

INSIGHTS

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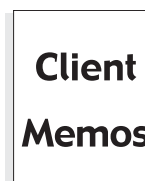
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SECURITIES LITIGATION

The Song Remains the Same: *Morrison v. NAB* Takes the Expected Next Step in Transnational Securities Frauds

In Morrison v. National Australia Bank, the Supreme Court limited the extraterritorial reach of Section 10(b) of the Securities Exchange Act of 1934. Some commentators have viewed this as a sea change in securities law that will severely limit the scope of plaintiffs entitled to bring Section 10(b) claims. As argued here, while Morrison altered the doctrinal landscape, the Supreme Court merely took the logical next step on the path that had been provided by lower courts.

By Neal Troum

In securities fraud lawsuits, the story is always the same. A security is traded on what is deemed an efficient market, where it can be assumed that the price of the security accurately reflects its value. Some new information comes to light, information which is alleged to have been previously concealed from the public. The price at which the security is traded plummets, and investor plaintiffs bring suit. They claim that the security's market price prior to the disclosure of the fraud was artificially inflated because the information that just went public (*i.e.*, the fraud) had been concealed. The damages sought are the difference between the true value of the security—the price at which it trades following disclosure of the fraud—and the artificially inflated price at which it had traded before the fraud went public.

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Section 10(b) of the Securities Exchange Act of 1934¹ exists to remedy such fraud. Its proscribes “manipulative or deceptive device[s] or contrivance[s]” “in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered”² One thing you cannot find in the text of Section 10(b), however, is its extraterritorial reach. The scope of a Section 10(b) claim in connection with foreign securities fraud was left for the courts to determine.

Federal courts stepped in and answered this question. They held that Section 10(b) can encompass extraterritorial securities frauds in one of two ways: (1) if sufficient *conduct* underlying the fraud took place in the United States, or (2) if the fraud had a sufficient *effect* in the United States.³ These tests went by the eponymous names of the “conduct” and “effects” tests.

The extremes of the continuum were easy—a foreign plaintiff, defrauded by a foreigner cooking the books in a foreign country, and a security traded on a foreign exchange. By any measure, such a case fell beyond an American court's reach. Contrast that with an American investor, bringing suit in connection with securities traded on a U.S. market, with fraud committed in the United States by an American defendant. Section 10(b) clearly encompassed such claims.

The middle, however, got murky. If some “effect” of a securities fraud had to be felt in the U.S. to assert a Section 10(b) claim, what kind of effect was required? If some of the fraudulent conduct had to take place in this country, how much conduct was needed? Courts addressed these questions over the years. On paper, the applicable tests to determine the extraterritorial reach of a Section 10(b) claim were straightforward, but their application was somewhat

unwieldy. Numerous commentators noted this confusion.⁴

An important part of this story is that the question at issue—how far abroad does Section 10(b) reach?—was addressed by courts in the context of subject matter jurisdiction. Thus, before deciding whether the elements of a Section 10(b) cause of action had been adequately pleaded, federal courts had to assure themselves that the fraud at issue had sufficient ties to the U.S.

Then came *Morrison v. National Australia Bank*.⁵ The question, as the Second Circuit viewed it, was whether so-called “f-cubed” cases fell within the ambit of Section 10(b).⁶ F-cubed means a foreign plaintiff (one “f”), allegedly injured by a foreign defendant (second “f”), in connection with a foreign security (third “f”). The f-cubed question was really a question about the proper application of the conduct test, because if the three f-cubed elements were all foreign, the only possible connection to the U.S. could be where the effect of the fraud was felt. The Second Circuit ruled that the f-cubed case before it did not fall within the court’s subject matter jurisdiction, but it left open the possibility that *some* f-cubed set of facts might fall within the court’s reach.⁷

Viewed in a certain light, the Supreme Court in *Morrison* turned all this on its head. But on closer examination, the Court merely picked up where the Second Circuit left off.

The Facts of *Morrison*

National Australia Bank’s (NAB) securities were publicly traded, but not in the United States.⁸ In 1998, NAB acquired an entity called HomeSide Lending, a mortgage service provider headquartered in Jacksonville, Florida. HomeSide was a profitable entity, and its profits (and, more importantly, projected future profits) were attractive to the investing public, bolstering the price at which NAB shares traded. HomeSide’s

calculations as to its future profitability were based on the fees it was projected to collect, and this figure was an important entry on NAB’s balance sheets.⁹

In 2001, it was publicly disclosed that there had been an incorrect assumption in HomeSide’s income model. This caused the value of NAB, HomeSide’s parent, to decrease in the public eye, and the price at which NAB securities traded fell and investors sued.¹⁰ Importantly, the only connection with the United States in this fact pattern was that the numbers on HomeSide’s balance books had allegedly been falsified in Florida. There was no other connection with the United States—no U.S. plaintiffs, no U.S. securities, and

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no U.S. defendant. *Morrison* thus presented the classic f-cubed scenario.

The Second Circuit Decision

The Second Circuit concluded that it lacked subject matter jurisdiction over the *Morrison* plaintiffs' claims.¹¹ The plaintiffs had not argued (and they could not have argued) that any of the effect of the fraud had been felt in the United States with respect to their claims. After all, no U.S. securities were involved, and the plaintiffs themselves were domiciled, and had purchased their securities, elsewhere. Instead, the *Morrison* plaintiffs relied exclusively on the conduct test, arguing that the alleged cooking of HomeSide's books had taken place in Florida. According to the plaintiffs, this conduct was sufficient to warrant the exercise of U.S. courts' subject matter jurisdiction. The Second Circuit disagreed and held that the conduct test had not been met. What had happened in Florida, according to the court, was not sufficiently central to the fraud to warrant the intervention of U.S. courts.

The Second Circuit grounded its holding on the facts that (1) the actions that took place in Australia (*i.e.*, the incorporation of the Florida-prepared numbers into the publicly-disseminated reports on which the investors had relied) comprised the heart of the fraud, and (2) the chain of causation between what had transpired in Florida and the ultimate harm suffered by investors was too attenuated.¹² While these facts were held to be insufficient to satisfy the conduct test, the court declined NAB's invitation to rule that no f-cubed case could ever find a home in a U.S. court.¹³

Before the Supreme Court's ruling, there looked to be only a few likely outcomes in *Morrison*. The Court could have put its imprimatur on the conduct and effects tests developed by the Second Circuit, and gone on to decide how the fact pattern before it came out under the conduct test. In other words, it could have weighed in on the ruling of the court below that insufficient

conduct had occurred in the U.S. to pass muster under the conduct test, but left the Second Circuit's doctrinal framework intact. Another possibility was to establish a bright line rule under which no f-cubed case could ever fall within U.S. court's subject matter jurisdiction. Such a ruling would effectively have done away with the conduct test. It would have made fraudulent conduct occurring in the U.S. irrelevant to courts' exercise of subject matter jurisdiction, and it would have left only the effect of the fraud felt in the United States—that is, what had happened to U.S. securities markets and U.S. investors—as the determinative factor.

Interestingly, the Court's decision in *Morrison*, at least on its face, took an unexpected turn.

The Supreme Court Ruling

Morrison was the first pronouncement of the Supreme Court addressing subject matter jurisdiction in the Section 10(b) securities fraud context. The Court's holding essentially had two parts. First, the Court held that the question before it was, in fact, not one of subject matter jurisdiction, but rather related to whether the elements of a Section 10(b) claim had been properly pleaded.¹⁴ Second, the Court replaced the effects and conduct tests in favor of a differently worded test: "Section 10(b) reaches the use of a manipulative or deceptive device or contrivance only in connection with the purchase or sale of a security listed on an American stock exchange, and the purchase or sale of any other security in the United States."¹⁵

The Court did not expressly abolish the effects or conduct tests. By implication, however, consideration of where the conduct underlying the fraud took place no longer controlled whether a plaintiff could proceed with a 10(b) claim; put differently, whether a securities fraud claim was viable was no longer a function of "the place where the deception originated," according to the Court.¹⁶

The Court framed its pronouncement with respect to the transnational scope of securities fraud cases in terms of a simple question: Does “section 10(b) contain[] [any]thing to suggest it applie[s] abroad?”¹⁷ In determining that it did not, the Court looked to the language of 10(b), and it further relied on the presumption against the extraterritorial application of U.S. law absent express Congressional intent to the contrary, what it called “the wisdom of the presumption against extraterritoriality.”¹⁸ Justice Scalia evocatively observed that “the presumption against extraterritorial application would be a craven watchdog indeed if it retreated to its kennel whenever some domestic activity is involved in the case.”¹⁹

As to the facts of the case before it, the Court had no difficulty deciding that its test had not been satisfied. “This case involves no securities listed on a domestic exchange, and all aspects of the purchases complained of by those petitioners who still have live claims occurred outside the United States.” It concluded: “Petitioners have therefore failed to state a claim on which relief can be granted.”²⁰

The Implications of *Morrison*

Morrison may herald a return to basics—a call to strict statutory interpretation, an emphasis on the presumption against extraterritoriality, and a limit on far-reaching judicial law-making where Congress has not spoken. But there is something interesting, and perhaps troubling, about the Supreme Court’s reliance on the presumption against extraterritorial application of U.S. law as the basis for its ruling. The Court spoke in language that sounded like a shot across the bow to lower courts who would expand the reach of the law where the text of the statute does not provide for such broad application. Indeed, the Court’s ruling is one that can be easily characterized as an exercise in the strict reading of the text of a statute, a reliance on what Congress has said and not its silence.

But in the end, it is a *presumption* on which the Supreme Court based its decision, and that presumption was created by courts as well. The presumption against the extraterritorial reach of U.S. law is judge-made law, created and applied by courts.²¹ Thus, the Court simultaneously criticized the Second Circuit’s creation of judge-made tests to decide whether Section 10(b) claims could apply to extraterritorial frauds, and at the same time relied on a judge-made rule to reach this conclusion. There is something of do-as-I-say-and-not-as-I-do on the Court’s part in *Morrison*.

In terms of what effect *Morrison* may have in the future, there will certainly be some ripples. *Morrison* may result in foreign companies electing not to list their public securities on U.S. markets in the form of ADRs to avoid the reach of U.S. securities laws. Or, it may invite lower courts to find ways to broaden the scope of the Court’s holding to include among the class of plaintiffs entitled to bring 10(b) claims more U.S. investors who have suffered harm. Some commentators have wondered whether the Court’s emphasis on the presumption against extraterritoriality will work a sea change in other areas of the law, such as environmental law.²² Others have asked what effect the fact of a foreign entity’s stock being traded on a U.S. exchange in the form of American Depositary Receipts (ADRs) will have on future frauds litigated in U.S. courts.²³

In the end, however, *Morrison* may change very little. The Supreme Court answered the question presented—on the facts of the f-cubed case before it, did a U.S. court have the power to adjudicate plaintiffs’ claims? Answer: No. The Court went a little further, deciding the fate of all f-cubed plaintiffs in its holding, but that aspect of its ruling—setting forth a test that both disposed of the case at bar and provided guidance for future cases—is hardly novel.

The Court’s holding that the extraterritorial reach of Section 10(b) was not a question of subject matter jurisdiction was somewhat unexpected.

Indeed, the Second Circuit had spoken of the effects and conduct tests in the context of subject matter jurisdiction for decades. In terms of the effect this doctrinal shift will have on future cases, however, there will likely be little consequence. Whether adjudicated as a subject matter inquiry or a threshold question to be decided in the context of a Rule 12(b)(6) motion to dismiss, the import of the question—is the fraud at issue too foreign?—is unlikely to change. Whether the fraud alleged has sufficient ties to the U.S. will still remain an initial question courts must address before reaching the merits of the claims before them.

But, in terms of outcome and analysis, there was very little that was new in *Morrison*. Though stated in language new to the foreign securities fraud context, the holding of the Court was simply one of the options that was expected. The Second Circuit had held that it could not adjudicate the f-cubed case before it. It did not, however, rule that no f-cubed case could ever fall with the scope of Section 10(b). The Supreme Court simply took the next step, holding that the relevant factors in deciding whether a U.S. court could adjudicate a foreign fraud were (1) whether the “securities [were] listed on a domestic exchange,” and (2) where the “aspects of the purchases complained of” had taken place. Consideration of such factors lies at the core of the effects test, which has always looked to U.S. stock or U.S. investors and has been around a long time.

Morrison thus merely answered the question before it—are f-cubed cases viable?—and it weighed in on the fate of f-cubed cases in the future. That is just what was expected from the Court.

NOTES

1. 15 U.S.C. § 78j(b).

2. The language of Section 10(b)'s SEC implementing regulation, Rule 10b-5, is similar, providing that “[i]t shall be unlawful for any person . . . by the use [1] of any means or instrumentality of interstate commerce, or [2] of the mails or [3] of any facility of any national securities exchange . . . to employ any device, scheme, or artifice to defraud to make any untrue statement of material fact . . .”

3. See *Morrison v. National Australia Bank Ltd.*, 547 F.3d 167, 171 (2d Cir. 2008).

4. See *Morrison v. National Australia Bank Ltd.*, — S. Ct. —, No. 08-1191, 2010 WL 2518523, at *8 (2010).

5. *Id.*

6. There had originally been American *Morrison* plaintiffs as well, but their claims had been dismissed for other reasons and they did not appeal. *Id.* at *4 n.1.

7. *Morrison*, 547 F.3d 167, 175.

8. NAB's American Depository Receipts (ADRs) did trade in the U.S., but none of the *Morrison* plaintiffs whose claims were based on the purchase and sale of these U.S. securities had appealed the dismissal of their claims to the Second Circuit or the Supreme Court. See n.6, *supra*.

9. *Morrison*, 2010 WL 2518523, at *3.

10. *Id.*

11. *Morrison*, 547 F.3d 167, 176.

12. 547 F.3d 167, 176-177.

13. 547 F.3d 167, 175.

14. *Morrison*, 2010 WL 2518523, at *4.*5.

15. *Id.* at *14.

16. *Id.* at *11.

17. *Id.* at *9.

18. *Id.* at *8.

19. *Id.* at *11.

20. *Id.* at *14.

21. Indeed, the Supreme Court cited to its own case law for support for the presumption against extraterritoriality. *Id.* at *5.

22. John P. Krill, Jr., and Amy O. Garrigues, “Extraterritorial Reach of U.S. Laws after *Morrison v. NAB*,” *Appellate, Constitutional & Governmental Litigation Alert*, July 1, 2010 (<http://www.klgates.com/newsstand/Detail.aspx?publication=6515>).

23. Ted Farris, “Implications of *Morrison v. National Australia Bank*,” June 28, 2010 (<http://www.mondaq.com/unitedstates/article.asp?articleid=104148&tw=2>).

MERGERS AND ACQUISITIONS

A “Unified” Approach to Controlling Shareholder Transactions?

In the recent decision, In re CNX Gas Corporation Shareholders Litigation, the Delaware Chancery Court addressed the important issue of the standard of review that applies to a transaction with a controlling shareholder. If upheld by the Delaware Supreme Court, the “unified” standard set forth in CNX would permit both tender offers and mergers with a controlling shareholder to be reviewed under Delaware’s deferential business judgment standard so long as certain procedural protections are in place.

by Peter L. Welsh and Christine A. Rodriguez

For over a decade, the Delaware Chancery Court has grappled with the appropriate standard of review to apply to fundamental transactions with controlling shareholders. With the recent decision in *In re CNX Gas Corporation Shareholders Litigation (CNX)*,¹ the Chancery Court has at last sought to bring to rest—or at least pave the way for the Supreme Court of Delaware to bring to rest—the longstanding question of which standards of review govern one-step and two-step freeze-out transactions and, in particular, whether a single, “unified” standard of review should apply to a freeze-out transaction, regardless of whether it is structured as a tender offer or a long-form merger.

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Under the “unified” standard set forth by Vice Chancellor Laster in *CNX*, business judgment deference will be afforded to a transaction with a controlling shareholder, regardless of the form of the transaction, if the following conditions are met: (1) The transaction was negotiated and approved (or recommend) by a fully empowered, independent special committee; and (2) a majority-of-the-minority of the shareholders voted in favor of the merger (or tendered their shares).² Notably, the transaction must be conditioned on these terms. If either of these conditions is not met, the transaction would be subject to the more stringent “entire fairness” standard of review.

CNX both raises the bar for unilateral tender offers by a controlling shareholder and relaxes the standard applicable to negotiated mergers with controlling shareholders. Specifically, in setting forth a “unified” standard of review for both tender offers and long-form mergers with a controlling shareholder, Vice Chancellor Laster declined to follow *In re Siliconix Inc. Shareholders Litigation (Siliconix)* and its progeny and apply business judgment review to all two-step, unilateral tender offers by a controlling shareholder.³ At the same time, the Vice Chancellor also sought to relax the standard applied to a negotiated merger transaction between a controlling shareholder and its subsidiary previously imposed by the Delaware Supreme Court in *Kahn v. Lynch Communication Systems, Inc. (Lynch)*.⁴

The CNX Tender Offer

The transaction at issue in *CNX* involved a proposed tender offer by CONSOL Energy, Inc. (CONSOL), the largest shareholder of *CNX*, which together with its officers and directors and the officers and directors of *CNX*, held approximately 83.5 percent of the

equity in CNX.⁵ T. Rowe Price Associates, Inc. (T. Rowe Price), the largest minority shareholder of CNX, owned approximately 6.3 percent of the outstanding common stock of CNX (representing approximately 37 percent of the minority non-CONSOL shares) and approximately 6.5 percent of CONSOL's outstanding common stock (in addition to holding CONSOL debt).⁶

The Negotiations and the Tender Offer

In September 2009, CONSOL commenced negotiations with T. Rowe Price to acquire all of its shares in CNX. Initial negotiations between CONSOL and T. Rowe Price fell flat, but resumed in March 2010. When they resumed, T. Rowe Price insisted on receiving a price between \$40 and \$42.50 for its shares of CNX.⁷ On March 15, 2010, CONSOL announced that it was considering a purchase of the public shares of CNX. Further negotiations between CONSOL and T. Rowe Price followed, culminating in a March 19 negotiation session during which T. Rowe Price once more insisted on a price of at least \$40.⁸ CONSOL refused, and T. Rowe Price responded by making a "final offer" of \$38.25 per share in cash—an offer that was later approved by the CONSOL board.⁹ The price reflected a premium of approximately 45.8 percent over the closing price of CNX's common shares on the day before the March 15 offer.¹⁰

On March 21, 2010, CONSOL and T. Rowe Price executed a tender agreement pursuant to which T. Rowe Price agreed to tender, and CONSOL agreed to purchase, T. Rowe Price's shares at a per share price of no less than \$38.25 in cash.¹¹ CONSOL commenced its tender offer on April 28.¹² The tender offer was subject to a non-waivable majority-of-the-minority condition, the calculation of which included the shares owned by T. Rowe Price.¹³ CONSOL therefore needed only an additional 12 percent of the outstanding shares to tender in order to satisfy the majority-of-the-minority condition.¹⁴

The Role of the Special Committee

At the time of the tender offer, the CNX board of directors was comprised of the Chief Executive Officer of CONSOL, two directors of CONSOL and one independent director.¹⁵ On April 15, 2010, after the announcement of the tender offer and the agreement with T. Rowe Price, the CNX Board approved the formation of a one-person special committee (the "Special Committee") consisting of the lone independent director of CNX.¹⁶ The Board limited the powers of the Special Committee in significant respects, authorizing it only to evaluate the tender offer, engage advisers and prepare a Schedule 14D-9.¹⁷ Notably, the Board did not authorize the Special Committee to consider alternatives, reasoning that any alternatives would be futile because CONSOL was unwilling to sell its CNX shares, or to further negotiate the terms of any deal with CONSOL.¹⁸ The Board also expressly denied the Special Committee's request for "the full powers and authority of the board of directors."¹⁹

The Special Committee's financial advisor, Lazard, Ltd., informed the Special Committee that it would be able to recommend that the \$38.25 per share price was fair from a financial point of view.²⁰ But the Special Committee and its advisors doubted that the results of the negotiations between T. Rowe Price and CONSOL reflected the maximum per share price that CONSOL was willing to pay.²¹ Despite not being authorized to negotiate with CONSOL, on May 5, the Special Committee informed CONSOL that it could not recommend the transaction at \$38.25 per share, but could likely recommend it at a price of \$41.20 per share.²² On May 10, the day before the Schedule 14D-9 was due, the CNX board retroactively granted the Special Committee the power to negotiate with CONSOL.²³ On May 11, CONSOL indicated to the Special Committee that it was unwilling to increase its price.²⁴

In CNX's 14D-9, the Special Committee remained neutral on the merits of the tender

offer and did not recommend for or against it.²⁵ In doing so, the Special Committee noted the following concerns: (1) the limited powers granted to the Special Committee; (2) the fact that CONSOL was unwilling to negotiate the price that it had agreed upon with T. Rowe Price; (3) the questionable effectiveness of the majority-of-the-minority provision, which would include the previously locked-up shares of T. Rowe Price; and (4) the potential incentive of T. Rowe Price to favor a lower price because it beneficially owned slightly more stock in CONSOL than it did in CNX.²⁶

Following the announcement of the deal, a putative class of minority shareholders of CNX filed an action challenging the deal on process and disclosure grounds and moved for a preliminary injunction against the proposed tender offer by CONSOL. Vice Chancellor Laster refused to enjoin the transaction.²⁷ In doing so, however, the Vice Chancellor dilated on the standards governing transactions with controlling shareholders.

The Standards of Review for Controlling Shareholder Transactions

In three lines of cases spanning fifteen years, including *Kahn v. Lynch Communication Systems, Inc.*, *In re Siliconix Inc. Shareholders Litigation*, and *In Re John Q. Hammons Hotels Inc. Shareholder Litigation*, the Delaware judiciary articulated standards of conduct for boards of directors and committees of boards of target corporations considering freeze-out transactions with a controlling shareholder as well as third-party transactions in which a controlling shareholder receives differential consideration.

Kahn v. Lynch Communication Systems, Inc.

In *Kahn v. Lynch*, the Delaware Supreme Court considered the appropriate standard of review in a controlling shareholder merger transaction. There, the special committee of Lynch Communication Systems, Inc. (Lynch) rejected a “final offer” by Alcatel U.S.A. Corporation (Alcatel)—a

controlling shareholder owning approximately 43 percent of the outstanding shares of Lynch—of \$15.50 cash per share for a merger with Alcatel.²⁸ Following Lynch’s rejection of the offer, Alcatel threatened to proceed with a hostile tender offer if the \$15.50 per share offer was not approved by the special committee, whose advisors had recommended a \$17 per share counteroffer to Alcatel’s initial offer of \$14 per share.²⁹ The special committee recognized that a “white knight” or other alternative was impractical because any change of control required, under the charter, an 80 percent shareholder approval.³⁰ The special committee therefore recommended that the board approve the offer, which it subsequently did.³¹

The Delaware Supreme Court held that entire fairness was the proper standard of review “because the unchanging nature of the underlying ‘interested’ transaction requires careful scrutiny.”³² The Court noted that, even where no coercion is intended, shareholders considering a controlling shareholder transaction might fear retaliation from the controlling shareholder if they do not vote in favor of the transaction.³³ As a consequence, the Court held that entire fairness review should apply to a merger transaction with a controlling shareholder.³⁴ The Chancery Court also held, however, that the burden of proof regarding the entire fairness of the transaction shifts to the shareholder challenging the transaction when an independent committee of directors or a majority of the minority shareholders approves the transaction.³⁵ In order for the burden to shift, the Court held, “[p]articular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm’s length.”³⁶

In re Siliconix Inc. Shareholders Litigation

In *Siliconix*, the transaction at issue was a stock-for-stock tender offer by Vishay Inter-technology, Inc. (thorough its wholly owned subsidiary) (Vishay), a controlling shareholder

and approximately 80 percent equity holder in Siliconix Inc. (Siliconix).³⁷ There, Vishay proposed an all cash, non-negotiated, unilateral tender offer, which was considered—and ultimately rejected—by a two-person special committee of directors with close relationships to Vishay’s management.³⁸ Vishay was unwilling to raise its offer price and proposed a stock-for-stock tender offer instead of a cash offer.³⁹ Vishay announced the exchange offer, without the prior approval of the special committee, at a ratio of 1.5 shares of Vishay for every share of Siliconix—a price that, unlike the cash offer, carried no premium for Siliconix shareholders.⁴⁰ The offer did include a non-waivable majority-of-the-minority provision.⁴¹ The 14D-9 reported that the special committee had determined to make no recommendation regarding Vishay’s tender offer.⁴²

In considering what standard of review to apply, the Court noted that “as long as the tender offer is pursued properly, the free choice of the minority shareholders to reject the tender offer provides sufficient protection.”⁴³ Thus, in the absence of coercion or actionable disclosure violations, “Vishay was not obligated to offer a fair price in its tender.”⁴⁴ In so holding, the Court acknowledged that “[i]t may seem strange” to review a controlling shareholder tender offer transaction under a different standard than a controlling shareholder merger, but explained that this rationale is rooted in the principle that an individual shareholder may reject a tender offer and, at least prior to any short-form merger, continue to own the stock of the target company.⁴⁵ The Court noted also that, unlike in a merger, a tender offer does not involve any corporate action by the board, but is instead a transaction between a controlling shareholder and the minority shareholders.⁴⁶

While acknowledging that these principles do not lead to the conclusion that target boards have *no* duties to shareholders in the context of a tender offer, the Court noted that, although the Delaware legislature has imposed on directors

specific duties under 8 Del. G. L. § 251 in a merger transaction, “it has not chosen to impose comparable statutory duties on directors of companies that are targets of tender offers.”⁴⁷ The Court therefore was unwilling to require the application of the entire fairness standard in tender offer transactions.⁴⁸

In Re John Q. Hammons Hotels Inc. Shareholder Litigation

In *In re John Q. Hammons Hotels Inc. Shareholder Litigation*,⁴⁹ John Q. Hammons, the controlling shareholder, owning approximately 76 percent of the voting shares of John Q. Hammons Hotels, Inc. (JQH), negotiated to sell JQH to a third party in a merger transaction in which he received differential consideration, including: (1) agreements intended to provide him with financing for other hotel development projects while avoiding tax liability; (2) a \$25 million short-term and a \$275 million long-term line of credit; and (3) a right of first refusal to purchase hotels following the merger transaction.⁵⁰ The transaction was negotiated by an independent special committee and included a majority-of-the-minority provision which required approval by a majority of the minority stockholders voting on the merger.⁵¹ Importantly, the majority-of-the-minority provision was waivable by the special committee.

On the defendants’ motion for summary judgment, the Chancery Court held that the transaction was subject to entire fairness review. The Court noted, however, that this result was not mandated by *Lynch*.⁵² The transaction at issue involved a transaction with a third party, albeit one that provided differential consideration to the controlling shareholder. It did not involve a controlling shareholder standing on both sides of the transaction and, therefore, entire fairness did not apply *ab initio*. However, because the controlling shareholder received differential consideration, the Court held, the business judgment standard of review did not automatically apply either.⁵³ Instead, “the use of sufficient procedural

protections for the minority stockholders *could* have resulted in application of business judgment review in this case.”⁵⁴ Specifically, the Court held, business judgment review could have been applied to the transaction if the transaction had been “(1) recommended by a disinterested and independent special committee *and* (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.”⁵⁵

The transaction did not, however, warrant business judgment review because, the Chancery Court held, the special procedures implemented in the case were inadequate.⁵⁶ Specifically, the Court held that the deal’s majority-of-the-minority condition was insufficient because it was waivable by the special committee and it called for a vote by a majority of the minority shareholders *voting*, as opposed to a majority of *all* minority shareholders.⁵⁷ The Court therefore applied the entire fairness standard of review and denied the cross motions for summary judgment on the issue of fair dealing.⁵⁸

The Case for a “Unified” Standard

In *In re Pure Resources, Inc. Shareholders Litigation (Pure Resources)*⁵⁹ and *In re Cox Communications Shareholders Litigation (Cox Communications)*,⁶⁰ Vice Chancellor Strine thoroughly reviewed the policy concerns raised by Lynch and Siliconix and undertook to reconsider the appropriate standard of review for controlling shareholder freeze-out transactions. In *Pure Resources*, for example, the Vice Chancellor asked:

When a transaction to buy out the minority is proposed, is it more important to the development of strong capital markets to hold controlling stockholders and target boards to very strict (and litigation-intensive) standards of fiduciary conduct? Or is more stockholder wealth generated if less rigorous protections are adopted, which permit acquisitions to proceed so long as the majority has not misled or strong-armed the minority?⁶¹

In both decisions, Vice Chancellor Strine called into question divergent standards of review for one-step and two-step transactions with controlling shareholders. Specifically, he took issue with the principle that a controlling shareholder transaction that is structured as a unilateral tender offer rather than a merger should receive a more lenient standard of review, and vice versa. Rather, as he noted in *Pure Resources*, minority shareholders in both transactions are susceptible to the proverbial “800-pound gorilla’s retributive capabilities”:

The problem is that nothing about the tender offer method of corporate acquisition makes the 800-pound gorilla’s retributive capabilities less daunting to minority stockholders. Indeed, many commentators would argue that the tender offer form is more coercive than a merger vote. In a merger vote, stockholders can vote no and still receive the transactional consideration if the merger prevails. In a tender offer, however, a non-tendering shareholder individually faces an uncertain fate....But whether or not one views tender offers as more coercive of shareholder choice than negotiated mergers with controlling stockholders, it is difficult to argue that tender offers are materially freer and more reliable measures of stockholder sentiment.⁶²

Similarly, in *Cox Communications*, a decision in which the standard of review for controlling shareholders was not being litigated, Vice Chancellor Strine made a case for a strengthening of the *Siliconix* line of decisions, criticizing the fact that, under such precedent, a transaction could escape entire fairness review even if the special committee made a recommendation *not* to tender.⁶³

In both decisions, Vice Chancellor Strine also made a strong argument for relaxing *Lynch*. In *Pure Resources*, Vice Chancellor Strine criticized the paternalism of *Lynch*, remarking that “the corporate law should not be designed on the assumption that diversified investors are infirm but instead should give great deference to

transactions approved by them voluntarily and knowledgeably.”⁶⁴ Similarly, in *Cox Communications*, Vice Chancellor Strine noted that the more stringent standard in *Lynch* gives all *Lynch* claims settlement value and therefore creates incentives for plaintiffs who have no injury to bring a claim.⁶⁵ To this last point, Vice Chancellor Strine made an appeal for the judiciary to “be vigilant to make sure that the incentives we create promote integrity and that we do not, by judicial doctrine, generate the need for defendants to settle simply because they have no viable alternative, even when they have done nothing wrong.”⁶⁶ Thus, in *Cox Communications*, Vice Chancellor Strine sought to refine the standard articulated in *Pure Resources* and proposed that one- and two-step freeze-out transactions involving controlling shareholders be governed by a “unified standard” applicable to controlling shareholder transactions regardless of the transaction structure.⁶⁷

The Unified Standard

At its core, *CNX* held that, in order for a controlling shareholder transaction to receive business judgment review, the transaction process *genuinely* must replicate a third-party transaction.⁶⁸ As Vice Chancellor Laster explained, “The animating principle underlying the unified approach is to give judicial deference to processes that simulate arms’ length third-party transactional approvals.”⁶⁹ The structural protections that therefore must be in place for the business judgment standard of review to apply include: (1) The negotiation and approval (or a recommendation for approval) by an independent special committee; *and* (2) a vote (or tender) by a majority-of-the-minority of the shareholders in favor of the transaction.⁷⁰ Importantly, the Court in *CNX* emphasized that that these processes must not only be in place, but also must be effective such that the decision to sell replicates an arm’s length, third-party transaction. These terms must also be conditions of a controlling shareholder transaction, and not merely the result of it. Thus, when both mechanisms are in place—and are in place

effectively—a controlling shareholder does not stand on both sides of a transaction and entire fairness review is inapplicable.⁷¹

As in *Pure Resources*, the Court in *CNX* stressed that a controlling shareholder in a tender offer has a duty “to permit the independent directors on the target board both free rein and adequate time to react to the tender offer,” as well as the ability to negotiate in a fully arm’s length manner, replicating a third-party transaction.⁷² Notably, this includes granting the special committee the authority to implement a poison pill—a mechanism that would be available in a third-party transaction:

Because a board in a third-party transaction would have the power to respond effectively to a tender offer, including by deploying a rights plan, a subsidiary board should have the same power if the freeze-out is to receive business judgment review. This does not mean that a special committee must use that power. The shadow of pill adoption alone may be sufficient to prompt a controller to give a special committee more time to negotiate or to evaluate how to proceed.⁷³

Vice Chancellor Laster’s suggestion that a special committee considering an offer from a controlling shareholder should have the authority to deploy a rights plan is remarkable and could mark a significant shift in the balance of power between subsidiaries and controlling shareholders in merger and tender offer transactions.

Along the same lines, the Court held that a special committee must be provided with “authority comparable to what a board would possess in a third-party transaction,” including the power to consider alternatives to the proposed transaction with a controlling shareholder.⁷⁴ In *CNX*, the Board’s denial of the Special Committee’s request for such authority cut against the Special Committee’s ability to negotiate for the best price for

the minority shares and supported a finding that entire fairness review was appropriate.⁷⁵

Under *CNX*, a majority-of-the-minority provision must be implemented in a manner that safeguards the negotiating leverage of the minority shareholders, and locking up the minority—or a significant portion of it—prior to the tender offer may well undermine the protections afforded by the provision.⁷⁶ Because CONSOL and T. Rowe Price had negotiated the terms of the tender prior to the offer being made to the rest of the minority shareholders, the Court examined the motives of T. Rowe Price to negotiate the best price for the minority shareholders and expressed skepticism concerning the effectiveness of the majority-of-the-minority condition. The Court noted that because T. Rowe Price had a slightly greater ownership interest in CONSOL than it did in *CNX*, it “arguably [had] an incentive to favor CONSOL. . . [This case] is about a direct economic conflict that at best renders T. Rowe Price indifferent to the allocation of value between CONSOL and *CNX* and at worst gives T. Rowe Price reason to favor CONSOL.”⁷⁷ The pre-offer lock-up of T. Rowe Price’s shares therefore increased the likelihood of the completion of the tender offer, thereby decreasing the effectiveness of the majority-of-the-minority provision as a negotiating tool to leverage a higher price for the minority shareholders.⁷⁸

A majority-of-the-minority provision must be implemented in a manner that safeguards the negotiating leverage of the minority shareholders.

In sum, to obtain the benefit of the business judgment rule in a controlling shareholder transaction, the special committee must seek to replicate a fully arm’s length negotiation with the controlling shareholder. At a minimum, this

requires that the special committee: (1) be fully independent of the controller; (2) be able to evaluate the controller’s offer, with sufficient time to react to the offer and negotiate with the controlling shareholder; (3) have comparable negotiation tools of a corporation or board in an arm’s length transaction (including, potentially, the ability to deploy a rights plan in response to a proportionate threat to shareholder interests from the controller); and (4) affirmatively recommend that the minority shareholders support the controlling shareholder’s offer. Furthermore, the transaction must be subject to a non-waivable majority of the minority shareholder approval or tender (likely excluding from the majority any shares subject to a pre-negotiated agreement to tender).

Practical and Legal Implications of *CNX*

Among the key lessons to be taken away from *CNX* include the following:

- ***Enhanced role of special committees.*** Special committees are now, for all intents and purposes, mandatory in controlling shareholder transactions. Moreover, their role has become increasingly crucial under *CNX* as such transactions will be subject to entire fairness review unless the special committee affirmatively recommends that the shareholders tender their shares.
- ***Full negotiation authority.*** Under *CNX*, a special committee must have authority similar to that given to boards considering third-party transactions. The special committee’s board authorization should clearly reflect this. This authority includes the ability to consider alternative transactions and to deploy defensive measures, such as implementing a poison pill.
- ***Single member committees are not preferable.*** The Chancery Court previously has cautioned against employing single member special committees. While Vice Chancellor Laster did not single out the lone committee member for criticism, *CNX* is a general

reminder that single members committees raise potential issues from a process perspective and may be less well-respected by the Delaware courts.⁷⁹

- **The risks of locking up the minority.** *CNX* also cautions against a pre-lock up of minority shares negotiated by a controlling shareholder. In *CNX*, the Court scrutinized the incentives of T. Rowe Price because T. Rowe Price and CONSOL had pre-negotiated the terms of the tender offer. The Court was ultimately skeptical of T. Rowe Price's motives in approving the shares, and disapproved of *CNX*'s efforts to include T. Rowe Price's shares in the numerator for calculating the majority of the minority.
- **Minimizing force of representative litigation?** The Court of Chancery's call to overturn *Lynch*—a decision that it has criticized as rendering it impossible for a controlling shareholder to obtain dismissal of even meritless shareholder litigation challenging a one-step merger—reflects an interest in minimizing the risk of Catch-22 business decisions that expose directors and parties in fundamental transactions to inevitable representative litigation with unavoidable settlement value.⁸⁰ This is consistent with other recent efforts by the Court of Chancery to rationalize the incentives created by the inevitable threat of shareholder litigation in any fundamental transaction.⁸¹

Conclusion

As Vice Chancellor Laster stated in *CNX*, his decision implicates “fundamental issues of Delaware law and public policy that only the Delaware Supreme Court can resolve.”⁸² On July 9, 2010, the Delaware Supreme Court held that the defendants' application for appeal of the Court of Chancery's decision in *CNX* was not ripe for review until a final judgment has been entered. Thus, the true effect of the *CNX* decision ultimately depends on whether the Delaware Court weighs in on the issue. Until then, two-step tender offers involving

controlling shareholders likely will be structured in accordance with the duties laid out in *CNX*—the more stringent of the possible standards of review. Because the transaction at issue in *CNX* was not a one-step merger, such transactions will likely, and should, still be structured with the entire fairness standard in mind until the Delaware Supreme Court weighs in on the issue.

NOTES

1. C.A. No. 5377-VCL, 2010 WL 2291842 (Del. Ch. May 25, 2010) (hereinafter, *CNX*).
2. *Id.* at *13.
3. C.A. No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001) (hereinafter, *Siliconix*).
4. 638 A.2d 1110 (Del. 1994).
5. *CNX* at *2. In June 2005, CONSOL, the largest producer of high-Btu bituminous coal in the United States, formed *CNX* to conduct its natural gas operations. *Id.* at *1. In early 2006, following an initial public offering of its shares, *CNX* began trading publicly on the New York Stock Exchange. *Id.*
6. *Id.* at *2.
7. *Id.* at *3-5.
8. *Id.* at *4.
9. *Id.* at *5.
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.* at *3.
16. *Id.* at *5.
17. *Id.* at *6.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.*
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.* at *6-7.
27. *Id.* at *21.
28. 638 A.2d 1110, 1112-1113.
29. 638 A.2d 1110, 1113.
30. 638 A.2d 1110, 1113, n.3.

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31. 638 A.2d 1110, 1113.
 32. 638 A.2d 1110, 1116.
 33. 638 A.2d 1110, 1116.
 34. 638 A.2d 1110, 1116. As Vice Chancellor Laster noted in *CNX*, while the transaction at issue in *Lynch* is assumed to have involved a long-form merger, it actually involved a two-step transaction, originally designed as a consensual tender offer followed by a long-form merger, but carried out as a tender offer followed by a short-form merger. *CNX* at *7, n.1. Following *Lynch*, the Chancery Court has applied the “entire fairness” standard of review to both consensual tender offers and squeeze-out mergers. *Id.*
 35. 638 A.2d 1110, 1117.
 36. 638 A.2d 1110, 1120-’21.
 37. *Siliconix* at *1.
 38. *Id.* at *1-3.
 39. *Id.* at *3.
 40. *Id.* at * 4.
 41. *Id.*
 42. *Id.* at *5.
 43. *Id.* at *6.
 44. *Id.*
 45. *Id.* at *7.
 46. *Id.*
 47. *Id.* at *7-8.
 48. *Id.* at *8.
 49. C.A. No. 758, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).
 50. *Id.* at *1, 7-8.
 51. *Id.* at *6-8.
 52. *Id.* at *10.
 53. *Id.*
 54. *Id.* at *2.
 55. *Id.* at *12.
 56. *Id.*
 57. *Id.*
 58. *Id.* at *14.
 59. 808 A.2d 421 (Del. Ch. 2002).
 60. 879 A.2d 604 (Del. Ch. 2005).
 61. 808 A.2d 421, 434-435.
 62. 808 A.2d 421, 441-442.
 63. 879 A.2d 604, 626.
 64. 808 A.2d 421, 444.
 65. 879 A.2d 604, 643.
 66. 879 A.2d 604, 643.
 67. 879 A.2d 604, 607.
 68. *See CNX* at *13.
 69. *Id.* at *13, n.8. In *CNX*, Vice Chancellor Laster noted that he departed from the approach suggested by Vice Chancellor Strine in *Cox Communications* by requiring that the special committee recommend that the minority tender. In *Cox Communications*, on the other hand, the Court suggested that business judgment review could be afforded so long as the special committee did not recommend that the minority *not* tender. *Id.*
 70. *Id.* at *13. *Lynch*, on the other hand, requires only that the special committee or a majority of the minority shareholders approve the transaction for the burden of proof on the issue of fairness to shift to the shareholder challenging the transaction. *Lynch* at 1117.
 71. *CNX* at *13.
 72. *See id.* at *12; *Pure Resources* at 445.
 73. *CNX* at *16.
 74. *Id.* at *14.
 75. *Id.*
 76. *Id.* at *16.
 77. *Id.* at *16-17.
 78. *Id.*
 79. *See Gesoff v. IIC Indus.*, 902 A.2d 1130, 1146 (Del. Ch. 2006) (“The court necessarily places more trust in a multiple-member committee than in a committee where a single member works free of the oversight provided by at least one colleague. But, in those rare circumstances when a special committee is comprised of only one director, Delaware courts have required the sole member, ‘like Caesar’s wife, to be above reproach.’”)
 80. *See, e.g., Cox Communications*, 879 A.2d 604, 605 (“Because [the *Lynch*] standard (as heretofore understood by practitioners and courts) makes it impossible for a controlling stockholder ever to structure a transaction in a manner that will enable it to obtain dismissal of a complaint challenging the transaction, each *Lynch* case has settlement value, not necessarily because of its merits but because it cannot be dismissed.”)
 81. *See generally, In re Revlon, Inc. S’holders. Litig.*, 990 A.2d 940 (Del. Ch. 2010) (Laster, VC).
 82. *CNX* at *14.
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SECURITIES LITIGATION

Sharing Attorney Work Product with Auditors

In a recent decision, the DC Circuit held that attorney work product may be shared with auditors without waiving protection of the relevant documents. There remain risks however.

By John H. Sturc

On June 29, 2010, the United States Court of Appeals for the District of Columbia issued the first court of appeals decision regarding whether a public company may share attorney work product with its outside auditor without waiving protection of those documents from discovery in subsequent litigation.¹ It held that, under the circumstances, such a sharing was not a waiver.

Public companies must often evaluate the possible financial impact of litigation in preparing financial statements and must often share their evaluation with auditors so that the auditors may determine whether the financial statements are fairly stated. Such contingent liabilities, many of which are the subject of potential or ongoing litigation, can frequently be material to a company's financial statements. But candor creates risks, as preparing and then sharing confidential assessments with outsiders creates the potential that a court may later hold that the data must also be shared with the company's adversary. Heretofore, this issue had only been decided by federal district courts which had reached mixed results.² In holding that a corporation may share attorney work product with its outside auditors without losing its protection from discovery, the Court's ruling

in *United States v. Deloitte LLP*, should, if followed elsewhere, facilitate the audit of financial statements of public companies.

The DC Circuit's Decision

In *United States v. Deloitte LLP*, a panel of the D.C. Circuit considered a claim by Dow Chemical Company (Dow) to preclude enforcement of a civil subpoena served by the United States on Dow's independent registered public accounting firm, Deloitte LLP (Deloitte) on behalf of the Internal Revenue Service (IRS) in federal civil litigation contesting tax adjustments to partnership returns filed by two Dow subsidiaries. The appeal focused on three documents which Deloitte withheld at Dow's instruction: (1) a draft memorandum written by Deloitte personnel summarizing a meeting between Deloitte, Dow personnel, and Dow's outside counsel regarding the potential for tax litigation as to one of the partnerships and the possible accounting for that contingency (which the court referred to as "the Deloitte Memorandum"); (2) a memorandum and flowchart prepared by a Dow accountant and a Dow lawyer; and (3) a tax opinion prepared by Dow's outside counsel (which the court called "the Dow Documents"). All three documents were provided to Deloitte in response to its assertion that the materials were needed for Deloitte's audit so that it could issue an opinion on Dow's financial statements.

In its analysis, the court first concluded that, subject to further factual findings by the District Court on remand, all three documents were potentially protected from disclosure on remand. It held that those portions of the Deloitte Memorandum which reflected the "thoughts and opinions of counsel developed in anticipation of litigation,"³ were protected from discovery because those thoughts and impressions

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had been created “because of” the prospect of litigation with the IRS.⁴ In so holding, the court adopted what it believed to be the majority rule and held that a document which evaluates the potential for litigation in connection with a possible business transaction can retain its work product protection.⁵ It declined to follow the “primary motivating purpose” test for creation of the documents applied by the Fifth Circuit in *United States v. El Paso Co.*,⁶ a test which confines work product protection to documents motivated by the defense or prosecution of litigation itself.

Second, the court concluded that Dow had not waived the work product protection by sharing the thoughts and mental impressions of its attorneys with its outside auditors. The court noted that voluntary disclosure of work product *may* waive the attorney-client privilege and that selective disclosure of work product with an adversary may also waive work product protection. However, it found that sharing work product information with an independent auditor did not cause a waiver of work product protection because it did not undermine the adversary process.⁷ The court concluded that the auditor was a neutral, and not an adversary. In so holding, it relied on American Institute of Certified Public Accountants rules stating that “the threat of litigation between an independent auditor and its client can compromise the auditor’s independence and necessitate withdrawal.”⁸ Additionally, the court found that even after disclosing work product to the auditors, Dow retained a reasonable expectation of continued confidentiality of the materials because of the auditors’ ethical obligations to maintain the confidentiality of client information.⁹

Distinguishing *United States v. Textron*

The D.C. Circuit’s conclusion regarding the work product status of Dow’s analysis of possible IRS claims contrasts with the recent *en banc* holding in *United States v. Textron, Inc.*,¹⁰ where a

sharply divided court of the First Circuit held, on a 3-2 vote, that tax accrual work papers prepared by the company’s tax department to support its calculation of tax reserves for its audited financial statements were not entitled to work product protection.¹¹ The First Circuit noted that “the purpose of the [tax accrual] work papers was to make book entries, prepare financial statements and obtain a clean audit. . .,”¹² and reasoned that documents prepared in the ordinary course of business evaluating the risk of loss in a “subject that might conceivably be litigated,”¹³ were too attenuated from the actual litigation process to warrant protection when subpoenaed by the Internal Revenue Service.¹⁴

In *Deloitte*, the D.C. Circuit distinguished the *Textron* decision because the Deloitte Memorandum and the Dow Documents principally focused on a legal analysis of a particular controversy, rather than all tax issues faced by the corporation, and because the particular tax accrual work papers at issue in *Textron* were of no use to *Textron* in actual litigation.¹⁵ In addition, the D.C. Circuit concluded that the *Textron* minority “makes a strong argument,”¹⁶ that the majority had wrongly applied a disfavored and “more exacting” “prepared for use in possible litigation” standard which the D.C. Circuit believed was both incorrect and a minority view.¹⁷

Implications for Practice

In reaching its conclusion, the D.C. Circuit was “mindful that independent auditors have significant leverage over the companies whose finances they audit,”¹⁸ and concluded that the government’s mere “desire to know what Dow’s counsel thought” was discovery that would undermine the adversarial process.¹⁹ Thus, public companies in jurisdictions which apply *Deloitte* should have greater freedom to brief auditors on legal issues facing the company.

The decision also suggests that work product may be shared with other, non-adversaries,

without creating a waiver. Thus, the *Deloitte* opinion relied on *United States v. Adlman*,²⁰ which accorded protection to work product of a tax payer's outside accounting firm regarding the risk of tax litigation in a merger. In *dictum*, the *Adlman* court stated that parties to a business transaction should be able to share work product about pending litigation to decide whether to proceed without running the risk of waiver.²¹ The *Deloitte* decision, which sought to promote efficient analysis of legal issues while maintaining the integrity of the adversarial process, supports such a result.

Contemplating sharing work product, companies should continue to guard against the risk of waiver.

Nonetheless, in contemplating sharing work product, companies should continue to guard against the risk of waiver and later disclosure to an adversary. First, the *Deloitte* decision does not protect against a claim of waiver of the attorney/client privilege. Second, it is a case of first impression in the courts of appeal and the *Texttron* case suggests a risk that some courts may disagree. Third, the *Deloitte* court cautioned that a provider of work product must establish that the documents shared are not likely to be relevant to the recipient in any dispute between the parties. It also is necessary to show that the disclosing party had a reasonable basis for believing that the work product would remain confidential, either because of pre-existing ethical standards imposed on the recipient, a common litigation interest with the receiving party, or a "relatively strong and sufficiently unqualified," confidentiality agreement.²²

NOTES

1. *United States v. Deloitte LLP*, F.3d ___, 2010 WL 2572965 (June 29, 2010).

2. For cases finding no waiver, see, e.g., *Regions Fin. Corp. v. United States*, No 2:06-CV-00895-RDP, 2008 WL 2139008 at *8 N.D. Ala, May 8, 2008); *Lawrence E. Jaffe pension Plan v. Household Int'l, Inc.*, 237 F.R.D. 176, 183 (N.D. Ill. 2006); *In re JDS Uniphase Corp. Sec. Lit.*, No. C-02-1486 CW, 2006 WL 286049, at *1 (N.D. Cal. Oct. 5, 2006); *Am. S.S. Owners Mut. Prot. & Indem. Ass'n v. Alcoa s.S. Co.*, No. 04-Civ.-4309, 2006 WL 278131 at *2 (S.D.N.Y. Feb. 2, 2006); *Frank Betz Assocs., Inc. v. Jim Walter Homes, Inc.*, 226 F.R.D. 533, 535 (D.S.C. 2005); *Merrill Lynch & Co., Inc., v. Allegheny Energy, Inc.*, 229 F.R.D. 441, 447-449 (S.D.N.Y. 2003); *In Re Honeywell Int'l. Inc. Sec. Litig.*, 230 F.R.D. 293, 300 (S.D.N.Y. 2003); *Gutter v. E.I. Dupont de Nemours s&Co.*, No. 95-CV-2152, 1998 WL 2017926 at I6 (S.D.N.Y. Dec. 23, 1993). For cases finding waiver, see, e.g., *Medinol, Ltd. v. Boston Scientific Corp.*, 214 F.R.D. 113, 115-117 (S.D.N.Y. 2002); *In Re Giasonics Sec. Litig.*, No. C-83-4584-RFP, 1986 WL 5402 at *1 (N.D. Cal. June 15, 1986).

3. *United States v. Deloitte LLP*, F.3d ___, 2010 WL 2572965 at *4.

4. *Id.*

5. *Id.* at *6.

6. 682 F.2d 530, 542 (5th Cir. 1982).

7. *Deloitte*, 2010 WL 2572965, at *8-10.

8. American Institute of Certified Public Accountants, AICPA Code of Professional Standards, Code of Professional Conduct § 101.08 (2005).

9. *Id.* Here the Court relied on AICPA Code of Professional Conduct § 301.01 "A member in public practice shall not disclose any confidential client information without the specific consent of the client.")

10. 577 F.3d 21 (1st Cir. 2009).

11. 577 F.3d 21, 22.

12. 577 F.3d 21, 27.

13. 577 F.3d 21, 29.

14. 577 F.3d 21, 30; The First Circuit noted that the tax accrual work papers had been shared with the company's outside auditors, *id.* at 24, but it did not hold that this sharing of information led to a waiver of work product protection. Instead, it concluded that the work papers were not entitled to protection at all.

15. *Deloitte*, 2010 WL 2572965, at* 6.

16. *Id.*

17. *Id.*

18. *Id.* at 11.

19. *Id.*

20. 134 F.3d 1194 (2d Cir. 1998).

21. 134 F.3d 1194, 1199-1200.

22. *Deloitte*, 2010 WL 2572965, at *9.

STATE CORNER

Recent Developments in the Use of Top-Up Options

By John F. Grossbauer and Joan-Alice M. Burn

Since first being developed early in the last decade, top-up options have become standard in two-step mergers. A “top-up” option is a stock option granted by the board of directors of a target corporation to an acquirer which has agreed to commence a tender offer, in most cases for all of the outstanding shares of the target corporation. By exercising the top-up option, the acquirer is able to purchase that number of newly issued shares of the target corporation’s capital stock which, when added to the number of shares of capital stock owned by the acquirer immediately following the tender offer, constitutes at least 90 percent of the outstanding shares of capital stock on a fully diluted basis. Virtually every two-step transaction considered in a recent study contained a top-up option.¹

The pervasiveness of top-up options in two-step mergers is understandable as these provisions appear to provide a “win-win” for acquirer and target. The acquirer benefits by allowing the back end of a merger transaction to close relatively quickly through the use of a short-form merger under Section 253 of the Delaware General Corporation Law (DGCL)² and the target’s stockholders benefit by permitting the non-tendering stockholders to receive cash sooner than would be the case if a formal stockholder meeting were required to

approve the back end merger. Despite the routine use of top-up options, the assumption that they provide a “win” for target stockholders has been challenged occasionally by plaintiffs’ lawyers.³ One recent case, *Olson v. ev3, Inc.*,⁴ highlights these challenges, and its outcome suggests the adoption of certain best practices that should be observed when drafting and disclosing such provisions.

The Challenges to Top-Up Options in *Olson v. ev3, Inc.*

At issue in *ev3* was the proposed acquisition of *ev3, Inc.* (*ev3*) by COV Delaware Corporation (COV), a Delaware Corporation wholly-owned by Covidien Group S.a.r.l. (Covidien).⁵ The transaction was structured as a two-step transaction with COV offering to purchase all outstanding shares of *ev3*’s common stock at a cash purchase price of \$22.50 per share and agreeing to promptly effect a short form merger thereafter.⁶ The agreement and plan of merger included a top-up option that COV would be required to exercise if, following the tender offer, it owned 75 percent of the shares.⁷ In *ev3*, Vice Chancellor Laster agreed to schedule an expedited injunction hearing focused on plaintiff’s claims that the top-up option was invalid for failure of consideration and that the top-up option granted by *ev3* was coercive and the disclosure related to it was inadequate.⁸

Technical Challenge

The technical challenge to the board’s agreement to accept a note as consideration for the issuance of the top-up shares centered on allegations that the board had not defined sufficiently the terms of the note at the time the option was approved. Section 157 (b) of the DGCL mandates that the terms of, and consideration for, options be stated in the certificate of incorporation or in a resolution adopted by the board of directors

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providing for the issuance of the options and detailed or incorporated by reference in the instrument evidencing the options.⁹ The *ev3* board's intention to finalize certain terms of the promissory note to be exchanged for the top-up shares in the event the option was exercised was challenged as a failure to set forth the terms of the consideration as required by statute and case law.¹⁰

Appraisal Dilution Theory

The plaintiff also alleged the top-up option coerced stockholders into accepting the tender price because the issuance of the top-up shares would dilute the value of the target's shares in a post-closing appraisal proceeding.¹¹ The alleged "appraisal dilution" stems from the fact that a top-up option requires that a large number of shares be issued at the merger price—an amount equal to 10 percent of the outstanding shares for every 1 percent by which the offer falls below the 90 percent threshold needed to accomplish a short-form merger under Section 253. Because these shares will be outstanding on the date the back end merger closes, as a technical matter, those shares, and the consideration paid for them, normally would be considered in an appraisal proceeding under Section 262 of the DGCL. If the shares are paid for with cash, the effect on appraised value may be neutral or even positive if the appraisal value is otherwise below the deal price.¹² However, if, like most top-up options, the consideration exchanged for the top-up shares is paid in the form of an unsecured note, plaintiffs may (and did in *ev3*) argue that the note could be worth substantially less than the merger price on a per share basis. This possibility, coupled with an alleged lack of disclosure about the mechanics of the top-up option, allegedly results in stockholders being coerced to tender into the deal, or at least not to elect to exercise appraisal rights.

Settlement Terms

The issues raised in *ev3*—how to handle the potential dilutive effect of a top-up option and

the disclosures required in connection with a top-up option—will, for now, remain unaddressed by a court as the parties agreed to settle the case before the Vice Chancellor had the opportunity to hear testimony. The settlement terms may, however, suggest a path forward.¹³

As part of the *ev3* settlement, the parties agreed to an amendment to the merger agreement providing that the top-up option consideration will be paid partly in cash (for the aggregate par value of the shares to be issued) with the remainder to be paid either in cash or by a promissory note, and setting forth the terms for such promissory note (including the interest rate).¹⁴ The *ev3* settlement agreement addressed the issue of "appraisal dilution" by including in the tender offer materials a statement that the parties had agreed "that, in any appraisal proceeding described herein, the fair value of the shares subject to the appraisal proceeding shall be determined in accordance with the DGCL without regard to the top-up option, any shares issued upon exercise of the top-up option or the Promissory Note."¹⁵

The approach taken here of expressly agreeing to exclude the top-up option shares from consideration in an appraisal proceeding was suggested in an article that Vice Chancellor Laster wrote in January 2009 before joining the bench in which he argued that merger partners should be able to address the issue by adding language in the merger agreement providing that the parties agree that any shares issued per the top-up option won't be considered for purposes of the appraisal.¹⁶ (The article did not, however, expressly suggest that such an agreement also provide that the value contributed for the shares to be issued should be excluded from the appraisal analysis, as was done in *ev3*, although that result is arguably implicit in the agreement to exclude the shares themselves.) The Vice Chancellor echoed this suggestion in *ev3* when he posited that the issue of appraisal dilution could be easily addressed by not counting those shares in the appraisal proceeding.¹⁷ Although he left open the question of whether the exclusion of

the top-up shares could be accomplished by agreement among the parties or by the court, he noted precedent for permitting parties to stipulate the number of shares in an appraisal proceeding and speculated that a court might be able to utilize the language of the appraisal statute itself to exclude the top-up shares from an appraisal proceeding on the theory that the shares represent “an element of value arising from the accomplishment or expectation of the merger.”¹⁸

Best Practice for Top-Up Options

The *ev3* settlement suggests certain best practices that acquirers and targets should follow to anticipate the types of challenges to the use of a top-up option made in that case:

- Merger agreements should include a provision that expressly addresses the treatment in an appraisal proceeding of top-up shares and the associated consideration. By expressly addressing this issue in the merger agreement, the acquirer and the target can reduce the uncertainty concerning how a court might address the issue in an appraisal proceeding.
- If the consideration to be exchanged for the top-up shares will include a note, then the specific terms of the note should be approved by the board and included in the disclosures.
- In addition, acquirers and targets should consider adding broader disclosure about the top-up option and its potential impact on appraised value in the tender offer materials in order to blunt any claims of inadequate disclosure about the top-up option and its effect (or lack thereof) on appraisal valuation.

NOTES

1. American Bar Association Mergers & Acquisitions Market Trends Subcommittee, 2009 Strategic Buyer/Public Target Mergers & Acquisitions Deal Points Study, at 106 (Sept. 10, 2009), available at <http://www.abanet.org/dch/committee.cfm?com=CL560003>. In 2008, with the exception of one transaction involving a controlling stockholder, 100 percent of the two-step transactions with a value over \$100 million in 2008 included a top-up option. *Id.*

2. 8 Del. C. § 253. Section 253 permits a corporation owning 90 percent of each outstanding class of voting stock to unilaterally complete a merger without any additional subsidiary board or stockholder approval.

3. *NECA-IBEW v. Prima Energy Corp.*, C.A. No. 522 (Del. Ch. June 30, 2004) (denying a motion to expedite a challenge to a “top-up” option founded on allegations that the option impermissibly interfered with stockholders’ voting rights); *In re Gateway Shareholders Litigation*, C.A. No. 3219-VCN (Del. Ch. Sept. 14, 2007) (granting a motion to expedite but characterizing as “far from compelling” claims that the top-up option served to avoid a stockholder vote and coerce stockholders into tendering their shares); J. Travis Laster and Matthew F. Davis, *Catching Up on Top Up Options*, 23 Insights (January 2009) at 9.

4. C.A. No. 5583-VCL (Del. Ch. June 25, 2010) (*ev3*).

5. *Olson v. ev3, Inc.*, C.A. No. 5583-VCL (Del. Ch. June 18, 2010) (complaint).

6. *ev3 Inc.*, Third Party Tender Offer Statement (Form SC TO-T), at iv (June 11, 2010).

7. *Id.*

8. *ev3*, transcript at 32. The Vice Chancellor refused to expedite based on the claims made regarding price and process, noting that this was an arm’s length deal with a third party and that all stockholders, including a stockholder that owns 24 percent of the common stock, are offered the same consideration. *Id.* at 14, 28-29.

9. 8 Del. C. § 157(b).

10. *ev3*, transcript at 24-25; 8 Del. C. § 157(b); see *Niehenke v. Right O Way Transp., Inc.*, C.A. Nos. 14392, 14444, Allen, C. (Del. Ch. Dec. 28, 1995) (finding option void and unenforceable where terms of option allegedly granted by board for the benefit of a director’s wife were not stated separately in either the certificate of incorporation or in a resolution adopted by the board).

11. *ev3*, transcript at 5-6. See also, *Chazen v. OSI Pharmaceuticals, Inc., et al.* (C.A. No. 5311-VCS); *Louisiana Municipal Police Employees’ Retirement System v. Ingram, et al.* (C.A. No. 5318-VCS); *Southeastern Pennsylvania Transportation Authority v. Ingram, et al.* (C.A. No. 5341-VCS); *Naiditch v. Ingram, et al.* (C.A. No. 5353-VCS) (collectively, OSI Pharmaceuticals) (another recent challenge to top-up options that raises the issue of appraisal dilution).

12. In an appraisal proceeding, although the court will determine the fair value of the shares of stock, a price resulting from arm’s-length negotiations with a third party may provide strong evidence of fair value. See *M.P.M. Entertainment, Inc. v. Gilbert*, 731 A.2d 790, 797 (Del. 1999) (“A merger price resulting from arm’s-length negotiations . . . is a very strong indication of fair price.”); *Van de Walle v. Unimation, Inc.*, 1991 WL 29303, at *17 (Del. Ch. Mar. 7, 1991) (“The fact that a transaction price was forged in the crucible of objective market reality (as distinguished from the unavoidably subjective thought process of a

valuation expert) is viewed as strong evidence that the price is fair.”). Moreover, because synergistic effects are not included in the appraisal valuation, the appraisal value as determined by the court in a strategic transaction could be lower than the merger price. *Union Illinois 1995 Inv. Ltd. Partnership v. Union Financial Group, Ltd.*, 847 A.2d 340, 353-354 (Del. Ch. 2004) (describing the discount applied to factor synergistic value out of the estimated fair value of a strategic transaction); *Tanzer v. International General Industries, Inc.*, 402 A.2d 382, 394-395 (Del. Ch. 1979) (noting that the appraisal statute precludes consideration of synergistic effect during an appraisal proceeding).

13. Although the parties have reached a settlement in principle, as of this writing the Court of Chancery has not approved the settlement.

14. The settlement terms also made it clear that guaranteed delivery shares are excluded from the purchaser’s ownership until delivered in settlement.

15. *ev3, Inc.*, Tender Offer Solicitation/Recommendation Statements (Form SC14D-9), at 10 (July 6, 2010). A similar approach was also taken in *Gateway*, where the settlement included an agreement not to assert for purposes of an appraisal proceeding that the number of shares would include the top-up shares. Laster and Davis, *supra*, at 14.

16. Laster and Davis, *supra*, at 13.

17. *ev3*, transcript at 33.

18. 8 *Del. C.* § 262(h). *See ev3*, transcript at 33-34.

IN THE COURTS

U.S. Supreme Court Decision in *Quon* Changes Workplace Privacy Law

By Jason C. Schwartz, Joshua P. Chadwick and Andrea R. Lucas

On June 17, 2010, the United States Supreme Court held that a city's review of a police officer's text messages sent while at work from his employer-issued pager constituted a reasonable Fourth Amendment search and suggested that the review "would be regarded as reasonable and normal in the private-employer context."¹ In its unanimous decision in *City of Ontario v. Quon*, the Court avoided direct resolution of the threshold question of whether the employee had a reasonable expectation of privacy.² In extensive dicta in his opinion for the Court, however, Justice Kennedy discussed multiple factors affecting the legitimacy of employees' privacy expectations in workplace communication devices.³

Both public- and private-sector employers should take note of *Quon*. First, as pointed out by Justice Scalia in his concurrence,⁴ lower courts and litigants are likely to use this dicta as guidance on when "operational realities" and societal expectations of privacy trigger Fourth Amendment protections for workplace technology and communications. Second, Fourth Amendment jurisprudence often influences case law dealing with the private employment context, due to the parallel standard of "reasonable expectations of privacy" underlying the right to privacy protected

by the common law.⁵ This is critical because of the important role of electronic communications in the modern workplace. Email and text message monitoring are often key sources of evidence in employer investigations of harassment, insider trading, trade secret misappropriation, and other issues. In this regard, careful planning and prudent employer policies may facilitate the lawful collection of such evidence while reducing the risk of invasion of privacy or similar claims.

The Supreme Court's Decision in *Quon*

The dispute in *Quon* arose from an internal affairs review of text messages sent by a SWAT team member on his employer-issued pager while at work. After issuing the pagers, the City informed its employees at a staff meeting and later in writing that all messages sent from the pagers would be considered equivalent to workplace email.⁶ As such, the City noted that the texts would be subject to the City's general technology-usage policy, which reserved the right to monitor and audit messages with or without notice.⁷ Quon previously had acknowledged his understanding and consent to the general policy.⁸ After Quon exceeded his monthly texting limit, the supervisor in charge of the texting contract reminded Quon of the official policy that texts were subject to auditing but informed him that he could reimburse the City for overage fees instead of being audited.⁹ The supervisor used this alternative practice of dealing with overages for Quon and other employees multiple times following the first incident.¹⁰ After a period of repeated overages by Quon, a member of the police department reviewed the content of the messages sent during working hours as part of an internal affairs investigation.¹¹ After Quon was disciplined for excessive personal use revealed by the investigation, he brought suit for violation of his Fourth Amendment rights, among other claims.¹²

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On appeal, the Ninth Circuit held that the City had violated Quon's Fourth Amendment rights by conducting a search that was unreasonable in scope. This holding was supported by the court's threshold conclusion that Quon had a reasonable expectation of privacy in the content of his text messages.¹³ This determination was based on a context-specific assessment of "operational realities" of the police department workplace, in particular the informal policy of allowing overage reimbursements without auditing which was established by the supervisor in charge of the pagers and applied repeatedly to Quon.¹⁴ Concluding that it could decide the case on the narrow grounds of whether there had been a reasonable search, the Supreme Court declined to officially rule on whether Quon had a reasonable expectation of privacy in his text messages' content; instead, the Court assumed this threshold finding for purposes of its analysis.¹⁵ Based on its determination that review of the text messages by the City was a reasonable search under the specific facts of the case, the Supreme Court reversed the Ninth Circuit's holding that the City violated Quon's Fourth Amendment rights.¹⁶

Despite the *Quon* Court's narrow holding, the opinion contains significant discussion in dicta concerning employee privacy expectations.¹⁷ This discussion stemmed from the Court's hypothetical application of the "operational realities" framework laid out by a plurality of the Court in *O'Connor v. Ortega*,¹⁸ an earlier case involving searches by government employers of their employees' physical workspaces. In *O'Connor*, the Supreme Court split on the proper analysis for determining if there were reasonable privacy expectations sufficient to trigger Fourth Amendment rights in a government workplace. A four-Justice plurality concluded that courts must conduct a case-by-case analysis and consider the effect of the "operational realities of the workplace" on employees' privacy expectations.¹⁹ In contrast, in his *O'Connor* concurrence, Justice Scalia concluded that the proper approach

was a bright-line rule that Fourth Amendment protections apply to government employee workplaces.²⁰

Although the Court in *Quon* stated that it would not choose between these approaches because it was unnecessary to resolve the dispute at hand, Justice Kennedy proceeded to note the potential factors the Court would consider "were we to assume that inquiry into "operational realities" were called for" to assess employee privacy expectations.²¹ These can be summarized into seven areas of inquiry affecting the existence of privacy expectations and their legitimacy: (1) whether official employer policy had been altered by informal practices with sufficient apparent and actual authority to set employer policy; (2) whether monitoring and review of such devices should have been anticipated based on the usual course of business in the workplace; (3) what general employer expectations were in society with regards to personal use of workplace communication-devices; (4) how the state statutory backdrop affected monitoring notice requirements; (5) to what degree society viewed technology such as cell phones and text messaging as part of an individual's self-expression or self-identification; (6) whether employees could have easily used equivalent, privately-purchased devices for personal use instead; and (7) whether the employer had set out clearly communicated policies concerning workplace communication-technology usage and monitoring.²²

Potential Impact of *Quon's* Dicta on Privacy Expectations Analysis

The *Quon* Court's dictum is likely to impact litigation in both the public- and private-employment contexts. In his concurrence in *Quon*, Justice Scalia noted that "[d]espite the Court's insistence that it is agnostic about the proper test" for assessing employee privacy expectations, "lower courts will likely read the Court's self-described "instructive" expatiation on how the *O'Connor* plurality approach would apply here . . .

as a heavy-handed hint about how *they* should proceed.”²³ He predicted that litigants would do likewise and “bombard[] lower courts with arguments about employer policies, how they were communicated, and whether they were authorized, as well as the latest trends in employees’ use of electronic media.”²⁴

Beyond its relevancy to government employers in Fourth Amendment privacy litigation, *Quon* is likely to affect litigation involving private employers. The common law tort of invasion of privacy, for example, generally requires proof that the “intentional intrusion . . . would be highly offensive to a reasonable person.”²⁵ Courts frequently frame this inquiry as whether the plaintiff employee had a reasonable expectation of privacy in the area upon which he or she was intruded, and cite case law analyzing the reasonableness of privacy expectations under state privacy tort law and the Fourth Amendment interchangeably.²⁶ It is expected that the Supreme Court’s treatment of the issue in *Quon* will be applied in private-sector employment litigation.

Practical Implications

In light of *Quon*, private sector employers should consider taking several steps to minimize risk in monitoring employee communications. At a minimum, employers should have a written policy specifically addressing workplace communications usage and monitoring. The policy should address every form of technology that the employer intends to regulate or monitor; and employers should emphasize that all technology and communication devices and systems are employer property subject to employer control and monitoring. It is critical that employers clearly convey that even if personal use of employer-issued technology is allowed, employees should not have any expectation of privacy.

In addition, employers should obtain written acknowledgement and consent from employees to their usage and monitoring policies. In drafting or

revising their policies, employers should be cognizant of the growing body of state and federal law in this area.²⁷ They also should take care to keep abreast of technology developments and update their policies as technology and the law evolve. In addition, employers should provide appropriate guidance to supervisors about the dangers of informal practices undermining official employer policy. Finally, when reviewing employee electronic communications, employers should proceed carefully and in a manner consistent with their policies.

Conclusion

Quon is part of a larger emerging body of employee and communication-technology privacy law that is both shaping and being shaped by current societal expectations of privacy. Amidst this changing landscape, *Quon* joins a large body of precedent that clearly indicates the important role that workplace policies play in setting privacy expectations. Following the best practices recommended above will help minimize employer liability.

NOTES

1. *City of Ontario v. Quon*, No. 08-1332, slip op. at 16 (U.S. June 17, 2010) (quoting Justice Scalia’s concurrence in *O’Connor v. Ortega*, 480 U.S. 709, 732 (1987)).
2. *Id.* at 9.
3. *Id.* at 10–11.
4. *Id.* at 2–3 (Scalia, J., concurring).
5. *See In Re Asia Global Crossing, Ltd.*, 322 B.R. 247, 257 (S.D.N.Y. 2005).
6. *Quon*, No. 08-1332, slip op. at 2–3 (majority opinion).
7. *Id.*
8. *Id.* at 2.
9. *Id.* at 3.
10. *Id.*
11. *Id.* at 4.
12. *Id.* at 5.
13. *Quon v. Arch Wireless Operating Co.*, 529 F.3d 892, 907 (9th Cir. 2008).
14. 529 F.3d 892, 907.
15. 529 F.3d 892, 907, No. 08-1332, slip op. at 9.

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16. 5 No. 08-1332, slip op. at 16.
 17. *Id.* at 9–12.
 18. 480 U.S., 709, 717–718.
 19. 480 U.S., 709, 717–718; *see also Treasury Employees v. Von Raab*, 489 U.S. 656, 671 (1989).
 20. 480 U.S. 709, 731.
 21. *Quon*, No. 08-1332, slip op. at 10 (quoting *O'Connor*, 480 U.S. 709, 717).
 22. *Id.* at 10–11.
 23. *Id.* at 2 (Scalia, J., concurring) (emphasis in original).
 24. *Id.* at 2–3.
 25. *Thygeson v. U.S. Bancorp*, No. 03-467, 2004 U.S. Dist. LEXIS 18863, at *61 (D. Or. 2004); *see also Brown-Crisuolo v. Wolfe*, 601 F. Supp. 2d 441, 455 (D. Conn. 2009); *Hilderman v. Enea TekSci, Inc.*, 551 F. Supp. 2d 1183, 1203 (S.D. Cal. 2008).
 26. *See, e.g., Thygeson*, No. 03-467, 2004 U.S. Dist. LEXIS at *61–*75; *Pietrylo v. Hillstone Rest. Grp.*, No. 06-5754 (FSH), 2008 U.S. Dist. LEXIS 108834, at * 17–20 (D.N.J. 2008); *Pure Power Boot Camp Inc. v. Warrior Fitness Boot Camp, LLC*, 587 F. Supp. 2d. 548, 559–560 (S.D.N.Y. 2008); *In Re Asia Global Crossing, Ltd.*, 322 B.R. 247, 256–258 (S.D.N.Y. 2005); *accord Stengart v. Loving Care Agency*, 990 A.2d 650 (N.J. 2010) (affording heightened protection to personal and attorney-client privileged communications made by employees on employer-provided devices and systems).
 27. A body of state statutes regulating employer monitoring has developed recently. For example, Connecticut and Delaware have recently passed laws requiring employers to give employees notice of monitoring. Conn. Gen. Stat. § 31-48d (2010); Del. Code Ann., Tit. 19, § 705 (2010). There are also a number of potentially relevant federal statutes, including the Electronic Communication Privacy Act of 1986 (ECPA), 18 U.S.C. § 2511 (2010), and the Stored Communications Act (SCA), 18 U.S.C. § 2701 (2010). The House Judiciary Committee is currently holding hearings on reforming the ECPA in light of the numerous technological changes that have occurred since its original passage. *See* Press Release, Representative Jerrold Nadler, Nadler Considers Possible Reforms to the Electronic Communications Privacy Act (May 5, 2010), available at http://nadler.house.gov/index.php?option=com_content&task=view&id=1443&Itemid=119.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Ballard Spahr LLP Philadelphia, PA (212-665-8500)

SEC Approves Amendments to Rule 15c2-12 (June 29, 2010)

A discussion of SEC amendments to Rule 15c2-12 of the Securities Exchange Act of 1934 (Exchange Act) that apply to underwriters who are participating in a primary offering of municipal securities.

Cleary, Gottlieb, Steen & Hamilton LLP New York, NY(212-225-2000)

European Commission Publishes Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies in the Financial Section (June 16, 2010)

A discussion of a Green Paper issued by the European Commission setting out suggestions to improve corporate governance in financial institutions and remuneration policies in the financial sector.

U.S. Supreme Court Limits Scope of Federal “Honest Services” Fraud Statute in Prosecutions of Jeffrey Skilling and Conrad Black (June 24, 2010)

A discussion of two Supreme Court opinions that significantly restrict the scope of the “honest services” fraud statute. The Court declined to rule that the law should be invalidated, but limited “honest services” fraud to reach only bribery and kickback schemes.

U.S. Supreme Court Upholds Sarbanes-Oxley Act and Public Company Accounting Oversight Board (June 30, 2010)

A discussion of the Supreme Court decision, *Free Enter. Fund v. Pub. Co. Accounting Oversight Bd.*, rejecting a broad constitutional challenge to the existence of the Public Company Accounting Oversight Board (Board). The Court held the removal restrictions violate the separation of powers section of the Constitution, but also held that members of the Board were validly appointed under the appoints clause of the Constitution. Thus, the Board can continue to operate, but the SEC now will have the ability to remove its Board members at will.

Davis Polk & Wardwell LLP New York, NY (212-450-4000)

Supreme Court to Address Securities Fraud Pleading Standards (June 16, 2010)

A discussion of the Supreme Court’s grant of certiorari in *Matrixx Initiatives, Inc. v. Sircusano*, which presents the Court with an opportunity to address conflicting standards in the US Court of Appeals for determining when a pharmaceutical manufacturer’s non-disclosure of reports of adverse effects may give rise to liability under Rule 10b-5 and Section 10(b) under the Exchange Act.

Faegre & Benson LLP Minneapolis, MN (612-766-7000)

SEC Continues to Deny Finders Exemption from Broker-Dealer Registration (June 23, 2010)

A discussion of a recent SEC response to a no-action letter involving the law firm of Brumber, Mackey & Wall, P.L.C. and relating to the finder exception from broker-dealer registration. The SEC refused to grant relief emphasizing the transaction-based compensation that the law firm would be receiving.

**Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-329-7870)**

**Amendments to the EU Prospectus
Directive: Summary of Key Changes
(June 23, 2010)**

A discussion of key changes to the EU Prospectus Directive that goes into effect in September/October 2010 and that member countries must implement within 18 months thereafter.

**K&L Gates
Pittsburgh, PA (412-355-6500)**

**SEC Proposes Tougher Disclosure Rules
for Target Date Funds (June 2010)**

A discussion of SEC proposed rule changes designed to “help clarify the meaning of a date in a target date fund’s name and enhance the information provided to investors in these funds as they invest for retirement.”

**Mayer Brown LLP
Chicago, IL (312-782-0600)**

**Court Reaffirms Limits on
Auditor Liability to Third Parties
(June 30, 2010)**

A discussion of a Third District Court of Appeal for the State of Florida decision reversing entry of judgment on a \$510 million jury verdict against BDO Seidman and remanding for a new trial. In its decision, the court reiterated a number of legal principles of particular relevance to public accounting firms.

**Milbank, Tweed, Hadley & McCloy LLP
New York, NY (212-530-5000)**

**Delaware Court Applies Entire
Fairness Analysis to Corporate
Transactions with Controlling Shareholder
(June 21, 2010)**

A discussion of a Delaware Court of Chancery decision, *Gentile v. Rosette*, reaffirming the duty of a board of directors to establish the “entire fairness” of both the process and the price of a transaction likely to benefit a controlling shareholder. The decision also points out that a director who approves a transaction found not to be entirely fair will not be held personally liable for damages as long as the director acts “loyally and in good faith” and the corporation’s charter includes appropriate exculpatory language.

**Delaware Court Clarifies Rules
of the Road for Assessing Direct
and Derivative Shareholder Claims
(June 15, 2010)**

A discussion of a Delaware Court of Chancery decision, *MCG Capital Corporation v. Jenzaber, Inc.*, clarifying the right of preferred shareholder to bring derivative claims and the considerations for an aggrieved shareholder when commencing a lawsuit alleging both direct and derivative claims.

**Shearman & Sterling LLP
New York, NY (212-848-4000)**

**Review of the UK Takeover Code
(June 23, 2010)**

A discussion of the announcement by the UK Panel on Takeovers and Mergers of a wide-ranging review of a number of fundamental principles of UK takeover regulation contained in the Panel’s City Code on Takeovers and Mergers. According to the memoranda, this review was prompted at least in part by the

controversial and ultimately successful bid by Kraft for Cadbury.

Wachtell, Lipton, Rosen & Katz
New York, NY (212-403-1000)

Sarbanes-Oxley Clawback Developments
(June 16, 2010)

A discussion of the SEC's significant victory in a case, *SEC v. Jenkins*, which is part of its campaign to use the "clawback" under the Sarbanes-Oxley Act of 2002 to force the return of incentive-based compensation by CEOs and CFOs to issuers even when they are not personally responsible for any alleged "misconduct."

INSIGHTS

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