SEAN DEXTER	*	**IN THE**
***Plaintiff*,**	*	**CIRCUIT COURT**
v.	*	**FOR**
ZAIS FINANCIAL CORP.*, et al.*	*	**BALTIMORE CITY, PART 23**
***Defendants*.**	*	**Case No.: 24-C-16-004740**

* * * * * * * * * * * * *

MEMORANDUM OPINION

This matter came before the Court on Sean Dexter's ("Plaintiff") Motion for an Award of Attorneys' Fees and Related Expenses, filed October 13, 2016, and ZAIS Financial Corp. ("ZAIS"), David L. Holman, Daniel T. Mudge, Marran H. Ogilvie, Michael F. Szymanski, and Christian M. Zugel (collectively "Director Defendants," and together with ZAIS, the "ZAIS Defendants") and Sutherland Asset Management Corporation and Sutherland Partners, L.P.'s (the "Sutherland Defendants") (collectively "Defendants") Memorandum of Law in Opposition to Application for Attorneys' Fees and Related Expenses, filed November 3, 2016, and Plaintiff's Reply in Further Support of Application for Attorneys' Fees and Related Expenses, filed November 10, 2016.

I. FACTS & PROCEDURAL HISTORY

On April 7, 2016, ZAIS, a publicly traded real estate investment trust ("REIT") incorporated in the State of Maryland, announced that it had entered into an Agreement and Plan of Merger (the "Merger Agreement") with Sutherland Asset Management Corporation ("Sutherland"), a real estate finance company that acquired, originated, managed, serviced, and financed primarily small balance commercial loans. The Merger Agreement provided that: (i) Sutherland would be merged into a subsidiary of ZAIS; (ii) ZAIS, subject to shareholder approval, would issue shares of ZAIS to Sutherland shareholders pursuant to an exchange ratio; and (iii) ZAIS would make a

pre-merger tender offer to ZAIS shareholders who did not desire to retain their shares in the to-be-combined companies. On August 24, 2016, Plaintiff, an individual shareholder of ZAIS, filed a Complaint (the "Complaint") (docket #00001000) in this Court against Defendants. On August 30, 2016, Plaintiff filed a Motion for Preliminary Injunction ("Injunction Motion") (docket #00003000) to enjoin the shareholder vote, alleging that Defendants failed to disclose material information to shareholders prior to a pending vote on the issuance of shares of common stock as a precursor to ZAIS' reverse merger with Sutherland Asset Management Corporation ("Sutherland"). It is noted that prior to Plaintiff filing suit, ZAIS and Sutherland jointly disseminated a Form S-4 (the "Registration Statement") on May 10, 2016, subsequently amending it on June 20, 2016, August 5, 2016, August 19, 2016, and August 26, 2016.[1] This Court's Case Management Order No. 1 (docket #00006001), issued September 12, 2016, detailed a briefing schedule for Plaintiff's Injunction Motion.

On September 15, 2016, Defendants filed a Memorandum of Law in Opposition to Plaintiff's Injunction Motion (docket #00003004) and a Motion to Dismiss (docket #00013000). Prior to Defendants filing their opposition to Plaintiff's Injunction Motion, on September 12, 2016, Defendants issued supplemental information on Form 8-K filings with the Security and Exchange Commission ("SEC") (the "Supplemental Disclosures"). Subsequently, the Supplemental Disclosures were amended a second time on September 19, 2016. Plaintiff withdrew his Injunction Motion (docket #00003001) on September 19, 2016, on the basis that the disclosure claims alleged in his Complaint and Injunction Motion were moot. This Court granted Plaintiff's Motion to Withdraw on September 19, 2016 (docket #0003002).

On September 30, 2016, Plaintiff filed a Stipulation and Proposed Scheduling Order Concerning Plaintiff's Petition for an Award of Attorneys' Fees and Expenses (docket

[1] August 26, 2016 is two days after Plaintiff filed suit, but prior to Defendants' knowledge of the suit.

#00016000). Plaintiff filed his opening brief in support of the Fee and Expense Petition on October 13, 2016 (docket #00020000), Defendants filed their opposition on November 3, 2016 (docket #00020001), and Plaintiff filed a reply brief on November 10, 2016 (docket #00020002). A hearing was held before this Court on November 22, 2016.

The Plaintiff's Complaint alleged, among other things, that ZAIS shareholders were not adequately informed about the impending Shareholder Vote because the Registration Statements failed to include the final Exchange Ratio, the per share Tender Offer price, and information regarding conflicts of interest implicating Board members and executives involved with negotiations for the Merger. In regards to Plaintiff's Motion for an Award of Attorneys' Fees and Related Expense, Plaintiff argued that Defendants' Supplemental Disclosures were made as a result of a demand letter (the "Letter") sent by Plaintiff to Defendants on September 2, 2016, which offered to dismiss the litigation if Defendants agreed to a number of conditions including disclosing the exact Exchange Ratio for the Share Issuance, the exact per share price of the Tender Offer, and details relating to potential conflicts of interest. The Letter insisted that these disclosures be made no later than September 12, 2016. On September 8, 2016, Defendants responded to the Letter, refusing to engage in any discussions and declining Plaintiff's offer of settlement. Nonetheless, as described *supra*, Defendants filed a Form 8-K with the SEC on September 12, 2016. Defendants argue that the Supplemental Disclosures were disclosed not due to Plaintiff's Letter, but rather in accordance with the August 26, 2016 Registration Statement (the "August Registration Statement).

The August Registration Statement disclosed that the Exchange Ratio to be applied in the transaction between ZAIS and Sutherland was to be based on the "adjusted book value per share" of ZAIS and Sutherland as of the "Determination Date," which, pursuant to the terms of

the parties' agreement, was July 31, 2016. *See* Herbst Aff., ¶ 9, Ex. B, A-24-25. The August Registration Statement also disclosed that the price per share to be paid in the tender offer would be equal to 95% of the adjusted book value per share of ZAIS, reduced by an $8,000,000 contractual termination payment to its managing advisor, (ii) $4,064,000 in additional agreed adjustments, and (iii) expenses and reserves associated with certain litigation relating to the mergers, if any, with such price per share rounded to the nearest whole cent. *Id.* at ¶ 12, Ex. A, p. 4. Accordingly, once the "adjusted book value per share" was disclosed, the price per share to be paid in the Tender Offer could be calculated. On September 19, 2016, ZAIS disclosed information regarding conflicts of interest implicating Board members involved with negotiations for the Merger. However, Defendants maintain that this information was previously disclosed as a part of the Schedule 14A disclosures.

II. ANALYSIS

A. The "Common Fund" and "Corporate Benefit" Doctrines.

The American Rule states that litigants generally bear the costs of their attorneys' fees and expenses. *In re First Interstate Bancorp*, 756 A.2d 357, 756 A.2d 353, 357 (Del. Ch. 1999). However, Delaware courts recognize two exceptions to the American Rule: the "common fund" doctrine and the "corporate benefit" doctrine.[2] *Id.* The "common fund" doctrine applies when a plaintiff's efforts have secured some sort of monetary reward to a class of plaintiffs, and the plaintiff is therefore "entitled to an allowance for fees and expenses to be paid from the fund or property which his efforts have created." *Id*.

[2] Courts in Maryland's Business and Technology Case Management Program look upon decisions of the Delaware Court of Chancery as persuasive authority on corporate law matters. *See, e.g., Shenker v. Laureate Education, Inc.*, 411 Md. 317, n.14, 903 A.2d 408 (2009) (quoting *Werbowsky v. Collomb*, 362 Md. 581, 618, 766 A.2d 123, 143 (2001)). Thus, the Delaware Court of Chancery's body of law relating to attorney fee awards is instructive.

This "common fund" doctrine stands in contrast to the "corporate benefit" doctrine, and is triggered when "a tangible monetary benefit has not been conferred" by the litigant's efforts, but some other valuable benefit is realized by the injured group. *Id*. Under Delaware's "corporate benefit doctrine," a court "may order the payment of counsel fees and related expenses to a plaintiff whose efforts result in . . . the conferring of a corporate benefit." *Tandycrafts, Inc. v. Initio Partners,* 562 A.2d 1162, 1164 (Del. 1966) (citing *Chrysler Corp. v. Dann*, 223 A.2d 384, 386 (Del 1966). While these benefits "need not be pecuniary" in character, they must be "substantial," not merely *de minimis* to warrant an award of attorneys' fees. *Id.*

B. Factors for determining counsel fees.

The justification for any discretionary award of attorney's fees awarded by a court in shareholder litigation lies with the benefit conferred by the litigation upon the entire class of shareholders. *United Vanguard Fund, Inc. v. TakeCare, Inc.*, 727 A.2d 844, 854 (Del. Ch. 1998). Since the benefit is conferred upon the entire class of shareholders, it is only fair that the cost of receiving this benefit be adequately apportioned from the class's common benefit. *Id.* at 850, 854.

Under the corporate benefit rule, a court may award attorneys' fees and expenses even when a defendant moots one or more claims by satisfying the plaintiff's demands. *Tandycrafts, Inc. v. Initio Partners,* 562 A.2d 1162, 1164 (Del. 1966) (citing *Chrysler Corp. v. Dann*, 223 A.2d 384, 386 (Del 1966). In the instant matter, it is argued that Defendants' Supplemental Disclosures mooted the balance of Plaintiff's claims, thus the standard adopted by the Maryland Court of Special Appeals in *Wittman* applies. Accordingly, Plaintiff's claim for attorneys' fees and related expenses must satisfy the following three conditions: (1) the suit was meritorious when filed; (2) the action producing the corporate benefit was taken by the defendant prior to a

judicial resolution; and (3) the resulting corporate benefit was causally related to the lawsuit. *Wittman v. Crooke*, 120 Md. App. 369, 379, 707 A.2d 422, 426 (1998); *see also United Vanguard Fund, Inc. v. TakeCare Inc.*, 693 A.2d 1076, 1079 (Del. 1997) *and Allied Artists Pictures Corp. v. Baron*, 413 A.2d 876, 878 (Del. 1980). When each of these conditions are met, the burden shifts to the defendant to show that the lawsuit did not cause the benefit ultimately obtained. *United Vanguard Fund, Inc.*, 693 A.2d 1080. A presumption of causation arises by chronology; that is, where claims against a defendant are mooted while litigation is pending, the actions mooting the claims are presumed to have resulted from the litigation. *In re Riverbed Technology, Inc., Stockholders Litigation*, C.A. No. 10484-VCG, 2015 WL 5458041, *7 (Del. Ch. 2015). However, at the outset the suit must be meritorious when filed.

A claim is considered meritorious, "if it can withstand a motion to dismiss on the pleadings." *Wittman*, 120 Md. App. 379, 707 A.2d 426 (quoting *Chrysler Corp. v. Dann*, 223 A.2d 384, 387 (Del. 1966)). Accordingly, if even one of the claims asserted in plaintiff's complaint can survive a motion to dismiss, the requirement of meritoriousness will be met. *In re First Interstate Bancorp Consol. Shareholder Litigation*, 756 A.2d 362; *see also United Vanguard Fund, Inc.*, 727 A.2d 850–51 ("Meritorious" litigation means that which would have been able to withstand a motion to dismiss, and where the plaintiff "must have possessed knowledge of provable facts which held out some reasonable likelihood of ultimate success"). Plaintiff's Complaint asserts two direct claims: (1) against the Director Defendants for breach of the common law duty of candor, and (2) against the Sutherland Defendants for aiding and abetting the Director Defendants' breach of the above-described duty.

The Court of Appeals has previously found that a shareholder may, under certain circumstances, bring direct claims against a corporation's board of directors for breaches of

common law duties as enumerated in Md. Code Ann., Corps. & Assocs. § 2-405.1. *See Shenker v. Laureate Education, Inc.*, 411 Md. 317, 338, 983 A.2d 408, 420 (2009). Plaintiff relies on *Shenker* to suggest that, because Defendants' Supplemental Disclosures corrected the omissions indicated in their Injunction Motion, the litigation was therefore meritorious and created a corporate benefit, for which Plaintiff is entitled to a fee award. However, the *Shenker* Court only addressed the common law duties within the context of a cash-out merger after the decision to sell the corporation had already been made. 411 Md. 317, 983 A.2d 408. Citing *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), the *Shenker* Court determined that the common law duties are triggered when the decision is made to sell the corporation, the sale of the corporation is a foregone conclusion, or the sale involved an inevitable or highly likely change-of-control situation. 411 Md. 338, 341, 983 A.2d 408.

It is Defendants' assertion that Plaintiff's claim for breach of the common law duties are misplaced, as no such duty is owed to the shareholders under *Shenker* and also under *Sutton v. FedFirst Financial Corp.*, 226 Md. App. 46, 85, 126 A.3d 765, 788 (2015). In *Sutton v. FedFirst Financial Corp.*, the Court of Special Appeals found that the Plaintiff did not have a direct shareholder action against the directors when the directors entered into a merger agreement between FedFirst and CB Financial involving a stock-for-stock transaction in which the combined corporation continued to remain in a large, fluid public market in which FedFirst's stockholders were left with a continuing interest in CB Financial. 226 Md. App. 90–91, 126 A.3d 791–92. Subsequent to this determination, the court in *FedFirst* did not apply the *Revlon* factors. *Id.*

The merger in the instant matter is a cash-stock election merger, wherein shareholders may elect to receive either all cash or all stock. Here, following approval of the stock issuance,

ZAIS shareholders were given the opportunity to tender their shares in ZAIS for cash, or to continue to own some, or all, of their shares in the publicly-traded company. Thus, as the merger is not a "cash-out" merger as contemplated by *Shenker*, the common law duties of candor and maximization of value do not apply, and individual shareholders may not bring direct claims against corporate directors for breaches of common law duties. Similar to the merger in *FedFirst*, the *Revlon* duties are not triggered. Accordingly, the Complaint was not meritorious when filed.

In *Wittman*, the trial court found the suit to not be meritorious. 120 Md. App. 369, 379, 707 A.2d 422, 426. The trial court stated:

> In my judgment the suit was not meritorious when it was filed, and even if I accept [that] some of the changes that appeared in the final version of the proxy were suggestions that plaintiffs made, it is undisputed that these very changes were also recommended by the SEC .... there was nothing that the [appellant] suggested that was not included by the SEC or was not already in the document prepared by the [appellees] and their agents.... I also find that the benefit that arose because of the changes to the proxy statement were not causally related to the lawsuit. If anything, it was mere happenstance.

Id. In the instant matter, while the action producing the corporate benefit was taken by the Defendants prior to a judicial resolution, Defendants' Supplemental Disclosures were not causally related to the lawsuit. Defendants purport that they had no knowledge of Plaintiff's Complaint until the end of the day on August 26, 2016, after the August Registration Statement was filed. *See* Defendants' Memorandum of Law in Opposition to Plaintiff's Application for Attorneys' Fees and Related Expenses, Herbst Aff. ¶ 5, Ex. C; Blank Aff. ¶ 2, Ex. E. In fact, akin to *Wittman*, the Supplemental Disclosures made on September 12 were made in accordance with the schedule included in the August Registration Statement. The August Registration Statement stated:

> the exchange ratio will be equal to the quotient . . . determined by dividing (i) the Sutherland adjusted book value per share by (ii) the ZAIS Financial adjusted book value per share as of a determination date, which the parties

have agreed will be July 31, 2016.

Registration Statement, August 26, 2016, p. 2; *see also id.* A-10, definition of "Determination Date." According to the August Registration Statement, ZAIS and Sutherland were to publicly announce the exchange ratio at least five business days prior to the stockholder meetings, scheduled for September 27, 2016. *Id.* The August Registration Statement included the option for the special meetings of both ZAIS and Sutherland to be postponed if the September 27, 2016 date was less than five business days following the exchange ratio announcement. *Id.* at 5.

The August Registration Statement included a prospectus, which demonstrated the calculation of the Exchange Ratio using the adjusted book values per share of ZAIS and Sutherland as of a determination date of June 30, 2016. *Id.* at 15. The Exchange Ratio included in the prospectus was 0.8567, 0.0211 higher than the final Exchange Ratio of 0.8356 disclosed on September 12, 2016. This translated to a cost differential of twenty-nine cents in the Tender Offer price, with shares changing in value from $15.65 to $15.36, respectively. Notwithstanding this decline, ZAIS shareholders ultimately approved the share issuance by an overwhelming majority, with 97.4 percent of shareholders voting in favor of the share issuance. As in *Wittman*, the "benefit that arose because of the changes to the proxy statement were not causally related to the lawsuit. If anything, it was mere happenstance." 120 Md. App. 369, 379, 707 A.2d 422, 426. Thus, the disclosure of the Exchange Ratio and Tender Offer price were not causally related to Plaintiff's litigation.

Finally, Plaintiff alleges that the Supplemental Disclosures regarding potential conflicts of interest of two Board members was caused by the instant litigation. While a presumption of causation arises by chronology, this presumption may be rebutted. *See In re Riverbed Technology, Inc., Stockholders Litigation*, C.A. No. 10484-VCG, 2015 WL 5458041 (Del. Ch.

2015). Defendants maintain that the potential conflicts of interest were previously disclosed. On June 23, 2016, prior to suit being filed, Defendants filed a Proxy Statement which disclosed Board member Christian Zugel's ("Zugel") voting control of ZAIS and Board member Michael Szymanski's ("Szymanski") unvested units. *See* Defendants' Memorandum of Law in Opposition to Plaintiff's Application for Attorneys' Fees and Related Expenses, Ex. 4, p. 4, 20, 24. Subsequently, Defendants' September 19, 2016 disclosures stated, in relevant part, as follows:

> As previously publicly disclosed by ZGH in its SEC filings, Christian Zugel holds certain equity interests in ZGH and Michael Szymanski holds certain unvested units exchangeable for equity interest in ZGH. By virtue of their direct or indirect equity interests in ZGH, Messrs. Zugel and Szymanski may be regarded as having indirect equity interests in ZAIS REIT Management, LLC. As previously disclosed in ZGH's SEC filings, in his capacity as trustee of the Class B Voting Trust, Mr. Zugel has effective voting control of ZGH.

However, the information provided by Defendants on September 19, 2016 was not different than that previously provided. In fact, included in the annual report on Form 10-K, filed on March 10, 2016, is a description of each of the Executive Officers of ZAIS. Regarding Szymanski, it states: "Mr. Szymanski also serves as Chief Executive Officer, President and director of ZAIS Group Holdings, Inc. ("ZGH"), the parent company of ZAIS." p.11. Zugel is also included on the Executive Officer list. *Id.* Included in the August Registration Statement is a general disclosure that, "some of the executive officers and directors of ZAIS Financial have financial interests in the mergers that are different from, or in addition to, the interests of ZAIS Financial stockholders generally." Registration Statement, August 26, 2016, p. 20. A more detailed description is provided that states: "As of July 18, 2016, each of ZAIS Financial's named executive officers . . . and all of ZAIS Financial's . . . executive officers as a group beneficially owned shares of ZAIS Financial's common stock." *Id.*, p. 160. It is also provided that Zugel "is the Chairman of the

ZAIS Financial board and its chief investment officer, and also serves as the chairman of the board of directors and chief investment officer of ZAIS Financial's advisor.[3] Further, security ownership of certain beneficial ownership is set out in a table, which details both Zugel and Szymanski's equity interests. *Id.* p. 334–35, (2) (3). Accordingly, this disclosure was not causally related to Plaintiff's Litigation.

C. The *Sugarland* Factors

Should there be sufficient benefit to justify awarding attorneys' fees, the amount of any award is governed by what are known as the "Sugarland factors," from *Sugarland Industries, Inc. v. Thomas*, 420 A.2d 142 (Del. 1980). These factors are:

> the results achieved by counsel plus…the amount of time and effort applied to a case by counsel for plaintiff, the relative complexities of the litigation, the skills applied to their resolution by counsel, as well as any contingency factor and the standing and ability of petitioning counsel.

Sugarland Indus., Inc., 420 A.2d at 149. Delaware courts have recently applied increasing scrutiny to the amount of attorneys' fees awarded for a non-pecuniary benefit. *See, e.g., In re Riverbed Technology, Inc., Stockholders Litigation*, C.A. No. 10484-VCG, 2015 WL 5458041, *7 (Del. Ch. 2015). In so doing, the chancellors have recognized their wide discretion in applying attorney's fees, but have also determined that the most important of the *Sugarland* factors that should provide guidance in any award of fees is the benefit conferred to the plaintiffs. *Id*. at *7-8. The cessation of litigation has not been recognized as a cognizable benefit. *Chrysler Corp. v. Dann*, 223 A.2d 384, 387 (Del. 1966). In the instant matter, as the claims were not meritorious when filed and no benefit was conferred to the Plaintiff, as discussed *supra*, this Court will not engage in further analysis of the *Sugarland* factors.

III. CONCLUSION

[3] ZAIS Financial's advisor has previously been described as ZAIS REIT Management, LLC. *See* Form 10-K, p. 5 (Mar. 10, 2016).

Upon consideration of the Plaintiff's Motion for an Award of Attorneys' Fees and Related Expenses, and for the foregoing reasons, the Plaintiffs' Motion for an Award of Attorneys' Fees and Related Expenses is **DENIED** in accordance with the Order of this Court issued on even date.

IT IS SO ORDERED, this 8th day of December, 2016.

/s/ Audrey J.S. Carrión
Judge Audrey J.S. Carrión
Case No.: 24-C-16-004740

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