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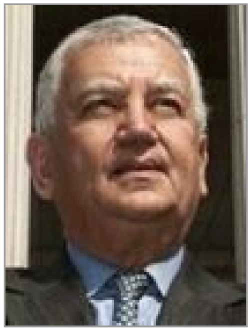
Abusive M&A Litigation Highlights Need For Securities Reform

By **Gregory Markel, Vincent Sama and Daphne Morduchowitz** (March 4, 2021, 4:13 PM EST)

Federal court challenges to announced M&A deals have not abated as a result of the current COVID-19 pandemic.



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In fact, in 2020, 95 out of approximately 122 federal class action deal challenges were filed in the U.S. District Court for the District of Delaware by a single group of lawyers working in concert, with an additional almost 450 non-class action federal challenges to M&A deals also filed in 2020.

The majority of these cases were voluntarily dismissed quickly, often after supplemental disclosures were issued by the defendant company and the lawsuits appear to be intended to generate mootness fees for plaintiffs counsel.

We expect this abusive litigation trend to continue unless there is wider recognition of the problem followed by reform.

M&A Challenges

In 2020, approximately 95 of the estimated 122 M&A class action deal challenges alleging violations of Section 14 of the Securities Exchange Act[1] were filed in District of Delaware jointly by one group of lawyers at Rigrodsky Law PA[2] and RM Law Group LLP.

These complaints allege that defendants omitted details regarding financial projections and deal background that purportedly render proxy or registration statements misleading, and they hardly differ from the disclosure suits criticized by the Delaware Court of Chancery in its 2016 decision in In re: Trulia Stockholder Litigation.[3]

Notably, more than 90 of the 95 cases, or approximately 95% of them, were voluntarily dismissed within months of their filings. Almost 70% of the voluntary dismissals followed the issuance of supplemental disclosures that do not appear to reveal any significant new information.

The dismissals and related settlements, which occur before class certification, rarely get reviewed by a court for fairness to the class of shareholders and appear to be without material benefit to the class. The quick timing of the voluntary dismissals and lack of discernable value to the shareholders strongly suggest that these cases are being filed for the benefit of plaintiffs counsel, rather than the shareholders they represent.

However, the data with respect to class actions tells only part of the story. Our review of non-class action filings, indicates that close to 450 non-class action M&A challenges were filed by individual plaintiffs in federal court in 2020 alleging violations of Section 14 of the Securities Exchange Act.[4]

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These complaints are similar to the class action complaints and almost 70% of them have been voluntarily dismissed, many in very short timeframes. Like the class actions, a majority of the dismissal of the non-class actions follow the filing of what appear to be superficial supplemental disclosures and likely involve mootness fees paid to plaintiffs counsel.

These numbers demonstrate that (1) plaintiffs attorneys continue to file a significant number of cases challenging M&A transactions, and (2) the clear need for legislative reform in this area to prevent what amounts to a burdensome deal tax imposed on companies and the resulting increases in directors and officers insurance premiums or the expansion of coverage exclusions for these cases in directors and officers policies.

Background

Beginning in 2009, filings of class action claims challenging mergers increased substantially. These cases generally alleged breaches of fiduciary duties and challenged the sufficiency of shareholder disclosures or the overall fairness of the proposed deals. By 2015, roughly 95% of merger transactions valued at more than $100 million were challenged and 60% of these challenges were filed in Delaware courts — more often than not in Chancery Court — while only 19% were filed in federal courts in other states.

These cases were normally resolved in early settlements with corrective disclosures which, like most settlements, generally required court approval

Because these corrective disclosures theoretically benefitted shareholder members of a class through the provision of additional information purportedly relevant in making an informed decision regarding the merger, plaintiffs attorneys were generally awarded attorney fees by the courts under the common law corporate benefit doctrine.

However, as the volume of cases increased, class actions seeking supplemental disclosures became a vehicle for plaintiffs firms to obtain attorney fees while providing little, if any, meaningful benefit to shareholders and rarely impacting shareholder votes on the merger.

Defendants were incentivized to quickly resolve the often meritless litigation in order to avoid costly litigation that could potentially complicate or delay the closing of the transaction. While class actions were created to benefit a class of injured claimants, it became clear that these disclosure-only lawsuits were being used as a tool to justify plaintiffs counsel attorney fees and often provided little benefit to the shareholders.

In fact, the broad releases of all future class claims routinely provided in connection with these settlements sometimes harmed shareholders by foreclosing potentially stronger claims that would not have the opportunity to be thoroughly vetted.

The Aftermath of Trulia

In its 2016 decision in Trulia, the Delaware Court of Chancery acknowledged the issue of meritless merger lawsuits and indicated a policy disfavoring approval of merger litigation settlements and the award of associated attorneys fees without a meaningful benefit to shareholders.

However, Trulia led to a new trend in merger litigation: Plaintiffs shifted from preclosing deal challenges seeking injunctive relief or additional disclosures to deal litigation under federal law alleging monetary damages for violations of Section 14 of the Securities

Exchange Act,[5] which prohibits materially misleading disclosures in connection with a proxy statement or tender offer.

As with the disclosure-only suits filed in the Delaware Court of Chancery, companies seeking to avoid delays in completing merger transactions and the expense of litigating a case on the merits often elected to resolve these suits with supplemental disclosures and payment of relatively modest attorney fees.

As a result, certain plaintiffs firms started filing cases in federal court without expecting meaningful benefits for shareholder class members through corrective disclosures or recovery, but with the sole intent of obtaining attorney fees — known as mootness fees — in exchange for voluntary dismissals and nonmaterial supplemental disclosures.

In this way, plaintiffs simply moved the battle ground over deal disclosures from Delaware Chancery Court to federal district courts.

While settlements of federal securities class actions and attendant attorney fee awards generally require approval by the federal district courts in order to ensure fairness to the class, plaintiffs have circumvented this process through voluntary dismissal of cases upon supplemental disclosures — which are often immaterial and minor — and payment by defendants of mootness fees to plaintiffs attorneys prior to class certification or by filing cases on behalf of individuals rather than on a classwide basis.

This arrangement bypasses court approval and the potential analysis of the settlement by courts under Trulia because settlements before class certification or settlements of individual actions typically do not require court approval.[6] The arrangement also typically avoids public scrutiny because mootness fees are generally immaterial to the paying company and are often not widely disclosed.

Conclusion

The public policy issues underlying the Trulia court's criticism of disclosure-only settlements are of even more concern with respect to the current mootness fee settlements. Like the settlements criticized in Trulia, the federal court mootness fee settlements provide no benefit to the company shareholders and serve as a deal tax on almost every M&A transaction involving a public company.

Even more egregiously, the federal court mootness fee settlements, unlike those at issue in Trulia, involve little transparency or court review. These actions, which are being filed on behalf of purported classes of shareholders and individual plaintiffs, are now a serious issue in federal court.

Because there is little incentive for an individual defendant to risk litigating these suits, we expect these deal tax lawsuits to continue unabated unless the issue is remediated by court action or through congressional reform of securities law.

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[1] These numbers do not include the Section 11 Securities Act challenges to M&A deals that are sometimes filed when an M&A transaction involves the issuance of shares to the seller.

[2] Prior to the 2016 decision in Trulia, Rigrodsky & Long frequently brought disclosure suits in Delaware Chancery Court. In fact, the firm represented plaintiffs in the Trulia case.

[3] In re Trulia Inc. Stockholder Litigation , 129 A.3d 884 (Del. Ch. 2016).

[4] Of these, more than 75 were filed by Rigrodsky & Long; over 100 were filed by Weiss Law LLP and approximately 84 were filed by Monteverde & Associates PC.

[5] Data collected by Cornerstone Research on securities class actions indicates unsurprisingly that since the 2016 Trulia decision there has been an increase in federal M&A class action filings and Rigrodsy & Long is responsible for a significant number of these cases. Cornerstone Research reports 2 M&A challenges filed in federal court in 2015; 59 in 2016; 249 in 2017; 168 in 2018; and 160 in 2019. Of these, Rigrodsky & Long filed 14 in 2016, 86 in 2017 and 54 in 2018.

[6] In a rare situation in the Northern District of Illinois, a shareholder sought to intervene and object to a settlement stipulation, which disclosed the payment of mootness fees prior to class certification. The court cited Trulia in abrogating the settlement.