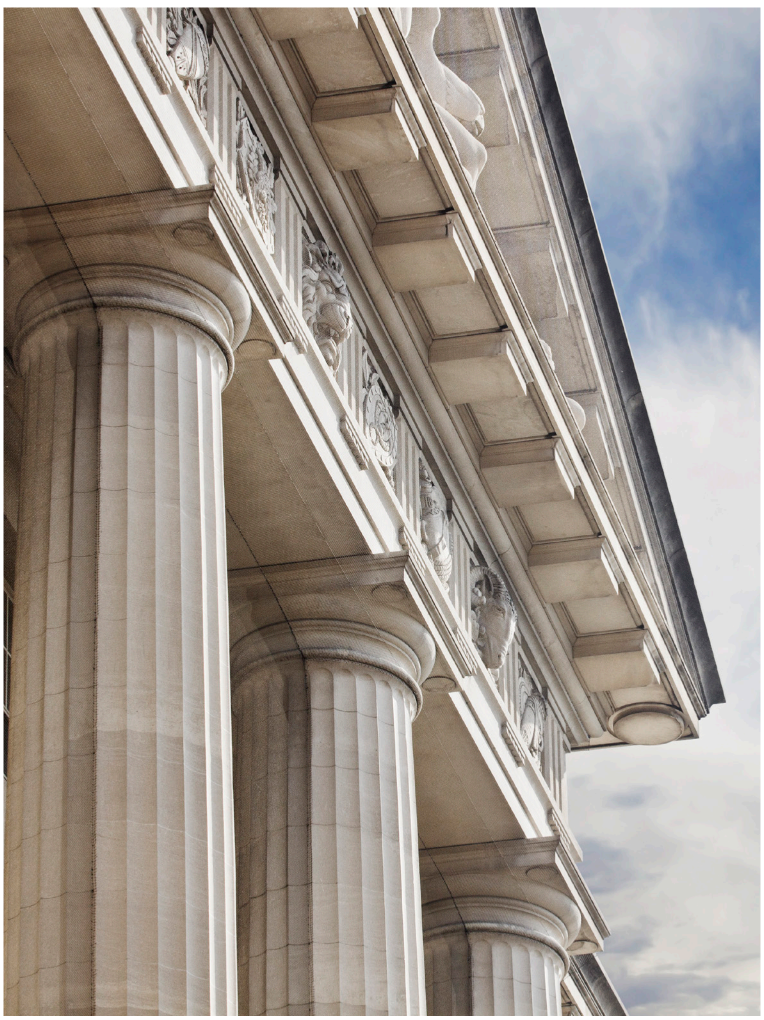
THE CHANGING DYNAMICS OF MERGER LITIGATION — EARLY IMPACTS ON FILINGS, SETTLEMENTS, TRIALS, AND INSURANCE



If your company announces a merger, multiple merger objection lawsuits will likely soon follow. Such lawsuits have often led to "disclosure-only" settlements, in which the target company agrees to make additional disclosures along with payment to the plaintiff's lawyers in exchange for a broad release of claims related to the merger. However, in a January 2016 decision, the Delaware Chancery Court rejected disclosure-only settlements as a means to resolve such cases. While the immediate impact of the ruling may be to reduce the number of lawsuits filed in Delaware in connection with proposed mergers, the long-term impact could be higher costs for companies, their directors and officers, and their D&O insurers.

PREDICTABLE PATTERNS

In recent years, more than 90% of deals valued at $100 million or more were followed by merger litigation.[1] These lawsuits generally followed a familiar and predictable pattern: Upon the announcement of the merger, plaintiffs' lawyers would quickly file multiple lawsuits, often both in the state in which the target corporation is headquartered and, if the target is a Delaware corporation, in the Delaware Court of Chancery. Members of the target's board of directors, the target company itself and the purchasing company would typically be named as defendants; in some cases, the target company's investment advisor would also be named. Such complaints would typically allege that the directors of the target company breached their fiduciary duties by:

- Conducting a flawed sales process, leading to an inadequate sale price.
- Agreeing to overly oppressive and restrictive "deal protection" provisions, which discouraged or prevented competing offers.
- Engaging in various conflicts of interest.

The lawsuits would often be accompanied by a motion for accelerated discovery seeking quick document production and early depositions of one or more directors and officers and the investment banker advising the target board. Once a company filed its preliminary proxy document, the complaint would often be amended to add claims that the proxy was materially misleading, with allegations that the proxy must include the minutest details of the board's or investment advisor's analysis.

This typical scenario would often lead to the parties reaching a disclosure-only settlement. By 2012, more than 80% of merger settlements were resolved in this way.[2]

This situation was somewhat of a mixed blessing for deal participants. Certainly, these lawsuits exacted a "toll" (referred to by some as a "deal tax") that had to be paid to allow the merger to proceed to closing. But this cost was often relatively small compared to the overall value of the transaction, and would insulate the deal from further challenges because of the broad release the defendants would receive (what came to be known as an "intergalactic release").

[1] *See* Mathew D. Cain *et al.*, *The Shifting Tides of Merger Litigation,* at 8-9 (U. Penn. Faculty Scholarship 2017).

[2] Matthew D. Cain & Steven M. Davidoff, *Takeover Litigation in 2012,* at 4 (Feb. 1, 2013).

DISCLOSURE-ONLY SETTLEMENTS REJECTED IN DELAWARE

However, Chancellor Bouchard's January 2016 decision rejected the disclosure-only settlement reached in *In re Trulia Shareholder Litigation*, 129 A.3d 884 (Del. Ch. 2016). In *Trulia*, in exchange for additional disclosures, plaintiffs dropped a motion to preliminarily enjoin the transaction and agreed to provide a broad release of all claims, including unknown claims "'arising under federal, state, foreign, statutory, regulatory, common law or other law or rule' held by any member of the proposed class relating in any conceivable way to the transaction."[3] The proposed settlement did not change the economics of the transaction and included defendants' agreement not to oppose a fee application by plaintiffs' counsel of up to $375,000.

Chancellor Bouchard rejected the proposed settlement, finding that it was not fair or reasonable to Trulia's shareholders and that the supplemental information disclosed as part of the proposed settlement was not material or helpful to shareholders.[4] The Chancellor also noted that even if the supplemental disclosures had been material and warranted some release of claims, the proposed release was too broad and would need to be limited to the claims being settled.[5] Subsequent to *Trulia*, several other courts have followed Delaware's lead.[6]

While it is still possible to enter into disclosure-only settlements, this approach to resolving merger litigation — at least in Delaware — appears to be waning.

MORE FEDERAL FILINGS

Post-*Trulia*, merger objection suit filings in Delaware Chancery Court are significantly down. However, this trend has been offset by a sharp increase in merger filings outside of Delaware and, in particular, in federal courts. The uptick in federal merger filings has contributed to a record pace for securities class-action filings in 2017.[7] By filing in federal court under the proxy disclosure rules of Section 14 of the 1934 Securities Exchange Act, plaintiffs continue to focus on disclosure issues and these cases could perhaps continue to be resolved based solely on enhanced disclosure with more certainty of the court approving significant fees. With these cases based solely on alleged disclosure violations, we anticipate that so-called "intergalactic" or broad releases will not generally be obtainable.

It is too early to predict how federal courts will react. The only federal court ruling we have seen on this issue so far adopted the *Trulia* reasoning and analysis.[8]

[3] *Id.* at 889.

[4] *Id.* at 900-08.

[5] *Id.* at 907 & n.89.

[6] *See, e.g., In re Walgreen Co. Stockholder Litig.*, 832 F.3d 718 (7th Cir. 2016) (Posner, J.); *Vergiev v. Aguero,* No. L-2276-15 (N.J. Super. Ct. Law Div. Sept. 26, 2016).

[7] See *Record Number of Federal Securities Class Actions Filed in First Quarter of 2017* (Cornerstone Research available at Cornerstone.com).

[8] *In re Walgreen, 832 F.3d 718.*

MORE STATE FILINGS OUTSIDE OF DELAWARE

Where not blocked by a Delaware bylaw, more filings are occurring in state courts outside of Delaware. Many state courts are presumably still willing to approve disclosure-only settlements. However, due to the dominance of Delaware Court of Chancery decisions, to which other courts often look for either governing or persuasive authority, it is likely that the practice of filing merger lawsuits alleging the full range of violations, from process to price received to disclosure, in the hope of obtaining quick and easy disclosure-only settlements is in decline.

The increasing presence of Delaware venue bylaws may still require that these suits be brought in Delaware state and/or federal court. However, the reality is that in many cases, where defendants and plaintiffs share a common interest in being able to easily settle these suits, more corporations that have such bylaw provisions may choose not to assert them. Some corporations may also be hesitatant to adopt such provisions in the first place.

EVOLVING LITIGATION DYNAMICS

In some ways, this merger litigation phenomenon is similar to that which was observed following passage of the Private Securities Litigation Reform Act (PSLRA) of 1995. The PSLRA reduced the classic "strike suit" to a large extent, but it also had the effect of making the securities class actions that were filed, and that survived the elevated pleading standards on a motion to dismiss, more difficult and costly to settle. Similarly, the merger cases being filed following the recent rejection of disclosure-only settlements (other than those filed in federal court in a clear effort to avoid the Delaware approach) may be cases that plaintiffs are more willing to take to an injunction hearing or continue post-closing in a damages claim.

If plaintiffs represent to the court that they seek— or may seek — to enjoin a shareholder vote or the closing of a merger, it is relatively easy to make a compelling argument at the outset of the case that they should be permitted accelerated discovery. After receiving the benefit of early discovery, including depositions conducted and documents produced under extremely rushed conditions, plaintiffs can choose to forego seeking an injunction and craft a more detailed amended complaint for damages that can easily satisfy the Rule 12 pleading standards applicable in fiduciary duty state court actions (as opposed to the higher standard applicable under the PSLRA). While plaintiffs will still face a defense of the exclusivity of appraisal remedies for monetary damages claims, it is relatively easy to plead around the standards for applying exclusivity of appraisal remedies, which tend to be ill-defined.

Once a case survives a motion to dismiss, an entirely new level of risk and expense presents itself as defendants face the prospect of a long and arduous lawsuit after a deal's closing. Furthermore, the merits of a merger case, which would be determined in a bench trial by a very sophisticated Chancellor or Vice-Chancellor in Delaware court, may now be litigated in other state courts, where judges will almost

certainly not be as experienced in this type of litigation and where plaintiffs may be entitled to a jury trial. This can completely change the risk profile and dynamics — as well as the expense — of the litigation.

INSURANCE AND INDEMNIFICATION IMPLICATIONS

The potential demise of the disclosure-only settlement has already had significant implications for the boards of public companies, for those owing indemnification obligations to individual defendants, and for directors and officers liability (D&O) insurers.

For example, with the possibility of more merger objection lawsuits proceeding post-closing with the benefit of early accelerated discovery, and the higher likelihood of such complaints surviving a motion to dismiss under more lenient non-PSLRA standards, larger settlements may be expected. The cost of defense will also increase significantly once a lawsuit over a complex issue, such as a merger, survives a motion to dismiss.

Furthermore, unlike securities class-action lawsuits, the lack of the required element of scienter (intent to defraud) may permit both plaintiffs and defendants to more realistically contemplate taking lawsuits to trial. However, the enhanced barriers to liability set up by director exculpation provisions — which limit monetary liability of directors to cases in which only the most egregious misconduct is proven — may keep in place many of the same disincentives to take a case to a verdict, with its inherent risks to insurance and indemnification coverage.

Historically, merger objection lawsuits were not viewed as a significant exposure for D&O insurers, as the cost of defense tended to be low, and the plaintiffs' fee portion of the settlement was typically fairly small, meaning that the entire claim would generally be resolved within the D&O retention. However in recent years, in response to the increase in the frequency of merger claims and size of plaintiffs' fee awards, some D&O insurers have begun imposing higher retentions on merger claims. Insurers are actively monitoring the changing landscape regarding merger objection claims. It remains to be seen how insurers may react with respect to pricing, policy language, limits, and/or retentions.

With merger lawsuits more focused on monetary recovery for the class, it is possible that disputes over the application of the D&O policy's "bump up" exclusion — a provision stating that any amount paid in settlement or judgment which represents an increase in the price paid for the target company — is not a covered "loss" — may substantially increase.

In addition, while most major D&O insurers now include language in their policies expressly stating that coverage is provided for a plaintiffs' fee that is paid as part of a settlement in certain circumstances, the language differs by insurers. Individual D&O insurers have taken and will

continue to take different positions about how that coverage applies in these merger cases. For example, some insurers expressly limit the coverage to a plaintiffs' fee award in connection with a "non-monetary settlement."

Furthermore, some D&O insurers are now providing coverage for the defense costs incurred by the acquiring company in connection with aiding and abetting claims asserted by the target's shareholders, costs which have not traditionally been covered under D&O policies. This coverage may become more significant as these cases continue post-merger and those costs increase.

In light of the increasing uncertainty and exposure in connection with merger objection cases, it is imperative that companies work with their insurance brokers and legal counsel to understand limitations on coverage and ensure they have negotiated the best policy language available.

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