

# Client Update

## Delaware Supreme Court Affirms "Narrow" *Rural/Metro* Ruling; Declines to Characterize Sell-Side Financial Advisors as "Gatekeepers"

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On November 30, 2015, the Delaware Supreme Court affirmed<sup>1</sup> the judgment of the Delaware Court of Chancery holding that RBC Capital Markets aided and abetted a breach of fiduciary duty by the directors of Rural/Metro Corporation in connection with Rural/Metro's 2011 sale.<sup>2</sup> The Rural/Metro directors—largely shielded from monetary liability under Rural/Metro's certificate of incorporation—and the company's second financial advisor had settled during trial, leaving RBC responsible for a \$75 million damages award, representing 83% of the total damages found to have been suffered by the Rural/Metro stockholder class.<sup>3</sup>

The initial Rural/Metro decision attracted attention both for the size of its damages award and for the potential breadth of its holding. Some commentators objected to the court's characterization of financial advisors as "gatekeepers" who are responsible for ensuring the integrity of an M&A sale process. Others questioned its holding that the circumstances surrounding the institution of the Rural/Metro sales process were subject to—and failed—enhanced scrutiny under *Revlon*. Both the Securities Industry and Financial Markets Association (SIFMA) and the National Association of Corporate Directors (NACD) filed amicus briefs urging the Delaware Supreme Court to reverse the lower court's decision, with

<sup>1</sup> *RBC Capital Markets v. Jervis* (Del. S. Ct. November 30, 2015).

<sup>2</sup> *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54 (Del. Ch. 2014).

<sup>3</sup> *In re Rural/Metro Corp. S'holders Litig.*, 102 A.3d 205 (Del. Ch. 2014).

the NACD asserting that it represented “a tectonic shift in the fiduciary landscape for directors.”

That effort was unavailing. The Delaware Supreme Court affirmed the Court of Chancery’s holdings that (i) the Rural/Metro directors breached their duty of care under the *Revlon* enhanced scrutiny standard, (ii) the directors violated their fiduciary duty of disclosure by making materially false statements in the Rural/Metro proxy statement, (iii) RBC, as the company’s financial advisor, aided and abetted those breaches, and (iv) those breaches resulted in damages to the Rural/Metro stockholders. The Court also upheld the trial court’s calculation of damages and the allocation of liability under the Delaware Uniform Contribution Amount Tortfeasors Act.

Despite upholding the lower court’s rulings in all respects, the Delaware Supreme Court took care to characterize both its and the Court of Chancery’s decisions as “narrow,” and the underlying facts on which they were based as exceptional. The Court emphasized that its decision did not expand the Court’s previous rulings, including as to the stage in the deal process at which *Revlon* duties attach,<sup>4</sup> the elements of an aiding and abetting claim<sup>5</sup> or the responsibility of a financial advisor to its director clients.<sup>6</sup>

Although of little comfort to the defendant, the Delaware Supreme Court also disavowed the Court of Chancery’s characterization of financial advisors as “gatekeepers” who provide “expert services” to corporate directors who “are not expected to have the expertise to determine a corporation’s value for themselves or to have the time or ability to design and carry out a sale process.” Instead, the Supreme Court emphasized the contractual nature—and potentially limited scope—of the advisor/client relationship:

The trial court’s description does not adequately take into account the fact that the role of a financial advisor is primarily contractual in nature, is typically negotiated between sophisticated parties, and can vary based

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<sup>4</sup> “[O]ur narrow ruling premised on these unusual facts effects no shifts in the *Revlon* landscape, let alone tectonic ones.”

<sup>5</sup> “The trial court . . . held that if a [i]f the 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.’ We affirm this narrow holding.”

<sup>6</sup> “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 a claim for aiding and abetting [that breach].”

upon a myriad of factors. Rational and sophisticated parties dealing at arm's-length shape their own 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. The engagement letter typically defines the parameters of the financial advisor's relationship and responsibilities with its client.

Notably, the Court gave no weight to the presence of a second financial advisor—which was unburdened by conflicts of interests and the conduct of which was largely unchallenged—or to the advice that second advisor gave to the board. While acknowledging that obtaining a second opinion “can have a salutary effect on a sale process,” the Court declined to find that it cleansed the Rural/Metro process or broke the causal chain between the first advisor's actions, the fiduciary breach by the directors, and the harm suffered by the stockholders. The Court noted both the secondary role played by the second bank as well as that bank's own financial interests: “[The] argument that [the second bank's] presence cleansed the process falls short, in part, because the supposedly conflict-cleansing bank was paid on the same contingent basis as the primary bank.”

Most financial advisors will undoubtedly accept the Court's invitation to focus even more carefully on their engagement letters, both to disclose potential conflicts and to try to circumscribe the advisor's responsibilities. Ultimately, however, the Court's decision underscores the need for financial advisors to rigorously police their own conflicts, to actively disclose those conflicts to their clients, and to make sure that their clients make clear and accurate disclosure of those conflicts to their stockholders.

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Please do not hesitate to contact us with any questions.