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Expert Analysis

Rural/Metro Case: Exploring Liability Against Financial Advisors

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On Nov. 30, 2015, the Delaware Supreme Court issued its much-anticipated decision in *RBC Capital Markets v. Jervis*.[1] The Supreme Court affirmed the Court of Chancery's $76 million verdict against Rural/Metro Corporation's financial advisor, RBC.[2] While the Supreme Court attempted to confine its holding to the unique facts of this case, the extent to which future decisions construe this ruling narrowly or expansively remains to be seen. This article examines *RBC Capital Markets v. Jervis* and the practical implications of this important opinion.[3]

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Factual Background

The Court of Chancery ruled that RBC aided and abetted breaches of fiduciary duties by Rural/Metro's Board of Directors in connection with the company's sale to a private equity firm. RBC appealed the ruling, but made a strategic decision not to challenge the Court of Chancery's factual findings and to focus instead on legal arguments. Thus, the Delaware Supreme Court adopted the Court of Chancery's description of the facts.

According to those findings, in mid to late 2010, Rural/Metro had been approached by potential buyers and had begun to consider strategic options, including buying a subsidiary of its main competitor, Emergency Medical Services Corporation (EMS). In December 2010, Rural/Metro's board empowered a special committee of independent directors "to retain an advisor to analyze the range of strategic alternatives available and to make a recommendation to the Board." However, the Supreme Court held that the special committee quickly exceeded that mandate by launching into a full sale process.

The special committee retained RBC as its financial advisor. RBC's engagement letter authorized it to provide stapled financing to a purchaser of Rural/Metro "if the Board of Directors or a special committee of the Board of Directors deem[ed] it desirable."[4] The engagement letter also authorized RBC to provide "investment banking and financial advisory services" with respect to a possible transaction between Rural/Metro and EMS.

> The Delaware Supreme Court's opinion in 'RBC Capital' incentivizes financial advisors to be increasingly judicious about conflict disclosures.

At the same time that Rural/Metro was considering a sale, EMS was marketing itself. The Delaware Supreme Court observed that the simultaneous sale process for EMS caused problems for Rural/Metro's auction process, including confidentiality restrictions that impeded potential buyers from pursuing both deals. However, the Supreme Court found that RBC nonetheless advised the committee to proceed with parallel sales rather than wait for EMS's process to conclude, because RBC wanted to "leverage" its sell-side work for Rural/Metro to help it win a buy-side financing role in the EMS deal.

A private equity firm ultimately won the bidding process for Rural/Metro in March 2011. The Supreme Court found that RBC, without first consulting with the board, pitched buy-side financing to the private equity firm for the purchase of Rural/Metro. According to the Supreme Court, the prospects of providing buy-side financing in the two deals colored RBC's advice to the special committee and the board. The court found that RBC failed to disclose these conflicts to the board, and ultimately induced the board to approve the transaction and provide inadequate disclosures to stockholders in the proxy statement, in breach of the board's fiduciary duties.

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The Supreme Court's Analysis

On appeal, the parties agreed that enhanced scrutiny under *Revlon v. MacAndrews & Forbes Holdings*[5] applied, but disagreed about when that standard was triggered. Under the Revlon doctrine, Delaware courts apply heightened scrutiny in the sale of control context and impose on the board of the target company a duty to obtain the highest value reasonably attainable for the benefit of the company's stockholders. In deciding whether a board satisfied this obligation, courts focus on whether the board's overall efforts to secure the best value were reasonable.

RBC argued that because *Revlon* applies only to a full board's actions, the special committee's actions in December 2010 did not trigger heightened scrutiny. Acknowledging that this was an "unusual" situation, the Supreme Court reasoned that because the board "ratifie[d] and restate[d]" the special committee's actions in a subsequent resolution,[6] those actions could be attributed to the full board for Revlon purposes.

Although the necessary degree of board oversight is not subject to bright-line rules, the Supreme Court found that the board's lack of oversight over RBC and the special committee was unreasonable. According to the Supreme Court, to conclude that *Revlon* applies only at the conclusion of the sale process "would potentially incentivize a board to avoid active engagement until the very end of a sale process by delegating the process to a subset of directors, officers, and/or advisors."[7]

The Supreme Court's decision to extend liability to RBC was premised on the trial court's finding that RBC had undisclosed conflicts of interest arising from its discussions about providing buy-side financing. The Supreme Court found that the language in RBC's sell-side engagement letter with Rural/Metro was not sufficiently specific to inform the board of such conflicts. Further, the Supreme Court placed particular importance on the board's lack of oversight, and adopted the trial court's conclusion that the board allowed a rushed sale process that coincided with the timing of the EMS sale, thereby limiting the potential pool of bidders for Rural/Metro.

The Supreme Court also found that valuation metrics on which the board relied included last-minute changes designed to make the bidder's offer for Rural/Metro look more appealing than the offer appeared under RBC's prior analyses. Given these unique facts, the Supreme Court endorsed the Court of Chancery's "narrow" holding that "[i]f 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."

Importantly, the Supreme Court rejected the Court of Chancery's pronouncement that financial advisors function as "gatekeepers" in M&A transactions, such that directors are not expected to design or evaluate a sale process. This dictum, the Supreme Court held, failed to contemplate that the function of financial advisors is generally governed by contract and negotiated among sophisticated actors. The trial court's language improperly "suggest[s] 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." But under the facts as found in this case, the Supreme Court had no trouble holding the advisor liable for aiding and abetting when (according to the trial court) the advisor had intentionally caused directors to breach their duty of care.

Practical Implications

The court emphasized the narrow nature of its ruling, which it confined to the facts of this case. Among other "unusual" facts that the court highlighted were the special committee's unauthorized initiation of a flawed sales process that the board retroactively ratified, the board's significant lack of oversight of both the special committee and the financial advisor, and the intentional nature of the advisor's conduct. Whether future decisions will cabin *RBC* to such unique facts remains to be seen.

The Supreme Court went out of its way to disavow the lower court's characterization of financial advisors as "gatekeepers," a concept the Supreme Court found amorphous and unduly expansive.

Although the Supreme Court largely affirmed the Court of Chancery, the Supreme Court's analysis differs in several noteworthy respects. Most importantly, the Supreme Court went out of its way to disavow the lower court's characterization of financial advisors as "gatekeepers," a concept the Supreme Court found amorphous and unduly expansive. While financial advisors have an obligation not to undermine the interests of the board, the advisors are not necessarily subject to liability merely for failing to prevent directors from breaching their fiduciary obligations.[8]

The Supreme Court's opinion also demonstrates that exculpation for breach of directors' duty of care does not prohibit aiding and abetting liability against financial advisors. As authorized by Delaware law,[9] Rural/Metro's certificate of incorporation exculpated its directors from monetary damages for violations of the duty of care. RBC contended on appeal that the Court of Chancery's application of this provision unfairly shifted to RBC liability for the directors' duty of care violations, damages for which the directors themselves could not be held liable.

Like the Court of Chancery, the Supreme Court rejected this argument. The Supreme Court reconciled this seemingly harsh application of the exculpatory provision by underscoring that financial advisors are protected in a way that directors are not: A financial advisor may be held liable for aiding and abetting a breach of fiduciary duty only if it acted with scienter. This additional requirement renders the necessary showing for aiding and abetting claims higher than that associated with duty of care claims and, according to the Supreme Court, "among the most difficult to prove."

Furthermore, the Supreme Court's opinion incentivizes financial advisors to be increasingly judicious about conflict disclosures. The case highlights the vigilance the Supreme Court expects financial advisors to show with regard to conflicts of interest. Raising potential conflicts at the outset of the engagement is not enough; rather, the advisor should bring issues to the attention of its client on an ongoing basis, as the potential conflicts materialize.

But the court explained that the board also has a responsibility to ensure that financial advisors regularly disclose material information regarding transactions, since the advisors may alone hold that information. And the Supreme Court clarified that so long as a financial advisor is fulfilling its obligations and not creating an informational vacuum, the financial advisor does not become secondarily liable for its clients' duty of care violations. Nevertheless, this opinion encourages financial advisors to err on the side of over-disclosing information to clients.

Finally, the court's opinion reveals that the presence of additional financial advisors may not cure an otherwise deficient sale process. Indeed, Rural/Metro retained two financial advisors for the transaction. As is common in the industry, a large part of both advisors' compensation was contingent on a successful sale. The Supreme Court rejected RBC's argument that the presence of another financial advisor broke the causal chain between RBC's actions and the damages to Rural/Metro's stockholders. The Supreme Court held that the other investment bank was merely a "secondary" advisor and was compensated on the same contingent basis as RBC. Thus, while the court noted that this compensation structure may serve to align the interests of a financial advisor with the interests of the company, it also cast doubt as to whether retaining a secondary advisor can have the desired ameliorative effect.

1. No. 140, 2015, 2015 WL 7721882, __ A.3d __ (Del. Nov. 30, 2015).
2. See *In re Rural/Metro Corp. Stockholders Litig.*, 102 A.3d 205 (Del. Ch. 2014); *In re Rural Metro Corp. Stockholders Litig.*, 88 A.3d 54 (Del. Ch. 2014).
3. The purpose of this article is to describe Delaware law as it now stands. The facts described are as found by Delaware courts, and the authors do not express a view about the accuracy of that fact-finding.
4. In light of the decision in *In re Del Monte Foods Co. Shareholders Litigation*, 25 A.3d 813 (Del. Ch. 2011), many banks have ceased the practice of offering stapled financing in connection with deals in which they serve as the seller's financial advisor. The facts at issue in *Rural/Metro*, however, occurred before the issuance of the Del Monte decision.
5. 506 A.2d 173 (Del. 1986).
6. The Supreme Court inferred that the board took this measure to address the special committee overstepping its initial authority.
7. The court emphasized that its application of *Revlon* "effects no shifts in the *Revlon* landscape."
8. Additionally, the Supreme Court eschewed the trial court's reliance on Delaware's Guest Statute and Tort Claims Act when the trial court found that the exculpatory provision in Rural/Metro's certificate of incorporation precluded contribution from exculpated directors. The Supreme Court distinguished the former statutes, observing that whereas they preclude all relief, the exculpatory provision bars only the recovery of monetary damages.
9. See 8 Del. C. §102(b)(7).

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