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Delaware Judges Have Been Heard

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Until very recently, abusive litigation related to mergers was all but certain to follow the announcement of a public merger. Last fall, we wrote an article discussing the proliferation of disclosure-only settlements used to resolve merger litigation, which in many cases do not provide any economic benefit to shareholders and foreclose potentially valuable claims that have not been thoroughly vetted. Plaintiffs attorneys in such cases typically fare better than their shareholder clients because they typically received fees of hundreds of thousands of dollars in connection with the disclosure-only settlements. Defendants are also incentivized to agree to these settlements in an effort to quickly resolve the litigation that otherwise stands as an impediment to closing the deal, and in return receive an extremely broad release of virtually all claims that relate to the transaction.

As we explained, the sophisticated Delaware Chancery Court, the nation’s premier bench resolving corporate governance issues, has recently made efforts to curb merger lawsuits that lack merit. The Delaware Chancery Court has expressed serious reservations about the frequency of these lawsuits, warning litigants that the days of automatic approval of disclosure-only settlements, broad releases for defendants and cash going only to plaintiffs lawyers are over.

Our predictions were borne out, and following a string of strongly worded decisions issued as recently as the second half of 2015, the number of lawsuits filed challenging public mergers dropped from 78 percent in the first nine months of 2015 to just 34 percent in the final quarter of 2015. On Jan. 22, 2016, the Chancellor of the Chancery Court, Andre Bouchard, delivered another major blow to disclosure-only settlements.

In a 43-page opinion in In re Trulia Inc. Stockholder Litigation, Chancellor Bouchard confirmed that the sun has set on routine approval of disclosure-only settlements. Chancellor Bouchard devoted 25 pages of the opinion to a well-reasoned discourse on the problematic issues and incentives that surround abusive merger litigation, and issued a resoundingly clear affirmation of the law in Delaware as it relates to this category of cases. He warned that "disclosure settlements are likely to be met with continued disfavor in the future." Delaware judges will continue to be "increasingly vigilant in scrutinizing" the proposed exchange in merger settlements to ensure that the terms are fair to absent class members. Given the abandonment of the Chancery Court's historical predisposition toward approving disclosure settlements, we expect the numbers of cases filed to drop even more significantly.

Background: The Abusive Nature of Much M&A Litigation

As we previously explained, in recent years, 93 percent of all public company M&A transactions are subject to lawsuits challenging the deal.[1] This is a dramatic increase from 10 years ago, when major lawsuits involving financial fraud, including cases involving Enron, Worldcom, Tyco and Adelphia, were prominent. By 2015, lawsuits were filed challenging the proposed merger after virtually every public merger was announced, in many cases with little regard to the merits of the claim. These cases often asserted boilerplate claims of breach of fiduciary duty against the directors and/or officers and failure to disclose all relevant facts about the merger. With or without a court order, the pace of meritless cases is often expedited and they "conveniently reac[h] disclosure settlements on a repeated pattern," often shortly before something of substance, such as a preliminary injunction hearing, is scheduled.[2] Assad v. World Energy (2015). The settlements generally require the company to make a few additional disclosures that typically do not impact shareholder approval of the deal. But as the Chancery Court has noted, "[i]t just can't be that there are meaningful disclosure violations in every single M&A case that's being filed in this court."[3] Assad.

Disclosure-only settlements have traditionally offered the "path of least resistance" for litigants. Defendants have been anxious to settle a case that they could otherwise successfully defeat because it is faster and cheaper than pursuing the litigation and the pending lawsuit may complicate closing the transaction.[4] Plaintiffs lawyers rely on the additional disclosures to form the basis for their fee request — generally amounting to hundreds of thousands of dollars. The lawsuits have become so common that they are anticipated by companies considering strategic transactions as a virtually certain "deal tax" on mergers — a tax that benefits lawyers but not the public.

Response of the Delaware Bench

Over the last year and a half, Delaware courts have spoken up and raised serious concerns about the flimsy nature of M&A lawsuits that provide no meaningful benefit to shareholders.[5] In a recent lawsuit involving claims of breaches of duty in connection with HP's acquisition of Aruba Networks, Vice Chancellor J. Travis Laster observed, "[w]e have reached a point where we have to acknowledge that settling for disclosure only and giving the type of expansive release that has been given has created a real systemic problem. ... when you get the sue-on-every-deal phenomenon."[6] In re Aruba Networks (2015).

The courts faced a dilemma. They profess belief in the value of the plaintiffs bar in policing corporate action through shareholder class actions. In the eyes of some judges, the existence of such suits has both a prophylactic affect in deterring abuse but also is a remedy for actual abuses. Yet, it was obvious to courts, commentators in the press and academia, politicians and others who follow merger developments that a substantial percentage of merger cases are frivolous and create a tax on companies involved in M&A that only benefits plaintiffs lawyers. The chancellor of the Chancery Court, along with several vice chancellors, have now publicly recognized that the underlying problem is baseless litigation. Because many of the frivolous cases are settled early, before their pleading or merits could be addressed by the court, the judiciary has only been able to attack the problem by addressing the terms of settlement rather than the underlying lack of merit. But the impact of their efforts are being felt.

Until as recently as early 2015, neither legislatures nor courts had done much to address this abuse except to decry the situation. Faced with inaction on the legislative front and the ongoing abuse in the merger context, the Chancery Court took action and its message is being heard. With the stern warnings from Chancellor Bouchard, the law from the Delaware Chancery Court on this issue has further solidified, and the chances of securing court approval for disclosure-only settlements have been dramatically reduced. Below we summarize some of the recent cases prior to the decision by Chancellor Bouchard in In re Trulia.

In Acevedo v. Aeroflex, (2015), a merger challenge lawsuit, Vice Chancellor Laster chastised the plaintiffs' counsel, stating, "what I don't think you're recognizing is sometimes when you've got nothing, you've got to acknowledge you've got nothing and just go away." Aeroflex. In rejecting the disclosure-only settlement, he expressed distaste for the practice, stating "[r]outine settlements also mean that some ... cases that should be litigated actually don't get litigated because ... you get in the habit of settling everything for ... 'a peppercorn and a fee.'" Aeroflex. Shortly thereafter, Vice Chancellor Laster rejected a settlement in a lawsuit arising out of the $2.78 billion merger of Hewlett-Packard with Aruba Networks and denied fees for the plaintiff's lawyers. He explained, "I don't think the case was meritorious when filed. At the time it was filed, what the market evidence suggested was an arm's-length strategic buyer, a 34 percent premium to unaffected market price, and an even higher premium based on other metrics." Aruba.

In other decisions, the court has approved the proposed settlement, albeit with warnings that its decision might be different in later cases. In In re Riverbed Tech. (2015), a stockholder challenged the merger of Riverbed Technology and Thomas Bravo LLC and Teachers' Private Capital. Vice Chancellor Sam Glasscock narrowly approved the proposed settlement, expressing reservations about the merit of the plaintiff's claims. The court showed its concern for the "very broad, but hardly unprecedented, release" and warned litigants that such releases "will be diminished or eliminated going forward in light of this Memorandum Opinion and other decisions of this Court." Riverbed.

In Assad, the Chancellor Bouchard lamented, "[e]very deal basically is the subject of litigation. ... I think there's a lot of concern that a lot of the stuff that has been occurring historically is very fluffy." Assad. Consequently, he instructed "everybody would be well-advised to make sure you got something real before you .... bring it in to the Court." Assad. This decision was a clear warning of what was to come — his most recent opinion in In re Trulia.

In re Trulia Confirmed the Law in Delaware

Chancellor Bouchard recently refused to approve a disclosure-only settlement of a stockholder class action challenging Zillow Inc.'s acquisition of Trulia Inc. in a stock-for-stock merger that closed in February 2015. The proposed settlement stipulation included the basic elements that are typical for this class of cases — certain additional disclosures in the proxy, an extremely broad release that encompassed unknown claims and "claims arising under federal, state, foreign, statutory, regulatory, common law or any other law or rule" held by any proposed class member, and an unopposed award of $375,000 attorneys' fees and expenses for the plaintiffs' counsel. Signaling what was to come, after a hearing on the proposed settlement, Chancellor Bouchard requested supplemental briefing from the parties on whether the disclosures meet the legal standard for materiality and the justification for including unknown claims in the proposed release.

The supplemental disclosures provided additional details concerning (1) certain synergy numbers in the financial adviser's value creation analysis; (2) selected comparable transaction multiples; (3) selected public trading multiples; and (4) implied terminal EBITDA (earnings before interest, taxes, depreciation, and amortization) multiples for a relative discounted cash flow analysis. Trulia at 27. However, in evaluating these additional disclosures, Chancellor Bouchard concluded that "none of the supplemental disclosures were material or even helpful to Trulia's stockholders." Trulia at *2. He explained that stockholders are entitled to receive a "fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely." Id. at *27. However, the summary need not contain "all information underlying the financial advisor's opinion or contained in its report to the board." Id. Chancellor Bouchard characterized the supplemental disclosures as "additional minutiae underlying some of the assumptions" or "trivialities" and thus concluded that this information could not reasonably be deemed material. Trulia at *34.

Regarding the release, after receiving Chancellor Bouchard's request for briefing on the justification of the scope of the release, the parties "commendably" agreed to a narrower release. The narrower release eliminated unknown and foreign claims, as well as any state or federal antitrust claims. Nevertheless, Chancellor Bouchard explained that it "still would have been too broad to support a fair and reasonable settlement because the revised release was not limited to disclosure claims and fiduciary duty claims concerning the decision to enter the merger." Trulia, at 41, n. 89. For these reasons, he declined to approve the proposed settlement, and set forth a clear road map for any plaintiffs who are litigating a merger objection lawsuit.

Resolving M&A Lawsuits With Disclosure-Only Settlements

Courts have expressed serious concern with the ill-effects of disclosure-only settlements. As we previously explained, the Delaware bench has been skeptical of the value added by the additional disclosures published as part of these settlements. The courts have recently acknowledged that the disclosures are often not material, are duplicative of other information or simply add gloss or unnecessary detail and do not impact how shareholders vote on transactions. This view was echoed by Chancellor Bouchard, who noted that "providing supplemental disclosures is a particularly easy 'give' for defendants to make in exchange for a release." Trulia, at 13.

Moreover, disclosure settlements present challenges for the court because it is asked to evaluate the fairness of a settlement on an extremely sparse record, with little or no motion practice. Without an adversarial process, the court is placed into the role of "forensic examiner of proxy materials" to probe the materiality of the additional disclosures from a shareholders viewpoint. Trulia at 15. Without defendants to help the court consider and assess the materiality of this information, "it falls to law-trained judges to attempt to perform this function, however crudely, as best they can." Id. Chancellor Bouchard suggested that in such circumstances, the court may need to appoint an amicus curiae to assist its evaluation of the alleged benefits of the supplemental disclosures. Trulia at 24.

The role of global releases obtained in exchange for these disclosures has also been addressed by the court. Vice Chancellor Laster has stated in very direct language: "I don't know why you get to release [claims other than disclosure claims] for nothing. The historical basis for this has just been the defendants' desire for complete peace. I would like complete peace. I would like peace in our time, without appeasement. But just because you want it doesn't mean you get it." Aruba.

Chancellor Bouchard joined the attack on global releases head on in In re Trulia. He challenged the scope of releases that encompass unknown or unrelated claims without performing appropriate due diligence on other available and possibly meaningful claims. Chancellor Bouchard warned that in disclosure cases, the subject matter of a proposed release should be "narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process." Trulia at 24.

How To Cure the Abuse: Incentives and Penalties

We previously considered how to best incentivize a change in behavior while not discouraging meritorious cases or appropriate settlements. We first suggested a possible legislative solution. That would include Delaware and other jurisdictions enacting legislation that parallels the Private Securities Litigation Reform Act. The PSLRA imposed heightened pleading standards in an effort to weed out weak claims at an early stage. Similar legislation could be put into place to raise the bar for frivolous lawsuits.

In the absence of any indication that state legislatures are imposing laws to discourage these lawsuits, we previously opined that the Delaware bench was the best and most likely available remedy in the near term to discourage baseless merger litigation. Consistent with our views, the Delaware judiciary has taken a serious and thorough approach to deciding these lawsuits. And their rulings have had an almost immediate impact in reducing the number of filings.

Chancellor Bouchard has recommended two possible solutions to adjudicate disclosure claims outside the settlement context and in an adversarial process (which enables the court to provide a meaningful assessment of the benefits to the shareholder class). First, during a preliminary injunction motion, the plaintiff would have to demonstrate on the merits that the alleged omission or misrepresentation was material. Or, second, plaintiffs counsel could apply for attorneys' fees award after defendants voluntarily supplement their proxy materials. Thus, defendants would be incentivized to oppose the fee request as excessive and in so doing, assist the court in its evaluation of the value of the supplemental disclosures. Trulia at 20-21.

Advice and Predictions for the Future

We have already seen a stark drop in the number of frivolous lawsuits filed. In light of the recent decision by Chancellor Bouchard, it now cannot be denied that the judiciary's solution to frivolous merger lawsuits will cause plaintiffs to think twice before filing weak lawsuits.

For those cases that are filed, the recent Delaware cases will also make settlements more difficult to negotiate, regardless of whether the claim has merit. For one, all parties will have to be very careful about whether the disclosures issued as part of a settlement are in fact material.[7] In addition, releases will have to be narrowly tailored to the claims at issue. Narrowing releases may have the unintended consequence of making it more difficult to put an end to another abuse: multijurisdictional litigation of claims in various state courts where some claims of a class may survive because releases in Delaware are narrowed.[8] Chancellor Bouchard offered the straightforward solution to this issue — merger parties can adopt a forum selection bylaw to ensure that it is only necessary to defend against litigation in one jurisdiction: Delaware

We remain of the view that a substantial decline in Delaware M&A litigation will also impact directors and officers insurance. In recent years, as the volume of M&A litigation has skyrocketed, insurance companies not unreasonably pushed for rates that were higher than they would otherwise be because of the virtually certain lawsuit that greets every transaction. This charge amounts to an additional tax on most corporations caused by abusive litigation. The recent and dramatic drop in M&A litigation will very likely soften pricing in the market for D&O insurance. However, settlements in the future will likely be approved with narrower releases allowing some multiple jurisdiction litigation to survive Delaware releases in the event the corporations do not have a forum selection bylaw. Corporate counsel may want to check their bylaws and will need to exercise judgment in structuring D&O coverage.

In our view, the Chancery Court has bravely and effectively addressed an abuse that needed to be addressed.

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[1] Olga Koumrian, Shareholder Litigation Involving Mergers and Acquisitions: Review of 2013 M&A Litigation at 1-2, Cornerstone Research (2014), available athttp://www.cornerstone.com/getattachment/73882c85-ea7b-4b3c-a75f-40830eab34b6/Shareholder-Litigation-Involving-Mergers-and-Acqui.aspx; Olga Koumrian, Shareholder Litigation Involving Acquisitions of Public Companies: Review of 2014 M&A Litigation at 1-2. Cornerstone Research (2015) available at https://www.cornerstone.com/GetAttachment/897c6ef-bfde-46e6-a2b8-5f94906c6332/Shareholder-Litigation-Involving-Acquisitions-2014-Review.pdf

[2] Assad v. World Energy Solutions Inc. No. 10324-CB, Hr’g Tr. at 38 (Del. Ch. Aug. 20, 2015) (“Assad”).

[3] Id.

[4] The settlement payment represents the “holdup value” of the lawsuit — in essence, an impediment to closing the merger. See Acevedo v. Aeroflex Holding Corp., C.A. No. 7930-VCL, Hr’g Tr. at 28-29 (Del. Ch. July 8, 2015) (“Aeroflex”)

[5] “[T]here is a lot of concern in this court about nonmonetary settlements.” Assad, Hr’g Tr. at 37.

[6] In re Aruba Networks, Inc. Stockholder Litig., C.A. 10765-VCL, Hr’g Tr. at 65 (Del. Ch. Oct. 9, 2015) (“Aruba”).

[7] Assad. Hr’g Tr. at 42; Haverhill Ret. Sys. v. Asali, C.A. No. 9474-VCL. Hr’g Tr. at 17 (Del. Ch. June 8, 2015) (holding that “if you had looked at the settlement in terms of the claims you asserted and gotten a release appropriately tailored to the claims you asserted” the settlement may have been approved).

[8] It is not uncommon for lawsuits involving substantial mergers to be filed in various state and federal courts around the country. It is obvious that such a practice results in higher legal fees and more

expensive resolutions with attorneys' fees to more plaintiffs firms. The broad releases in merger case settlements have been a partially effective deterrent to cases in multiple jurisdictions because the first settlement with a broad release tends to undermine the claims elsewhere. While the logic of having a release fit the claim being settled is hard to assail, narrowing releases will also make claims less attractive to settle as well as making multiple jurisdictional claims more difficult to manage.