CARLTON FIELDS

Flawed Auctions and Buy-Side Conflicts: Financial Advisor Liability for Aiding and Abetting Breach of the Duty of Care in RBC Capital Markets v. Jervis

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On November 30, 2015, the Delaware Supreme Court affirmed a Court of Chancery decision holding a financial advisor liable for almost $76 million in damages for aiding and abetting corporate directors in breaches of fiduciary duty during the sale of the company to a private equity firm. The opinion covers multiple issues, but this article focuses on the aiding and abetting claim against the board's financial advisor. After a summary of the decision, the article will offer some lessons for both financial advisors and directors in such change of control scenarios. In the fall of 2010 a special committee of the Board of Rural/Metro Corporation ("Rural") hired RBC Capital Markets, LLC ("RBC"), to serve as a financial advisor in connection with the potential sale of the company. After an auction process, the Board signed a merger agreement in March 2011 in which the company would be sold to a private equity fund upon shareholder approval. The lawsuit followed challenging the transaction. In *RBC Capital Markets, LLC v. Jervis*, the Court concluded that RBC knowingly participated in the Rural Board's breach of its duty of care by allegedly creating a "flawed and conflict-ridden" sales process. The Court based its conclusion on the trial court's findings that: (i) RBC effectively reduced the pool of bidders for Rural by structuring the sale process to facilitate RBC's undisclosed objective to secure a financing role with the bidders of a parallel sale of a Rural competitor; (ii) RBC negatively affected Rural's negotiating position over the final sale price by soliciting the sole final bidder for a financing role in the purchase during final price negotiations; and (iii) RBC delivered a flawed valuation analysis without providing the Board with any time to reasonably reflect on the valuation before voting on the sale. Ultimately, RBC's failure to disclose its conflicts tainted the sales process beyond repair and led to a material omissions in the merger Proxy Statement, the Court concluded. There is a silver lining for financial advisors though. The Court reiterated the strict scienter requirement of an aiding and abetting claim and explicitly refused an

expansive reading of its decision. To establish scienter, the plaintiff must demonstrate that the aider and abettor had "actual or constructive knowledge that [its] conduct was legally improper." The Court basing its narrow holding on the "manifest intentionality" of RBC's conduct in this case, and stated that its opinion would not allow aiding and abetting claims to arise from instances where a financial advisor only failed to prevent directors from breaching their duty of care. While the Court acknowledged the general difficulty in proving the requisite scienter in an aiding and abetting claim, its emphasis on conflicts disclosures should encourage financial advisors to be cautious about the information withheld from their client boards about the financial advisors' own interests in the transaction, including relationship-making with any bidders. Financial advisors should consider employing the following strategies when faced with conflicting interests during an engagement:

1. Do not "act in a manner that is contrary to the interests of [a] client board." More specifically, a financial advisor who is aware of a client board acting on "fragmentary and misleading information" and allows the action to continue—particularly if the advisor has any self-interested motives—could risk liability.

2. Establish internal processes and reporting systems that provide client boards with adequate disclosures of current or potential conflicts, both at the outset of an engagement and throughout a sales process.

3. At a minimum, disclose to and receive approval from the client board regarding the timing and scope of any interactions with bidders regarding actual or attempted participation in buy-side financing.

4. Explicitly address the parameters for soliciting or engaging in any buy-side financing with a bidder within client board engagement letters.

5. Be mindful of internal communications that include internal objectives and incentives because litigation discovery of such communications could provide support for finding the requisite scienter in an aiding and abetting claim.

In addition to affirming the aiding and abetting liability, the Court strongly criticized the Rural Board's role in the flawed sales processes, particularly its lack of active oversight of RBC's conflicts of interest. Therefore, directors should consider the following recommendations:

1. Evaluate potential financial advisors before an engagement to uncover any actual or potential conflicts of interest, including inquiries into any past interactions between a financial advisor and the potential bidders in a sale process.

2. Negotiate preliminary and ongoing disclosure obligations for a financial advisor regarding material information that might impact the sales process.

3. Record board efforts to identify and evaluate the advisor's conflicts of interests, both in meeting minutes and the Proxy Statement.
4. Should the board consent to an advisor's conflict, be especially diligent in overseeing the conflicted advisor throughout the sale process.
5. Note that retaining a second financial advisor might not sufficiently rehabilitate conflict-related defects in a sale process, particularly if the second financial advisor's involvement and advice carries less weight with the board than does the first.

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