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Litigating Post-Close Merger Cases

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Shareholder lawsuits over mergers are as ubiquitous as they are meritless. The incidence of suits over public-company acquisitions rounds to always. It doesn't matter how high the premium or how clean the deal: someone (usually, one of the same someones) will sue.

The frequency of merger lawsuits has increased steadily over time. What has changed more abruptly is their life cycle. Until recent years, once a deal closed, the lawsuit usually went away. If the plaintiffs had been unable to wring out a "therapeutic" settlement pre-close (usually, "enhanced" disclosure + a fee) they ignored or dismissed the case after the acquisition was complete. The conventional wisdom was that plaintiffs' leverage — threatening to interfere with the deal — was gone, and so there was no longer a path to payday.

In several recent cases, however, plaintiffs' merger lawyers have refined their business model. They keep the litigation alive post-close. They take extensive discovery, especially against the executives of the acquirer, who now control the pursestrings. This phenomenon occurs even in situations where objective factors suggest a lack of merit to the claims: e.g., high premium; no contesting bidders; overwhelming shareholder approval; customary deal terms.

Why are the plaintiff lawyers pursuing these cases?

Three reasons suggest themselves. First, as I've written elsewhere,[1] the plaintiffs' bar itself has been in flux. Many are searching for their own little piece of land. Just as during energy shortages, frackers return to old wells, so have some lawyers decided to pursue cases that they would have let run dry in the past.

Second, these post-merger cases have their own *in terroram* value, albeit a different one from the pre-close suits. Before the close, plaintiffs have a theoretical possibility of interfering with the

[1] *Shareholder Litigation After the Fall of the Iron Curtain*, http://borisfeldman.com/Iron_Curtain.pdf.

deal, so the parties (usually, at the acquirer's behest) give them a little money to go away. Post-merger, there is nothing to interfere with: the deal has closed. Nevertheless, the post-close suits have their own nuisance value: they subject executives of the acquirer to discovery (often not covered by the target's D&O insurance policy) and threaten to make public at a trial the sensitive processes and analyses that led to the acquisition. The acquirer may not care about the burden to the target's former officers and directors, but usually does want to minimize the waste of its own executives' time, along with public exposure of confidential acquisition materials. Therefore, even post-close suits have some "go away" value to the surviving company.

Third, I suspect that plaintiffs' lawyers are pursuing cases post-close as part of a long-term strategy to induce additional settlements pre-close. Historically, many acquirers declined to pay off the plaintiffs unless there was a realistic chance that they might interfere with the deal. Now that some plaintiffs' lawyers have shown that they will persevere, even in a weak case, for years, acquirers (and perhaps even the target's directors) may just say "pay them and get rid of it" before the deal closes. In this sense, a plaintiffs' lawyer rationally could pursue a frivolous case, at great expense, post-close, even with low odds of getting a recovery, in order to improve the profitability of the rest of his inventory. That is in fact what I think some of them are doing.

In this article, I address a few of the litigation issues that arise in defending these post-merger suits.

Forum

The vast majority of merger suits involve companies incorporated in Delaware but headquartered somewhere else. Historically, a rough rule of thumb was that, if the plaintiffs thought they had a good claim, they sued in the Delaware Court of Chancery; if the case was weak, they sued in state court where the company was based. The thinking was that a Delaware judge would toss out a frivolous suit more readily than another state court judge less familiar with fiduciary-duty claims.

A related phenomenon was that, in the event of multiforum litigation, the case would usually proceed in only one court. That court was often, though not always, the court in which the first shareholder suit had been filed.

This has gotten jumbled in recent years. Judges in Delaware have been more assertive in seeking to hold on to cases even if similar suits had been filed elsewhere first. Similarly, some Judges in Delaware have expressed concern about multiforum merger suits being settled in a forum rather other than Delaware.

This situation has made it more likely that a defendant sued over a merger may have to litigate

the same claims in multiple courts. Ultimately, appellate courts may have to impose some order in these situations, as the United States Supreme Court has done in the past.[2]

Motions to Dismiss

Defense lawyers have gotten spoiled by the Private Litigation Securities Reform Act. We have become used to Federal judges routinely tossing non-meritorious shareholder claims at the pleading stage.

Alas, the same is not true of merger suits alleging breach of fiduciary duty. State courts — whether in Delaware, California, or elsewhere — have generally been reluctant to use motions to dismiss or demurrers as tools to weed out meritless merger suits. State court judges often focus solely on the formal elements of the cause of action: if alleged, that's enough, regardless of how implausible. The recent trend in this regard is discouraging: state court judges are reluctant to toss these merger cases on the pleadings, even if they had refused to enjoin the deal closed and it had been resoundingly approved by shareholders.

That is not, however, to say that early motion practice is pointless. Two recent developments in California courts are potential game-changers. First, several
Superior Courts have recently held that plaintiffs in these merger cases are not entitled to trial by jury, on the ground that breach of fiduciary duty claims are equitable in nature.[3]

These decisions, if followed by other courts, make merger suits triable. Imagine a case in which, after years of discovery, plaintiffs unearth some internal documents from the acquirer suggesting that, if the target had only held out a little longer, the acquirer would have paid another fifty cents per share. For public companies with millions of shares, half a buck is nothing to sneeze at. With a jury trial, there is risk that jurors unfamiliar with M&A might well award the four bits. By contrast, in a bench trial — especially in a Complex Case court in California, where the judges have acquired substantial experience in dealing with securities claims — the odds that they add a little to the price are low. Striking the jury demand makes these cases as triable in California as they are in Delaware (where the Court of Chancery has never allowed jury trial on breach of fiduciary duty claims).

The second development applies to companies incorporated in California. A recent decision held that, under California law, these types of merger claims are derivative in nature, not direct.[4] They

[2] *Matsushita Elec. Indus. Co., Ltd. vs. Epstein*, 516 U.S. 367 (1996).

[3] *In re McAfee, Inc. Shareholder Litigation*, No. 110-CV-180413 (Santa Clara County Superior Court); *In re Epicor Software Corp. Shareholder Litigation*, No. 30-2011-00465495 (Orange County Superior Court).

[4] *Sullivan v. Actel Corporation*, No. 110-CV-184257 (Santa Clara County Superior Court); *Jarackas v. Applied Signal Technology, Inc.*, No. 111-CV-191643 (Santa Clara County Superior Court).

must therefore be asserted by way of a shareholder derivative suit, rather than a shareholder class action. This imposes the demand requirement on the plaintiff, which is often a show-stopper. More important, once the deal has closed, the plaintiff usually is no longer a shareholder of the target (which is now wholly owned by the acquirer) and has no standing to assert a derivative claim. Thus, the deal closes and — poof — the plaintiff disapparates. If this decision is widely followed, it could lead some companies headquartered in California to reconsider Delaware incorporation.

Timing and Discovery

A wise mentor of mine, Abe Krash, used to say that all litigation is about timing: do you speed the case up or slow it down? Nowhere is this more true than in merger litigation. In my opinion, the answer differs pre- and post-close.

Before the merger closes, it is rarely in defendant’s interest to hurry things along. Remember, the plaintiff hopes to get money by threatening to interfere with the vote. The longer the plaintiff waits to get the show on the road, the lower the chance that he can block the deal. For example, it used to be nearly automatic that a merger plaintiff could obtain expedited discovery. Now, however, many judges (both in Delaware and in California) have denied expedited discovery in merger cases on the ground that the plaintiff waited too long after the deal was announced to get to work. Thus, pre-close, it is usually in defendants’ interest to keep the litigation on simmer.

Post-close, my experience has been that the strategies flip. Plaintiffs are no longer in a rush. They want to keep the case alive as long as they can. They want to take as many depositions as they can get away with. No document production is enough document production. No non-party is too far removed. I think this is true for two reasons. First, usually, plaintiff’s claim is usually weak on the merits; she needs to scour many emails in hopes of concocting a theory that passes the laugh test. Second, the longer the case drags on, the less enthusiasm everyone on the defense side has for it. The directors and management of the acquired company have moved on. The last thing they want is to be deposed a year or two after the merger about “what-if’s” they wrote years before; plus, they have new jobs now and don’t want to take the time for preps, depos, trial. Ditto for the executives and board of the acquirer. This was yesterday’s deal. It may not have worked out so well, in which case, the last thing they want to do is relive it. The longer the litigation continues, the greater the likelihood that the acquirer says “just make it go away.”

I think that company counsel therefore should consider something anathema to many defense lawyers: speed up the case. Don’t let plaintiffs drag it out for two or three years. One way to do that is to move for summary judgment immediately after the deal closes, particularly if your case

is outside of Delaware. The court is likely to allow plaintiffs to take discovery before they file their opposition; but the period for such discovery should be months instead of years, and it may be limited to identifiable issues rather than the known universe. Post-close, delay is the plaintiff's friend and alacrity its foe.

One additional note on discovery: refresh your witnesses. Defense lawyers are so used to cases not going to trial that they are often content for their witnesses, Sergeant Schultz-like, to remember nothing. I believe that these merger cases, however, are eminently triable, especially if the jury demand has been stricken. You should then prepare your directors to answer in detail what they did and why they did it. Prepare them for the deposition as if you were preparing them for trial. Indeed, since these will be bench trials, the odds are that the judge will actually read portions of the depositions, especially in Delaware. "I don't recall's" can sink your ship.

Conversely, my experience has been that plaintiffs at these depos often want to ask about everything except what matters. The last thing on earth they want is for the director to put on the record what she thought about the company's standalone prospects. The plaintiffs don't believe these cases will go to trial, so all they want is an uncluttered record to use in opposing summary judgment. Thus, while it is often unthinkable for a defendant to examine his own witness at a deposition, in these merger cases, it may make sense to have your witness put a few key trial themes on the record at deposition, even if the other side doesn't want to hear them.

Summary Judgment

Q: Why do plaintiffs' lawyers bring merger suits in state court instead of Federal?
A: To get across the road.

They would be tossed from Federal court — probably on a motion to dismiss; almost certainly on summary judgment. Federal judges are comfortable wading through paper thickets to conclude that there is no material factual dispute.

State court, not so much. Recent decisions in Delaware have generally been stingy as to the granting of summary judgment. Similarly, in California Superior Courts, the perceived wisdom on summary judgment has generally been: "if the briefs are too high, you must deny." Moreover, courts have been reluctant to grant summary judgment without a full record following extensive discovery.

This is changing and, I submit, will change more. The legal system, not unlike the human lymphatic system, gradually adapts to illness. Just as Federal courts (even pre-Reform Act)

eventually figured out that most “missed quarter” suits were bogus, so, too, I believe, will judges eventually decide that most merger claims are strikesuits and will extirpate them before trial.

Indeed, in one of the more procedurally advanced cases in the recent wave, that is what just happened. In the litigation over Intel’s acquisition of McAfee, the Superior Court had overruled demurrers and given plaintiffs wide-ranging discovery. Two months before trial was set to begin, the Court tossed the entire case on summary judgment.

One of the principal grounds for the summary judgment in McAfee, I submit, will prove to be plaintiffs’ Achilles’ Heel in many of these suits: the exculpatory provisions of Delaware Code Section 102(b)(7). Other states have similar provisions. Most public companies have implemented such provisions in their charters. In simplest terms, these provisions preclude damage claims against directors for breaches of fiduciary duty unless plaintiffs can establish serious conflicts of interest and/or bad faith. In my opinion, it will be the rare case indeed where plaintiffs have such evidence against any director, much less a majority of the Board. Some courts have dismissed claims at the pleading stage based on the exculpatory charter provisions. My prediction is that many more courts will be willing to do so at summary judgment. The odds of reversal are especially low because the grant does not deprive plaintiffs of trial by jury, pursuant to the discussion above.

So my advice to defendants is: persevere. Summary judgment in these cases is attainable, even in state court.

Trial or Settlement?

Almost no shareholder class actions go to trial. The risks are thought to be too great, especially in light of the available insurance, jury vagaries, complexity of the issues, and so on.

Merger cases are different. They can be tried, especially in a bench trial. Almost by definition, the case involves an acquisition at a substantial premium over the market price, with experienced investment bankers and lawyers on both sides, a credible fairness opinion, and strong shareholder approval. A potential adverse judgment, although costly, is rarely likely to be a substantial threat to the acquirer’s wellbeing. I believe that very few judges will be willing to second-guess the decisions of an independent, well-advised board of directors as to what their company was worth.

By contrast, settling one of these cases is not so simple. Pre-close, the formula is well-defined, albeit slimy: disclosure + a fee. Post-close, how does one settle? Sure, if the acquirer is willing to pay additional consideration to the former shareholders of the target, that can form the basis for a

righteous settlement. But few are; and if they do, the odds that the D&O carrier will fund it are low (they invoke the “bump-up” exclusion).

What type of “therapeutics” can one adopt post-close? How do such therapeutics benefit the former shareholders, cashed out and retired to Boca Raton? On what basis can the defendants agree to pay plaintiffs’ counsel a fee?

These are serious, difficult questions — ones which will be asked not just by bloggers, but also by men in black.

That, in the final analysis, may be the ultimate irony in plaintiffs’ new endeavor: having kept their cases alive post-merger, they cannot figure out a way to monetize them that survives judicial scrutiny.