

# CLIENT UPDATE

## HOW SELL SIDE ADVISORS CAN REDUCE LITIGATION RISK IN LIGHT OF DELAWARE'S RURAL/METRO DECISION

### NEW YORK

Gregory V. Gooding  
ggooding@debevoise.com

Gary W. Kubek  
gwkubek@debevoise.com

Maeve L. O'Connor  
mloconnor@debevoise.com

William D. Regner  
wdregner@debevoise.com

On March 7, 2014, Vice Chancellor Laster of the Delaware Court of Chancery found RBC Capital Markets, LLC liable for damages for aiding and abetting breaches of fiduciary duty by the directors of Rural/Metro Corporation in connection with Rural's 2011 sale to an affiliate of Warburg Pincus LLC. [See \*In re Rural Metro Corp. Stockholders Litig.\*, C.A. No. 6350-VCL.](#) The opinion seems likely to increase litigation risk for target financial advisors. At the same time, it offers a number of important reminders for advisors as they help targets manage sale processes.

By many measures, the Rural acquisition was a success for Rural stockholders. The Court noted that the deal price represented a premium of 37% over the company's pre-announcement trading price, which itself had increased almost 400% over the prior two years. The transaction was approved by holders of over 72% of Rural's shares. Moreover, the transaction was far from a success for the buyer: Rural filed for bankruptcy barely two years after the transaction closed, as a result of the debt taken on to finance the acquisition.

Nonetheless, the Delaware Court of Chancery found that Rural's directors breached their duty of care in connection with the process they employed and certain decisions they made in the course of selling Rural. That finding followed a trial at which RBC was the only defendant, the Rural directors and RBC's co-financial advisor having settled the claims against them shortly prior to trial.

In addition to the procedural lessons for sell-side financial advisors, the Court's decision confirms that an advisor can be held liable for damages for aiding and abetting a breach of fiduciary duty by directors even where the directors themselves have no monetary exposure for such a breach. Rural's charter contained an exculpatory provision, as authorized by Section 102(b)(7) of the Delaware General Corporation Law, that absolved the directors of monetary liability for duty of care failures. However, the Court, in what appears to be a case of first impression, held that Section 102(b)(7) does not protect financial advisors. The Court relied for this conclusion on the text of Section 102(b)(7) and explained that the legislature could have "decided rationally to authorize exculpation for independent, disinterested directors who act in good faith, but not to extend exculpation to the highly compensated advisors on whom the directors are entitled (and encouraged) to rely." The Court emphasized the "gatekeeper" role of financial advisors and expressed the view that "the threat of liability helps incentivize gatekeepers to provide sound advice, monitor clients, and deter client wrongs."

While nearly all public company mergers in recent years have attracted stockholder litigation, these claims are almost always settled prior to closing. Except in going private transactions or other cases where directors' duty of loyalty is implicated, Section 102(b)(7) exculpatory provisions remove much of the incentive to pursue litigation against target directors following closing. However, the Rural decision can be expected to give new life to post-closing litigation in the form of aiding and abetting claims against sell-side advisors.

What can sell-side advisors do to limit exposure to aiding and abetting claims? Vice Chancellor Laster's opinion provides a number of important reminders:

*Make sure your client's board has authorized the sale of the company.*

The Court repeatedly noted that the initial decision to sell Rural "was not made by a competent decisionmaker." The board never made a formal decision to put the company up for sale. Although the board formed a special committee following reports that Rural's primary competitor, EMS, was up for auction, the special committee was authorized only to analyze strategic alternatives, not to launch a sale process. This original sin colored much of the Court's criticism of the process followed by the directors and its advisors and the Court's conclusion that the decision to put the company up for sale constituted a breach of the directors' fiduciary duties.

*Disclose all conflicts.*

Chancellor Laster took Rural's financial advisor to task for its efforts to get financing engagements from bidders for EMS as well as from Warburg in connection with its bid for Rural. Those efforts continued throughout the sales process, including during the final merger price negotiations. Although RBC's engagement letter included an acknowledgement by Rural that RBC may provide normal course financial products and services to companies that may be involved in a proposed transaction with Rural and may provide financing to buyers of businesses that compete with Rural, the Court found this language to be insufficiently specific to insulate the bank from liability. The Court concluded that the directors' failure to police their advisor's conflicts – or even to learn of them – constituted a breach of their duty of care. Moreover, the Court held that the failure of those conflicts to be specifically disclosed in the merger proxy statement constituted a separate fiduciary duty breach.

*Take care in defining the universe of potential acquirors.*

Only financial buyers were invited into the Rural sale process. In the absence of any record of the board's deliberating on the issue of which bidders to approach and making an informed decision that it was in the company's interest to exclude strategic buyers, the Court was left to conclude that this decision was made by the company's bankers in order to further their own objectives. A good decision-making record would have made this decision much less open to post-game criticism.

*Keep the board involved throughout the sale process.*

The Rural board met only once, and the special committee only twice, during the three months between Rural's engagement of financial advisors and the meeting to approve the merger agreement with Warburg. The Court found the assertion, in the minutes of that one board meeting, that the special committee had provided "detailed oversight" of the sale process to be "sadly, false." While it may seem unfair to blame this dereliction on the financial advisor, it is important to keep in mind that Rural's advisors would have had no liability had the Court not determined that the Rural directors breached their fiduciary duties. Although the Court chastised the Rural board for failing to adequately supervise its advisors, the fact that it was the advisor which was stuck with the ultimate liability (as a result of the Rural board having settled) makes clear that part of the advisor's role is to monitor the actions of its client. In the words of the Court, "the prospect of aiding and abetting liability for investment banks creates a powerful financial reason for the banks to

advise boards in a manner that helps ensure that directors carry out their fiduciary duties when exploring strategic alternatives and conducting a sales process.”

*Don't wait until the last moment to provide valuation advice to the board.*

One result of the limited number of board and special committee meetings during the months leading up to the final merger agreement was the absence of opportunities for the financial advisor to present valuation analyses to the directors. The Court noted that the valuation materials delivered to the board little more than an hour before the board meeting to approve the transaction constituted “the first valuation information that the board ever received as part of the sale process.” As a result, the Court found the directors were deprived of the “opportunity to examine [the fairness] material critically and understand how the value of the merger compared to Rural’s value as a going concern.” These conclusions supported the Court’s finding that the board lacked an adequate informational basis upon which to approve the transaction.

*Make sure your fairness analysis is internally consistent.*

The Court found that the comparable company multiples used in the bankers’ final fairness analysis were inconsistent with those used when they pitched their engagement, as well as with the views it expressed throughout the sale process. It made similar findings with respect to adjustments to historical EBITDA and exit multiples used in the DCF analysis. These unexplained inconsistencies allowed the Court to characterize the final analysis as being more result-driven than impartial.

*Have a standing fairness committee of experienced bankers.*

The Court criticized Rural’s bankers for the ad hoc nature of their fairness committee process, finding that the fairness committee consisted of “any managing directors who happen to be available and willing [to serve]” – in this case, two bankers, one of whom had never previously served on a fairness committee. The Court contrasted this approach with that of other leading investment banks, which “have a standing fairness committee staffed by senior bankers who oversee the opinion process and review opinions to ensure their quality and consistency.”

*It's dangerous to be the last defendant standing.*

Despite the fact that a critical issue before the Court was whether the Rural directors breached their fiduciary duties, the only defendant left to go to trial was Rural’s financial advisor. This left RBC in the difficult position of defending the directors’ conduct in

circumstances where the directors themselves had little to no skin in the game. Moreover, the fact that the directors settled also likely led to the plaintiffs' decision to forgo duty of loyalty claims (to which the Section 102(b)(7) exculpatory provision would not apply) and to assert only duty of care claims. The Court left open the question of whether either the directors' contributory fault or the amount they paid in settlement might reduce RBC's liability.

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The Rural decision opens the door to additional litigation risk for sell-side financial advisors. However, Vice Chancellor Laster's opinion also provides a roadmap for how an advisor can limit that risk. The Court's admonitions in its opinion are not new. Nevertheless, they are important reminders that director and financial advisor liability most often results from process failures, and that a substantial premium does not absolve fiduciaries and their advisors for shortcomings in that process.

Please do not hesitate to contact us with any questions.

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