Expert Q&A on Judicial Activism and Disclosure-Only Settlements in Delaware

Sending a forceful signal to the plaintiffs' bar and corporate defendants, the Delaware Court of Chancery in *In re Trulia, Inc. Stockholders Litigation* adopted a new standard for judicial approval of disclosure-only settlements in litigation challenging public mergers and acquisitions (M&A). Practical Law asked *Gregory Markel* and *Gillian Burns* of *Cadwalader, Wickersham & Taft LLP* to explain the implications of the *Trulia* decision and offer guidance for companies and counsel facing potential M&A-related disputes.

GREGORY A. MARKEL
SENIOR COUNSEL
CADWALADER, WICKERSHAM & TAFT LLP

Greg is a trial attorney recognized as a national star by leading independent publications. His practice areas include securities litigation, corporate governance litigation, M&A, and other complex litigation. Greg speaks and writes frequently on securities litigation, jury trial practice, corporate governance, and other legal topics.

GILLIAN GROARKE BURNS
SPECIAL COUNSEL
CADWALADER, WICKERSHAM & TAFT LLP

Gillian concentrates her practice on complex commercial and securities litigation and regulatory investigations. She represents underwriters, lenders, professional firms, corporate directors, and other individuals in a variety of industries, including financial services, energy, pharmaceuticals, manufacturing, real estate, and telecommunications.

Why do Delaware courts play a unique role in M&A litigation?

Over half of the corporations in the US are incorporated in Delaware, and most corporate governance and M&A-related disputes are litigated in Delaware courts. The reason for this is the internal affairs doctrine, a choice of law principle that provides that the law of the state of incorporation applies to disputes relating to the internal governance of a corporation.

As a result, both the judges of the Delaware Court of Chancery and the justices of the Delaware Supreme Court have developed significant expertise in a variety of issues of corporate law. Indeed, no other jurisdiction boasts a similar concentration of judges with an equal depth of experience and knowledge of corporate law and, therefore, other jurisdictions generally pay widespread deference to Delaware courts on these issues.

What are disclosure-only settlements and how did they gain prominence?

By 2014, 93% of public mergers were the subject of shareholder or derivative suits (commonly known as strike suits) that attacked the adequacy of the compensation or disclosures provided to shareholders in connection with a proposed transaction. Because the proposed mergers typically involved large companies with a significant amount of money at stake, counsel for shareholders filed these strike suits knowing that corporate defendants were strongly incentivized to reach an

early settlement to resolve the dispute and close the transaction without delay.

In most instances, the parties settled these claims using what are commonly known as disclosure-only settlements. These settlements provided additional disclosures about the transaction to shareholders in exchange for a release of claims, which generally was broader in scope than the claims actually asserted by the shareholders. These releases also served to clear a path to close the transaction without any follow-on litigation. As one court observed, disclosure-only settlements offer "the path of least resistance" for all litigants (*In re PAETEC Holding Corp. S'holders Litig.*, 2013 WL 1110811, at *6 (Del. Ch. Mar. 19, 2013)).

While a substantial subset of these suits raised non-trivial issues, these disclosure-only settlements generally offered no meaningful remedy or benefits to the allegedly aggrieved shareholders beyond the supplemental disclosures, which were rarely of any substantive importance. Moreover, courts often awarded substantial fees to plaintiffs' counsel, despite their minimal investment in bringing these suits and their marginal achievements for their shareholder clients. Even where defendants had the stronger litigation position, and likely could have successfully defended against the claims raised, protracted litigation made closing merger transactions more difficult. Settling the claims provided certainty for the companies and cost comparatively little, as attorneys' fees were the only cash outlay.

Courts, academics, commentators, and companies criticized these strike suits and disclosure-only settlements as a tax on public mergers, and many felt that the legal system was being gamed primarily for the benefit of a small number of plaintiffs' attorneys. Despite this criticism, state legislatures took no action to address the problem.

What must the parties show to win judicial approval of a disclosure-only settlement in Delaware?

The Delaware Court of Chancery Rules have similar procedures for approving class action settlements as the Federal Rules of Civil Procedure and civil rules in most other states. Rule 23(e) of the Delaware Court of Chancery Rules requires that:

- The court approve a class action settlement.
- Notice be given to all class members who will be bound by the settlement.

When a settlement is proposed, the court holds a hearing to determine if the settlement agreement is "fair, reasonable, and adequate." To make this determination, the court, acting as a fiduciary to protect the interests of absent class members, must evaluate the claims and possible defenses and consider whether the proposed settlement will benefit the absent class members who were not involved in negotiating the settlement agreement.

By the time this hearing is set, both sides are generally invested in having the settlement approved. To persuade the court that a proposed disclosure-only settlement agreement meets the fair, reasonable, and adequate standard, the parties must demonstrate that the supplemental disclosures offer sufficiently material information to shareholders to justify a broad release of claims. Disclosures are material when there is a substantial likelihood that a reasonable shareholder would either:

- Consider the information "important in deciding how to vote."
- View the omitted information as "alter[ing] the total mix of information made available."

(*In re Trulia, Inc. Stockholder Litig.*, 129 A.3d 884, 899 (Del. Ch. 2016) (internal quotations omitted).)

Search Class Action Toolkit: Settlement for a collection of resources to assist counsel with settling class actions in federal court.

Have Delaware courts typically approved disclosure-only settlements?

Consistent with other federal and state courts, Delaware courts generally support parties' agreements to end litigation through settlement and, until recently, regularly approved disclosure-only settlements.

In 2015, however, the Delaware judiciary took more aggressive steps toward curbing abusive M&A litigation. The Vice Chancellors of the Delaware Court of Chancery began issuing opinions that:

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- Expressed skepticism that virtually every merger had disclosure violations justifying litigation.
- Voiced concerns about the value to shareholders of the additional disclosures.
- Warned that overbroad releases can possibly bar legitimate claims.
- Noted the haste with which cases were resolved on an often sparse record consisting of nothing more than post-settlement confirmatory discovery and a payout to plaintiffs' attorneys following minimal work.
- Threatened that disclosure-only settlements would be rejected in the future if the consideration on both sides of a settlement was not real and proportional.

This increased judicial skepticism of disclosure-only settlements culminated in *In re Trulia, Inc. Stockholder Litigation*, which made clear that disclosure-only settlements would no longer be approved as a matter of course. Chancellor Bouchard cautioned that litigants who choose to resolve claims through disclosure-only settlements should expect the court to conduct a case-by-case assessment of the reasonableness of the bargain reflected in a settlement, and that a settlement will not be approved unless:

- The supplemental disclosures address a "plainly material misrepresentation or omission." The court clarified that it "should not be a close call that the supplemental information is material as that term is defined under Delaware law."
- The proposed release is narrowly drafted to include "nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently."

(*In re Trulia, Inc.*, 129 A.3d at 898.)

The *Trulia* decision emphasizes the vital function of the Delaware judiciary in dealing with significant issues of corporate governance and policy, particularly in situations where the legislature has refused to act. Indeed, the coordinated effort by the Delaware judiciary reflected in the series of decisions leading up to *Trulia* that challenged disclosure-only settlements effectively changed the law without depending on action by the Delaware legislature. The level of judicial activism exhibited by the experienced judges on the Delaware Court of Chancery is unique to that court.

Search Developments in Disclosure-Based Deal Litigation Settlements and Delaware Court of Chancery Issues Definitive Ruling on Disclosure-Only Settlement Approvals for more on the *Trulia* decision.

What are the advantages and disadvantages of the heightened standard set out in *Trulia*?

The main advantage of the new *Trulia* standard is that it should minimize the number of frivolous lawsuits that are filed almost automatically following the announcement of a public M&A transaction and eliminate the associated transaction costs. The heightened standard also incentivizes plaintiffs' counsel to appropriately scrutinize proposed M&A transactions and challenge only those that truly are not in the best interests of shareholders.

Conversely, one disadvantage of the heightened standard is its potential chilling effect on some meritorious lawsuits. Additionally, it is now more difficult to settle a suit after it has started, which disadvantages parties who might wish to avoid an unwanted trial.

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How have jurisdictions other than Delaware handled disclosure-only settlements?

Courts outside of Delaware hold a similarly dim view of disclosure-only settlements. For example, in New York, the primary jurisdiction confronting disclosure-only settlements outside of Delaware, courts have rejected disclosure-only settlements. These courts have criticized disclosure-only settlements by suggesting that they:

- **Offer immaterial supplementary disclosures that provide no genuine benefit to absent class members.** For example, in *In re Allied Healthcare Shareholder Litigation*, the court denied approval of a proposed disclosure-only settlement noting that the additional disclosures proposed by the settlement agreement were insignificant and did not alter any of the terms of the merger agreement (2015 WL 6499467, at *1 (N.Y. Sup. Ct. Oct. 23, 2015)). Similarly, in *Gordon v. Verizon Communications, Inc.*, a New York court denied a proposed disclosure-only settlement, asserting that the supplemental disclosures, which presented already-provided information but in tabular or graphic form, were "so trivial or obviously redundant as to add nothing of material value" (2014 WL 7250212, at *3, *7 (N.Y. Sup. Ct. Dec. 19, 2014); see *City Trading Fund v. Nye*, 2015 WL 93894, at *13, *19 (N.Y. Sup. Ct. Jan. 7, 2015) (characterizing proposed supplemental disclosures as grossly and utterly immaterial)).

- **Raise the specter of collusion among the parties.** New York courts have expressed concern over the perception of collusion that arises in proposed disclosure-only settlements, with plaintiffs' counsel receiving significant fees and corporate officers receiving broad releases (see *In re Allied Healthcare*, 2015 WL 6499467, at *2 (noting that the net effect of a disclosure-only settlement was to settle on terms that offered "nothing to the shareholders except that attorneys they did not hire will receive a $375,000 fee and the corporate officers who were accused of wrongdoing will receive general releases"); *City Trading Fund*, 2015 WL 93894, at *8-9, *21 (suggesting that plaintiffs' counsel's allegiance was to their fees rather than to class members)).
- **Perpetuate abusive litigation.** New York courts also have been wary of arguments, typically in support of a fee award for plaintiffs' counsel, that derivative litigation serves a societal and prophylactic purpose even where there is no meaningful recovery (see *In re Allied Healthcare*, 2015 WL 6499467, at *2 (characterizing this argument as "horse-hockey")). Instead, these courts have lamented that disclosure-only settlements set up a "perverse result" where plaintiffs "will continue to unjustifiably extract money from shareholders, who get no benefit from the litigation but nonetheless end up paying two sets of attorneys," unless courts serve as gatekeepers and deny approval of these settlements (*City Trading Fund*, 2015 WL 93894, at *20; see also *Gordon*, 2014 WL 7250212, at *8 (describing the trend toward strike suits and disclosure-only settlements as turning law intended to protect shareholder interests "on its head" by "divesting them of valuable rights" and imposing "additional gratuitous costs")).

The Seventh Circuit may be the next court to address disclosure-only settlements (see Opening Brief & Required Short Appendix of Appellant John Berlau, *Hayes v. Berlau*, No. 15-3799 (7th Cir. Mar. 11, 2016) (in appeal of a district court's approval of a disclosure-only settlement in a strike suit, urging the Seventh Circuit to adopt the Delaware Court of Chancery's *Trulia* approach to disclosure-only settlements)).

Given Delaware's reputation, other jurisdictions might begin to impose the heightened standard set out in *Trulia*, though its exact application remains to be seen. However, that is not to say that other jurisdictions always follow Delaware courts on issues raised in M&A litigation. Courts in other jurisdictions have on occasion rejected a Delaware approach to certain M&A-related issues. Indeed, a recent decision from the New York Court of Appeals declined to follow Delaware precedent protecting pre-closing communications between parties to a merger agreement as privileged under the common interest doctrine, and instead found that under New York law, a communication shared between parties must relate to either pending or anticipated litigation for the common interest exception to apply (*Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, 2016 WL 3188989 (N.Y. June 9, 2016)).

Search New York Court of Appeals Narrows Common Interest Doctrine for Asserting Privilege over Pre-Merger Discussions or see page 11 in this issue for more on the *Ambac* decision.

What changes should counsel expect in light of the *Trulia* decision?

Public estimates suggest that the number of lawsuits challenging public mergers has dropped from 93% of all proposed transactions in 2014 to 34% since October 1, 2015 (see Liz Hoffman, *The Judge Who Shoots Down Merger Lawsuits*, Wall St. J., Jan. 10, 2016). As the impact of the *Trulia* decision continues to be felt in Delaware and other jurisdictions, that number is likely to drop even further.

When M&A litigation is filed and the parties reach a proposed settlement, counsel will have to be prudent about the nature and scope of the releases to obtain judicial approval. Counsel can expect that the Delaware Court of Chancery will be very critical of broad releases. As a result, defendants could find themselves subject to multiple lawsuits related to the same transaction.

Should companies continue to choose Delaware in forum selection clauses relating to corporate governance matters?

Yes, in most cases, because corporate defendants can anticipate:

- A lower likelihood of strike suits because the *Trulia* standard for settlement approval is likely to cause plaintiffs' counsel to more carefully consider the merits of potential suits before filing.
- That a judge adept at handling corporate governance disputes will preside over any litigation concerning corporate matters, and settlements resolving M&A litigation will no longer be approved as a matter of course.

Given these circumstances, corporate defendants likely will recognize that the benefits of litigating corporate disputes in Delaware will outweigh the downside that settlements will face more rigorous evaluation.

The Delaware General Corporation Law now permits boards to select Delaware as an exclusive forum for internal corporate claims in corporate certificates of incorporation or by-laws (8 Del. C. § 115 (2015)). In most cases, boards will take advantage of this option. Where they do not, however, corporate boards planning a public M&A transaction should consider including an exclusive forum selection clause designating Delaware in the transaction documents.

Search By-Laws or Certificate of Incorporation: Delaware Forum Selection for a Standard Clause for the certificate of incorporation or by-laws of a Delaware corporation selecting the Delaware Court of Chancery as the exclusive jurisdiction for intra-entity disputes, with explanatory notes and drafting tips.

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