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RE: *Kalisman, et al. v. Friedman, et al.*, C.A. No. 8447-VCL

Dear Counsel:

Plaintiff Jason Taubman Kalisman is a director of nominal defendant Morgans Hotel Group Co. (“Morgans” or the “Company”). The individual defendants are the remaining members of the Company’s board of directors. Kalisman has filed a motion to

compel (the “Motion”) seeking a determination that Morgans cannot invoke the attorney-client privilege or work product doctrine against Kalisman because of his status as a director. The defendants opted to file a redundant cross-motion for protective order. *See* Ch. Ct. R. 37(a)(4)(B) (“If the motion [for order compelling discovery] is denied, the Court may enter any protective order authorized under Rule 26(c)”). I have treated the cross motion as an opposition to the Motion. Subject to specified parameters, the Motion is granted.

FACTUAL BACKGROUND

Morgans is a Delaware corporation whose common stock trades on the NASDAQ. In addition to serving as a director of Morgans, Kalisman is a founding member of co-plaintiff OTK Associates, LLC (“OTK”), currently Morgans’ largest single common stockholder with approximately 13.9% of the outstanding common stock.

Kalisman has served as a director of Morgans since April 2011. From July 2011 until March 2013, he served on the Corporate Governance and Nominating Committee. In December 2011, the board established a committee to evaluate potential strategic alternatives for the Company (the “Special Committee”). The members of the Special Committee are Kalisman and defendants Michael D. Malone, Thomas L. Harrison, and Robert Friedman. The Special Committee retained Greenhill & Co., Inc. as its financial advisor and Richards, Layton & Finger, P.A. (“RLF”) as its counsel.

According to Kalisman, the Special Committee developed a range of options for the Company, but the process of exploring strategic alternatives stalled in November 2012. It then resumed in earnest shortly after March 18, 2013, when OTK announced that it would nominate candidates for election and make certain business proposals at the Company’s annual meeting. At the time, the annual meeting was scheduled for May 15 with a record date of March 22. All eight of the Company’s directors would stand for election. OTK proposed to nominate seven candidates, including Kalisman.

But while the defendants allegedly sprang into action after OTK’s announcement, they kept their activities secret from Kalisman. When he asked for information, he was told nothing was in the works.

Kalisman learned the truth on Friday, March 29, 2013, when Company counsel notified him via email that a special meeting of the board would take place the following day to review, consider, and approve a recapitalization. Under the terms of the transaction, the Company would transfer one of its signature assets, the Delano Hotel in Miami Beach, Florida, and one of its subsidiaries, The Light Group, to entities affiliated with The Yucaipa Companies LLC (collectively, the “Yucaipa Investors”). The Yucaipa Investors are controlled by defendant and Company director Ronald W. Burkle. In

exchange, the Yucaipa Investors would transfer to the Company 75,000 shares of its Series A preferred stock, warrants to purchase 12.5 million shares of its common stock, and \$88 million of its notes. In addition, the Yucaipa Investors would backstop a \$100 million rights offering. If any shares were not purchased in the rights offering, the Yucaipa Investors would have the right to purchase those shares. According to the complaint, the board anticipated that many of the Company's stockholders would not participate in the rights offering and that the Yucaipa Investors would emerge with a block of approximately 32% of the Company's common stock.

The email informing Kalisman of the special meeting attached eleven documents: (1) a summary of the recapitalization (twelve single-spaced pages); (2) draft resolutions approving the recapitalization (nineteen single-spaced pages); (3) a draft exchange agreement (ninety-one single-spaced pages including exhibits); (4) an amendment to the Company's rights plan (three single-spaced pages); (5) amended corporate governance guidelines (seven single-spaced pages); (6) a draft investment agreement (fifty-eight single-spaced pages including schedules); (7) a membership interest purchase agreement (eighty-four single-spaced pages including exhibits); (8) a draft registration rights agreement (nineteen single-spaced pages); (9) a waiver, release, assignment and termination agreement (seven single-spaced pages); (10) a Deutsche Bank commitment letter (eighty-three single-spaced pages including schedules); and (11) a CFO certificate (two single-spaced pages).

Later on March 29, 2013, the Special Committee's counsel notified Kalisman via email that the committee members would convene the next day to consider the recapitalization. The email attached (i) a memorandum from counsel opining that the recapitalization would not require a stockholder vote under Section 271 of the Delaware General Corporation Law (fifteen single-spaced pages) and (ii) draft committee resolutions (eight single-spaced pages). During the evening of March 29, Greenhill distributed a presentation on valuation issues (fifty-four pages).

Traditionally, the Company had not scheduled special meetings on such short notice. Nor had the Company traditionally provided such extensive amounts of information on the day before a meeting.

On March 30, 2013, at 2:00 p.m., the Special Committee met. Kalisman objected to the adequacy of notice. The Special Committee then voted to create a subcommittee comprising the directors other than Kalisman. After that, the meeting was adjourned.

On March 30, 2013, at 4:30 p.m., the board met. Kalisman objected to the adequacy of notice. The Special Committee members were asked to vote on the recapitalization. Other than Kalisman, they voted in favor. The board then voted on the recapitalization. Other than Kalisman, they voted in favor.

On April 1, 2013, Morgans announced the recapitalization. Morgans also announced that it was postponing the annual meeting until July 10 and deferring the record date until May 29. Morgans stated that the purpose of the postponement was to enable stockholders who purchased shares in the rights offering to vote at the annual meeting. The rights were scheduled to begin trading on April 18 with the subscription period to end on May 8.

Also on April 1, 2013, Kalisman filed a complaint challenging the postponement of the annual meeting, the resetting of the record date, and the completion of the recapitalization. Kalisman sought a prompt hearing on a motion for a temporary restraining order to be followed by a hearing on an application for preliminary injunction. The defendants opposed expedition, arguing among other things that the Company's liquidity constraints made it critical that the recapitalization close as scheduled and that further harm would result because Deutsche Bank's commitment letter would expire. A hearing on the motion for a temporary restraining order was scheduled for April 17, the day before the rights would begin to trade. A hearing on an application for preliminary injunction was scheduled for May 13.

On April 9, 2013, the Company announced that it had rescheduled the rights offering so that the subscription period would not close until after the record date for the Company's annual meeting. Apparently the Company's liquidity constraints were not as dire, nor Deutsche Bank as inflexible, as previously represented. In light of the Company's change of position, the hearing on the motion for temporary restraining order was taken off the calendar.

Meanwhile, Kalisman moved forward with this litigation, and OTK intervened to cure the defendants' objection that Kalisman lacked standing to sue derivatively on behalf of the Company. On April 3, 2013, Kalisman served his first requests for production of documents. That same day, Kalisman asked the defendants to explain how they proposed to handle the attorney-client privilege and work product doctrine in light of Kalisman's status as a director. The defendants said they were considering it.

On April 4, 2013, Kalisman served a subpoena on the Company's legal advisors at Potter, Anderson & Corroon LLP, which represented Morgans in the period leading up to the announcement of the recapitalization. Kalisman also served a subpoena on RLF, counsel to the Special Committee. On April 12, Kalisman served additional subpoenas on Hogan Lovells US LLP, and Sullivan & Cromwell LLP, additional counsel to the Company. Kalisman followed up unsuccessfully with the defendants to determine their position on privilege. To address the risk of waiver, Kalisman proposed a three-tier confidentiality stipulation that would include a "Kalisman-only" category of documents.

Not until April 11, 2013, did the defendants finally respond substantively on the privilege issue, taking the position that they would assert the attorney-client privilege and work product doctrine notwithstanding Kalisman's status as a director. On April 15, Kalisman filed the Motion, in which he asserts that the defendants cannot invoke the attorney-client privilege or work product doctrine against him.

LEGAL ANALYSIS

A director's right to information is "essentially unfettered in nature." *Schoon v. Troy Corp.*, 2006 WL 1851481, at *1 n.8 (Del. Ch. June 27, 2006) (quoting *Milstein v. DEC Ins. Brokerage Corp.*, C.A. Nos. 17586, 17587, at 3 (Del. Ch. Feb. 1, 2000) (TRANSCRIPT)); *accord Intrieri v. Avatex*, 1998 WL 326608, at *1 (Del. Ch. June 12, 1998); *Belloise v. Health Mgmt., Inc.*, 1996 Del. Ch. LEXIS 127, at *36 (Del. Ch. June 11, 1996) (Allen, C.). The right includes "equal access to 'board information.'" *Moore Bus. Forms, Inc. v. Cordant Hldgs. Corp.*, 1996 WL 307444, at *5 (Del. Ch. June 4, 1996); *accord Intrieri*, 1998 WL 326608, at *1 ("a sitting director is entitled to . . . receive whatever the other directors are given"). A company "cannot pick and choose which directors will receive [which] information." *Hall v. Search Capital Grp., Inc.*, 1996 WL 696921, at *2 (Del. Ch. Nov. 15, 1996).

The director's right to information extends to privileged material. As a general rule, "a corporation cannot assert the privilege to deny a director access to legal advice furnished to the board during the director's tenure." *Moore*, 1996 WL 307444, at *4; *see id.* at *6 ("Mr. Rogers was a member of that board, having the same status as the other directors. No basis exists to assert the privilege against him . . ."). The rationale for this rule is that "all directors are responsible for the proper management of the corporation, and thus, should be treated as a 'joint client' when legal advice is rendered to the corporation through one of its officers or directors." Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* § 7.02[d], 7-46 (2012) (footnote omitted); *see Moore*, 1996 WL 307444, at 4 n.4 (same); *Kirby v. Kirby*, 1987 WL 14862, at *7 (Del. Ch. July 29, 1987) (same).

Under these precedents, Morgans cannot pick and choose which directors get information by asserting the attorney-client privilege against Kalisman but not against the defendant directors. Kalisman has a right of equal access to the materials he seeks in his capacity as a director of Morgans and in light of his status as a joint client of the subpoenaed law firms. Under Delaware law, there is no privilege "[a]s to a communication relevant to a matter of common interest between or among 2 or more clients if the communication was made by any of them to a lawyer retained or consulted in common, when offered in an action between or among any of the clients." D.R.E. 502(d)(6); *see* 1 Paul R. Rice, *Attorney-Client Privilege In The United States* § 4:30 (2012) ("[B]ecause each client has equal rights to the protection of the privilege, one of

the joint clients . . . cannot assert the privilege against the other if they subsequently become adversaries.”).

Citing cases from other jurisdictions, the defendants argue for a different rule under which a board majority can invoke the attorney-client privilege against a fellow director and deprive the director of information. *See Am. S.S. Owners Mut. Protection & Indem. Ass'n, Inc. v. ALCOA S.S. Co., Inc.*, 232 F.R.D. 191, 198 (S.D.N.Y. 2005) (federal common law); *Milroy v. Hanson*, 875 F. Supp. 646 (D. Neb. 1995) (Nebraska law). Those decisions do not accurately describe the law of this State. Under Delaware law, each director has a right to information that is “correlative with his duty to protect and preserve the corporation.” *Henshaw v. Am. Cement Corp.*, 252 A.2d 125, 128 (Del. Ch. 1969). “The rights of directors to access the corporate books and records are recognized by Delaware law as of fundamental importance and a necessary concomitant to the imposition upon directors of fiduciary duties.” *Holdgreiwe v. The Nostalgia Network, Inc.*, 1993 WL 144604, at *3 (Del. Ch. Apr. 29, 1993).

There are three recognized limitations on a director’s ability to access privileged information. First, the director’s right can be diminished “by an *ex ante* agreement among the contracting parties.” *See Moore*, 1996 WL 307444, at *5. The extent to which an *ex ante* agreement is subject to recognized limitations on the ability of a fiduciary to contract away its duties or agree to conduct that would lead to breach has not been fully determined. No one alleges that an *ex ante* agreement existed in this case, so I do not address this limitation further.

Second, a board can act “pursuant to 8 *Del. C.* § 141(c) and openly with the knowledge of [the excluded director] to appoint a special committee.” *Moore*, 1996 WL 307444, at *6. A committee “would [be] free to retain separate legal counsel, and its communications with that counsel would [be] properly protected,” at least to the extent necessary for the committee’s ongoing work, such as conducting a special committee investigation or negotiating an interested transaction. *Id.* The degree to which such a committee would need to provide some form of update periodically or upon request to other directors or the board has not been fully determined and is likely fact-dependent, as is the extent to which a committee can protect its information from other directors or the board after its work has been completed. In the current case, Kalisman was a member of the Special Committee and a joint client of RLF. His fellow directors did not act openly and with his knowledge until March 30, when the other members of the Special Committee formed the subcommittee. Kalisman has challenged the formation of the subcommittee, but for present purposes I will treat its formation as sufficient for the valid assertion of privilege with respect to the committee’s work and RLF’s advice from that point onward.

Third, a board or a committee can withhold privileged information once sufficient adversity exists between the director and the corporation such that the director could no longer have a reasonable expectation that he was a client of the board's counsel. *See SBC Interactive, Inc. v. Corporate Media P'rs*, 1997 WL 770715, at *6 (Del. Ch. Dec. 9, 1997). In this case, the adversity exception applies from March 30, 2013 on with respect to the recapitalization and the matters at issue in this litigation. After the meetings of the Special Committee and the board on that date, Kalisman could no longer have a reasonable expectation that he was a client of the board's counsel or the Special Committee's counsel with respect to the recapitalization and other matters placed at issue in this case. Although tensions likely began rising between Kalisman and his fellow directors as soon as OTK proposed to nominate its own slate, the defendants chose to respond in secret and to conceal their activities until March 30. Company counsel went so far as to represent to Kalisman, days before the March 30 meeting, that no transaction was under consideration. In light of the defendants' efforts to mislead Kalisman, it would be inequitable to give them the benefit of an earlier date for purposes of limiting Kalisman's informational rights.

The defendants contend that Kalisman will use privileged information to harm the Company in violation of his fiduciary duties. Delaware law presumes that directors act "in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Fear that a director "may abuse his position as a director and make information available to persons hostile to the [c]orporation or otherwise not entitled to it" does not provide grounds for the corporation to refuse to provide the information. *Henshaw*, 252 A.2d at 129. "If [Kalisman] does violate his fiduciary duty in this regard, then the Corporation has its remedy in the courts." *Id.* The fact that a director potentially faces a breach of fiduciary duty claim and remedial consequences if he misuses information serves to ensure that a director only will assert his rights when his need for information is *bona fide*.

If Morgans had concrete evidence that Kalisman would use privileged information improperly, then that fact might counsel in favor of a different result. *See Schoon v. Troy Corp.*, 2006 WL 1851481, at *1 (Del. Ch. June 27, 2006) (finding that director had improper purpose for seeking information when director represented stockholder that wanted to sell its shares and director would be compensated by the stockholder based on a percentage of the price achieved). It is far from clear at this stage whether either side can claim the moral high ground. "As former Chancellor Allen has said, the most interesting corporate law cases involve the color gray, with contending parties dueling over close questions of law, in circumstances when it is possible for each of the contestants to claim she was acting in good faith." *Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1028 (Del. Ch. 2004) (citing William T. Allen, *Ambiguity In Corporation Law*, 22 Del. J. Corp. L. 894, 899 (1997)), *aff'd*, 872 A.2d 559 (Del. 2005). One can

readily envision scenarios in which both sides could believe they were acting loyally and in a manner required by their fiduciary duties.

The defendants also argue that Kalisman will share the information with OTK. When a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director. *See Moore*, 1996 WL 307444, at *4; *KLM v. Checchi*, 1997 WL 525861, at *2-3 (Del. Ch. July 23, 1997); *AOC Ltd. P'ship v. Horsham Corp.*, 1992 WL 97220, at *1 (Del. Ch. May 5, 1992). Any dispute on this issue is not yet ripe, because Kalisman has undertaken *not* to share privileged information with OTK, and his three-tiered confidentiality order implements this approach.

Because Kalisman has included in his complaint counts that seek to enforce his informational rights under the common law and pursuant to Section 220(d), the defendants say it would be improper to grant him the same information in discovery in this proceeding. *See, e.g., Norfolk Cnty. Ret. Sys. v. Jos. A. Bank Clothiers, Inc.*, 2009 WL 353746, at *13 n.106 (Del. Ch. Feb. 12, 2009), *aff'd*, 977 A.2d 899 (Del. 2009) (TABLE). At this point in the case, the informational counts are likely superfluous. What Kalisman actually seeks is discovery in support of his plenary claims.

The defendants argue most vigorously that Kalisman cannot obtain discovery because he lacks standing to sue derivatively for breach of fiduciary duty. Kalisman asserted those claims originally because only he knew the relevant information, no stockholder was in a position to sue, time was of the essence, and consequently a "failure of justice" would occur if Kalisman did not bring the action. *Schoon v. Smith*, 953 A.2d 196, 210 (Del. 2008). Consistent with the Delaware Supreme Court's decision in *Schoon*, OTK promptly intervened in its capacity as a stockholder to assert the derivative claims. *See id.* at 208-09 (holding that there was no need for director derivative standing on the facts presented because the stockholder that had nominated the director was able to sue).

Kalisman argues that he continues to have standing to maintain the derivative claims because there is information that OTK cannot access. I need not reach that issue, because Kalisman has standing to maintain and can seek discovery with respect to his direct claims. To establish standing, a plaintiff must demonstrate that (i) he suffered an injury in fact, (ii) there is a causal connection between the injury and the conduct complained of, and (iii) the injury will likely be redressed by a favorable decision. *In re Celera Corp. S'holder Litig.*, 59 A.3d 418, 429 (Del. 2012). Kalisman contends that the board and Special Committee meetings were improperly noticed and that the defendants breached an obligation to deal candidly with him as a director. He alleges that he suffered an injury to his rights when the defendants violated Delaware law and Section

2.4 of the Company's bylaws by failing to provide adequate notice of the March 30 meetings and more generally when they froze him out of the deliberative process. The injuries to Kalisman and his legal rights resulted directly from the defendants' actions, and a favorable decision would remedy Kalisman's injuries by potentially invalidating the votes taken at the meetings and the resulting transactions. Kalisman therefore has standing to pursue his direct claims. All of the information that Kalisman seeks is relevant to and discoverable in connection with his direct claims.

The defendants lastly argue that Kalisman's requests are too numerous and overly broad. They ask at a minimum that the law firms be obligated only to produce external communications. Having reviewed Kalisman's requests, they appear appropriately targeted for this action and are drafted in a straightforward manner. The parties have negotiated search terms, and the volume of documents to be reviewed is not excessive in light of the gravity of the issues and the number of sophisticated law firms involved. The granting of the motion to compel should lessen the burden on the defendants, because they will not have to review documents for privilege or prepare a privilege log. Although the defendants have identified two transcript rulings in which the Court limited the production obligation of law firms to external communications when the waiver of privilege resulted from an advice-of-counsel defense, the current situation is different. In an advice-of-counsel situation, the key question is what the client was told. Here, the issues to be litigated involve the planning and scheduling of the meetings and the related structuring of the recapitalization. Just as internal discussions among investment bankers are relevant to transactional challenges and routinely produced, the internal discussions among lawyers are relevant and subject to production here.

The foregoing discussion has focused on the attorney-client privilege, but the principles apply equally to work product. A law firm cannot invoke the work product doctrine against its own client. *See, e.g., Spivey v. Zant*, 683 F.2d 881, 885 (5th Cir. 1983) (“[T]he work product doctrine does not apply to the situation in which a client seeks access to documents or other tangible things created or amassed by his attorney during the course of the representation.”); *Gottlieb v. Wiles*, 143 F.R.D. 241, 247 (D. Colo. 1992) (“An attorney may not withhold work product from his own client.”).

CONCLUSION

The Motion is granted. Defendants cannot assert the attorney-client privilege or work product doctrine against Kalisman, except as to legal advice and work product relating to the matters that are the subject of this litigation and post-date the board meeting on March 30, 2013. The documents shall be produced subject to Kalisman's proposed three-tier confidentiality order and may be designated as “Kalisman-only” to the extent applicable.

This ruling addresses only the production of documents. It does not address their use or potential restrictions that may be necessary to avoid or limit any waiver of privilege. Once Kalisman and his counsel have identified the documents that Kalisman intends to use in this litigation, the parties shall meet and confer regarding what additional precautions, if any, may be appropriate.

Sincerely yours,

/s/ J. Travis Laster

J. Travis Laster
Vice Chancellor

JTL/krw