage conflicts as part of its oversight of the process. A board's consent to the conflicts of

its financial advisor necessitates that the directors be especially diligent in overseeing the conflicted advisor's role in the sale process."

A board needs to be adequately informed on an ongoing basis during a sales process about the value of the company being sold. The board also failed to conduct a reasonable sales process because it was not adequately informed concerning the company's value. The Financial Adviser failed to include any valuation metrics or analysis in board presentations until only three hours before the board voted to approve the deal. Moreover, the lower court determined that, unbeknownst to the board, the Financial Adviser altered its financial analyses in its fairness presentation to make the Warburg bid look more attractive, namely by (1) disregarding its prior reliance on comparable company analyses; (2) reducing the low-end multiple in both the management case and "consensus" case projections by "weigh[ing] heavily the 2004 acquisition of AMR by Onex Partners at 6.3x EBITDA, a course of action it had discredited earlier"; and (3) lowering the "consensus" adjusted earnings before interest, taxes, depreciation and amortization by deducting certain one-time expenses, even though its earlier analyses had added these one-time charges back to EBITDA.

A board's approval of a merger is unlikely to pass muster under Revlon where the board has failed to obtain and review on an ongoing basis unbiased and thorough analyses from its advisers, including reliable valuation metrics prepared by an independent financial adviser. The board should take steps to ensure that its financial adviser has provided it with all of the relevant information needed to make an informed decision on the transaction, and should require its advisers to disclose any material changes to its prior analyses, regardless of whether those prior analyses were provided to the board.

Financial advisers are not gatekeepers with fiduciary-like obligations to structure an appropriate sales process. In a lengthy footnote, the court expressed its disagreement with Vice Chancellor Laster's view that financial advisers function as "gatekeepers" that shoulder the responsibility of determining the corporation's value and designing and carrying out a sale process. The court explained that financial advisers and directors — "rational and sophisticated parties" — dealing at arm's length shape their contractual arrangements, and "it is for the board, in managing the business and affairs of the corporation, to determine what services, and on what terms, it will hire a financial advisor to perform in assisting the board in carrying out its oversight function." According to the court, "[a]dhering to the trial court's amorphous 'gatekeeper' language would inappropriately expand our narrow holding here by incorrectly suggesting that any failure by a financial advisor to prevent directors from breaching their fiduciary duty of care gives rise to an aiding and abetting claim against the advisor."

Advisers are not "gatekeepers" with unbounded responsibility to ensure that directors do not breach their duty of care. The court therefore walked back from the lower court's characterization of their roles, which seemed to be an attempt to impose extracontractual duties on, or at least greater scrutiny of, financial advisers than warranted under contract or traditional tort principles. While that is good news for financial firms, as this case shows, they remain exposed to liability (even where the directors themselves are protected under a Section 102(b)(7) charter provision) in the event they fail to disclose material information to their client, manipulate financial analyses to support a self-interested outcome, or otherwise seek to advance their own interests to the detriment of the seller.

Aiding-and-abetting liability requires that an adviser knowingly facilitate a board's breaches of fiduciary duty. Failure to prevent directors' breaches, without more, does not suffice for adviser liability. The court affirmed the Chancery Court's "narrow" holding that, "[i]f a third party knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum, then the third party can be liable for aiding and abetting." The aider and abettor must act knowingly, or with scienter. Here, the court agreed with Vice Chancellor Laster that the Financial Adviser did so by failing

to disclose to the board its interest in using its role in the Rural sale to secure buy-side financing for bidders for EMS, knowingly failing to provide the board with information about Rural's true value (including by manipulating valuation analyses at the 11th hour to present a more compelling picture for a sale to Warburg), and repeatedly attempting to secure a buy-side financing role with Warburg, which it kept from the Rural board. The court agreed that the Financial Adviser "misled the Rural directors into breaching their duty of care, thereby aiding and abetting the Board's breach of fiduciary duty."

While sell-side financial advisers are not technically barred from pursuing buy-side financing roles, at the very least it is critical that the adviser disclose its intention to pursue, and that it is in fact pursuing, such an arrangement to the board and that the board disclose that information to shareholders. Even then, it is questionable whether a sell-side financial adviser can safely pursue staple financing even after disclosure. It is possible that seeking to do so will be viewed by a court as creating a bias on the part of the financial adviser that renders its advice not independent and disinterested, and therefore taints (or at least does not cleanse infirmities in) a board's sales process, although perhaps such attempts, if disclosed, would not support aiding-and-abetting liability.

At the very least, the adviser must negotiate and put expressly in the engagement letter the scope of permissible conduct with respect to staple financing and similar arrangements posing the threat of a conflict. Here, while the Financial Adviser's engagement letter granted it the exclusive right to offer staple financing to a potential purchaser, the letter was silent about attempting to use its position as Rural's adviser to offer buy-side financing to EMS purchasers, nor did the Financial Adviser disclose the fact that it was actually attempting to provide staple financing to Warburg. The letter therefore did not disclose the conflicts that "ultimately emerged."

Secondary financial advisers will "cleanse" a primary adviser's flawed conduct only in certain circumstances.
The court affirmed the Chancery Court's finding that, but for the Financial Adviser's actions, the Rural board would not have breached its duty of care, and rejected the Financial Adviser's argument that the Secondary Adviser's independent financial analysis cleansed the Financial Adviser's conflict and broke the proximate causal link between the Financial Adviser's conduct and the board's breach. The court explained that the Secondary Adviser was "only a secondary actor in the valuation process, and — like the Financial Adviser — was compensated for its advisory role on [a] contingent basis."

As the court observed, advisers are not guarantors that directors will satisfy their fiduciary duties. However, where a primary, conflicted adviser has created the environment that caused the directors to breach their duty of care, courts will likely not be swayed by the fact that the board had also retained a secondary, supposedly independent adviser. If the "secondary actor" is to have any "cleansing" effect to the extent there are deficiencies in the primary adviser's analyses or conduct, the secondary adviser should not be treated by the board as having second-class status, should be paid on a noncontingent basis and should perform its own analysis independent of the primary adviser's analysis.

The Court's decision highlights the importance of tactical trial decisions when some but not all defendants settle prior to trial. The court affirmed the Chancery Court's calculation of damages and its allocation of fault on a pro rata basis, which concluded that the Financial Adviser was liable for 83 percent of the total $91,323,544.61 in damages. The court rejected the Financial Adviser's argument that all eight defendants, including the Financial Adviser, should have borne an equal 12.5 percent share of the damages because "pro rata" means "proportionate," not "equal," and the Financial Adviser was disproportionately at fault compared to the other defendants. The court also affirmed the Chancery Court's ruling that the doctrine of unclean hands barred the Financial Adviser from seeking contribution on the disclosure claim or sale

process claim relating to the approval of the merger because, otherwise, the financial adviser would be taking advantage of the very "targets of its own misconduct."

The court's decision also underscores the importance of recognizing the tactical issues raised in deciding whether to call a defendant to testify at trial. The Chancery Court might have found that a third director breached a duty of loyalty and attributed a percentage of fault to him, thereby reducing the Financial Adviser's damages, if such director had testified at trial. The Chancery Court refused to find that this director breached his fiduciary duties, notwithstanding "evidence suggesting that selfish motives played a role in [his] actions" because "[c]ritically ... no one called [him] at trial, and I did not have an opportunity to evaluate his credibility. In my view it would take a powerful and persuasive evidentiary showing to permit a court to find in absentia that a director acted disloyally or in bad faith." On that record, the Supreme Court had no basis to reverse the Chancery Court's ruling and order contribution from the nontestifying directors. The court also rejected the Financial Adviser's claims of prejudice due the "timing of the eve-of-trial settlements" because "that is simply a function of RBC being the last non-settling defendant."

Section 102(b)(7) charter provisions potentially heighten the risk that financial advisers will be sued and make it more difficult for them to settle at reasonable amounts. The court also affirmed the Chancery Court's ruling that Rural's Section 102(b)(7) charter provision precluded contribution under DUCATA from all but two of the Rural directors because those directors (none of whom testified) were not alleged to have engaged in nonexculpated breaches of duty. The other two directors, who were alleged to have breached their duty of loyalty, testified at trial. The Financial Adviser argued that 102(b)(7) provisions are designed to eliminate liability, not shift it to nonfiduciaries, and therefore the Chancery Court's ruling would inequitably make financial advisers guarantors for directors who negligently approve M&A transactions. Rejecting this argument, the court explained that third-party advisers have a benefit not available to directors—they must be found to have acted with scienter to be held liable for aiding and abetting. Moreover, the court explained, Section 102(b)(7) provisions are not intended to "safeguard third parties and thereby create a perverse incentive system where trusted advisors to directors could, for their own selfish motives, intentionally mislead a board only to hide behind their victim's liability shield."

Advisers that are held liable for aiding and abetting may be left without recourse against the directors whose breach of duty they have allegedly "aided and abetted," even if those directors (as would have to be the case for aiding-and-abetting liability) are found to have breached their duty of care. As a nonexculpated deep pocket, financial advisers confront a situation where they are likely to be sued along with directors and may find it difficult to settle such suits at acceptable amounts.

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