YOUNG CONAWAY STARGATT & TAYLOR, LLP

YCST PORTFOLIO COMPANY GROUP TREND WATCH

By now, you have likely read the Delaware Court of Chancery opinions in Rural/Metro regarding (i) the liability of an investment banker for aiding and abetting a breach of fiduciary duty (the "Liability Opinion") and (ii) the damages assessed on account of such breach (the "Damages Opinion") (the Opinions are available by hyperlink to the right of this Trend Watch). Initially, the Liability Opinion was somewhat startling within the industry, as it is common for a seller-side investment banker to also offer to provide buy-side staple financing. However, the Liability Opinion and the Damages Opinion both provide important lessons that should be heeded by investment bankers, attorneys and board members in the context of any sale, re-financing or merger process.

1. **Disclose, disclose, disclose …** – One of the dispositive facts in Rural/Metro was the clear failure of the advisor to disclose to the special committee, Board and shareholders the advisor's attempt to solicit the opportunity to provide the buy-side staple financing. While there certainly were other facts that weighed against the advisor, it was imperative to disclose its real conflict – if you have to ask whether something should be disclosed, then it likely should be disclosed.

2. **A general disclosure in an engagement letter is not "disclosure" of a specific conflict** – In defense of its disclosure obligations, the advisor in Rural/Metro relied upon a general provision in its engagement letter that the advisor "may also provide a broad range of normal course financial products and services to … companies that may be involved in a Transaction contemplated by this Agreement …." The Court flatly rejected this argument, finding that such a "generalized acknowledgment … did not amount to a non-reliance disclaimer that would waive or preclude a claim … for failing to inform the Board about specific conflicts of interest." Remember - disclose, disclose, disclose!

3. **Pigs get fat, hogs get slaughtered** – The facts in Rural/Metro did not involve an inadvertent failure to disclose that led to a breach of fiduciary duty finding and judgment. The Court detailed an extensive record to support its finding that the advisor knowingly misled "the directors into breaching their duty of care" for the advisor's "own improper motives." Specifically, the Court found that the advisor (i) failed to disclose its interest in providing buy-side financing in connection with the sale of a competitor, (ii) failed to provide any meaningful data and, in fact, provided false valuation information to the board and the special committee, (iii) failed to disclose its excessive lobbying of the prospective buyer, (iv) failed to disclose that it provided a revolver facility to the prospective buyer's unrelated portfolio company in order to incentivize the buyer to use the advisor for buyer-financing, and (iv) effectively diminished the sale price/process by steering a sale to an entity that it expected would select the advisor as the financier of the deal.

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Rural/Metro Relevant Opinions

Liability Opinion

Damages Opinion

Had the advisor run the process in a more transparent manner with specific disclosures and not secretly pushed a deal to serve its own financial interests, the decision may have turned out much differently. The fact that the Court found the "testimony of the two [of the advisor's] managing directors who appeared at trial. . . . at times strained credulity" did not help.

4. **Board must be diligent notwithstanding the establishment of a special committee** – While the board in Rural/Metro appointed a special committee to select a financial advisor to advise regarding a 'possible' sale process, the board then failed to meet for months after making that decision and the directors never actually authorized a sale process. The appointment of a special committee does not obviate the need for the board to remain diligent. Had the board met regularly after establishing the special committee, it might have been in a position to think critically about the process or to appropriately inquire as to the roles/motives of the advisor within that process. Having not done so over a critical 2 month period, the board was uninformed when it finally met to approve a sale of the company. Even if the board appoints a special committee to embark on a specific task or process, it is imperative that the board stay informed regularly throughout the process.

5. **The Board must keep a detailed record of its diligence** – It is not enough to be diligent; the board must also maintain a detailed account of its diligence and the decision-making process. While the full board in Rural/Metro failed to meet for 2 months after approving the special committee's engagement of a financial advisor, it would have been instructive to the Court and helpful to the board's position had it conducted and recorded diligence that should have occurred throughout the process.

6. **The Board minutes will not override the facts** – While the Court acknowledged that there were concerns articulated in the board minutes regarding the risk of proceeding with an advisor that had a potential conflict, it noted that the minutes "have the feel of a document drafted in anticipation of litigation…" Moreover, as evidenced in the Liability Opinion, the Court rejected any attempt to spin the story in the minutes by finding a breach of fiduciary duty and that the investment banker aided and abetted the same. It is important that board minutes be accompanied by intervening facts, action and diligence to support the board's business judgment.

7. **Ensure that there is a true "independent" on the special committee** – The Vice Chancellor points out very early in the Liability Opinion that each member of the special committee had a potential or real conflict with respect to the transaction process. In order to provide the independence and certainty that are the overwhelming objectives of a special committee, it is critical that the board select a truly independent member or committee who can consider and decide issues without the taint of conflict (real or potential).

8. **Necessity of a standard process for fairness opinion** – The Court had two problems with the fairness opinion delivered by the advisor regarding the proposed sale. First, it was not conducted by a standing committee; instead, the process at the firm was *ad hoc* such that an email was sent to all potential professionals who could provide the fairness opinion and the first 2 to respond were effectively the fairness committee. The Court found such a process to be imperfect and lacking in credibility. Second, the Court took issue with the fact that the deal team provided the value metrics to the fairness team and provided significant review and revision to the fairness opinion. Based upon the Court's ruling and the standard practice of most investment banking firms, the establishment of a standing committee and the need for independence of such committee within the firm should be paramount.

9. **Requirement for finding of "knowing participation" in fiduciary breach** – It has traditionally been viewed as a stretch to suggest that a court could find a

professional liable for aiding, abetting and participating in a breach of fiduciary duty. However, the elements of such cause of action and the ruling in Rural/Metro suggest otherwise. The Court looked to established Chancery Court precedent in finding that a professional advisor can be held liable for knowingly participating in a board's breach of its duty of care if (i) there is an underlying breach and (ii) the advisor "knowingly participates in the breach" (the "knowing" modifies the ""participates" and not "breach"). So as long as there exist facts that satisfy the existence of the breach and knowing participation in the breach, a professional can and likely will be held liable in connection with the board's breach .

10. **The significant downside of improper corporate governance and failure to disclose** – In the Damages Opinion, the Vice Chancellor assessed liability against the advisor in the amount of $75,798,550.33 (exclusive of pre- and post-judgment interest). Enough said.

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