The M&A LAWYER

April 2014 ■ Volume 18 ■ Issue 4

Dusting Off Appraisal Rights: The Development of a New Investment Strategy

BY ELIZA W. SWANN AND GREGORY F. GEWIRTZ

Eliza Swann is a partner, and Gregory Gewirtz is an associate, in the New York office of Shearman & Sterling LLP. Contact: eliza.swann@shearman.com or gregory.gewirtz@shearman.com.

Dole Food Company, Inc. was taken private by its Chairman and Chief Executive Officer, David Murdock, on November 1, 2013, for $13.50 per share. Three hedge funds that together hold more than a quarter of the outstanding Dole common shares not owned by Mr. Murdock are hopeful, however, that they will obtain a higher price through their pursuit of appraisal claims with the Delaware Court of Chancery. This, after all, was the result achieved by certain stockholders of Cogent, Inc. who filed appraisal actions following the closing of its acquisition by 3M Company in December 2010. Those stockholders received over $12 million more in the aggregate (including interest) than they would have had they accepted the merger price of $10.50 per share. Last fall, Carl Icahn withdrew his appraisal demand in connection with the founder-led buyout of Dell Inc., but not before prompting great speculation in the M&A community regarding how the Court of Chancery might view his 8.9% stake in Dell, valued at over $2 billion based on the merger terms.

High profile—and high stakes—appraisal actions like these have brought attention to the increased incidence in recent years of appraisal claims tied to U.S. M&A deals. There were roughly 28 deals that drew Delaware appraisal claims in 2013,

CONTINUED ON PAGE 4

Content HIGHLIGHTS

Complete Table of Contents listed on page 2.

WEST®

41501728

Table of CONTENTS

Editorial Board

The M&A Lawyer
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

One Year Subscription ■ 10 Issues ■ $762.00
(ISSN#: 1093-3255)

9. *Id.* at 862.
10. Section 8 of the Clayton Act prohibits an individual from serving as an officer or director of two or more competing corporations if certain financial thresholds are met.

Banker Conflicts, Redux: Court of Chancery Tags Financial Advisor With Aiding and Abetting Liability Following Trial

BY S. MICHAEL SIRKIN

S. Michael Sirkin is an attorney at Seitz Ross Aronstam & Moritz LLP in Wilmington, Delaware. Before entering private practice, Mr. Sirkin was a law clerk for Vice Chancellor J. Travis Laster of the Delaware Court of Chancery. Contact: msirkin@seitzross.com.

On March 7, 2014, the Delaware Court of Chancery held a sell-side financial advisor liable for aiding and abetting breaches of fiduciary duty by the Rural/Metro board of directors in connection with the $590 million cash sale of Rural/Metro to an affiliate of Warburg Pincus. The 91-page post-trial opinion in *In re Rural Metro Corp. Stockholders Litigation*[1] takes its place alongside the *Del Monte*[2] and *El Paso*[3] preliminary injunction decisions in what has become a trilogy of high-profile Court of Chancery decisions addressing conflicts of interest facing sell-side financial advisors in M&A transactions.

Although the facts of this case are unique and seem unlikely to repeat themselves, the opinion is worthy of careful study by M&A lawyers, especially those who represent financial advisors, for its teachings about how to identify, assess and manage conflicts of interest in a sale process and how to best position the participants in the process for the inevitable stockholder litigation. This article first discusses the Rural/Metro sale process and briefly analyzes the circuitous procedural history of the litigation. Next, the article synthesizes the Court's holdings and analysis and highlights some of the issues of process planning and execution that have resurfaced in the Delaware Courts.[4]

Factual Background

A brief background of Rural/Metro's industry helps to contextualize the key facts of this case. After decades of industry consolidation, the emergency medical services sector has two national players. One is Rural/Metro, a Delaware corporation based in Scottsdale, Arizona. The other is American Medical Response Inc. ("AMR"), a Colorado-based subsidiary of Emergency Medical Services Corporation ("EMS").[5] Rural/Metro and AMR, therefore, have often been linked as logical merger partners, including by a special committee of the Rural/Metro board in the summer of 2010. In August of that year, the special committee reached out to EMS about acquiring AMR but EMS was uninterested in selling AMR in Rural/Metro's price range.

One reason for EMS's lack of interest in August became clear in December, when EMS put itself up for sale. It became an open secret on Wall Street that EMS was in play, and an investment banker from RBC Capital told Rural/Metro's special committee chair that many of the large private equity firms rumored to be involved in the EMS process would be interested in a follow-on transaction to combine AMR and Rural/Metro.

At the time, the Rural/Metro board began discussing three strategic alternatives: (1) pursuing its standalone business plan, (2) selling the company and (3) pursuing an AMR transaction. The board authorized the special committee to hire advisors and to recommend a course of action to the board.

Internally, RBC's bankers recognized that the winning bidder for EMS might decide to buy Rural/Metro rather than sell AMR. And RBC viewed a sell-side advisory engagement with Rural/Metro as pole position for a financing engagement with the winning bidder for EMS, who would presumably look to RBC for its established connections to Rural/Metro. So when the Rural/Metro special committee interviewed three investment banks in late December to serve as its financial advisor, RBC pitched for the work.

In its pitch, RBC emphasized a sale of the company over the other alternatives and disclosed its intention to offer buy-side financing to potential bidders for the company. As RBC was being hired to advise the special committee, its contemporaneous documents showed that the bankers were coveting the lucre of financing a larger potential transaction involving EMS.[6]

The Sale Process

RBC launched the process to sell Rural/Metro alongside the ongoing EMS process. Multiple large private equity firms declined to participate in the Rural/Metro process precisely because they were involved with EMS. Nonetheless, 21 firms signed confidentiality agreements with Rural/Metro, and six made first-round bids. Among them was Clayton Dubilier & Rice, which had just won the auction for EMS and consequently would be unable to meet the process timeline. Yet the special committee determined not to accommodate this interested and logical bidder, now armed with the long-recognized AMR synergies. On March 15, 2011, approximately three months after the special committee embarked on a sale process and shortly before final-round bids were due, the board formally authorized the committee to conduct a full-fledged sale process.

Meanwhile, as the bid deadline neared, RBC redoubled its efforts to court a buy-side financing role from Warburg Pincus, a firm that had been among the high first-round bidders. RBC sought approval internally to finance Warburg's entire purchase and delivered signed commitment papers to Warburg before final bids were due. When Warburg made the only final-round bid for the company, RBC made another approach, trying again to elbow its way into a buy-side financing role, to no avail.

RBC then turned its sights on closing a transaction to secure its sell-side advisory fees. On Friday, March 25, 2011, Warburg raised its bid from $17 per share to a best-and-final $17.25, and set it to expire on Monday, March 28. Meanwhile, the special committee once again declined a request by Clayton Dubilier & Rice, now the proud owner of EMS and AMR, to extend the process to allow it a chance to make a bid.

The Warburg best-and-final bid set in motion a frantic weekend at RBC. As its most senior bankers made a final push to be included in Warburg's financing package, others were making late revisions to the fairness analyses, virtually all of which had the effect of making the Warburg bid look more attractive. Additionally, RBC convened a two-member ad hoc fairness committee to review the fairness presentation. This committee suggested, and the deal team made, a number of adjustments that once again had the effect of making the transaction look more attractive. The leader of the Rural/Metro deal team coordinated these efforts.

With the RBC fairness presentation in hand, the Rural/Metro board approved the merger with Warburg. RBC's fairness presentation, which the board received approximately an hour before the meeting to approve the merger, was the first valuation information given to the members of the board by RBC throughout the sale process.

The Litigation

The case has taken a long, strange trip through the Delaware deal litigation machine. The announcement of the merger prompted several putative class actions challenging the deal in Delaware, where Rural/Metro is incorporated, and in Arizona, where its operations are based. Following consolidation in Delaware, the parties agreed to settle the case for supplemental disclosures.

Plaintiff Joanna Jervis, who had originally filed her case in Arizona, objected to the proposed settlement in the Delaware action. Jervis argued that discovery had revealed conflicts of interest and that, as a result, the proposed disclosure-only settlement was inadequate. The Court of Chancery agreed, rejected the proposed settlement, and installed Ms. Jervis's counsel to represent the plaintiff class of former Rural/Metro stockholders.

Following discovery and on the precipice of trial, the defense group fractured. The Rural/Metro defendants settled all of the claims against them for $6.6 million, and another financial advisor that had taken a secondary role to RBC settled for $5 million. These settlements left RBC alone to try the case, and the Court of Chancery denied its motion to postpone trial following these late-breaking developments.

The Court of Chancery's Post-Trial Decision on RBC's Liability

After trial, the Court of Chancery held RBC liable for aiding and abetting breaches of fiduciary duty by the Rural/Metro board.[7] Because the aiding and abetting claims required an underlying breach of fiduciary duty, the directors remained a focus at trial despite having settled the claims against them. The Court held that the Rural/Metro directors breached their fiduciary duties both in connection with the sale process and the disclosures made to stockholders in connection with the merger.

In connection with the sale process, the Court applied the familiar enhanced scrutiny (née *Revlon*[8]) standard that governs cash-out mergers, but with an unusual twist. In a *Revlon* case, the burden of proof is on the defendant directors to establish that their conduct falls within the range of reasonableness. But here, because the plaintiffs settled with the directors before trial, the plaintiffs bore the burden of proving that the directors' conduct fell outside of the range of reasonableness as an element of the aiding and abetting claims against RBC. Nonetheless, the Court held that the plaintiffs met their burden with respect to two related aspects of the sale process.

First, the Court held that the board's decision to initiate the Rural/Metro sale process in parallel to the EMS process was unreasonable. The Court first noted that the board's December resolution did not empower the special committee to launch a sale process. The special committee's decision to initiate the sale process therefore was fundamentally defective because it was made by an unauthorized corporate decision-maker. Moreover, the Court held that the decision to initiate the sale process in parallel to the EMS process was substantively unreasonable because of RBC's undisclosed desire to use its Rural/Metro engagement to generate financing fees in an EMS transaction. And even putting the lack of authority and conflicts issues aside, the Court noted that the decision to initiate the Rural/Metro sale process in parallel would be a "close call" because certain bidders already involved in the EMS process would be effectively precluded from also bidding for Rural/Metro.

Second, the Court held that the board's decision to accept Warburg's final bid "lacked a reasonable informational basis" and thus was unreasonable.[9] The Court held that RBC's familiar contingent compensation structure, in which it would only be paid (on the sell side) in the event of a completed transaction, created "powerfully conflicting incentives" between RBC and its client. While RBC would only get paid if a deal closed, the best value for its client Rural/Metro may have been not doing any deal at all. These powerfully conflicting incentives, the Court held, caused RBC to spend the critical final hours of the sale process simultaneously courting Warburg's financing business and changing to the fairness presentation to make the deal look more attractive to the board. And because RBC never gave the Rural/Metro directors any financial analysis between RBC's pitch and its final fairness presentation, which was sent to the board approximately an hour before a late Sunday night meeting to approve the proposed transaction, the Court held that the board's decision was not reasonably informed.

Having concluded that members of the Rural/Metro board breached their fiduciary duties in connection with the sale process, the Court next concluded that RBC "knowingly participated" in the breaches of duty. The Court cited *Goodwin v. Live Entertainment Inc.*,[10] a 1999 decision by then-Vice Chancellor, now Chief Justice Strine, for the proposition that a third party may be held liable for aiding and abetting when it, "for improper motives of its own, misleads the directors into breaching their duty of care." That, according to the trial court, is exactly what RBC did here, by creating the informational deficit that plagued the directors' sale process and by failing to disclose the conflicts of interest caused by its appetite for financing fees.[11]

But, the Court also noted that under Delaware's law of contribution, RBC's ultimate monetary liability still may be limited by the settling defendants' proportionate share of the total damages award.[12] As with the ultimate damages calculation, the Court requested supplemental submissions from the parties on the issue of contribution.

Remedies and Defenses

In its post-trial opinion, the Court of Chancery did not decide, and requested supplemental submissions from the parties regarding, the bottom-line issues of what would be an appropriate remedy in this case.

Because of the conflicts of interest and the debatable tactical decisions made during the sale process, the Court concluded that the auction, which generated six first-round bids at a premium to the company's unaffected market price, "prevented the emergence of the type of competitive dynamic among multiple bidders that is necessary for reliable price discovery." The Court consequently held that it would conduct an appraisal-style damages analysis, using the discounted cash flow methodology, to value Rural/Metro as a going concern as of the time of the merger. Under this analysis, damages will be calculated as the difference between the fair value of Rural/Metro as calculated by the Court and the $17.25 per share merger price.

The Court also addressed and rejected two legal defenses set forth by RBC. First, the Court's opinion confirmed that an exculpation provision in a corporation's charter pursuant to Section 102(b)(7) of the Delaware General Corporation Law has no legal effect on an aiding and abetting claim. As the Court reasoned, even in the case of an exculpated breach of the duty of care, for which a director may not be held liable for money damages, two of the underlying predicate elements of an aiding and abetting claim—the existence and breach of the directors' fiduciary duty—remain intact. Second, the Court held that the boilerplate disclaimer language in RBC's engagement letter provided no defense to its aiding and abetting liability.

Lessons and Implications for M&A Lawyers

As discussed above, it is important to keep in mind that in some key ways, the story of Rural/Metro is not yet all told. The Court has not yet made its damages determination, nor has it apportioned fault among RBC and its co-defendants, who settled the claims against them pre-trial. And in any event, an appeal to the Delaware Supreme Court seems inevitable.

Yet regardless of how those issues are ultimately resolved, some market consequences seem certain to follow from this important post-trial opinion. It seems certain, although regrettable, that financial advisors will start (or restart) being dragged in as named defendants in merger suits more often by the relentless and opportunistic M&A plaintiffs' bar. And even where they are not named defendants, financial advisors can expect that the discovery sought of them will be more fulsome, whether it is warranted or not in a given deal.

And there are also lessons to be learned and new best practices to be implemented and improved as a result of the Court of Chancery's rare post-trial foray into the nuts and bolts of an M&A process. All M&A lawyers, from deal makers to litigators to those who advise financial advisors, should keep the following takeaways in mind as they work through the next deal.

Synchronicity from the Start: In the eyes of the Court, the Rural/Metro sale process went sideways at the outset when the special committee, which was authorized to hire an advisor to explore three strategic alternatives, hired a financial advisor that pitched to start an immediate sale process. This case thus reinforces the need for financial advisors and their counsel to review the authorizing resolutions before the initial pitch. That way, financial advisors can tailor their pitch materials to stay within the bounds of the specific process that has been authorized by the board, and can kick off the engagement on sound corporate footing. And as always, this case reinforces the urgent need for financial advisors, directors and counsel to have a full and frank discussion of all of the economic incentives and potential conflicts of interest of all parties involved in the process.

Intermediate Financial Analysis: The Court's oft-repeated criticism that RBC never provided valuation analyses between the pitch book and the final fairness presentation makes clear that financial advisors ought to be providing routine valuation updates to the directors, or at least making a record that valuation materials are available upon request, so that all decisions made by those directors may be made on a reasonable informational basis. And now that financial advisors are likely to be preparing multiple sets of financial analyses, they should scrupulously document, and explain to the board, all changes in their methodologies and analyses throughout the course of the engagement.

Beware the Bankers-Only Negotiations: One conflict identified by the Court in this case appears in virtually all M&A cases, and that is the final-stage negotiation conflict caused by a financial advisor's contingent compensation structure. The Court concluded that when negotiations come down to the short strokes, the contingently compensated advisor is incentivized to close the best available deal, while the board's fiduciary duties require it to close a deal only if a deal offers more long-term value to the corporation's stockholders than any available alternative, including remaining independent. Unless financial advisors and their clients are willing to explore alternative compensation structures, best practices now would suggest that one or more members of the board should participate with the bankers in conversations with a prospective bidder. This will ensure that the board has access to the bidder's "body language" in the negotiations without that information being filtered through a contingently compensated advisor, and will also mitigate the negotiation conflict identified by the Court in *Rural Metro*. As *Rural Metro* makes clear, this joint negotiations policy can benefit both the bankers and the board.

Maximize the Value of Meeting Minutes and Fairness Committees: The Court expressed skepticism at two critical steps in the process: (1) the minutes of a March 15, 2011 board meeting, which the Court described as having "the feel of a document drafted in anticipation of litigation"; and (2) the RBC ad hoc fairness committee process, which the Court described as the "call for the available and willing." Both of these criticisms represent defense-side opportunities to bolster the record of future M&A processes. First, at least in the context of an M&A process, the Court will undoubtedly view meeting minutes as litigation documents. As such, they can be more persuasive evidence for the defendants if they are drafted and finalized near in time to the meeting to which they pertain, and if there is no discernible difference in the nature or scope of minutes prepared purely for use in litigation. Second, financial advisors should consider having standing fairness committees made up of senior personnel who do not report to any of the individuals on a particular deal team. This will add a layer of credibility to the fairness opinion process that the Court seemed to find lacking in the ad hoc committee process employed in *Rural Metro*.

Another Premature Eulogy for Staple Financing: The business press and many legal commentators have concluded that *Rural Metro* marks the end of the deal-making technology known as "stapled financing," in which the sell-side advisor offers to finance any bids for the target on stated terms that are thought to be stapled to the back of bid documents. Yet just as in the wake of *Del Monte*, rumors of stapled financing's demise, from a legality perspective, have been greatly exaggerated. Stapled financing remains, in challenging credit markets, a process-enhancing tool that removes credit market uncertainty as a barrier to entry for prospective bidders and reduces post-signing uncertainty for the target and its stockholders.[13] Nothing in the *Rural Metro* decision changes this fact. What the Court found problematic was that RBC was not offering staple financing in the traditional bid-generating sense, but was instead trying to use its position as sell-side advisor to bolster its relationship with, and earn fees from, certain private equity bidders for the company (and for EMS).

Contribution—The Other Shoe to Drop: From a doctrinal perspective, the forthcoming contribution analysis will be a fascinating resolution of the defining tension in this case and in *Del Monte*, in which the Court found that a mostly innocent board was duped by a conflicted advisor. How the Court of Chancery will apportion fault for process and disclosure deficiencies between the board on the one hand, and what the court has determined to be a conflicted, self-interest financial advisor on the other, is anyone's guess. Both the Court of Chancery and the Delaware Supreme Court will be closely scrutinized should they address this question.

Conclusion

Rural Metro did not involve innovative legal principles so much as it involved the application of existing law for the first time in the highly textured factual setting of a post-trial decision. Its pages provide powerful reminders of the importance of full and frank disclosure and evaluation of potential conflicts of interest in the context of an M&A process, and practitioners would be well advised to heed its warnings and adjust their best practices accordingly. In the meantime, practitioners and commentators await, along with the parties, the conclusion of this litigation, in which the Court of Chancery will tackle the difficult questions of remedy and contribution that it has deferred. And the Delaware Supreme Court stands ready to have the last word.

It's also worth noting (although legally irrelevant to the case) that, with the benefit of hindsight, Rural/Metro's former stockholders are probably thankful for their $17.25 per share. In 2013, the post-merger Rural/Metro filed for bankruptcy protection. Instead of suffering this ignominious fate, the stockholders were given $17.25 per share in the merger, plus whatever they ultimately recover in the litigation.

NOTES

1. 2014 WL 971718 (Del. Ch. Mar. 7, 2014).
2. *In re Del Monte Foods Co., S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).
3. *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432 (Del. Ch. 2012).
4. The facts stated herein are synthesized from the Court of Chancery's factual findings as set forth in its post-trial opinion.
5. On June 11, 2013, EMS announced that it was changing its corporate name to Envision Healthcare Corporation to better reflect the company's diversity of service offerings. This article uses the historical name EMS to remain synchronous with the language used in the Court of Chancery opinion, which is historically accurate for the period being discussed.
6. The Court noted in its opinion that RBC was seeking financing fees of $55 million, more than ten times the sell-side advisory fee.
7. Recall that the Rural/Metro directors settled the claims against them just before trial.
8. *See generally Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).
9. The Court also held that in one respect, the plaintiffs failed to meet their burden of proving that the directors' conduct fell outside of the range of reasonableness. Specifically, the Court held that the directors' decision to continue the sale process after receiving some negative feedback was not unreasonable because, flawed though it may have been, the process did generate six first-round bids at a premium to the company's unaffected stock price. Paradoxically, even though the decisions to start and to end the sale process were unreasonable, the decision to continue it once underway was not.
10. 1999 WL 64265 (Del. Ch. Jan. 25, 1999), *aff'd*, 741 A.2d 16 (Del. 1999).
11. Apart from, but related to the sale process claims, the Court also held RBC liable for aiding and abetting in connection with two disclosure deficiencies. *First*, the Court held that the "consensus projections" in RBC's fairness presentation, which were then reproduced as such in the proxy statement, were mislabeled; they were actually Rural/Metro's reported results, rather than analyst projections, and they did not adjust for certain one-time expenses as Wall Street consensus projections would have done. *Second*, the Court held that the proxy statement misleadingly disclosed the reasons that RBC was permitted by the board to offer staple financing to prospective bidders for Rural/Metro, and failed to disclose how, as the Court concluded, "RBC used the initiation of the Rural sale process to seek a role in the

EMS acquisition financing." Nor did the proxy statement disclose that RBC in fact received more than $10 million for its part in financing the acquisition of EMS.

12. For a thorough analysis of Delaware's law of contribution as it likely will be applied in this case, see J. Travis Laster & Michele D. Morris, *Breaches of Fiduciary Duty and the Delaware Uniform Contribution Act*, 11 Del. L. Rev. 71 (2010).

13. For an excellent analysis of the benefits of stapled financing in turbulent credit markets, see Christopher M. Foulds, *My Banker's Conflicted and I Couldn't Be Happier: The Curious Durability of Staple Financing*, 34 Del. J. Corp. L. 519 (2009).

Corporate Governance Feature: Recent U.K. Corporate Governance Summary

BY RICHARD MAY

Richard May is a partner in the London office of Fried, Frank, Harris, Shriver & Jacobson. Contact: richard.may@friedfrank.com.

Directors' Duties: *Madoff Securities v. Raven and Others*

A recent decision of the High Court arising from the collapse of the Ponzi scheme operated by Bernard Madoff, *Madoff Securities International Limited (MSIL) v. Raven and Others*, gives an interesting insight into English law relating to directors' duties.

MSIL was a U.K. company in the Madoff group. MSIL was engaged in proprietary trading. It was not involved in the Ponzi scheme.

The case was brought by the liquidators of MSIL against its former directors, including two of Mr. Madoff's sons. It concerned, amongst other things, the legitimacy of various payments which had been made by MSIL, including payments to another defendant for written research which the directors considered to be irrelevant to MSIL's business, payments to Mr. Madoff himself, and payments for certain luxury items. All of the payments were funded by loans to MSIL from Mr. Madoff, and at all relevant times the company was solvent.

Among other things, the liquidators alleged that that in making or permitting the payments, the directors had acted in breach of their duties to act in the company's best interests and to exercise independent judgment.

The claims against the directors were dismissed.

Duty to Act in the Company's Best Interests

One issue before the Court was whether, by complying with Mr. Madoff's recommendations in relation to the payments without further enquiry or challenge, the directors had breached their duty to act in MSIL's best interests.

The Court recognized that while responsibility for particular aspects of management may be delegated to individual directors, each director owes a duty to inform himself about the company's affairs and to seek to supervise them. Consequently, if a director allows himself to be "dominated, bamboozled or manipulated" by a dominant fellow director and does not, as a result, consider the best interests of the company, this will constitute a breach of duty.

However, the Court emphasized that directors are entitled to rely on the judgment and advice of fellow directors whose integrity and competence they have no reason to mistrust. Part of a director's duty is to listen to his fellow directors and to take account of those views. Critically, a director is not in breach of this duty just because, if left to himself, he would do things differently, just as he need not resign because he disagrees with a board decision.

The Court also explained that if a director fails to consider whether a transaction is in the company's best interests, he is not automatically liable for the consequences of that transaction. In those circumstances, the question is whether an honest and intelligent man in the director's