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EXPERT ANALYSIS

Delaware High Court Restricts Potential Claims Against Bankers For Flawed M&A Process

By Gardner Davis, Esq., and Danielle Whitley, Esq.
Foley & Lardner

The Delaware Supreme Court has affirmed a $76 million judgment against RBC Capital Markets for aiding and abetting breaches of fiduciary duty by the board of Rural/Metro Corp. in connection with a flawed sale process. *RBC Capital Mkts. LLC v. Jervis,* No. 140, 2015, 2015 WL 7721882 (Del. Nov. 30, 2015). However, this decision is a victory for investment bankers generally because it curbs the nascent trend in Delaware of treating financial advisers as "gatekeepers" and holding them accountable for the effectiveness of the corporate board's M&A process.

Banker RBC's problems stemmed from alleged undisclosed conflicts of interest, including both its purported plan to leverage the Rural sell-side engagement to gain an opportunity to participate in the buy-side financing for a competitor and its push to participate in the Rural buy-side financing during the final round of price negotiations with the buyer. RBC is also alleged to have manipulated its valuation analysis to support a lower price for Rural so it could collect a transaction fee for a deal that was arguably not in its shareholders' best interests.

A THIRD-PARTY CHILL

The original Chancery Court opinion, *In re Rural Metro Corp. Shareholders Litigation*, 88 A.3d 54 (Del. Ch. 2014), understandably sent chills through the investment banking community. That ruling, which followed in the wake of the Chancery Court's *El Paso*, *Atheros* and *Del Monte* decisions, demonstrated the court's heightened sensitivity to potential conflicts of interest that may compromise investment bankers' loyalty and objectivity.[1]

In *Rural Metro,* the Chancery Court characterized investment bankers as "gate-keepers" who are responsible for ensuring the integrity of the M&A sale process. The Chancery Court has recently applied its *Rural Metro* analysis in a variety of different contexts, suggesting the M&A advisory function of investment banks and the inevitable conflicts that arise may soon be subject to full-fledged supervision by the Delaware courts.

Both the Securities Industry and Financial Markets Association and the National Association of Corporate Directors filed amicus briefs asking the Delaware Supreme Court to overturn the Chancery Court's decision.

Although the Delaware Supreme Court affirmed the Chancery Court's $76 million judgment against RBC Capital Markets, it went to great lengths to narrow the Chancery Court's holding to the exceptional facts of the case by stating, "Our narrow ruling premised on these unusual facts effects no shifts in the *Revlon* landscape."

The original Chancery Court opinion, In re Rural Metro Corp. Shareholders Litigation, *understandably sent chills through the investment banking community.*

It expressly rejected the Chancery Court's amorphous characterization of financial advisers as "gatekeepers." It also emphasized the contractual nature of the relationship and said it is for the board to determine what services financial advisers are hired to perform.

The court expressly rejected the suggestion that any failure on the part of a financial adviser to *prevent* directors from breaching their duty of care gives rise to a claim for aiding and abetting a breach of that duty. It emphasized that any plaintiff asserting this type of claim against an investment banker must establish scienter; that is, the plaintiff must show that the banker acted with an "illicit state of mind" and had "actual or constructive knowledge that ... [its] conduct was improper."

ASSESSING OPPORTUNITIES

Rural was a Nasdaq-listed provider of ambulance and fire protection services in more than 400 communities across 22 states. In summer 2010, RBC pitched Rural on the possibility of acquiring Rural's only national competitor in the ambulance business, a subsidiary of Emergency Medical Services Corp.

In December 2010, EMS was rumored to be for sale. RBC told Rural's chairman and CEO that some private equity firms believed EMS should separate itself from the ambulance subsidiary. RBC claimed that several private equity firms were looking for a partner and had mentioned Rural as an "angle."

RBC realized — but according to the Chancery Court did not disclose — that a private equity firm that acquired EMS might buy Rural rather than sell the ambulance subsidiary. RBC recognized that if Rural engaged in a sale process led by RBC, then RBC could use its position as Rural's sale-side adviser to secure lucrative buy-side financing roles with the private equity firms bidding for EMS.

At a regularly scheduled meeting Dec. 8, 2010, the Rural board discussed the company's three strategic alternatives: pursuing a current stand-alone business plan, pursuing a sale of the company, or pursuing a transaction that would take advantages of the synergies available in some form of business combination transaction involving EMS' ambulance subsidiary.

The board charged a special committee of independent directors with the task of retaining advisers and generating a recommendation for the board on the best course of action. It did not authorize the special committee to pursue a sale.

On Dec. 23, 2010, the Rural special committee interviewed potential financial advisers. During its interview, RBC devoted the bulk of its presentation to a sale and recommended coordinating the effort with the EMS process. It also noted that it hoped to offer staple financing to potential buyers in any transaction.

The Chancery Court found, however, that RBC did not disclose that it planned to use its engagement as Rural's financial adviser to capture financing work from the bidders for EMS.

DUAL FEES

The Chancery Court found that RBC hoped to generate up to $60 million in fees from the Rural and EMS deals. RBC anticipated earning an M&A advisory fee of $5 million and staple financing fees of $14 million to $20 million on the Rural deal. It also hoped to capture $14 million to $35 million by financing a share of the EMS deal.

The $55 million in potential financing fees was more than 10 times the advisory fee, giving RBC a powerful reason to take steps to promote itself as a financing source at the expense of its advisory role for Rural.

The Delaware Supreme Court affirmed the Chancery Court's finding that the directors breached their fiduciary duty of care under the *Revlon*[2] doctrine. In the M&A context, the Delaware court

examines both the reasonableness of the directors' decision-making process, including the information they used to make their decision, and the reasonableness of their action under the circumstances.[3]

The Rural board breached this duty by not developing a reasonably adequate understanding of the financial metrics, including the value of forgoing a transaction. The Rural special committee and the entire board should have received briefings from the investment bankers on the value of the business as a stand-alone going concern as well as the value of the company based on traditional transaction values.

WHAT MADE *RURAL/METRO* UNIQUE?

The standard requires that directors not only receive the information, but that they also have adequate time to consider it. In *Rural*, it was simply not sufficient that the board received the first valuation information at 9:42 p.m. on a Sunday evening preceding an 11 p.m. board meeting.

The Rural board did not have an opportunity to examine those materials critically and understand how the value of the merger compared with Rural's value as a going concern. By the time the directors received RBC's book, there was no time to seek follow-up information or probe inconsistencies.

To provide the required active and direct oversight of the sale process, a board and special committee must act reasonably to learn about actual and potential conflicts faced by directors, management and their advisers. The Rural directors never understood the magnitude or extent of RBC's efforts to obtain both EMS buy-side financing and the buy-side financing for the Rural deal.

If other companies in the industry are also currently for sale, directors should specifically discuss with the company's banker the foreseeable advantages and disadvantages of initiating a simultaneous sale process, including the potential restrictions on a potential bidder's ability to participate in both processes. The Chancery Court faulted the Rural process because there was no contemporaneous evidence that these issues had been considered.

The Chancery Court also found that the board breached its duty of care by failing to provide active and direct oversight of RBC during final price negotiations, stating, "When it approved the merger, the board was unaware of RBC's last minute efforts to solicit a buy-side financing role from Warburg ... and did not know about RBC's manipulation of its valuation metrics."

The Chancery Court found that "rather than pushing for the best deal possible for Rural, RBC did everything it could to get a deal, secure its advisory fee and further its chances for additional compensation from Warburg."

The Chancery Court found that on the last day of negotiations, RBC worked "to lower the analyses in its fairness presentation to make Warburg's bid of $17.25 look more attractive." RBC "provided the board with a board book designed to convince them to accept Warburg's bid of $17.25 per share." Its financial analyses "contained outright falsehoods."

The Chancery Court found "RBC took advantage of the information vacuum it created to prime the directors to support a deal at $17.25."

The Delaware Supreme Court affirmed the Chancery Court's finding that "RBC knowingly induced the breach by exploiting its own conflicted interests to the detriment of Rural and by creating an information vacuum."

It added, "RBC's knowing participation included its failure to disclose its interest in obtaining a financing role in the EMS transaction and how it planned to use its engagement as Rural's adviser to capture buy-side financing work from bidders for EMS" and "its knowledge that the board and special committee were uninformed about Rural's value."

The primary takeaway from RBC Capital *is that boards and investment bankers must be sensitive to actual or potential conflicts of interest throughout the engagement.*

According to the court, "RBC's illicit manipulation of the board's deliberative process for self-interested purpose was enabled, in part, by the board's own lack of oversight, affording RBC the opportunity to indulge in the misconduct that occurred. ... Propelled by its own motives, RBC misled the Rural directors into breaching their duty of care, thereby aiding and abetting the board's breach of its fiduciary duty."

It held that "the record evidence amply supports the trial court's conclusion that RBC purposely misled the board so as to proximately cause the board to breach its duty of care."

TAKEAWAYS

The Delaware Supreme Court emphasized that its ruling was premised on the egregious facts of the case, including the financial adviser's intentional efforts to mislead the board into breaching its *Revlon* duty of care. As the court explained: "Our holding is a narrow one that should not be read expansively to suggest that any failure on the part of a financial adviser to *prevent* directors from breaching their duty of care gives rise to a claim."

The primary takeaway from the Delaware Supreme Court's narrow ruling in *RBC Capital* is that boards and investment bankers must be sensitive to actual or potential conflicts of interest throughout the engagement. However, after full and accurate disclosure of all the relevant facts a board may make the business decision to engage and rely on a potentially conflicted financial adviser — provided adequate procedural safeguards are implemented.

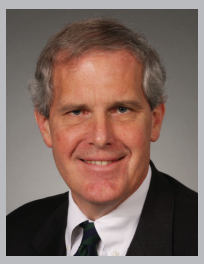
Moreover, a banker is not required to "police" a board's decision-making process provided that the banker acts in good faith and in the best interest of its client. In the wake of *RBC Capital*, boards and financial advisers should review their engagement letters carefully to ensure the parameters of the financial adviser relationship and representation with the client are clearly spelled out.

NOTES

[1] *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432, 439 (Del. Ch. 2012); *In re Atheros Commc'ns S'holder Litig.*, No. 6124-VCN, 2011 WL 864928 (Del. Ch. Mar. 4, 2011); *In re Del Monte Foods Co. S'holder Litig.*, 25 A.3d 813, 830-31 (Del. Ch. 2011).

[2] *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 182 (Del. 1986).

[3] *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994).



Gardner Davis (L) is a partner in the transactional and securities practice of **Foley & Lardner** in Jacksonville, Florida. He frequently represents buyers and sellers in M&A transactions and advises boards of directors and special committees in regard to fiduciary-duty issues. He can be reached at 904-359-8726 or gdavis@foley.com. **Danielle Whitley** (R) is a partner in the firm's finance and financial institutions practice, as well as its transactional and securities practice. She focuses her practice in the areas of mergers and acquisitions, finance, and general corporate law. She can be reached at 904-359-8789 or dwhitley@foley.com.