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Delaware Supreme Court affirms damages award against target company's banker

Last week, in its decision in the *Rural Metro* case, the Delaware Supreme Court upheld a $75.8 million damages award against the financial adviser to the target company in an all-cash third party buyout. The Court found the financial adviser liable for aiding and abetting breaches of fiduciary duties by the target company's directors, even though the directors themselves could not have been liable in damages for those breaches because of standard statutorily-authorized exculpatory clauses in the target company's charter.

The Supreme Court emphasized that for a plaintiff to prevail in an aiding and abetting claim against a financial adviser it must prove *scienter* on the part of the adviser-defendant, which normally will be difficult, and that its finding of liability in this case was based on the financial adviser's knowing and active involvement in wrongdoing. According to the Court, a financial adviser will not be liable as an aider and abettor merely for failing to prevent its client's directors from breaching their fiduciary obligations.

The Supreme Court adopted the findings by the Chancery Court below (discussed here) that the financial adviser's advice to Rural Metro's board had been flawed because the financial adviser had pursued its own interests to the detriment of the sale process. *RBC Capital Markets v. Joanna Jervis*. The findings included the following:

- The financial adviser had recommended that Rural Metro pursue a sale process at the same time as a competitor, which reduced the number of serious bidders for Rural Metro but enhanced the adviser's prospects of securing mandates related to the competitor's sale process;
- The financial adviser leaked information to the private equity sponsor that ultimately acquired Rural Metro, including regarding process and valuation issues, while seeking to obtain a financing mandate from that sponsor;
- The financial adviser manipulated the valuation analyses and other information provided to Rural Metro's directors with a view to pushing them to approve a transaction; and
- The financial adviser had provided narrative disclosure for inclusion in Rural Metro's merger proxy materials that contained material omissions and misstatements.

The Supreme Court then adopted the reasoning followed by the Chancery Court to impose liability on the financial adviser. Liability was not imposed based on a breach of an obligation owed by the financial adviser to the plaintiff shareholders (and under current law probably could not have been). Instead, liability was imposed on the financial adviser for aiding and abetting the Rural Metro directors' breaches of their fiduciary duties. There was a somewhat circular aspect to this analysis, in that the fiduciary breaches found to have been aided and abetted consisted to a significant extent of the directors' failures to effectively

supervise the financial adviser's conduct. The financial adviser acted badly, the board failed to detect or prevent that bad behavior, so the financial adviser was liable for knowingly participating in that oversight failure. The directors' monetary liability for the breaches that the financial adviser was found to have aided and abetted was zero, because those breaches were exculpated under a Section 102(b)(7) exculpatory provision in Rural Metro's certificate of incorporation.

The Supreme Court also adopted the Chancery Court's analysis and findings on the amount of damages to be awarded against the financial adviser. That analysis began with a quasi-appraisal valuation, leading to a conclusion that the flawed process resulted in damages to Rural Metro's shareholders of $4.17 per share, or $91.3 million. Of that amount $75.8 million was allocated to the financial adviser.

Having adopted the Chancery Court's analysis and conclusion, the Supreme Court went out of its way to reject the statements (characterized by the Supreme Court as *dicta*) made by the lower court to the effect that financial advisers have a "gatekeeper" function. The Supreme Court noted that a "gatekeeper" analysis of the type suggested by the Chancery Court could lead to imposition of liability on advisers to target boards in a broad array of settings, and that such a result would be inconsistent with the Supreme Court's narrow holding. The Court made clear that merely failing to prevent fiduciary breaches by directors would not lead to liability on the part of an adviser.

Take-aways

- Although the route taken by the Court was necessarily circuitous, the result seems entirely appropriate, especially given the Court's insistence that aiding and abetting liability will be imposed on advisers only in narrow circumstances.
- This is the latest in a series of recent Delaware decisions that illustrates a dichotomy in the treatment of M&A transaction participants: those found to have behaved badly and without any good faith belief that their conduct was appropriate risk substantial liability. This principle applies to advisers (as in this case) as well as to directors and controlling shareholders (as illustrated by the recent *Dole* decision discussed here). By contrast, transaction participants who proceed in the good faith belief that their chosen course of conduct is appropriate will escape liability even if that course of conduct in fact was sub-optimal.
- The Delaware Supreme Court in *Rural Metro* made clear that, consistent with this dichotomy, the circumstances in which an adviser will be liable in an M&A transaction are narrowly limited to cases of knowing, active participation in wrongdoing. By providing this clarity the Court has effectively defused the criticism leveled by investment banks and others at the Chancery Court's "gatekeeper" articulation.
- The prospect of bankers behaving badly and becoming subject to substantial damages awards is likely to result in renewed attention to the indemnity provisions of financial advisory engagement letters and to the exclusions from indemnification contained in these same provisions. Depending on how those provisions are written, in some circumstances the new owner of the banker's former client may have to pick up some or all of the tab for flaws in the sale process even when the acquirer was not a participant in the wrongdoing.
- Although the Supreme Court did not directly address the issue, it seems clear based on the Court's recent decision in *Corwin v. KKR Financial Holdings LLC* that, if the misconduct and resulting flaws in the sale process had been appropriately disclosed to Rural Metro's shareholders in the merger proxy materials and the disinterested shareholders nonetheless had approved the sale, since this was not an 'entire fairness' case there would have been no liability. That is how the Chancery Court ruled in *In re Zale Corp. Stockholders Litig.* This creates a strong incentive for sell-side bankers, and for acquirers who may inherit indemnification obligations toward those bankers, to insist on comprehensive merger proxy disclosure (although of course in some cases that kind of disclosure could lead to a no vote).

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