The Evolving Face of Deal Litigation

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As dealmakers put the finishing touches on public M&A transactions, the question is no longer if there will be a lawsuit, but rather when, how many and in what jurisdiction(s). And while many of the cases remain of the nuisance strike-suit variety, recently it seems every few weeks there is an important Delaware decision or other litigation development that potentially changes the face of deal litigation and introduces new risks for boards and their advisers. Now more than ever, dealmakers need to be aware of, and plan to mitigate, the resulting risks from the earliest stages of any transaction.

- Increasing Skepticism of Disclosure-Only Settlements. Historically, a healthy majority of strike-suits have been resolved pre-closing with the target agreeing only to make a number of additional disclosures in exchange for the cases being settled with full releases. When the settlements came up for court approval post-closing, the plaintiffs' attorneys would seek and usually obtain an award of fees (typically less than $1 million) for extracting these additional disclosures. Companies were willing to pay this manageable "tax" on deal activity in exchange for a relatively painless disposition of most of these nuisance cases, and to an extent, certain dealmakers became somewhat desensitized to the greater threat of substantive deal litigation. However, Delaware courts recently have become more skeptical of the value of these additional disclosures and the benefits they offer to shareholders. The courts are increasingly likely to critically assess the true materiality of the added information, and in some recent cases have awarded substantially reduced attorneys' fees (e.g., *Deltek* and *Amylin*) or even outright rejected the settlement (e.g., *Medicis* and *Rural Metro*). Assuming this trend continues, it remains to be seen whether the long-term practical impact will be a more selective approach by the plaintiffs' bar in choosing which cases to bring and what jurisdiction to bring them in, and/or an increase in the number of cases pursued rather than settled.
- Risk of Significant Post-Closing Damages Awards. The growing suspicion of disclosure-only settlements has been accompanied by explicit and implicit encouragement by the Delaware judiciary of pursuit by plaintiffs of the admittedly limited number of cases where real, rather than imagined, issues exist, most often in circumstances involving an actual or perceived conflict. In recent high-profile cases involving findings of material breaches of fiduciary duties by the target board or advisers, the court has awarded or signaled that it will award significant damages (in *Southern Peru* and *Rural Metro*) and attorneys' fees (in *Del Monte* and *El Paso*). Taken together with the disclosure settlement trend described above, the Chancery court appears to be using economic incentive (and disincentive) to seek to influence the behavior of the legal community in separating the wheat from the chaff in M&A litigation.
- Key Issues Getting Traction in Delaware Courts. With this increased risk of post-closing litigation, the ever-evolving nature of deal-related litigation claims has presented a set of issues *du jour* that appear on a repeat basis in recent adverse opinions. Here is a short outline of topics currently garnering attention:
    - → *Financial Adviser Conflicts* — While acknowledging that staple financing may be value-generating for a target under appropriate circumstances and conditions, courts will be alert to the conflict of interest that may result from permitting, or at least not supervising, the efforts of a target financial adviser to seek, even unsuccessfully, a role in financing a bid by one or more potential buyers (*Del Monte* and *Rural Metro*). Together with other cases involving a variety of potential adviser conflicts (*El Paso*), these decisions highlight the risk of advisers that have potential financial incentives outside of their M&A advisory fees and the need for explicit evaluation by boards of any resulting perceived conflicts.

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- *Board Independence and Supervision* — The courts expect that the board will critically assess the independence of its own members (*Orchard*), focusing specifically on the context of a particular transaction as opposed to merely applying the generic stock exchange standards. Similarly, courts expect boards to set ground rules and then supervise their own members and advisers to ensure they are acting within the proper scope of authority (*Del Monte* and *Rural Metro*).
- *Differential Interests of Large Stockholders and "Why Now?"* — Even in transactions where all target shareholders receive the same consideration, the courts are willing to entertain claims that the timing of the transaction may have been less than opportune because a director who is a large stockholder or affiliated with one may have been motivated to influence the timing and terms of a sale because of its own concerns (e.g., a director needing liquidity as in *infoGroup* or a financial investor needing a sale to bolster its track record while raising a new fund as in *Rural Metro*). The rationale for pursuing a transaction at a given time, and the reasons for selecting a particular path to achieving that aim, should be explicitly considered by boards and carefully documented.
- *Disclosure Claims* — While claims relating to deficient disclosure have generally been treated as afterthoughts in post-closing damages suits, some recent cases (e.g., *Orchard*) have shown that material omissions or misstatements can be used as a wedge to assert broader breach of loyalty claims or as a means to seek a classwide quasi-appraisal remedy based on the argument that the integrity of the shareholder approval or decision whether to seek appraisal was tainted by the fact that the shareholders were not fully informed.
- *Changes to Projections or Valuation Analyses* — Courts will be suspicious of changes, particularly when sudden or sharp, which can appear geared towards indirectly justifying the fairness of a particular sale price. Boards and their advisers should carefully document the bridge between various iterations and develop an understanding of the reasoning behind any such changes (*Southern Peru* and *Rural Metro*). Similarly, where practical within the framework of a sale process, courts expect that the valuation exercise by a target board is one that develops over the course of the process, rather than being left as a seeming afterthought on the eve of announcement (*Rural Metro*).

- Appraisal Rights as an Asset Class. As we noted in an earlier *M&A Update*, appraisal claims have become an increasingly prevalent alternative, and often more lucrative, avenue of attack for plaintiffs seeking economic opportunities in deal litigation. While not yet a feature of every deal like strike-suits, appraisal claims by significant financial investors have become a regular occurrence in the deal landscape over the past year. We have seen continuing growth in the range of long- and short-term investors willing to explore this remedy, as well as an increase in funds dedicated specifically to appraisal as an independent investment opportunity. In a number of cases, significant buying activity occurred right before closing for the sole purpose of using those shares to pursue an appraisal claim, with the net effect of creating potentially significant economic uncertainty for acquirers, which can be particularly troublesome for financed transactions. The slow upturn in actual litigated appraisal cases, which can take years to work their way through the courts, has been complemented by growth in confidential, and often expensive, settlements at early stages of appraisal proceedings. In that regard, a recent decision by VC Glasscock (*CKx*) highlighted the potential coercive impact of accruing interest (at the Fed discount rate plus 5%) owed on the appraisal award (regardless of outcome), with the court explicitly encouraging policymakers to give close consideration to the interest provisions that create "rent-seeking" opportunities for plaintiffs generating "perverse litigation incentives."
- Multiforum Litigation and Forum Selection Bylaws. Despite well-intentioned efforts by the Delaware courts, the specter of overlapping cases in multiple jurisdictions remains a continuing reality for deal parties, adding complexity, expense and forum-shopping risk. Following the endorsement by the Delaware court in *Chevron*, a growing number of companies have been implementing forum selection bylaws that provide that Delaware

courts are the exclusive forum for any fiduciary duty cases against the company. While some questions remain whether courts in other jurisdictions would defer to the bylaw provisions, a number of recent decisions in Louisiana (*Edgen*), New York (*Aspen*) and Illinois (*Beam*) suggest that courts are likely to respect the bylaws and grant motions to dismiss litigation brought outside Delaware in violation of the exclusivity term. These cases have highlighted a number of practice pointers to enhance the likelihood that the forum selection bylaw will be effective in avoiding multiforum M&A litigation: (1) implementation of these bylaws on a clear day (i.e., before a sale process begins), or at least enactment early in the process, could enhance the prospects that a non-Delaware court evaluating fiduciary duty claims relating to a deal will respect the jurisdictional exclusivity and (2) there may be value in also adding to the bylaws a provision requiring shareholders who bring fiduciary duty claims to consent to personal jurisdiction in Delaware to increase the chances that, in the face of claims in another jurisdiction, the validity and effectiveness of the bylaw itself can be litigated in Delaware.

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