Memorandum

Delaware Chancery Court Finds Duty of Loyalty Breach By Director-Representative of Hedge Fund Stockholder of Rural/Metro

October 31, 2014

Introduction

On October 10, 2014, Vice Chancellor Laster issued a post-trial decision in *In Re Rural/Metro Corporation Stockholders Litigation,* setting the amount of damages owed by RBC Capital Markets for aiding and abetting fiduciary duty breaches by the board of directors of Rural/Metro Corporation in connection with its 2011 sale to Warburg Pincus LLC.[1] In determining the amount of RBC's liability, the Court also evaluated the conduct of the Rural directors and concluded that several had committed breaches of their duty of loyalty, for which exculpation of personal liability is not permissible, including a director who served as the representative of a hedge fund which was a large Rural stockholder. The Court concluded that the investment goals of the hedge fund investor, including its policies on holding periods and concentrations as well as a pending fund-raising effort, created a conflict of interest with other stockholders and that its director representative's actions in pressing for a near-term sale of Rural were a breach of his duty of loyalty.

The opinion, like the Chancery Court decision in the *Answers Corporation* stockholder litigation in 2012, serves as an important reminder that courts may closely examine the particular circumstances of individual directors and the stockholders they may represent (including such stockholders' liquidity needs) to determine whether those circumstances are sufficiently different from other stockholders so as to create

[1] Plaintiffs initially filed suit against the members of the Rural board of directors and its financial advisors, RBC and Moelis & Company LLC. Moelis had been hired as a second financial advisor. Shortly before the 2013 trial, the Rural directors and Moelis settled the case. In setting the amount of damages payable by RBC as a result of the trial, Vice Chancellor Laster, using a quasi-appraisal methodology, determined that the fair value of Rural was $91,323,555 higher than the merger price (or $4.17 more per share). The Court found RBC liable for 83% of such damages, granting RBC a credit for 17% of the damages which were attributed to the conduct of two Rural directors (for reasons further discussed herein).

conflicts of interest and potential duty of loyalty claims.[2] The opinion is also noteworthy because then-Chancellor Strine appeared to take a different approach to this issue in the 2013 stockholder litigation related to the sale of Morton's Restaurant Group, holding that when all stockholders received the same sale consideration in a well-run sale process (which was determined by the Court not to be the situation in the *Rural/Metro* case) the Court would not evaluate the specific circumstances of each director and their motivation to sell the company, absent extraordinary facts.

Discussion

In the *Rural/Metro* opinion, Vice Chancellor Laster analyzed the potential duty of loyalty breaches of each of Rural's directors. Rural's then-Chairman of the Board (and head of the special committee appointed to assess Rural's strategic alternatives) was also a managing director of an activist hedge fund which was one of Rural's largest stockholders. The opinion discussed the hedge fund's practice of taking concentrated positions in and obtaining influence over small-cap companies and facilitating an exit in three to five years. The Court noted that shortly prior to the sale, Rural represented 22% of the hedge fund's portfolio (which was twice the target size, representing a huge unrealized capital gain for the fund) and that a sale or other strategic transaction was the logical next step. Vice Chancellor Laster also highlighted the hedge fund's concurrent fund-raising activities, noting "perhaps most significantly" that the Rural sale would be a good marketing tool for new fund investors. The Court acknowledged that Delaware law generally presumes that the interests of large stockholders are aligned with the interests of other stockholders, but in this case concluded that the trial evidence showed the hedge fund had "unique reasons to favor a near-term transaction that caused their interests to diverge from those of the Rural's equity as a whole". This conflict, combined with the hedge fund-affiliated director's activities to press a sale of the company without board approval at an arguably inopportune time and in a hasty manner, led the Court to find, in the context of determining the measure of damages to be paid by RBC, that the hedge fund-affiliated director had breached his duty of loyalty (despite the fact that the plaintiffs did not contend at trial that any director violated the duty of loyalty).[3]

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[2] In the stockholder litigation related to the sale of Answers Corporation, Vice Chancellor Noble denied a motion to dismiss claims of fiduciary duty breaches (including breaches of the duty of loyalty) upon finding, among other things, that two director-representatives of a venture capital firm could be deemed "interested" because they may have been motivated to sell Answers Corporation in order to obtain liquidity for the firm's shares, which would only be possible through a sale of the entire company unlike other stockholders who could sell shares in the open market.

[3] Vice Chancellor Laster also criticized the conduct of the then-CEO, also a member of the special committee, noting that he would not have been entitled to exculpation in this matter because his support of the sale to Warburg Pincus was due to his "deference" to other conflicted and potentially conflicted directors and the fact that the sale advanced his personal financial interests. The opinion notes that the trial record documented the then-CEO's initial opposition to the sale and the fact that he "fell into line" after being "chastised" by the other conflicted and potentially conflicted directors on the special committee. The opinion also found the then-CEO's actions appeared to have been motivated by his desire to retain his

In contrast, the *Morton's* stockholder litigation, which included a claim that Morton's former private equity sponsor (which held two board seats) acted in its own self-interest and caused the board to sell Morton's quickly and without regard to the interests of the other stockholders, resulted in a different outcome. In that case, then-Chancellor Strine focused on the presumption that when a large stockholder takes "the same price as everyone else" there is a strong indication of fairness which can only be overcome in unusual circumstances such as a fire-sale crisis involving a tainted sale process (e.g., a truncated market check or failure to provide other logical buyers with reasonable time and a fair opportunity to consider whether to make an offer). Chancellor Strine addressed the private equity fund's alleged conflicts, including its then-ongoing fund-raising efforts and customary divestment strategy of selling portfolio companies every three to five years, finding that those circumstances did not support a breach of loyalty in a lengthy sales process. Importantly, Chancellor Strine's decision did not discuss whether the private equity fund's reasons for selling at that particular time created a conflict with the interests of other stockholders, but instead focused only on the integrity of the sale process and whether it was likely to achieve the highest price in a sale at that time. Conversely, the Court in *Rural/Metro* looked past the fact that the shares held by the outside director's hedge fund would be treated in the same manner as the other Rural stockholders and Chancellor Strine's comments that pro rata treatment of stockholders is a "safe harbor" for stockholders. Vice Chancellor Laster instead found that the hedge fund's timing needs created a conflict for the fund's representative on the Board that adversely impacted Rural's sale process and resulted in a breach of that director's duty of loyalty to the other stockholders. The comparability of the two cases is of course affected by the fact that the sale of Morton's was found to be the product of a reasonable and thorough process while the sale of Rural was found to be outside the range of reasonableness for several reasons, including an impaired sale process at an inopportune time with obvious and foreseeable disadvantages to the company.

The Court's decision in the *Rural/Metro* case reflects the continued sensitivity in recent Chancery Court cases to conflicts or potential conflicts of interest and in that regard underscores the importance to the directors in a *Revlon* process of identifying and carefully considering the implications of potential conflicts, including the perceived conflicts that may be alleged in stockholder litigation involving director representatives of private equity funds and hedge funds. You can download a copy of the October 10th *Rural/Metro* opinion by clicking **here**.

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employment going forward. Given these facts, the Court concluded that the then-CEO would not be entitled to exculpation. Vice Chancellor Laster also noted that a third director faced conflicts of interest because he needed to decrease his number of directorships by a certain date due to ISS policy and a voluntary resignation would have resulted in a forfeiture of his unvested equity in Rural which, in contrast, would vest on a change of control. Vice Chancellor Laster noted that this director often sat on boards as a hedge fund nominee or outside director acceptable to activist stockholders, but ultimately concluded that the evidence was not sufficient to support a finding that he had breached his duty of loyalty.

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