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Corporate Litigation:

Limitations on Director Access to Company Information

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Corporate directors have a near-absolute right of access to company information, which ordinarily extends to privileged communications with company counsel. It is widely accepted, however, that limitations on directors' right of access are appropriate in certain circumstances. When the interests of one or more directors (or the stockholder for whom the director serves as board designee) have clearly diverged from the company's interests, the company may seek to withhold corporate books and records from the adverse director. Recent Delaware Court of Chancery decisions have offered fine-grained guidance on the governance procedures a company must follow to invoke the adversity exception to directors' access, and the scope of permissible restrictions on access to company information

Background

Directors' general right of unfettered access to company books and records arises from recognition that the individuals responsible for managing the company should have access to all information (including communications with company counsel) that a reasonable director needs for informed decision-making. In Delaware, directors are "joint clients" with the company for purposes of privileged communications with company counsel. A joint client ordinarily is entitled to obtain any advice or other communications shared between counsel and any other joint client. But what if the legal or financial interests of one of the joint-client directors diverge from those of the company—for example, if certain directors or the stockholder who appointed them announce an intention to pursue a transaction a majority of the board believes not in the company's best interest?

The must-read precedent is *Kalisman v. Friedman*, 2013 WL 1668205 (Del. Ch. April 17, 2013), which established Delaware's approach for properly limiting dissident director access to company information. Kalisman served on the Morgans Hotel Group board as a designee of its largest stockholder, OTK Associates. He also was a member of a special committee of the Morgans board formed to evaluate strategic alternatives for Morgans. OTK then announced a planned proxy contest for control of Morgans at the company's next annual meeting. Without informing Kalisman, the non-Kalisman committee members determined that Kalisman and OTK were now adverse to the company, postponed the annual meeting, and pursued strategic alternatives, culminating in a proposed recapitalization transaction with a third party. After excluding Kalisman from its work for weeks, the special committee sent Kalisman a large package of materials for board

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consideration hours before a special board meeting convened to approve the recapitalization. Kalisman objected and sued to enjoin the meeting, and demanded broad access to company information—including attorney-client communications between the special committee and its counsel and the board and its counsel.

Vice Chancellor J. Travis Laster concluded that as a sitting director, Kalisman had a right of equal access to the requested privileged materials he sought in his capacity as a director of Morgans and attendant status as a joint client of the subpoenaed law firms. The court disagreed that a litigation showing of adversity between the interests of Kalisman and Morgan justified barring Kalisman's access to privileged information other directors could receive. Rejecting the company's objection that Kalisman would share privileged materials with OTK, the court stated that "[w]hen a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director." The safeguard against misuse of that information, the court said, is a claim for breach of fiduciary duty against the director who shares the information.

The court then described two circumstances in which board members may screen specific directors from certain communications, without the agreement of the excluded directors. The hallmark of either path is transparency: (1) a board can act openly, with the knowledge of the excluded director, to appoint a special committee, which then may retain separate counsel, and its communications with that counsel would be protected "at least to the extent necessary for the committee's ongoing work, such as conducting a special committee investigation or negotiating an interested transaction"; or (2) a board or committee can withhold privileged information once sufficient adversity exists between the director and the corporation such that the director could no longer have a reasonable expectation that he or she is a client of the board's counsel.

The court held that the clear adversity necessary to invoke the second exception applied with respect to the recapitalization and related matters after the meetings of the Special Committee and the board to vote on the recapitalization—at that point Kalisman could no longer have a reasonable expectation that he was a client of the board's counsel or the Special Committee's counsel as to these matters. In discovery Kalisman therefore received company-privileged and other communications that preceded that late date.

In re CBS Corp. Litig., 2018 WL 3414163 (Del. Ch. July 13, 2018), illustrates the fact-intensive nature of the *Kalisman* standard. NAI controls approximately 80 percent of the voting power of CBS. CBS outside counsel has represented CBS since 2006, including on matters regarding its relationship with NAI. In 2016, NAI sent a letter to CBS asking it to consider a potential combination with Viacom (also controlled by NAI). CBS formed a special committee of independent directors to consider, negotiate and oversee any potential transaction, but merger talks stalled after three months. In early 2018, NAI again formally approached the boards of CBS and Viacom and pressed for a combination of the two companies. CBS formed a second Special Committee to evaluate. In May 2018, the Special Committee determined that a CBS/Viacom merger was not in the best interests of CBS minority stockholders. It also recommended that the Board consider issuance of a dividend of voting stock, which would dilute NAI's voting power from 80 percent to 20 percent. The day before a Board meeting requested by the Special Committee, NAI delivered written consents to amend CBS's bylaws to require approval by 90 percent of the directors then in office in order to declare a dividend. The Board voted to approve the dilutive stock dividend by a vote of 11-3, with NAI's three designees dissenting. Litigation over the dividend's validity followed.

NAI moved to compel CBS to produce privileged communications involving pre-May 2018 communications between board and special committee members and CBS counsel. Under *Kalisman*, to bar director access, two questions must be answered affirmatively: Was there adversity and was it known to the directors seeking access? The court concluded that for the eleven-year period predating the formation of the 2016 Special Committee, the record was too undeveloped to make informed judgments about (1) when moments of adversity may have arisen between CBS and the NAI-affiliated directors concerning a given issue during this period and, if they did, (2) whether the NAI-affiliated directors were (or reasonably should have been) aware of the adversity inconsistent with a reasonable expectation that they were clients of CBS counsel at a given time.

For the period between the first Special Committee's formation (September 2016) until May 14, 2018 (when litigation commenced), the NAI-affiliated directors (and by extension NAI) were not entitled to obtain CBS's privileged information. When NAI asked the CBS Board to consider a potential combination of CBS and Viacom, it placed itself across the negotiating table from CBS. NAI's board designees had no "reasonable expectation that [they were] a client of the board's counsel or the Special Committee's counsel with respect to" matters delegated to the Special Committees. In forming a Special Committee in 2016 and again in 2018 to consider a potential combination, CBS employed appropriate governance procedures that openly put the NAI-affiliated Directors on notice that they would be segregated from the CBS side of the deliberations, including privileged information. CBS's privilege protection extended to director communications to and from both the Committee's own counsel and CBS counsel. "It is logical," the court said, "to expect that a special committee charged with evaluating a proposed transaction (including matters 'relating to' and 'arising from' such proposed transaction) may wish or may need to confer with the corporation's in-house lawyers and outside counsel to discharge their duties in an informed and responsible manner."

The court emphasized the limited scope of permissible exclusion of directors with adverse interests from privileged company communications. The absence of a factual basis to support a conclusion that the NAI-affiliated Directors were made aware (or reasonably should have been aware) that CBS counsel was not representing them jointly with the other CBS directors concerning anything other than matters within the purview of the Special Committees meant that the NAI-affiliated Directors remained entitled to obtain privileged communications that were not about a potential NAI transaction.

Chancellor Andre G. Bouchard recently revisited the special committee exception to all-director access in two decisions in *Schnatter v. Papa John's Int'l Inc.* In July 2018, Papa John's board formed a special committee to investigate all agreements between the company and John Schnatter, the company's founder, former CEO and Chairman of the Board, after press reports that he had used a racial slur during a training exercise. The committee terminated two of those agreements, prompting Schnatter to serve a books and records demand on the company under Delaware Code Section 220(d), seeking 17 categories of documents concerning himself and the special committee's work. Schnatter filed suit when his demand was denied. Reiterating that Delaware law affords directors virtually unfettered access to company books and records, Chancellor Bouchard rejected the company's arguments that Schnatter had no proper purpose in making the demand, citing Schnatter's desire to personally vindicate himself and bolster his separate derivative complaint, brought in his capacity as stockholder, alleging company mismanagement. *See* 2019 WL 194634 (Del. Ch. Ct. Jan. 15, 2019). Citing the "reality of today's world" for what constitutes corporate books and records, in addition to attorney-client privileged communications the court required production of the committee members' personal emails and text messages concerning Schnatter's performance. The court also declined to require Schnatter to sign a confidentiality agreement concerning the responsive information (as stockholders routinely must do), noting that as a director Schnatter already was subject to fiduciary duties to the company. But in a subsequent order, the court ruled that Schnatter was *not* entitled to production of communications with the special committee's soon-to-be outside counsel for the two days preceding formal appointment of the special committee. Although Schnatter was at that point unaware that a special committee would soon be formed to investigate him, there was no evidence suggesting either Schnatter or committee counsel ever believed that law firm would represent the Board or Papa John's. Consequently, under *Kalisman* he had no expectation of having access to that privileged information belonging to the committee. 2019 WL 939205 (Del. Ch. Ct. Feb. 25, 2019).

Conclusion

Delaware law provides clear guidance to boards and their advisers seeking to preserve the ability to screen any director with interests adverse to the company from privileged and other sensitive information regarding the subject of the adversity. The key is to take steps, such as formation of a special committee to consider the subject of the adversity, which foreclose any reasonable expectation that the adverse directors are represented by the board's counsel or special committee's counsel with respect to matters in which the adverse directors have interests divergent from the company. Under *Kalisman*, transparency is paramount. The recent *Papa John's* decision instructs that the special committee exception to all-director access may apply even for a period in which a purportedly adverse director is unaware that a special committee is contemplated—if the adverse director had no reason to believe that any counsel approached to represent the special committee would ever represent the company or the board as a whole.
