The Harvard Law School Forum on Corporate Governance and Financial Regulation

Court of Chancery Stresses Need for Board Monitoring of Advisors and Potential Conflicts

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Editor's Note: Paul Rowe is a partner in the Litigation Department at Wachtell, Lipton, Rosen and Katz. This post is based on a Wachtell Lipton memorandum by Mr. Rowe, David A. Katz, William Savitt, and Ryan A. McLeod. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

Last week, the Delaware Court of Chancery reached the rare conclusion that an independent, disinterested board breached its fiduciary duties in connection with an arm's-length, third-party, premium merger transaction. The decision, In re Rural Metro Corp. Stockholders Litig., C.A. No. 6350-VCL (Del. Ch. Mar. 7, 2014), which relies heavily on findings that the board's financial advisor had undisclosed conflicts of interest, holds the advisor liable for aiding and abetting the breaches, but does not reach the question of whether the directors themselves could have been liable, as they settled before trial. The decision sends a strong message that boards should actively oversee their financial advisors in any sale process.

The opinion arose out of the 2011 sale of Rural Metro to a private equity buyer. In late 2010, Rural's board formed a special committee to evaluate the potential acquisition of a competitor then being auctioned. The Court found that the committee's financial advisor believed that if Rural were involved in a sale process at the same time as its competitor, the possibility of combining all or part of the two companies would present financing opportunities to the advisor that would dwarf the advisory fees it stood to receive from the special committee assignment alone. Without disclosing its desire to provide such buy-side financing, the advisor counseled the special committee to commence a limited auction for Rural, and the committee proceeded to do so. The Court found that this decision was a breach of duty, because the committee did not give appropriate weight to the fact that there were restrictive confidentiality agreements that many potential bidders for Rural had entered into in connection with the process being run by its competitor, thus making it an inopportune time to sell Rural. The Court also found fault in the fact that the board never authorized the special committee to explore the sale of the company. In its ruling, the Court was influenced by evidence that the members of the special committee had

personal reasons to favor a near-term sale of the company unrelated to shareholder interests generally.

Even after it became clear that Rural would not be a buyer for its competitor, the special committee continued with the sale process and the financial advisor continued to desire a role in buy-side financing for any potential sale of Rural itself. Although the special committee negotiated for a sale price representing a 37% premium to market, the Court found that the committee's process was insufficient and ill-informed, as the committee held "only two formal meetings" and "had not received any valuation information until three hours before the meeting to approve the deal." And that valuation information, the Court found, was revised downward by the financial advisor at the same time the advisor was "secret[ly] lobbying" the buyer to supply buy-side financing.

On this record, the Court ruled that the Rural directors failed to discharge their responsibility to provide "active and direct oversight" of both the process and the activities of their financial advisor. The Court explained that this required the directors to be "reasonably informed about the alternatives available to the company" and to "act reasonably to identify and consider the implications of the investment banker's compensation structure, relationships, and potential conflicts." The Court noted that the actions taken here may have been reasonable had they been made by a "well-informed board." But because here the financial advisor "misled the Board," and because the board failed to provide appropriate oversight, it was "not a case where a Board's independent sense of the value of the company is sufficient to carry the day." Because the directors settled before trial, the Court did not address the question of whether the kinds of breaches found on this record could result in personal liability.

Rural Metro does not disturb the well-established principle that Delaware courts will respect the decisions of well-informed boards that engage in a careful sale strategy. It does emphasize the importance of the board's role in identifying and addressing potential conflicts—be they of management, other directors, or financial advisors. To ensure that directors are protected in a sale process, boards should be sensitive to conflicts and should satisfy themselves that any sale process is thoughtfully structured, supported by an appropriate contemporaneous record, and at all times executed under the supervision of the board itself.