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Delaware Supreme Court Upholds Rural/Metro Decision

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The Delaware Supreme Court recently affirmed the 2014 decisions of the Delaware Court of Chancery finding the lead financial advisor for Rural/Metro Corporation ("Rural") liable to a class of Rural stockholders for aiding and abetting breaches of fiduciary duties by Rural's board of directors in connection with Rural's 2011 sale to an affiliate of Warburg Pincus LLC. By affirming the decisions, which, among other things, set the amount of the financial advisor's liability at US$75.8 million, the Delaware Supreme Court highlighted the importance of identifying, monitoring and addressing potential financial advisor conflicts of interest.

Undisclosed conflicts viewed skeptically

In reaching its conclusion, the Court focused on the design of the sale process and, specifically, on the timing of Rural's sale process concurrently with the sale process of a competitor. The Court found that concurrent sale processes had inherent disadvantages to Rural as it potentially impeded or prevented parties otherwise interested in acquiring Rural from submitting an offer. The Court noted that, while the Rural Board's decision as to the timing of a process would typically fall within the range of reasonableness, the financial advisor's failure to disclose certain potential conflicts of interest required such decision to be viewed more skeptically. According to the Court, the record indicated that the financial advisor designed a process that provided the financial advisor with an opportunity to obtain financing fees in connection with the sale of Rural's competitor in addition to the fees that could be generated from Rural's sale process. The Court found that the Rural Board was not informed of the potential disadvantages of embarking on a parallel sale process and, as a result, took no steps to address or mitigate potential conflicts of interest.

Directors must be active and advisors not given a "free pass"

The Court emphasized that directors must be active and reasonably informed when overseeing a sale process, "including identifying and responding to actual or potential conflicts of interest." When faced with an advisor laboring under a conflict, the Court urged boards to "require disclosure of, on an ongoing basis, material information that might impact the board's process." The Court further cautioned that, even when the financial advisor discloses such information to the board, a financial advisor is not entitled to "a 'free pass' to act in its own self-interest and to the detriment of its client."

Gross negligence by directors not required for advisor liability

The Court also rejected the financial advisor's contention that the trial court erred by concluding that the Rural Board breached its duty of due care without finding gross negligence. While acknowledging that a determination of gross negligence must be made in order to sustain a monetary judgment against directors,

the Court held that the Rural Board's failure to take reasonable steps to obtain the best value reasonably available to stockholders in connection with its sale process was sufficient to support a finding of aiding and abetting liability against its financial advisor.

Specific intent required for aiding and abetting liability

With respect to finding the lead financial advisor liable for aiding and abetting the breaches of the Rural Board's fiduciary duty, the Court affirmed (as a narrow holding of the lower court) that "if 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." The Court added that in order to be liable for aiding and abetting, the aider and abettor must act "knowingly, intentionally or with reckless indifference" and have "actual or constructive knowledge that their conduct was legally improper."

Exculpatory charter provisions do not protect advisors

The Court further affirmed that, while Section 102(b)(7) of the Delaware General Corporation Law (the "DGCL") insulates directors from monetary damages stemming from a breach of the duty of care, the protections of DGCL Section 102(b)(7) are not applicable to third parties, such as advisors, aiding and abetting such breaches. In reaching this conclusion, the Court rejected the argument that it would be inequitable to permit stockholders to "shift damages from the fiduciaries (directors) who are primarily liable but who are statutorily immunized from a damages claim, to a non-fiduciary" who is not so immunized. The Court observed, among other things, that a third party, such as an advisor, will not be subject to liability if its actions only amount to gross negligence. Rather, unlike a director who can be found liable under a gross negligence standard, the aider and abettor standard "affords the advisor a form of protection by insulating it from liability unless it acts with *scienter*."

Financial advisors are not "gatekeepers"

While the Court generally affirmed the principal legal holdings of the lower court, the Court expressly rejected the lower court's characterization that financial advisors serve as "gatekeepers" in M&A transactions. The Court noted that such "amorphous" gatekeeper language would inappropriately suggest 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. The Court confirmed that the obligations of a financial advisor in an M&A transaction are primarily established by contract, and that a financial advisor's engagement letter will typically define the parameters of its relationship with, and responsibilities to, its client.

Conclusion

The Delaware Supreme Court's Rural/Metro decision reaffirms that directors must be active, vigilant and informed during a sale process to ensure that a board of directors fulfills its duty to maximize value for stockholders. During the process, the board should inquire into potential conflicts of interest of advisors and seek disclosure of information that may impact the sale process in order to fulfill its fiduciary duties. Advisors should also proactively monitor potential conflicts throughout the process and timely apprise the board as appropriate. Failure to monitor, disclose and manage such conflicts creates the potential for significant liability.

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