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The Shifting Landscape in M&A Litigation

Recent reports indicate that the number of mergers that were challenged by stockholders during the fourth quarter of 2015 dropped significantly, with estimates ranging from 34% to 21%.[1] This is a seismic shift from prior years, when almost 95% of public company transactions resulted in litigation. The drop in lawsuits is attributable to a series of rulings by the Delaware Court of Chancery during the second half of last year. In these rulings, the court expressed significant concern with the routine approval of settlements in stockholder litigation and, in some cases, the court refused to approve the settlement. These rulings demonstrate the Delaware judges' dissatisfaction with the current state of M&A litigation. As Vice Chancellor J. Travis Laster put it in the *Aruba Networks* case,[2] "we 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." We describe below the four court rulings issued between July and October of 2015 that led to the current state of play. We also offer some observations on the shifting landscape of M&A litigation.

Background

According to Cornerstone Research, 93% of merger transactions valued over $100 million were litigated in 2014.[3] Over half of those lawsuits were settled. Of those settlements, almost 80% were "disclosure-only," meaning the defendants made additional disclosures prior to the stockholder vote but did not pay any other consideration to the stockholder class.

These disclosure-only settlements require the company to make additional disclosures in exchange for a broad release of all claims by stockholders and an award of attorneys' fees. The disclosures often involved mundane details relating to the investment banker's financial analysis of the transaction. This system incentivizes plaintiffs' attorneys to file suit after every deal, work the case long enough to settle, and ultimately obtain relatively large fees from the company for the purported "benefit" conferred by the litigation. Stockholders are left with additional disclosures, no financial recovery and a release of claims against the defendants that extends beyond the claims at issue in the lawsuit.

Over the past few years, the Delaware courts have grown concerned with the state of M&A litigation. Last year, however, the Court of Chancery significantly upped its criticism of disclosure-only settlements. As discussed below, four recent rulings ending with the *Aruba Networks* case signal an end to the routine

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[1] *See* Liz Hoffman, *Judge Makes Merger Lawsuits Disappear*, WALL STREET JOURNAL, Jan. 11, 2016, at C1 (reporting that just 34% of mergers involving Delaware corporations after October 1, 2015, were challenged); Matthew D. Cain & Steven Davidoff Solomon, *Takeover Litigation in 2015* (preliminary) (finding that M&A lawsuits dropped to 21.4% during the fourth quarter of 2015).

[2] *In re Aruba Networks, Inc. S'holder Litig.*, C.A. No. 10765-VCL (Del. Ch. Oct. 9, 2015) (TRANSCRIPT).

[3] OLGA KOUMRIAN, CORNERSTONE RESEARCH, SHAREHOLDER LITIGATION INVOLVING ACQUISITIONS OF PUBLIC COMPANIES: REVIEW OF 2014 M&A LITIGATION (2015). Of the cases filed in 2014, 52% have settled, 30% are pending and 13% were voluntarily dismissed. *See id.* at 4.

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approval of disclosure-only settlements and may potentially change the M&A litigation landscape in even more profound ways.

Key 2015 Delaware Cases Dealing with Approval of Disclosure-Only Settlements

Acevedo v. Aeroflex Holding Corp.[4]

Acevedo arose out of Cobham plc's acquisition of Aeroflex Holding Corporation. Plaintiffs alleged conflicts of interest on the part of the directors, but plaintiffs' counsel quickly negotiated a settlement including: (i) a reduction in the break-up fee from $32 million to $18 million; (ii) a reduction in the buyer's matching right period, from four business days to three; and (iii) supplemental disclosures in the proxy statement regarding the potential conflicts of interest. In exchange, the plaintiffs provided the directors with what has come to be a typical release — and so broad that Chief Justice Strine has dubbed them "intergalactic" — and plaintiffs' counsel sought an $825,000 fee. Vice Chancellor J. Travis Laster rejected the settlement primarily on the following three grounds:

- **The Proposed Settlement Terms Lacked Value.** The Vice Chancellor asserted that the proposed settlement "fixed something that didn't need fixing." The limited discovery conducted revealed no conflict of interests. Furthermore, to the extent plaintiffs' counsel identified any other potential concerns with the transaction, the settlement did not remedy them. Instead, the Vice Chancellor suggested that the proposed settlement was a "testament to the holdup value of a lawsuit," with the costs of enjoining the deal acting as the only driver of the settlement.

- **The Attorneys' Fees Were Unjustifiable.** Because the proposed settlement terms lacked value, the court denied the fee request. Vice Chancellor Laster did not refute that plaintiffs' counsel worked diligently on the case, but rather asked the question of "why [they] should get paid for it." The Vice Chancellor noted that the $825,000 fee request resulted from just three weeks of work on a settlement that gained nothing of value for the stockholders and extinguished all of their potential claims moving forward.

- **The Release Was Too Broad.** The court concluded that the extremely broad release, described by Vice Chancellor Laster as "intergalactic," unjustifiably extended to claims well beyond those raised by the plaintiffs.

In re TW Telecom, Inc.[5]

TW Telecom arose out of Level 3 Communications, Inc.'s acquisition of TW Telecom, Inc. In his ruling, which came just over a month after *Acevedo*, Chancellor Andre G. Bouchard came "as close as [he's] gotten to not approving a settlement in [his] time on the bench." He "reluctantly" approved the settlement, but highlighted the serious issues he had with the terms and expressed his hope that future cases take his concerns into account. His concerns were similar to those raised by Vice Chancellor Laster in *Acevedo*:

- **Weakness of Settlement Terms.** Chancellor Bouchard struggled with the "very broad release" of "even unknown claims" as compared to the "quality of what was obtained for that release" which was, in his view, "not great." He lamented that the majority of the disclosures had "no consequential value, to be blunt." He also suggested that any value of adjusting a "matching rights" period in the merger agreement from five days to three was "so ethereal and so speculative, it's hard to really give it much value."

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[4] *Acevedo v. Aeroflex Holding Corp.*, C.A. 7930-VCL (Del. Ch. July 8, 2015) (TRANSCRIPT).

[5] *In re TW Telecom, Inc. S'holder Litig.*, C.A. 9845-CB (Del. Ch. Aug. 20, 2015).

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- **Unsubstantiated Attorney's Fees.** Chancellor Bouchard also characterized the "level of actual work that was done" by the plaintiffs' counsel as "pretty minuscule." He described the two depositions and roughly 2,500 pages of reviewed documents as a "modest" effort for a "modest" benefit. Ultimately, Chancellor Bouchard awarded $150,000, in attorney's fees, inclusive of expenses, which was far less than requested by plaintiffs' counsel.

In re Riverbed Technology, Inc.[6]

Riverbed was decided a month after *TW Telecom*. In a written opinion, Vice Chancellor Sam Glasscock III stressed the need to examine "the incentives that operate on" plaintiffs' counsel in these settlements, namely obtaining fees. He also suggested that the defendants' incentives (i.e., closing the deal and obtaining releases) are also factors in evaluating such settlements. Although Vice Chancellor Glasscock ultimately approved the settlement, he reduced the fee award, criticized this type of settlement, and suggested the court was unlikely to continue approving similar settlements. The Vice Chancellor's criticisms fell into two main categories:

- **The Settlement's Small Value Matched the Release's Small Scope.** The court found that the disclosures in the settlement "had tangible, although minor, value" to the stockholders. The Vice Chancellor stressed that fairness of the merger was the heart of the issue, and if what the stockholders received was a "peppercorn, what has been released looks more like a mustard seed." Though the language of the release was broad, the practical application was not, because of the nature of the transaction and the investigation into other claims by plaintiffs' counsel. In approving the settlement, the Vice Chancellor made frequent use of qualifiers, such as "in light of the unique circumstances" and "in the specific circumstances," to limit his acceptance of such a broadly worded release.

- **Attorney's Fees Unjustified by Settlement's Small Value.** Plaintiffs' counsel sought $500,000 in fees, which was unopposed by the defendants. Vice Chancellor Glasscock, however, reduced the award to $300,000 (plus costs of $29,881.61) because he thought the result for the stockholders was "too modest a benefit to justify the fee sought."[7] He noted that the pleadings "contained much in the way of boilerplate of the type ubiquitously pled in connection with public-company mergers."

In re Aruba Networks, Inc.[8]

The fourth ruling of note was *Aruba Networks*, which was decided in October 2015. After conducting limited discovery, plaintiffs' counsel abandoned its challenge to the merger price in favor of a claim attacking the company's disclosures about the timing of certain employment negotiations. Ultimately, the company agreed to supplement its disclosures in exchange for a release of all merger-related claims against the company, its directors and officers, and other third parties. During oral argument, Vice Chancellor Laster questioned plaintiffs' counsel extensively and ultimately rejected the settlement and dismissed the case for three central reasons:

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[6] *In re Riverbed Technology, Inc. S'holder Litig.*, C.A. 10484-VCG (Del. Ch. Sept. 17, 2015).

[7] The court applied the *Sugarland* factors. *See Sugarland Indus., Inc. v. Thomas*, 420 A.2d 142, 149-50 (Del. 1980) ("These factors are: (i) the amount of the time and effort applied to the case by counsel for the plaintiffs; (ii) the relative complexities of the litigation; (iii) the standing and ability of petitioning counsel; (iv) the continent nature of the litgation; (v) the stage at which the litigation ended; (vi) whether the plaintiff can rightly receive all the credit for the benefit conferred or only a portion thereof; and (vii) the size of the benefit conferred.").

[8] *In re Aruba Networks, Inc. S'holder Litig.*, C.A. No. 10765-VCL (Del. Ch. Oct. 9, 2015) (TRANSCRIPT).

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- **The Case Was Not Meritorious When Filed.** Plaintiffs originally challenged only the adequacy of the consideration, which Vice Chancellor Laster concluded was not a viable claim. He opined that the litigation was a "harvesting-of-a-fee opportunity … because there wasn't a basis to file in the first place." Even though plaintiffs' counsel eventually discovered a litigable claim, "it was just dealt with through the disclosure and the fee."

- **Plaintiffs' Briefs Overstated Their Attorneys' Work.** Vice Chancellor Laster criticized plaintiffs' counsel for its misleading use of adjectives in its "canned brief" and a "pattern of overstatement" in these cases. Specifically, the Vice Chancellor took issue with the use of the word "extensive" plaintiffs' counsel used to describe the work it had performed — namely, two depositions and a review of 1,200 documents. He noted the irony of a brief relating to the accuracy and thoroughness of a proxy statement that had misleading statements itself.

- **The Release Was Too Broad.** Vice Chancellor Laster observed that the "intergalactic" release covered far more potential claims (including unknown claims) than were addressed during the litigation. In particular, he focused on the fact that the release was not limited to disclosure claims. Vice Chancellor Laster also refused to accept plaintiffs' counsel's assertion that they investigated other potential claims; he reasoned that plaintiffs' counsel's "path to getting paid is to reassure" the court about the scope of the release and the investigation of the released claims. In a proceeding to approve a settlement that, by its nature, is not adversarial, Vice Chancellor Laster was simply unwilling to take plaintiffs' counsel's word for it.

Conclusion

Delaware courts have become increasingly wary of M&A litigation. The four cases described above, however, suggest a new regime. As Chancellor Bouchard stated, "disclosure settlements" will be "scrutinized more going forward." Moreover, recent empirical data indicates that the overall number of merger lawsuits declined significantly after *Aruba Networks*. It thus appears that the plaintiffs' bar is evaluating the new landscape.

Although it is impossible to predict the future of M&A lawsuits, we offer the following observations:

- Plaintiffs' counsel will become more selective in bringing lawsuits. Mergers involving conflicts of interest (e.g., management-led buyouts and controlling stockholder freeze-outs) will be much more likely to be targeted than third-party transactions.

- Plaintiffs may find that litigating outside of Delaware is more appealing. Delaware companies can try to safeguard against this threat by adopting exclusive forum bylaws.

- Disclosure-only settlements will face significant scrutiny going forward. Mundane supplemental disclosures will be unlikely to justify a broad release of claims covering the process in which the merger was approved.

- Plaintiffs' counsel will seek settlements that go beyond supplemental disclosures. Clearly, a monetary payment to the stockholder class will always be the most prized concession from defendants, but plaintiffs will also focus on other therapeutic or behavioral remedies.

- Releases will be more narrowly tailored to the allegations, the actual work done by the plaintiffs' counsel, and the benefits provided by the settlement.

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- Stockholder objections may be seen more frequently. In particular, Fordham law professor Sean Griffith has objected in his capacity as a stockholder to numerous disclosure-only settlements.[9]
- Because the business model of most plaintiffs' firms depends on maintaining a large portfolio of cases, plaintiffs' lawyers may continue to bring lawsuits but instead litigate post-closing. This strategy will be difficult, however, in light of the Delaware Supreme Court's recent ruling in *Corwin v. KKR Financial Holdings LLC*, which held that the business judgment rule will apply to a merger once it has been approved by the stockholders on a fully informed basis.
- As evidenced in *Rural/Metro* and *Southern Peru*, Delaware courts will continue to reward plaintiffs' counsel for vigorously pursuing meritorious claims through trial.

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[9] *See, e.g., In re Trulia Inc. S'holder Litig.*, C.A. 10020-CB, amicus br. (Del. Ch. Oct. 16, 2015).