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Reducing the "Deal Tax": Delaware's Recent Scrutiny of Nonmonetary Settlements

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The surge in litigation over public company mergers has led to an increase in nonmonetary settlements that yield fee awards for plaintiffs' counsel, global releases for defendants, and little benefit for stockholders. This article discusses what some have characterized as a "deal tax" on M&A activity and recent decisions in the Delaware Court of Chancery – the nation's preeminent forum for business litigation – that may reduce the "tax" by increasing scrutiny of nonmonetary settlements, as well as potential implications and consequences of these decisions.

The "Deal Tax" in M&A Litigation

Stockholder litigation challenging U.S. public company mergers has increased markedly. In each of the past five years, over 90 percent of such transactions were challenged, with larger transactions challenged at even higher rates. These lawsuits are filed shortly after the signing of a merger agreement and are based on public information such as proxy statements. Such suits, brought on behalf of a stockholder class, allege the target's directors breached fiduciary duties by (1) conducting a flawed sales process that failed to maximize value, and (2) failing to disclose information material to stockholders' voting decision. Many such cases are expedited, and plaintiffs' counsel quickly obtain discovery of nonpublic information in advance of an injunction hearing. This uniquely positions plaintiffs' counsel to oversee directors' compliance with fiduciary duties in a sale of control.

While many cases are brought, very few proceed to an injunction hearing or trial. Most cases are resolved through an early settlement, subject to court approval. Approximately 80 percent of such settlements afford stockholders only additional disclosures. Some early settlements also provide therapeutic (i.e., nonpecuniary) benefits such as reducing potential impediments to topping bidders. Only 4–8 percent of such settlements in recent years resulted in increased payments to stockholders.

Through these settlements, the defendants typically receive a global release covering all possible claims, known or unknown, whether or not suspected or matured, arising under any law (state or federal), in connection with facts or issues relating to events leading up to the transaction, the transaction itself, or allegations in any litigation challenging those events or transactions. They run in favor of the target, acquirer, and all affiliated persons or entities, including any controlling persons, employees, and advisors. A court-approved release is entitled to "full faith and credit" in other jurisdictions, even when releasing claims that could not have been brought in the jurisdiction approving the settlement. *See Matsushita Elec. Indus. Co., Ltd. v. Epstein*, 516 U.S. 367 (1996).

Class counsel typically work on a contingent-fee basis, and receive a fee award from the corporation under the "corporate benefit" doctrine when litigation benefits the corporation or its stockholders. Cognizable "benefits" may include supplemental disclosures or therapeutic relief. In a typical settlement, the defendants agree not to oppose a fee application up to a specific sum. The court evaluates the fairness of the settlement and considers counsel's fee application, typically ruling from the bench.

Traditionally, litigation yielding meaningful supplemental disclosures could merit a mid-six-figure fee, with lower fees for disclosures of lesser quality. The availability of fees for obtaining disclosures arguably incentivized M&A litigation and the frequency of nonmonetary settlements. Commentators have critiqued the costs of ubiquitous M&A litigation as a "deal tax."

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Increased Concern for Traditional M&A Settlements

The Court of Chancery in recent years has increasingly scrutinized disclosure-only settlements. In a series of decisions, it reduced fees in such settlements, reasoning that precedents supporting higher fees are no longer persuasive. In addition, at times the Court rejected nonmonetary settlements that it determined could not support broad releases. In early 2013, for example, after the court expressed concern that a settlement would release unknown claims of stockholders who did not participate in the challenged exchange offer and who, as a result, would not receive consideration under the settlement, the parties agreed to limit the release from those stockholders to only known claims, and the settlement was approved. *See In re Revlon, Inc. S'holders Litig.*, C.A. No. 4578-VCL (Del. Ch. Feb. 20, 2013).

Then, in a pair of decisions, then-Chancellor, now Delaware Supreme Court Chief Justice, Leo E. Strine, Jr., rejected disclosure-only settlements. *See In re Transatlantic Holdings Inc. S'holders Litig.*, C.A. No. 6574-CS (Del. Ch. Mar. 8, 2013); *In re Medicis Pharm. Corp. S'holders Litig.*, C.A. No. 7857-CS (Del. Ch. Feb. 26, 2014). In both cases, the court viewed the additional disclosures as not meaningful to a reasonable stockholder, noting among other things the extremely high level of voting in favor of the transactions after the disclosures. The *Medicis* court suggested that when class counsel receive discovery confirming the weakness of their claims, they should dismiss the case without prejudice.

Subsequently, in *Rubin v. Orbagi Med. Prods., Inc.*, C.A. No. 8433-VCL (Del. Ch. Apr. 30, 2014), the court rejected a disclosure-only settlement that would release "unknown unknowns" – potential claims "which have been completely unexplored by the plaintiffs." The court suggested the release should extend only to "claims actually investigated by plaintiff's counsel[.]" Similarly, in *In re Theragenics Corp. S'holders Litig.*, C.A. No. 8790-VCL (Del. Ch. May 5, 2014), the court rejected a disclosure-only settlement because there were unexplored potential fiduciary duty claims relating to the sale process. The court explained it must "have some confidence that the issues in the case were adequately explored, particularly where there is going to be a global, expansive, all-encompassing release given."

These concerns are founded in experience. For example, in *In re Celera Corp. S'holder Litig.*, 59 A.3d 418 (Del. 2012), the Delaware Supreme Court granted an objector's request to opt-out of a nonmonetary settlement approved by the Court of Chancery. The objector was the company's largest stockholder and indicated it intended to pursue money damages claims. Thereafter, the objector filed claims in a California federal court under the securities laws and for breaches of fiduciary duties. The case was settled by a confidential agreement. Had it not vigorously opposed its inclusion in the class, the *Celera* objector could not have obtained additional relief. Perhaps due to the rational apathy of stockholders without such large holdings, however, well-supported objections to settlements are rare.

A recent study by law professors tested the hypothesis, in accord with *Transatlantic* and *Medicis*, that supplemental disclosures in viable settlements should convey new unfavorable information and therefore lead to reduced support for a transaction. *See* Jill E. Fisch, et al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 Tex. L. Rev. 557 (2015). Examining voting data in public company mergers, the authors conclude that disclosure-only settlements are not correlated with a statistically significant difference in stockholder support for the challenged transaction. They similarly found no significant relationship between fee awards, which should correlate with the benefits achieved by counsel, and stockholder voting behavior.

2015 Decisions Scrutinizing M&A Settlements

These developments coincide with recent decisions further scrutinizing proposed settlements. In June 2015, in *Haverhill Ret. Sys. v. Asali*, C.A. No. 9474-VCL (Del. Ch. Jun. 8, 2015), the court rejected a settlement due to the scope of a release. The *Haverhill* plaintiffs brought relatively narrow claims regarding a large stockholder's sales of stock. The court agreed that the relief from a prompt settlement, largely comprised of supplemental disclosures and discrete corporate governance reforms, was reasonable in light of the claims at issue. It explained, however, that the release could be read to give "a colossally broad clean bill of health" to other possible wrongdoing at the company, whose governance did not "inspire[] confidence." The court said, "it's perhaps something that historically hasn't been appreciated, but the breadth of these releases is startling and the number of places where they can be invoked is equally surprising." Among other options, the parties could resubmit the settlement with a "truly narrow release."

The trend continued in early July in two settlement hearings on the same day. In *Acevedo v. Aeroflex Holding Corp.*, C.A. No. 9730-VCL (Del. Ch. Jul. 8, 2015), the court rejected a proposed settlement premised on a reduced termination fee, a reduction in duration of matching rights, and supplemental disclosures. The complaint alleged that a rival bidder received disparate treatment and was impeded by its nondisclosure agreement with the target. The court analogized the "benefits" achieved by loosening different deal protection measures to bringing a car with a faulty transmission to a mechanic who only changes the oil but still asks for payment. The court contrasted these purported fixes to the "[G]lobal . . . Big . . . Huge" release for the defendants. Echoing *Medicis*, the court suggested that plaintiffs' counsel who conclude that there are no viable claims should voluntarily dismiss the case.

The *Acevedo* court also spoke generally about the problems of "ubiquitous merger litigation." Among other things, it stated the study described above supports that disclosure-only settlements do not provide identifiable benefits to stockholders. The Court opined that "routine approval of these settlements carries real conse-

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quences, all of them bad," and accordingly the "trend in which the Court of Chancery looks more carefully at these settlements is a good one." It suggested that the parties could, among other things, "come back with a release that's limited to the Delaware fiduciary duty claims" – commensurate with "what the plaintiffs actually investigated" – and which "would not have these problems of providing protection against a vast universe of unknown unknowns." The defendants also could move to dismiss, but because they agreed the plaintiffs obtained corporate benefits, the plaintiffs could request a fee. When the defendants chose the latter route, the court promptly dismissed the case, but retained jurisdiction to consider the plaintiffs' fee application.

The same day, the court declined to approve another disclosure-only M&A settlement. *See In re Intermune, Inc. S'holders Litig.*, C.A. No. 10086-VCN. *Intermune* involved supplemental disclosures regarding a financial advisor's valuation analysis. The court questioned why the global release was not limited to disclosure claims. It reasoned, "[t]he defendants want total peace. They do some . . . relatively minimal disclosures, and they buy deal insurance. And there is something about that that has always troubled me." Later, the court added, ". . . I have in private moments said I sell deal insurance, and that's perhaps too cynical, but that's what I'm worried about here." The court acknowledged it had approved settlements "where the disclosures were no better or no worse than the disclosures here[,]" but it reserved decision on the *Intermune* settlement.

Subsequently, in *In re TW Telecom, Inc. S'holders Litig.*, C.A. No. 9845-CB (Del. Ch. Aug. 20, 2015), the court considered a settlement for supplemental disclosures and a reduction of the duration of matching rights. The court questioned why the release was not limited to claims over disclosures in the proxy statement, the sales process, and deal protections, which were the focus of the plaintiffs' litigation efforts. It stated that disclosure-based settlements "need to be more scrutinized going forward," and plaintiffs must explain why disclosures "matter in the real world[,]" because the prevalence of weak M&A claims followed by disclosure-only settlements "is a cause of great concern in this Court[.]" The court was "truly on the fence," but approved the settlement in light of the value provided by one disclosure and the weak nature of the plaintiffs' claims. Echoing statements in *Medicis* and *Acevedo*, it suggested that "[t]here are some times when it's just better, once you've poked your nose under the tent, to pack it up and go home . . . as opposed to giving a very broad release." While it approved the settlement, the court granted fees and expenses of just $150,000, less than 40 percent of the sum plaintiffs requested.

This trend continued into September. In *In re Trulia, Inc. S'holder Litig.*, C.A. No. 10020-CB (Del. Ch. Sept. 16, 2015), the court declined to approve a disclosure-only settlement that included a global release. Contrasting settlements for monetary consideration, the court reasoned it was presented with the "underbelly of settlements." The court reserved decision and ordered further briefing on whether (1) disclosures that are not "material" may provide benefits sufficient to support a settlement, and (2) releases in such a settlement should extend beyond where "the tires were kicked" in discovery and release unknown claims.

The next day, in *In re Riverbed Tech., Inc. S'holders Litig.*, 2015 Del. Ch. LEXIS 241 (Del. Ch. Sept. 17, 2015), the court issued a written opinion providing further notice of this trend. Although the disclosure-only settlement at issue provided "negative information of the type this Court has in the past found of value[,]" 99.48 percent of all shares voted still voted in favor of the merger, which showed the disclosures "were not of great importance." The court also found the global release was "troubling," reasoning it was "hubristic" to suggest a proposed disclosure-based settlement permits the court to "properly evaluate, and dismiss as unsubstantial" all potential claims. The court ultimately approved the settlement, however, in light of the "formerly settled practice in this Court" of doing so – a factor the court acknowledged "will be diminished or eliminated going forward" in light of these recent decisions.

As recently as October 9, 2015, in *In re Aruba Networks, Inc. S'holder Litig.*, C.A. No. 10765-VCL (Del. Ch. Oct. 9, 2015), the court declined to approve a disclosure-only settlement that included a global release. The court reasoned that the suit was not meritorious when filed and that the "intergalactic" or "global" releases at issue were inappropriate given the limited benefit of the supplemental disclosures. Further, the court criticized plaintiffs for failing to pursue any additional relief with respect to facts adduced in discovery demonstrating that the acquirer's negotiations to retain incumbent management began much earlier in sales process than the proxy statement suggested. These facts, the court reasoned, could give rise to litigable money damages claims. The court stated that if the release had covered only disclosure claims, then it would have approved the settlement. Ultimately, the court denied class certification, denied approval of the settlement, and dismissed the case with prejudice as to the named plaintiffs, all on the basis of inadequate representation. The court also stated it would not approve the payment of any mootness fee to plaintiffs' counsel.

Considerations Looking Forward

While these developments are continuing and their effects remain to be seen, the trend arguably makes certain policy trade-offs.

First, this trend has the potential to substantially reduce the "deal tax" in M&A litigation by reducing incentives for routine M&A challenges. If plaintiffs' counsel have difficulty pursuing fees for nonmonetary settlements, they should be reluctant to invest time and expense litigating weak claims. From a stockholder's perspective, excessive M&A litigation is detrimental due to costs that rarely yield corresponding financial benefits and settlements that release unexplored claims. Accordingly, these developments should result in benefits to stockholders in the long run.

These benefits may, however, entail somewhat reduced monitoring of directors' compliance with fiduciary duties. A credi-

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ble threat of oversight by plaintiffs' counsel should help deter wrongdoing and therefore enhance value for stockholders. Such desirable effects relate directly to the likelihood of litigation and the potential for discovery of nonpublic information. Plaintiffs' counsel's monitoring function must come at the cost of some number of meritless complaints and a "deal tax" of one kind or another. Should M&A class action filings be confined to instances in which the target's own public filings evidence significant conflicts of interest, a sales process outside of a range of reasonableness or clear disclosure violations, stockholders may at times be substantially worse off. For example, in *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54 (Del. Ch. 2014), expedited discovery revealed conflicts of interest that caused the court to reject an early disclosure-only settlement. The litigation of those issues then yielded an additional $87 million in relief – significant "corporate benefits."

Concerns that effective monitoring may be compromised should be mitigated somewhat by a countervailing recent Delaware trend: awarding historically high fees where litigation efforts obtain significant monetary relief. It may remain viable for plaintiffs' counsel to more selectively bring complaints and obtain discovery, but, per the reasoning of *Medicis*, *Acevedo*, and *TW Telecom*, voluntarily dismiss claims that initial discovery confirms are not viable. Where initial discovery reveals potentially viable claims (as in *Rural Metro*), the changing incentives should cause more such claims to be pursued rather than being compromised in early nonmonetary settlements.

Second, while deterring weak litigation is beneficial, rejection of nonmonetary settlements jeopardizes corporations' primary path out of such suits. Traditionally, when plaintiffs were unwilling to dismiss weak claims following early discovery, corporations could resolve litigation through a nonmonetary settlement. Often such settlements could be obtained sooner and at lower cost than engaging in motion practice. Increased rejection of nonmonetary settlements restricts this option. While most corporations should benefit from a decrease in meritless litigation, some corporations that have been sued may be worse off in those cases.

These developments also give rise to practical considerations. First, forum selection bylaws provide corporations with control over whether M&A settlements will be subject to this increased scrutiny. Following decisions upholding board-adopted forum selection bylaws, Delaware's General Assembly recently adopted 8 Del. C. § 115, expressly authorizing Delaware exclusive forum bylaws. Without such provisions, M&A litigation is often brought in multiple jurisdictions. A corporation faced with suits in multiple jurisdictions may seek a settlement in a jurisdiction more amenable to nonmonetary settlements or global releases (even perhaps by waiving exclusive forum bylaws) – although decisions from other jurisdictions suggest the trend of increased scrutiny for disclosure-only settlements is not confined to Delaware. *See, e.g.*, *City Trading Fund v. Nye*, 9 N.Y.S. 3d 592 (N.Y. Sup. Ct. 2015) (rejecting disclosure-only M&A settlement).

Second, the Court of Chancery's focus on the breadth of releases in relation to actual litigation efforts should cause parties to consider the scope of discovery in proportion to the terms of negotiated releases. Cases like *Theragenics*, *Intermune*, and *Aruba Networks*, for example, reflect that parties to disclosure-only settlements should be prepared to justify why releases should cover other potential claims. Defense counsel seeking to settle M&A litigation for nonmonetary relief should be prepared to provide discovery needed to support the desired releases.

Finally, this trend provides greater incentives for corporations to unilaterally moot disclosure challenges by issuing supplemental disclosures and then contesting any fee application from plaintiffs' counsel. A corporation traditionally benefits from reaching a settlement, versus mooting disclosure claims, by obtaining a global resolution and a negotiated cap on the fees plaintiffs' counsel request. The court's recent decisions cast doubt on the availability of broad releases and also demonstrate a judicial recognition that the corporate benefits of supplemental disclosures may be de minimis. These factors increase the relative attractiveness of mooting disclosure claims and arguing that the disclosures provided little or no "corporate benefit."

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