The "Gatekeepers": Delaware Court Holds Conflicted Financial Advisor Liable for Aiding and Abetting Breach of Fiduciary Duty

March 13, 2014

Background

Delaware courts have increasingly shined a spotlight on what they consider to be conflicts of interest for sell-side financial advisors. On March 7th, the Delaware Chancery Court hit these conflicts with a laser beam. In a post-trial opinion in *In re Rural/Metro Corp. S'holders Litig.*, Vice Chancellor Laster found RBC Capital liable for aiding and abetting breaches of fiduciary duty by the board of Rural/Metro in connection with Rural/Metro's 2011 sale to private equity firm Warburg Pincus, for $17.25 a share. Repeatedly noting that RBC was "highly compensated" and a "gatekeeper," the court found that RBC was monetarily liable, even though the directors themselves were shielded from liability under Delaware law, because RBC had prevented the board members from fulfilling their fiduciary and disclosure duties. The court cited evidence that RBC did not disclose its conflict in seeking to finance the buyer's bid, engaged in behind-the-scenes manipulation of the sale process, and did not appropriately analyze the company's value. The *Rural/Metro* decision is a stark reminder that financial advisors face potential liability where their advice appears to be conflicted or results-driven.

Takeaways

The opinion continues the growing trend in Delaware of courts scrutinizing the conduct of sell-side financial advisors, particularly where a conflict such as providing financing to a bidder exists. Vice Chancellor Laster emphasized that "the threat of liability helps incentivize gatekeepers [such as financial advisors] to provide sound advice, monitor clients, and deter client wrongs," indicating that heavy scrutiny of financial advisors in these cases could increase. With this in mind, financial advisors should consider the following lessons from *Rural/Metro*, and other related decisions:

1. Unbiased Valuation. The court based its decision in part on what it called RBC's "belated and skewed valuation deck," which resulted in an unreasonable approval of the Warburg bid by the Rural/Metro board. Particularly, RBC did not provide the board with any valuation metrics until the board meeting approving the deal, even though there had been several meetings with directors to discuss the sale process. Moreover, when the board finally saw valuation materials, it was "less then twelve hours before the expiration of Warburg's bid," and reflected weeks of

the RBC team "working to lower the analyses in its fairness presentation to make Warburg's bid of $17.25 look more attractive." The court highlighted several skewed valuation analysis techniques pursued by RBC, noting that parts of the board book contained "outright falsehoods." For example, the bankers did not make pro forma adjustments and add back a multi-million dollar one-time expense to Rural's valuation, contrary to common practice. The court was especially critical of what it viewed as RBC's unwillingness to share valuations or advice that would support a rejection of the Warburg bid or a decision by the company to remain independent. This case echoes then-Vice Chancellor Strine's opinion in *In re El Paso Corp. Shareholder Litigation*, which criticized the advisor after finding that there were "questionable aspects" to the valuation, including apparently results-driven revisions, particularly in light of the advisor's conflicts. Delaware courts are increasingly scrutinizing the inputs to the models supporting fairness opinions. Financial advisors need to ensure that those inputs are defensible, factually supported and based upon their unbiased professional judgment. Courts are proving unwilling to tolerate evidence that the models are being manipulated toward a specific outcome (especially one that generates fees or future business for the advisor).

2. Complete and Timely Disclosures. Vice Chancellor Laster also repeatedly criticized what the opinion termed RBC's failure to disclose key conflicts to the board. RBC was hoping to leverage its sell-side advisory work for Rural/Metro into a role in the buy-side financing of Rural/Metro's larger competitor, EMS, a conflict that RBC never disclosed. Furthermore, RBC was pursuing buy-side financing in the Rural-Warburg deal itself up to the very last minute, another fact that it failed to disclose, again leaving the Rural/Metro board without a complete picture on which to base decisions. Vice Chancellor Laster had made a similar finding in *In re Del Monte Foods Co. Shareholders Litigation*, when he criticized a sell-side advisor for failing to disclose its interest in buy-side financing from the very beginning. While these cases do not reflect a *de facto* prohibition on the participation by a sell-side advisor in transactions that present a conflict of interest (such as participation in buy-side financing), if financial advisors intend to pursue related transactions that create potential conflicts, those conflicts and their import must be disclosed fully to the board.

3. Sale Process. The court's decision emphasizes the importance of a sell-side financial advisor's role in designing a proper sale process to maximize shareholder value and ensure that directors are fully informed of the rationale and strategy of the proposed sale process. The court continuously criticized RBC for moving forward with the sale process despite the existence of readily foreseeable problems. For example, the court found that it should have been clear to RBC that bidders participating in the EMS sale process would be less likely to participate in the Rural/Metro sale process because of restrictions in their confidentiality agreement with EMS. Furthermore, the sale process was conducted at a time when potential strategic acquirors were distracted by their own change of control transactions. While the court noted that a well-informed board might have pursued a sale of the company despite these red flags, the court found that the determination to move forward with a sale process was outside the range of

reasonableness because "RBC did not discuss obvious and readily foreseeable disadvantages" of conducting a process on the proposed timeframe. The court's decision demonstrates the care financial advisors should take to ensure that the board is fully informed as to the pros and cons of commencing a sale process, the universe of bidders that may be interested in participating in the process and any outside influences that may limit potential bidders from participating in the process.

4. Fairness Opinion Committees. Vice Chancellor Laster criticized the ad hoc nature of RBC's opinions committee. Rather than a standing committee of senior bankers experienced in preparing and reviewing fairness opinions, RBC's committee was, according to the court, an *ad hoc* arrangement comprised of any managing director-level employee who volunteered to serve with respect to a given opinion. To be effective, fairness opinion committees should be structured to be truly knowledgeable and independent checks on the deal team, with relevant experience and the clout to push back when a proposed fairness opinion is inadequate or questionable.

5. Conflict Waivers in Engagement Letters. The court rejected RBC's argument that the generic conflict disclosure in its engagement letter with Rural/Metro insulated it against liability arising from conflicts of interest. While the engagement letter acknowledged that RBC could "provide a broad range of normal course financial products and services to their customers . . . , including companies that may be involved in a Transaction contemplated by this Agreement," this was not "a non-reliance disclaimer that would waive or preclude a claim against RBC for failing to inform the board about specific conflicts of interest." RBC and Rural/Metro may have agreed that RBC could potentially provide financing to parties involved in the Rural/Metro sale, but that did not mean they could do so without disclosing it.

6. Proxy Statement Disclosures. In addition to being thorough in disclosing all actual and potential conflicts of interest to their clients, financial advisors should review the applicable proxy statement and be diligent in disclosing material conflicts in the proxy statement.

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