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M&A Update

Delaware Supreme Court Upholds *Rural Metro* Decision, but Financial Advisors Can Breathe a Sigh of Relief

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In a November 30, 2015 decision, the Delaware Supreme Court upheld the Delaware Chancery Court's $76 million damages award against RBC Capital in *In re Rural/Metro Corp. S'holders Litig.* The ruling, however, notably rejected the trial court's characterization of financial advisors as "gatekeepers" of the M&A process, and the Court emphasized that its holding is to be narrowly viewed in the context of the specific facts of the case.

Takeaways

The decision reinforces the liability risks financial advisors take on when they fail to disclose alleged conflicts of interest to their clients or allegedly act in a manner that is not in the best interests of their clients. Financial advisors, nevertheless, can take comfort in the case's narrow holding and the Court's clarification that financial advisors will not be held responsible under an aiding and abetting theory of liability absent affirmative misconduct taken by a financial advisor with an "illicit state of mind." The following are key takeaways from the decision:

1. Financial Advisors are Not "Gatekeepers". The Court rejected the Chancery Court's characterization of financial advisors as "gatekeepers" of an M&A process having a duty to "determine a corporation's value" and "design and carry out a [corporation's] sale process." Prior to the Court's decision, many financial advisors and M&A practitioners interpreted the Chancery Court's characterization as inappropriately expanding a financial advisor's responsibilities beyond the customary obligations that it is contractually required to perform. In rejecting this concept, the Court noted that the Chancery Court's "gatekeeper" characterization does not adequately take into account that the role of the financial advisor is the product of a contractual arrangement between sophisticated, arms-length parties and that it is the Board's responsibility to determine for what services, and on what terms, it will hire a financial advisor. The Court stated that a financial advisor's aiding and abetting liability arises when the financial advisor, in performing the services, acts in a manner that is not in the best interest of the company, thereby undermining the very same advice that it has been retained to provide. The Court further noted that "adhering to the trial court's amorphous

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'gatekeeper' language would inappropriately expand [its] narrow holding here by suggesting that any failure by a financial advisor to prevent directors from breaching their duty of care gives rise to an aiding and abetting claim against the advisor."

2. A Financial Advisor Must Act with *Scienter* to be Held Liable for an Aiding and Abetting Claim. The decision makes clear that in order for a financial advisor to be held liable for aiding and abetting a breach of fiduciary duty, the financial advisor must act with *scienter*; that is act "knowingly, intentionally or with reckless indifference" and with an "illicit state of mind." To establish liability, the plaintiff has to demonstrate that the aider and abettor had "actual or constructive knowledge that their conduct was legally improper." Here, the Court found that the financial advisor knowingly induced the breach by creating an informational vacuum and by exploiting its own conflicted interests to the detriment of the company. However, the Court did emphasize that this holding should be viewed as a narrow one and that the requirement that the financial advisor be deemed to have acted with *scienter* makes an aiding and abetting claim among the most difficult claims to prove.

3. Financial Advisors Can Still be Liable Even if Directors Themselves Do Not Face Monetary Liability. Under Delaware law, a disinterested director is not liable for monetary damages for a breach of the duty of care unless the director's behavior constitutes gross negligence. In this case, the Court found that the Board violated its situational duty by failing to take reasonable steps to attain the best value reasonably available to the shareholders, but that the directors' conduct did not rise to the level of gross negligence. The financial advisor argued that a Board's breach of the duty of care that does not rise to the level of gross negligence should not be able to form the basis of a post-closing aiding and abetting damages claim. The Court rejected this argument, noting that the exemption of board members from monetary damages absent grossly negligent conduct was based upon independent policy concerns and that the breach of the Board's fiduciary duty, without a finding of gross negligence, was a sufficient predicate for finding aiding and abetting liability.

4. *Revlon* Duties Commence Upon the Initiation of an Active Sale Process. The Court found that the Board's enhanced *Revlon* duties commenced upon initiation of the company's sale process in December 2010, and rejected the argument that *Revlon* duties should not have commenced until the end of the auction process in March 2011 on the theory that the company was merely reviewing strategic alternatives until such time. In making this determination, the Court found that the Special Committee of the Board and the financial advisor had initiated an active (albeit unauthorized) sale process in December 2010, that the company did not explore other strategic alternatives between December 2010 and March 2011 and that the financial advisor believed it had been hired to assist in the sale of the company. The Court further rejected the argument that *Revlon* duties cannot apply to a sale process in the absence of Board authorization, finding that the Board retroactively ratified

initiation of the unauthorized sale process and that to come to such a conclusion would allow the Board to benefit from a more deferential standard of review during a time when, due to its lack of oversight, the Special Committee and financial advisor had undertaken a sale process without Board approval. While the decision makes clear that the breach of a Board's fiduciary duties is only one factor in determining whether financial advisor aiding and abetting liability exists, financial advisors would be well served by ensuring that a sale process has been properly authorized by the Board.

5. Boards May Look to Protect Themselves from Financial Advisor Conflicts of Interest Through Expanded Engagement Letter Provisions. The Court made clear that a Board's blanket consent to a financial advisor's conflict of interest does not give the financial advisor a "free pass" to act in its own self-interest and against the best interests of its client. Moreover, a Board's ability to rely on the advice of a conflicted advisor presupposes that the Board has undertaken to manage the impact of any conflicts. While the Board may consent to certain conflicts, consent necessitates that directors be especially diligent in overseeing a conflicted advisor's role in a sale process. In this regard, the Court suggested that this increased oversight may include a Board's insistence that provisions be included in engagement letters requiring financial advisors to specifically disclose conflicts at the outset and throughout the process.

6. Retention of a Secondary Financial Advisor Does Not by Itself Absolve the Primary Advisor from Liability. The Court made clear that the retention of a secondary financial advisor is not by itself adequate to absolve the primary advisor of liability based on its conflicts of interest and related misconduct. The Court noted that the Board's receipt of a secondary financial analysis did not break the causal link between a financial advisor's actions, the Board's failure to satisfy its fiduciary duties and the harm suffered by the company's shareholders. In coming to this conclusion, the Court further noted that the Board treated the second financial advisors' advice as secondary and that significant fees to be paid to the second financial advisor were similarly contingent on consummation of the transaction. Here, the Court explained that the financial advisor "knowingly induced the breach [of fiduciary duties] by exploiting its own conflicted interests . . . by creating an informational vacuum" and that "the stockholders went to the ballot box on the basis of a deficient Proxy Statement, the insufficiency and misleading nature of which was due to the financial advisor's failure to be forthcoming."

For a full copy of the opinion, click here.

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