Will other courts give 'disclosure only' settlements closer scrutiny like Delaware?

By Richard A. Barkasy, Esq. and Daniel M. Pereira, Esq.
Schnader Harrison Segal & Lewis

Throughout 2015, the Delaware Court of Chancery issued a series of opinions applying increasingly close scrutiny to so-called "disclosure only" settlements,[1] which arise from shareholder litigation that has become routine in the area of corporate mergers and acquisitions.

In early 2016, the Chancery Court addressed the issue head on in *In re Trulia Inc. Stockholder Litigation*.[2] That opinion, authored by Chancellor Andre G. Bouchard, provides a framework for courts to more closely scrutinize disclosure-only settlements and expressly signals that such increased scrutiny will continue to be the norm in Delaware.

Shareholder complaints quickly followed by disclosure-only settlements have become standard operating procedure in the corporate merger context. The facts of *Trulia* show how such settlements typically work.

In July 2014 real estate websites Trulia and Zillow announced that they had entered into a definitive merger agreement. Shortly thereafter, four Trulia stockholders challenged the merger, filing nearly identical class-action complaints that were later consolidated.

Less than four months after the complaints were filed — and only five days after the plaintiffs had submitted a brief in support of a preliminary injunction — the parties entered into an agreement-in-principle to settle the litigation.

In exchange for some modest supplemental disclosures and confirmatory discovery, the plaintiffs agreed to an "extremely broad" release of claims. The settlement agreement also provided for plaintiffs' counsel to seek unopposed attorney fees not to exceed $375,000.

'MERGER TAX' CRITICS

Critics of disclosure-only settlements have described them as "merger taxes" because they are viewed as an anticipated but unavoidable cost of completing a merger. These critics argue that plaintiffs' counsel, with a minimum output of effort, earn unjustified attorney fees for obtaining modest disclosures that provide little to no benefit to plaintiff shareholders.

On the flip side, corporations are readily willing to shell out what they perceive as tolerable payments of attorney fees in exchange for broad releases of shareholder claims and the avoidance of protracted litigation that might otherwise impede or delay a complex transaction.

As Chancellor Bouchard explained in *Trulia*, "defendants are incentivized to settle quickly in order to mitigate the considerable expense of litigation and the distraction it entails, to achieve closing certainty, and to obtain broad releases as a form of 'deal insurance.'"

> Two recent decisions hint that more courts may follow Delaware's lead and apply greater scrutiny to disclosure-only settlements.

Accordingly, the arms'-length negotiations that typically underpin other litigation settlements are less likely to occur in merger and acquisition suits because it is in the interest of both sides to quickly resolve the matter.

JUDGE AS DEVIL'S ADVOCATE

Chancellor Bouchard noted that the "lack of an adversarial process often requires that the court become essentially a forensic examiner of proxy materials so that it can play devil's advocate in probing the value of the 'get' for stockholders in a proposed disclosure settlement."

Although the Delaware Court of Chancery previously had a long history of "predisposition toward approving disclosure settlements," in recent years — and particularly in 2015 — it began to scrutinize such arrangements more closely. Chancellor Bouchard's opinion in *Trulia* crystallized this growing line of cases.

Chancellor Bouchard highlighted the proliferation of class-action suits in the context of mergers and acquisitions of public corporations. Such litigation, he observed, "far too often ... serves no useful purpose


A seasoned trial attorney and co-chair of the creditors' rights and business restructuring practice group at **Schnader Harrison Segal & Lewis** in Philadelphia, **Richard A. Barkasy** (L) devotes a substantial portion of his practice to bankruptcy cases and handles a variety of complex commercial litigation matters. He is a member of the firm's executive committee and is an adjunct professor of bankruptcy, secured transactions, business organizations and construction law at Rutgers University School of Law in Camden, New Jersey. **Daniel M. Pereira** (R) is an associate in the firm's business services department and focuses his practice on counseling clients on bankruptcy-related matters. His practice also includes a range of complex transactional matters, including asset purchases, commercial loan agreements, and commercial real estate leasing and financing.

for stockholders. Instead, it serves only to generate fees for certain lawyers who are regular players in the enterprise of routinely filing hastily drafted complaints on the heels of the public announcement of a deal."

Discussing this growing prevalence of shareholder litigation and disclosure-only settlements, Chancellor Bouchard cautioned that going forward, "practitioners should expect that the court will continue to be increasingly vigilant in applying its independent judgment to … the 'give' and 'get' of such settlements."

More specifically, Chancellor Bouchard warned that in the future, Delaware courts will continue to disfavor disclosure-only settlements "unless the supplemental disclosures address a plainly material misrepresentation or omission," while adding that "it should not be a close call that the supplemental information is material."

Critics of disclosure-only settlements have described them as "merger taxes" because they are viewed as an anticipated but unavoidable cost of completing a merger.

Under Delaware law, information is considered material if there is a substantial likelihood that a reasonable shareholder would find it important in deciding how to vote. In addition to this materiality standard, the subject matter of any release of claims must be "narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process."

Chancellor Bouchard closely analyzed the supplemental disclosures provided by Trulia and found that not only were the disclosures not material, but they were not even helpful to the voting shareholders. Accordingly, he declined to approve the settlement.

Likely as a result of this increased scrutiny, the number of such merger and acquisition lawsuits filed in Delaware has recently declined substantially.[3] Although some courts outside Delaware have continued to approve disclosure-only settlements with little in-depth analysis, two recent decisions — one authored by Judge Richard Posner of the 7th U.S. Circuit Court of Appeals and the other an unpublished decision out of the New Jersey Superior Court — indicate that courts are beginning to answer Chancellor Bouchard's call to pay closer attention to disclosure-only settlements.

POSNER PANS DISCLOSURE-ONLY PACTS

In *In re Walgreen Co. Stockholder Litigation*, decided last August, the 7th Circuit reversed a trial court's decision to approve a settlement between plaintiff stockholders and merging corporations.[4]

Judge Posner's opinion did not pull any punches. It criticized the practice of disclosure-only settlements as a "racket" and admonished the plaintiffs' counsel for failing to adequately represent the interests of the class of plaintiff stockholders.

Judge Posner succinctly described such "strike suits" as "cases in which a large public company announces an agreement that requires shareholder approval to acquire another large company, and a suit, often a class action, is filed on behalf of shareholders of one of the companies for the sole purpose of obtaining fees for the plaintiffs' counsel."

Walgreens acquired a 45 percent interest in Swiss company Alliance Boots GmbH. Just weeks after Walgreens filed a proxy statement seeking shareholder approval, the plaintiffs filed a class-action suit challenging the transaction. A mere 18 days later — and less than a week before the scheduled shareholder vote — they agreed to settle.

As in *Trulia*, the settlement agreement required Walgreens to make some modest supplemental disclosures and released it from all disclosure-related claims. As is typical of such arrangements, the settlement agreement also provided for the plaintiffs' attorneys to seek an unopposed six-figure fee.

Expressly endorsing the *Trulia* standard for the approval of such settlements, the 7th Circuit closely scrutinized the supplemental disclosures and described them as "only a trivial addition to the extensive disclosures already made in the proxy statement."

The supplemental disclosures totaled fewer than 800 words, representing a less than 1 percent increase to the text of the original proxy statement. The court described the six supplemental disclosures as "worthless" and found that they added nothing of substance to the proxy statement.

It noted that the merger was approved by 97 percent of the voting Walgreens shareholders and said it was "inconceivable" that the supplemental disclosures had any effect on shareholder support for the transaction.

Criticizing such strike suits generally, the court stated that the "type of class action illustrated by this case — the class action that yields fees for class counsel and nothing for the class — is no better than a racket. It must end. No class action settlement that yields zero benefits for the class should be approved, and a class action that seeks only worthless benefits for the class should be dismissed out of hand."

In addition to rejecting the settlement agreement and adopting Chancellor Bouchard's analysis from *Trulia*, Judge Posner's opinion went one step further, concluding that "class counsel, if one may judge from their performance in this litigation, can't be trusted to represent the interests of the class."

The 7th Circuit directed the District Court, on remand, to give "serious consideration" to either appointing new class counsel or dismissing the case outright.

NEW JERSEY JOINS WITH DELAWARE

Another recent non-Delaware case applying the *Trulia* analysis is *Vergiev v. Aguero*.[5] On June 15, 2015, Metalico Inc. and Total Merchant Ltd. entered into a merger agreement whereby Total Merchant would acquire all outstanding shares of Metalico.

Shortly after the announcement of the merger, plaintiffs filed four class-action lawsuits challenging the transaction in the New Jersey Superior Court.

By that August, the parties had entered into a settlement agreement under which defendants would provide supplemental disclosures in the proxy statement and would not oppose the plaintiffs' application for $525,000 in attorney fees.

Notably, as in the Walgreens case, shareholder objections provided the impetus for the court's rejection of the agreement. The court in *Vergiev* found that *Trulia* was controlling, presumably because the companies were both Delaware corporations.

The court rejected the settling parties' contention that Metalico's additional disclosures were "material." It found that the disclosures merely provided minor, albeit more specific, details underlying the analysis already disclosed in the proxy statements. These additional details did not work to correct any material misrepresentations or omissions and were "of no practical value" to shareholders, the court found.

The court thus declined to approve the settlement, noting that its decision was "in line with the policy considerations surrounding the proliferation of disclosure settlements that have burgeoned in this country, which in many instances provide more to attorneys in the way of fees than they provide to shareholders."[6] WJ

CONCLUSIONS

In *Trulia*, Chancellor Bouchard, acknowledging the concern that closer scrutiny in Delaware would encourage plaintiffs to bring suit in other jurisdictions, expressed his "hope and trust that our sister courts will reach the same conclusion if confronted with the issue."

Trulia and *Vergiev* hint that more courts may follow Delaware's lead and apply greater scrutiny to disclosure-only settlements. Given the nationwide influence of the Delaware Court of Chancery in the area of corporate governance and shareholder litigation, it is reasonable to anticipate that Chancellor Bouchard's hope will become reality.

NOTES

[1] *See, e.g., In re Aruba Networks Inc. S'holder Litig.,* No. 10765-VCL, 2015 WL 5924767 (Del. Ch. Oct. 9, 2015); *In re Riverbed Tech. Inc.,* No. 10484-VCG, 2015 WL 5471241 (Del. Ch. Sept. 17, 2015); *In re TW Telecom Inc. S'holders Litig.,* No. 9845-CB, *order and final judgment of settlement issued* (Del. Ch. Aug. 20, 2015); *Acevedo v. Aeroflex Holding Corp.,* No. 7930-VCL, 2015 WL 4127547 (Del. Ch. July 8, 2015).

[2] 129 A.3d 884 (Del. Ch. 2016).

[3] Through the first half of 2016, plaintiffs filed lawsuits challenging 64 percent of mergers and acquisitions valued at over $100 million. This number is down from 84 percent in 2015 and 93 percent in 2014. *See* Cornerstone Research, Shareholder Litigation Involving Acquisition of Public Companies (2016), https://www.cornerstone.com/publications/reports/shareholder-litigation-involving-acquisitions-2016.

[4] 832 F.3d 718 (7th Cir. 2016).

[5] No. L-2276-15, *final order and judgment issued* (N.J. Super. Ct., Union Cty. June 6, 2016).

[6] Even before *Trulia*, New York courts had begun to apply greater scrutiny to disclosure-only settlements. *See, e.g., In re Allied Healthcare S'holder Litig.,* No. 652188/2011, 2015 WL 6499467 (N.Y. Sup. Ct., N.Y. Cty. Oct. 23, 2015) (denying approval of disclosure-only settlement and observing that "[t]he willingness to rubber-stamp class-action settlements reflects poorly on the [legal] professions and on those courts that, from time to time, have approved these settlements"); *City Trading Fund v. Nye,* No. 651668/2014, 2015 WL 93894 (N.Y. Sup. Ct., N.Y. Cty. Jan. 7 2015) (denying approval of disclosure-only settlement after closely scrutinizing supplemental disclosures and finding them immaterial); *Gordon v. Verizon Commc'ns Inc.,* No. 653084/13, 2014 WL 7250212 (N.Y. Sup. Ct., N.Y. Cty. Dec. 19, 2014) (denying approval and noting that "[a]n increasing body of commentary has decried the tsunami of litigation, and attendant suspect disclosure-only settlements, associated with public acquisitions today").

Dole CEO

CONTINUED FROM PAGE 1

When Murdock turned to the insurers, which had initially paid the legal bills of the company and its officers, they declined to reimburse the CEO for the settlement, citing the fraud exemption and Murdock's alleged failure to get consent prior to settling.

NOT 'FINAL' FRAUD

When the insurers sought a declaratory judgment that the fraud exemption relieved them of any duty to pay, Judge Davis noted that case law supports the defendant officers' position that only final judgments trigger the exemption.

While the Chancery Court's 2015 opinion was not final, neither was the settlement a final adjudication of fraud, the judge said, although he noted that it was "carefully crafted to mitigate the findings in the ... opinion."

> "The reason for the fraud exclusion's detailed trigger requirements is to ensure that mere allegations and ... even a conviction of fraud is not sufficient to preclude insurance coverage for an appeal," legal analyst Kevin LaCroix said.

Kevin M. LaCroix, an insurance law specialist who edits The D&O Diary blog, said in a Jan. 4 post, "The reason for the fraud exclusion's detailed trigger requirements is to ensure that mere allegations and ... even a conviction of fraud is not sufficient to preclude insurance coverage for an appeal."

While it's "troubling" that the defendants may have engineered a settlement to avoid the fraud exclusion, LaCroix noted that settlements usually occur *before* a court has made fraud findings. Therefore, a fraud determination as in this case will occur only rarely, he said. WJ

Attorneys:

Plaintiffs: Robert J. Katzenstein and Kathleen M. Miller, Smith, Katzenstein & Jenkins LLP, Wilmington, DE

Defendants: Elena C. Norman and Mary F. Dugan, Young Conaway Stargatt & Taylor LLP, Wilmington, DE; Kirk A. Pasich and Pamela Wood, Liner LLP, Los Angeles, CA; Mikaela Whitman, Liner LLP, New York, NY

Related Filing:

Opinion: 2016 WL 7414218

See Document Section A (P. 23) for the opinion.