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Mergers & Acquisitions

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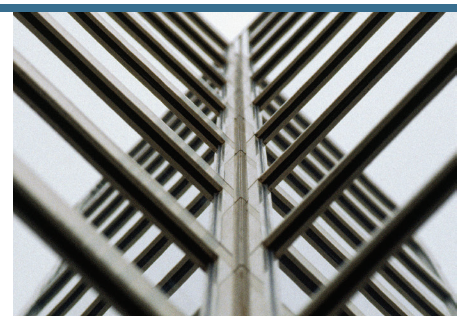

In the *Rural/Metro* Decision, Delaware Court Emphasizes Conflicts of Interest in Finding Breaches of Fiduciary Duties

Citing various conflicts of interests involving management, board members and financial advisors, Vice Chancellor Laster of the Delaware Court of Chancery found that the Board of Directors of Rural/Metro Corporation ("Rural") breached its fiduciary duties to its stockholders in connection with its 2011 acquisition by an affiliate of Warburg Pincus LLC ("Warburg"). The Court further found Rural's lead financial advisor liable for aiding and abetting such breaches. Following the *Del Monte* and *El Paso* decisions, the opinion again highlights the importance of identifying and addressing potential conflicts of interest early in a transaction.

Background

In March 2011, after a three-month sale process, Rural agreed to be acquired by an affiliate of Warburg. After public announcement of the transaction, certain Rural stockholders commenced litigation. A Memorandum of Understanding was entered into to settle the litigation in exchange for additional disclosure and an agreement not to oppose the plaintiffs' fee application. After this settlement, the Rural stockholders approved the merger, with 72 percent voting in favor.

In January 2012, the Delaware Court of Chancery conducted a hearing regarding the reasonableness of the settlement set forth in the Memorandum of Understanding. A Rural stockholder objected to the settlement, arguing that evidence obtained during discovery revealed conflicts of interest. The disclosure-only settlement was rejected by the Court as inadequate and the case proceeded. The complaint was then amended to add claims against RBC Capital Markets, LLC ("RBC") and Moelis & Company ("Moelis"), Rural's financial advisors. Shortly before trial, the Rural directors settled for US$6.6 million and Moelis settled for US$5 million. The plaintiffs' case against RBC proceeded to trial.

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Findings

The Court reviewed the Rural Board's decision to conduct a sale process simultaneously with a competing sale process for Emergency Medical Services Corporation ("EMS"), the parent company of Rural's only national competitor, American Medical Response. While such a decision would ordinarily be given deference by a Delaware court, the Court held that the existence of undisclosed conflicts of interest required the decision to be viewed skeptically. In the case of the Rural Board, the Court found that three directors had personal circumstances that inclined them towards a quick sale. The Court also found that the Special Committee of the Board began the sale process without approval from the full Board. The Special Committee had been formed only to retain advisors and generate a recommended course of action. Finally, the Court found that the lead financial advisor failed to disclose its efforts to participate in the financing for the EMS transaction. According to the Court, the lead financial advisor attempted to use its position as sell-side advisor to Rural to secure buy-side roles with private equity firms bidding for EMS. The Court also criticized the lead financial advisor for failing to advise Rural of the disadvantages of conducting a sale process in parallel with a competitor's sale process, including the difficulty potential bidders would have in participating in both processes concurrently. In the end, Warburg was the only firm to submit a final bid. In the Court's view, failing to take these various conflicts into account caused the decision to conduct a parallel process to be unreasonable, resulting in a breach of the Rural Board's fiduciary duties.

The Court also reviewed the Rural Board's ultimate decision to accept Warburg's offer. The Court found that the Board failed to provide active and direct oversight of the lead financial advisor. In particular, the Board was unaware of the efforts of the lead financial advisor to solicit a buy-side financing role from Warburg. The Court also criticized the fact that valuation information with respect to Rural was provided to the full Board only hours before the Board meeting at which the transaction was approved and, as a result, the Board did not have an opportunity to examine the materials critically, seek follow-up information or probe inconsistencies. Finally, the Court criticized last-minute changes to the financial advisors' valuation metrics, which had the effect of making the Warburg bid appear more attractive. In particular, the Court noted that certain of these changes were inconsistent with a prior presentation of the financial advisor. In addition, the Court criticized the lead financial advisor's use of "consensus" EBITDA numbers without making adjustments for one-time expenses, an approach which, in the Court's view, was inconsistent with the approach of Wall Street analysts that covered Rural. With these deficiencies, the Court found that the Board's decision-making process was unreasonable and therefore resulted in a breach of its fiduciary duties.

In finding Rural's lead financial advisor liable for aiding and abetting the Board's breach of fiduciary duties, the Court concluded that such financial advisor "knew that the Board was uninformed about these critical matters, but failed to disclose the relevant information to further its own opportunity to close a deal, get paid its contingent fee and receive additional and far greater fees for buy-side financing work."

While the Court has found the lead financial advisor liable for aiding and abetting the Rural Board's breaches of fiduciary duties, it has not yet determined an appropriate remedy.

Takeaways

- Consistent with previous decisions, Delaware courts continue to take a keen and critical view of potential conflicts of interest. A board should remain informed and seek periodic updates from management, board members, advisors and other key participants for potential conflicts prior to structuring a sale process and at critical times during such process. Advisors also should monitor potential conflicts throughout the process, keep the board apprised as appropriate and receive clear direction from the board. Failure to do so may result in Delaware courts viewing board decisions and the actions of other participants skeptically.
- The opinion does not declare that all stapled financing efforts are inappropriate. It does, however, question why stapled financing was offered by Rural and its lead financial advisor when Rural previously had been advised that the debt markets were open and available to bidders.

- A strong process is often one's best defense. Boards should actively seek and obtain advice, including information relevant to valuation, throughout a sale process, and such advice should be contemporaneously documented. The Court suspiciously noted that minutes of Rural's October 1, 2010 and December 8, 2010 Board meetings were not prepared until March 2011.
- While Rural's engagement letter with its financial advisors contained a general acknowledgment that they might extend acquisition financing to other firms, the Court found that such acknowledgment did not preclude a claim for failing to disclose a specific conflict of interest. In particular, the Court was not convinced that the Rural Board had provided informed consent to its lead financial advisor's efforts to seek a role in financing Warburg's bid.
- Even though Rural's certificate of incorporation contained an exculpatory provision authorized by Section 102(b)(7) of the Delaware General Corporation Law, the Court ruled that such provision offered no protection to a defendant charged with aiding and abetting fiduciary duty breaches. The Court referenced the literal language of the statute which only covers directors.