Recent Decisions Show Courts Closely Scrutinizing Fee Awards in M&A Litigation Settlements

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Shareholder class and derivative suits quickly follow virtually every significant merger announcement.[2] The vast majority of those suits that are not dismissed settle quickly, with the defendant corporation typically agreeing to additional disclosures (or other non-cash relief) and payment of attorneys' fees.[3] As one commentator has put it, payment of attorneys' fees effectively becomes a tax on M&A transactions.[4] The three recent rulings discussed below, however, suggest a trend towards greater judicial scrutiny of "disclosure-only" merger litigation settlements and, in particular, attorneys' fee awards in such settlements.

IN RE TRANSATLANTIC HOLDINGS INC. SHAREHOLDERS LITIGATION

On March 8, 2013, Chancellor Leo Strine of the Delaware Court of Chancery denied an unopposed motion to approve a settlement in *In re Transatlantic Holdings Inc. Shareholders Litigation*,[5] finding that the settlement did not provide sufficient benefits to the shareholder class to justify a class-wide release of claims and an award of attorneys' fees.[6]

Background

In re Transatlantic arose from the 2012 merger between reinsurer Transatlantic Holdings and specialty insurer Alleghany Corp. In 2011, Transatlantic had tentatively agreed to merge with Allied World Assurance Company before abandoning that deal, paying Allied World a $115 million termination fee, and agreeing instead to merge with Alleghany. When Transatlantic announced the Alleghany merger in November 2011, several Transatlantic shareholders who had previously sued challenging the Allied World merger amended their complaints to assert class and derivative claims against Transatlantic, several of its directors and officers, Allied World, and Alleghany. In essence, the plaintiffs alleged that Transatlantic's board of directors breached its fiduciary duties—by abandoning the merger with Allied World, paying the termination fee, and accepting Alleghany's superior proposal—and that Allied World and Alleghany aided and abetted those breaches. The plaintiffs also alleged that the preliminary proxy statement filed in connection with the merger failed to provide Transatlantic shareholders with information necessary to decide on the shareholder vote.

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[2] In 2010 and 2011, over 90% of M&A deals valued over $100 million spurred litigation. Andrew J. Pincus, *The Trial Lawyer's New Merger Tax*, U.S. Chamber Inst. For Legal Reform (Oct. 2012) at 2.

[3] Of deal litigation filed in 2010 and 2011, more than half settled within two months of filing. *Id.* at 4. Moreover, 84% of settlements in 2011 were "disclosure only" settlements, providing no monetary award to shareholders. Matthew D. Cain & Steven M. Davidoff, *Takeover Litigation in 2011* (Feb. 2012), at 4, *available at* http://ssrn.com/abstract=1998482.

[4] Pincus, *supra* note 2.

[5] *In re Transatlantic Holdings Inc. S'holders Litig.*, C.A. No. 6574-CS, 2013 WL 1191738 (Del. Ch. Mar. 8, 2013).

[6] It should be noted that Chancellor Strine has awarded significant fees where he considered them appropriate, including a 2011 award of $285 million in fees in the *Grupo Mexico* litigation.

In January 2012, the parties entered into an agreement under which Transatlantic agreed to make additional disclosures related to the merger to its shareholders in advance of the shareholder vote. In the proxy statement supplement, Transatlantic expressed its view that the new disclosures were not material to shareholders' evaluation of the deal, but that it had agreed to make such additional disclosures to minimize litigation risk. Under the parties' agreement, after the merger closed, the parties entered into a settlement stipulation that they submitted to the Court of Chancery for approval.

In the settlement, the plaintiffs' attorneys requested a $500,000 fee award. In support of their application, they argued that negotiating the settlement "required a high level of experience and expertise in stockholder litigation" and that the additional disclosures provided "a significant measure of protection and benefit to the Class." Transatlantic did not oppose the fee award request.

The Court's Decision

In a hearing on the settlement, Chancellor Strine rejected the settlement in strong language, declined to certify a class, and denied the fee application, expressing serious doubts about the usefulness of the agreed upon supplemental disclosures and the adequacy of the named plaintiffs as class representatives. Indeed, Chancellor Strine concluded that the plaintiffs "achieved nothing substantial for the class . . . [and] participated in no meaningful way in making sure that the class got something meaningful."[7] The court recognized that the decision placed the defendants in a difficult position—without a class settlement, the defendants could not receive their bargained-for releases and "defendants are essentially being kept in litigation for no reason"—and Chancellor Strine encouraged the plaintiffs to voluntarily dismiss their claims with prejudice. The case was dismissed on March 18, 2013.

IN RE PAETEC HOLDING CORP. SHAREHOLDERS LITIGATION

On March 19, 2013, Vice Chancellor Sam Glasscock approved an application for $500,000 in attorneys' fees in connection with the settlement of litigation arising from the merger of PAETEC Holding Corp. and Windstream Corp. But, in doing so, Vice Chancellor Glasscock echoed many of the concerns animating Chancellor Strine's decision in *In re Transatlantic* and reaffirmed the court's role in scrutinizing fee awards in class settlements.

Background

In *In re PAETEC Holdings*,[8] the plaintiffs alleged that the members of PAETEC's board of directors breached their fiduciary duties to the company's shareholders by selling the company for an inadequate price and pursuant to a flawed process. The plaintiffs supported their claims largely with allegations of inadequate and misleading disclosures. Among other things, the plaintiffs alleged that the company should have disclosed that Windstream's financial advisers had previously advised PAETEC on other issues and, as a result, had access to material non-public information about PAETEC in the months before the merger. Prior to a preliminary injunction hearing, the

[7] 2013 WL 1191738, at *3.

[8] *In re PAETEC Holding Corp. S'holders Litig.*, C.A. No. 6761-VCG, 2013 WL 1110811 (Del. Ch. Mar. 19, 2013).

parties agreed to settle in exchange for additional disclosures from PAETEC, including disclosures about its previous relationship with Windstream's financial advisers. As part of the settlement, the plaintiffs' attorneys requested a $500,000 fee award and PAETEC did not oppose the request. The court approved the settlement on December 13, 2012, but reserved judgment at that time "on the issue of whether and in what amount PAETEC should pay the Plaintiffs' attorneys' fees and costs."

The Court's Decision

In the briefing on the fee application, the plaintiffs' attorneys argued that judicial scrutiny of "agreed-to" fee awards was generally inappropriate and limited solely to "ferreting out collusion." Vice Chancellor Glasscock rejected this argument in strong terms, holding that "the position of Plaintiffs' counsel stands contrary to this Court's case law and longstanding practice of exercising judicial scrutiny over attorneys' fees even in cases where the fee request is uncontested by the defendant or by any of the stockholder class." Echoing the concerns expressed by Chancellor Strine in *In re Transatlantic*, the court explained that such scrutiny is particularly appropriate "in the context of merger litigation that produces disclosure-only settlement" because of the "risk in any disclosure-only settlement that both the plaintiffs and the defendants have agreed to trivial disclosures as the path of least resistance." Accordingly, Vice Chancellor Glasscock stated that courts should "scrutinize disclosure-only settlements, both substantively and to determine whether the plaintiffs' efforts have conferred a benefit on the class."[9]

Ultimately, Vice Chancellor Glasscock found that the additional disclosure of the potential conflicts of Windstream's financial advisers conferred a significant benefit on the class and he approved the $500,000 fee request. But, coming shortly after Chancellor Strine's decision in *In re Transatlantic*, Vice Chancellor Glasscock sent a strong message about the importance of judicial scrutiny of fee awards in class settlements.

KAZMAN V. FRONTIER OIL CORP.

On March 28, 2013, in *Kazman v. Frontier Oil Corp.*,[10] Texas's Fourteenth District Court of Appeals held that the state's Rules of Civil Procedure precluded any fee award as a matter of law under a class settlement that did not provide cash benefits to class members, regardless of the benefit conferred on shareholders by additional disclosures or other relief.

Background

In 2003, Texas amended its Rules of Civil Procedure to require that "in a class action, if any portion of the benefits recovered for the class are in the form of coupons or other noncash common benefits, the attorney fees awarded in the action must be in cash and noncash amounts in the same proportion as the recovery for the class."[11] In

[9] 2013 WL 1110811, at *6.

[10] *In re Kazman v. Frontier Oil Corp.*, No. 14-12-000320-CV, 2013 WL 1244376 (Tex. Ct. App. Mar. 28, 2013).

[11] *See* Tex. Civ. Prac. & Rem. Code § 26.001(a).

Kazman, the court applied this rule to reject a $600,000 fee award request in connection with a proposed disclosure-only merger litigation settlement.

In support of the settlement, the plaintiffs' attorneys argued that the Texas legislature amended the rules to discourage so-called "coupon settlements," in which class members receive coupons, discounts, or other non-cash compensation from defendant corporations while attorneys receive cash payments. But, according to the plaintiffs' attorneys, the rule was not intended to inhibit suits seeking solely injunctive or other equitable relief. The trial court accepted this argument and approved the settlement, including the fee award. The Court of Appeals reversed.

The Court's Decision

The Court of Appeals, based on the plain language of the rule, found that the legislature meant to discourage *any* non-cash settlements, regardless of whether the settlement provides for coupons or injunctive relief and regardless of the value conferred by any injunctive relief. The Court of Appeals noted that adopting the plaintiffs' reading of the amendment to the rules "would result in attorneys receiving 100 percent of their fee where the class recovers no cash, but only a fraction of their fees if the class recovers a small percentage of cash . . . an outcome . . . plainly inconsistent with the legislature's intended result." Accordingly, the Court of Appeals held that, under Texas law, if the class recovers "only the 'noncash common benefit' of additional disclosures and no cash, Rule 42(i)(2) precludes an award of attorney's fees."[12] The Court of Appeals further concluded that—because of the parties' agreement that the attorney fee provision was severable from the remainder of the settlement agreement—it could modify the trial court's judgment to delete the award of attorneys' fees to class counsel while affirming the judgment approving the remainder of the settlement.

As noted above, the majority of merger suits settle with no cash payment to shareholders. If the *Kazman* decision stands, courts in Texas will not have the power to award attorneys' fees in such settlements, effectively precluding merger litigation in Texas courts.

Implications

Delaware is, of course, the most popular state of incorporation and its Chancery Court is the most popular forum for merger litigation. The decisions in *In re Transatlantic* and *In re PAETEC Holdings* show the plaintiffs' bar that the Chancery Court will not rubber stamp fee awards in merger litigation. Plaintiffs' attorneys often attempt to escape such scrutiny by bringing suit in other jurisdictions, most often the state where the defendant corporation's headquarters are located. But it appears that *Kazman* effectively precludes merger litigation in Texas, the country's second-most populous state and home to the second-most Fortune 500 companies. As a result, taken together, these cases should cause the plaintiffs' bar to evaluate more carefully the basis of merger suits and the relief to shareholders that such suits are meant to secure.

[12] 2013 WL 1244376, at *9.

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