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Delaware Court of Chancery Clamps Down on Disclosure-Only Settlements

What Does the Future Hold for M&A Litigation?

By Bruce A. Ericson and Melisa Olmos

In recent years, lawsuits challenging mergers and acquisitions have become almost ubiquitous. Virtually all of these cases settled for disclosure-only settlements in which the target's stockholders received no money. Of course, money did change hands, but that money went to the plaintiffs' lawyers, who often were the real drivers behind this sort of litigation. Now the Delaware Court of Chancery is clamping down on these disclosure-only settlements.

Each year from 2011 through 2014, well over 90 percent of deals with a nominal value in excess of $100 million drew at least one, if not more, securities class actions.[1] These cases follow a pattern: the target's Board is accused of breaching its fiduciary duties by not getting a good enough deal. The acquirer is accused of aiding and abetting the target's Board in breaching its fiduciary duties, on the theory that the acquirer got too good a deal. And both sides are accused of failing to disclose in the disclosure documents something they should have disclosed.

What is a Disclosure-Only Settlement?

Until very recently, virtually all of these cases settled, and settled early, for what are called disclosure-only settlements. These are settlements in which the target's stockholders get a supplemental S-4 with additional disclosures, while the money that changes hands all goes to the plaintiffs' lawyers. In return, the defendants get peace—at least the sort of peace that a broad release can provide. The release becomes a type of insurance policy against another lawsuit. But in a series of recent decisions, the Delaware Court of Chancery has started to clamp down on these disclosure-only settlements, criticizing them roundly.

[1] Matthew D. Cain and Steven Davidoff Solomon, *Takeover Litigation in 2015*, at 2 (Berkeley Law Jan. 2016), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2715890

The *Trulia* Decision

On January 22, 2016, the Delaware Court of Chancery rejected the proposed settlement of a stockholder class action lawsuit challenging Zillow, Inc.'s acquisition of Trulia, Inc. in a stock-for-stock merger valued at something between $2.5 billion and $3.5 billion.[2] Chancellor Andre Bouchard found that the proposed settlement was neither fair nor reasonable because the company would be providing its stockholders with useless and immaterial supplemental disclosures that did not justify a broad release of claims.[3] Chancellor Bouchard also warned that, moving forward, the Court of Chancery will no longer approve disclosure-only settlements unless (1) the supplemental disclosures satisfy a "plainly material" standard and (2) the proposed release is sufficiently narrow.[4]

The *Trulia* decision follows a series of recent decisions in which the Court of Chancery has signaled its growing unwillingness to approve disclosure-based settlements of merger litigation.

Vice Chancellor Sam Glasscock III examined the problems with disclosure-only settlements in his September 17, 2015 opinion in *In re Riverbed Technology, Inc. Stockholder Litigation*.[5] He noted the incentives: Plaintiffs' counsel get a quick and certain fee. And defendants avoid future litigation by paying a deal tax to gain a broad release—a release that could displace the interests of stockholder class members in diligently pursuing and investigating real claims.[6] Although Vice Chancellor Glasscock narrowly approved the proposed settlement in *Riverbed*, he insisted that the court would approach future proposed settlements with increased scrutiny, particularly with respect to the breadth of claim releases.[7]

Less than a month later, Vice Chancellor J. Travis Laster rejected a proposed settlement arising from an action challenging the $2.7 billion acquisition of Aruba Networks, stating that plaintiffs' counsel had inadequately represented the stockholder class members.[8] At the settlement hearing, Vice Chancellor Laster questioned the merits of the case at the time it was initially filed, took note of the weak discovery record of plaintiffs' counsel and expressed concerns over the fact that the proposed release extended far beyond the disclosure claims to cover future, unknown claims. The Courts' close scrutiny of the proposed settlement in *Aruba* set the stage for Chancellor Bouchard to issue his stern warning in *Trulia* several months later.

Vice Chancellor John Noble cited *Trulia* in a February 19, 2016 opinion cutting a fee award in another case from $1.85 million to $144,375. The parties had agreed on a disclosure-only settlement, conditioned on the merger closing, in which case defendants agreed not to oppose a fee application up to $1.85 million. The

[2] In *re Trulia, Inc. Stockholder Litigation,* C.A. No. 10020-CB, 2016 WL 325008, at *1 (Del. Ch. Jan. 22, 2016). The agreed-upon additional disclosures would have added to the existing 224-page proxy "(1) certain synergy numbers in J.P. Morgan's value creation analysis; (2) selected comparable transaction multiples; (3) selected public trading multiples; and (4) implied terminal EBITDA multiples for a relative discounted cash flow analysis." *Id*. at *11.

[3] The court rejected the settlement even though the parties narrowed the release to exclude unknown claims and antitrust claims. As narrowed, the release still released all claims "arising under federal, state, foreign, statutory, regulatory, common law or other law or rule" held by any member of the proposed class relating in any conceivable way to the transaction. *Id.* at *3-*4.

[4] *Id.* at *10 ("[P]ractitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission, and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process, if the record shows that such claims have been investigated sufficiently. In using the term 'plainly material,' I mean that it should not be a close call that the supplemental information is material as that term is defined under Delaware law."). The Chancellor also encouraged parties to adjudicate disclosure claims outside the context of a settlement—either by a preliminary injunction motion or by a contested fee application. Neither would result in a release.

[5] C.A. No. 10484-VCG, 2015 WL 5458041, at *3-4 (Del. Ch. Sept. 17, 2015).

[6] *Id.*

[7] *Id.* at *6.

[8] *In re Aruba Networks, Inc. Stockholder Litigation*, C.A. 10765-VCL, Hr'g Tr. (Del. Ch. Oct. 9, 2015)

additional disclosures were made but the deal cratered, nullifying the settlement. Plaintiffs then sought a "mootness" settlement (a process suggested by *Trulia*)[9] for prompting the additional disclosures, asking for between $475,000 and $647,500. The court analyzed the benefits conferred, then awarded $144,375.[10]

Lessons Learned from *Trulia*

- New "Plainly Material" Standard—*Trulia* established a new standard for evaluating the adequacy of supplemental disclosures offered as part of a proposed settlement. To pass muster, a company's supplemental disclosures must "address a plainly material misrepresentation or omission." [11] In other words, the supplemental disclosure will only support a settlement if the company's previous disclosure was materially misleading. Relatedly, courts may request supplemental briefing or appoint an *amicus curiae* to help evaluate the alleged benefits of a supplemental disclosure.

- No More "Deal Insurance" for Companies and Their Boards—Defendants in stockholder class actions will no longer be able to secure deal certainty by making supplemental disclosures and paying attorneys' fees in exchange for global claim releases. Releases must be much narrower: Only narrow releases that "encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process"[12] will support a settlement. Courts will likely not accept releases that include "unknown claims" or general language referring to "any claims arising under federal, state, statutory, regulatory, common law, or other law or rule," like the release in *Trulia*.[13]

- Difficulty of Negotiation—The new "plainly material" standard for supplemental disclosures and the narrow release requirement will make it more challenging for parties to negotiate settlements in the future. Put simply, plaintiffs will have every incentive to insist upon a monetary settlement sufficient to generate a "common fund" out of which fees can be awarded. Otherwise, if only disclosures are achieved, plaintiffs will need to prove their materiality, insist on only a narrow release and then be prepared to litigate the amount of their fees, rather than cut a deal.

- Decreased Filings in Delaware—The court's increased scrutiny of disclosure-only settlements will likely lead to fewer filings in Delaware of lawsuits traditionally targeted at securing these types of settlements. If plaintiffs' attorneys do choose to file claims in response to public company M&A deals, the lawsuits will likely be of a higher quality compared to those filed pre-*Trulia*, and will seek money. Already there is evidence of this trend. As noted, in recent years, over 90 percent of deals resulted in a lawsuit. For the year 2015 as a whole, this percentage fell slightly, to 87.7 percent. But in the fourth quarter of 2015, this percentage fell to 21.4 percent.[14]

- Forum-Shopping—Already, many merger objection cases are filed in jurisdictions other than Delaware. Plaintiffs' counsel now may attempt to file even more merger objection cases in other jurisdictions to avoid increased scrutiny by Delaware courts. The effectiveness of this strategy will depend on whether those jurisdictions choose to follow *Trulia* and whether the corporation has adopted a forum selection

[9] 2016 WL 325008, at *9 -*10.

[10] *Louisiana Municipal Police Employees' Retirement System v. Black*, C.A. No. 9410–VCN, 2016 WL 790898 (Del. Ch. Feb. 19, 2016). "Mootness" settlements are explained at *id.* *6, n.40.

[11] *Trulia, Inc.*, 2016 WL 325008, at *10.

[12] *Id.*

[13] *Id.* at *4.

[14] Cain and Solomon, *supra* note 1, at 1.

bylaw specifying Delaware as its designated forum.[15] But defendants might not always resist another forum. The new Delaware "plainly material" standard is a very high standard. Other states might conclude that additional disclosures have some value even if they do not correct a material misstatement or omission—or at least that approval of a settlement need not require proof that defendants made a material misstatement or omission in the original disclosures.

- Decline in Cost of D&O Insurance?—Might rates for directors' and officers' liability insurance fall as a result of a decrease in the volume of frivolous merger opposition lawsuits? Maybe, but maybe not. In recent years many D&O policies have had very high self-insured retentions for M&A litigation—often $1 million or more. As a result, insurers often pay little or nothing toward disclosure-only settlements. Therefore, a decrease in such settlements may not cause premiums to decline.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the attorneys below.

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[15] To date, at least three North Carolina opinions have cited *Trulia*, two seemingly with approval, and one by noting differences between the laws of the two states.