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Delaware Court of Chancery Issues Guidance for Dealing with Dissident Directors

In a series of recent rulings, the Delaware Court of Chancery has provided guidance for boards coping with dissident directors. [*Kalisman v. Friedman*, C.A. No. 8447-VCL](#).

OTK Associates, LLC is the largest stockholder of Morgans Hotel Group Co. Jason Kalisman is a founding member of OTK and a member of the Morgans board and, since late 2011, was a member of a special committee of the Morgans board tasked with evaluating the company's strategic alternatives. In mid-March 2013, OTK announced that it intended to run a proxy contest for control of Morgans at its next annual meeting, then scheduled for May 15. After this announcement, Kalisman claimed, the committee kept him in the dark as it sought to push back the annual meeting date to July and negotiate a recapitalization and sale transaction with a third party. Skirmishing in the courts ensued, as Kalisman demanded broad access to company information—including attorney-client information—and an injunction barring postponement of the meeting.

The Court of Chancery largely sided with the dissident. As to Kalisman's information demands, the court held that a director's right to company information is "essentially unfettered in nature," and companies may not pick and choose which directors receive which information. The court held that Kalisman should be treated as a "joint client" in respect of legal advice rendered to the company, insofar as he—like the other directors—had a responsibility for proper management of the company. The court thus determined that Kalisman was entitled to receive privileged company information. And in response to the company's concern that Kalisman would share the materials with OTK, the court concluded that "[w]hen a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director," noting, however, that the director could be held to account if company information was misused as a result.

At a later hearing on the merits, the court found on a preliminary record that the board had deprived Kalisman of his rights to participation, impaired the ability of the board to engage in a collective deliberative process, and appeared to have moved the meeting date to improperly favor the incumbents. The court thus enjoined Morgans from proceeding with the proposed recapitalization transaction and barred the company from delaying the vote past mid-June. The meeting proceeded on June 14, and the entire dissident slate was elected.

The Morgans matter offers important lessons for boards dealing with dissident members. While the court recognized broad director information rights, it also noted important limitations on the rights of dissident directors, expressly observing that a board can create a special committee (or a committee can create a subcommittee) that excludes certain directors. So long as this is done on an appropriate record and with the knowledge of the excluded directors, such a committee can retain separate legal counsel and its communications with counsel will, to the extent necessary for the committee's work (such as negotiating a transaction), remain privileged relative to the excluded directors. Similarly, the court indicated that when a defendant corporation can show "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," the board or committee may withhold privileged information from the adverse director.

On the substantive matters, the ruling shows that decisions taken without proper notice to a dissident, or otherwise not in accordance with good governance practices, will be subject to harsh judicial scrutiny, and that the courts will not hesitate to interfere with corporate action apparently designed to interfere with an electoral challenge or a transaction undertaken to thwart a dissident. The episode reaffirms that while well-counseled boards can create significant leeway to respond to dissident directors, they must be careful to establish a record of open and informed deliberation that facilitates the ability of all directors to fulfill their fiduciary duties.

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