Delaware Supreme Court Provides Guidance on Aiding-and-Abetting Liability for Financial Advisors

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On November 30, 2015, the Delaware Supreme Court issued a much-anticipated opinion in *RBC Capital Markets, LLC v. Jervis*, No. 140, 2015, 129 A.3d 816 (Del. 2015). The Supreme Court unanimously affirmed the Court of Chancery's decisions in *In re Rural/Metro Corp. Stockholders Litigation*, which held a financial advisor liable for aiding and abetting a board's breaches of fiduciary duty during a sale of control transaction. In so ruling, the Supreme Court confirmed the viability under Delaware law of aiding-and-abetting claims based on breaches of the duty of care. The Supreme Court stressed, however, that the requirement of establishing scienter on the part of the alleged aider and abettor makes such claims "among the most difficult to prove," and described its holding as "a narrow one," arising from the "unusual facts" of the case.

Background

On March 28, 2011, Rural/Metro Corporation (Rural) entered into a merger agreement with Warburg Pincus LLC, a private equity firm, to sell Rural for $17.25 per share. Stockholder plaintiffs brought class claims for breach of fiduciary duty against the board, alleging that the sale process was not reasonable under *Revlon*, and that the proxy statement issued in connection with the merger was materially misleading. The plaintiffs included claims against Rural's financial advisors — RBC Capital Markets, LLC (RBC) and Moelis, LLC — for aiding and abetting the board's breaches of fiduciary duty.

Days before trial, Moelis and the board agreed to pay $5 million and $6.6 million, respectively, to settle the claims against them. The case proceeded to trial, with claims pending against RBC alone. In March 2014, the Court of Chancery issued its post-trial opinion, finding RBC liable for aiding and abetting the board's breaches of the duty of care. *In re Rural/Metro Corp. Stockholders Litig.*, 88 A.3d 54, 63 (Del. Ch. 2014).

In his opinion, Vice Chancellor J. Travis Laster found that in December 2010 the board formed a special committee to explore strategic alternatives, including the possible acquisition of a business owned by its chief competitor, Emergency Medical Services (EMS). The court went on to find, however, that the board had not expressly authorized the special committee to initiate a sale process at that time. Nevertheless, the court found that the special committee proceeded as if Rural was for sale and interviewed several financial advisors, ultimately selecting RBC to serve as its primary financial advisor. According to the court, RBC pitched the board on the efficacy of coordinating the timing of the Rural sale with the sale of EMS but did not disclose its plan to use the Rural engagement as an "angle" to provide financing to potential bidders for EMS.

The court held that RBC's desire to obtain financing work for the EMS acquisition also drove it to favor certain bidders in the Rural sale process. Specifically, the court found that RBC's "two-track" auction process enabled it to prioritize EMS bidders so they would include RBC in their financing trees. The court also explained that RBC continued to drive this dual track process despite receiving negative feedback about its timing and design. The vice chancellor found that this "faulty design prevented the emergence of the type of competitive dynamic among multiple bidders that is necessary for reliable price discovery," as many of the large private equity firms were "sidelined" because of the EMS process, and the timing was not right for the logical strategic bidders. As a result, Warburg (which had withdrawn from the EMS process) was able to price its offers aggressively.

The court also found that in the last days before the merger was approved, RBC unsuccessfully lobbied Warburg to provide "stapled financing" for the Rural acquisition. The court held that during this time, RBC purposely manipulated its fairness analysis in order to make the Warburg offer look more attractive.

Moelis and RBC provided written financial analyses, and RBC orally opined that the merger was fair to the Rural stockholders at $17.25 per share, or roughly $437 million equity value. According to the court, the board had never before received any valuation for the company and received these analyses just three hours before the board met to consider the transaction. Nevertheless, the board approved the merger, and it closed in June 2011 following approval by Rural's stockholders.

The Court of Chancery concluded that the board's actions beginning in December 2010 were subject to enhanced scrutiny under *Revlon*, and that the plaintiffs had proven the board's decisions in the sale process were outside the range of reasonableness. The vice chancellor further held that the proxy statement Rural issued in connection with the transaction was materially misleading as to several issues, including RBC's financial analysis and its undisclosed conflicts of interest arising from its use of the Rural deal as an "angle" to obtain business from an EMS transaction. Finally, the court held that RBC was liable for aiding and abetting the board's breaches of fiduciary duty. In a later opinion, the Court of Chancery held that the Rural stockholders had suffered damages of $4.17 per share, or roughly $91.3 million, before interest. *In re Rural/Metro Corp. Stockholders Litig.*, 102 A.3d 205 (Del. Ch. 2014). It further held that, under the Delaware Uniform Contribution Among Tortfeasors Act (DUCATA), RBC was liable for 83 percent of those damages, amounting to about $75.8 million.

Supreme Court's Opinion in *RBC Capital Markets*

Justice Karen L. Valihura, writing for a unanimous court *en banc*, affirmed all of the Court of Chancery's holdings.

As to the breaches of fiduciary duty, the Supreme Court affirmed the Court of Chancery's conclusion that under *Revlon*, the board's overall course of conduct in the sale process was outside the range of reasonableness. In support of that conclusion, the Supreme Court pointed to the board's lack of awareness regarding RBC's conflicts and the "two-track" bidding process. Because the board was ill-informed, it "took no steps to address or mitigate RBC's conflicts." In addition, the Supreme Court agreed that the board was not adequately informed as to Rural's stand-alone value, which, based on the evidence adduced at trial, exceeded what Warburg or another private equity buyer would have paid. Finally, the Supreme Court affirmed the Court of Chancery's holding that the proxy statement was materially misleading, because it did not accurately represent the valuation analysis RBC conducted and did not disclose RBC's "unquestionably material" conflicts of interest. Although not specifically discussed in Justice Valihura's opinion, it would seem that this latter holding — that the proxy statement was materially misleading — was a necessary predicate for the court's application of *Revlon* enhanced scrutiny notwithstanding the Rural stockholders' vote to approve the merger, which, under the recent Delaware Supreme Court opinion in *Corwin v. KKR Financial Holdings LLC*, would otherwise have operated to invoke the protections of the business judgment rule.

As to the claim against RBC for aiding and abetting, the Supreme Court affirmed the vice chancellor's "narrow holding" that if a third party, such as a financial advisor, "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." Justice Valihura discussed the requirement of showing that the alleged aider and abettor acted with scienter, or an "illicit state of mind," consisting of "actual or constructive knowledge that their conduct was improper." The Supreme Court held that RBC had "intentionally duped" the board and "knowingly induced" its breaches by failing to disclose its interest in obtaining work in the EMS transaction and using the Rural deal to bolster that effort, and by failing to disclose its "eleventh-hour" attempts to secure a role in Warburg's financing of the Rural transaction. RBC's knowing participation also included modifying its valuation analysis. Thus, the court affirmed the Court of Chancery's determination that RBC, with "manifest intentionality," misled the Rural board into breaching its duty of care, resulting in a poorly timed sale that involved a process not designed to obtain the best price reasonably available.

In upholding RBC's liability on the theory of aiding and abetting, the Supreme Court also rejected RBC's argument that the presence of a second financial advisor, Moelis, broke the chain of proximate causation between RBC's actions and any damages suffered by the stockholders.

In perhaps the most important passage of Justice Valihura's opinion, the court addressed the argument that recognizing a claim against third parties, who cannot be protected by exculpatory provisions under 8 Del. C. § 102(b)(7), "would create an anomalous imbalance of responsibilities where a non-fiduciary may be held liable for an unintentional violation of a fiduciary duty by a fiduciary." The court called such a concern "overstated" because RBC had committed "fraud on the board" and was liable for aiding and abetting because, for its own motives, it "'intentionally duped' the directors into breaching their duty of care." The court cautioned that this holding was "a narrow one," justified by the "unusual facts proven at trial," which RBC did not challenge on appeal. The court further stated that its opinion "should not be read expansively" to suggest that a financial advisor could be liable for aiding and abetting merely because it failed "to *prevent* directors from breaching their duty of care." In the same vein, it expressly rejected language from the court below, which had described financial advisors as "gatekeepers." The Court of Chancery's "amorphous 'gatekeeper' language," according to Justice Valihura's opinion, "does not adequately take into account the fact that the role of a financial advisor is primarily contractual in nature," and adhering to it "would inappropriately expand our narrow holding here by suggesting 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."

Finally, the Supreme Court affirmed the Court of Chancery's finding that the quasi-appraisal value of Rural at the time of the merger was $21.42 per share, and that the stockholder class therefore suffered damages of $4.17 per share — roughly $91.3 million, before interest. In so ruling, the court affirmed the vice chancellor's determination that, under DUCATA, RBC was liable for 83 percent of the total damages. The court also held that RBC was not prejudiced by the decision of the board defendants and Moelis to settle days before trial, because RBC had the opportunity to develop a record during trial that could have satisfied its burden to prove that the other defendants were "joint tortfeasors" for purposes of DUCATA. The court also affirmed the vice chancellor's application of the unclean hands doctrine to preclude RBC from seeking contribution from the settling defendants for the disclosure claim or the aspects of the sale process claim relating to the final approval of the merger.

Implications

One of the most closely watched issues of Delaware corporation law in 2016 will be the application of the *RBC Capital Markets* opinion going forward. In particular, the impact of *RBC Capital Markets* will depend on how exactingly the Court of Chancery adheres to the scienter pleading requirement — which the Delaware Supreme Court discussed at length and expressly described as a "form of protection" for financial advisors facing aiding-and-abetting claims. In addition, all parties involved in deal-related lawsuits will benefit from several points of guidance contained in the *RBC Capital Markets* opinion:

- The Delaware Supreme Court emphasized that claims against third parties such as financial advisors for aiding and abetting a breach of fiduciary duty are "among the most difficult to prove" because of the difficulty of adequately pleading an "illicit state of mind" on the part of the third-party aider and abettor, which requires facts suggesting that the third party "intentionally duped" the directors into breaching their fiduciary duties.
  - Moreover, because the aiding-and-abetting claims involved in *RBC Capital Markets* were predicated on the finding that the directors breached their duty of care under *Revlon*, the effect of a fully informed stockholder

vote — which, under *Corwin v. KKR Financial Holdings LLC*, insulates the transaction from such challenges by invoking the business judgment rule — may further limit plaintiffs' ability to prevail on aiding-and-abetting claims in future cases.

  - In its first post-*RBC Capital Markets* case dealing with aiding-and-abetting claims against a financial advisor, the Supreme Court in *Singh v. Attenborough* re-emphasized the difficulty of pleading scienter, stating that it was "skeptical" that there was "a rational basis to infer scienter" based on the allegations in the *Singh* case — which involved the advisor's late disclosure of a business pitch it had made to the acquirer that was then considered by the target board, determined to be immaterial and fully disclosed in the proxy.

- The Supreme Court in *RBC Capital Markets* reaffirmed that the relationship between a financial advisor and the board of directors is a contractual relationship, not one in which the financial advisor can be targeted for its actions on the theory that it acted as a "gatekeeper" responsible for ensuring that the members of a board of directors satisfy their fiduciary duties. The *RBC Capital Markets* opinion clarifies that as long as the board is "active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts," it remains within the board's judgment to consent to a conflict of interest on the part of its financial advisor, although this informed consent "does not give the advisor a 'free pass' to act in its own self-interest and to the detriment of its client."
- Notwithstanding the importance of the legal conclusions in *RBC Capital Markets*, the court's analysis was grounded on the "unusual facts proven at trial," which the Supreme Court reviewed in careful detail. Boards of directors and financial advisors should consult with legal counsel in considering how the teachings of *RBC Capital Markets* might apply to the particular facts and circumstances they face.