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Shareholder Litigation in M&A: Procedural Issues, Remedies, Defense Strategies, Responding to Meritless Claims

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July 1, 2021

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M&A Litigation: An Overview

What is M&A Litigation?

SHAREHOLDER LITIGATION	DISPUTES BETWEEN MERGER PARTIES*
— Section 14 Disclosure Claims — Breach of Fiduciary Duty • *Revlon* / *Unocal* Claims • Unfair Price • Unfair Process • Disclosure Claims • Aiding & Abetting — Section 220 — Appraisal — *Caremark* Claims*	— Material Adverse Effect (MAE) Clauses — Interim Operating Covenants — Purchase Price Adjustments — Earnouts — Breach of Representations and Warranties

* This presentation will focus on shareholder M&A litigation only.

Timing of Shareholder Claims

PRE-CLOSING

- Before a transaction closes (but after the merger agreement is signed), shareholder plaintiffs may seek injunctive relief.
- For disclosure claims, plaintiffs will typically move to enjoin the shareholder vote unless and until additional disclosures are made.
- Where the complaint alleges breach of the duty of loyalty based on directors' failure to obtain the best possible price, plaintiffs may seek an injunction against the transaction closing.
- Where the complaint alleges directors breached their fiduciary duties by *refusing* to enter into a transaction, plaintiffs may seek to enjoin defensive measures adopted by the board.

POST-CLOSING

- For public company deals, after the transaction has closed, typically the only viable remedy is monetary damages. It is virtually impossible to unwind the transaction.
- Most post-closing damages cases are litigated as class actions (or shareholder derivative actions).
- Depending on the facts, there may be different forms of monetary damages available, including "rescissory damages" and "quasi-appraisal" damages.

Disclosure Only Claims and Settlements

"Disclosure Only" Settlements: A Historical Perspective

From 2007 to 2014, the percentage of public-company transactions valued over $100mm subject to shareholder suits rose from approximately 44% to 93%.

A large majority were quickly resolved through "disclosure only" settlements.

Disclosure settlements allowed target companies to avoid monetary payment to the class by agreeing to make additional disclosures (often of dubious value to shareholders), and paying plaintiffs' attorneys fees.

In 2016, the Delaware Court of Chancery effectively put an end to this practice. In *In re Trulia, Inc. Stockholder Litig*., the court explained that it would no longer approve disclosure-only settlements unless the disclosures are "plainly" material in a way that "significantly alters the total mix of information made available" to stockholders.

Trulia's impact was magnified by the Court of Chancery's 2013 decision, *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, which upheld the usage of forum selection bylaws requiring shareholder suits (under state law) be brought in Delaware.

Disclosure-Only Settlements Migrate to Federal Courts

Instead of disappearing, however, merger-related strike suits migrated to federal courts, where the disclosure claims are brought under Section 14 of the Exchange Act of 1934 rather than under state law.

Between 2015 (the year before *Trulia*) and 2019, M&A-related shareholder claims filed in federal courts increased nearly fivefold.

These cases tend to be brought by plaintiffs and firms amenable to quick settlement and ultimately present few risks for the transactions they challenge.

Like their state law predecessors, these federal claims are typically settled on a disclosure-only basis, with a "mootness fee" paid to the plaintiffs' lawyers.

Because these cases are usually resolved prior to a lead plaintiff being appointed, and generally do not include a class-wide release, the settlements generally do not require court approval.

Other Options for Dealing with Federal Disclosure Claims

Plaintiffs are likely to have a hard time successfully pleading a Section 14 claim, which requires pleading more than a state law duty-of-disclosure claim. Plaintiffs must plead not only that a material fact was omitted but that the allegedly omitted fact renders the proxy statement disclosures materially misleading.

As a result, we may be more likely to see defendants litigate rather than settle these claims. In *Karp v. SI Financial Group, Inc.*, 2020 WL 1891629 (D. Conn. Apr. 16, 2020), the defendants chose not to follow the usual playbook and litigated and defeated the plaintiff's Section 14 claim at the motion to dismiss stage.

If more defendants refused to make supplemental disclosures, these cases would at once become less lucrative for the plaintiffs' lawyers who file them and more expensive (given the cases would actually have to be litigated at the pleadings stage), which may discourage such cases from being filed in the first place.

Repeat players in the public M&A space that find themselves subject to these suits may want to pursue a public strategy of refusing to settle these cases as a way of discouraging the plaintiffs' bar from filing complaints in cases in which they are involved.

Some courts have ruled that the PSLRA bars attorneys' fees when plaintiffs only achieve a non-monetary recovery (such as supplemental disclosures) on behalf of a class, though some plaintiffs have sought to get around this by only filing an individual action.

Plaintiff's counsel in one matter were forced to disgorge their mootness fee based on the court's finding that the supplemental disclosures defendants agreed to make did not provide any substantial benefit to the stockholders. An appeal is pending but if the decision is affirmed, it would substantially eliminate plaintiffs' lawyers incentives to file Section 14 claims in the Seventh Circuit (and potentially beyond).

Fiduciary Duty Litigation

What Fiduciary Duty Litigation Looks Like Today

A smaller number of cases continue to be filed in the Delaware Court of Chancery, often brought by more motivated plaintiffs (e.g., large institutional shareholders, hedge funds or other activists).

These suits frequently involve attempts to enjoin a transaction or seek substantial damages on a class-wide basis after a transaction has closed.

Typically involve public targets

Suits usually filed by shareholder plaintiffs represented by small group of repeat-player firms

Filed in Delaware Court of Chancery

- Court of equity with deep expertise in corporate law and business disputes
- Appealable as of right to Delaware Supreme Court

Usually filed against board or target, but frequently also includes controlling shareholder, buyer, and/or advisors as defendants

What Are A Director's Fiduciary Duties?

DUTY OF CARE

— Directors must act with the care, vigilance, and foresight of an ordinary person in like position acting under similar circumstances.

— Practically speaking, this means that when making a decision, (i) directors have a duty to inform themselves of all material information reasonably available, and (ii) must act with due care.

— Most corporate charters include an exculpatory provision under DGCL § 102(b)(7), which protect directors from liability for duty of care claims.

DUTY OF LOYALTY

— Directors must act on a disinterested and independent basis, in good faith, with honest belief that action is in best interests of the company and its stockholders.

DUTY OF CANDOR

— Directors must disclose fully and fairly all material information with board's control when seeking shareholder action.

Standards of Review

Business Judgment

- Highly deferential standard of review that applies as default when there is no change-of-control.
- Presumption will apply, and courts will not second-guess the board's decision-making, so long as the decision was undertaken with due care and in good faith.
- Does not require that the board's decision was the best or wisest; the court merely asks whether the business decision was rational.
- When business judgment rule applies, courts typically dismiss stockholder claims at the pleading stage unless plaintiff pleads specific facts rebutting the presumption.

UNDER DELAWARE LAW

"[A] board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose."

Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721 (Del. 1971)

Enhanced Scrutiny (*Revlon* and *Unocal*)

Intermediate standards of review.

Revlon applies to change-of-control transactions or when the company is put up for sale.
— Does not apply to stock for stock merger—merger must have cash component.

Revlon duties require that directors take reasonable efforts to sell for highest price possible.

Burden is on director defendants to prove they acted with proper care under the circumstances to pursue a reasonable strategy to maximize price for shareholders, including that they were able to obtain best price available.

Still a reasonableness standard applies—directors need to show they made a reasonable decision, not a perfect decision.

Defensive measures (e.g., poison pills, etc.) are subject to a variation of enhanced scrutiny: the court asks (i) whether the defensive measure is reasonable in relation to the threat posed, such that it is neither "preclusive" nor "coercive," and (ii) if the action is within a permitted "range of reasonableness."

Entire Fairness

Most searching level of review.

Applies where a majority of directors approving transaction were interested or where majority stockholder stands on both sides of transaction.

Defendants must prove that the transaction was fair, both with respect to process and price.

Fair price and fair dealing are separate, but related, issues.

Where entire fairness applies, the complaint is almost never dismissed at the pleading stage.

Defenses

Corwin Cleansing

Corwin v. KKR Fin. Hldgs. LLC, 125 A.3d 304 (Del. 2015)

Even a transaction subject to "enhanced scrutiny" under *Revlon* will be reviewed under business judgment rule if it:

— Does not involve a conflicted controller; and

— Is approved by a fully informed vote of disinterested, uncoerced stockholders.

— Under *Corwin*, claims involving transaction approved by fully informed stockholder vote will be dismissed unless plaintiff sufficiently alleges corporate "waste."

— When *Corwin* applies, "dismissal is typically the result."

MFW Roadmap for Conflicted Controller Transactions

Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014)

Conflicted controller transaction reviewed under business judgment (instead of entire fairness) where transaction is conditioned *ab initio* on (i) approval of special committee of independent directors and (ii) fully informed, uncoerced vote by majority-of-minority stockholders.

At a more granular level this means that:

- Controller conditions the transaction from the outset on approval of both a special committee and majority of minority stockholders;
- Special committee is independent;
- Special committee is empowered to freely select its own advisors;
- Special committee meets its duty of care in negotiating a fair price;
- Minority vote is informed; and
- Minority is not coerced.

MFW conditions do not need to be in place at time of first offer as long as they are implemented before economic negotiations begin.

MFW: Not The Promised Panacea

Since *MFW* was decided in 2014, only five Court of Chancery decisions have granted motions to dismiss based on business judgment review of a conflicted transaction. *Dell* is a notable decision that highlights several ways shareholder plaintiffs can overcome an *MFW* defense at the pleading stage.

***In re Dell Tech. Inc. Class V Stockholders Litig.*, 2020 WL 3096748 (Del. Ch. June 11, 2020)**

BACKGROUND	The case involved an effort by Dell Technologies to redeem its Class V shares. Although any redemption was subject to the *MFW* conditions, the controller reserved the right to engage in a forced conversion of the shares if redemption terms could not be reached with the special committee. After a deal was reached with the special committee, several large Class V shareholders objected, and the controller negotiated directly with them, resulting in better terms for the shareholders. Several Class V shareholders brought suit against the controller and the board alleging they breached their fiduciary duties in negotiating the redemption.
HOLDING	The court found that Dell's *MFW* defense was deficient in two respects: — First, the special committee did not properly exercise its role throughout the course of negotiations because (i) the forced conversion alternative was not subject to the special committee's authority and (ii) the controller bypassed the special committee to negotiate directly with stockholders — Second, the Class V stockholder's approval was potentially coerced. The court found it reasonably conceivable that the controller had created a coercive situation by retaining authority to pursue the forced conversion and by publicly preparing to move forward with the forced conversion while the special committee was negotiating the redemption transaction.

Exculpation Provisions

Exculpation provisions under DGCL Section 102(b)(7) protect directors from monetary liability for breaches of duty of care.

OFFICER LIABILITY

- Officers cannot be exculpated from due care claims.
- Shareholder plaintiffs increasingly target officers with due care claims.
- Frequently involve allegations of disclosure failures.

- In *In re Cornerstone Therapeutics Inc., Stockholder Litig.*, the Delaware Supreme Court held that to survive a motion to dismiss where director defendants are protected by an exculpatory provision, plaintiff must plead non-exculpated claims, regardless of the standard of review.
- As a result, independent directors are often dismissed at outset of the case where breach of loyalty claims are insufficiently pled.
  - For example, in *In re USG Corp. S'holder Litig.*, a recent Chancery Court decision, the court dismissed claims against directors protected by an exculpatory provision because the complaint failed to adequately allege bad faith despite finding that "*Corwin* cleansing" did not apply.

Aiding & Abetting Claims

Aiding and abetting claims are sometimes asserted against:

- Buyer
- Advisors (e.g., financial and legal)
- Others who participate in a board's transaction process

Standard for aiding and abetting is "stringent" – proof of scienter required.

Four elements: (1) existence of fiduciary relationship, (2) breach of fiduciary relationship, (3) knowing participation in breach by alleged aider and abettor, and (4) damages proximately caused by the breach. *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001).

Aiding and abetting claims are cleansed by good disclosure under *Corwin*. *See, e.g.*, *In re Volcano Corp. S'holder Litig.*, 143 A.3d 727 (Del. Ch. 2016), *aff'd*, 156 A.3d 697 (Del. 2017); *Singh v. Attenborough*, 137 A.3d 151 (Del. 2016).

Where there is no cleansing, even if breach of fiduciary duty claims against directors are dismissed as a result of DGCL Section 102(b)(7), claims can still survive against advisors for aiding and abetting a breach of the duty of care. *See, e.g.*, *Morrison v. Berry*, 2020 WL 2843514 (Del. Ch. June 1, 2020).

Other Types of Shareholder Litigation

Section 220

DGCL Section 220 grants stockholder qualified right to inspect company's books and records.

Stockholder must state "proper purpose" for inspection.

- Investigating potential breaches of fiduciary duty generally considered proper purpose so long as stockholder can show "credible basis" to suspect wrongdoing.
- "Credible basis" is lowest standard of review.

Scope of request must be "necessary and essential" to accomplish the stated purpose.

Company has five days to respond—if stockholder believes company's response is inadequate, stockholder can bring a Section 220 action in Delaware Chancery Court seeking order to compel.

Section 220 demands are commonly seen following mergers, and actions usually litigated on expedited basis.

Recent cases have expanded Section 220 inspection rights, both with respect to what is a proper purpose and what materials are necessary and essential.

- Recent Delaware Supreme Court decision held that 220 plaintiffs are not required to identify an "end" for their inspection request, or to establish a basis to suspect "actionable wrongdoing."
- Shareholders may be able to inspect more than board minutes and other formal board materials, including electronic communications where formal board materials are insufficient (e.g., if corporation's formal record-keeping is inadequate) and management and employee-level documents and communications.
- Courts have even ordered a deposition on what records exists.

Section 220 Demands – 6 Key Learnings

1	Company should strike delicate balance when deciding whether (and to what extent) to comply with a stockholder's Section 220 demand.
2	Assuming a proper purpose (which courts view broadly), refusing to hand over any (or very limited) documents is risky – it could lead to fee-shifting, earn the courts ire, and draw unfavorable inferences in later litigation.
3	Companies may continue to resist producing emails and other electronic communications on the grounds that more formal board materials are sufficient to satisfy the stockholder's demand.
4	Companies must weigh the risk that handing over formal board materials at the outset could provide plaintiffs with additional bases to then persuade a court that there are "gaps" in those formal materials, necessitating the production of electronic communications.
5	Companies should implement additional protections as part of 220 productions: include confidentiality protections, limitations on use of material, and incorporation provisions so that documents can be used defensively on a motion to dismiss; and carefully review proposed productions to assess litigation risk.
6	Document, Document, Document: Formal record keeping will mitigate risk that e-communications will need to be produced, and thoroughly documenting board review of, and action taken on, critical issues and key risks will mitigate liability.

Appraisal

- DGCL Section 262 gives shareholder right to judicial appraisal of their shares post-merger.
- Entitles shareholders to faire value of their shares in lieu of merger consideration.
- If sales process was robust, Delaware courts generally give substantial weight to deal price.
- Significant decline in appraisal petitions since 2016 (76 in 2016 vs. 26 in 2018).
- Company permitted to prepay appraisal petitions, which halts accrual of interest.
  - Amendment has made appraisal arbitrage less attractive.
  - However, no refund for prepayment where court later determines deal price exceeds fair value.

TO BRING AN APPRAISAL ACTION, SHAREHOLDER MUST

- Deliver written appraisal demand prior to merger vote;
- Not vote in favor of transaction;
- Continuously hold stock through closing of merger; and
- Perfect appraisal right after closing.