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WHY MERGER CASES SETTLE

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A lot of ink has been spilled about lawsuits filed immediately after a public company sale or merger is announced. The consulting firms that historically tracked only traditional securities class actions now assiduously monitor M&A litigation and the outcomes of those cases. As a consequence, we now know things about this particular species of litigation that we previously just thought we knew. For example: 96 percent of 2012 M&A deals valued at more than $500 million attracted lawsuits. We also know that it was right to use the plural in describing the number of suits: 5.4 lawsuits per deal were filed. Finally, we know that the cases settle. Sixty-four percent of 2012 cases with ascertainable outcomes were settled. Most of those cases were settled with the target making additional disclosures (i.e., no increase in the deal consideration) and the payment of a fee to plaintiff's counsel.

There is a general, and I believe accurate, perception that the lawsuits are just opportunistic strike suits that amount to a tax on sound transactions. So, if indeed they have no merit, why do the cases settle? This article offers a few explanations, as well as some suggestions for altering the landscape to make settlement a less obvious result.

People, Including Public Company Directors, Dislike Litigation

And they want someone to make it go away. Imagine you are a public company director and that you have worked hard for many years to make conscientious decisions in the best interests of the corporation and the shareholders whom you serve. Imagine further that the company receives an offer that represents a premium to its current stock price and that the offered price exceeds reachable expectations for the company's performance on a standalone basis. Such an offer results in a lot of work for company directors and officers, including numerous meetings with bankers and lawyers in addition to meetings with suitors for the company. A significant milestone in the transaction is the announcement of the deal. Minutes after that announcement, the first of many press releases by plaintiffs' law firms begin to appear, seeking to investigate "potential breaches of fiduciary duty" by the target company's board of directors for its decision to sell the company. Actual lawsuits are filed soon after, often in more than one jurisdiction.

This article won't belabor the litigation steps a merger suit entails but, in a nutshell, the sequence includes: document retention, hiring of counsel, trying to get the case in a single jurisdiction, fighting or acceding to expedited document production, depositions, filing of amended complaints, a motion to enjoin the transaction, a hearing on the injunction, and, if the case doesn't settle, two or three years of litigation activity leading to a trial. All of this is time consuming and expensive, even through the injunctive relief phase. Typical merger cases, last year, settled for an average of $540,000.

So, if you are in the position of our not-so-hypothetical public company director or general counsel, do you wish to engage in litigation activity that may result in your deposition or those of your bosses—not to mention company-wide disruption and inconvenience—when you can settle the matter, once and for all, for an amount equal to or less than defense costs? Add to this mosaic some quantum of risk that a good transaction gets delayed or enjoined, and the cost-benefit decision gains greater clarity.

Even at this fairly straightforward juncture of our analysis, the decision is pretty clear. Settling makes a lot of sense. The discussion below makes the decision even easier.

Post-Merger Litigation: The Gift that Keeps on Giving

It is not uncommon for plaintiffs contesting a merger to fail in their quest to enjoin a deal prior to a shareholder vote or the close of a tender offer. The parties to the transaction, the defendant directors, and the stockholders who voted in favor of the deal or tendered their shares have moments of joy. A spurious lawsuit has been "defeated." Except that it hasn't. The case is not over, only the plaintiff's request for an injunction has been rebuffed. The case has not been dismissed. The deal concludes and the litigation often continues. The litigation is different, however, in a variety of ways. Some of the differences pose real risks to the defendant directors of the acquired company.

First, it's not as time sensitive or interesting. The risk to the transaction is past and with it goes the temporal urgency. There are no frequent updates on the transaction and the litigation threatening the transaction. There may be the long delays between events as is typical in ordinary, non-expedited litigation. Defendants may begin to feel disconnected from the day-to-day activity, which is unsurprising as the company at issue and the board seats of the defendant directors no longer exist.

Second, the litigation has a new "boss." The acquiring company assumed the litigation along with the rest of the target company. The in-house team monitoring the litigation may never have met the director defendants or met them only in passing. The acquiring company's directors are not defendants, so the litigation doesn't present the same political dynamic as it did within the old company. To the extent the acquiring company has an incentive to get rid of the case, it is a financial one. The acquiring company often is a defendant in merger cases, on the theory that it aided or abetted the target company defendants' breaches of fiduciary duty. The cost of that defense, which should be much less than the cost of defending the main claims, is not covered by insurance.

Finally—and this one is critical—post-merger cases are very difficult, if not impossible, to settle. This is true based on several factors that weave together. They are:

- Most merger cases settle before the closing of the transaction based on the allegations that the disclosures relating to the transaction were insufficient, not the allegation that the price was inadequate. As noted above, the settlement consists of additional disclosures and court-approved attorneys' fees. After the close, one can't issue additional disclosures, so the most common and cheapest avenue of settlement is gone.
- In most circumstances, a disclosure-based settlement also provides releases for all claims that were brought or could have been brought, including those based on inadequate process or price, thereby giving the defendants the certainty that the litigation is over.
- The disclosure-based settlements referenced above often are paid for in whole or in part by Directors and Officers Insurance, which does cover allegedly deficient or fraudulent disclosures.
- The obvious way to settle the case, post-close, is to increase the amount the acquiring company paid for the target and distribute the proceeds, less attorneys' fees, to the stockholder class of the acquired company.

- Directors and Officers Insurance does not cover increases in merger consideration.
- Directors and Officers Insurance does pay for defense costs in post-merger cases, however, so the litigation does not impose a cost burden on the acquiring company.
- The acquiring company thus would have to pay to settle a case out of its own coffers, but fighting is free.
- Acquiring companies understandably are reluctant to increase the consideration post-close to the detriment of their balance sheets, share prices, and stockholders. This is particularly true given that the cases rarely have merit.

It Matters Because There Is Risk

Acquiring companies inherit the acquired company's indemnification obligations. Even under Delaware law, however, there are limits to the power to indemnify. It would be difficult for a company to indemnify directors for breaches of the duty of loyalty—the duty to act in good faith to advance the interests of the corporation and its stockholders. As Delaware Chancellor Strine wrote, "Although [the Delaware indemnification statute] never uses the word loyalty, there seems to be little doubt that the statute's use of the words that traditionally define it in business judgment cases was intended as a general prohibition against the indemnification of directors breaching the duty of loyalty."

So, should plaintiffs obtain a verdict after trial holding that the directors violated their duty of loyalty by selling the target company at a certain price or for reasons that exhibit a conscious disregard of their fiduciary duties, there is a risk that the award against the directors will not be indemnifiable. There is a similar risk that Directors and Officers Insurance will not cover the loss or that there will not be enough insurance to cover the potential damages.

Given the cost-benefit analysis discussed earlier, the difficulty of settling cases post-close, and the risk of a judgment that is neither insurable nor indemnifiable, one understands why merger cases settle before the deal closes.

Modest Proposals for Change

Actually, these proposals for change will not be modest. They cannot be. It's important to bear a couple of things in mind. We're talking about cases filed reflexively immediately after transactions are announced by a business-minded plaintiffs' bar. Those cases are adjudicated by very able judges across the country and particularly in the Delaware Chancery Court. Those judges use the tools at their disposal to dismiss cases when they should be dismissed and permit settlements when they are in the best interests of a class. Judges cannot prevent cases from being filed, nor can they alter the cost of litigation or change the rules of civil procedure.

- Delaware has a procedure obtaining an "appraisal" for shares post-merger. The appraisal statute should be modified to encompass post-merger class claims. This would have the effect of compelling anyone who wished to have a post-merger recovery to vote "no" on the merger or decline to tender one's shares to a tender offer. This should be the exclusive remedy for post-merger claims. Appraisal claims are more efficient to litigate and place the financial risk on the acquiring company, not the directors of the old target.
- If importing the appraisal remedy is too extreme, Delaware law should be changed to limit classes to persons who voted "no" on a merger or did not tender their shares. This would limit theoretical damages considerably and reduce the leverage plaintiffs have in a post-

close case where they are bringing claims on behalf of class members that, in fact, did not object to the deal.

- Another way to limit the class, and therefore the damages, is to require an opt-in class. That is, in order to recover in a class action, an absent class member must affirmatively choose to be a member of the class at the certification stage. This would limit the size of the class because the former shareholders often are content or disinterested in the litigation.
- The courts should take a harder look at the plaintiffs in these cases to see if they are proper representatives of the class that they purport to represent. In a significant number of cases challenging mergers, the plaintiffs are small holders with no real financial interest in the case or repeat "professional" plaintiffs who serve as nothing but a figurehead for plaintiffs' counsel. As with the abuses that led Congress to change the federal securities laws in the 1990s to require that the plaintiffs in those cases be bona fide plaintiffs, the merger litigation landscape is littered with bad plaintiffs.
- In California and other states, post-close consideration claims are considered derivative claims and cannot be pursued post-close. In light of Delaware Supreme Court law to the contrary, the Delaware legislature would have to pass a law rendering these cases derivative. Because of the continuous holding requirement in a derivative case, plaintiffs would not be able to establish standing and there would be no post-merger consideration claims.

Conclusion

Absent marked changes in the legal landscape such as those described above or other, better ideas, there is no reason to believe that the current deal litigation realities will change. Plaintiffs' lawyers will sue on virtually every deal, and defendants will have rational incentives to settle.

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