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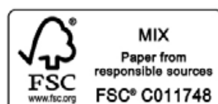

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For Corporate Litigation, Delaware is Still the First State

Adam O. Emmerich

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Trevor S. Norwitz

Delaware has long been the chosen jurisdiction of incorporation for most public companies in the United States. More than two-thirds of publicly traded companies in the United States are organised in Delaware, including two-thirds of Fortune 500 companies.[1] Delaware's preeminence as a home for business entities is due in no small part to its sophisticated and efficient judicial system. The Court of Chancery, a specialised court made up of skilled jurists renowned for their expertise in complex corporate matters, efficiently handles many of the most important and difficult disputes facing American businesses. An equally sophisticated and motivated Supreme Court ensures that a party dissatisfied with a Chancery decision has prompt recourse and the possibility of a timely reversal. As a result, Delaware has an unparalleled and ever-growing body of legal precedent to draw on to ensure both consistency of legal interpretation and doctrinal creativity to respond to new situations that arise. These strengths notwithstanding, in a recent survey by the U.S. Chamber of Commerce Institute for Legal Reform into which states corporate attorneys and executives feel have the friendliest climates for business litigation, Delaware fell precipitously from first to 11th place, marking the first time in the 15-year history of the survey that Delaware had failed to capture the winner's laurels.[2] Reasons cited for this change in perception focus mainly on legislative decisions, such as lack of meaningful tort reform and Delaware's broad statutory ban on "fee-shifting" bylaws , but also included heightened activity in appraisal litigation, and reduced predictability in judicial decisions. To the extent this survey reflects a loss of confidence in Delaware's judicial system, this would be, in our view, unwarranted. Recent cases highlight that Delaware's judiciary continues to be among the most thoughtful and responsive to changes in the landscape of merger-related litigation, particularly in the areas of frivolous shareholder litigation and appraisal claims.

* * *

On July 28, 2014, Zillow, a corporation that operates a real estate website, announced that it had entered into a merger agreement to acquire Trulia, a competitor that was publicly traded and incorporated in Delaware. Over the next few months, events unfolded in accordance with a well-trodden path. Shortly after the deal was announced, four Trulia stockholders filed complaints in Delaware alleging that Trulia's directors had breached their fiduciary duties in approving the proposed merger and that the exchange ratio was unfair. Within a few months, the parties reached an agreement to settle the litigation after Trulia agreed to supplement its proxy materials with additional details about the transaction. Perhaps the only thing really striking about the litigation was how perfectly typical it was. Shareholders filed lawsuits challenging 93% of the mergers that were announced in 2014; the first complaint was filed an average of 14 days after the deal was announced; an average of 4.5 complaints were filed per deal; and 79% of the settlements reached in such lawsuits in 2014 were in exchange for only supplemental disclosure.[3]

The fees that companies have had to pay to plaintiffs' lawyers to settle merger-related litigation, like the one that was agreed to with the *Trulia* plaintiffs' lawyers, have long been viewed as simply an inevitable cost of doing deals in the United States. In exchange for these additional disclosures and fees, companies insisted on broad releases of the class claims brought, which ended and foreclosed virtually any and all litigation related to the transaction in question (which some judges criticised as "intergalactic releases"[4]). In some cases, where the transaction raised the real possibility of litigable claims, these settlements were viewed by companies as relatively cheap insurance policies. But as the number of frivolous stockholder complaints and corresponding, relatively worthless disclosure-only settlements continued to grow, judges, as well as some practitioners and observers, grew increasingly critical of these settlements, which yielded no economic benefits for stockholders but lined the pockets of the plaintiffs' bar, encouraging frivolous lawsuits.[5] The Court of Chancery, attuned to how frequent these types of settlements had become and the criticisms that had accompanied them, began to scrutinise them more closely.

When the plaintiffs' lawyers in the *Trulia* case sought to have the settlement they had negotiated with the company approved by the Court of Chancery, the Court declined to follow the familiar well-trodden path. Chancellor Bouchard refused to approve the disclosure-only settlement agreed between the parties, explaining that "[g]iven the rapid proliferation and current ubiquity of deal litigation, the mounting evidence that supplemental disclosures rarely yield genuine benefits for stockholders, the risk of stockholders losing potentially valuable claims that have not been investigated with rigor, and the challenges of assessing disclosure claims in a non-adversarial settlement process, the Court's historical predisposition toward approving disclosure settlements needs to be reexamined".[6]

The Court of Chancery explained that, going forward, "practitioners should expect that the Court will continue to be increasingly vigilant in applying its independent judgment to its case-by-case assessment of the reasonableness of the 'give' and 'get' of such settlements in light of the concerns discussed above. To be more specific, practitioners should expect that disclosure settlements are likely to be met with continued disfavour 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".[7]

The *Trulia* decision severely limits the ability of plaintiffs' lawyers in Delaware to obtain quick and easy disclosure-only settlements in weak cases that had given the plaintiffs' bar the financial incentive to initiate litigation in virtually every public company merger or acquisition. The Delaware courts clearly expressed that they are not interested in facilitating frivolous litigation, and prefer to keep their resources to deal with – and to direct the efforts of the Delaware plaintiffs' bar towards – litigation where there are serious claims at issue. Some on the corporate side may regret the elimination of these "cheap insurance policies" against future litigation, but we believe that discouraging nuisance suits is better for business in the long run.

Just a few months before the Delaware Court of Chancery issued its decision in *Trulia*, the Delaware Supreme Court, in *Corwin* v. *KKR*,[8] reiterated and clarified that the business judgment rule is the appropriate standard of review for a third-party merger that has been approved by a fully informed, uncoerced majority of the disinterested stockholders. *Corwin* highlighted that challenging mergers that have been approved by informed stockholders in the absence of a conflict of interest, which most public company mergers are, would be unlikely to prove fruitful for plaintiffs' lawyers. In *Corwin* the Supreme Court adopted the principled position that informed stockholders are capable of making their own decisions and do not need the Court's protection (or second-guessing). This decision was a double-blow to plaintiffs' lawyers. In third-party situations where the directors who approved the transaction had no conflict, it provided a basis to dismiss claims as long as the shareholders approved the transaction on a fully-informed basis. And for transactions involving conflicted directors,[9] which are generally subject to the very onerous "entire fairness" standard of judicial scrutiny, it provided a path to achieve "business judgment" deference as long as the process replicated the negotiating dynamics of a third-party transaction (that is, it was negotiated and submitted to a vote by independent directors and approved on a fully-informed basis by a majority of the unconflicted shareholders).

In the aftermath of *Corwin* and *Trulia*, many plaintiffs' lawyers who had previously been repeat players on the disclosure-only settlement scene in Delaware started bringing their claims in other forums. The number of federal class actions challenging mergers increased from 28 in the first six months of 2016 to 95 in the first six months of 2017.[10] Our experience is that the vast majority of these cases have involved disclosure-only settlements, and seem to have been brought in federal court in response to the Court of Chancery's decision in *Trulia*. While Delaware corporations can adopt forum selection by-laws that restrict the ability of plaintiffs to bring claims in other states,[11] such bylaws do not prevent plaintiffs from bringing similar disclosure claims under Rule 14a-9 of the Exchange Act, the anti-fraud rule governing proxy solicitations.[12] Enterprising plaintiffs' lawyers have continued to find ways to bring claims, and the long-term fate of such settlements in federal courts remains to be seen. Litigation in federal courts is more unpredictable, in part because federal judges across many jurisdictions have less experience in corporate matters and do not communicate as closely as Delaware judges do to ensure a consistent doctrine. It is possible that the scourge of frivolous litigation will continue in federal courts, arguably to the financial detriment of lawyers in Delaware. Cases like *Corwin* and *Trulia* not only illustrate the acumen of Delaware judges and their responsiveness to trends in merger litigation, but highlight their principled efforts to achieve the most favourable business environment even if it is contrary to the near-term interests of some in their own state.

Shareholder class actions challenging mergers were not the only type of merger-related litigation to have grown significantly in recent years. Appraisal claims were also becoming more frequent and significant. Delaware appraisal lawsuits increased 267% between 2012 and 2016, to a high of 77 claims (targeting 48 deals) in 2016, according to an analysis of Bloomberg Law data.[13] The number of deals targeted by these suits has risen 140% over the same period, to a high of 48 deals challenged in 2016.[14] Some scholars have noted that the increase in appraisal litigation could have been due, in part, to a shift away from fiduciary duty claims in light of *Trulia* and *Corwin*.[15]

Appraisal litigation reached fever pitch in 2016 following a series of decisions from the Delaware Court of Chancery indicating that, even in arm's-length negotiated public company mergers, shareholders could receive consideration in excess of the deal price through appraisal litigation, even if they did not own the shares in question when the deal was announced, or even when the shareholder vote on the deal was held. For several years, a growing number of hedge funds had been engaged in appraisal arbitrage – buying shares in a target company after the announcement of a deal specifically for the purposes of asserting appraisal rights. The attraction of this strategy was partially due to the possibility of a windfall recovery and partially due to the limited downside as a result of the high statutory interest rate paid to dissenting shareholders under Delaware law.[16] Several commentators (ourselves included) have long criticised appraisal arbitrage as an abusive technique that should be eliminated by statutory amendment.[17] This has not yet been accomplished, largely as a result of political considerations in Delaware.[18] However, the Delaware courts have demonstrated the will and the ability to prevent appraisal arbitrage from getting out of hand.

Appraisal arbitrage came to be perceived as a significant threat to deal activity following the Court of Chancery decision in *In re Appraisal of Dell Inc.*[19] In *Dell*, Vice-Chancellor Laster awarded petitioners $17.62 per share – almost four dollars over and nearly 30% more than the $13.75 paid in the 2013 going-private merger. In making its determination, the Court acknowledged the thorough and robust sales process run by the special committee of the Dell board, which the Court said "would easily sail through" enhanced scrutiny review in a fiduciary duty challenge. Indeed, the special committee running the sales process contacted over 60 potential merger partners over the course of the pre-signing auction and post-signing go-shop. Nonetheless, the Court found that the agreed deal price, which it determined was a result of the "financial sponsors' willingness to pay based on their LBO pricing models rather than the intrinsic fair value of the Company", was almost a third below the company's fair value.

A few weeks later, the Court of Chancery once again declined to look solely to the deal price in an appraisal action. On July 8, 2016, in *In re Appraisal of DFC Global Corp.*, the Court of Chancery awarded $10.30 per share to former shareholders who sought appraisal; $0.71 per share more than the merger consideration.[20] The Court of Chancery acknowledged that the deal price was generally a reliable measure of value, but found in that case that regulatory uncertainties made the market price an unreliable indicator of fair value.

After *Dell* and, to a lesser degree, *DFC*, many private equity buyers and legal practitioners expressed concern that these decisions would have unintended consequences, as acquirers would be unwilling to risk significant liability in appraisal actions after the deal closed, or would simply shift this risk to the shareholders of target companies in the form of lower prices. The Delaware Supreme Court responded promptly in a thoughtful and careful manner. DFC Global Corp. appealed the Court of Chancery's decision and, in August 2017, the Delaware Supreme Court reversed the Court of Chancery's decision. The Supreme Court, noting that the statute required the consideration of "all relevant factors", declined to adopt a presumption in favour of the deal price in appraisal proceedings. The Court did, however,

explain that its "refusal to craft a statutory presumption in favour of the deal price . . . does not in any way signal our ignorance to the economic reality that the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous". The Court went on to explain that fair value "does not mean the highest possible price that a company might have sold for had Warren Buffett negotiated for it on his best day and the Lenape who sold Manhattan on their worst".

In December 2017, the Delaware Supreme Court again reiterated the importance of the deal price in its decision when it reversed, in part, the Court of Chancery's decision in *Dell*.[21] The Supreme Court noted that "the record as distilled by the trial court suggests that the deal price deserved heavy, if not dispositive, weight" and further explained that "the price produced by an efficient market is generally a more reliable assessment of fair value than the view of a single analyst, especially an expert witness who caters her valuation to the litigation imperatives of a well-heeled client". The Delaware Supreme Court also rejected the Court of Chancery's conclusion that the price a financial sponsor was willing to pay was not indicative of fair value, noting that there was "'no rational connection' between a buyer's status as a financial sponsor and the question of whether the deal price is a fair price". Although the *Dell* and *DFC Global* Supreme Court decisions do not eliminate the possibility that hedge funds will continue to engage in appraisal arbitrage, and we continue to hope that the Delaware legislature will act to eliminate this abusive investment strategy, the decisions do demonstrate the responsiveness of Delaware courts to rapidly changing circumstances.

Merger-related litigation in the United States is constantly evolving as market conditions change, corporate lawyers develop new deal structures, and plaintiffs' lawyers find new ways to challenge deals. The changes in recent years – including the swelling tide of disclosure-only settlements and the flood of appraisal litigation fuelled by appraisal arbitrage – has certainly tested the Delaware judiciary but, in our view, only highlighted the First State's judges' legal acumen and responsiveness. To the extent other legislative polices in Delaware lead to a reduction in the state's standing and prestige as a friendly climate for business litigation, we believe that should not tarnish the reputation of the Delaware Court of Chancery and the Delaware Supreme Court as the preeminent courts for fiduciary and M&A-related litigation.

Endnotes

1. *See* Delaware Department of State, Division of Corporations, *available at*: https://corp.delaware.gov/aboutagency.shtml.
2. Matt Chiappardi, *Delaware No Longer King Of The Hill For Biz Litigation*, Law360, *available at*: https://www.law360.com/articles/962407/delaware-no-longer-king-of-the-hill-for-biz-litigation; U.S. Chamber of Commerce: Institute for Legal Reform, 2017 Lawsuit Climate Survey: Ranking the States (September 2017), *available at*: http://www.instituteforlegalreform.com/uploads/pdfs/Harris-2017-Executive-Summary-FINAL.pdf.
3. Cornerstone Research, Shareholder Litigation Involving Acquisitions of Public Companies: Review of 2014 M&A Litigation, *available at*: https://www.cornerstone.com/Shareholder-Litigation-Involving-Acquisitions-2014-Review.
4. *Acevedo* v. *Aeroflex Holding Corp.*, C.A. No. 7930-VCL, at 73 (Del. Ch. Jul. 8, 2015) (Transcript).
5. *See, e.g.*, Marc Wolinsky & Ben Schireson, *Deal Litigation Run Amok: Diagnosis and Prescriptions*, REV. SEC. & COMM. REG., Jan. 8, 2014, at 2 ("[t]he reality is that the system is broken. And the single most important reason why the system is broken is that the financial incentives for shareholder suits are out of whack. The plaintiff's bar, filled with able and entrepreneurial lawyers, is responding to the financial incentives that make it profitable for them to bring litigation in virtually every case"); Robert M. Daines & Olga Koumrian, *Merger Lawsuits Yield High Costs and Questionable Benefits*, N.Y. Times Dealbook, Jun. 8, 2012, *available at*: http://dealbook.nytimes.com/2012/06/08/merger-lawsuits-yield-high-costs-and-questionable-benefits/ ("[t]he cost of these suits is pretty clear. Companies typically agree to pay plaintiffs' lawyer fees (about $1.2 million on average in the last two years) and must usually cover their own legal costs. What is less clear is how shareholders are benefiting from litigation. A decade ago, more than half of the settlements included cash payments to shareholders of the companies being acquired, while only a few—10 percent—required companies to make additional disclosures before a shareholder vote. However, in the last two years, these numbers have reversed: a modest 5 percent of settlements produce more cash for shareholders, while more than 80 percent of suits required only additional disclosures").
6. 129 A.3d 884, at 896 (Del. Ch. 2015).
7. *Id.*
8. *Corwin* v. *KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. Oct. 2, 2015) (*en banc*).
9. Corwin does not confer "business judgment" deference *ab initio* on entire fairness cases such as squeeze-out mergers, which are still subject to the "entire fairness" standard of review.
10. Cornerstone Research, Securities Class Action Filings, 2017 Midyear Assessment, *available at*: https://www.cornerstone.com/Publications/Reports/Securities-Class-Action-Filings-2017-Midyear-Assessment.
11. *Boilermakers Local 154 Retirement Fund* v. *Chevron*, 73 A.3d 934 (Del. Ch. 2013).
12. 17 C.F.R. 240.14a-9.
13. Michael Greene, *M&A Deal Price Challenges Spiking in Delaware*, Bloomberg BNA (Jan. 13, 2017), *available at*: https://www.bna.com/ma-deal-price-n73014449766/.
14. *Id.*
15. Matthew D. Cain, Jill E. Fisch, Steven Davidoff Solomon, Randall S. Thomas, *The Shifting Tides of Merger Litigation*, Vanderbilt L. Rev. (2018, forthcoming), *available at*: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2922121. ("[T]he Corwin decision may have led plaintiffs to shift their approach to deal litigation. We find, in 2016, a sharp movement away from class action fiduciary duty cases toward filing appraisal cases. In 2015, for instance, 33 deals were targeted with 51 appraisal petitions. By comparison, in 2016, 48 deals were challenged by 77 appraisal petitions.")
16. 8 Del. C. § 262(h). ("[I]nterest from the effective date of the merger through the date of payment of the judgment shall be compounded quarterly and shall accrue at 5% over the Federal Reserve discount rate (including any surcharge) as established from time to time during the period between the effective date of the merger and the date of payment of the judgment.")
17. *See, e.g.*, Trevor Norwitz, *A Debate: Is the Delaware Appraisal Rights Remedy in Need of Repair*, American Bar Association: Business Law Today (January 2017), *available at*: https://www.americanbar.org/publications/blt/2017/01/03_norwitz.html; Trevor S. Norwitz, *Delaware Legislature Should Act to Curb Appraisal Arbitrage Abuses*, The CLS Blue Sky Blog (February 10, 2015), *available at*: http://clsbluesky.law.columbia.edu/2015/02/10/delaware-legislature-should-act-to-curb-appraisal-arbitrage-abuses/.

18. A limited statutory amendment was adopted that allowed a buyer to proffer a portion of the purchase price to the party seeking appraisal and thereby stop the accrual of above-market interest as to that portion. 8 Del. C. § 262(h). In our view, this is an inadequate response to the abusive technique of appraisal arbitrage.
19. 2016 WL 3186538 (Del. Ch. May 31, 2016).
20. 2016 WL 3753123 (Del. Ch. July 8, 2016).
21. *Dell, Inc.* v. *Magnetar Global Event Driven Master Fund Ltd.*, No. 565, 2016 (Del. Dec. 14, 2017) (*en banc*).

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In addition to his professional practice, Trevor teaches a course in M&A at Columbia Law School, is active on several bar committees, and was a member of an international advisory group to the South African government on company law reform. He is a regular speaker and contributor to professional publications on topics relating to M&A and corporate governance, areas in which his expertise is recognised by *Who's Who Legal* and *Chambers*. He holds law degrees from Oxford University and Columbia Law School.

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