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THE INTERPLAY OF ATTORNEY-CLIENT PRIVILEGE AND "ADVERSE" DIRECTORS IN NEW YORK

By: JOAN M. SECOFSKY | RICHARD I. JANVEY

The "popular wisdom" is that a corporate director has an absolute right to inspect the corporation's books and records, including communications from corporate counsel. A recent First Department decision, *Barasch v. Williams Real Estate Co.*, 104 A.D.3d 490 (1st Dep't March 14, 2013), limits those rights where a director's interests are adverse to the corporation and the other directors, at least in the context of the appraisal rights provided by Business Corporation Law ("BCL") § 623.[1] While earlier decisions in the case resolve interesting questions whether unconventional transactions trigger appraisal rights, this note focuses on the attorney-client privilege aspect.

But first, a disheartening note on how slowly the wheels of justice may grind, especially where delay is to one party's strategic advantage. The subject transaction closed in 2008; petitioner Candace Barasch ("Barasch"), a shareholder/director of the corporate defendant, commenced her Petition in 2009. Respondent Williams Real Estate and related entities ("Williams") claimed that she did not have any appraisal rights, and it was not until 2011 that the court granted her Petition and ordered an appraisal of the fair value of her shares. Williams appealed twice to the Appellate Division: first in 2011 as to whether Barasch had appraisal rights, and then in 2012 on the attorney-client privilege issue. In 2012, the Appellate Division affirmed that Barasch did have appraisal rights. While the second appeal was pending, the parties continued to litigate, and exchanged expert reports. The original trial judge retired in 2012 and the case was reassigned. At some point, the parties engaged in unsuccessful mediation before JAMS.

In August 2012, while the attorney-client privilege appeal was pending, Barasch's counsel wrote to the newly assigned trial judge, requesting that a valuation hearing be held at the Court's earliest convenience. Barasch's expert valued the company at $49,118,000, with her proportionate share at $4,205,000, before interest, while Williams' expert valued the company at $11,019,000, with her proportionate share at $1,138,000. In September 2012, the Court scheduled a hearing for January 2013, requiring Respondent to take "all available steps to obtain an expedited hearing and determination of its appeal."

The case settled before the valuation hearing, presumably somewhere between the two expert reports, in the neighborhood of $3 million or so.[2] By Stipulation, dated December 27, 2012, the case was dismissed with prejudice; the trial judge was informed, and the valuation hearing cancelled. Four years elapsed after the closing of the transaction and substantial time, expense and judicial resources were consumed.

Apparently, however, no one told the Appellate Division. It rendered its decision reversing the attorney-client privilege holding three months after the case was dismissed! Needless to say, this is not supposed to happen. Nevertheless, the decision remains good law.

Background. Barasch commenced her Petition in January 2009 to compel various related Williams entities to pay the fair value of her approximately 10% inherited interest in the corporation. In summary, Barasch, a Williams director and one of six shareholders, voted against an extremely complex restructuring and thereafter tendered her shares pursuant to the statutory appraisal rights of BCL § 623. After the new entity failed to comply with BCL § 623, she instituted an appraisal proceeding against Williams, the other shareholders and the acquirer.

In 2009, Justice Fried dismissed Barasch's claims against the individuals and the acquirer, but denied Williams' motion to dismiss, rejecting Williams' argument that Barasch had no appraisal rights. He denied Barasch's request that the parties proceed directly to an appraisal because the parties had not submitted any documents regarding the actual transaction or engaged in any discovery.

Two years later, in a lengthy decision analyzing the transaction under BCL § 623 and related provisions, Justice Fried granted Barasch's motion for an appraisal of the fair value of her shares; the transaction "effectively constituted a transfer of 'substantially all of the assets.'" 33 Misc.3d 1219 (Sup. Ct. N.Y. Co. 2011).[3] In 2012, the First Department unanimously affirmed in a one paragraph decision; Williams was "estopped from denying that it disposed of substantially all of its assets."

The Attorney Client Discovery Issue in Supreme Court. In January 2010, Barasch served her first request for production of documents. Williams argued, *inter alia*, that all documents to and from Moses & Singer ("M&S") Williams' corporate counsel, were privileged and refused to produce them. In response to Barasch's motion to compel, Williams argued that she had an "adversarial relationship" to the transaction at issue, so that the privilege precluded production.

In its April 2010 decision on privilege, the Court agreed with Barasch that "a corporate director has an absolute, unqualified right, with roots in the common law to inspect the corporate books and records," and ordered production based on her status as a director.[4] Williams did not appeal, and after some legal skirmishes, documents were provided to both sides.[5]

Thereafter, the privilege arose again at the deposition of Williams' in-house counsel, who was directed not to answer questions based on privilege about an M&S email. The email, sent two weeks before Barasch dissented from the underlying transaction, described her as "hostile" to the transaction and warned Williams that Barasch could use the shareholders' agreement to her advantage. Barasch moved to compel compliance with the April 2010 decision and for sanctions and costs.

In his second privilege decision, Justice Fried described the issue as "whether a corporate director, by dissenting from a corporate transaction, retaining separate counsel, and threatening potential legal challenges to block the transaction, becomes 'adverse' to the corporation, such that she waives her absolute right to inspect corporate books and records, including attorney-client communications." In answering the question in the negative and ordering compliance, he concluded:

> Because Barasch was and is a director of Williams, she is and has been a corporate insider by definition, and therefore not adverse to Williams, during the relevant times. Williams' directors cannot reasonably have expected to exclude a fellow director from their attorney-client communi-

cations concerning the valuation of her shares.[6]

In both sets of briefing in the trial court, both parties relied on the identical handful of cases, "spinning" them to their respective ends. *Tekni-Plex, Inc. v. Meyner & Landis,* 89 N.Y.2d (1996), was the most significant. Not surprisingly, since Barasch won both rounds of briefing, Justice Fried sided with Petitioner's interpretation (the appellate court did not; see *infra*).

Tekni-Plex is an extremely interesting and important case on several privilege issues. It arose in the context of a breach of warranty arbitration between the purchaser and seller of Tekni-Plex and turned on who owned Tekni-Plex's attorney-client privilege—the original company and its sole shareholder/president/chief executive officer/sole director—or the business that merged Tekni-Plex into an acquisition subsidiary and then changed the subsidiary's name to Tekni-Plex and continued in the identical business. The Court of Appeals concluded that the new company controlled the attorney-client privilege with respect to the business operations (specifically environmental issues at its facility) of old Tekni-Plex. However, to the extent the arbitration related to the merger negotiations, the old company and its owner continued to control the privilege.

The First Department Reversal. The First Department rejected the basic tenet of the lower court that Barasch, as a director, was a corporate insider by definition and could not be adverse to Williams. The Court focused on the facts that Barasch was a shareholder as well as a director, was suing in her capacity as a shareholder and had retained separate counsel to represent her interests at the time of the transaction. Therefore, the Court found it "clear" that she was adverse to Williams, so that the communications between Williams and corporate counsel regarding how to deal with her were privileged.

The Court found that *Tekni-Plex* supported Williams, stating that in *Tekni-Plex,* the Court of Appeals "held, with application here, that the law firm should be enjoined from disclosing the substance of those [environmental] communications to [the sole shareholder] who, like petitioner here, was both a director and a shareholder of Tekni-Plex at the time of those communications."

Interestingly, although the Court cited (and distinguished) several other New York decisions, it relied extensively on an almost thirty year old case rendered by an intermediate appellate California court, *Hoiles v. Superior Court of Orange Co.*, 157 Cal. App.3d 1192, 204 Cal Rptr. 111 (1984).[7] *Hoiles* involved a similar fact pattern: petitioner shareholder/director sought to depose the family owned corporation's in-house counsel about communications with the other directors relating to petitioner's threats to dissolve the corporation or sell his stock. The California appellate court refused to permit discovery because the petitioner, like Barasch, "has not brought suit as a director, only as a shareholder."

The Take Away. First, if you settle a case that is pending in the appellate court, let the court know before it drafts a decision on a dismissed case.

Second, *Barasch* presents yet another layer of complexity in the governance and counseling of closely held corporations and has implications for both directors and counsel. Being forewarned by the decision should make interested parties forearmed, or at least more strategic in their contemporaneous decision making.

A director may need to walk a fine line before declaring outright opposition to a significant potential corporate action where counsel is involved, particularly if it implicates BCL § 623 appraisal rights. Once a director makes known opposition to a proposal, the corporation and its counsel could take the position—strengthened by the *Barasch* appellate decision—that the "outlier" director should no longer be in the attorney-client communications loop. The absence of information could impede the director's decision making process to the disadvantage of both the director and the company. If enough is at stake—or perceived to be at stake—attempting to freeze out the dissenter from contemporaneous legal advice could potentially give rise to immediate litigation seeking injunctive relief even before a corporate decision is made.

Corporate counsel needs to be particularly vigilant about who the client is when representing a closely held business, especially where the directors and shareholders are one and the same, in any transaction where all are not in agreement. Even if counsel recognizes the potential conflict and insists on separate representation for the "outliers," there is always the possibility that in future litigation, attorney-client communications may lose their privilege. Counsel should try to insure that he or she will not be haunted down the road by those communications.

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[1] BCL § 623 details the rights and responsibilities of a shareholder to enforce rights to receive payment for his shares upon the shareholder's dissent from corporate action and the concomitant obligations of the corporation.

[2] This case is yet another instance where the parties successfully avoided the requirement of CPLR 2104 that "the terms of such stipulation [of settlement] shall be filed by the defendant with the county clerk." See our prior article, *'Confidential' Settlement Agreements in NY? Think Again*, published both on the Diamond McCarthy website and on *Law360*, March 28, 2013.

[3] The Court did not rule on that portion of Petitioner's motion which sought interim payment toward the fair value of her shares pursuant to BCL § 623(g), but did exercise discretion under BCL § 623(h)(7), and awarded partial summary judgment on her claim for costs and attorneys' fees. The amount was never adjudicated; presumably it factored into the settlement agreement.

[4] The Court did not reach her alternative argument that she was entitled to the documents in her shareholder capacity, under the "fiduciary exception" to the privilege. The nuances of the fiduciary exception to the attorney-client privilege would make an apt topic for its own note.

[5] Because Williams failed to appeal this order, the dissenting judge on the appeal argued that the Appellate Division did not have jurisdiction to hear the appeal and also raised other standing and jurisdictional issues.

Interestingly, Williams had produced its backup tapes in its document production to Barasch, which included numerous communications with M&S, some of which also were subsequently produced by M&S.

[6] The January 13, 2011 Order from which the appeal was taken provides: "Respondents may not withhold from Petitioner, on the basis of any privilege or protection heretofore asserted by Respondents or M&S, documents created on or before January 7, 2009, including any such documents referenced in the

privilege logs produced by M&S, except to the extent such documents are the work of Respondents' litigation counsel,…or reflect communications with [them]."

[7] The First Department's reliance on *Hoiles* is surprising because that case interpreted a California privilege statute and petitioners appeared to overreach in their legal argument, asserting as a matter of law that a closely held corporation has no attorney-client privilege concerning the communications of some of its owners as against other owners.

Richard I. Janvey, Partner, is a business advisor, mediator and litigator involved in commercial, inter- and intra-company disputes and internal investigations. Richard has completed numerous mediation programs, including the Program on Negotiation at Harvard Law School's Mediation Workshop. Rjanvey@diamondmccarthy.com

Joan M. Secofsky, Senior Counsel, focuses on corporate and securities litigation, arbitration and mediation. Jsecofsky@diamondmccarthy.com

Both are based in the New York office:

DIAMOND MCCARTHY LLP

620 Eighth Avenue (between 40th & 41st Streets), 39th Floor, New York, NY 10018
Phone: (212) 430-5400 Fax: (212) 430-5499