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First Department Adds Two New Factors to New York's Standard of Review for Non-Monetary Settlements of Shareholder Class Actions

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On Feb. 2, 2017, the Appellate Division, First Department issued a unanimous decision in *Gordon v. Verizon Communications, Inc.*, No. 653084/13, 2017 BL 31251 (1st Dep't Feb. 2, 2017), that may have significant consequences for non-monetary settlements of shareholder class actions in New York. Justice Melvin L. Schweitzer, then of the Commercial Division, rejected the putative settlement due to concerns about whether shareholders could benefit from the additional disclosures that were to be made. In an opinion by Justice Marcy L. Kahn, the First Department reversed and approved the proposed settlement. Justice Kahn applied the five-factor test that the First Department had previously adopted in *Matter of Colt Indus. Shareholders Litig. (Woodrow v. Colt Indus, Inc.)*, 155 AD2d 154, 160 (1st Dep't 1990), and added two new factors to that test. However, the court's failure to clearly define which parties these two new factors are meant to protect—*i.e.*, the shareholders or the corporation—may lead to confusion as courts apply this modified standard in the future.

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Background

The case arose out of a 2013 transaction between Verizon and Vodafone through which Verizon agreed to acquire certain Vodafone subsidiaries that held interests in a wireless telephone partnership for approximately $130 billion, with the consideration consisting primarily of cash and Verizon shares. Plaintiff Natalie Gordon, on behalf of herself and other similarly situated Verizon shareholders, filed a class action in the Commercial Division asserting that Verizon had breached its fiduciary duties to its shareholders by agreeing to the transaction with Vodafone, which allegedly resulted in Verizon paying an excessive and dilutive price to acquire the Vodafone shares.

Following the commencement of the suit, Verizon filed a preliminary proxy statement with the Securities and Exchange Commission detailing the terms and background of the transaction. After reviewing the preliminary proxy, Plaintiff concluded that Defendants' additional statements did not contain sufficient information for shareholders to make an informed vote on the transaction. Therefore, Plaintiff filed an amended complaint asserting additional claims for breach of fiduciary duty based on Verizon's failure to disclose material information about the transaction.

The First Department's holding could usher in a new approach to reviewing non-monetary settlements of shareholder class actions.

In December 2013, the parties entered into settlement discussions and came to an agreement in principle under which Verizon agreed that: (1) it would make additional disclosures to allow its shareholders to make an informed vote on the Vodafone transaction, and (2) for the three years following the settlement, Verizon would obtain a fairness opinion from an independent financial advisor if its board of directors engaged in a transaction involving the sale of more than $14.4 billion of its assets (representing approximately 5 percent of the company's $288.9 billion value). The proposed settlement also provided for an award of Plaintiff's attorneys' fees.

In October 2014, Justice Schweitzer of the Commercial Division issued a scheduling order certifying the class, preliminarily approving the settlement, and setting a date for a hearing to determine whether the settlement was fair, reasonable, adequate, and in the best interests of the class. During the hearing, ''strong opposition'' to the proposed settlement voiced by two objectors prompted the Commercial Division to ''take a second look'' at the settlement terms. In so doing, the court reached the conclusion that the additional disclosures ''fail[ed] to materially enhance the shareholder's knowledge about the merger'' and ''provide[d] no legally cognizable benefit to the shareholder class.'' Similarly, as to the provision for fairness opinions in future transactions, the court found that requiring such opinions could inhibit the ability of Verizon's directors to ''employ their collective business experience'' to take actions on minor corporate dispositions. Therefore, the court rejected the settlement as not being fair, adequate, reasonable, and in the best interests of the class.

First Department Decision

While the Commercial Division's holding did not analyze the *Colt* factors, the First Department evaluated the settlement—and reversed the Commercial Division—based on those factors. As a starting point for the court's analysis, Justice Kahn reviewed the history of non-monetary or disclosure-only settlements, noting that they came to prominence in the 1980s and 1990s in response to growing complaints regarding corporate misfeasance. However, the Appellate Division observed that these settlements had come to be regarded as a ''merger tax'' because shareholders would frequently bring non-meritorious complaints, the settlement of which generated significant attorneys's fees, but were of little value to either the shareholders or the corporations involved. Judicial disfavor of these class action settlements was highlighted in the 2016 Delaware Chancery Court ruling in *In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884 (Del. Ch. 2016), which declined to approve such a settlement unless the added disclosures ''significantly alter[ed] the 'total mix' of information made available.'' Several New York courts were similarly wary of these disclosure-only settlements.

Despite the skepticism of some courts, other Delaware and New York courts had recently begun to find that in certain instances, disclosure-only settlements were beneficial to shareholders. For example, in *City Trading Fund v. Nye*, 144 AD3d 595 (1st Dep't 2016) and *In re Xoom Corp. Stockholder Litig.*, No. 11263-CVG, 2016 BL 252274 (Del. Ch. Aug. 4, 2016), both New York and Delaware courts approved disclosure-only settlements where there was some discernible benefit to the shareholders. As such, some courts and commentators advocated for a more ''balanced approach'' towards evaluating these settlements.

With this background, Justice Kahn undertook an analysis of the proposed settlement at issue in *Gordon*. At the outset, the court decided that New York law would apply to the analysis given that the proposed settlement agreement contained a New York choice-of-law clause. The court then applied the ''longstanding standard'' outlined in *Colt*, which analyzes: the likelihood of success of the case, the extent of support for the settlement from the parties, the judgment of counsel, the presence of good faith bargaining over the settlement terms, and the nature of the issues of law and fact. In considering the facts of the case, the court found that these factors all weighed in favor of settlement.

Two New Factors

The court then expanded the reviewing court's inquiry under *Colt* by adding two new factors to the analysis of non-monetary settlements—*i.e.*, whether the agreement is in the best interests of the members of the putative class of shareholders and whether the proposed settlement is in the best interests of the corporation. The *Gordon*court noted that both New York and Delaware law had long favored enhanced judicial scrutiny of class action settlements. The addition of these two new factors, the court concluded, was simply an extension of the longstanding tradition of New York and Delaware courts to conduct an enhanced review of class action settlements.

Although the court indicated that revisiting the *Colt* factors was needed ''in order to effect an appropriately balanced approach to judicial review,'' it did not address a critical question—*i.e.,* how to distinguish between the best interests of the shareholders and the best interests of the corporation. This need for demarcation is especially important in this particular case where the shareholder class includes all shareholders of the company (as opposed to a segment of the shareholders) and their interests are thus difficult to distinguish from those of the corporation itself. This question will likely arise again as parties attempt to craft settlement agreements that will satisfy the First Department's newly expanded standard.

It remains to be seen whether the *Gordon* decision will encourage more merger challenges to be filed in New York—as opposed to Delaware.

The *Gordon* court's application of these two new factors did not shed any light on how this distinction would be made in an expanded *Colt* analysis. As to the new sixth factor, the Appellate Division found that the proposed disclosures provided a benefit to the shareholders (albeit in some instances a ''minimal'' benefit) so that they were in the shareholders' best interests. But it was the fairness opinion requirement that the court found to be the ''most beneficial aspect of the proposed settlement.'' Rejecting the Commercial Division's concerns, the First Department concluded that this requirement benefited the company's shareholders without inhibiting the directors' ability to make ''pricing determination[s]'' in future transactions. Thus, the court ruled that the settlement was in the best interests of the shareholders.

Applying the new seventh factor, the court found that the proposed settlement was also in the best interests of the corporation. Apparently alluding to its analysis of the sixth factor, the court held: ''*Again*, the proposed settlement would resolve the issues in this case in a manner that would reflect Verizon's direct input into the nature and breadth of the additional disclosures to be made and the corporate governance reform to be included.'' (emphasis added.) In addition, the court noted that Verizon would not have to incur additional legal fees in defending the action. The court did not elaborate on how giving the company ''direct input'' into the settlement made it an agreement that was in the company's best interests or how the best interests of the corporation were different, if at all, from the best interests of the shareholders.

Concurring Opinion

In a concurring opinion, Justice Moskowitz agreed that the court should approve the settlement, but she concluded that the majority had gone ''much further than is necessary to determine this appeal.'' She observed that the parties had not taken issue with the existing *Colt* test and thus had not had the opportunity to brief the two new factors articulated by the court. Justice Moskowitz viewed the requirement that a settlement be ''in the best interests of the class'' as part of the larger framework under which the *Colt* factors should be applied—not a new factor to add to the *Colt* test. According to Justice Moskowitz, the First Department had established in *Rosenfeld v. Bear Stearns & Co.*, 237 AD2d 199, 199 (1st Dep't 1997), that class action settlements should be evaluated under CPLR § 908's requirement that settlements be ''fair, adequate, and in the best interests of the class.'' She noted that in determining whether a settlement was ''in the best interests of the class,'' a court should apply the five-factor *Colt* test. As a result, Justice Moskowitz was of the view that in this case, where the proposed settlement agreement was found to be ''fair, adequate, and [in] the class members' best interest,'' the court should approve the settlement based solely on the original five-factor *Colt* test. Further, she thought that the court ought not to ''add a new factor to a long-established test without giving the parties the opportunity to brief the matter.''

In the majority opinion, Justice Kahn addressed these concerns, noting that the court was not obligated to afford parties the opportunity to brief the two new factors. Indeed, the court concluded that to ''insist'' on briefing whenever the court is ''contemplating a refinement of a common-law standard'' would be ''inconsistent'' with the court's duty to articulate changes to the common law as it deems it necessary. The First Department further concluded that the sixth factor of the test had already been established by prior case law as a ''benchmark'' for evaluating non-monetary settlements. Finally, the majority observed that the *Colt* standard was 25 years old and was in need of some enhancement in order to address the evolutions in non-monetary settlements that had occurred in the intervening years since *Colt* was decided.

Disposition of the Case and Its Potential Impact

In light of the newly enhanced *Colt* test for reviewing settlements of shareholder class actions, the Appellate Division reversed the Commercial Division's order and remanded the case for a hearing on attorneys' fees. The court also dismissed ''as academic'' an appeal from Justice Anil C. Singh's order denying Plaintiff's motion to renew.

The First Department's holding in this case could usher in a new approach to reviewing non-monetary settlements of shareholder class actions. However, the lack of clarity between the best interests of the shareholders as opposed to the corporation itself may lead to some confusion as parties seek to craft settlement agreements that will withstand scrutiny under the First Department's expanded *Colt* factors. It remains to be seen whether the *Gordon* decision will encourage more merger challenges to be filed in New York—as opposed to Delaware.