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# Managing Sell-Side Financial Advisor Conflicts under Evolving Delaware Law

By Steven J. Daniels and Faiz Ahmad

On March 7, 2014, the Delaware Court of Chancery issued its opinion in *In re Rural Metro Shareholders Litigation*, adding to the growing body of Delaware case law dealing with sell-side financial advisor conflicts of interest. Following in the wake of the Chancery Court's prior decisions in *In re Del Monte Foods Company Shareholder Litigation* and *In re El Paso Corporation Shareholder Litigation*, the Chancery Court in *Rural Metro* held that the financial advisor advising the Rural Metro board of directors knowingly aided and abetted the board's breach of its fiduciary duties by "fail[ing] 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." Going farther than any of the key preceding opinions dealing with financial advisor conflicts, the *Rural Metro* Court discussed the "gatekeeper" role served by financial advisors and found that the financial advisor here had "created [an] unreasonable process and informational gaps that led to the Board's breach of duty." The Rural Metro directors settled before trial for approximately $5.6 million and the co-financial advisor settled before trial for approximately $5 million. The primary financial advisor's disclosure-only settlement was rejected by the Court and the matter proceeded to trial, leaving the financial advisor now exposed for the up to $127 million in damages sought by the plaintiffs.

Boards of directors are well advised to take notice of the Court of Chancery's recent decisions in this area. As described in greater detail below, the factual background in these cases ranges from the relatively more modest conflicts in the *El Paso* case to what the Chancery Court perceived to be material process flaws in *Rural Metro*. Despite the range of outcomes in these cases and the divergent factual posture, these cases all suggest that boards of directors must seek out financial advisor conflicts and deal with them proactively. Failure to do so can expose the directors and the companies they serve to significant risk, and can jeopardise an otherwise well run and successful sale process.

### *Rural Metro*

Rural Metro, a leading national provider of ambulance and fire protection services, commenced a sale process in early 2011 based, in part, on prompting from a financial advisor. Having become aware in late 2010 that Rural Metro's lone national competitor, Emergency Medical Services ("EMS"), was evaluating strategic alternatives, according to the Court's findings, the financial advisor reasoned that a buyer of EMS might acquire Rural Metro and that the bank's involvement as Rural Metro's sell-side advisor could make it an attractive provider of financing for an EMS acquisition. A previously existing special committee of Rural Metro directors was reactivated with a limited mandate of evaluating strategic alternatives, including an acquisition of EMS, an acquisition of Rural Metro or a stand-alone plan in which Rural Metro would execute on its previously developed growth strategy. The financial advisor subsequently was engaged to provide advice to the special committee. Although Rural Metro's financial advisor disclosed to the special committee its desire to provide "staple" financing to Rural Metro bidders, the Court found that Rural Metro's financial advisor did not disclose its additional goal of providing financing to potential bidders for EMS. Despite the lack of clear authority under its mandate and without approval of the full Rural Metro board, the special committee and its financial advisor commenced a sale process for Rural Metro. As the Rural Metro process developed, it became clear that the EMS situation – which by that time had developed into a formal sale process – was more of an impediment than a benefit to the Rural Metro process. Many prospective bidders were unable to participate in a

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Rural Metro process because of confidentiality restrictions in the bidders' confidentiality agreements with EMS. At the conclusion of the process, Rural received only one bid and one indication of interest, both at a price of $17 per share. After the formal bid was increased to a best and final offer of $17.25, the board quickly acted to approve the formal bid. Rural Metro's financial advisor did not provide any valuation analysis of Rural Metro or the individual acquisition proposals until the process concluded, and then only several hours before the Rural Metro board met to approve the sale.

Stockholders of Rural Metro filed suit after announcement of the merger claiming breaches of fiduciary duty by the Rural Metro directors and aiding and abetting by Rural Metro's financial advisor. Applying the enhanced scrutiny standard of *Revlon* and its progeny, the Court found that the directors' conduct failed to meet a standard of reasonableness and constituted a breach of the board's duty of care. Specifically, the Court found that the directors: failed to adequately oversee the financial advisor's activities during the sale process; did not actively inform themselves of the value of Rural Metro or consider alternatives; and failed to investigate conflicts of interest of its bankers. Having determined that the directors breached their fiduciary duties, the Court further held the financial advisor liable for aiding and abetting.

The Court found that Rural Metro's financial advisor "knowingly participated" in the board's breach of fiduciary duty by purposefully inducing the breach. In particular, the Court noted that the financial advisor: put the company "in play" without full board approval; did not disclose to the board its intent to use its position as a sell-side advisor to secure buy-side roles with the financial sponsors bidding for EMS; secretly attempted to provide financing to the buyer while also advising the board that the offer was fair; worked to lower the analyses in its fairness presentation so that the buyer's bid looked more attractive; despite a three-month sale process, failed to provide financial analysis until hours before the final board meeting approving the sale; and knew the board was not fully informed about the company's value or the advisor's conflicts.

### *El Paso*

Just two years prior to the *Rural Metro* decision, the Chancery Court in *El Paso* reviewed the conduct of El Paso's financial advisor in the sale of El Paso to Kinder Morgan. At the time, El Paso was evaluating a spin-off with the assistance of its financial advisor. Upon receiving an unsolicited acquisition proposal from Kinder Morgan, El Paso's financial advisor disclosed to the El Paso board that it owned 19% (approximately $4 billion) of Kinder Morgan's stock and held two seats on the Kinder Morgan board. El Paso's financial advisor failed to disclose, however, that the lead banker on the spin-off engagement also had a personal ownership stake of over $300,000 in Kinder Morgan. El Paso and its financial advisor sought to remedy the conflicts by engaging a second financial advisor. In its opinion, the Court noted that the circumstances of the second banker's engagement did little to ameliorate the conflict with the first banker, because the primary advisor continued to intervene and provide advice in the process and sought to collect its contingent fee on a sale. Importantly, the Court noted that the second banker's engagement was limited to a transaction with Kinder Morgan, and that it would not receive any fee if the company instead pursued a spin-off or a transaction with another party. Although the Court declined to enjoin the transaction, the Court was critical of the directors' actions in managing these conflicts.

### *Del Monte*

In 2011, the Chancery Court found that Del Monte's financial advisor manipulated the Del Monte sale process in order to secure lucrative buy-side financing fees and withheld information from the board regarding potential conflicts. The Court further found that Del Monte's financial advisor had not disclosed to the board its efforts to

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put Del Monte in play, or its goal of providing financing to potential acquirers. After the first iteration of Del Monte's sale process failed, Del Monte's banker approached two putative private equity bidders and suggested they team up to submit a revised offer in contravention of each fund's confidentiality agreement with Del Monte. Once negotiations were well underway but before the parties agreed to a price, Del Monte's financial advisor requested authorisation to provide financing to potential buyers. The board consented and Del Monte executed a waiver that expressly permitted Del Monte's financial advisor to act in its interest as a lender to the buyers in the event of a conflict. Del Monte's board engaged a second banker to provide a fairness opinion at a cost to Del Monte of $3 million. The Chancery Court found that the banker's efforts to secure financing fees from potential buyers tainted its advice to the Del Monte board. As a result, the Court issued a preliminary injunction delaying a stockholder vote on the transaction for 20 days and enjoining enforcement of the parties' negotiated deal protection devices.

*Lessons Learned*

The Chancery Court's decisions in *Rural Metro*, *El Paso* and *Del Monte* are each driven by unique and specific facts, but the cases present a unifying theme. Given the interconnections and close relationships among private equity buyers and investment banks and the need to retain a financial advisor with knowledge of the applicable industry and connections with its participants, financial advisors often will face conflicting pressures that result in actual or potential conflicts of interest. Directors must be diligent about identifying these conflicts and taking steps to mitigate them.

Although likely intuitive, the cases suggest that when choosing a banker directors must weigh positives such as a company's existing relationship with the banker or the banker's familiarity with the industry and likely process participants against any actual or potential conflicts of interest. In evaluating conflicts, the board must not stop at identifying the more obvious conflicts such as security ownership by the advisor or its lead bankers. Directors also must be vigilant in seeking information about other business relationships the financial advisor is either involved in or pursuing during the pendency of the transaction process (such as providing advisory services to bidders or industry peers or participating in buy-side financing for the transaction or related transactions). The cases demonstrate that actual or potential conflicts are best addressed where the board receives full disclosure from the financial advisor at the earliest possible time, thereby enabling the board to take appropriate measures to address the conflict. While engaging a second banker may be useful in some cases, boards must be careful in crafting an appropriate mandate and fee structure, and consideration should be given to requiring the second banker's fees to offset the primary banker's compensation.

Careful consideration also must be given to the terms of the financial advisor's engagement letter, which should require disclosure of actual or potential conflicts on an ongoing basis, as well confirmation that appropriate ethical walls will be maintained where the circumstances so require. These undertakings should be policed throughout the process by means of proactive information gathering concerning the advisor's activities. Having counsel check in with the advisor at specific touch points during the process will allow conflicts to be addressed before fatal process flaws develop. Additional consideration should be given to addressing upfront the primary banker's obligation to pay for a second banker's fees, if and when a conflict arises or is disclosed.

Directors also should be closely involved in determining the parties to be contacted in the sale process, with particular focus on whether any obvious category of bidders is being excluded. For example, failure to include an appropriate mix of strategic and financial bidders should be evaluated and the motivations

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behind any exclusion should be discussed. Boards also should fully understand and consider the value of not engaging in a transaction at all. The financial advisor should provide valuation analyses periodically throughout the sale process and, in any event, well in advance of final transaction approval. Although seemingly obvious, this analysis should address all alternatives presented to the board, including competing proposals and any stand-alone alternatives, and the board and its advisors should be cognisant of changes in this financial analysis relative to prior iterations and the rationale for these changes.

It is clear from the Chancery Court's opinions in *Rural Metro, El Paso* and *Del Monte* that the subject of sell-side financial advisor conflicts remains at the forefront of judicial attention in the mergers and acquisitions deal litigation context. Given the significant potential exposure faced by directors and financial advisors that run afoul of these issues, and the difficulty managing these conflicts if they are discovered too late or not at all, directors are encouraged to be vigilant and proactive in identifying and mitigating actual or potential conflicts.

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