Simpson Thacher

Securities Law Alert

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Simpson Thacher's "[i]mpressive bench is notably well-versed in complex securities class actions."

– Chambers USA 2015

D.C. Circuit: Federal Courts Have No Jurisdiction Over Constitutional Claims Brought by Respondents in Pending SEC Enforcement Proceedings

On September 29, 2015, the D.C. Circuit held that respondents in pending SEC administrative enforcement proceedings may only "secure judicial review" in federal court "when (and if) the proceeding[s] culminate[ ] in [an adverse] resolution." *Jarkesy v. SEC*, 2015 WL 5692065 (D.C. Cir. 2015) (Srinivasan, J.). The D.C. Circuit determined that even if respondents assert constitutional or other challenges to the SEC's authority, they may not "'jump the gun' by going directly to [a] district court to develop their case." Earlier this year, the Seventh Circuit reached the same conclusion in *Bebo v. SEC*, 799 F.3d 765 (7th Cir. 2015).

Background

When enforcing the federal securities laws in civil proceedings, the SEC may either "bring a civil action against the alleged violator in federal district court, or it can initiate an administrative enforcement proceeding." *See* 15 U.S.C. § 78u(d) et seq. Respondents in SEC enforcement proceedings may appeal adverse agency resolutions in federal court. *See* 15 U.S.C. § 78y(a)(1).

In the case before the D.C. Circuit, the SEC had commenced administrative enforcement proceedings against an unregistered investment adviser and its manager. Before the SEC hearing began, respondents filed suit in federal district court raising constitutional

challenges to the SEC's authority to bring enforcement proceedings. The district court dismissed respondents' complaint for lack of subject-matter jurisdiction. Defendants appealed.

Applying the *Thunder Basin* Test, D.C. Circuit Finds Congress Implicitly Precluded Federal Court Jurisdiction Over Constitutional Challenges Brought by Respondents in Pending SEC Enforcement Proceedings

The D.C. Circuit applied the two-part test set forth in *Thunder Basin Coal Co. v. Reich*, 510 U.S. 200 (1994) to assess "whether Congress [had] implicitly precluded [respondents'] district-court suit by channeling [respondents'] challenges through the securities laws' scheme of administrative adjudication and judicial review in a court of appeals." Pursuant to the *Thunder Basin* test, a court can "determine that Congress intended that a litigant proceed exclusively through a statutory scheme of administrative and judicial review when (i) such intent is 'fairly discernible in the statutory scheme,' and (ii) the litigant's claims are 'of the type Congress intended to be reviewed within [the] statutory structure'" (quoting *Thunder Basin*, 510 U.S. 200). Courts must also consider "whether the claims can be afforded meaningful [judicial] review" under the statutory scheme. *Thunder Basin*, 510 U.S. 200.

Court Finds It "Fairly Discernible" That Congress Intended Appellate Review of Final SEC Resolutions to Be the Exclusive Means for Respondents in Pending SEC Enforcement Proceedings to Obtain Judicial Review

The D.C. Circuit found that it could "fairly discern Congress's intent to preclude suits by respondents in SEC administrative proceedings in the mine-run of cases." *Jarkesy*, 2015 WL 5692065. In light of the "'painstaking detail with which' Congress set forth the rules governing the court of appeals' review of [SEC] action," the D.C. Circuit concluded that "'Congress intended to deny [aggrieved respondents] an additional avenue of review in district court'" (quoting *Elgin v. Dep't of Treasury*, 132 S. Ct. 2126 (2012)). The D.C. Circuit reasoned that "Congress granted the choice of forum to the [SEC], and that authority could be for naught if respondents … could countermand the [SEC]'s choice by filing a court action."

Court Concludes That the Statutory Scheme Will Ultimately Allow for "Meaningful Review" of Respondents' Constitutional Claims

The D.C. Circuit determined that "'a finding of preclusion' would not 'foreclose all meaningful judicial review' of [respondents'] claims." The court found it immaterial that "the [SEC] lack[ed] the authority to rule on" respondents' constitutional claims. The D.C. Circuit explained that the Supreme Court's recent decision in *Elgin* "reiterated that, so long as a court can eventually pass upon the challenge, limits on an agency's own ability to make definitive pronouncements about a statute's constitutionality do not preclude requiring the challenge to go through the administrative route." "Because [respondents'] constitutional claims … [could] eventually reach 'an Article III court fully competent to adjudicate'" those claims, the D.C. Circuit concluded that it was "of no dispositive significance whether the [SEC] ha[d] the authority to rule on them in the first instance during the agency proceedings" (quoting *Elgin*, 132 S. Ct. 2126).

Court Rejects Respondents' Contention That the Constitutional Claims at Issue Were Not of the Type Congress Intended to Be Reviewed within the Statutory Scheme

Respondents contended that their constitutional challenges were "'wholly collateral' to the securities laws' scheme" and were "not of the type Congress intended to be reviewed within this statutory structure'" (quoting *Thunder Basin*, 510 U.S. 200). The D.C. Circuit found this argument "simply incorrect." The court determined that respondents' "constitutional … claims [did] not arise 'outside' the SEC administrative enforcement scheme—they [arose] from actions the [SEC] took in the course of that scheme." The court found "the fact that [respondents'] claims attack[ed] the process rather than the result [did] not mean [their] claims should receive preemptive resolution in a district court."

The D.C. Circuit reasoned that creating "an exception to an otherwise exclusive scheme for constitutional challenges in general, or facial attacks on a statute in particular, or some other as-yet-undefined category of constitutional claims, would encourage

respondents in administrative enforcement proceedings to frame their challenges to the [SEC's] actions in those terms and thereby earn access to another forum in which to advance their arguments." The court found it doubtful that "Congress intended that result."

The D.C. Circuit concluded that "the securities laws provide an exclusive avenue for judicial review that [respondents] may not bypass by filing suit in district court." The court affirmed dismissal of respondents' claims for lack of subject-matter jurisdiction.

Ninth Circuit: Adverse Interest Exception to Imputing an Executive's Scienter to the Corporation Does Not Apply If (1) the Executive Acted with Apparent Authority; and (2) an Innocent Third Party Relied on the Executive's Misrepresentations

On October 23, 2015, the Ninth Circuit held that fraudulent misrepresentations made by Ron Chan, the founder and CEO of ChinaCast Education Corporation, could be imputed to ChinaCast even though Chan had acted adversely to ChinaCast's interests by "embezzl[ing] millions" from the company. *In re ChinaCast Educ. Corp. Sec. Litig.*, 2015 WL 6405680 (9th Cir. 2015) (McKeown, J.) (*ChinaCast II*). The Ninth Circuit determined that the adverse interest exception to the general rule imputing an executive's scienter to the corporation did not apply because the complaint alleged that (1) "Chan [had] acted with apparent authority on behalf of the corporation" and (2) "third-party shareholders [had] understandably relied on Chan's representations, which were made with the imprimatur of the corporation that selected him to speak on its behalf and sign SEC filings."

Background

ChinaCast is "a for-profit postsecondary education and e-learning services provider" that at one point "boasted a market capitalization topping $200 million." In March 2011, ChinaCast disclosed that its outside accounting firm (an affiliate of Deloitte & Touche LLP) "had identified 'serious internal control weaknesses' with respect to [the company's] financial oversight." Plaintiffs alleged that "despite this 'clear warning from Deloitte' … the company and its board 'turned a blind eye' to the problem."

Between June 2011 and April 2012, "Chan [allegedly] 'transferred' $120 million of corporate assets to outside accounts that were controlled by him and his allies" and also engaged in a variety of other maneuvers that eventually "brought ChinaCast to financial ruin." During this time, Chan allegedly "emphasized the company's financial health and stability" in public statements to investors. In March 2012, after "ChinaCast's board discovered that Chan had attempted to interfere with an annual audit," the board removed Chan as chairman and CEO.

ChinaCast's shareholders subsequently brought the instant securities fraud action. In December 2012, the Central District of California dismissed plaintiffs' complaint with prejudice for failure to allege scienter. *In re ChinaCast Educ. Corp. Sec. Litig.*, 2012 WL 6136746 (C.D. Cal. Dec. 7, 2012) (Walter, J.). The court held that Chan's scienter could not be imputed to ChinaCast based on the adverse interest exception, pursuant to which courts "refus[e] to impute scienter from the fraud of a rogue agent." The court found that here, there was "no allegation that Chan or his accomplices [had] acted out of anything other than their own self-interest, or that their conduct [had] in any way benefitted ChinaCast." Plaintiffs appealed.

Ninth Circuit Reverses, Finding That Chan's Scienter May Be Imputed to ChinaCast Because the Company's Shareholders Relied on Misrepresentations Made by Chan within the Scope of His Apparent Authority

On appeal, the Ninth Circuit explained that it has "adopted the general rule of imputation" pursuant to which "a corporation is responsible for a corporate officer's fraud committed 'within the scope of his employment' or 'for a misleading statement made by an employee or other agent who has actual or apparent authority'" *ChinaCast II*, 2015 WL 6405680 (quoting *Hollinger*

v. Titan Capital Corp., 914 F.2d 1564 (9th Cir. 1990)). The Ninth Circuit noted that a number of courts in other circuits have "follow[ed] the same principles, even after the advent of" the Private Securities Litigation Reform Act ("PSLRA") "and its strict focus on scienter."

Here, defendants did "not dispute that Chan [had] acted within the scope of his apparent authority," but claimed that "the ordinary rule of imputation [was] inapposite because of the common law's so-called 'adverse interest exception.'" The Ninth Circuit acknowledged that Chan had "lined his own pockets at the expense of ChinaCast's interests," but determined that "the adverse interest rule doesn't apply in every instance where there is a faithless fraudster within the corporate ranks."

The Ninth Circuit found that "the adverse interest exception itself has an exception: the principal is charged with even the faithless agent's knowledge when an innocent third-party relies on representations made with apparent authority." Because plaintiffs alleged that ChinaCast's shareholders had "relied on Chan's representations," the Ninth Circuit held that "Chan's scienter [could] be imputed to ChinaCast" at the pleading stage "for those material misrepresentations or omissions made within the scope of [his] apparent authority."

The Ninth Circuit held that it was appropriate to impute Chan's scienter to ChinaCast given the "public policy goals of both securities and agency law—namely, fair risk allocation and ensuring close and careful oversight of high-ranking corporate officials to deter securities fraud." The court found that plaintiffs had "pled sufficient allegations to support imputation and survive the pleading requirements of the PSLRA." The court noted that even though the ChinaCast board had received an audit report indicating significant internal control weaknesses, the board had "failed to take significant action or heighten oversight." The court emphasized that "Chan was hardly a random corporate bureaucrat or mid-level manager." As the company's CEO, Chan was "the one person on whom the board undoubtedly should have kept close tabs."

Ninth Circuit Discusses Whether Defendants Can Obtain Dismissal of Securities Fraud Complaints at the Pleading Stage Based on the Adverse Interest Exception

The Ninth Circuit observed that "at the pleading stage, a key inquiry in § 10(b) and Rule 10b-5 cases is whether the complaint sufficiently alleges scienter attributable to the corporation." The court stated that in cases where defendants assert the adverse interest exception, "[a] threshold question is whether the pleadings support application of the adverse interest rule at all." The Ninth Circuit found that "as a practical matter, having a clean hands plaintiff eliminates the adverse interest exception in fraud on the market suits because a bona fide plaintiff will always be an innocent third party."

However, the Ninth Circuit noted that the adverse interest exception may provide a basis for dismissal on the merits at a later stage if defendants can either show that the plaintiff was not an innocent party or rebut the presumption of reliance.

Delaware Supreme Court: Business Judgment Rule Standard of Review Applies to Non-Controlling Stockholder Transactions Approved by a Majority of Fully Informed, Disinterested Stockholders

On October 2, 2015, the Delaware Supreme Court affirmed dismissal of an action brought by stockholders of KKR Financial Holdings LLC ("Financial Holdings") who sought post-closing damages in connection with Financial Holdings' acquisition by KKR & Co. L.P. ("KKR"). *Corwin v. KKR Financial Holdings LLC*, 2015 WL 5772262 (Del. 2015) (Strine, C.J.) (*KKR II*). The Delaware Supreme Court found that plaintiffs' allegations failed to support an inference that KKR was a controlling stockholder of Financial Holdings. The Court further held that "the voluntary judgment of the disinterested stockholders to approve the merger invoked the business judgment rule standard of review." The Delaware Supreme Court reasoned that "Delaware corporate law has long been

reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party other than a controlling stockholder is in their best interests."

Delaware Supreme Court Finds the Complaint Does Not Allege Facts Supporting an Inference That KKR Was a Controlling Stockholder of Financial Holdings

The Delaware Supreme Court found that the Chancery Court had properly rejected plaintiffs' contention that "KKR was a controlling stockholder of Financial Holdings" and that "the transaction was [therefore] presumptively subject to the entire fairness standard of review." The Chancery Court found it significant that "KKR owned less than 1% of Financial Holdings' stock, had no right to appoint any directors, and had no contractual right to veto any board action."

The court recognized that a KKR affiliate managed Financial Holdings pursuant to "a contractual management agreement that could only be terminated by Financial Holdings if it paid a termination fee." Applying Delaware precedent, the Chancery Court "looked for a combination of potent voting power and management control such that [KKR] could be deemed to have effective control of the [Financial Holdings] board without actually owning a majority of stock." The Chancery Court found "no well-pled facts from which it [was] reasonable to infer that KKR could prevent the [Financial Holdings] board from freely exercising its independent judgment in considering the proposed merger or … that KKR had the power to exact retribution by removing the [Financial Holdings] directors from their offices if they did not bend to KKR's will in consideration of the proposed merger." *In re KKR Fin. Holdings LLC Shareholder Litig.*, 101 A.3d 980 (Del. Ch. 2014) (Bouchard, C.) (*KKR I*). The Chancery Court expressly declined "to impose fiduciary obligations on [KKR]" even if "pre-existing contractual obligations with [KKR] that constrain[ed] the business or strategic options available to [Financial Holdings]." *KKR II*, 2015 WL 5772262.

The Delaware Supreme Court determined that the Chancery Court had "correctly applied the law" in holding that KKR was not a controlling stockholder of Financial Holdings and in finding that the transaction was therefore not subject to the entire fairness standard of review.

Delaware Supreme Court Holds the Business Judgment Rule Standard of Review Applied Because a Fully Informed Majority of Financial Holdings' Stockholders Voluntarily Approved the Merger

The Delaware Supreme Court found that the Chancery Court had properly applied the business judgment rule standard of review to the KKR-Financial Holdings transaction "because the merger was approved by a disinterested stockholder majority." The court explained that "when a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies."

The Delaware Supreme Court found that the Chancery Court had correctly held that *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) "did not alter the effect of legally required stockholder votes on the appropriate standard of review." In *Gantler*, the Delaware Supreme Court determined that the entire fairness standard of review applied to a reclassification of a corporation's shares that was approved by a majority of the corporation's disinterested stockholders where the proxy disclosures were allegedly materially misleading. The *KKR II* court agreed with the Chancery Court that "the effect a statutorily required vote [would have] had on the appropriate standard of review … was not even squarely before the Court in *Gantler* because [the *Gantler* Court had] found the relevant proxy statement to be materially misleading." The *KKR II* court also concurred with the Chancery Court's view that if *Gantler* had "intended to unsettle a long-standing body of case law" on the effect of a fully-informed vote of a majority of disinterested stockholders on the appropriate standard of review, the Delaware Supreme Court would "likely have said so." "To erase any doubt on the part of practitioners," the *KKR II* court clarified that *Gantler* did not address "the question of what standard of review applies if a transaction not subject to the entire fairness standard is approved by an informed, voluntary vote of disinterested stockholders."

The *KKR II* Court emphasized that the business judgment rule only applies in cases involving "fully informed, uncoerced stockholder votes." In the event that "troubling facts regarding director behavior were not disclosed that would have been material to a voting stockholder, then the business judgment rule is not invoked."

Finally, the *KKR II* Court explained that "the long-standing policy of [Delaware] law has been to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of a transaction for themselves." The Court stated that "the core rationale of the business judgment rule … is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decisionmakers with … an actual economic stake in the outcome." Provided "stockholders have had the voluntary choice to accept or reject a transaction," the Delaware Supreme Court stated that "the business judgment rule standard of review is the presumptively correct one and best facilitates wealth creation through the corporate form."

Delaware Supreme Court: Allegations of Both a Close Friendship and a Business Relationship with an Interested Party May Be Sufficient to Plead That a Director Could Not Act Independently of the Interested Party for Demand Futility Purposes

On October 2, 2015, the Delaware Supreme Court reversed dismissal of a shareholder derivative action brought against the directors of the Sanchez Energy Corporation alleging a "gross overpayment" in connection with a transaction involving Sanchez Resources, LLC. *Del. Cnty. Emps. Ret. Fund v. Sanchez*, 2015 WL 5766264 (Del. 2015) (Strine, C.J.). Two of the Sanchez Energy directors—including the chairman of Sanchez Energy—were interested in the transaction. The Delaware Supreme Court found that "plaintiffs had pled particularized facts raising a pleading-stage doubt about the independence of" Alan Jackson, one of the other Sanchez Energy directors, by alleging that (1) Jackson "had a close friendship of over half a century with" the chairman of Sanchez Energy; and (2) Jackson's "primary employment (and that of his brother) was as an executive of a company over which the [chairman of Sanchez Energy] had substantial influence."

Delaware Supreme Court Finds Jackson's Close Personal and Economic Ties to the Chairman of Sanchez Energy, Considered Together and in Context, Sufficient to Plead That Jackson Was Interested in the Transaction for Purposes of the Demand Futility Analysis

The Delaware Supreme Court explained that in order "[t]o plead demand excusal under Rule 23.1, a plaintiff in a derivative action must plead particularized facts creating a 'reasonable doubt' that either '(1) the directors are disinterested and independent or (2) the challenged transaction was otherwise the product of a valid exercise of business judgment'" (quoting *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984)). The Court underscored that "all reasonable inferences from the pled facts must … be drawn in favor of the plaintiff in determining whether the plaintiff has met its burden under *Aronson*."

In the case before it, the Delaware Supreme Court determined that the Chancery Court had erred in "consider[ing] the facts the plaintiffs pled about Jackson's personal friendship with [the chairman of Sanchez Energy] and the facts they pled regarding [Jackson's] business relationships [with the chairman] as entirely separate issues." The Chancery Court had "concluded that neither category of facts on its own was enough to compromise Jackson's independence for purposes of demand excusal." The Delaware Supreme Court found "[t]he problem with [the Chancery Court's] approach is that [Delaware] law requires that all the pled facts regarding a director's relationship to the interested party be considered in full context in making the, admittedly imprecise, pleading stage determination of independence."

Here, the Delaware Supreme Court found that plaintiffs had not pled "the kind of thin social circle friendship … which was at issue in" *Beam v. Stewart*, 845 A.2d 1040 (Del. 2004). The *Beam* court "held that allegations that directors 'moved in the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as 'friends,' … [were] insufficient, without more, to rebut the presumption of independence'" (quoting *Beam*, 845 A.2d 1040 (Del. 2004)). In *Sanchez*, the Delaware Supreme Court clarified that the *Beam* decision did not mean to "suggest that deeper human friendships could not exist that would have the effect of compromising a director's independence." The court found that "[w]hen, as here, a plaintiff has pled that a director has been close friends with an interested party for a half century, the plaintiff has pled facts quite different from those at issue in *Beam*." The court reasoned that "when a close relationship endures for that long, a pleading stage inference arises that it is important to the parties."

The *Sanchez* Court found it significant that plaintiffs "did not rely simply on" allegations of a close friendship between Jackson and the chairman of Sanchez Energy to plead Jackson's interestedness in the transaction. Plaintiffs also "pled facts regarding the economic relations [between Jackson and the chairman] that buttress[ed] their contention" that Jackson and the chairman were "confidants and that there is a reasonable doubt that Jackson [could have] act[ed] impartially in a matter of economic importance to [the chairman] personally." The Court determined that these allegations gave rise to "a pleading stage inference that Jackson's economic positions derive[d] in large measure from his 50-year close friendship with [the chairman], and that he [was] in these positions because [the chairman] trust[ed], care[d] for, and respect[ed] him."

The Delaware Supreme Court concluded that the plaintiffs had "pled particularized facts, that when considered in the plaintiff-friendly manner required, create[d] a reasonable doubt about Jackson's independence." The Court found that plaintiffs had adequately alleged demand excusal under Rule 23.1 and *Aronson*, and reversed dismissal of plaintiffs' complaint.

Delaware Chancery Court: Merger Price May Be the Best Indication of Fair Value for Section 262 Appraisal Purposes If the Sales Process Was Thorough and Unbiased

On October 21, 2015, the Delaware Chancery Court issued a post-trial decision in an appraisal action brought in connection with the private equity buyout of BMC Software. *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. 2015) (Glasscock, V.C.). The court held that it was "appropriate to look to the price generated by the market through a thorough and vigorous sales process as the best indication of fair value."

Background

At the outset of its analysis, the Chancery Court observed that the case "present[ed] what has become a common scenario." The court explained that the buyout involved "a robust marketing effort for a corporate entity result[ing] in an arm's length sale where the stockholders [were] cashed out, which sale [was] recommended by an independent board of directors and adopted by a substantial majority of the stockholders themselves." After the sale, "dissenters … [sought] statutory appraisal of their shares." During the trial that followed, "the dissenters/petitioners present[ed] expert testimony opining that the stock was wildly undervalued in the merger, while the company/respondent present[ed] an expert, just as distinguished and learned, to tell [the court] that the merger price substantially *exceed[ed]* fair value."

Chancery Court Conducts Its Own DCF Analysis and Determines the Fair Value to Be Slightly Higher Than the Merger Price

The Chancery Court noted that 8 *Del. C.* § 262 "vests the [c]ourt with significant discretion to consider the data and use the valuation methodologies it deems appropriate." The court began its analysis with the discounted cash flow ("DCF") valuation approach, which both parties agreed was "the appropriate method by which to determine the fair value of BMC." The court's DCF analysis produced a valuation of $48 per share—slightly higher

than the merger price of $46.25 per share. However, the court was "reluctant to defer" to its own DCF valuation because it was based on management projections that were, according to the company's expert, "historically problematic, in a way that could distort value." The court was also "concerned about the discount rate" given the "meaningful debate on the issue of using a supply side versus historical equity risk premium." (Following recent Delaware precedent, the court used a supply side equity risk premium ("ERP"), but recognized that "there is an argument in favor of using the historical ERP.") Finally, the court used "the midpoint between inflation and GDP as the [c]ompany's expected growth rate" in accordance with Chancellor Strine's decision in *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497 (Del. Ch. 2010), *aff'd*, 11 A.3d 214 (Del. 2010), but stated that it did not have "complete confidence in the reliability of this approach."

Chancery Court Finds the Merger Price to Be the Best Indication of Fair Value Because the Sales Process Was Thorough and Fair

The Chancery Court then considered the merger price. The court explained that in *Huff Fund Investment Partnershp v. CKx, Inc.*, 2015 WL 631586 (Del. Feb. 12, 2015), *aff'g*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013), the Delaware Supreme Court held that "the deal price is a relevant measure of fair value" provided "the sales process is thorough, effective, and free from any spectre of self-interest or disloyalty." Here, the court found that BMC had engaged in "a robust, arm's-length sales process during which the [c]ompany … conducted two auctions over roughly the course of a year, actively marketed itself for several months in each, as well as vigorously marketed itself in the 30-day Go Shop period." The court deemed meritless petitioners' claims that an activist investor had pressured BMC "into a rushed and ineffective sales process that ultimately undervalued the [c]ompany." While the court found that the investor "was clearly agitating for a sale," the court determined that this "agitation did not compromise the effectiveness of the sales process."

The court further found that no reduction to the merger price was warranted to account for merger-related synergies as opposed to value that could be "attributed to the corporation as an independent going concern." The court rejected petitioners' contention that the court should deduct "tax savings and other cost savings that the acquirer professed it would realize once BMC [was] a private entity." The court reasoned that "such … savings [are] logically a component of the intrinsic value owned by the stockholder that exists regardless of the merger." The court further found that even if the merger price reflected some merger-related synergies, petitioners had failed to meet their burden to demonstrate that there "were synergies realized from the deal" that "were … captured by sellers in the deal price."

Because "the sales process was sufficiently structured to develop fair value" for BMC, the court held that "the merger price [was] the most persuasive indication of fair value available."

New York Appellate Division: First Department Adopts *Garner* Test for Determining Whether the Fiduciary Exception to the Attorney-Client Privilege Applies

Pursuant to the fiduciary exception to the attorney-client privilege, shareholders who bring suit against corporate management for breach of fiduciary duty or similar claims may, under certain circumstances, obtain access to communications between management and corporate counsel. On October 8, 2015, the New York Appellate Division, First Department, adopted the multifactor test set forth in *Garner v. Wolfinbarger*, 430 F.2d 1093 (5th Cir. 1970) for determining whether the fiduciary exception applies with respect to any given attorney-client communication. *NAMA v. Greenberg Traurig LLP*, 2015 WL 5839311 (1st Dep't. 2015) (Acosta, J.).

Background

In the case before the court, NAMA Holdings, an investor in a real estate development entity, The Alliance Network, brought suit against the managers and other members of that entity asserting various direct and derivative claims, including breach of fiduciary duty claims. Defendants objected

to certain of NAMA's document requests in connection with the suit on grounds of attorney-client privilege. NAMA asserted that "the 'fiduciary exception' to the attorney-client privilege compelled production, because the [m]anagers owed a fiduciary duty to NAMA and accordingly sought legal advice on its behalf."

The trial court found that the key inquiry for purposes of the fiduciary exception was "whether NAMA and Alliance [had] ever developed an adversarial relationship." Following a hearing on the issue, a special referee "concluded that no such relationship existed" and therefore found that all of the disputed documents must be produced. The trial court adopted the special referee's report and ordered defendants to produce all documents as to which defendants had asserted the attorney-client privilege. Defendants appealed.

Rejecting the Trial Court's Adversity-Based Analysis, First Department Holds the *Garner* Factors Govern the Application of the Fiduciary Exception

On appeal, the First Department stated that "the fiduciary exception has been widely accepted throughout most of the United States in trustee-beneficiary and corporation-shareholder cases." The court noted that "[s]everal New York courts have also recognized the fiduciary exception." The First Department explicitly adopted the *Garner* test for assessing whether the fiduciary exception applies.

In *Garner*, the Fifth Circuit "set forth a non-exhaustive list of factors that should be considered to determine whether a party has shown good cause for applying the exception in a given case." "These factors include (1) 'the number of shareholders and the percentage of stock they represent,' (2) 'the bona fides of the shareholders,' (3) 'the nature of the shareholders' claim and whether it is obviously colorable,' (4) the apparent necessity or desirability of the shareholders having the information and the availability of it from other sources,' (5) 'whether, if the shareholders' claim is of wrongful action by the corporation, it is of action criminal, or illegal but not criminal, or of doubtful legality,' (6) 'whether the communication related to past or to prospective actions,' (7) 'whether the communication is of advice concerning the litigation itself,' (8) 'the extent to which the communication is identified versus the extent to which the shareholders are blindly fishing,' and (9) 'the risk of revelation of trade secrets or other information in whose confidentiality the corporation has an interest for independent reasons'" (quoting *Garner*, 430 F.2d 1093). The First Department found that the *Garner* test "strikes the appropriate balance between respect for the privilege and the need for disclosure." The First Department further found that the *Garner* test's "requirement of a good-cause showing appropriately accounts for the sensitive nature of discovery disputes over attorney-client privilege, particularly in the corporate context."

The First Department explained that although "some factors in the *Garner* test are relevant to a determination of adversity, *Garner* did not create a categorical adversity limitation." The Court concluded that "adversity is not a threshold inquiry" for purposes of the fiduciary exception but rather, "a component of the broader good-cause inquiry." The First Department found that under *Garner*, whether the fiduciary exception applies to attorney-client communications made during the existence of an adversarial relationship depends on the nature of those communications. Communications "that (1) concerned how to deal with the plaintiff, (2) were specifically relevant to the handling of the very issues the plaintiff had been threatening to litigate, or (3) were of advice concerning the litigation itself will likely remain privileged—unless other factors are strong enough to establish good cause." However, "[o]ther communications that are germane to the allegations in the complaint, even those that occurred after adversity arose, would still be discoverable pursuant to the fiduciary exception (provided good causes exists)." The First Department reasoned that "[t]his communication-specific adversity inquiry operates as a fail-safe, maintaining balance in the operation of the fiduciary exception."

First Department Remands Case for a Comprehensive Good Cause Analysis and an In-Camera Review of Each Contested Document

The First Department remanded the case for the trial court "to conduct a comprehensive good-cause analysis" under *Garner*. The First Department explained that the trial court, "given its discretion under CPLR article 31, may not need to evaluate each factor listed in *Garner*." However, the First Department emphasized that if "a court finds that a shareholder has demonstrated good cause to apply the fiduciary exception and pierce the corporate attorney-client privilege, it must at least address those factors that support such a finding."

Notably, the First Department stated that "a court's ability to conduct an in camera review of the communications" can be "crucial" to the analysis. Here, the special referee had not "review[ed] a single document in camera, despite being instructed by the motion court to conduct an item-by-item review." The First Department found that "[a]bsent a review of the communications (or at least a sampling thereof), it would be impossible to determine whether they involved advice concerning the instant litigation or 'how to deal with' NAMA." The First Department concluded that it could not "affirm an order directing the production of more than 3,000 purportedly privileged communications without a single one of those communications having been reviewed."

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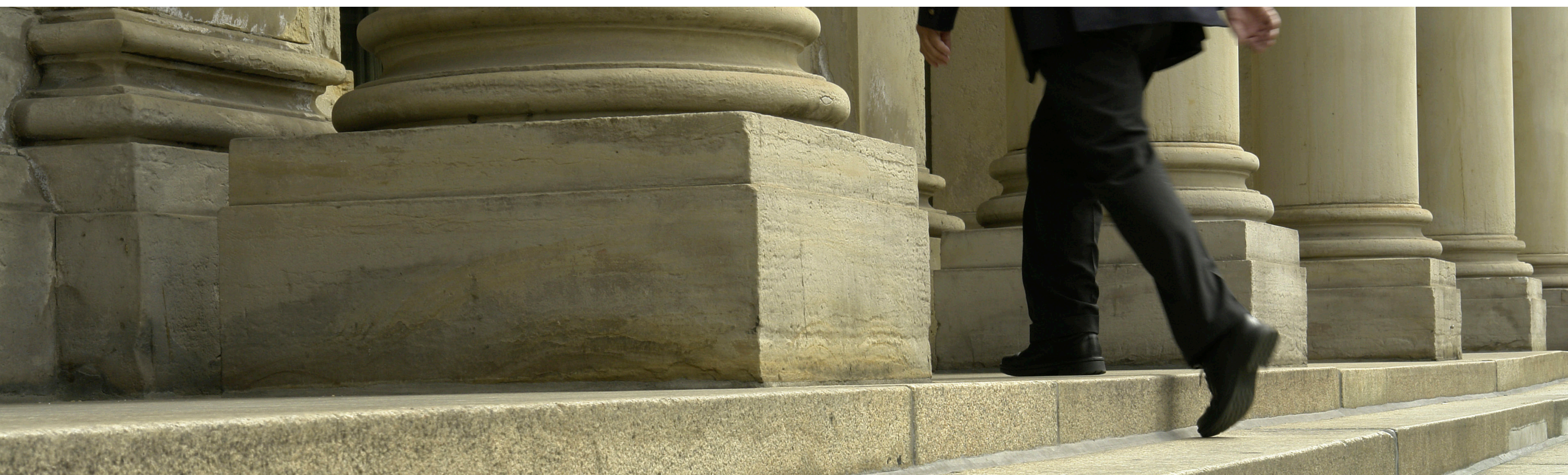

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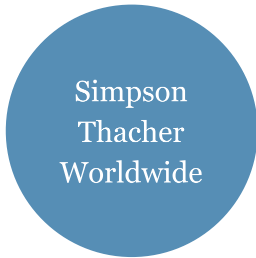

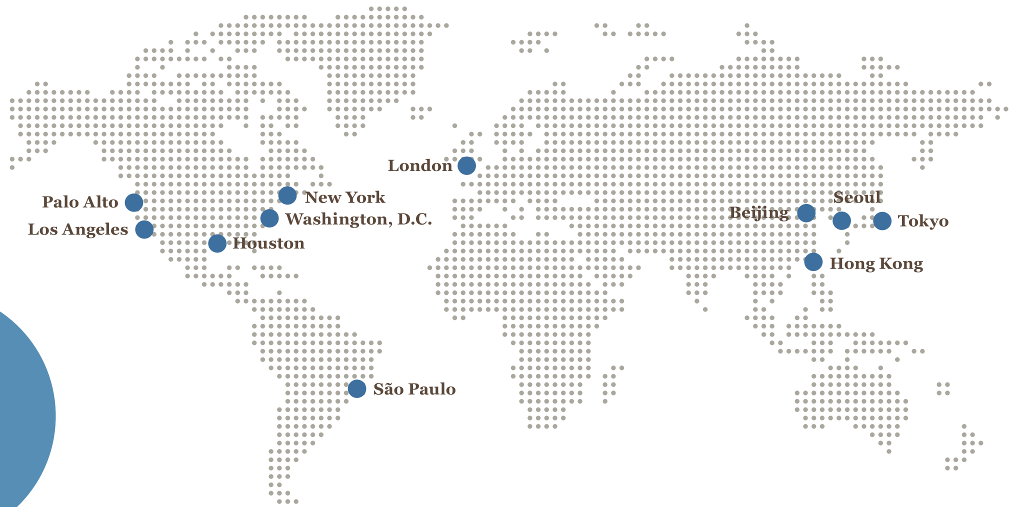

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