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Static from balloons

By Neill May

There is an old joke about a guy flying in a hot air balloon over the countryside. He sees someone standing on a field and shouts, "Where am I?" The landlubber responds with precise latitudinal and longitudinal information as well as wind speed. The balloonist shouts back, "You must be a lawyer, because I'm sure that information is accurate but it doesn't do me any good at all." The guy on the ground responds, "You must be a client, because I'm standing here minding my own business, I answer your question correctly, and now suddenly all of your problems are my fault."

Corporate transactions continue to get more complex, underlining the importance, and at the same time compounding the difficulty, of dealing with them as good counsel: by anticipating the potential problems before the balloon leaves the ground. The recent series of Delaware cases about financial adviser conflicts, including the recent appellate decision in *Re Rural Metro Corp. Stockholders Litigation,* provides sound evidence of this phenomenon.

Much of the commentary concerning the *Rural/Metro* decision focuses on the US$76-million damage award imposed on Rural/Metro's lead financial adviser on the basis that it aided and abetted a breach of fiduciary duty by the company's board. Though much of the analysis concerns U.S.-based law, the Delaware Supreme Court's discussion of the actual and potential conflicts that arose is instructive to Canadian counsel.

The Rural/Metro board created a special committee, a customary approach in M&A transactions, to address potential conflicts of interest and for the efficiency benefits from a small group of heavily engaged directors. But *Rural/Metro* comments on factors potentially affecting independence less commonly considered. For example, the court commented on the potential conflicts of two committee members because one was "over-boarded" and the other (the chairman) worked at a hedge fund with a large stake in the company, suggesting both may have been very motivated to sell. The court also examined the committee process, considering whether the committee exceeded its mandate, the degree to which it deferred to its chairman, whether the board was kept properly informed, and whether the board itself properly oversaw the process.

Financial adviser potential conflicts often arise where the bankers have an economic interest in a transaction being completed. In *Rural/Metro,* the court found the lead banker was motivated to trigger a sale of the company so it could leverage that role to provide lucrative financing to the acquirer. Target companies looking for buyers do sometimes have their bankers offer "stapled financing" (debt capital made available to potential buyers) where it is determined that to do so will help maximize value. But clearly the target's advisers having financial interests on the buy side raises potential conflicts that must be scrutinized and — according to the court — can't be saved by boilerplate contractual waivers.

Stapled financing was also the core issue in the 2011 Delaware decision in *re Del Monte Foods Co. Shareholders Litigation,* where the target's financial adviser was found to have breached its duty by concealing its role in putting the company in play, its desire to provide stapled financing to the buyers, and by undermining the auction process by pairing high bidders.

There are also typically questions in M&A transactions concerning the degree of detail to be included in the proxy materials sent to shareholders. In *Rural/Metro,* the court concluded that material misstatements were made in describing the financial adviser's analysis — which the court found didn't reflect steps that had been taken to reduce the value of the company to make the proposed transaction look better. The court commented that once parties "travel . . . down the road of partial disclosure . . . they . . . [have] an obligation to provide the stockholders with an accurate, full, and fair characterization. . . ." Setting aside circumstances where disclosure may be incorrect, it is difficult to know where to draw the line where a little disclosure is not enough and too much is incomprehensible. Sometimes, it may seem that only Goldilocks would know how much is just right.

What is clear is that conflicts of interest must increasingly be comprehensively and continuously considered, and disclosure and boilerplate contractual language may not be sufficient to fully insulate the process. (In another recent Deleware case from 2012, in *re El Paso Corp. Shareholders Litigation,* the board was found to have breached its duties for relying on a financial adviser with a conflict that was not only clearly disclosed but was a product of the company's own adviser compensation structure.)

It is noteworthy, too, that in *Rural/Metro* the financial adviser was financially accountable for aiding and abetting a breach by the board though the directors themselves were not liable (they were exculpated from financial liability under the company's charter).

Maybe hot air balloons are the correct metaphor. Not for reasons my kids might suggest, referencing lawyerly "hot air" or the constant risk that when I'm talking others might "drift off." More like the potential conflicts in M&A deals are now so intricate and dynamic it's as if the sky is filled with hot air balloons through which M&A participants must carefully navigate. If those balloons collide, the potential liability could make for a very loud boing. **CL**

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