The Continuing Shift Of Merger Litigation To Federal Courts

By **Robert Long and Andrew Sumner** (December 18, 2018, 2:12 PM EST)

Robert Long

Andrew Sumner

Class actions challenging proposed corporate mergers, while down from their peak numbers in the early 2010s, continue to be filed at record levels in the federal court system. This shift from state to federal courts is now a well-documented phenomenon. In 2017, 73 percent of deals valued over $100 million were challenged by shareholders, down from 94 percent in 2013,[1] but 87 percent of those lawsuits were filed in the federal courts, compared to only 32 percent in 2013.[2] Nearly half of all federal securities class actions are now mergers and acquisitions cases.[3] Although the numbers for 2018 have not yet been finalized, there are no signs this trend has eased or that it will let up in the years to come.

The wave of merger-related class actions filed in the federal courts was triggered three years ago by the Delaware Chancery Court's landmark In re Trulia decision.[4] There, Chancellor Andre Bouchard rejected a proposed disclosure-only settlement of a merger lawsuit filed in connection with Zillow's acquisition of Trulia. In the opinion, Bouchard criticized the settlement, which had no true financial consideration, for failing to provide Trulia's shareholders with "any economic benefits."[5] Bouchard observed that the only money to change hands would be the customary attorneys' fees sent to class counsel in exchange for its diligent prosecution of the case.[6] The point of Trulia undoubtedly was to curb the number of merger-related strike suits filed in the Delaware state courts, which were filed nearly every time a merger involving a public company was announced. It worked. In the two years following Trulia, the number of merger suits filed in Delaware declined precipitously, from more than half of all M&A suits in 2015, to one-third of M&A suits in 2016, to less than 10 percent of M&A suits in 2017.[7]

The impact of this has been a corresponding increase in the number of lawsuits filed in jurisdictions outside Delaware, particularly in the federal courts. These federal merger challenges have followed a predictable pattern, one that is nearly identical to the merger cases that shareholders used to file in Delaware. Within days of the announcement of a proposed merger, plaintiffs' firms typically will issue press releases that "alert" shareholders of the pending transaction, advise them of their "rights" and invite them to contact the firm to learn more. Often, the shareholders who respond to these notifications are the same shareholders who ultimately serve as lead plaintiff. These shareholders are usually natural persons (not institutions), typically hold a relatively few number of shares and are not intimately familiar with the merger strike suit process.

The majority of the allegations presented in the federal complaints are also nearly identical to those that were filed in Delaware. Plaintiff shareholders typically object to the purchase price, to the process employed by the target company's board of directors, to certain terms of the merger agreement, and to the information disclosed in connection with the shareholder vote. Perhaps the biggest difference between the federal and state filings is that the plaintiffs in federal court will usually lead with their disclosure-based claims under Section 14(a) of the Exchange Act to establish a proper jurisdictional basis for the complaint. Supplemental Section 20(a) claims and, in some cases, state law claims for breach of fiduciary duty and aiding and abetting are then tacked on to the end of the complaint.

The defendants in the crosshairs have not changed. They are typically the target company and the members of its board of directors. If the shareholder disclosure is filed jointly or if state law claims are included in the complaint, the acquiring company may also be named. State law fiduciary duty claims continue to focus on alleged flaws in the merger process, purported conflicts of interest by key executives and board members, and alleged onerous deal protection measures. If multiple complaints are filed challenging a particular transaction, the complaints usually are very similar and often are identical. The only difference is the named plaintiff.[8] Due to time constraints, hard-fought battles over lead plaintiff and lead counsel status are unusual in federal M&A cases. Expect these disputes to be worked out behind the scenes and for multiple complaints to be consolidated under one caption.

As they did in Delaware, plaintiff shareholders typically will identify a laundry list of information that was allegedly omitted from the relevant shareholder disclosure, from certain minutiae about the merger process to financial arcana underlying the target company's internal forecasts. No matter how detailed the disclosure, a determined shareholder will always try to use the absence of evidence to his advantage, pointing to purported gaps in information and alleging that this information was withheld. When pressed, the plaintiffs in federal courts are more likely to focus on only a handful of the dozens of alleged omissions identified in the complaint, while completely abandoning others. Often, M&A complaints are so hastily put together that information alleged by the plaintiff to have been omitted from the disclosure was actually disclosed. Of course, the plaintiff's counsel will rarely acknowledge this oversight and will simply pivot to other alleged omissions, but it is important to call these out, not only because it will foreclose the plaintiff's ability to rely on the alleged omission going forward but also because it raises credibility issues with the court.

Regarding the relief sought, shareholders in federal court continue to claim that they will suffer immediate and irreparable harm if the merger price is not increased, if the information underlying the alleged omissions is not disclosed, if the target company's board does not take certain corrective actions, or if the allegedly preclusive deal protection measures are left in place. Although plaintiffs can and will seek expedited discovery and move for a preliminary injunction, more often than not the real relief sought continues to be additional disclosures made in advance of the shareholder vote. Indeed, unlike in days gone by in Delaware, there are now times when the plaintiffs only half-heartedly seek discovery if they seek it at all.

Choosing to file in federal court brings with it a number of speed bumps for the plaintiff that are not necessarily encountered in the state courts and that give strategic advantages to companies, their boards of directors, and defense counsel. The most obvious is the Private Securities Litigation Reform Act's heightened pleading requirements, which apply to Section 14(a) claims just as they do to the more traditional Section 10(b) and Rule 10b-5 claims. The PSLRA requires a plaintiff to plead with particularity "each statement alleged to have been misleading" and the "reason or reasons why the statement is misleading."[9] This heightened standard takes on increased significance in merger cases because rarely does an affirmative misstatement make its way into an official deal-related communication. Because of this, the plaintiff shareholder usually must point to information that was allegedly omitted from the disclosure, and for an omissions case, the PSLRA requires the plaintiff to identify the specific affirmative statements that were rendered materially misleading by the omissions and also to explain why.[10] Most of the time, plaintiffs do not devote as much of the complaint to this as they perhaps should, and it often significantly undermines their claims.

Less talked about is the PSLRA's loss causation pleading requirement, which requires a plaintiff to allege facts sufficient to show that the defendants' acts or omissions "caused the loss for which the plaintiff seeks to recover damages."[11] In the context of Section 14(a) claims, this requires the plaintiff to "connect the [disclosure's] misstatements with an actual economic harm."[12] Plaintiffs sometimes overlook this requirement and fail to address loss causation in the complaint. Courts can and have used this as a basis for dismissing an M&A complaint.[13]

The disclosure obligations under the federal securities laws also differ from those in Delaware in ways that can benefit defendants facing meritless merger strike suits. While companies should never base their disclosures on where they think they might get sued, this is an often overlooked benefit for companies that happen to get sued in the federal courts. Under Delaware's disclosure standard, corporate directors are required to "disclose fully and fairly all material information within the board's control when it seeks shareholder action."[14] A Section 14(a) claim, however, must be based on an affirmative misrepresentation or on the omission of information that "the SEC regulations specifically require" or that "makes other statements in the proxy statement materially false or misleading."[15] Unlike Delaware law, Section 14(a) does not mandate an affirmative duty to disclose "all material information," and omitting information required by the SEC is rare. Thus, in federal court, even if an omission is material, there is no Section 14(a) violation unless the disclosure is "made false or misleading as a result" of an omission.[16] While the contours of Delaware's disclosure law are certainly more nuanced and are informed by well-established case law, the distinction between the federal and Delaware disclosure standards is an important one. That said, the touchstone here is that whether in federal court or in Delaware, companies and their directors should rest assured that they need not reveal every possible detail of a deal to meet their disclosure obligations.

The PSLRA's automatic discovery stay is also a significant benefit for the defendants in a federal M&A lawsuit.[17] The stay, which is triggered by the filing of a motion to dismiss, is critically important because the plaintiff will often attempt to obtain expedited discovery to support its planned preliminary injunction motion. Filing a motion to dismiss will effectively halt discovery unless the plaintiff can show that it is necessary to preserve evidence or prevent undue prejudice.[18] While filing a motion to dismiss is by no means a guarantee against discovery, a motion to dismiss should always be considered, with the timing of the filing ideally before the plaintiff moves for expedited discovery. With no discovery, the viability of a preliminary injunction motion plummets, especially if the defendants are able to submit a report or affidavit by a qualified disclosure expert with their opposition to the motion.

Another obstacle for plaintiffs in federal court are the judges. Although arguably no court can claim to be as well-versed in the intricacies of merger litigation as the Delaware Chancery Court, compared to other state courts, federal judges typically have more resources at their disposal to handle these types of fast-paced and demanding cases. This is often an advantage for the defendants because lawsuits challenging proposed mergers often have very little substance. A capable federal judge should be able to filter out most of the noise and identify when a plaintiff's claims have no merit. And while federal courts are not legally bound by Bouchard's decision in Trulia and other relevant Delaware case law, recent decisions from the last few months indicate that federal judges are taking a harder look at the plaintiffs' claims when the defendants fight back.[19] This is likely one of the reasons for the significant uptick in voluntary dismissals in 2017.[20]

Finally, sanctions are sometimes in play for M&A suits filed in federal court. Under the PSLRA, the court is required to review and include specific findings regarding the plaintiff's compliance with Rule 11 upon dismissal of the lawsuit. While this rule often goes unnoticed, courts can and have imposed sanctions for frivolous merger challenges.[21]

Despite the continued shift of merger suits to federal courts, the plaintiff's playbook has not changed all that much. Plaintiffs are often still content with settling for supplemental disclosures in exchange for attorneys' fees. These fees are now smaller than ever before,[22] and they continue to be covered by directors and officers insurance in most cases, assuming the insurance retention (deductible) is met. While a disclosure-only settlement certainly might seem to be the easiest way to resolve these types of cases, companies sued in federal courts should think long and hard before deciding to go this route, as there are several not-so-apparent drawbacks. First, such deals often do not guarantee a global release of claims from the class of shareholders, particularly if it is a mootness fee settlement, so there is the possibility of post-merger lawsuits by other shareholders. Second, if an acquiring company is looking to purchase other companies, a settlement entered into too easily might invite additional lawsuits down the road. Third, there is always a possibility that a disclosure-only settlement might not be approved by the court. Federal courts recently have published Trulia-like decisions of their own that express a healthy skepticism for disclosure-only settlements. It is also possible that an unnamed shareholder might object to the settlement, which puts further pressure on the court.[23]

Smart companies will always evaluate the strengths and weaknesses of the plaintiff's claims and their own defenses, the timing of the deal and their own appetite for risk, among many other variables, before deciding to settle. In any case, companies should remember that when facing a merger lawsuit, the plaintiff is asking the court for extraordinary relief on which it is inherently difficult for the plaintiff to succeed. Above all, know that the odds in the federal courts are good for the defendants.

Robert R. Long is a partner at Alston & Bird LLP and leader of the firm's securities litigation group.

Andrew T. Sumner is a senior associate at the firm.

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[1] Cornerstone Research, Shareholder Litigation Involving Acquisitions of Public Companies, available at https://www.cornerstone.com/Publications/Reports/Shareholder-Litigation-Involving-Acquisitions-of-Public-Companies-Review-of-2017-M-and-A-Litigation. Cornerstone also reports that it is taking plaintiffs longer to file suit than in years past and that the average number of lawsuits filed per deal in 2017 was at a 10-year low.

[2] See Matthew D. Cain, et al., The Shifting Tides of Merger Litigation, 71 Vand. L. Rev. 603, at 621 (2018), available at https://s3.amazonaws.com/vu-wp0/wp-content/uploads/sites/89/2018/03/13181642/The-Shifting-Tides-of-Merger-Litigation.pdf.

[3] NERA Economic Consulting, Recent Trends in Securities Class Action Litigation: 2017 Full-Year Review (2018), available at http://www.nera.com/content/dam/nera/publications/2018/PUB_Year_End_Trends_Report_0118_final.pdf.

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

[5] Trulia, 129 A.3d at 887.

[6] Trulia, 129 A.3d at 887.

[7] See Cain, et al., supra note 2 at 621.

[8] On the other hand, there has also been an increase in repeat plaintiff activity in recent years. See, e.g., Parshall v. HCSB Fin. Corp., No. 4:17-cv-01589-RBH, 2017 U.S. Dist. LEXIS 114948, at *3 n.3 (D.S.C. July 24, 2017) (discussing how named plaintiff had filed at least 32 complaints seeking to enjoin similar merger transactions).

[9] 15 U.S.C. § 78u-4(b)(1)(B).

[10] Under both federal and Delaware law, an omission is material if it "would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Indus. Inc. v. Northway Inc., 426 U.S. 438, 449 (1976).

[11] 15 U.S.C. § 78u-4(b)(4).

[12] Resnik v. Woertz, 774 F. Supp. 2d 614, 632 (D. Del. 2011).

[13] See, e.g., Goldfinger v. Journal Commc'ns Inc., No. 15-C-12, 2015 U.S. Dist. LEXIS 61314 (E.D. Wis. May 8, 2015); Beck ex rel. Equity Office Properties Trust v. Dobrowski, No. 06 C 6411, 2007 WL 3407132, at *6 (N.D. Ill. Nov. 14, 2007).

[14] Dent v. Ramtron Int'l Corp., No. CIV.A. 7950-VCP, 2014 WL 2931180, at *10 (Del. Ch. June 30, 2014) (emphasis added).

[15] Seinfeld v. Becherer, 461 F.3d 365, 369 (3d Cir. 2006) (quoting Resnik v. Swartz, 303 F.3d 147, 151 (2d Cir. 2002)).

[16] Cohen v. Ayers, 449 F. Supp. 298, 315 (N.D. Ill. 1978), aff'd, 596 F.2d 733 (7th Cir. 1979); accord Hysong v. Encore Energy Partners LP, No. 11-cv-781, 2011 WL 5509100, at *5 (D. Del.

Nov. 10, 2011) ("Rule 14a–9's 'materially misleading omission' ... requirement is comprised of two discrete elements: (1) the omission must be 'material,' and (2) the omission must render some statement included in the proxy solicitation 'false or misleading."').

[17] 15 U.S.C. § 78u-4(b)(3)(B).

[18] 15 U.S.C. § 78u-4(b)(3)(B).

[19] Ratner v. Forest City Realty Trust Inc. , No. 1:18CV2605, 2018 U.S. Dist. LEXIS 199615 (N.D. Ohio Nov. 26, 2018); Carlson v. Triangle Capital Corp. , No. 5:18-cv-00332, 2018 U.S. Dist. LEXIS 122139 (E.D.N.C. July 23, 2018); Campbell v. Transgenomic Inc. , No. 4:17-CV-3021, 2018 U.S. Dist. LEXIS 74789 (D. Neb. May 3, 2018); Trahan v. Interactive Intelligence Grp. Inc. , 308 F. Supp. 3d 977 (S.D. Ind. 2018); Stein v. Almost Family Inc. , No. 3:18-cv-00129, 2018 U.S. Dist. LEXIS 46910 (W.D. Ky. Mar. 21, 2018); Parshall v. HCSB Fin. Corp. , No. 4:17-cv-01589-RBH, 2017 U.S. Dist. LEXIS 114948 (D.S.C. July 24, 2017).

[20] See Cornerstone research, supra note 1 at 6.

[21] See, e.g., Goldfinger v. Journal Commc'ns, Inc., No. 15-C-12, 2015 U.S. Dist. LEXIS 186504 (E.D. Wis. Aug. 4, 2015).

[22] See Cain, et al., supra note 2 at 612.

[23] See, e.g., In re Walgreen Co. Stockholder Litig. , 832 F.3d 718 (7th Cir. 2016).