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Merger litigation tax 'racket' challenged

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John Zak of Hodgson Russ says that since the top objective of most companies involved in a merger is to close the deal, they often decide to settle when confronted with a lawsuit alleging a breach of fiduciary duties.

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Efforts have been made in recent years to curtail a trend in which nearly every public merger transaction ends up in litigation.

The phenomenon started in the mid-2000s, and by 2014 more than 90 percent of merger transactions involving a publicly traded company were sued in a class action alleging breaches of fiduciary duties by the board of directors.

More than half of these companies are incorporated in Delaware due to the state's sophisticated business court that rules on corporate law disputes.

Shortly after the announcement of a deal, the plaintiff's lawyers send out letters to shareholders claiming they are investigating possible failures to disclose certain items having to do with the merger. While these claims can be legitimate at times, it became clear that many plaintiff's lawyers were only after a fee, according to John Zak, a partner at Hodgson Russ and leader of the securities regulation and corporate compliance practice.

> Some plaintiff's lawyers have adjusted to the changing landscape by trying to sue cases elsewhere, including federal court and in states other than Delaware.

Since a company's top priority is to close the deal, settlements became the norm, he said. Plaintiff's lawyers file a complaint in court on behalf of the class of shareholders, and once the settlements are approved, the attorneys would earn a fee ranging from $250,000 to $1 million, depending on the size of the deal.

In the settlement, the company agrees to minor changes to disclosures in the proxy statement that presumably help the disclosure but many times are essentially immaterial, he said. Some deals can be in the $100 million range so the settlements turn out to be a mere "tax."

"The reason plaintiff's fees weren't opposed is because they weren't asking for a lot," Zak said. "It tells you it was kind of a tax racket because they weren't looking for big paydays; they were looking for a stream of fees. They knew they could go to court and get a judge to listen, and the company didn't want to run the risk that the judge would block or delay the deal."

He has represented clients in similar cases and wound up settling them. The fee paid was enough to make the case go away so the merger could move forward, he said.

"You can tell a client they can fight this and if they take it to trial you'll win, but you have to weigh that against the risk that the court will issue an injunction to look at it more closely. If you've got two weeks until closing, you want to close," Zak said. "When the client hears that it will go away for a half-million dollars, they think, 'Let's pay it and move on.' But it doesn't make it right."

In many of these cases, plaintiff's lawyers get a hefty fee, said Bond Schoeneck & King member Joseph Kubarek, who focuses on mergers and acquisitions, securities and corporate finance and governance. He said these lawsuits became so prevalent that when a company came up with its budget for a merger, it would include the cost for a settlement.

Kubarek

"If you talked to me two years ago and were planning an M&A transaction, I would tell you there was nearly a 100 percent chance that there was going to be a lawsuit," Kubarek said.

"I think plaintiff's lawyers saw an opportunity and the courts were being lenient in their diligence on approving the settlements, so everyone got on the bandwagon."

Horn

These merger objections, sometimes referred to as "strike suits" by defense counsel, are meant to hold up the transaction just long enough for plaintiff's counsel to be able to exact some injunctive relief and concessions. That's according to Harter Secrest & Emery attorney John Horn, who said the most significant and sometimes only monetary portion of many of the settlements is in attorney fees.

"They'll continue to happen until they're not effective on any level," said Horn, managing partner in the firm's Buffalo office who represents clients in complex business matters.

Zak of Hodgson Russ said that is happening as more individuals complain about these lawsuits. In 2015, the Delaware Legislature passed a change to the corporate law that allowed Delaware corporations to adopt bylaws that designate the state's Chancery Court as the exclusive forum for any shareholder disputes. It was a way to avoid claims from occurring all over the country and stop forum shopping for the best potential results.

Then last year there was a decision in the Trulia case in a Delaware business court that further changed the direction of lawsuits. A judge ruled for the first time that a disclosure-only settlement, where the company agrees only to add minor additional information to its proxy statement, was not enough to support a fee to plaintiff's counsel.

"That was a shock to the Plaintiff's Bar," Zak said. "The court said there is no genuine benefit to stockholders so there should be no fee earned. This was brewing and there was a lot of discussion about whether these things were fair and appropriate. Over time, it came to a head in this case."

The court said in Trulia that a new disclosure would actually have to change someone's vote on the merger, Kubarek said. As a result of the decision, in the first part of 2016 there was a nearly 30 percent decrease in the litigation of these transactions, he said.

After working its way through hundreds of such lawsuits, the Delaware business court came down hard on plaintiff's attorney fee applications, Horn said. Settlements were being done hastily and without much discovery.

However, in certain situations these lawsuits are brought in good faith, as the result of concern among shareholders that terms of the deal or the process by which the terms were arrived at were fundamentally unfair, according to Horn. That could mean a conflict of interest, an undisclosed coziness between parties or a failure by the company's directors or officers to adequately shop the company around.

"There are legitimate grievances brought in the context of these merger objection suits," Horn said. "It's just that they have been a vehicle for significant abuse and that's why there have been efforts by various courts, including Delaware, to curtail that abuse."

Some plaintiff's lawyers have adjusted to the changing landscape by trying to sue these cases elsewhere, including in federal court and in states other than Delaware. They justify getting into federal court on a state business matter using the argument that since the proxy statement was filed with the SEC, there are federal securities law violations.

The difficulty in taking these cases to federal court is that class actions are more difficult to sustain because the standard is rigorous, according to Kubarek. However, federal court judges don't do as much corporate law, so that can also result in a variety of decisions, he said.

In the Seventh Circuit Court of Appeals, in the Walgreens case, a judge overturned a federal district decision and instead adopted the Trulia standard. Kubarek said the court called the plaintiff's counsel disclosure-only settlement claims a "racket."

However, in New York's Appellate Division, First Department, in the Verizon Communications and Vodafone merger, the court reversed a lower court's denial of a plaintiff's attorney fee, citing the state's standards for class-action settlements. In the decision, the court stated there was some benefit derived from these disclosures, which was enough to support a settlement.

"Even though there's less of this litigation, from a deal lawyer's standpoint, I'm actually a little more concerned because I don't know how these things are going to be handled in these state and federal courts," Zak said. "The merger agreements on some of these deals are 300 pages long and full of financial analysis and other information about how the deal works. It's just not something some of these judges have ever done."

Kubarek said it is increasingly common for companies going into a transaction to amend their bylaws to include a clause that bars the entity from paying any legal fees incurred by shareholders in this type of litigation. Some believe the law would support companies incorporated throughout the country in doing the same.

"If I had a public company that was a Delaware corporation or forming one sitting across the table from me and I saw they did not have that in their bylaws, I would advise them that there was a deficiency," he said.