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Brophy Revisited

DE Supreme Court Reinstates Stockholders' Right to Bring Derivative Actions Against Corporate Fiduciaries for Insider Trading

By Robert S. Reder, David Schwartz and Roxana Azizi

A current "hot button" issue in corporate law is the extent to which federal law can — or should — pre-empt state corporate law regimes. Due to its prominence as the state of incorporation for so many U.S.-domiciled corporations, Delaware has frequently found itself at the epicenter of this debate. One area in which this tension recently flared is in the context of insider trading. When one thinks of insider trading actions, § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder naturally come to mind. However, as long ago as 1949, in "the venerable case" *Brophy v. Cities Service Co.*, 70 A.2d 5 (Del. Ch. 1949), the Delaware Court of Chancery recognized the right of Delaware stockholders to sue corporate fiduciaries derivatively to recover profits derived from insider trading on the basis of "confidential corporate information." According to the *Brophy* court, "[e]ven if the corporation did not experience actual harm, equity requires disgorgement of that profit."

In 2010, the Court of Chancery had the opportunity to re-visit the continued viability of *Brophy*. In *Pfeiffer v. Toll*, 989 A.2d 683 (Del. Ch. 2010), the Court of Chancery rejected the argument that *Brophy* is a "misguided vehicle for recovering the same trading losses that are addressed by the federal securities laws." Instead, the Court of Chancery declared, the "federal insider trading regime as currently structured rests on a foundation of state law fiduciary duties." However, in so ruling, the *Pfeiffer* court limited *Brophy* by observing that the harm addressed is "not measured by insider trading gains or reciprocal losses," as under the federal regime, but rather by "harm *to the corporation*" measured by its "costs and expenses for regulatory proceedings and investigations, fees paid to counsel and other professionals, fines paid to regulators, and judgments in litigation."

Then, in June 2011, the Delaware Supreme Court was called upon to consider whether *Pfeiffer* correctly limited *Brophy* to an action to recover only such

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Quarterly State Compliance Review

By Sandra Feldman

This edition of the Quarterly State Compliance Review looks at some legislation of interest to corporate lawyers that went into effect between Aug. 1 and Oct. 1, including amendments to Delaware's corporation, LLC and LP laws. It also looks at some recent decisions of interest, including two from the Delaware Supreme Court.

IN THE STATE LEGISLATURES

DE Amends Its General Corporation Law, LLC Act and LP Act

Senate Bill 77, effective Aug. 1, enacted amendments to Delaware's General Corporation Law. The bill, among other things, permits a corporation that is both a nonprofit nonstock corporation and an association of professionals to have a name that does not contain a corporate indicator under certain circumstances and permits a corporation to use the word "trust" in its name under certain circumstances.

The indemnification section was amended to clarify when the right to indemnification or advancement of expenses arising under a provision of the certificate of incorporation or a bylaw can be eliminated or impaired by an amendment to the certificate of incorporation or a bylaw.

The provisions governing conversions of other entities

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Compliance Review

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and domestications were amended to provide that the certificates required to be filed (a certificate of incorporation and a certificate of conversion/domestication) must be filed simultaneously or provide for the same future effective date or time.

The bill also clarified that no corporation may be dissolved, merged, transferred or converted until all franchise taxes have been paid and all annual franchise tax reports have been filed.

Delaware's LLC Act and LP Act were amended by Senate Bill 76 and Senate Bill 95 respectively, effective Aug. 1. The bills provide, among other things, that the name of an LLC and an LP must be distinguishable from the name of another domestic entity of the same type and that a certificate of cancellation that is filed before the dissolution or winding up of an LLC or LP may be corrected by filing a certificate of correction.

The bills also provided that a future effective date set forth in a certificate filed under the LLC or LP act may not be later than the 180th day after filing, effective for filings made on or after Jan. 1, 2012. The provisions governing conversions of other entities and domestications were amended to provide that the certificates required to be filed must be filed simultaneously or provide for the same future effective date or time.

The bills also clarify that consents to actions without a meeting may be made by electronic transmission, and that a supermajority amendment provision of an LLC or partnership agreement only applies to provisions of the agreement that are expressly included in the agreement. In addition, the LLC act was amended to provide that, for LLCs formed on or after Jan. 1, 2012, if an LLC agreement does not provide for the manner in which it may be amended, the LLC agreement may be amended with the approval of all members.

Amendments to Business Entity Laws of Other States

In Connecticut, House Bill 6590, effective Oct. 1, amended the corporation law to authorize the board of directors to fix separate record dates for determining shareholders entitled to notice of a meeting and to vote at the meeting, and authorizes the board to allow shareholders to participate in a meeting remotely.

In Missouri, Senate Bill 366, effective Aug. 28, authorized corporations to enter into conversions. In Nevada, Senate Bill 405, effective Oct. 1, amended the provisions of the corporation law dealing with, among other things, restrictions on mergers between certain public corporations and acquiring stockholders, electronic notices and communications, stock transfers, proxies, dissolution, indemnification, and dissenters' rights.

In North Carolina, Senate Bill 457, effective Oct. 1, amended the provisions of the corporation law governing appraisal rights. And in Texas, Senate Bill 748, effective Sept. 1, amended the provisions of the Business Organizations Code dealing with, among other things, plans of merger, exchange and conversion, dissenters' rights, appointment of receivers, conflict of interest transactions, limited partner voting, charging orders for partnership interests, and the effect of death or divorce on LLC interests.

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The NLRB Wants to Be Your 'Friend'

By Joseph G. Schmitt and Lisa M. Schmid

The popular social networking website Facebook currently boasts 750 million active users, 50% of whom log in on any given day. A recent study by the Pew Research Center indicates that 13% of Americans use Twitter. Google+, the new social networking upstart that is expected to give Facebook a run for its money, grew to more than 10 million users in two weeks of its invitation-only test phase. LinkedIn, a more professional social networking site, reached 100 million users in March of this year. Finally, many others utilize alternate social networking websites, including MySpace, as well as blogs, e-mail list servs, or online chat rooms.

These numbers are impressive to say the least, but what do they mean for employers? Well, given the popularity of such sites, it is likely that your employees are using at least one form or another of social media. Odds are that your employees use the sites to post information about their workplace, supervisors, or co-workers. Recognizing this trend, many employers have implemented or at least considered implementing Internet/social media policies in an effort to protect their reputations, protect their employees, and prevent the dissemination of confidential or proprietary information on the Internet. Many of these policies likely contain blanket prohibitions of disparaging, discriminatory, or defamatory remarks in relation to the company or its employees. These policies seem to make perfect sense, but unfortunately, employers need to re-think them in light of the National Labor Relations Board's ("NLRB") recent decision in *Hispanics United of Buffalo, Inc.*, Case No. 3-CA-27872, 2011 NLRB LEXIS 503 (N.L.R.B. Sept. 2, 2011).

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Hispanics United

Hispanics United of Buffalo, Inc. ("Hispanics United") is a nonprofit corporation that provides social services to economically disadvantaged individuals. It drew the NLRB's ire after it fired five employees for their Facebook exchange in which employee Mariana Cole-Rivera, a non-unionized employee, posted regarding her co-worker Lydia Cruz-Moore's allegations that the agency's employees failed to do enough to serve their clients. In the post, Cole-Rivera asked her co-workers how they felt about the allegations, and five employees posted responses on Facebook, defending their performance and complaining about their working conditions, including staffing levels and their workload. None of the posts attacked Cruz-Moore, and they did not take place during working hours or on Hispanics United's computers. Cruz-Moore was scheduled to meet with management regarding her concerns about her co-workers' performance before Cole-Rivera's Facebook post.

Hispanics United fired Cole-Rivera and four other employees who posted after it learned of the Facebook exchange, claiming that their posts constituted harassment of Cruz-Moore. The NLRB disagreed and filed a complaint against Hispanics United on May 9, 2011. In its complaint, the NLRB alleged that the fired employees' Facebook posts constituted protected concerted activity under § 7 of the National Labor Relations Act ("NLRA") and that as a result, Hispanics United's actions violated § 8(a)(1) of the Act, which prohibits employers from punishing employees engaged in protected concerted activity. The case was tried in July 2011, and a decision was issued on Sept. 2, 2011. In the decision, the administrative law judge held, for the first time ever, that the employees' discussion of their work on Facebook constituted protected concerted activity. The judge then ordered Hispanics United to reinstate the terminated employees and to provide back pay and lost benefits.

American Medical Response

While the Hispanics United case is the first decision of its kind, it was not the first time the NLRB has gone after employers for taking disciplinary action against their employees for their social media postings. In fact, the NLRB started its pursuit in late October 2010, when it filed a complaint against American Medical Response of Connecticut ("AMR"), an ambulance service company, after it fired one of its medical technicians for posting disparaging messages about her supervisor on Facebook. The AMR employee in question, Dawnmarie Souza, called her supervisor a scumbag and referred to him as a psychiatric patient on her Facebook page. Several of Souza's co-workers responded in a supportive manner, and that led to additional derogatory comments about Souza's supervisor. After it discovered the posts, AMR terminated Souza for violation of its social media policy, which prohibited employees from "making disparaging, discriminating or defamatory comments when discussing the company or the employees' supervisors, co-workers and/or competitors." AMR's policy also prohibited employees from depicting the company in any way on Facebook or other social media sites on which employees posted pictures of themselves.

In response to the firing, the NLRB filed a complaint claiming that AMR interfered, restrained, or coerced employees engaged in the exercise of their § 7 rights. The NLRB also alleged that AMR's social media policy itself violated the NLRA because it "interfere[d] with, restrain[ed] and coerc[ed] employees in the exercise of the rights guaranteed in Section 7 of the Act … "

A hearing was set for Jan. 25, 2011, but the case settled the day before. As part of the settlement, AMR agreed to revise its "overly broad"

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social media policy to allow employees to discuss working conditions, including their wages and hours, on social media sites. AMR also agreed to not discipline or fire employees for engaging in these activities and separately settled the employee's individual claims.

Knauz Motors

The NLRB also filed a complaint on May 20, 2011 against Karl Knauz Motors, Inc. ("Knauz Motors"), a Chicago-area car dealer, for its termination of an employee after he posted negative commentary about his employer on his Facebook page. The Facebook posts that led to the termination arose out of an event at which Knauz was promoting a new BMW model. Robert Becker, a Knauz salesperson, felt that the dealership botched the event by offering hotdogs and bottled water to its customers instead of high-end appetizers. Becker expressed his displeasure on Facebook, and he included pictures of the food. Several of Becker's coworkers agreed with him, and the salespeople worried that the event might harm their sales.

Knauz Motors subsequently discovered Becker's Facebook posts and asked him to remove them. Becker complied, but Knauz terminated him a week later. Knauz Motors claims that it fired Becker for reasons other than his Facebook posts, but the NLRB filed its complaint anyway, alleging that Becker's Facebook posts were protected under § 7 and that Knauz violated the NLRA by terminating his employment. This matter has yet to be resolved.

Unfortunately, Hispanics United, AMR, and Knauz Motors are not the only employers doing battle with the NLRB over Internet/social media policies and employees' usage of social media to discuss their employers. In fact, the NLRB recently stated that all 52 of its regions currently have active complaints related to employees' social media use as protected concerted activity. Further, in addition to filing complaints, the NLRB has threatened to file complaints against companies, including Thomson Reuters, if they refuse to settle employee complaints about adverse actions resulting from social media usage. Given all of its actions, it is clear that the NLRB has made this issue a top priority, and that spells trouble for employers' Internet/social media policies or employers that have taken adverse action against employees for employment-related social media posts.

Some Good News

Despite the gloom and doom above, there is some good news too. Recently, three NLRB Regional Directors have made it clear that not all employer-related social media posts by employees are protected concerted activity, and in each of those cases, the Regional Directors recommended dismissal of a filed complaint.

The first case from July 7, 2011, involved a bartender employee of JT's Porch Saloon and Eatery, Ltd. ("JT's") who complained verbally about his employer's tipping policy and then complained to his stepsister about the same policy and his working conditions generally on Facebook. The bartender never discussed the Facebook post with his co-workers, and none of them responded to it. Approximately a week later, JT's fired the bartender for his Facebook posts, but the Regional Director concluded that JT's did not violate § 8(a)(1) of the NLRA because the bartender's actions did not constitute protected concerted activity. The bartender's Facebook post did not grow out of his previous griping, the bartender did not discuss his Facebook post with any other employees, and none of his co-workers responded to it. Moreover, the bartender did not initiate action to change the tipping policy, and he did not attempt to bring the bartenders' complaints to management.

In the second case from July 19, 2011, a Wal-Mart employee posted complaints about his working conditions on his Facebook page, and several of his co-workers responded sympathetically but did not engage in a conversation about their working conditions. Wal-Mart disciplined the employee, and the charge followed. The Regional Director concluded that the posts were simply individual gripes rather than concerted activity, and as such, he recommended that the charge be dismissed.

Finally, in the third case, also from July 19, 2011, an employee of Martin House, a residential facility for homeless people, engaged in a Facebook conversation with two friends about her job and the residents, essentially poking fun at some of them. Upon discovery of the conversation, Martin House terminated the employee and the complaint followed. The Regional Director concluded that the employee's actions did not constitute protected concerted activity because she did not discuss the posts with any of her fellow employees.

Regardless of the recent recommendations for dismissal by Regional Directors, it is still clear that the NLRB is determined to continue its aggressive pursuit of this issue, particularly given the high number of outstanding cases. As a result, employers must take action to protect themselves if and when the NLRB comes calling.

Protecting Employers

Fortunately, there are some concrete actions employers can take to enhance their protection against such complaints. First, though it might seem risky in light of the *Hispanics United* decision and the NLRB's recent actions, employers should continue to maintain already established Internet/social media policies and should establish such policies if they do not exist. These policies are still valuable as they provide protection for both the employer and the employee. Rather than throw out the policy completely, employers should take the following steps to avoid running afoul of the NLRB:

- Do not include blanket prohibitions of employee speech related to work and working conditions like the one included in AMR's policy. Such policies may draw the attention of the NLRB even if an employer does not take adverse action against an employee.
- Include a provision that expressly states that the policy does not prevent employees from discussing their working conditions, including but not

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Is Your Company Sitting on Buried Treasure?

Finding Resources in Insurance Policies

By James J. Leonard and John L. Watkins

Many companies are sitting on buried treasure and do not even know about it. Buried treasure is often found in insurance policies the company purchased, including policies purchased many years ago. In other cases, substantial resources are unlocked in policies the company inherited through a merger or acquisition. This buried treasure can often be worth millions or even tens of millions of dollars that go directly to a company's bottom line. This may sound too good to be true, but it happens more often than you might think. The key is to know where to look for buried treasure in your insurance resources and what to do if you find it.

In order to find buried treasure in your company's insurance policies, it is first important to understand how it was lost in the first place. There are many ways in which companies overlook or fail to pursue available insurance resources. Here are some of the more common.

A claim was submitted, but the insurance company denied coverage and the denial was not challenged.

When this happens, companies often simply engage counsel at their own expense and deal with the claim, often by paying a settlement or judgment. As the matter proceeds, often at a cost of hundreds of thousands or millions of dollars, the claim under the policy is forgotten.

However, all may not be lost. So long as the matter is within the state's statute of limitations, the company can probably still challenge the denial (in litigation if necessary) and potentially recoup defense costs as well as settlement and judgment expenses. Of course, there still has to be a basis for coverage under the policy, but many times insurers "win" simply by denying the claim and the insured not pursuing coverage.

In most states, the bar for requiring an insurance company to provide a defense (pay for lawyers to defend a claim) is lower than the bar for paying for a settlement or judgment. Further, in most states, if part of a claim is covered, the insurer is obligated to provide a defense for the entire claim. Getting back some or all of the legal fees spent in defending a case can be a substantial recovery in itself.

The company may not understand the nature of occurrence based policies.

Many policies, especially commercial general liability ("CGL") policies, are written on so-called "occurrence" based forms. In broad terms, these policies cover bodily injury or property damage caused by an occurrence during the policy period.

Under an occurrence based policy, *if a claim asserted is based on events that happened years ago, the policies in force at that time may still cover the claim.* Environmental and asbestos claims are examples of this type of situation. In some instances, policies written in the 1950s and even earlier are providing coverage today for these types of claims. Pursuing coverage under older policies can be important and beneficial, because they contain fewer exclusions (such as the partial and absolute pollution exclusion) found in more modern policies.

The company may not understand the breadth of claims potentially covered.

Even sophisticated policyholders typically assume that only bodily injury and tangible property damage are covered by insurance. Although this is often true, under some policies (and depending on the jurisdiction), it may be possible to obtain coverage for claims such as trade secret violations, breach of contract and loss of data. The key point here is to base decisions on what the policies and law provide, and not what you assume may or may not be covered.

The company may be unaware of what its modern policies cover.

Policies are now available that specifically provide coverage for environmental issues (referred to as "environmental impairment liability" coverage or simply "pollution coverage"), breach of trade secrets and breach of contract (such as under "media tech" policies often marketed to the software industry), and other types of risks. For example, other insurance products are being marketed to provide coverage for data breaches and cyber liability issues.

In some instances, a company may have policies providing coverage, but does not realize it has coverage available. Although this may seem unlikely, it does happen. For example, a company may separate its risk management and legal functions. If one department is responsible for procuring insurance and another for giving notice of claims, it is possible that all available coverage will not be pursued. This type of situation happens more often than you might think. Further, in this day of frequent turnover due to mergers and acquisitions, layoffs, and general movement of personnel from one company to another, those now responsible for managing insurance issues may simply be lacking a thorough institutional knowledge of the scope of coverage previously purchased.

Looking for Treasure

Now that you understand how buried treasure can be lost, here is a map to start looking for your company's insurance resources.

Make sure you are getting copies of insurance policies from your insurance company or broker or agent when they are issued.

This may seem obvious, but we often have to work to get copies of the relevant policies. It is very common to ask for the policy and to get

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Insurance Policies

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a copy of an insurance certificate or a declarations page. An entire business policy is usually many pages long, and an insurance certificate or "dec page" is only the tip of the iceberg. If you do not have a set of policies, contact your agent or broker (or your carrier) and ask for copies.

Gather and keep all policies in a central repository.

As you can gather from the discussion above, old policies can be valuable, so do not throw them away. Policies can (and should) be scanned and stored (or backed up) electronically off-site. That way, they will always be available.

Never blindly accept your insurer's statement that a claim is not covered.

The same is true for assessments by agents and brokers. Although such assessments may be correct, our experience is that they are often wrong.

Review files for prior denials of claims.

As noted above, it may well be possible to pursue coverage if an insurance company has denied a claim and your company has been forced to incur the expense of hiring counsel and paying a settlement or judgment. Statutes of limitation (which vary from state to state) may come into play here, so it is very important to review claim files for denials as quickly as possible and to analyze whether coverage should be pursued.

If you consult with an attorney regarding coverage issues, make sure that the attorney has substantial experience in handling coverage claims.

Although an insurance policy is a contract, it is a particular type of contract. Insurance coverage issues are often not intuitive. Experienced coverage counsel can usually tell you pretty quickly whether coverage exists or at least whether there is a reasonable basis for pursuing coverage. An experienced coverage lawyer will also have greater credibility in dealing with an insurance company than a generalist.

Going forward, give notice of claims early and often.

Always assume that a claim may be covered. Insurance companies often raise late notice as a defense, and, depending on the circumstances and the jurisdiction, they may be able to avoid coverage on this basis.

Note that special rules exist for "claims made" policies.

Claims made policies, as a general rule, only cover claims that are made during the policy period. These policies are designed to eliminate the "long tail" risk discussed above regarding occurrence policies. "Claims made" policies are typically written for professional liability and D&O coverage, although they may be used in other circumstances. Under claims made policies, giving notice within the policy period or extended reporting period is typically a prerequisite to coverage, which makes giving notice an even more important issue.

Many claims made policies have "notice of circumstances" provisions. These provisions are designed to ameliorate the sometimes harsh application of claims made policies and allow the policyholder to report events during the policy period that may give rise to a claim later, even though a claim has not yet been made. If a "notice of circumstances" provision exists, and such a notice is properly made during the policy period, the policy should cover claims made after the policy period. It is thus a good idea to make a careful internal review of circumstances that may give rise to a claim before the expiration of a policy period.

Conclusion

Companies buy insurance policies to protect themselves from claims, but, in many instances, do not pursue or take advantage of the coverage they have purchased. However, with a little bit of digging and review, it is often possible to find coverage in those policies. We hope we have provided a map to start finding the buried treasure at your company.

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limited to their wages, hours, workload, etc.

- Expressly state that any confidentiality provisions do not prohibit an employee from discussing his or her own wages or working conditions.
- Do not prohibit employees from identifying themselves as company employees.
- Expressly explain that the policy is meant to protect both the employer and the employee and ask the employee to think twice about Internet/social media usage in relation to the company. Note that negative posts about the employer can reflect poorly on the employee as well.
- Be aware of union organization when considering implementation of the policy; drafting or revising the policy in the face of union organizing activities could draw a complaint.

Furthermore, and despite the *Hispanics United* decision and the NLRB's recent actions, an Internet/social media policy can and should still prohibit disclosure of the company's or the company's clients' confidential or proprietary information as well as disclosure of legally protected private information, such as medical information protected by HIPAA. Additionally, the policy can and should still prohibit harassment and discrimination, obscenity, and disloyalty, which amounts to defamatory and false statements.

In addition to drafting or revising Internet/social media policies, employers should educate supervisors about the policies, particularly in relation to employees' § 7 concerted activity rights. Supervisors should be instructed to hold off on immediately disciplining or terminating employees in response to social media posts about the employer, their supervisors, or their co-workers as those posts could constitute protected concerted activity. Supervisors should also consider involving human resources or legal counsel before taking action.

Finally, employers must educate their employees about their Internet/social media policies. In doing

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Taking Responsibility For the e-Discovery Process

Lessons Learned from J-M Manufacturing Company, Inc. v. McDermott Will & Emery

By Sophia Lee and Christine Soares

Your company has just been sued in federal court. In this age of electronic discovery, you know you will apportion a large majority of your litigation costs to discovery, with the bulk of the expense for e-discovery. You also know the process of gathering, recovering, reviewing and producing electronically stored information ("ESI") can be expensive, time-consuming and tedious. Your company may not have all of the resources in place to handle the task, and the job may even be too big for your outside counsel to handle in its entirety. It is no wonder, then, that when discussing pre-trial strategy with your litigation team, outsourcing the e-discovery process is a topic on the table.

Outsourcing, however, is not without risk. Often, IT consultants do not understand the law, the review team is not intimately involved in the case, and counsel lacks basic knowledge of information systems, affecting their ability to manage the process. Combine all three risks into one case, and you have the makings of a perfect sanctions or legal malpractice storm.

The recent legal malpractice lawsuit filed by J-M Manufacturing Company, Inc. ("J-M Manufacturing") against the company's lawyers, McDermott Will & Emery ("McDermott"), over the production of 3,900 privileged documents to the federal government in a qui tam investigation highlights some of the risks inherent in outsourcing the e-discovery process. The amended complaint alleges the following relevant facts:

- In response to subpoenas from the federal, California and Tennessee governments, McDermott and J-M Manufacturing identified 160 custodians likely to possess responsive ESI.
- McDermott worked with J-M Manufacturing to collect the custodians' data, and transferred the data to two third-party e-discovery vendors, Stratify, Inc. ("Stratify") and Navigant Consulting, Inc. ("Navigant").
- Navigant and Stratify ran search-term and privilege filters through the collection to identify relevant documents and separate out documents protected by the attorney-client privilege.
- After McDermott produced the documents to the federal government, the federal government notified McDermott that a significant amount of the production included non-responsive and attorney-client privileged documents and asked McDermott to conduct a privilege review and resubmit the documents.
- Prior to the second production of documents, McDermott retained contract attorneys from Hudson Global Resources to perform the privilege review. The second production included 250,000 documents, 3,900 of which were later determined to be privileged.
- J-M Manufacturing was later informed that the document production including the privileged documents was subsequently produced to counsel for the whistleblowers, who refused to return the documents, arguing the attorney-client privilege had been waived.

While it is not the purpose of this article to comment on the merits of the case, the lawsuit serves as a sobering reminder that although outside counsel can delegate the tasks of e-discovery to both the client and third-party vendors, the overall responsibility for e-discovery cannot be delegated. The e-discovery process must be defensible at every step, both to the opposition and to the courts regardless of who actually handles the task. Below is a checklist of best practices for both in-house and outside counsel to consider, discuss and monitor throughout the litigation to ensure confidence in the client relationship and the e-discovery process.

Issue Litigation Hold Notice

The duty to preserve information for discovery is triggered whenever a party reasonably anticipates litigation. A litigation hold notice should issue to key custodians expected to have relevant information in their possession, custody or control. The language of the memorandum should be clear and understandable to non-legal personnel, explain the nature of the information to be preserved, and provide adequate instruction as to how the information should be preserved and collected. The notice should adequately explain the nature of the litigation to help the custodians determine what information needs to be preserved. To determine the efficacy of the notice, counsel may want to consider testing the notice on a small focus group for ambiguities or concerns.

The obligations attendant to the litigation hold notice do not end at its issuance. Counsel should

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periodically review the notice as the litigation progresses and more details are learned about the dispute to determine whether any part of the notice needs to be modified or whether the list of key custodians needs to be amended. Counsel should also determine an appropriate time span for reissuance of the notice as a reminder to the custodians of their continuing obligation to preserve while the litigation is pending. Once the litigation has resolved, a separate notice should be issued to the key custodians indicating the litigation and the duty to preserve have ended.

Identify Key Custodians

To determine the key custodians, counsel should interview employees and third parties who are familiar with the disputed issues to determine who may have discoverable information. The interviews should cover both the nature and location of the relevant information, as well as the substance of the litigation. The substantive understanding will help with development of the list of filtering terms (described below) and litigation strategy, such as determining whether certain information should be designated as confidential and/or privileged. The interview is an opportunity to remind the custodians of the negative inferences and impact on the company where there is spoliation or destruction of evidence, as well as to answer any questions or clarify issues posed by the custodians. Interviews should also be conducted to determine whether the universe of custodians has been captured in the distribution for the notice. Counsel should amend the litigation hold notice to include new custodians when they are discovered. The team should also track the list of custodians who have acknowledged receipt of the notice.

Understand Data Management Systems

It is not enough for counsel to give the client's IT personnel lists of search terms and custodians and direct them to collect the ESI. Understanding the client's data management systems is a critical component to a defensible e-discovery strategy and a responsibility that cannot be delegated. In fact, most mistakes involving the collection of ESI that result in discovery disputes and/or sanctions occur because counsel fails at this best practice.

Counsel must, at a minimum, work with the client's IT personnel to understand the company's data retention architecture and where the ESI resides. If counsel is not up to this task, counsel should work with another attorney (not an IT expert) who is competent to do it. Knowing where data, metadata, files, communications, e-mails, etc. are stored on a client's computer system is essential. One of the most effective ways to understand the client's information systems and processes is by creating and implementing a data map, which outlines, in detail, what information is available within an organization and where it resides. A data map also aids with understanding the purpose of the data, *e.g.*, how the data are inputted and how the data are used or reported, which helps with making determinations about whether information should be designated as confidential and/or privileged. Counsel can create a data map at any time, even before the client is involved in litigation.

In addition, recognizing the interplay of the client's records retention policy with the data management system will help counsel with understanding the temporal parameters of the data. While the litigation hold notice supersedes the rules of the retention program in that destruction deadlines applicable to relevant information are suspended, understanding the parameters of the data management system may help to explain why data predating a certain time may be unavailable. Depending on the complexity of the data management system, counsel should consult IT personnel or an IT consultant to explain the functionality of a system. The IT expert should be available to testify if called upon.

Thereafter, counsel must actively monitor the collection, rather than completely delegate the collection of ESI to an IT expert and wait for the documents to arrive. If discovery misconduct is found, the court will sanction the party and its counsel, not the IT expert.

Agree upon Filtering Terms

No one wants to review millions of documents, and reviewing large ESI collections leaves more room for error. Based on information gleaned from the custodian interviews, counsel should develop a list of filtering terms that will yield relevant and responsive documents. The filtering terms should effectively narrow the number of documents that need to be reviewed and prepared. The filtering terms should be tested against a data sample to ensure a defensibly high yield of responsive information. As recommended by the Sedona Conference, quality assurance and iterative formulation are components to defending keyword search methodologies. Keyword searches should be repeated and tested. The results of the keywords should be evaluated, and errors should be identified. For example, a keyword that results in a high percentage of ESI may indicate the term is too broad or needs to be included with additional terms.

Counsel should consult opposing counsel on the filtering terms to avoid disputes about improper or incomplete searches. In the wake of the Sedona Conference Cooperation Proclamation, the federal courts have increased their scrutiny of filtering term disputes and are imposing an absolute duty of cooperation on parties in developing effective keyword search methodologies.

The courts have recognized the limits and challenges of relying solely on keyword searches to identify privileged documents. Accordingly, if counsel uses keyword searches to cull ESI for privileged documents, counsel must closely manage the process, consult heavily

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with e-discovery search and retrieval experts and apply significant quality controls.

Develop and Train on Document and Data Review Protocol

Developing a review protocol and training the review team is of paramount importance. Counsel should prepare a written review protocol based on the understanding gained from the client and custodian interviews regarding what data should be considered relevant, responsive and/or privileged. The review protocol should be as detailed as possible and approved by the client to ensure agreement on a going-forward basis during this phase of discovery.

Important to this step of the discovery process is for the litigation team to determine who is responsible for managing different levels of review, *e.g.*, first-level relevance, second- and third-levels for responsiveness and privilege, and for managing the privilege log. As the Sedona Conference noted in its Commentary on Achieving Quality in the e-Discovery Process, a review for privilege "can require an even more nuanced legal analysis and, as such, can be a more expensive review per document than review for relevance or confidentiality." Incorporating processes such as creating a "potentially privileged" category of documents that receives a second-level review can safely minimize the cost and burden of reviewing ESI for privilege. Whether it is done by outside counsel or in-house counsel, this process must be thorough and thoughtful to be defensible.

Whether the client, outside counsel or contract attorneys review the documents, lead counsel must supervise the review team at all times. The review team should receive abundant training and should have access to the supervising attorneys when questions arise. Daily meetings with the supervising attorneys and the review team are highly recommended, as they will bring potential issues to light.

Develop and Enforce Quality Controls

Once the review is complete and the quality of the labels checked and assured, the production of responsive and non-privileged documents and data to opposing counsel begins. Without proper controls, opposing counsel stands a good chance of arguing for waiver of privilege when privileged documents are inadvertently disclosed. To avoid these arguments, the litigation team should develop and enforce the quality controls discussed above, such as frequently sampling the accuracy of data labels and closely monitoring the accuracy rate according to individual members of the review team. Depending on the volume of data to be reviewed and the time required for adequate review, the litigation team may consider hosting refresher trainings for the review team.

Conclusion

Almost five years have passed since the federal e-discovery rules were enacted. Although ESI has played a predominant role in pretrial discovery, attorneys continue to make serious mistakes in the collection and production of ESI. The courts have handed down hundreds of sanction awards, and the number increases every year. However, collecting and producing ESI can be simple and seamless when it is properly managed by counsel and best practices are followed. Counsel can avoid and effectively defend against sanctions and legal malpractice lawsuits by following such best practices and taking responsibility for the e-discovery process.

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litigation and regulatory-related "costs and expenses." In *Kahn v. Kohlberg, Kravis, Roberts & Co., L.P.*, 23 A.3d 831 (Del. 2011), the Supreme Court rejected *Pfeiffer*'s application of *Brophy*, concluding instead that *Brophy* claims should be analyzed "without any assumption that an element of harm to the corporation must exist before a disgorgement equitable remedy is available" against a fiduciary for improperly trading on material, nonpublic information. In so ruling, the Delaware Supreme Court not only re-established that *Brophy* permits a corporate fiduciary to be sued for insider trading — without proof of harm to the corporation — but re-asserted the Delaware courts' role in an area that is more often associated with actions under the federal securities laws.

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Pfeiffer v. Toll

Toll Brothers is a publicly traded company that "designs, builds, markets, and arranges financing for single-family homes in luxury residential communities throughout the United States." In 2003 and 2004, the luxury residential market saw "booming growth" and Toll Brothers experienced record financial performance.

By mid-2005, however, the markets "became worried about a housing bubble … and began to question the ability of homebuilders [such as Toll Brothers] to maintain their red-hot performance." Nevertheless, Toll Brothers continued to assure that it was on target for net income growth of 20% in both 2006 and 2007. The company also "rejected the notion that there was a 'housing bubble' that was about to pop," boasting that "it catered to a niche market of luxury home buyers who were not affected by rising interest rates."

During this period, Toll Brothers' stock price significantly outperformed the S&P Homebuilders

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Index, more than doubling. And Toll Brothers' directors profited personally from the strong market in the company's stock. From December 2004 through September 2005, and "particularly during the summer and fall of 2005," the directors collectively sold 14 million shares (in some cases representing more than 80% of their individual holdings), generating proceeds exceeding $615 million.

It was not until November 2005 that the company publicly recognized the "softening demand" in the market and the "increasingly complex regulatory process" for opening new residential communities. One month later, Toll Brothers surprised the market by lowering projections for 2006 from net income growth of 20% to only 0.5%. The reaction was "profoundly negative," and the stock price fell dramatically.

In addition to lawsuits filed under the federal securities laws, one Toll Brothers stockholder, Milton Pfeiffer, initiated a derivative action in the Court of Chancery against Toll Brothers' directors. Pfeiffer's lawsuit alleged, among other things, that "from December 2004 on, the defendants knew their representations about 2006 and 2007 had no reasonable basis in fact," but they nevertheless engaged in sales of stock "while in the possession of material, non-public information about Toll Brothers' future prospects" in violation of their fiduciary duty under *Brophy*. The directors moved to dismiss on the ground, among others, that "*Brophy* is an outdated precedent that should be rejected."

The Court of Chancery's Analysis

The Court of Chancery began its assessment of the adequacy of Pfeiffer's insider trading claim by noting the two required elements of a *Brophy* claim: "1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information." For purposes at least of the motion to dismiss before it, the Court of Chancery agreed that both of these elements were satisfied:

- With respect to the first element, the Court of Chancery determined that Pfeiffer had sufficiently pled "a reasonable basis" from which to infer that Toll Brothers' directors possessed material, nonpublic information about the company. In fact, because the directors reviewed reports and materials concerning core operations, the Court of Chancery observed that "[i]t would afford an ostrich-like immunity to directors not to grant the plaintiff … [an] inference [for pleading purposes] that … Director Defendants knew about core information of this type."
- With respect to the second element, the Court of Chancery considered "the trades made by the … [d]efendants as sufficiently unusual in timing and amount to support a pleading-stage inference that the sellers took advantage of confidential corporate information not yet available to the public to unload significant blocks of shares before the market's view of Toll Brothers' prospects dramatically changed."

Furthermore, the Court of Chancery rejected the directors' characterization of *Brophy* as "a persistent anachronism from a time before the current federal insider trading regime." To the contrary, the Court of Chancery noted that "[t]he history and nature of the federal regime … supports the conclusion that a breach of fiduciary duty claim for harm to the corporation is preserved." Moreover, because "the federal insider trading regime … rests on a foundation of state law fiduciary duties," the Court of Chancery explained that "[i]f Delaware were to hold that the fiduciary duties of directors and officers did not limit their insider trading, the cornerstone of the federal system would be removed."

Notably, however, the Court of Chancery cited one other reason for preserving *Brophy* that potentially — and ironically — limited *Brophy*'s reach. In the Court of Chancery's view, *Brophy* addressed "harm to the corporation" rather than serving as a device "to recover losses by contemporaneous traders," which are available under the federal regime. The damages available under a *Brophy* claim, therefore, are "not measured by insider trading gains or reciprocal losses," but instead by "costs and expenses for regulatory proceedings and investigations, fees paid to counsel and other professionals, fines paid to regulators, and judgments in litigation" incurred by the corporation. On this basis, the Court of Chancery rejected the directors' argument that *Brophy* was a "misguided vehicle for recovering the same trading losses that are addressed by the federal securities laws."

Kahn v. Kohlberg, Kravis, Roberts & Co., L.P.

Several months later, the prominent leveraged buyout firm Kohlberg, Kravis, Roberts & Co., L.P. ("KKR") found itself defending a *Brophy* claim arising from its investment in Primedia, Inc. Not surprisingly, KKR seized upon *Pfeiffer*'s limitation of the reach of *Brophy* in an attempt to avoid liability for its own alleged insider trading.

Background

In December 2001, the Board of Directors of Primedia, Inc., a publicly traded media company, approved a plan to redeem "up to $100 million of its preferred shares, at 50% to 60% of their redemption value, in exchange for common stock." At that time, KKR owned approximately 60% of Primedia's outstanding common stock and had three designees on its Board. The Primedia Board increased this authorization by $100 million the following May.

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IN THE STATE COURTS

DE Supreme Court Holds That Corporations Waived Deadline for Members to Elect Merger Consideration

In *Amirsaleh v. Board of Trade of the City of New York, Inc.*, No. 75, 2010 (Del. Supr.), decided Aug. 16, 2011, the plaintiff was a member of a New York corporation that merged into a Delaware corporation. The merger agreement allowed the members to choose their consideration as long as they submitted an election form before the deadline stated in the agreement. The plaintiff and other members failed to submit their forms by the deadline. The defendant corporations decided to waive the deadline. The plaintiff and other members then submitted their election forms. The defendants, in an ad hoc manner and without notifying the members, imposed a new deadline and decided that the plaintiff's form was untimely. As a result, the plaintiff, who was electing to receive stock in the survivor, received cash instead.

The plaintiff filed a suit in the Delaware Chancery Court, alleging a breach of the implied covenant of good faith and fair dealing. The Chancery Court ruled in the defendants' favor, and the plaintiff appealed.

The Delaware Supreme Court reversed. However, its ruling was not based on the implied covenant of good faith and fair dealing, but on the waiver doctrine. The court found that the defendants waived the initial deadline. The court then noted that to retract a waiver the retracting party must give reasonable notice to the non-waiving party before that party suffers prejudice. Here, the defendants never gave the plaintiff reasonable notice of the new deadline. Instead they engaged in an ad hoc, sub-optimal process to establish a new deadline retroactively that resulted in the plaintiff being prejudiced. Therefore, the defendants failed to retract their waiver, and the election form submitted by the plaintiff was timely and had to be honored.

DE Supreme Court Holds That Indemnification Claim Was Timely Under Laches Analysis

In *InterActiveCorp. v. O'Brien*, No. 629, 2010 (Del. Supr.), decided Aug. 11, 2011, the plaintiff, a corporate officer, filed suit in Florida seeking indemnification of his litigation expenses from his corporate employer. The trial court found for the employer, but the appellate court reversed. The employer then filed for bankruptcy, and the plaintiff filed an action in the Delaware Chancery Court against the defendant, the employer's parent corporation, which had assumed the employer's obligation to indemnify the plaintiff. The defendant moved for summary judgment on the grounds that the suit was barred by the statute of limitations. The Chancery Court held that it was not required to apply the statute of limitations, that it could instead apply a laches analysis, and that under that analysis the plaintiff's suit was timely. The defendant appealed.

The Delaware Supreme Court affirmed. The court acknowledged that under ordinary circumstances a suit in equity will not be stayed for laches after the time fixed by the analogous statute of limitations at law — which in this case would be three years and would bar the plaintiff's suit. However, the court agreed with the lower court that this was one of the few cases where the statute of limitations should not be applied because of extraordinary circumstances.

The court first pointed out that the plaintiff promptly sought indemnification and advancement in Florida, and that he could not move against the parent while the decision denying his request was on appeal. The court then pointed out that the employer's bankruptcy was unexpected and that the plaintiff filed his action in Delaware shortly after the employer's bankruptcy plan was approved. Thus, the plaintiff's delay was not unreasonable. Furthermore, considering the parent controlled the litigation from the outset and was the party ultimately responsible for any award in the plaintiff's favor, the parent was not prejudiced.

CA Appellate Court Holds That Directors of Insolvent Corporations Do Not Owe Fiduciary Duties to Creditors

In *Henry v. Edgell*, G-043639 (Cal. App., 4 Dist.), decided Aug. 23, 2011, a creditor of a corporation sued the corporation's directors alleging they breached their fiduciary duties to him by failing to prevent the misappropriation of corporate assets and by acquiring a major asset for themselves. The trial court sustained demurrers in favor of the defendants, and the plaintiff appealed.

The California Court of Appeal held that under California law a director of an insolvent corporation does not owe a fiduciary duty to the corporation's creditors. The court also declined to create such a duty, which, according to the court, would conflict with and dilute the statutory and common law duties that directors owe the corporation and its shareholders. Therefore, the only extra-contractual duty owed to a creditor is that owed under the trust fund doctrine — which is the duty to avoid actions that divert, dissipate or unduly risk corporate assets that might otherwise be used to pay creditors. However, the court did find that the plaintiff had alleged that the defendants breached their duties under the trust fund doctrine and reversed the trial court's judgment.

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Five days later, the three KKR directors "authored an advisory memo to KKR's Investment Committee and Portfolio Committee containing a [nonpublic] update on Primedia's second quarter performance and advocating the purchase of Primedia's preferred shares" by KKR. Soon thereafter, KKR requested "permission for KKR to purchase Primedia's preferred shares, as long as Primedia was not purchasing those shares in the market." The Primedia Board determined that permitting KKR to purchase up to $50 million of preferred shares was "acceptable and not a usurpation of corporate opportunity." Accordingly, between July 8 and Nov. 5, KKR engaged in open market purchases of Primedia preferred shares.

On Sept. 26, the Primedia Board "approved the sale of one of its biggest assets, the American Baby Group, for approximately $115 million in cash." The sale was not disclosed to the public until Nov. 4. Of the preferred shares purchased by KKR, more than half were purchased during the interval between approval of the American Baby Group sale and its public announcement.

Subsequently, two Primedia stockholders filed a derivative action alleging that KKR's purchases were made on the basis of nonpublic information, including that: 1) "Primedia's earnings would be better than previously forecasted to the market" and 2) Primedia's unannounced sale of American Baby Group. According to the complaint, these purchases "were unfair to Primedia and resulted in the enrichment to KKR, at a cost to Primedia." Relying on *Brophy*, these stockholders sought to recover KKR's sales profits for and on behalf of Primedia.

The Court of Chancery dismissed the complaint, holding that "disgorgement was not an available remedy for … *Brophy* claims." In the Court of Chancery's view, consistent with *Pfeiffer*, the purpose of a *Brophy* claim is to "remedy harm to the corporation," meaning that "disgorgement is 'theoretically available' [only] in two circumstances: (1) 'when a fiduciary engages directly in actual fraud and benefits from trading on the basis of the fraudulent information;' and (2) 'if the insider used confidential corporate information to compete directly with the corporation.'" Given the absence of either of these circumstances, the Court of Chancery granted Primedia's motion to dismiss. Plaintiffs appealed.

The Supreme Court's Analysis

The Supreme Court saw no need to unduly narrow *Brophy* by requiring "an element of harm to the corporation before disgorgement is an available remedy." To the contrary, the Supreme Court pointed out that *Brophy* "explicitly held that the corporation did not need to suffer an actual loss for there to be a viable claim." As for the *Pfeiffer* court's "thoughtful, but unduly narrow interpretation of *Brophy* …," the Supreme Court declared that "[t]o the extent *Pfeiffer v. Toll* conflicts with our current interpretation of *Brophy v. Cities Co.*, *Pfeiffer* cannot be Delaware law."

In support of its conclusion, the Supreme Court observed that *Brophy* was built on the "seminal Delaware decision" *Guth v. Loft, Inc.*, 5 A.2d 503 (Del. 1939), in which the Supreme Court issued its "iconic warning" that "public policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, *regardless of whether his employer suffers a loss*" (emphasis added). In the Supreme Court's opinion, *Brophy* similarly "focused on preventing a fiduciary wrongdoer from being unjustly enriched" from insider trading. Having due regard to this precedent, the Supreme Court saw "no reasonable public policy ground to restrict the scope of disgorgement remedy in *Brophy* cases — irrespective of arguably parallel remedies grounded in federal securities law." On this basis, the case was reversed and remanded to the Court of Chancery for further proceedings on the merits.

Conclusion

Kahn's broad reading of *Brophy* re-establishes the right of Delaware stockholders to sue corporate fiduciaries to disgorge profits from insider trading — regardless of harm to the corporation, and regardless of the avenues provided by federal securities laws to address insider trading claims. The availability of a state law claim under *Brophy* for insider trading will preserve for stockholders — especially stockholders of private corporations who are less likely to pursue federal securities law claims than stockholders of public corporations — a useful litigation tool. And, clearly, *Kahn* serves as a reminder that the Delaware Supreme Court will not lightly accept an argument that its corporate law is pre-empted by a federal regulatory scheme.

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so, employers should explain the employees' obligations under the policy and also emphasize that nothing in the policy is meant to limit their right to discuss their working conditions via social media.

Though the *Hispanics United* decision and the NLRB's actions as of late in regard to employees' use of social media are a cause for concern, these steps should go a long way in protecting employers if and when the NLRB comes calling.

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