Potter Anderson Corroon LLP

# Delaware Law Updates

## IN RE RURAL METRO CORP. S'HOLDERS LITIG., C.A. NO. 6350-VCL (DEL. CH. MAR. 7, 2014) (LASTER, V.C.)

March 7, 2014

In this post-trial decision, the Court of Chancery held a financial advisor liable for aiding and abetting breaches of fiduciary duty by a target board in the sale of the company. The Court concluded that the financial advisor put the company in play, provided false and materially misleading information to the board and held an undisclosed conflict of interest in the transaction. The Court also held that an exculpatory provision contained in the certificate of incorporation pursuant to Section 102(b)(7) of the General Corporation Law of the State of Delaware ("DGCL") only covers directors and does not extend to aiders and abettors of a breach of fiduciary duty by directors.

On June 30, 2011, an affiliate of Warburg Pincus LLC ("Warburg") merged with Rural/Metro Corporation ("Rural"). Rural common stockholders received $17.25 per share as a result of the merger. Plaintiffs, shareholders of Rural, filed suit alleging breaches of fiduciary duty by the Rural board of directors (the "Board") for approving the merger and failing to disclose material information in Rural's proxy statement. Plaintiffs also filed suit against RBC Capital Markets, LLC ("RBC"), the primary financial advisors to the Board, and Moelis & Company LLC ("Moelis"), the secondary financial advisors to the Board, for aiding and abetting the Board's breaches of fiduciary duty. Plaintiffs settled with the Board and Moelis before trial.

Plaintiffs' aiding and abetting claims against RBC fell into two main categories: (1) misconduct leading to breaches of duty during the sale process and (2) misconduct leading to disclosure violations. In analyzing these claims, the Court evaluated the Board's actions under the enhanced scrutiny standard of review because the disputed merger involved the sale of a corporation for cash. The Court noted that, in a typical fiduciary duty action against directors under enhanced scrutiny, the burden of proof shifts to the defendant fiduciaries. However, since the Plaintiffs chose to settle with the Board and continue only with the aiding and abetting claim, the Plaintiffs would have the burden to prove each element of an aiding and abetting claim, including the existence of a breach.

With respect to the sale process, the Court found two Board decisions unreasonable under the enhanced scrutiny standard of review. First, the Court found that the Board's decision to run the sale process in parallel with the sale process of Emergency Medical Services Corporation ("EMS") was unreasonable. As a threshold matter, the Court noted that the decision to initiate the sales process was not reasonable because an authorized corporate decision-maker did not make it. The Board charged a special committee to analyze alternatives, but the special committee instead hired RBC to sell Rural. In addition to that fundamental problem, RBC did not disclose that proceeding in parallel with the EMS process served RBC's interest in attempting to obtain buy-side financing of the EMS deal. RBC recommended to the special committee that they run the sale process of Rural in parallel with the EMS process because the finalists in the EMS process would likely also be interested in Rural. RBC knew but did not disclose, however, that the bidders for EMS would believe that they could have an inside track on acquiring Rural after an EMS acquisition if RBC participated in the financing of the EMS deal. RBC also did not discuss with the special committee several obvious disadvantages of a parallel process, including the fact that standard confidentiality agreements would limit the ability of bidders to participate in both processes, as the bidders would need separate teams of advisors maintaining separate confidentiality obligations. The Court noted that a well-informed Board could not have concluded that it was reasonable to pursue a parallel sales process, but neither the Board nor the special committee made such a decision. The Court therefore held that this decision to run a sale process in parallel with EMS was unreasonable.

Second, the Court found that the Board's decision to approve the $17.25 price from Warburg unreasonable since the Board lacked a reasonable informational basis to make such a decision. The Board did not receive any valuation materials until three hours before the meeting to approve the merger. When the valuation materials were finally provided to the Board, the Court noted that aspects of the materials conflicted with earlier RBC advice, contravened the Board's business plan for Rural, and contained "outright falsehoods." Further, the Board was uninformed about RBC's divergent interests in obtaining the best price, including RBC's continuing efforts to provide buy-side financing in the deal. When Warburg delivered its offer package that did not include RBC as a financing bank, RBC redoubled its efforts on the buy-side financing front and, in an effort to play nice on the deal front, revealed information to Warburg about internal Board dynamics including the directors' competing views on price. As a result, the Court concluded that, rather than negotiating for the best price, RBC was pushing to get the deal done, secure its advisory fee, and potentially get additional compensation from Warburg.

Next, the Court held that RBC knowingly participated in the Board's breaches of fiduciary duty in connection with the sales process. As a general rule, when a third party with improper motives misleads a board into breaching its fiduciary duties, the third party is liable for aiding and abetting. According to the Court, RBC knew that the Board was not well informed regarding critical valuation and conflict matters but, motivated by personal gain, decided not to disclose this information. The Court found that RBC created this unreasonable process and information gap. Accordingly, the Court held that RBC knowingly participated in the breach.

In holding RBC liable for aiding and abetting during the sales process, the Court rejected arguments that the RBC engagement letter and Section 102(b)(7) of the DGCL insulated RBC from liability. While the engagement letter stated that "RBC may arrange and extend acquisition financing . . . to purchasers," this language did not operate as a waiver for any claim against RBC for failing to inform the Board about specific conflicts of interests. This language also did not serve as a waiver of any claim that RBC's sell-side advice would be tainted by an undisclosed material self-interest. Further, the Court held that Section 102(b)(7) of the DGCL applies only to directors and does not extend to aiders and abettors of a breach of fiduciary duty by directors. In support of this holding, the Court reasoned that financial advisors serve as gatekeepers. The Court reasoned that the prospect of liability for investment banks that induce boards to breach their fiduciary duty creates a powerful reason for banks to provide meaningful fairness opinions.

The Court then turned to Plaintiffs' proxy disclosure claims. The Court found two disclosure violations. First, the proxy statement included a disclosure that RBC used Wall Street research analyst consensus projections in deriving EBITDA for 2010. This disclosure was included based on a representation by RBC to the Board that it had used such data. The Court found that such data was not, in fact, used by RBC and thus the disclosure was false. In addition, the proxy did not disclose RBC's personal motives in consummating a deal and obtaining buy-side financing in both the EMS deal and the Rural deal.

Finally, for both the sale process and the proxy disclosure violations, the Court ordered both sides to submit further briefing on the issue of damages, contribution, and fee shifting. The Court stated that, although it had not reached any conclusions, it seemed possible that the facts could support a bad faith fee shifting award.