SULLIVAN & CROMWELL LLP

October 17, 2014

In re Rural/Metro Corp. Stockholders Litigation

Delaware Chancery Court Holds Financial Advisor Liable for 83% of Damages to Stockholders in Connection with Aiding and Abetting Breaches of Fiduciary Duty by Board of Directors

SUMMARY

In an opinion[1] issued on October 10, 2014, the Delaware Court of Chancery (VC Laster) determined post-trial that RBC Capital Markets, LLC ("RBC"), a financial advisor to Rural/Metro Corporation ("Rural") in its 2011 sale, was liable for approximately $75.8 million in damages plus interest to stockholders for aiding and abetting breaches of fiduciary duty by the Rural board of directors. The opinion follows a March decision[2] by the Delaware Court of Chancery in which VC Laster found after trial that RBC, the sole remaining defendant following the settlement of the case by the other Rural financial advisor (for $5 million) and the defendant Rural directors (for $6.6 million), had aided and abetted the Rural directors' breaches of their duty of care and duty of disclosure by running a flawed sale process and by failing to disclose material information, including RBC's potential conflicts of interest, in the proxy statement issued in connection with the merger, and that the breach had damaged Rural stockholders by causing Rural to be sold at a price below its fair value. Having determined in the earlier decision the inputs to the discounted cash flow model that would apply for determining Rural's going concern value range, the Court found that the damage suffered by stockholders was $91.3 million, representing the difference between the value the stockholders received in the merger and Rural's going concern value. Applying the Delaware Uniform Contribution Among Tortfeasors Act ("DUCATA"),[3] the Court determined that RBC was entitled only to a limited (17%) contribution (or settlement credit) for damages suffered by the plaintiffs from joint tortfeasors—those who were not entitled to the exculpation provisions of 102(b)(7) of the DGCL—rather than to a pro rata contribution from all the settling defendants. Seemingly applying a non-*Lyondell*[4] standard for breach of the duty of loyalty to the facts of the case, as in *Chen v. Howard-*

Anderson[5] decided earlier this year, the Court found that the chair of the Rural special committee and the CEO director would not have been entitled to exculpation had they not settled because they were motivated by personal interests and therefore failed to act in good faith.[6]

The opinion once again highlights the importance of instituting and implementing sale processes that ensure that directors will not be second-guessed under the judicial lens of enhanced scrutiny. In that connection, boards should ensure that they are providing appropriate oversight of committees, management, and advisors, that the directors chosen for a special committee have been vetted for potential conflicts, and that directors are aware of any material conflicts that their bankers may have. At the same time, the opinion makes clear that Delaware will hold financial advisors responsible as experts upon which directors are entitled to rely without liability with respect to areas within their expertise. Financial advisors need to ensure not only that they keep boards fully informed with respect to their valuations of the target companies the boards serve but also that boards are aware of all potential conflicts that could reasonably be expected to affect a court's view of the reasonableness of a sales process.

BACKGROUND

On March 28, 2011, Rural announced that it was being acquired by Warburg Pincus LLP in a transaction valued at $437.8 million, or $17.25 in cash per share of Rural's common stock. The merger closed on June 30, 2011.

The plaintiffs, who were stockholders of Rural, filed suit against Rural, Rural's directors, and Rural's financial advisors, RBC and Moelis & Company LLC ("Moelis"), alleging that the director defendants had breached their fiduciary duties and that RBC and Moelis had aided and abetted the breaches.

Before trial, all of the defendants other than RBC entered into a settlement with the plaintiffs. Under the terms of the settlement, the settling defendants obtained releases that foreclosed RBC's ability to seek contribution but also included "joint tortfeasor" releases, pursuant to which the damages recoverable against RBC would be reduced to the extent of the settling joint tortfeasor defendants' pro rata shares, as permitted by DUCATA. In November 2013, the Court approved the settlement; RBC did not object to its terms. The settlement order barred RBC from seeking contribution against the settling parties. As a result of the settlement, the case went to trial solely against RBC.

On March 7, 2014, the Court found that the director defendants had breached their duty of care and duty of disclosure by running a flawed sale process and by failing to disclose material information, including RBC's potential conflicts of interest, in the proxy statement issued in connection with the merger. The Court concluded that the breach had damaged the Rural stockholders by causing Rural to be sold at a price below its fair value.

The Court found that the director defendants' decision-making process and actions with respect to the sale process fell outside the range of reasonableness and that RBC knowingly participated in the directors' breaches of their duty of care by creating the unreasonable process and informational gaps that led to the breaches. These flaws included (1) allowing Christopher Shackelton—a director who led Rural's special committee and represented a hedge fund with a 22% stockholding—and RBC to initiate a sale process even though the Rural board had only authorized the special committee to investigate potential strategic alternatives, (2) initiating a sale process that ran in parallel with a sale process for a competitor of Rural's, Emergency Medical Services Corporation ("EMS"), in which RBC was seeking to get on bidders' financing trees—a fact RBC did not disclose to the Rural board, (3) failing to oversee the special committee, including failing to become reasonably informed about Rural's potential strategic alternatives, and failing to learn about actual and potential conflicts of interest faced by directors, management, and advisors, and (4) approving the merger without adequate information, including the value of not engaging in any transaction. With respect to RBC, the Court held that knowing participation that induced the breaches of fiduciary duty included (1) RBC's failure to disclose its interest in obtaining a financing role on the EMS transaction and how it planned to obtain that role through its role on the Rural sale, (2) its knowledge that the Rural board and special committee were uninformed about Rural's value, having not obtained any valuation materials from RBC until hours before the Rural board approved the merger, and (3) not disclosing to the board its interest in providing the winning bidder on the Rural sale with buy-side financing and its last minute attempts to secure that role at the same time as it was leading the negotiation with respect to price. The Court concluded that RBC's actions led to an ill-timed sale of Rural at a price that was not the best value reasonably attainable and that Rural's value on a stand-alone basis exceeded the sale price obtained in the merger. The Court also held that RBC aided and abetted the Rural board's breach of its fiduciary duty of disclosure insofar as the proxy statement sent to Rural's stockholders included materially misleading information that RBC presented to the board in its financial presentation and omitted information about RBC's conflicts. According to the Court, the Rural stockholders were thereby denied the information necessary to make an informed decision. The March opinion did not, however, fix an amount of damages suffered by the plaintiffs (ordering the experts to revise their discounted cash flow analysis based on the inputs the Court approved) or address RBC's argument that any monetary liability it bore should be reduced by the greater of the other defendants' share of liability and the amounts the other defendants paid in settlement of the case (ordering the parties to brief the issue). The Court addressed these questions in its recent decision.

THE COURT'S DECISION

A. DAMAGES SUFFERED BASED ON QUASI-APPRAISAL

The Court found that the quasi-appraisal method was the appropriate manner of measuring the compensatory damages suffered by the plaintiffs, namely money damages equal to the "fair" or "intrinsic" value of the Rural stock at the time of the merger less the price per share that stockholders actually received. Using a discounted cash flow model with inputs the Court deemed reasonable, the Court determined that the quasi-appraisal value for Rural as of the date of the merger was $21.42 per share, as against the $17.25 per share actually received by stockholders in the merger. Thus, the Court concluded, the plaintiffs suffered damages of $4.17 per share, amounting to a total aggregate amount of damages of $91.3 million.

B. LIMITED CONTRIBUTION AVAILABLE FROM SETTLING JOINT TORTFEASORS

The Court, recognizing that a defendant who aids and abets a breach of fiduciary duty is jointly and severally liable for the resulting damages, then turned to the question of whether the amount of the judgment entered against RBC should be less than the total amount of the damages suffered by the plaintiffs and concluded that RBC was not barred from claiming a settlement credit under DUCATA, despite the fact that it knowingly participated in the Rural directors' breach of their fiduciary duties. The Court rejected the plaintiffs' argument that because RBC committed an intentional tort it could not as a matter of law claim a settlement credit under DUCATA or any other form of contribution. Recognizing that the Delaware Supreme Court has not ruled on the issue, the Court concluded that the plain language of DUCATA does not bar contribution from joint tortfeasors for intentional torts, finding support for its position in the legislative history to DUCATA's predecessor statute, analogous Delaware statutes that authorize contribution for conscious misdeeds, and federal securities laws in which contribution among joint tortfeasors who act with scienter is permitted.[78] The Court noted that neither state nor federal case law was dispositive on the question since the approaches were either not on point or not uniform.

C. EQUITABLE DEFENSE OF UNCLEAN HANDS BARS CONTRIBUTION

At the same time, the Court stated that courts retain discretion to deny contribution under DUCATA if warranted by the facts of the case. The Court rejected the plaintiffs' argument that the equitable doctrine of *in pari delicto* should bar RBC from receiving a settlement credit since RBC did not engage in criminal or illegal conduct, but held that the equitable doctrine of unclean hands barred RBC from claiming a settlement credit for the disclosure claims and, to the extent that the breaches of duty related to the board's final approval of the merger, the sales process claims.[9] According to the Court, RBC committed a "fraud upon the board" by providing it with false information in its financial presentations and failing to disclose the basis for its "manipulation" of analyses and its conflicts of interest. Thus, the Court stated, "if RBC were permitted to seek contribution for these claims from the directors, then RBC would be taking advantage of the targets of its own misconduct."[10] In reaching its decision regarding unclean hands, the Court noted the important "backdrop" that Section 141(e) plays, stating that if RBC could assert a claim of contribution back against the directors who relied on the "false and materially incomplete" information RBC provided them, directors would not receive the full protection they are entitled to under Section 141(e) for reasonably relying on their advisors.

D. SETTLEMENT DID NOT ESTABLISH JOINT TORTFEASOR STATUS

Noting that DUCATA only recognizes a right of contribution among joint tortfeasors,[11] the Court found that RBC sustained its burden only in establishing that Shackelton and Michael DiMino, Rural's CEO and member of the board, were joint tortfeasors. In so finding, the Court rejected the plaintiffs' claim that RBC's failure to assert at trial that the settling defendants were joint tortfeasors amounted to a waiver of its right to make such a claim, noting that precedent established that contribution issues can be determined post-trial. The Court also rejected RBC's claim that by executing the settlement, the settling defendants conceded that they were joint tortfeasors or were estopped from claiming otherwise, noting that the settling defendants used the term "if any" to describe possible liability as joint tortfeasors as to the first claim and that settlement alone, absent an admission of liability, is insufficient to invoke estoppel. Lastly, the Court rejected RBC's argument that it was deprived by the settlement of the opportunity to assert that the settling defendants were joint tortfeasors, noting that RBC had the opportunity at trial to develop a record in support of its contribution claims and did not object to the settlement.

E. EXCULPATED DIRECTORS ARE NOT JOINT TORTFEASORS

The Court went on to hold as a matter of first impression that the settling defendants could not be considered joint tortfeasors for purposes of DUCATA if they were entitled to exculpation under Section 102(b)(7) of the DGCL. The Court held that RBC established only that two settling defendants, Shackelton and DiMino, would not be entitled to exculpation and accordingly qualified as joint tortfeasors. In reaching its conclusion, the Court, as it did in *Chen v. Howard-Anderson*, but admittedly on worse facts, seemingly elided the standard established in *Lyondell Chemical Co. v. Ryan* for finding a non-exculpated breach of the duty of loyalty—whether a director "utterly failed to attempt to obtain the best sale price" or demonstrated a "conscious disregard" of his or her duties—again stating that the appropriate standard for finding bad faith was whether a fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation. In particular, the Court found that in putting Rural into play without board authorization, Shackelton was "sufficiently motivated" by his personal interests and those of his fund to not be able to avail himself of 102(b)(7) exculpation. The Court found that as a managing director of a hedge fund that owned approximately 22% of Rural's stock, that sought to exit its investments in a three-to-five year horizon, and that was looking to raise a new fund, Shackelton was improperly motivated to seek and engineer a sale of Rural. According to the Court, Shackelton's desire for liquidity drove his decisions to ignore the special committee's limited mandate and effect the Rural sale. The Court also found that DiMino similarly supported a near-term sale because of his personal financial interests and therefore would not have been entitled to 102(b)(7) exculpation, noting that despite his initial opposition, DiMino became a proponent of a near-term sale after Shackelton and another director chastised him and he realized that he would be better off with a new, post-sale board, in addition to being able to cash out of his equity awards early if the sale were to occur. The Court concluded that RBC had failed to meet the burden of showing that any of the other directors or Moelis were joint tortfeasors, noting that RBC and Moelis did not engage in the same conduct, and in particular that, unlike Moelis, RBC devoted the bulk of its pitchbook to a sale process, especially one coordinated with the EMS process, as well as the fact that RBC pushed hard to be part of the bidder's financing, while Moelis did not, and that unlike Moelis, RBC played the lead advisory role.

F. RELATIVE FAULT CAN BE USED TO APPORTION DAMAGES

The Court concluded by finding that since DUCATA permits a finding of relative degrees of fault of joint tortfeasors in determining their pro rata share of damages when there is a disproportion of fault among tortfeasors, damages should be apportioned 83% to RBC, 10% to Shackelton, and 7% to DiMino. The Court arrived at the apportionment by determining that (1) 50% of the damages were attributable to the disclosure claims, for which RBC was solely responsible, (2) 25% of the damages were attributable to breaches of duty in connection with the approval of the merger, for which RBC was not entitled to settlement credit as a result of unclean hands, and (3) of the 25% of the damages attributable to initiating the sale process, Shackelton warranted the greater share of the responsibility and RBC warranted a greater share of the responsibility than did DiMino. Since RBC was entitled to a reduction in its liability equal to the greater of (i) the share of responsibility attributable to the joint tortfeasors and (ii) the settlement payments by the joint tortfeasors, RBC was entitled to a reduction of $15.5 million (17% of $91.3 million) in the form of contribution and thus was liable for approximately $75.8 million in damages.

IMPLICATIONS

The *Rural/Metro* decision makes clear that the cost to a financial advisor for being found to have induced a breach of fiduciary duty will be severe. In many cases, whether as a result of the exclusion of exculpated parties from joint tortfeasor status or a court's allocation, damages will fall disproportionately on those without the benefit of exculpation—officers and advisors.

*   *   *

ENDNOTES

1 *In re Rural/Metro Corp. Stockholders Litigation*, C.A. No. 6350-VCL slip op. (Del. Ch. Oct. 10, 2014) (hereinafter, "Slip Op.").

2 *In re Rural/Metro Corp. Stockholders Litigation*, C.A. No. 6350-VCL slip op. (Del. Ch. Mar. 7, 2014).

3 10 Del. C. § 6301, et seq.

4 *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235 (Del. 2009).

5 C.A. No. 5878-VCL slip op. (Del. Ch. Apr. 8, 2014). For a full discussion of the *Chen* decision, see our publication, dated April 23, 2014, entitled "*Chen v. Howard-Anderson*."

6 *See* Slip Op. at 76, quoting *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 67 (Del. 2006) ("A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation.").

7 The Court noted that the principal drafter of the Uniform Contribution Among Tortfeasors Act, on which DUCATA was based, had made statements that suggested that he believed that contribution should be available for all torts, including intentional torts, but that a court should be able to exercise its discretion to deny contribution based on the particular facts in any case. Slip Op. at 31.

8 The Court looked, among other things, to Section 174 of the DGCL, pursuant to which a director who wrongfully declares dividends is entitled to seek contribution. Slip Op. at 31-32.

9 The Court stated that "[r]easonable minds can differ about whether permitting a defendant like RBC to obtain contribution or, in this case, a settlement credit undermines the policy goal of deterring tortious conduct." Slip Op. at 49-51, n.15.

10 Slip Op. at 48.

11 *See Med. Ctr. of Del., Inc. v. Mullins*, 637 A.2d 6, 8 (Del. 1994) ("The credit provided for in the Delaware Uniform Contribution Law is applicable exclusively to joint tortfeasors.").

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Nathalie-Claire Chiavaroli (+1-212-558-3976; chiavarolin@sullcrom.com) in our New York office.

CONTACTS

New York

Francis J. Aquila	+1-212-558-4048	aquilaf@sullcrom.com
Audra D. Cohen	+1-212-558-3275	cohena@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Brian T. Frawley	+1-212-558-4983	frawleyb@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Brian E. Hamilton	+1-212-558-4801	hamiltonb@sullcrom.com
John L. Hardiman	+1-212-558-4070	hardimanj@sullcrom.com
Matthew G. Hurd	+1-212-558-3122	hurdm@sullcrom.com
Alexandra D. Korry	+1-212-558-4370	korrya@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Scott D. Miller	+1-212-558-3109	millersc@sullcrom.com
James C. Morphy	+1-212-558-3988	morphyj@sullcrom.com
Keith A. Pagnani	+1-212-558-4397	pagnanik@sullcrom.com
George J. Sampas	+1-212-558-4945	sampasg@sullcrom.com
Melissa Sawyer	+1-212-558-4243	sawyerm@sullcrom.com
Krishna Veeraraghavan	+1-212-558-7931	veeraraghavank@sullcrom.com

Washington, D.C.

Janet T. Geldzahler	+1-202-956-7515	geldzahlerj@sullcrom.com

Los Angeles		
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
Palo Alto		
Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
London		
Richard C. Morrissey	+44-20-7959-8520	morrisseyr@sullcrom.com
David Rockwell	+44-20-7959-8575	rockwelld@sullcrom.com
Paris		
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
Frankfurt		
Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
David Rockwell	+49-69-4272-5533	rockwelld@sullcrom.com
Melbourne		
Robert Chu	+61-3-9635-1506	chur@sullcrom.com
Tokyo		
Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
Hong Kong		
William Y. Chua	+852-2826-8632	chuaw@sullcrom.com
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com
Beijing		
Garth W. Bray	+86-10-5923-5958	brayg@sullcrom.com