Protecting Directors from the New Trends in M&A Litigation

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When a public company is sold, the company's board of directors will most likely be sued. This discussion considers how a board of directors can seek to reduce the potentially harmful impacts of litigation. Educating a board of directors on the options available to it is the first step toward protecting it from M&A litigation.

Background

The long days of negotiations have ended. The board of directors has approved the final deal and received the fairness opinions from its bankers. The agreement is signed and the champagne flows. Having successfully navigated the ins and outs of negotiating the transaction, the board of directors can now sit back and look forward to . . . being sued.

In a dramatic change from even just a few years ago, litigation following M&A transactions has become a fact of life for boards of directors of public companies. Today, almost all sales of public companies are challenged by the filing of multiple lawsuits, often in more than one jurisdiction. These deals typically involve huge amounts of money and events that are critical to both the target and the buying company.

Although these sorts of high profile transactions have always attracted litigation, in the past, this litigation most often challenged the substance of the transaction. For example, past litigation generally focused on whether the board of directors had sold for too little, the process by which the transaction had been approved, or whether the board of directors had sufficiently investigated other potential buyers or had some conflict of interest that affected its decision.[1]

Certainly, claims like these are still being brought, but the dramatic increase in litigation over announced M&A transactions of public companies is being fueled by allegations that the target company provided inadequate disclosure of how the company was sold and the basis for the board of directors' acceptance of the transaction price.[2] A recent study completed by Cornerstone Research highlights this, finding that the percentage of M&A deals attracting litigation has more than doubled over the last decade.[3]

In 2005, slightly fewer than 40 percent of M&A deals with a value over $100 million were challenged.[4] By 2009, shareholder litigation was being brought in 86 percent of deals valued over $100 million.[5]

In 2012, boards of directors were sued in 93 percent of M&A deals valued over $100 million and 96 percent of deals valued over $500 million. These numbers have steadily increased and vividly demonstrate the increasingly hostile environment surrounding a board of directors' decision to sell.

The Cornerstone Research study also corroborates that there has been a shift away from suits challenging the terms of the transaction and toward suits alleging inadequate disclosure. In any acquisition of a public company, there is extensive disclosure regarding the transaction, the parties to the transaction, and other subjects.

The form and content of this disclosure is in large part dictated by comprehensive regulations of the Securities and Exchange Commission (SEC), comments and positions taken by the staff of the SEC, and is also informed by the experience of the lawyers and others who prepare such disclosures.

These disclosure documents, typically a tender offer to purchase document or a proxy statement, are filed with the SEC and broadly distributed to shareholders.

Among other things, the documents containing these disclosures describe how and why the target company board of directors reached the decision to sell, any other alternatives and bidders that were considered, details regarding the negotiations between the target and the acquirer, as well as with any other bidder, and how the board of directors decided that the price and other terms being offered were fair to the shareholders.

These cases alleging inadequate disclosures in the company's SEC filings are typically brought within days of a merger announcement and can settle just as quickly. These suits are sometimes filed even before the disclosure that is being challenged has been drafted.[6]

The rush to the courthouse is perhaps affected by the tendency of courts to permit the lawyers who are the early filers to represent the class of shareholder plaintiffs, giving these lawyers a better position from which to argue for an award of attorneys' fees.

For example, plaintiffs in recent transactions have alleged that companies' disclosures failed to adequately provide sufficient information concerning matters such as the following:

- The background to the transaction and other details about the course of negotiations between the acquirer and the target, as well as other alternatives considered besides that being recommended to the shareholders
- Why the board of directors recommended a certain course of action over other alternatives that were being considered and the principal assumptions behind that recommendation
- Any pre-existing or past relationships between investment bankers, or other advisers, and the winning bidders or any other potential bidder
- The basis for assumptions in calculating projected earnings or synergies from a combination including assumed tax rates or the impact of deferred tax assets
- Circumstances surrounding the procurement of a fairness opinion
- Compensation of financial advisers
- Factors that could have negatively affected processes used by the board of directors, such as potential conflicts of interest or misaligned financial incentives

Most suits alleging inadequate disclosure seek an injunction to prevent the transaction; however, many end up settling before any injunction hearing is held, with defendants supplementing the SEC filings in order to "cure" the alleged disclosure deficiencies.[7]

In 2012, in more than 80 percent of the settlements the only relief granted to shareholders was additional disclosure about the transaction and, of course, attorneys' fees for the lawyers who brought the case.[8]

Generally, these additional disclosures take the form of an amendment or supplement to the original disclosure documents, which is publicly filed with the SEC. In many cases the supplemental disclosures are not be required to be actually delivered to the shareholders for whose benefit they presumably have been created.

In merger litigation, any settlement typically must be approved by a court. In connection with seeking approval of the settlement, the plaintiffs' attorneys seek a fee award for their efforts in obtaining supplemental disclosures for shareholders.

In some jurisdictions, fees may be awarded, even if shareholders do not receive monetary relief, so long as the additional disclosures confer a "substantial benefit" to the shareholders, as determined by the court hearing the lawsuit. Some commentators have been skeptical as to whether the additional disclosures obtained can in fact be considered of "substantial benefit" to shareholders.[9]

Instead, some have called a settlement comprised of questionable supplemental disclosures and the payment of attorneys' fees a "deal tax," suggesting that the short time frame between litigation being filed and settlement proves that it is "feigned litigation."[10]

In any event, the plaintiffs' bar appears to have benefitted from the situation. In 2012, the average plaintiffs' attorney fee in cases that resulted in disclosure-only settlements was $540,000.[11]

While the lawyers may be profiting from this trend, these cases can also be of great advantage to the target company, its board of directors, and the acquirer.[12]

If a settlement is court approved, the approval generally will prevent other claims that relate to the same matter from being pursued.[13] This creates a type of insurance for target companies.

Indeed, even before obtaining court approval, reaching agreement with plaintiffs' counsel on the terms of a disclosure only settlement typically removes the threat that the transaction will be enjoined and allows the target company to consummate the transaction.

The company may also be able to avoid other issues that weren't raised in the first litigation, but which sufficiently relate to the issues that were raised, such that they will be "precluded" in any subsequent litigation. In this way, a quick settlement on a disclosure claim can preclude subsequent litigation on more serious claims.

The only money that changes hands in these cases is the attorneys' fees paid by the target company or the acquirer or often an insurance company, to the lawyers who brought the cases being settled.

These fees are typically small when viewed in the context of the total deal value, and often less than what it would have cost to aggressively defend the claims. As the costs are low and as the benefit of closing the transaction is high, disclosure only settlements can be attractive to defendants.

Responding to this Increased Risk

Such litigation can be costly in a variety of ways. The board of directors and officers can be distracted from the business in order to participate in depositions and to respond to other discovery obligations. While many of the monetary costs are often covered by insurance (including the payment of attorneys' fees to the plaintiffs' lawyers as part of a settlement), the process can nonetheless be a serious distraction.

In addition, during the discovery that occurs, the plaintiffs' lawyers may uncover fodder for more substantive claims. This would potentially allow them to shift the focus of their claims from alleged inadequate disclosure to more substantive allegations of misdeeds, conflicts of interest, or breach of fiduciary duties.

If this change of claims occurs, it could potentially delay the transaction or even put it at risk. At the very least, such a change of claims could expose the company to a possibly significant increase in monetary liability.

In the current environment, it is almost certain that lawsuits will be filed when a public company is sold. There are a number of steps that can be taken to minimize the impact these claims can have on a transaction and to increase the likelihood of a quick and favorable settlement.

These suggestions are mostly focused on the processes that occur before the transaction is announced. But in the context of the current disclosure-focused litigation, the board of directors and their advisers need to continually be aware of the high probability that disclosure-based claims will be asserted.

The board of directors and their advisers should prepare adequately, so that such claims are sufficiently anticipated and responses developed to the most frequently-asserted claims. This may effectively help minimize the cost of settling the claims once they are filed and reduce the distraction such claims can cause.

The board of directors of a target company has fiduciary obligations, among others, to make the decision to sell on an informed basis, with adequate time to negotiate on behalf of the shareholders, analyze and discuss the proposed transaction and any alternative transactions, and weigh all the many factors that come into play when considering a decision of this significance.

This deliberative process should be carefully considered and documented, with thought given to how it will be described in the publicly filed proxy statement or tender offer documents.

For example, the board of directors should not, as a group, discuss or consider factors that it would not want to reveal to a plaintiffs' lawyer in discovery or include in a supplement to the target company's public disclosures.

If the target's board of directors has, before the final terms of the sale transaction are determined, discussed matters that could appear to suggest that the board of directors has put its own interests before those of the shareholders, these matters may need to be disclosed.

Examples of such topics include serving on the acquiring company's board of directors or payment of a substantial bonus or other amounts to themselves or management.

Such issues, may, of course, be appropriate for consideration by the board of directors. However, in general it would not be advisable for such matters to take precedence over the interests of the shareholders.

Shareholder suits often allege that one or more members of a board of directors had a conflict of interest in approving a sale transaction. If a conflict is found, the conflicted director's actions will be analyzed under more demanding legal standards. This makes finding potential conflicts an important objective in litigation brought around a public company sale.

For the same reason, the board of directors should be aware of any potential conflicts involving a member of management or any of its advisers. These could include, for example, a substantial preexisting business relationship between the target's investment bank and the acquirer. Some might perceive such a relationship to affect the independent judgment of the bankers.

While not every conflict can, or even should, be avoided, they should be identified and the board of directors should affirmatively determine either that, in the context of the broader transaction, the conflict is not material, or that the conflict can be appropriately addressed. The latter can be done, for example, by walling off the conflicted person from information and decisions that involve the conflict.

And, importantly, the company's acquisition disclosures should reflect that the board of directors considered any potential conflicts and took proper measures to prevent them from affecting the process adversely.

The following are additional considerations:

- Act with the shareholders in mind. Discuss all of the issues that could be considered significant to the transaction from the shareholders' perspective. Document these discussions. This not does prevent the board of directors from considering other constituencies, but this should also be described in the acquisition disclosures.

- Select qualified and independent advisers. When relying on outside advisers, be sure to ask them about their qualifications to advise the board of directors and any actual or apparent conflicts of interest, including any work done for other potential parties to the transactions being considered.
- Verify information in fairness opinions. When the board of directors' banker provides its fairness opinion on the transaction, make sure that all of its assumptions and facts align with those as understood by the company. It also is important to evaluate whether any of the assumptions are based on strategic plans or other information that may be difficult to publicly disclose, such as projections that assume the unannounced potential shutdown or divestiture of a significant business unit.
- Anticipate all possible outcomes of the transaction. Because transactions sometimes end up not closing, analyze whether the benefits of the specific transaction outweigh the potential adverse effects of not proceeding with that transaction or with dealing with a failed transaction.
- Maintain detailed and accurate records of decision-making processes. Thoughtful consideration of a transaction typically implies that the deliberative process has continued for an extended time. Document that process and the different times and places when the discussion occurred.

The above discussion is by no means an exhaustive description of the process and considerations that apply to the sale of a public company. It is not even a comprehensive list of the considerations that a board of directors should evaluate in such transactions. Each company and each attendant decision to enter into a change-in-control transaction will present its own particular facts and circumstances, making generalizations difficult.

However, we hope to have illustrated the broad range of issues that may arise. In this current environment of almost omnipresent litigation around transaction disclosures for public company sales, these issues need to be considered earlier in the process.

This evaluation should include not only the substance of the issue, but also whether and how the issue, and the board of directors or advisers' consideration of the issue, will be viewed by a hostile lawyer when included in disclosures, and whether and how this all should be disclosed in the proxy statement or other transaction disclosures.

Moreover, the acquisition disclosures should be prepared on the assumption that they will be carefully examined for any mistakes or omissions, even regarding information that may not be considered to be material to the shareholders.

The appropriate disclosures should be developed, even if only in outline form, as the transaction progresses, and should not be deferred until after signing. This is important because in the excitement and feverish activity that often accompanies such transactions, recollections can be imprecise or events transposed, creating possible inconsistencies that may become awkward to explain in any ensuing litigation.

Equally important, this disclosure outline should be reviewed by experienced litigators who have seen and dealt with the disclosure claims considered in this discussion.

This review should not only encompass the details, such as clarifying why or how a particular price negotiation proceeded as it did, but should always include an evaluation of whether any particular issue should be revisited by the parties, either to provide additional clarity or perhaps even to correct some misstep.

And, special attention should be paid to whether any issues would potentially be identified by the plaintiffs' lawyers, such as requiring additional disclosures.

With litigation challenges approaching 100 percent of public M&A transactions, even the most carefully planned and coordinated transactions are today subject to second-guessing and to a discovery process that can potentially expose flaws or purported flaws in the way the transaction was handled or in the public disclosures about the transaction.

This degree of scrutiny is one result of the trend of identifying alleged disclosure deficiencies to justify significant attorneys' fees to plaintiffs' counsel. The combination of these factors has exerted even greater pressure on the public disclosure to be increasingly comprehensive and detailed, which frankly often comes at the expense of clear and straightforward discussion of the truly material factors with which the shareholders are concerned.

Like much else in the world today, in M&A transaction litigation risk is driving the disclosure of significantly more information, with the accompanying costs, but without any clear advantage to the shareholders. But whatever the global trends, each board of directors and its advisers should nonetheless take all reasonable steps to minimize exposure to this disclosure-based litigation.

Conclusion

Over the past several years, there has been a steady increase in litigation challenging the disclosures made by public companies in sale transactions, and there is no indication that this trend will change any time soon. The board of directors should recognize that dealing with litigation following the announcement of an M&A transaction has simply become a cost of doing business.

While protecting the board of directors from deal litigation is far from an exact science, taking the precautions outlined above should help to minimize exposure to potential claims and help to provide more favorable outcomes when litigation does arise.

Notes:

1. See for example, Doug Raymond, "Holding Back the Tide of M&A Litigation," *Directors & Boards*, available at http://www.drinkerbiddle.com/resources/publications/2011/holding-back-the-tide-of-ma-litigation?Page=6&Section=Publications&Year=&Practice=0&Attorney=0 (March 1, 2011).
2. Robert M. Daines and Olga Koumrian, *Shareholder Litigation Involving Mergers and Acquisitions*, Cornerstone Research (2013).
3. Id.
4. See Matthew D. Cain and Steven Davidoff, "A Great Game: The Dynamic of State Competition and Litigation," available at http://ssrn.com/abstract=1984758 (January 16, 2013).
5. Daines and Koumrian, *Shareholder Litigation*.
6. Id.
7. See Sean J. Griffith and Alexandra D. LaHav, "The Market for Preclusion in Merger Litigation," available at http://ssrn.com/abstract=2155809 (2012).
8. Daines and Koumrian, *Shareholder Litigation*.
9. Levin LaCroix, "Proposals to Address the M&A-Related Litigation Problem," the *D&O Diary*, available at http://www.dandodiary.com/2012/10/articles/securities-litigation/proposals-to-address-the-marelated-litigation-problem/ (October 24, 2012).
10. John C. Coffee Jr., "M&A Litigation: More and More Dysfunctional," *New York Law Journal* (March 21, 2013).
11. Daines and Koumrian, *Shareholder Litigation*.
12. Ibid.
13. Matsushita Elec. Indus. Co. v. Epstein, 516 U.S. 367, 369 (1996).

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