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Assessing A Judicial Solution To Abusive Merger Litigation

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This article addresses abusive litigation related to public mergers that has increased dramatically in recent years. It also addresses related disclosure-only settlements, which in many cases do not benefit shareholders. Plaintiffs attorneys in such cases fare better than their shareholder clients because fees of hundreds of thousands of dollars have, up until now, generally been paid to plaintiffs attorneys in disclosure-only settlements. It also discusses the breadth of the releases that are generally given to defendants in these cases and finally the incentives created by the attempts to fix the problems created by the abusive litigation.

The sophisticated Delaware Chancery Court, the home to a great deal of corporate governance litigation, has recently made efforts to curb merger lawsuits that lack merit. Such cases make up a substantial portion of the claims that follow almost every public merger and are often resolved with nothing more than a few meaningless disclosures, a broad release and hundreds of thousands of dollars of plaintiffs attorneys' fees. Examining these issues now is timely because the Delaware Chancery Court has expressed serious reservations about 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.

Background: The Abusive Nature of Much M&A Litigation

In recent years, 93 percent of all public company M&A transactions are subject to lawsuits challenging the deal. This is a dramatic increase from 10 years ago, when the lawsuits du jour involved Enron, Worldcom and Tyco. Today, lawsuits are filed after virtually every public merger is announced, in many cases with little regard to the merits of the claim. These cases often assert 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 to occur. 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.” Assad.

The disclosure-only settlements offer the “path of least resistance” for the litigants. Defendants are 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. 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 viewed by companies as an expected “deal tax” on mergers — a tax that benefits lawyers but not the public.

Response of the Delaware Bench

Delaware courts have recently raised serious concerns about the flimsy nature of M&A lawsuits that provide no meaningful benefit to shareholders. 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.” In re Aruba Networks (2015).

The courts also have 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 is obvious to courts, commentators and politicians that a substantial percentage of merger cases are frivolous. While several members of the Chancery Court have recognized that the underlying problem is baseless litigation, they have only been able to attack the problem by addressing the terms of settlement rather than the underlying lack of merit. That is because many of the frivolous cases are settled early, before their merits could be addressed by the court.

Until recently, neither legislatures nor courts have done much to address this abuse except to decry the situation. This is unlike the situation of the “stock drop” cases in the 1980s and early 1990s that prompted Congress to pass the Private Securities Litigation Reform Act (PSLRA), which started a movement toward eliminating the most frivolous of the “stock drop” cases.

Faced with inaction on the legislative front and the ongoing abuse in the merger context, the Chancery Court is now taking action. In a dramatic departure from historical practice, the court has begun to reject proposed disclosure-only settlements or at least express serious concern with, albeit ultimately approving, other settlements.

In Acevedo v. Aeroflex (2015), a merger challenge lawsuit, the court 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.

Vice Chancellor Laster rejected a settlement in a lawsuit arising out of the $2.78 million merger of Hewlett-Packard with Aruba Networks and denied fees for the plaintiffs' 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 Technology(2015), where a stockholder challenged the merger of Riverbed Technology and Thomas Bravo LLC and Teachers’ Private Capital, Vice Chancellor 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 court 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, the court instructed “everybody would be well-advised to make sure you got something real before you ... bring it in to the Court.” Assad.

Resolving M&A Lawsuits With Disclosure-Only Settlements

Frivolous lawsuits prompt disclosure-only settlements, and courts have expressed serious concern with the ill effects of disclosure-only settlements. First, the Delaware bench has been skeptical of the value added by the additional disclosures published as part of the settlement. The disclosures are generally not material and do not impact how shareholders vote on transactions.

The Chancery Court has also challenged global releases that serve as a form of “deal insurance” for defendants. Vice Chancellor Laster has questioned, “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.

The Chancery Court seems especially concerned where the proposed settlement includes a release of unknown or unrelated claims. Judges have begun to question the logic of surrendering claims without performing appropriate due diligence on other possibly available and possibly meaningful claims.

How To Cure the Abuse: Incentives and Penalties

Given the recognition that frivolous merger cases need to be curtailed, the question arises: how to properly incentivize a change in behavior while not discouraging meritorious cases or appropriate settlements?

From a statutory standpoint, Delaware and other jurisdictions could pass legislation that parallels the PSLRA. The PSLRA imposed heightened pleading standards in an effort to weed out weak claims at an early stage. Similar legislation could be enacted in Delaware and other jurisdictions to make it harder for frivolous lawsuits to survive earlier challenges to the claims.

Since legislation may not be practical, the efforts of Vice Chancellor Laster and others on the Delaware bench may be the best available remedy in the short and medium term to the scourge of baseless merger litigation. This solution does carry with it the risk of creating some less-than-perfect incentives.

Advice and Predictions for the Future

Without a legislative solution, the actions of the courts described above are likely to reduce the number of frivolous lawsuits. However, they will also make settlements more difficult to negotiate, regardless of whether the claim has merit. They will make releases fit better the claims at issue in the litigation. However, 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 a narrow release in Delaware.

Despite the worries about the incentives created, the judiciary's solution to frivolous merger lawsuits should at least cause plaintiffs to think twice before filing weak lawsuits. Plaintiffs and defendants will have to give more thought to the appropriate breadth of releases and whether disclosure-only settlements are based on disclosures that will be seen as meaningful.

This sea change 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 pushed for higher rates to account for the virtually certain lawsuit that greets every transaction. Given the regime signaled by recent opinions, we expect that there will be a downturn in M&A litigation and the market for D&O insurance may soften. However, settlements in the future will likely be approved with narrower releases allowing some multiple jurisdiction litigation to survive Delaware releases. Corporate counsel will need to exercise judgment in structuring D&O coverage.

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