

# Sell-Side Financial Advisors in the M&A Crosshairs

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Zale I: *Aiding & Abetting Directors' Breach of their Duty of Care*  
Zale II: *"Cleansing Effect" of a Fully Informed Stockholder Approval*

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## I. INTRODUCTION

In their search for deep-pocketed litigation defendants in M&A transactions, plaintiffs' counsel have come to view the sell-side financial advisor as an inviting target. In early 2014, the Delaware Court of Chancery required RBC Capital to pay approximately \$75.8 million in damages to Rural Metro Corporation stockholders, based on the theory that the financial advisor aided and abetted a breach by the Rural Metro board of its duty of care in connection with a private equity firm's acquisition of Rural Metro.<sup>1</sup> In the wake of *Rural Metro*, the Chancery Court has refused to dismiss aiding and abetting claims brought against several target company financial advisors.

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1. *In re Rural Metro Corp. Stockholders Litig.*, 88 A.3d 54 (Del. 2014), *aff'd sub nom.* RBC Capital Markets, LLC v. Joanna Jervis, No. 140, 2015, opinion (Del. 2015).

It is now an all-too-familiar statistic that 97.5% of mergers exceeding \$100 million in value attract stockholder litigation.<sup>2</sup> But other than cases where a controlling stockholder either buys out, or receives favorable treatment relative to, public stockholders,<sup>3</sup> it has become exceedingly difficult for stockholders unhappy with an M&A transaction to obtain judicial relief (outside of appraisal) from Delaware courts. The Chancery Court is loath to enjoin a merger pre-closing, especially if only one active bidder remains and stockholders have an opportunity to reject the transaction. Post-closing, plaintiff stockholders face a very high bar in convincing the Chancery Court to assess damages against target company directors.

Generally, in the M&A context, stockholders of Delaware corporations must prove that defendant directors were grossly negligent (or worse) to establish they breached their fiduciary duty of care. However, most public corporations have taken advantage of Section 102(b)(7) of the Delaware General Corporation Law (“Delaware § 102(b)(7)”), which allows them to immunize directors from personal damages for a duty of care breach. Although Delaware § 102(b)(7) does not protect directors from breaches of their duty of loyalty, the level of culpability to establish such a breach—bad faith or willful misconduct—presents an even more difficult burden of proof for plaintiff stockholders to satisfy.

It is not surprising, therefore, that plaintiffs’ counsel have turned to sell-side financial advisors as a potential source of damages for their clients (and to buttress claims for attorneys’ fees). In addition to saddling RBC with significant damages, the *Rural Metro* court explained that financial advisors, unlike directors, are *not* protected by Delaware § 102(b)(7). Therefore, even though directors of a corporation that has adopted Delaware § 102(b)(7) do not face personal liability for breach of their duty of care, if plaintiffs can establish, *first*, that such a breach has occurred and, *second*, that the financial advisor aided and abetted the breach, the financial advisor may face a serious damages award. In light of the Chancery Court’s recent refusal to dismiss aiding and abetting claims at the early pleading stage, settlement seemed the advisors’ only practical recourse.

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2. Jill E. Fisch, Sean J. Griffith & Steven Davidoff Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEXAS LAW REV. 557, 558-59 (2015) (incorporating data from 2013).

3. In these cases, the most intrusive standard of judicial review—the entire fairness test—is applied by the Delaware courts.

On October 2, 2015, however, the Delaware Supreme Court, in *Corwin v. KKR Financial Holdings LLC*,<sup>4</sup> provided a potential pathway for dismissal of these aiding and abetting claims. By declaring that “the voluntary judgment of the disinterested stockholders to approve the merger invoked the business judgment rule standard of review,”<sup>5</sup> rather than a more intrusive standard, *KKR* provided an ex post vehicle to overcome a board’s duty of care breach, thereby undercutting a related aiding and abetting claim against the board’s financial advisor.

The potential impact of the *KKR* cleansing device is demonstrated in the two recent decisions rendered by the Chancery Court in the *In re Zale Corp. Stockholders Litigation*, referred to below, respectively, as *Zale I*<sup>6</sup> and *Zale II*.<sup>7</sup> In *Zale I*, decided by Vice Chancellor Donald Parsons before *KKR*, the Vice Chancellor refused to dismiss a claim that a sell-side financial advisor aided and abetted the target board’s alleged breach of its duty of care. Soon after *KKR*, Vice Chancellor Parsons reversed course in *Zale II*. Applying the deferential business judgment standard of review, instead of enhanced scrutiny as mandated by *Revlon*<sup>8</sup> and its progeny, to the target board’s conduct, the Vice Chancellor determined that plaintiffs had not established a breach of duty of care on the part of the target board and, therefore, dismissed the related aiding and abetting claim against the sell-side financial advisor. Financial advisors everywhere no doubt breathed a collective sigh of relief.

## II. BACKGROUND

*Zale I* and *Zale II* are stockholder suits arising from Signet Jewelers Limited’s 2014 acquisition of Zale Corporation. Zale is “a leading retailer of fine jewelry in North America.”<sup>9</sup> Signet is Zale’s “largest competitor,” operating in both the United States and the United Kingdom.<sup>10</sup>

By 2013, Zale had engineered a successful turnaround from the 2008 financial crisis. On November 7, 2013, Signet formally proposed to

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4. *Corwin v. KKR Fin. Holdings LLC*, No. 629, 2014, 2015 WL 5772262, at \*6 (Del. 2015). In so ruling, the Court noted that “*Unocal* and *Revlon* are primarily designed to give stockholders ... the tool of injunctive relief to address important M&A decisions in real time, before closing. They were not tools designed with post-closing money damages in mind . . . .” *Id.*

5. *Id.* at \*1.

6. *In re Zale Corp. Stockholders Litig.*, No. CV 9388-VCP, 2015 WL 5853693 (Del. 2015).

7. *Id.*

8. *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

9. *In re Zale Corp.*, 2015 WL 5853693, at \*2.

10. *Id.* at \*1.

acquire Zale. In response, Zale's board of directors retained Merrill Lynch as its financial advisor.<sup>11</sup> Merrill Lynch, which had previously worked for Zale, was hired following a presentation wherein it represented that it had "limited prior relationships and no conflicts with Signet."<sup>12</sup> Although the board considered reaching out to other strategic buyers, Merrill Lynch advised that none would be interested. Following negotiations, on February 19, 2014, the parties signed a merger agreement providing for Signet's purchase of Zale at a cash purchase price of \$21 per share. Merrill Lynch rendered a fairness opinion in support of the transaction.

Despite its claims to the contrary, Merrill Lynch indeed had potential conflicts in taking on this representation. First, between 2012 and 2013, Signet paid Merrill Lynch \$2 million in fees for various services rendered. More troubling, just prior to its retention by Zale, Merrill Lynch made a presentation to Signet "aimed at soliciting business from Signet and proposed an acquisition of Zale at a value of between \$17 and \$21 per share."<sup>13</sup> Jeffrey Rose, a Merrill Lynch managing director, was a senior member of *both* the team that made the initial presentation to Signet as well as the team that advised Zale during the sale process.

Merrill Lynch did not disclose the prior Signet representation to Zale until March 23, 2014—over a month after the merger agreement was signed—in connection with preparation of the proxy materials to be used to solicit Zale stockholder approval of the transaction. Notably, the final merger price of \$21 per share matched the top-end of the range that Merrill Lynch had previously suggested to Signet.

Several Zale stockholders challenged the merger, both in public comments and through litigation in the Chancery Court. TIC Advisors, LLC, for example, filed materials with the SEC stating, among other concerns, that the "sales process [was] replete with numerous conflicts of interest, particularly relating to...[Merrill Lynch], doom[ing] shareholders [sic] chances for a fair outcome."<sup>14</sup> Nevertheless, the Chancery Court refused to preliminarily enjoin the transaction and, after Zale stockholders owning 53.1% of the outstanding shares approved the merger in May 2014, Signet completed the acquisition.

Undeterred, plaintiffs amended their complaint in September 2014 to include a damages claim alleging that Merrill Lynch "aided and

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11. Merrill Lynch, Pierce, Fenner and Smith Incorporated is now the corporate and investment banking division of Bank of America.

12. *In re Zale Corp.*, 2015 WL 5853693, at \*3.

13. *Id.* at \*3.

14. *Id.* at \*5.

abetted the Director Defendants' breaches of fiduciary duties."<sup>15</sup> Specifically, plaintiffs alleged that Merrill Lynch "undermined the Board's ability to maximize stockholder value in the Merger by making a presentation to Signet 'with an illustrative price analysis of Zale' at a time when Merrill Lynch had access to Zale's non-public information."<sup>16</sup> All the defendants, including Merrill Lynch, moved to dismiss.

### III. ZALE I: ENHANCED SCRUTINY

In *Zale I*, Vice Chancellor Parsons, while dismissing *Revlon*-based claims against the Zale directors and Signet,<sup>17</sup> declined to dismiss the aiding and abetting claim against Merrill Lynch. Initially, the Vice Chancellor noted that, to establish an aiding and abetting claim, plaintiffs must allege, among other things, "a breach of the fiduciary's duty . . . [and] knowing participation in that breach by the defendants."<sup>18</sup>

***Breach of the Duty of Care.*** Vice Chancellor Parsons reviewed the Zale board's actions under the *Revlon* lens of enhanced scrutiny, which "focuses on whether the Defendant Directors' actions fall within a range of reasonableness with the ultimate goal of maximizing the Company's sales price."<sup>19</sup> On this basis, Vice Chancellor Parsons found it "reasonably conceivable that the Defendant Directors did not act in an informed manner," thereby breaching their duty of care, by failing to do a better job "detecting a preexisting conflict when engaging a financial advisor."<sup>20</sup>

Further, from the Vice Chancellor's perspective, it mattered not that Zale stockholders approved the transaction. While acknowledging that he found himself in an unsettled area of Delaware law,<sup>21</sup> Vice Chancellor Parsons reasoned that "where, as here, the merger consideration paid to the target company's stockholders is cash, *Revlon* enhanced scrutiny applies, even after the merger has been approved by

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15. *Id.* at \*7.

16. *Id.* at \*7.

17. Zale's Delaware § 102(b)(7) provision insulated the directors from any potential breach of their duty of care, and Vice Chancellor Parsons concluded that the directors' handling of Merrill Lynch's conflict "hardly constitutes the conscious disregard of the directors' duties required to demonstrate bad faith in the *Revlon* context." *Id.*

18. *Id.* at \*21.

19. *Id.* at \*18.

20. *Id.* at \*19.

21. It should be noted that the Chancellor Bouchard in *In re KKR Fin. Holdings LLC Shareholder Litigation*, 101 A.3d 980 (Del. 2014) recognized the "cleansing effect" of an informed stockholder vote. While Vice Chancellor Parsons had this decision before him, he decided not to follow it until the Delaware Supreme Court affirmed it.

a fully informed, disinterested majority of stockholders.”<sup>22</sup> And consistent with *Rural Metro*, although the directors were protected from personal liability for this breach by *Zale*’s Delaware §102(b)(7) provision, Merrill Lynch was not so insulated.

**Knowing Participation.** Next, the Vice Chancellor found that Merrill Lynch contributed to the *Zale* board’s potential breach of care when it failed to be up-front about the firm’s presentation to Signet. Referring to *Rural Metro*, he noted that Merrill Lynch’s undisclosed conflicts “hampered the ability of Merrill Lynch and, consequently, the Board to seek a higher price for *Zale*’s stockholders.”<sup>23</sup> On this basis, the Vice Chancellor concluded that plaintiffs had successfully alleged that “Merrill Lynch knowingly participated in, and therefore aided and abetted”<sup>24</sup> the board’s breach of its duty of care.

#### IV. *ZALE II*: BUSINESS JUDGMENT RULE

Just one day after *Zale I*, the Delaware Supreme Court rendered its decision in *KKR*, leading Vice Chancellor Parsons to grant Merrill Lynch’s motion for reargument. As the Vice Chancellor put it, “I misapprehended the law regarding the cleansing effect of a fully informed, statutorily required vote by a disinterested majority of the stockholders in the circumstances of the *Zale* case. This misapprehension was both material and potentially outcome-determinative . . . because I incorrectly applied *Revlon* rather than BJR [the business judgment rule] when I reviewed the Complaint to determine whether it adequately alleged that the Defendant Directors breached their fiduciary duties.”<sup>25</sup>

The Vice Chancellor had already concluded in *Zale I* that it was not “reasonably conceivable that . . . *Zale*’s stockholder vote was not fully informed.”<sup>26</sup> Accordingly, and in light of *KKR*, the Vice Chancellor ruled in *Zale II* that the more deferential business judgment rule, rather than the enhanced scrutiny standard applied in *Zale I*, was the proper standard for evaluating the *Zale* board’s conduct.

This change in the standard of review completely altered the outcome of Vice Chancellor Parsons’s analysis. He continued to find it “troubling”<sup>27</sup> that the *Zale* board did not take further investigative steps to verify Merrill Lynch’s claim that it had no conflicts in taking on the

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22. *In re Zale Corp.*, 2015 WL 5853693, at \*10.

23. *Id.* at \*20.

24. *Id.* at \*22.

25. *Id.* at \*2.

26. *Id.* at \*10.

27. *Id.* at \*5.

representation of Zale. The key question, however, no longer was whether the board acted reasonably. Rather, “the standard for finding a breach of the duty of care” under the business judgment rule “is gross negligence.”<sup>28</sup> The Vice Chancellor did not believe the board’s conduct was “so grossly off-the-mark as to amount to reckless indifference or a gross abuse of discretion” or suggestive of “a *wide* disparity between the process the directors used . . . and [a process] which would have been rational.”<sup>29</sup>

In this new light, Vice Chancellor Parsons did not find it “reasonably conceivable that the Zale Director Defendants breached their duty of care by acting in a grossly negligent manner as to their engagement of Merrill Lynch.”<sup>30</sup> Thus, there was no underlying board breach for Merrill Lynch to have aided or abetted and, accordingly, the Vice Chancellor granted Merrill Lynch’s motion to dismiss.

## V. CONCLUSION

While the *Zale* litigation ultimately ended favorably for the financial advisor, the decision cannot, of course, be relied on *ex ante*. Only if a court determines *ex post* that the stockholder vote was fully informed and disinterested will the presumption of the business judgment rule apply to the target board’s conduct.<sup>31</sup> Consequently, rather than counting on a result consistent with *Zale II*, target boards and their sell-side financial advisors are well advised to be more cognizant of (and in the case of financial advisors, more forthcoming with respect to) potential conflicts of interest, and to proactively strengthen their processes for conflict management.

Instructively, Vice Chancellor Parsons outlined in *Zale I* the specific actions that he believed would enable a target board to satisfy its duty of care when selecting financial advisors. Specifically, the Vice Chancellor suggested that boards consider “negotiating for

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28. *Id.* at \*3. It should also be noted that *RBC Capital Markets, LLC v. Joanna Jervis*, No. 140 (Del. 2015) clarified that gross-negligence is the applicable standard only to determining whether monetary judgments should be granted. It is not the standard that should be used to determine whether a breach – especially in the context of aiding and abetting – has occurred; “[w]hen disinterested directors themselves face liability, the law, for policy reasons, requires that they be deemed to have acted with gross negligence in order to sustain a monetary judgment against them. That does not mean, however, that if they were subject to *Revlon* duties, and their conduct was unreasonable, that there was not a breach of fiduciary duty.”

29. *In re Zale Corp.*, 2015 WL 5853693, at \*4.

30. *Id.*

31. It should be noted that *Rural Metro* did not apply the “cleansing effect” of the stockholder vote. The Chancery Court found that that the “Proxy Statement contained materially misleading disclosures.” While not explicitly stated, it can be assumed that because the vote was not informed, it did not deserve the business judgment presumption.

representations and warranties in the engagement letter as well as asking probing questions to determine what sorts of past interactions the advisor has had with known potential buyers.”<sup>32</sup> Just discussing the potential that Merrill Lynch could be conflicted and relying “without question on Merrill Lynch’s representation that it had ‘limited prior relationships [with Signet] and no conflicts,’ ”<sup>33</sup> was not enough, in the Vice Chancellor’s opinion, to satisfy the board’s fiduciary duties. Vice Chancellor Parsons also was critical of the relative quickness with which the Zale board selected Merrill Lynch, not to mention the fact that Merrill Lynch was the “only candidate they considered.”<sup>34</sup>

The *Zale* litigation exemplifies the increased attention paid by the Delaware courts over the last five years to potential financial advisor conflicts. The courts clearly recognize an “oversight duty” on the part of boards in selecting and monitoring financial advisors. In connection with any merger process, it therefore would serve boards, as well as their financial advisors, well not just to pay lip service to the identification and resolution of potential conflicts of interest. Although financial advisors are not accustomed to clients challenging their representations regarding conflicts, a thorough airing of potential conflicts is ultimately in the best interests of all. Otherwise, if a breach of the board’s duty of care is ultimately found to have occurred in connection with the retention of the financial advisor, it is the financial advisor who might end up “holding the bag” for fiduciary breaches committed by its client.<sup>35</sup>

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32. *In re Zale Corp.*, 2015 WL 5853693, at \*19.

33. *Id.*

34. *Id.*

35. This is the situation in which RBC found itself in *Rural Metro*, to the tune of approximately \$75.8 million.