Securities and Shareholder Litigation

2014 YEAR-END REVIEW

BASS BERRY + SIMS PLC

2014: THE YEAR OF THE BYLAWS

2014 was notable for two decisions addressing the validity of bylaws affecting a stockholder's ability to bring intra-corporate disputes involving Delaware corporations. The Delaware Court of Chancery upheld the validity of bylaws mandating a forum other than Delaware for litigating such disputes, and the Delaware Supreme Court upheld a "fee-shifting" bylaw permitting non-stock corporations to recover their attorneys' fees and expenses from unsuccessful members. Both decisions have prompted much discussion and reaction from corporations, stockholders and proxy advisors.

Forum Selection Bylaws

In September, the Delaware Court of Chancery ruled that the board of directors of a Delaware corporation may unilaterally amend a company's bylaws to specify a forum other than Delaware for litigating intra-corporate disputes, such as stockholder claims alleging that officers or directors breached their fiduciary duties. In ***City of Providence v. First Citizens Bancshares, Inc.,*** Cons. C.A. No. 9795-CB (Del. Ch. Sept. 8, 2014), the board of directors of First Citizens Bancshares, Inc., a Delaware corporation operating primarily in North Carolina, adopted and approved Amended and Restated Bylaws that included a forum selection bylaw naming the United States District Court for the Eastern District of North Carolina, or, if that court lacks jurisdiction, any state court in North Carolina, as the exclusive forum for litigating intra-corporate disputes.

In response to a stockholder challenge to the legitimacy of the bylaw, the Court of Chancery concluded that, while Delaware might be the most obvious forum in which to litigate the intra-corporate disputes of a Delaware corporation, choosing the "second most obviously reasonable forum" - i.e., where the corporation operates and is headquartered - "does not ... call into question the facial validity of the Forum Selection Bylaw." Plaintiff, therefore, had failed to make a showing that "the Board's selection of North Carolina as the exclusive forum was irrational." (Slip Op. at pp. 10, 14). The court noted that there was no reason why a non-Delaware court could not address and rule on issues of Delaware law, and that the plaintiff had failed to rebut the business judgment rule with respect to the board's adoption of the challenged bylaw.

The ***First Citizens*** opinion followed 2013's decision in ***Boilermakers Local 154 Retirement Fund v. Chevron Corp.,*** 73 A.3d 934 (Del. Ch. 2013), in which then-Chancellor Strine upheld a board's general authority to adopt forum selection bylaws mandating a Delaware forum without a shareholder vote if the corporation's certificate of incorporation so permits. These decisions, when taken together, essentially entrust the issue of the forum/venue for litigating stockholder disputes to the business judgment of the board of directors.

Fee-Shifting Bylaws

More controversial was the decision in ***ATP Tour, Inc. v. Deutscher Tennis Bund,*** 91 A.3d 554 (Del. 2014), in which the Delaware Supreme Court held that a "fee-shifting provision in a non-stock corporation's bylaws can be valid and enforceable under Delaware law." So-called "fee-shifting" bylaws permit a company to recover its attorneys' fees and costs from unsuccessful plaintiffs in intra-corporate lawsuits. The court upheld a bylaw adopted by the German Tennis Federation, a non-stock corporation, which provided for recovery

of its attorneys' fees and expenses from a plaintiff who "does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought." *Id.* at 557. The court did note that the enforceability of a fee-shifting bylaw depends on the manner in which it was adopted and the circumstances under which it was invoked. The court was "able to say only that a bylaw of the type at issue here is facially valid, in the sense that it is permissible under [Delaware's statutes], and that it may be enforceable if adopted by the appropriate corporate procedures and for a proper corporate purpose." *Id.* at 559.

Much of the controversy surrounding this decision stems from assertions by proponents of fee-shifting bylaws that ***ATP's*** rationale is equally applicable to stock corporations as it is to non-stock corporations. Non-stock corporations are substantially different from stock corporations, in that they are primarily used by nonprofit entities and are similar to member-owned limited liability companies. Immediately following the decision in ***ATP,*** businesses and their counsel began to speculate as to whether it was legally permissible to adopt fee-shifting bylaws for stock corporations. As quickly as those talks began, the Council of the Corporation Law Section of the Delaware State Bar Association drafted proposed legislation to confine ***ATP*** to its facts and restrict fee-shifting bylaws to non-stock corporations.

Approximately a month after the proposed legislation was presented, it was withdrawn to allow a further study of the possible benefits and harm of using fee-shifting bylaws in stock corporations. In the meantime, noted Delaware jurists such as former Delaware Supreme Court Justice Jack Jacobs have weighed in on the intended scope of the ***ATP*** holding. Justice Jacobs, speaking at PLI's Securities Regulation Institute in November 2014, expressed surprise that so many commentators assumed that the rationale of the ***ATP*** decision would apply to stock corporations. Justice Jacobs, who sat on the court at the time ***ATP*** was decided, compared a non-stock entity to a private club or closely held corporation and observed that the types of bylaws appropriate for such entities would not necessarily translate into the public company context. Vice Chancellor Laster also spoke on the subject at Brooklyn Law School's Center for the Study of Business Law & Regulation. He made several interesting points, including that the adoption of fee-shifting bylaws by stock corporations may violate the Delaware General Corporation Law. The Vice Chancellor noted that litigation expenses incurred by a company—including attorneys' fees—are debts of the company, and 8 *Del. C. §* 102(b)(6) prohibits the imposition of company debts on stockholders unless there is a specific charter provision authorizing it. Furthermore, 8 *Del. C. §* 325(b) prohibits suing stockholders for corporate debts until a judgment is obtained against the corporation and remains unsatisfied.

Whether or not directors of Delaware stock corporations should adopt fee-shifting bylaws before the Delaware General Assembly or the Delaware courts further clarify the issue is a thorny question. Boards should weigh their specific company needs (e.g., specific threats posed to the corporation by frivolous shareholder litigation) against the many risks adopting such a bylaw would entail, namely: the risk that proxy advisory services such as Institutional Shareholder Services ("ISS") and Glass Lewis would recommend against retention of directors who vote to unilaterally take action to "impair stockholder rights" (see below); the risk that the company will be forced to revise bylaws yet again in the event of any statutory amendments or adverse rulings from Delaware's judiciary; the degree of likely investor opposition and ensuing dissatisfaction among the company's stockholder base, and litigation risk resulting from a potential challenge to the bylaw. Some companies have reacted to ***ATP*** by incorporating fee-shifting provisions into their original bylaws and charters. Specifically, Alibaba Group Holding Ltd. incorporated a fee-shifting provision into its articles of incorporation prior to its initial public offering. Proxy advisors and other "shareholder advocates" have taken notice and are urging the SEC to require disclosures alerting prospective investors to the existence of these provisions and their impact on an investor's ability to challenge certain corporate actions via litigation.

More Bylaw Developments to Watch

Recently, the Board of Directors of Imperial Holdings, Inc., a Florida corporation, adopted a minimum-stake-to-sue bylaw, which requires that shareholders garner support of at least three percent of the outstanding shares before initiating a suit. Investors of Imperial Holdings must deliver written consents proving they hold or have the support of three percent of shareholders (approximately 630,000 shares), before they can maintain a suit. The board justified the new bylaw on the grounds that there is "a disturbing trend of

lawsuits brought by shareholders with very small stakes … purportedly on behalf of a class of shareholders or on behalf of the company" and those suits are resulting in "no meaningful benefit and indirectly incurring the cost of the plaintiff's lawyer and the company's lawyer." Imperial Holdings' press release stated, "[t]he board believes it is in the best interest of the company to require a shareholder claiming to represent a class of shareholders or the company to demonstrate a minimum level of shareholder support." Delaware courts have not weighed in on the validity of minimum-stake bylaws.

Reaction of Proxy Advisors to Forum Selection and Fee-Shifting Bylaws

On November 6, 2014, ISS issued its updated 2015 Proxy Voting Guidelines, which will be effective for shareholder meetings that take place on or after February 1, 2015. ISS specifically addressed the topic of bylaws or charter provisions that impact shareholders' "litigation rights," including "exclusive venue" and "fee-shifting" provisions. Unsurprisingly, ISS now recommends that shareholders "[g]enerally vote against bylaws that mandate fee-shifting whenever plaintiffs are not completely successful on the merits (i.e., in cases where the plaintiffs are partially successful)." With respect to other bylaws that "impact shareholders' litigation rights" (including exclusive venue provisions), ISS recommended that shareholders vote on a "case-by-case" basis, after considering several factors, including:

> "The company's stated rationale for adopting such a provision; Disclosure of past harm from shareholder lawsuits in which plaintiffs were unsuccessful or shareholder lawsuits outside the jurisdiction of incorporation; The breadth of application of the bylaw, including the types of lawsuits to which it would apply and the definition of key terms; and Governance features such as shareholders' ability to repeal the provision at a later date (including the vote standard applied when shareholders attempt to amend the bylaws) and their ability to hold directors accountable through annual director elections and a majority vote standard in uncontested elections."

ISS also addressed the issue of amendments to bylaws where shareholder approval has not been obtained, observing that "[t]here has recently been a substantial increase in the number of bylaw/charter amendments made by boards that adversely impact shareholder rights without seeking shareholder ratification of the amendments." According to ISS, "a portion of the increase in unilateral amendments is a recent trend of companies adopting a suite of shareholder-unfriendly governance provisions shortly before, or on the date of, their initial public offerings ("IPOs")."

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With respect to "Unilateral Bylaw/Charter Amendments," ISS recommends that shareholders "[g]enerally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering the following factors, as applicable:

> The board's rationale for adopting the bylaw/charter amendment without shareholder ratification; Disclosure by the company of any significant engagement with shareholders regarding the amendment; The level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter; The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions; The company's ownership structure; The company's existing governance provisions;

Whether the amendment was made prior to or in connection with the company's initial public offering; The timing of the board's amendment to the bylaws/charter in connection with a significant business development; Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

In other words, directors who approve bylaws that arguably diminish stockholders' litigation rights without seeking and obtaining stockholder approval should expect opposition, unless they can present a compelling justification for their course of action.

Glass Lewis expressed a consistent view "that charter or bylaw provisions limiting a shareholder's choice of legal venue are not in the best interests of shareholders. Such clauses may effectively discourage the use of shareholder claims by increasing their associated costs and making them more difficult to pursue. As such, shareholders should be wary about approving any limitation on their legal recourse including limiting themselves to a single jurisdiction (e.g., Delaware) without compelling evidence that it will benefit shareholders." Glass Lewis also urged shareholders to vote against fee-shifting and loser pays bylaws, saying that it "strongly opposes the adoption of such fee-shifting bylaws, and, if adopted without shareholder approval, will recommend voting against the governance committee."

Conclusions

While Delaware courts have indicated that they will afford some deference to boards when considering the propriety of bylaws affecting stockholders' litigation rights, boards should still tread carefully in order to avoid raising the ire of proxy advisors (and thus provoking an otherwise avoidable proxy contest or lawsuit). The law governing the propriety of forum selection bylaws appears relatively settled in favor of the validity of these provisions, yet directors considering such a bylaw should still carefully weigh the pros and cons of adopting such a bylaw, especially when selecting a non-Delaware forum. Factors to be considered include, but are not limited to: (i) an analysis of local procedural and substantive rights that may be implicated by litigating in the chosen jurisdiction; (ii) the quality of the local judiciary (who likely will be asked to apply Delaware law); (iii) the likelihood that the frequency of litigation will increase or decrease; and (iv) any cost savings that may result from mandating what might be a more convenient forum for the corporation and its officers and directors. As with any decision, directors also should be aware that they are subject to fiduciary duties as defined under Delaware law and, thus, should consider whether adopting such a bylaw is in the best interests of the corporation and its stockholders only after fully informing themselves on the implications of selecting a given forum.

With respect to fee-shifting bylaws, unless a company has a documented history of facing frivolous shareholder litigation and the board in good faith deems such a provision necessary to protect the company's interests, boards would be well advised to await further guidance from the Delaware legislature and/or the Delaware Supreme Court prior to adopting such a provision.

THE ATTORNEY-CLIENT PRIVILEGE IN CHANGE OF CONTROL TRANSACTIONS

During the past several years, a fairly significant body of case law has developed governing the treatment of the attorney-client privilege in the mergers and acquisitions context. Two common situations in which privilege questions have arisen and created unexpected problems post-closing are addressed below.

The first situation concerns potential transactions and when, if ever, communications between parties to a proposed merger and their counsel are privileged, and relatedly, when, if ever, parties to the transaction can share privileged documents without waiving the privilege. For example, a buyer always insists on discussing the target company's legal exposure arising from pending and potential litigation and/or regulatory enforcement actions. Due diligence materials requested by buyers can include, but are not limited to, potentially sensitive legal analysis prepared by the target company's attorneys. The risk of sharing such information and discussing such legal advice is obvious: traditionally, disclosure of otherwise privileged communications or documents to a third party waives any claim of attorney-client privilege. Opposing parties in later litigation might seek production of disclosed information on the grounds that the attorney-client privilege has been waived. Courts have found, however, that in certain circumstances, parties to a transaction share a "common interest," and have recognized an exception to the general waiver rule that protects otherwise privileged communications shared between prospective parties to a merger and their attorneys.

The second situation relates to who controls the attorney-client privilege over pre-closing communications between the acquired company and its attorneys *after* a merger or other similar transaction has closed. Sellers increasingly insist on including contractual provisions in which the seller "reserves" control over the privilege post-closing, at least for communications concerning the transaction itself. While such provisions are commonplace, they may still present problems for the buyer if the communications in question are relevant to any post-closing litigation.

The following article surveys the current state of the law with respect to both issues and offers some brief observations on how parties can take steps to assert or preserve the attorney-client privilege using the "common interest" doctrine. We also examine the implications of contractual provisions providing that the seller retains control over the privilege post-closing, and considerations buyers should take into account when deciding whether or not to agree to them.

Sharing Privileged Communications between Prospective Parties to a Merger

Whether or not the sharing of otherwise privileged communications between prospective parties to a merger results in waiver of the attorney-client privilege or work product doctrine is an inquiry specific to the jurisdiction in which the issue is being litigated. While the law in most jurisdictions provides that production of a privileged document to a third party waives any privilege attached to the document, some courts have found the privilege preserved under the "common interest" doctrine when the document is provided to promote a shared legal interest between the parties. Most courts agree that parties to a merger or sale of assets must share a legal, rather than a purely commercial, "common interest" at the time the information is shared in order for no waiver of the privilege to take place. However, there has been some disagreement among courts as to what constitutes a "shared legal interest," and the extent to which it must be shared by the parties in order for the common interest doctrine to apply.

Delaware Approach

Delaware courts take a broad approach. In ***3Com Corp. v. Diamond II Holdings, Inc.,*** 2010 Del. Ch. LEXIS 126, at *32-33 (Del. Ch. May 31, 2010), the court noted that Delaware Rule of Evidence 502(b) expressly "extends the attorney-client privilege to certain communications made by the client, his representative, or lawyer, to a lawyer 'representing another in a matter of common interest,'" defined "in the transactional context, as an interest so parallel and non-adverse that, at least with respect to the transaction involved, [the two parties] may be regarded as acting as joint venturers." The ***3Com*** court therefore recognized that communications between parties to a merger and

their counsel could be considered privileged under the "common interest" doctrine, but the analysis would depend on whether the parties were adverse to one another "at the time each challenged communication was made." *Id.* at *33. The court indicated that the parties might not be able to claim privilege over certain communications between them during negotiations of a side letter and the termination provisions of the merger agreement. At the same time, the court rejected the position (which had been taken by New York courts and is discussed further below), that litigation implicating both parties must be "pending or reasonably anticipated" in order for the common interest doctrine to apply.

New York Approach

Until recently, New York courts took a strict approach when evaluating whether parties to a merger share a common legal interest. In the most recent New York case to have addressed the issue, ***Ambac Assurance v. Countrywide Home Loans, Inc.,*** the trial court found that in order for parties to a prospective merger to share any sort of "common interest" that would preserve the attorney-client privilege, litigation against the parties must be pending or reasonably anticipated. 41 Misc. 3d 1213(A), 1213(A) (N.Y. Sup. Ct. 2013). In ***Ambac,*** a third party sought discovery of Countrywide documents relating to the merger between Countrywide and Bank of America. The parties to the merger argued that certain communications between the parties and their attorneys were privileged because they shared the common legal interest of furthering a "legal enterprise"—a signed but not completed merger agreement, pursuant to which both parties eventually could be exposed to litigation. The trial court found that, despite the fact that the merger agreement had been signed, the parties' shared interest was not sufficiently "legal" in nature because no litigation was pending or reasonably anticipated at the time.

On appeal, the Appellate Division reversed, finding that "in today's business environment, pending or reasonably anticipated litigation is not a necessary element of the common-interest privilege." In the view of the appeals court, Countrywide and Bank of America "have a common legal interest because they were engaged in merger talks during the relevant period and now have a completed and signed merger agreement. Indeed, the circumstances presented in this case illustrate precisely the reason that the common-interest privilege should apply—namely, that business entities often have important legal interests to protect even without the looming specter of litigation." ***Ambac Assurance Co. v. Countrywide Home Loans, Inc.,*** 2014 N.Y. Slip Op. 08510 (App. Div. 1st Dep't. Dec. 4, 2014). At the same time, the court recognized that another line of New York appellate authority "requires pending or reasonably anticipated litigation for the common interest privilege to apply," though the court declined to apply that line of cases in the context of a merger. *Id.* Given this split of authority, and because the Appellate Division is an intermediate level appellate court, the New York Court of Appeals (the state's highest court) may need to address this issue in the future. While the ***Ambac*** opinion might give parties governed by New York law some comfort that certain pre-merger discussions will be protected, they should keep in mind that some ambiguity remains over whether the common interest doctrine applies in the absence of pending litigation.

Other Jurisdictions and Considerations

There is a large body of federal case law from various jurisdictions in which courts have applied the common interest doctrine to communications exchanged between parties to a pending merger transaction. Most federal courts apply the common interest doctrine somewhat broadly, consistent with the settled Delaware position that there does not need to be pending litigation involving both parties in order for a "common interest" to exist. See, e.g., ***FSP Stallion 1, LLC v. Luce,*** 2010 U.S. Dist. LEXIS 110617, at *57-58 (D. Nev. Sept. 30, 2010) (common interest doctrine applies when parties are engaged in a common legal enterprise, even if actual litigation is not in progress); ***Nidec Corp. v. Victor Co.,*** 249 F.R.D. 575, 578 (N.D. Cal. 2007) ("The protection of the privilege under the community of interest rationale, however, is not limited to joint litigation preparation efforts. It is applicable whenever parties with common interests join forces for the purpose of obtaining more effective legal assistance.")

Determinations of whether a "common interest" is adequately "legal" or adequately "shared" by the parties, however, are often highly contextual. When, for example, the parties are still in early stages of negotiations, their interests are less aligned than they would be after a merger agreement has been signed

and closing of the transaction is more certain. Courts have made clear that the timing of the disclosure of the privileged information and the certainty of the transaction will impact a determination of whether the common interest doctrine preserves privilege or not. See ***In re JP Morgan Chase & Co. Secs. Litig.,*** 2007 U.S. Dist. LEXIS 60095, at *15 (N.D. Ill. Aug. 13, 2007) ("The Court agrees that after the parties to the merger signed the merger agreement, they shared a common interest in ensuring that the newly agreed merger met any regulatory conditions and achieved shareholder approval. . . . With this in mind, the court sees significant benefit in allowing the [parties'] attorneys to communicate freely and openly and to exchange confidential documents.") The lack of a signed merger agreement, or the existence of multiple suitors will likely weigh heavily against a finding that disclosure of privileged information did not result in a waiver. See ***Nidec,*** 249 F.R.D. at 579. In some cases, courts have required a signed merger agreement before finding the parties' interests sufficiently common for the doctrine to apply. See ***In re JP Morgan Chase & Co. Secs. Litig.,*** 2007 U.S. Dist. LEXIS 60095, at *15; see generally ***Katz v. AT&T Corp.,*** 191 F.R.D. 433 (E.D. Pa. 2000). Finally, courts have held that a party could not claim privilege over documents sent to the other party's investment banker, since any shared interest impacting the banker would be a purely financial interest, not a legal one. See, e.g., ***Blanchard v. Edgemark Fin. Corp.,*** 192 F.R.D. 233, 237 (N.D. Ill. 2000).

Who Holds the Privilege Post-Closing?

Separate from the issue of whether communications and documents exchanged during the course of negotiations will be considered privileged, parties to a potential merger also must consider how the acquired company's privileged information will be handled post-acquisition. In ***Commodity Futures Trading Comm'n v. Weintraub,*** 471 U.S. 343, 349 (1985), the Supreme Court recognized the general rule that "when control of a corporation passes to new management, the authority to assert and waive the corporation's attorney-client privilege passes as well." In the years following the ***Commodity Futures*** decision, however, courts have gradually stepped back from such a categorical position.

Some courts have found that while a seller does transfer its privilege to the buyer on most subjects, it retains control of pre-merger privileged communications that relate to the merger and its negotiations. In ***Tekni-Plex, Inc. v. Meyner & Landis,*** 89 N.Y.2d 123, 127 (N.Y. 1996), the New York Court of Appeals evaluated communications in two categories: (i) privileged communications regarding the company's general operations; and (ii) privileged communications relating to the merger negotiations. The court reasoned that because communications in the latter category were made at the time the seller was adverse to the buyer, the privilege over the communications remained with the seller after the close of the transaction. The court held that to find otherwise would "thwart, rather than promote, the purposes underlying the privilege." *Id.* at 138.

Courts also have been hesitant to acknowledge a full transfer of control over privileged communications when a sale is not a complete merger, but a sale for all or substantially all of the company's assets. See ***Postorivo v. AG Paintball Holdings, Inc.,*** 2008 Del. Ch. LEXIS 17, at *29 (Del. Ch. Feb. 7, 2008) (finding control over privilege of pre-merger communications remained with seller when sale was not for all assets and parties specifically agreed by contract that privilege would remain with the seller).

Arguably the most significant recent development addressing treatment of attorney-client privilege post-acquisition is the Delaware Chancery Court's decision in ***Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP,*** 80 A.3d 155 (Del. Ch. Nov. 15, 2013). In ***Great Hill,*** the acquiring corporation brought suit against members of the target corporation for fraudulent inducement after the merger had closed, claiming that it had uncovered pre-merger communications between the target corporation and its attorney evidencing fraud. The seller objected to use of these communications, claiming that they were privileged.

In evaluating the situation, the court explained that while the bright line rule set out in ***Commodity Futures*** and codified in § 259 of the Delaware General Corporation Law ("DGCL") continues to apply, parties may contract around a transfer of the privilege in the merger documents. In ***Great Hill,*** the privilege passed to the surviving corporation, and was not retained by the seller, because the parties did not carve it out of the deal, and the court found it particularly instructive that the seller did nothing to preserve the privilege, leaving the documents in question in the possession of the acquiring company for a year before taking any action to recover them.

Takeaways

The first major takeaway from this discussion should be that the parties to any transaction should pay close attention to the law that might govern any dispute over privilege. As noted above, different jurisdictions have treated these issues in different ways, and whether certain communications are considered privileged or whether the privilege would be deemed waived by certain disclosures might depend on what law applies.

Second, out of an abundance of caution, parties probably should assume that any communications made prior to the signing of a merger agreement, any communications made directly to the other party (without attorneys copied), or communications shared with the other party's investment banker will not be covered by the attorney-client privilege as extended by the common interest doctrine. Parties also should delay as long as practicable the exchange of any sensitive legal materials, preferably until after the merger agreement has been signed and there is a reasonable certainty of the transaction closing. Even then, parties should limit the number of persons receiving access to such information, and take appropriate action to ensure that it is labeled and treated as confidential. Proceeding with these considerations in mind will reduce the risk of any inadvertent waiver.

Finally, the parties should make sure that both parties have a clear understanding of who will hold the privilege for certain documents post-closing, and clearly define the scope of any retention of control by the seller and its controlling shareholders. In the event the seller demands a contractual retention of control as envisioned in ***Great Hill,*** buyers would be well-advised to limit the scope of any such provision to documents relating to the negotiation of the transaction itself, and to negotiate access to any such documents if they become relevant to post-closing litigation with third parties (such as a shareholder dispute or a dispute between parties other than the buyer and the seller). The buyer also should consider negotiating restrictions on the seller's ability to disclose privileged communications to any third party.

2014 M&A CASE LAW REVIEW

As the leading forum for business law in the United States, Delaware courts issued several important decisions in 2014 that impact mergers and acquisitions. While not exhaustive, the following highlights some of 2014's most significant developments.

Controlling Stockholder Transactions

The Delaware Supreme Court issued what is being described as a landmark ruling in ***Kahn v. M&F Worldwide Corp.,*** 88 A.3d 635 (Del. 2014), which involved a challenge to a controlling stockholder's going private transaction, where a parent corporation offered to purchase all unaffiliated shares at a premium. The court held that the more deferential business judgment standard of review applied to controlling stockholder buyouts under Delaware law if and only if: (i) the controlling stockholder conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority. If any of these procedural protections are absent, the court will apply the much stricter "entire fairness" standard of review. See ***In re Nine Sys. Corp. S'holders Litig.,*** C.A. No. 3940-VCN, 2014 Del. Ch. LEXIS 171 (Del. Ch. Sept. 4, 2014) (using the "entire fairness standard of review where a corporation with a controlling stockholder implements a recapitalization that benefits the controlling stockholder to the detriment of other stockholders."); ***In re Cornerstone Therapeutics Inc. Stockholder Litig.,*** C.A. No. 8922-VCG, 2014 Del. Ch. LEXIS 170 (Del. Ch. Sept. 10, 2014) (finding that plaintiff sufficiently pled that a stockholder controlled the corporate machinery and disinterested directors to invoke entire fairness review and survive a motion to dismiss).

Controlling stockholders quickly invoked ***M&F Worldwide*** to take advantage of business judgment review. Just six months after ***M&F Worldwide,*** Vice Chancellor Laster issued a transcript ruling in ***Swomley v. Schlecht,*** C.A. No. 9355-VCL (Sept. 10, 2014) granting a group of controlling stockholders' motion

to dismiss and rejecting plaintiffs' claims challenging a transaction in which non-management minority stockholders of a private company were cashed out. Vice Chancellor Laster applied the business judgment rule, which resulted in dismissal before discovery. He had no trouble applying ***M&F Worldwide*** at the pleading stage, stating that "the whole point of encouraging this structure was to create a situation where defendants could effectively structure a transaction so that they could obtain a pleading stage dismissal." (Trans. Op. at 5). The ***Swomley*** plaintiffs had not pled facts sufficient to show that the defendants' hadn't structured their deal in compliance with ***M&F Worldwide's*** six requirements.

Delaware courts also issued several opinions this year clarifying when a stockholder can be considered "controlling," focusing largely on the extent to which the stockholder exercised actual control over the company's board of directors. See ***In re KKR Fin. Holdings LLC S'holder Litig.,*** 101 A.3d 980, 983 (Del. Ch. 2014) (holding that a stockholder who held less than one percent of the company's stock but nevertheless managed the company's day-to-day operations was not a "controlling" stockholder because the allegations did "not support a reasonable inference that [the stockholder] controlled the board of KFN when it approved the merger"); ***In re Crimson Exploration Inc. Stockholder Litig.,*** C.A. No. 8541-VCP, 2014 Del. Ch. LEXIS 213 (Del. Ch. Oct. 24, 2014) (holding that a stockholder's 33.7 percent interest in the company did not constitute a controlling stockholder because the allegations did not show that the non-majority stockholder "actually controlled the board's decision about the transaction at issue"); I***n re Sanchez Energy,*** C.A. No. 9132-VCG, 2014 Del. Ch. LEXIS 239 (Del. Ch. Nov. 25, 2014) (directors holding 21.5 percent interest were not considered "controlling" because plaintiffs failed to allege sufficient facts that the defendants were able to "exercise actual control over the board"); ***In re Zhongpin Inc. Stockholders Litig.,*** C.A. No. 7393-VCN, 2014 Del. Ch. LEXIS 252 (Del. Ch. Nov. 26, 2014) (holding that a 17.3 percent owner of the company's common stock was a controlling stockholder because "he could control the corporation as a practical matter" based, in part, on public statements made in the company's SEC Form 10-K).

Merger Objection Lawsuits

2014 continued to see a steady flow of merger objection lawsuits. Last year, however, courts subjected these routinely filed actions to greater scrutiny, particularly when plaintiffs asserted disclosure-only claims. For example, Vice Chancellor Parsons dismissed claims alleging that proxy statement disclosures were materially deficient because they failed to include certain projections used by the company's financial advisor in issuing its fairness opinion. ***Dent v. Ramtron Int'l Corp.,*** C.A. No. 7950, 2014 Del. Ch. LEXIS 110 (Del. Ch. June 30, 2014). In dismissing these and other claims, the court held that stockholders are "[e]ntitled to a fair summary of a financial advisor's work, not the data to make an independent determination of fair value." *Id.* at *35.

Courts in and outside of Delaware continued to scrutinize the amount of attorneys' fees awarded in merger objection lawsuits. See ***In re TPC Group S'holders Litig.,*** C.A. No. 7865-VCN, 2014 Del. Ch. LEXIS 219 (Del. Ch. Oct. 29, 2014) (denying a $3.1 million fee request on the grounds that the resulting increased merger price was not causally related to the merger objection lawsuit); ***Kaniecki v. O'Charley's Inc.,*** No. M2012-02221, 2014 Tenn. App. LEXIS 69 (Tenn. Ct. App. Feb. 11, 2014) (affirming the complete denial of the plaintiffs' request for attorneys' fees based only on supplemental disclosures made by the Company, which mooted plaintiffs' disclosure claims); ***Skabialka v. Dynamics Research Corp.,*** No. 14-0445-BLS 2 (Superior Court Mass. Sept. 8, 2014) (approving an award of $150,000 in connection with a disclosure-only settlement, finding that the supplemental disclosures were not "substantial" enough to justify a higher award requested by plaintiff, and also noting that the experience of plaintiffs' counsel pursuing merger litigation should lead to higher efficiency in prosecuting these cases).

Revisiting *Revlon* Review and Change of Control Transactions

Several 2014 decisions addressed fiduciary duties in the context of change of control transactions, and how boards can be sure they've satisfied their fiduciary duties to act reasonably under the circumstances. ***Revlon v. MacAndrews & Forbes Holdings, Inc.,*** 506 A.2d 173 (Del. 1986) requires a board's good faith efforts to secure the transaction offering the best value reasonably available for the stockholders. In ***C&J Energy Servs. v. City of Miami Gen. Employees' & Sanitation Employees' Ret. Trust,*** No. 655/657, 2014 Del. LEXIS 602 (Del. Dec. 19, 2014), the Delaware Supreme Court reversed the Court of Chancery's decision that plaintiff had pled a "'plausible' violation of the board's ***Revlon*** duties

because the board did not affirmatively shop the company either before or after signing." The Court reiterated that ***Revlon*** never established a single blueprint for boards, and a formal auction is not required to satisfy ***Revlon*** "when a board exercises its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal." On the same day, the Delaware Court of Chancery issued its decision in ***In re Family Dollar Stores, Inc.,*** C.A. No. 9985-CB, 2014 Del. Ch. LEXIS 263 (Del. Ch. Dec. 19, 2014), in which it declined to enjoin Dollar Tree's purchase of Family Dollar, even though Dollar General subsequently offered to acquire Family Dollar for a markedly higher price. Family Dollar's board acted reasonably in selecting the Dollar Tree deal because it had reasonable concerns about the proposed Dollar General transaction (including antitrust issues) and, thus, satisfied ***Revlon's*** requirements. The court explained that no "single blueprint" exists for directors in trying to "obtain the highest value reasonably attainable," and the "Board's decision reflects the reality that, for the Company's stockholders, a financially superior offer on paper does not equate to a financially superior transaction in the real world if there is a meaningful risk that the transaction will not close for antitrust reasons."

Aiding and Abetting Liability for Financial Advisors of Merger Transactions

One of the biggest developments in 2014 was the Court of Chancery's decision holding a financial advisor liable for $75.8 million in damages for aiding and abetting a board's breaches of fiduciary duty in a sale transaction. The post-trial decisions in ***In re Rural Metro Corp. Stockholders Litig.,*** 88 A.3d 54 (Del. Ch. 2014), determined that Rural Metro's financial advisor, RBC Capital Markets, LLC, engaged in conduct that led to the board's breach of fiduciary duties during the sales process and subsequent disclosure violations. The court took issue with RBC's conflict of interest and failure to disclose that conflict, as RBC intended to "use its position as sell-side advisor to secure buy-side roles with the private equity firms bidding" for Rural Metro's direct competitor, which also was for sale. "RBC correctly perceived that [private equity] firms would think they would have the inside track on Rural if they included RBC among the banks financing their bids for [the competitor].... RBC believed that with the Rural angle, it could get on all of the [competitor's] bidders' financing trees." The conflicts were concealed from the board, which in turn failed to disclose them to Rural Metro's stockholders, resulting in what the court determined to be a materially misleading proxy statement.

HALLIBURTON II: PRESERVING *BASIC*

On June 23, 2014, the Supreme Court of the United States released its decision in ***Halliburton v. Erica P. John Fund,*** No. 13-317. The decision was easily one of the most eagerly anticipated of October Term 2013, involving fundamental questions about the viability of securities fraud class action litigation that had many securities litigators holding their breath about the future of their practice.

At issue was the so-called "fraud-on-the-market" presumption of reliance created by the Court in ***Basic v. Levinson*** some 25 years ago, which allows plaintiffs to obtain certification of securities fraud class actions without having to demonstrate individual reliance on an alleged misrepresentation by each member of the putative class. This plaintiff-friendly presumption rests on the "efficient market" theory – that is, that the share price of a publicly traded security reflects all publicly available information about that security, including alleged misrepresentations. A showing of individual reliance, therefore, is unnecessary if the alleged misrepresentation was public because the average shareholder relies on a company's share price when buying or selling shares. Eliminating the "fraud-on-the-market" presumption would have made it much harder, if not impossible, for plaintiffs to pursue claims for securities fraud under § 10(b) of the 1934 Act and/or Rule 10b-5 as class actions – a major concern for firms specializing in such work.

As many predicted, however, such concerns were overblown. In its unanimous decision, the Supreme Court effectively split the baby: refusing to overturn the "fraud-on-the-market" presumption, while at the same time clarifying that defendants should be allowed to rebut the presumption at the class certification stage using evidence of no price impact. The decision reverses earlier decisions in the case by both the district court and the United States Court of Appeals for the Fifth Circuit, which had ruled that defendants are

not entitled to introduce evidence at the class certification stage intended to rebut the presumption of reliance.

According to the Supreme Court, this case presented no "special justification" to warrant "overturning a long-settled precedent" established in ***Basic.*** Specifically, the Court rejected the argument that plaintiffs in securities fraud class actions should have to prove reliance on an individual basis, as well as the argument that the "efficient market" theory underlying ***Basic*** was no longer valid. The Court also saw no justification to require plaintiffs to affirmatively prove price impact, which the Court said "would radically alter the required showing" of reliance in a 10(b) / 10b-5 action.

The Supreme Court did, however, clarify that defendants have the chance to rebut the presumption of reliance at the all-important class certification stage using evidence that no "price impact" had occurred. Here, the Court seemed to undertake a "fair's fair" analysis – because plaintiffs typically must introduce indirect evidence of price impact to establish entitlement to the presumption (via evidence of market efficiency and the public nature of an alleged misrepresentation), defendants should be allowed to fight back, especially where they may have direct evidence showing no price impact. "Defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock." (Emphasis supplied).

CYBERSECURITY: LESSONS LEARNED FROM 2014

Amid fallout from several major corporate data breaches, 2014 witnessed efforts by shareholders to hold companies' boards of directors responsible for alleged security shortcomings that led to the breaches, and calls for new legislation and/or regulation designed to ensure that corporations are adequately addressing cyber risk. It is clear that, going forward, data infrastructure and protection is now a responsibility of the company's board of directors. This article will briefly examine events that shaped 2014, discuss why the board of directors should closely monitor the company's cybersecurity infrastructure, and propose procedures and policies a board can implement to minimize the expense and exposure associated with a cybersecurity event.

A Look Back at 2014's Cybersecurity Events

On the heels of the much-publicized Target data breach in late 2013, January 2014 brought reports of yet more major data breaches involving consumer data from both Michaels, Inc. and Neiman Marcus, with hotel conglomerate White Lodging also reporting a breach in February. In March, Sally Beauty rounded out the first quarter by reporting a data breach that exposed more than 280,000 credit and debit cards. By the end of the year, PF Changs, Community Health Systems, UPS, Dairy Queen, Jimmy Johns, Home Depot, Goodwill, K-Mart, JP Morgan, Bebe, Sony and Staples all had announced that they were the victims of cybersecurity events.

While the implications of the security breaches for the directors and officers of these companies still remains unclear, the case of Target may be instructive. During the 2014 proxy season, ISS asked shareholders to vote against seven of Target's ten directors on the grounds that they should be held responsible for contributing to conditions that led to the 2013 intrusion. Although the directors survived ISS's challenge, the board announced in August that the data breach cost Target about $150 million dollars, or about 11 cents per share. Target also saw a federal district court green-light many of the claims asserted

The events of 2014 sent a clear message: cybersecurity is an infrastructure and enterprise integrity issue for firms of all sizes, and affects every aspect of business operations.

against it, denying the company's motion to dismiss a large consumer class action filed against it.

Directors of companies that have suffered data breaches will continue to feel heat in 2015. In November, the National Association of Corporate Directors announced that a board's ability to manage cyber risks would be a dominant concern in 2015 proxy contests, as institutional investors are looking at the degree to which boards are engaged in the oversight of risk management as a key metric of board effectiveness. And, as always, shareholder litigation—derivative or otherwise—remains a threat as data breaches impact companies' bottom lines and share price.

Litigation risk to directors and officers will only increase as cybersecurity failures become more and more costly to companies. A study by Hewlett Packard indicated that, within its sample set, the annualized cost of cybercrime was $7.6 million per company. Many of the costs associated with a data breach are hard to measure and can include: (i) the expenses associated with defending, settling or paying judgments associated with civil lawsuits filed in response to cybersecurity incidents (whether by consumers or shareholders); (ii) potential civil penalties and fines; (iii) increased regulatory compliance costs; (iv) expenses associated with proxy contests; and (v) increased insurance premiums.

Proposed Guidelines for Addressing Cyber Risk

The events of 2014 sent a clear message: cybersecurity is an infrastructure and enterprise integrity issue for firms of all sizes, and affects every aspect of business operations. Accordingly, the company's board of directors should be deeply engaged on the subject. The cybersecurity needs of every company are different, and as with any emerging and unpredictable threat, there is no blueprint for preventing cybersecurity events and no way to guarantee that any company will be immune from what is rapidly becoming regarded as an inevitable occurrence. Following a few basic guidelines, however, will increase the company's readiness for a cybersecurity event and prepare the board of directors for handling the response to a data breach.

Know the NIST Framework. On February 12, 2014, the National Institute of Standards and Technology ("NIST") released its Framework for Improving Critical Infrastructure (the "NIST Framework"). The NIST Framework is designed to be adaptable to any organization, and quickly has become the benchmark for measuring a company's approach in developing, implementing and testing security policies. *The Wall Street Journal* recently reported that "[s]ince its issuance earlier this year, there seems to be a growing consensus that the Framework is fast becoming the de facto standard for private sector cybersecurity as viewed by regulators and U.S. lawyers.... If ... a company suffers a breach, the CIO (and ultimately the CEO and Directors) may have to explain to regulators, or to plaintiffs in any lawsuit, why they had not previously implemented and documented compliance with the Framework. Companies that are not in compliance with the Framework's standards may be at increased risk of liability for security breaches."

A company should consider its existing policies in light of the NIST Framework, which encourages the adoption of several policies:

Firms should implement a **written information security plan ("WISP").** The WISP will encompass several other plans and documents, including a **technology map, an access rights map and a responsibility map.**

The **responsibility map** outlines who will do what in terms of preventing, responding to and recovering from a cybersecurity event. The Framework encourages having point persons for each deliverable in the data security policy.

The firm should have a **data flow map.** A data flow map will help the board understand the firm's business uses for data, enabling it to make better decisions regarding the data's vulnerability and what can be done to protect it.

Inventory physical devices, systems and software, as well as external information systems. Clear documentation will allow the firm to know the exact scope of a data breach.

Assess existing policies dealing with data sharing with third parties. Clarify your expectations and consider updating the firm's **data sharing policies.**

Creating and maintaining a **response plan** that can be implemented in the event of a breach can minimize the scope of damages. The plan should include parameters for whether and how to disclose the event (what will be disclosed to investors, what will be disclosed externally), and the urgency of those disclosures.

Exercise Policy Leadership. Investors increasingly are expecting the board to take the lead in developing and implementing the company's cybersecurity policy. Many boards have created an Enterprise Risk Committee, which is already required for financial institutions under the Dodd Frank Act. As of now, 48 percent of corporations have board-level risk committees responsible for privacy and security risks. If the board lacks the technical expertise to formulate cybersecurity policies, it should retain advisors, and possibly impose cyber risk education requirements on their directors. Moreover, boards need to understand the capabilities of those who implement the measures they enact at the executive level, and ensure they have adequate resources to carry out the company's cybersecurity policy.

Communicate. Along with leadership in managing risks, investors are expecting communication and transparency from boards. Clear communication regarding what steps the company is taking to prevent cyber-attacks, and how the company is responding to any attacks that have occurred, should boost investor confidence and potentially reduce the likelihood of a proxy contest or shareholder lawsuit.

Documentation. Having demonstrable processes and procedures memorializing the company's efforts to mitigate cybersecurity risks will aid the board in defending any potential lawsuit or regulatory action that occurs. Companies would be well-advised to log efforts on data security improvement efforts and document compliance with the firm's WISP and any existing regulations. Moreover, the board's meeting minutes should document the board's consideration of cybersecurity concerns, including the

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amount of time spent discussing it and the experts who reported on the state of the firm's data infrastructure. Having demonstrable procedures can also potentially reduce insurance premiums.

Revisit Insurance Coverage. With many insurers now carving out cybersecurity events from general policies, the board should determine what is covered, which policies provide coverage, and how much coverage is appropriate, and if they have appropriate data-breach policies. D&O policies should be reviewed to determine if directors are covered for claims associated with cybersecurity events.

ABOUT BASS, BERRY & SIMS PLC SECURITIES & SHAREHOLDER LITIGATION PRACTICE GROUP

Bass, Berry & Sims' Securities & Shareholder Litigation team members are recognized in *Chambers USA* for corporate and securities litigation and shareholder class actions. Our team represents more than 35 publicly traded companies and, in the past five years alone, has represented clients in dozens of investigations, securities, corporate governance and merger-related lawsuits, including more than 25 class actions and more than 30 actions involving sub-prime investments. We have defended clients in litigation involving merger and leveraged buy-out transactions totaling more than $75 billion.

Our work on behalf of clients takes us to state and federal trial and appellate courts throughout the United States. We also defend clients nationwide in securities-related arbitrations, as well as other forms of alternative dispute resolution.

We take great pride in our record of favorably resolving cases in their early stages, but we are just as effective in taking these matters to trial. For example, we prevailed as lead trial counsel in the nationally publicized Genesco, Inc. trial – one of the first credit crisis-related trials in the country. There, we obtained an order of specific performance relating to a failed $1.6 billion merger, which resulted in a $215 million post-trial settlement.

Shayne R. Clinton
Member

865.521.0372 TEL
sclinton@bassberry.com

Joseph B. Crace, Jr.
Member

615.742.7896 TEL
jcrace@bassberry.com

Wallace W. Dietz
Member

615.742.6276 TEL
wdietz@bassberry.com

Britt K. Latham
Member

615.742.7762 TEL
blatham@bassberry.com

W. Brantley Phillips, Jr.
Member

615.742.7723 TEL
bphillips@bassberry.com

Overton Thompson III
Member

615.742.7730 TEL
othompson@bassberry.com

The following attorneys contributed to the 2014 Year-End Review:

Jamie Brown counsels public companies in shareholder disputes arising from alleged breaches of fiduciary duty and violations of federal and state securities laws. She works with clients in a variety of industries including healthcare and financial services. Jamie practiced in Wilmington, Delaware, where she prosecuted stockholder actions and litigated securities fraud cases.

Shayne Clinton represents clients in federal securities litigation, class action lawsuits, disputes involving mergers, and actions brought by the Securities and Exchange Commission. His work has ranged from the successful representation of a public company involving the breach of a $1.5 billion merger agreement to winning a case of first impression under the Securities Litigation Uniform Standards Act.

Joe Crace is the co-chair of the firm's Securities & Shareholder Litigation Practice Group. He has handled securities and shareholder litigation matters for both public and private companies in various industries, including healthcare, financial services and food services. Joe also has represented multiple healthcare-related companies and their directors and officers in litigation related to mergers and acquisitions with valuations exceeding $3.6 billion, and has advised public and private clients involved in internal investigations.

Wally Dietz is chair of the firm's Compliance & Government Investigations Practice Group. He has more than 30 years of experience guiding his clients through complex litigation and investigations where exposure is significant. His practice includes handling shareholder class actions and defending directors and officers against allegation related to fiduciary duties, waste and governance. Wally also has served as lead counsel representing Special Litigation Committees charged with investigating derivative claims and allegations of breaches of fiduciary duties.

Britt Latham is chair of the firm's Litigation & Dispute Resolution Practice Group. He represents public companies, their directors and senior management in complex securities class actions, merger class actions, and other types of business disputes, as well as advising public and private clients involved in internal investigations. He has protected the interests of clients in more than 50 class actions in various states, with billions in potential exposure.

Brant Phillips is the co-chair of the firm's Securities & Shareholder Litigation Practice Group. For nearly 20 years, he has served as lead counsel to public and private companies in federal securities class actions, derivative actions and other shareholder disputes arising from alleged violations of federal and state securities laws, breaches of fiduciary duty, fraud, breach of contract and other matters involving significant potential liability.

Brittain Sexton represents companies in federal securities class actions, derivative actions and other shareholder disputes and has counseled Special Litigation Committees to effectively and efficiently investigate derivative claims and allegations of breaches of fiduciary duties.

Overton Thompson has represented a multitude of clients in bet-the-company matters where hundreds of millions, and sometimes billions, of dollars have been in dispute. Overton works with officers, directors and leaders of companies on disputes involving securities and shareholder class actions, derivative actions; merger and acquisition litigation; officer and director liability; breach of fiduciary duty; and breach of securities laws, including claims brought under Section 10-b/10-b-5.

Gingie Yetter concentrates her practice in complex business and securities litigation, including claims arising from alleged violations of federal and state securities laws, breach of contract and business torts. She defends clients in matters relating to mergers and acquistitions, Federal Trade Commission investigations, and multistate investigations and litigation.

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