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**FINANCIAL INSTITUTIONS****What M&A Financial Advisors Need to Know About Delaware's Business Judgment Rule**

BY ANDREW W. STERN, JAMES HEYWORTH, AND  
BENJAMIN F. BURRY

In recent years, Delaware courts reviewing M&A transactions simultaneously have become more deferential to well-functioning corporate boards and more suspicious of those boards' financial advisors. That is, Delaware courts more frequently have closely scrutinized transactions where financial advisors have, or appear to have, conflicts of interest but, at the same time, they have expanded business judgment rule deference to boards and their advisors when their actions have been approved by an uncoerced, fully-informed

*Andrew W. Stern and James Heyworth are partners and Benjamin F. Burry is an associate with Sidley Austin LLP in New York. They are members of Sidley's Securities and Shareholder Litigation group.*

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shareholder vote. This article provides financial advisors and their counsel with considerations and perspective from recent Delaware cases concerning fiduciary duties of directors and the impact on potential liability for their advisors in mergers and acquisitions.

**Background: Aiding and Abetting Breach of Fiduciary Duty Claims**

Public company boards of directors invariably hire a financial advisor when evaluating significant transactions. Conflicts of interest can arise between the company and its financial advisor, such as where the advisor assisting the corporation with a sale also is seeking to provide financing to a potential buyer.

As a general rule, under Delaware law, financial advisors do not owe fiduciary duties to a company's shareholders. Advisory firms can be liable, however, for aiding and abetting fiduciary duty breaches by the directors that they advise. Aiding and abetting breach of fiduciary duty has four elements: (i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary's duty, (iii) knowing participation in the breach by the non-fiduciary advisor, and (iv) damages caused by that breach.

In the M&A context, shareholder-plaintiffs commonly assert breach of fiduciary duties claims against the directors, and also aiding and abetting claims against the acquiring or target company's financial ad-

visors. With decisions like *Del Monte* (2011) (holding that an advisor “secretly and selfishly” steered the \$4 billion sale of Del Monte Foods to a buyer group that was paying it financing fees) and *Rural Metro* (2015) (finding that an advisor used its role to capture buy-side financing work), the Delaware Supreme Court has made clear that third party advisors may be held liable for aiding and abetting a corporate board’s breach of fiduciary duty, even in the absence of primary liability. In fact, in some cases (e.g., *Rural Metro* (2015)), plaintiffs have settled with the director defendants and proceeded solely against the company’s financial advisor. *Rural Metro* underscored that, while Delaware law sometimes shields directors from liability for breaches of the duty of care, advisors do not receive such protections. Moreover, even where directors have been exculpated for a particular breach of fiduciary duty, the company’s financial advisor may be liable for aiding and abetting that same breach.

### **Corwin v. KKR And Its Progeny Give Deference After a Fully Informed Shareholder Vote**

The Delaware Supreme Court’s 2015 decision in *Corwin v. KKR* is critical because it established that a fully informed vote of a majority of the disinterested stockholders of a corporation approving a transaction benefits from the presumption of the business judgment rule. Prior to the ruling, “enhanced scrutiny” under *Revlon* (1986) applied, whereby fiduciaries bear the burden of proving that they acted reasonably to seek the transaction offering the best value reasonably available to the stockholders. *Corwin* should reassure advisors as well; not just directors. Delaware has effectively narrowed the scope of aiding and abetting liability for advisors by heightening the standard of review applicable to a claim that directors breached fiduciary duties—a required element of an aiding and abetting claim. A claim for aiding and abetting a breach of fiduciary duty cannot survive unless an underlying breach of fiduciary duty can be shown.

The Delaware Chancery Court’s recent decision in *Zale* is a good example of the effect of *Corwin* on aiding and abetting liability for advisors. One day before *Corwin* was decided, the Chancery Court in *Zale* upheld an aiding and abetting claim against the financial advisor to jewelry retailer Zale. The court found that the advisor failed to disclose that it was also advising the acquirer in the deal, Signet. It held that the shareholder plaintiff adequately alleged that the advisor knowingly participated in, and therefore aided and abetted, the directors’ breaches of their fiduciary duties because a managing director of the advisor “was a member of both the team that presented to Signet and the team that advised the [Zale] Board,” and that it was the advisor’s decision to delay disclosing the conflict that caused the Zale directors’ breach of their duty of care. Hearing reargument following *Corwin*, the Chancery Court found *Corwin* “outcome-determinative” as to the advisor’s liability, and dismissed the aiding and abetting claim because the appropriate standard was the business judgment rule and, therefore, there was no predicate breach of fiduciary duty by the director defendants. *Zale* (2015).

On appeal, the Delaware Supreme Court in *Attenborough* (2016) clarified the difficulty of pleading the sci-

enter required for aiding and abetting liability under Delaware law, holding it was “skeptical” as to whether the Zale advisor’s late disclosure constituted a “rational basis to infer scienter.” The Court, however, also underscored that it would be wrong to conclude that an advisor can only be held liable if it aids and abets a non-exculpated breach of fiduciary duty, noting that Delaware a director’s good faith reliance on misleading advice tainted by the advisor’s own knowing disloyalty may not insulate advisors from liability.

Most recently, the Delaware Supreme Court affirmed dismissal of aiding and abetting claims against an advisor in *Volcano* (2017), agreeing with the Chancery Court’s finding that the advisor was protected by the “fully informed and voluntary” shareholder vote, and invoking the high burden plaintiffs face in alleging a financial advisor acted with the requisite scienter for an aiding and abetting claim, as articulated in *Attenborough* (2016).

The ultimate takeaway from these recent Delaware cases is that once a transaction is approved by an informed vote of disinterested stockholders, courts likely will be reluctant to inquire into the board’s underlying conduct, thereby freeing advisors from possible aiding and abetting liability based on an underlying breach by directors. As courts further implement and solidify this relatively new rule, however, there are some important things for advisors to consider.

### **More Than Ever, The Key For Advisors Is Disclosure**

Disclosure of all material facts, including potential conflicts of interest, has always been of paramount importance. Recent cases have underscored that, more than ever, plaintiffs challenging a corporate merger have enormous incentives to attack the adequacy of a company’s disclosures. Without thorough disclosures, a shareholder vote is not “fully informed,” and directors and advisors may not benefit from the favorable business judgment rule deference under *Corwin*. To benefit from the protection a disinterested stockholder vote can offer against aiding and abetting liability, advisors must take pains to fully disclose to boards of directors, and to ensure that disclosures are made to shareholders, regarding any potential advisor conflicts prior to shareholder approval of a transaction. The standard is “materiality” – information is material if, from the perspective of a reasonable stockholder, there is a substantial likelihood that it significantly alters the “total mix” of available information. For disclosure to be required, the information cannot merely be “helpful”; it must be “plainly material.” For example, in *Volcano* (2017), where stockholders were aware that the advisor’s payout would have decreased if the merger was consummated at a later date, it was not “material” that the board did not describe that the decline was “exponential.”

Nonetheless, despite recent victories for advisors, it is important for advisor counsel to understand that Delaware courts repeatedly have emphasized the particular importance of a company’s full disclosure regarding their financial advisors. In *Del Monte* (2011), the Delaware Supreme Court recounted that “this Court has required full disclosure of investment banker compensation and potential conflicts,” and reminded

that “[t]his Court has not stopped at disclosure, but rather has examined banker conflicts closely to determine whether they tainted the directors’ process.” After *Corwin*, and even when finding against aiding and abetting liability, Delaware courts have held to these themes. In *Zale* (2015), the Chancery Court explained “[the central role played by investment banks,” and emphasized directors’ obligation “to identify and consider the implications of the investment banker’s compensation structure, relationships, and potential conflicts,” including “additional steps,” such as “negotiating for representations and warranties in the engagement letter” and “asking probing questions to determine what sorts of past interactions the advisor has had with known potential buyers.”

Certainly in situations where the court believes an advisor has structured a sale process to further its ability to provide buy-side financing, has not disclosed to the board its efforts to secure buy-side financing, or has not disclosed interactions with the firms to which the advisor would provide such financing, advisors run the risk of increasing their exposure to aiding and abetting liability.

### **Advisors May Instead Face Pre-Closing Litigation or Federal Claims**

Even with Delaware courts’ sensitivity to financial advisor conflicts of interest, *Corwin* may be enough to incentivize plaintiffs’ firms to find avenues to litigate other than post-closing claims against advisors under Delaware law.

First, there may be increasing focus by plaintiffs’ firms on pre-closing litigation, including seeking expedited discovery in aid of a preliminary injunction. Whereas a post-closing action will force a plaintiff to establish that a shareholder vote was not fully informed (thus triggering enhanced scrutiny rather than business judgment rule deference), in a pre-closing action, a plaintiff may benefit from the *Revlon* heightened scrutiny standard at the outset. Relatedly, plaintiffs who are willing to relinquish their pre-closing claims to enjoin a merger may be more demanding of concessions, such as discovery. Notably, *Del Monte* (2011) was a pre-closing case where plaintiffs sought a preliminary injunction postponing the shareholder vote, and the misconduct by *Del Monte*’s advisor was not known when

plaintiffs filed their suit – as the Court observed, “discovery disturbed the patina of normalcy surrounding the transaction.” An advisor is highly unlikely to be left as the sole defendant in pre-closing action (as happened in *Rural Metro* (2015), a post-closing action) because pre-closing the company and board presumably will have an interest in moving forward with the deal, either by litigating and obtaining dismissal of, or settling, the case.

It will be interesting to watch this area of law develop, as advisors seek to use business judgment rule deference from a fully-informed shareholder vote against efforts by plaintiffs’ firms to provoke Delaware courts’ skepticism of financial advisor conflicts of interest and related disclosures.

### **Takeaways for Financial Advisors in Significant Corporate Transactions**

- Even where directors have been exculpated for a particular breach of fiduciary duty, the company’s financial advisor may be liable for aiding and abetting that same breach.

- Delaware courts continue to examine financial advisor conflicts of interests closely to determine whether they tainted the directors’ process.

- Advisors must take pains to fully disclose material facts to boards of directors, and seek to ensure that disclosures are made to shareholders, prior to a shareholder vote on a transaction.

- Where an advisor has structured a sale process to further its ability to pursue other (often more lucrative) business, such as providing buy-side financing, and has not fully disclosed to the board all facts relevant to those efforts, it runs the risk of increasing its potential exposure to aiding and abetting liability.

- If a court is satisfied that a transaction has been approved by an informed vote of disinterested stockholders, it is less likely to inquire into the board’s underlying conduct, thereby freeing advisors from possible aiding and abetting liability based on an underlying breach by directors.