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Merger Objection Lawsuits: A Threat to Primary D&O Insurers?

An Advisen Special Report

Executive Summary

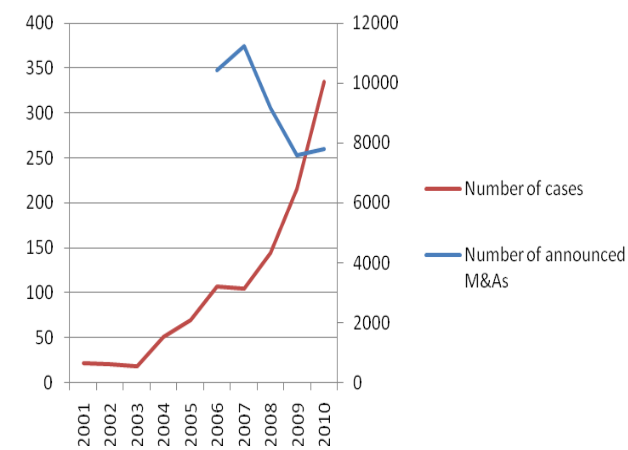
Merger objection suits are lawsuits filed by disgruntled shareholders of a company that has been, or is about to be, acquired. The number of lawsuits filed skyrocketed in recent years, even as the number of mergers and acquisitions plummeted during the Great Recession. Most often these suits seek injunctive relief rather than monetary damages, but the plaintiff's attorney fees typically are included in settlements. Thus far these suits have not posed a significant challenge to D&O insurers, but the sheer volume of suits, plus the fact that a single M&A transaction can trigger suits in multiple jurisdictions, suggest they increasingly will have an impact on primary and first excess D&O underwriting and pricing.

Introduction

The number of security class action lawsuits filed in 2010 was lower than the 2009 total, yet the total number of securities-related lawsuits filed increased from 1,171 in 2009 to 1,196 in 2010. As the number of securities class action suits fell, suits filed in both state and federal courts alleging breach of fiduciary duties by corporate directors increased to fill the void. Most of these suits were so-called merger objection suits, filed by displeased shareholders of companies that had been, or were in the course of being, acquired.

Merger objection suits are not a new phenomenon; mergers and acquisitions long have been a catalyst for shareholder litigation. In recent years, however, the number of filings has skyrocketed, even as the volume of mergers and acquisitions fell during the 2007-2009 recession years. As Exhibit 1 shows, the number of merger objection suits filed per year, per Advisen's MSCAd™ large loss database, has been trending upward since 2003, and has surged since 2007 (red line). On the other hand, the number of US M&A deals announced per year dropped sharply in 2007, 2008 and 2009, and rebounded only a bit in 2010 (blue line).

Exhibit 1 Lawsuits versus Announcements



Sources: Advisen MSCAd™, Thomson Reuters

Merger objection lawsuits defined

Merger objection lawsuits are filed by shareholders who allege that a company's board of directors sold, or planned to sell, a company at terms unfavorable to the shareholders. Transactions include management buyouts and going private transactions, as well as mergers with, or acquisitions by, other companies. These suits typically claim that directors breached one or more fiduciary duties to shareholders (usually described as the duties of loyalty, care, and good faith or fair dealing). Many allege the auction process was flawed, and some claim that directors had conflicts of interests and would benefit from a transaction that was suboptimal from the perspective of shareholders. Suits filed in federal courts often raise objection to merger-related proxy disclosures.

Approximately 80 percent of merger objection cases are filed in state courts. Actions filed in state courts avoid the higher pleading standards of federal class action suits. Courts in many states also are regarded as more plaintiff friendly than federal courts. Most cases, both state and federal, are brought as class actions.

Plaintiffs may demand monetary damages, but more commonly they seek injunctive relief, typically requiring directors and officers to take certain actions to satisfy shareholders that their best interests are being represented. Even though monetary damages are not sought, attorney fees typically are part of the settlement.

The growth in merger objection lawsuit filings

As Exhibit 1 illustrates, after drifting downward between 2001 and 2003, the number of suits filed per year shot up over the next several years, from 18 in 2003 to 107 in 2006. Following a one-year lull, the number of suits per year skyrocketed, reaching 335 in 2010. Likely reasons for the surge include:

- The credit crisis/recession years of 2007-2009 were a buyer's market for acquirers with cash or access to scarce financing. Deals were often done at depressed prices relative to pre-recession valuations. Some distressed takeovers were essentially at fire sale prices. Throughout the spectrum of deals, buyers often were able to insist on highly favorable terms such as limiting the seller's available remedies in the event of a breach by the buyer. Not surprising, shareholders sometimes were dissatisfied with the outcomes.
- Plaintiff attorneys increasingly recognized that these suits represent a potentially lucrative new source of income. Companies often are willing to quickly settle suits that threaten to hold up a deal. Plaintiff attorneys collect about $500,000 per case on average, according to Advisen MSCAd™ data.

As the number of suits filed since 2006 has increased, the typical size of the companies involved has fallen. In 2006 the median market cap of a public company targeted for a merger or acquisition that sparked a lawsuit was $1.1 billion. By 2010 the median market cap had decreased to $509 million. One explanation is that progressively smaller law firms have discovered that hometown mergers and acquisitions can be a new source of income. Barrett Johnston & Parsley LLC, a five lawyer firm in Nashville, Tennessee, is an example of a smaller law firm that has seized on M&A lawsuits as a specialty. The firm was first to file after the Dollar General, Central Parking, HCA, iPayment and Thomas Nelson buyout announcements.

Some observers have characterized at least a portion of these suits as "strike suits" – suits filed with the expectation that defendants will settle quickly regardless of the merits of the suit rather than investing the time and expense to defend them. Some judges agree. Delaware Vice Chancellor Travis Laster calls the attorneys behind many of these suits "frequent filers," and has replaced law firms he believed to be motivated by a quick payday rather than by representing the best interests of their clients. In a suit involving the buyout of Revlon Inc, Vice Chancellor Laster lambasted the plaintiffs' initial counsel for pursuing the case with no "vigor, ardor, or any other form of vibrant activity." Instead of zealously representing their clients, according to the Vice Chancellor, the law firm "settled on terms that would be easy gives for the defendants while still arguably sufficient to support a release and a fee."

While the strategy of some law firms may be to file quickly and settle as soon as possible with a minimum of effort expended, some merger objection suits can be the source of serious and expensive litigation. Attorney Jerry Silk of Bernstein Litowitz Berger & Grossman LLP, speaking in Advisen's 2010 Securities Litigation Wrap-Up Webinar, said that it was his firm's objective to engage in "high impact litigation" in M&A suits, "to press to get it to trial and actually make a difference." As examples, he pointed to his firm's involvement in high-profile merger cases involving Affiliated Computer Services, Landry's Restaurants and retailer J. Crew.

A Typical Merger Objection Chronology
The Activity Corporation Saga
MSCAd Case ID 9330

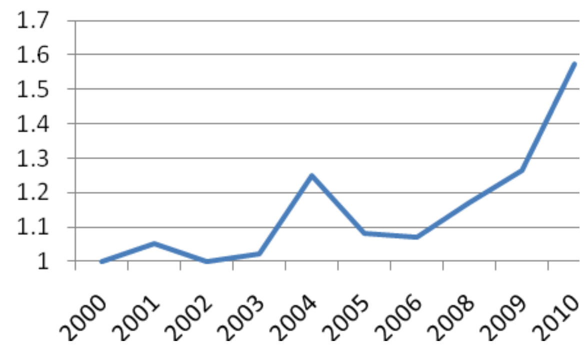
Date		Event
October 11, 2010		ActivIdentity announced that the company has entered into a definitive agreement to be acquired by ASSA ABLOY AB in a cash transaction at a price of $3.25 per share, or approximately $162 million. This per share price represents a premium of approximately 43% over the closing price of ActivIdentity shares on Friday, October 8, 2010 and a premium of 48% over the 20-day average of closing prices.
October 12, 2010		The following law firms announced an investigation: Kendall Law Group; The Briscoe Law Firm; Powers Taylor; LLP, Robbins Umeda LLP; Abington Cole; Brodsky & Smith, LLC; Goldfarb Branham LLP; Law Offices of Howard G. Smith and Levi & Korsinsky, LLP
October 12, 2010		Robbins Geller Rudman & Dowd LLP and Ryan & Maniskas, LLP filed in Superior Court of the State of California, County of Alameda (MSCAd Case #643898). This and subsequent actions were captioned *Vladimir Gusinsky Revocable Trust v. ActivIdentity Corp., et al.*, RG10541071 (Lerach Coughlin Stoia Geller Rudman & Robbins LLP), *Lin v. ActivIdentity Corp., et al*., RG10541379 (Robbins Geller Rudman & Dowd LLP), *Weisleder v. ActivIdentity Corp., et al.*, RG10541759 (Glancy Binkow & Goldberg LLP), *Simpson v. Evans et al.,* RG10542346 (Levy & Korsinsky, LLP) and *Gallagher v. Evans, et al*., RG10542346 (Johnson Bottini LLP)
October 15, 2010		Finkelstein Thompson LLP announced an investigation
October 18, 2010		Robbins Geller Rudman & Dowd LLP and Goldfarb Branham LLP filed in the United States District Court of the Northern District of California – San Francisco Division docketed as *Sacks v. ActivIdentity Corporation, et al.*, Case No. 10-4705-JCS
October 20, 2010		Bull & Lifshitz, LLP announced an investigation
October 26, 2010		Brodsky & Smith, LLC and Rosenthal, Monhait & Goddess, P.A. filed in the Court of Chancery of the State of Delaware (MSCAd Case #648403) in a case captioned as *Tomaselli v. ActivIdentity, et al*., 5928.
November 5, 2010		Faruqi & Faruqi, LLP announced an Investigation
November 30, 2010		Faruqi & Faruqi, LLP and Cooch and Taylor, P.A. filed in the United States District Court for the District of Delaware in a case captioned as Servent v. ActivIdentity Corporation et al .
December 9, 2010		ActivIdentity entered into a memorandum of understanding with the plaintiffs in the Superior Court of Alameda County Actions, the California State Actions, and the Delaware State Action and agreed to file supplemental disclosures and pay plaintiffs' counsel an amount up to $475,000.
December 10, 2010		In its 10-K, ActivIdentity 10-K acknowledged indemnification agreements for its executive officers and directors but claimed the "maximum potential amount of future payments the Company could be required to make under these indemnification agreements is not estimable." The company also confirmed it carries D&O insurance. No liability for these indemnification agreements was recorded at September 30, 2010 or September 30, 2009.
December 16, 2010		Actividentity shareholders voted to approve the acquisition
December 17, 2010		ActivIdentity filed to terminate the registration of its shares

Impact on the D&O market

A few merger objection suits have resulted in large monetary settlements, but most seek injunctive relief with the only monetary component being the plaintiff's attorney fees. Many of these cases come to a quick resolution, keeping defense costs low, and therefore tend to be relatively inexpensive for D&O insurers. Mr. Silk confirmed that many of these cases should not be a major concern for carriers. "There are significant M&A cases, but those are handled differently," he said. Citing Vice Chancellor Laster's criticism of some of the firms filing M&A suits, he noted that "there are a lot more law firms involved in M&A [than in other types of securities litigation], and they tend to have a different standard and different types of clients. We tend to see a lot of non-significant resolutions."

Kevin LaCroix of OakBridge Insurance Services, speaking in the same Advisen webinar, agreed that merger objection suits tend to be relatively small, but the rapid growth in the number of M&A suits and other types of corporate and securities suits nonetheless had implications for both primary and excess insurers. "It changes the way we think about the needs of the D&O insurance policy," he said. "Our default analysis is towards the securities class action lawsuit exposure, but increasingly it is other types of lawsuits that are producing corporate and securities litigation. You are going to have higher frequency and lower severity claims producing heightened loss for the primary and first level excess carriers, and perhaps lower severity experience for the high attaching excess carriers."

Exhibit 2 Number of jurisdictions per M&A*



*Given that at least one suit is filed.
Source: Advisen MSCAd™

Although individual merger objection suits are likely to settle for comparatively small amounts, insurers nonetheless need to be concerned about the aggregation of losses arising from one event. As Exhibit 2 demonstrates, the average number of jurisdictions in which suits are filed per contested M&A event is growing. In 2010, for all transactions sparking at least one lawsuit, suits were filed, on average, in 1.57 jurisdictions. In some instances, as many as 6 different jurisdictions were involved.

The future of merger objection litigation

The number of M&A-related lawsuits almost certainly will grow in the near term – the question is by how much. M&A activity typically increases following a recession, and the present recovery, which already is stimulating an uptick in M&A activity, will provide more opportunities for highly motivated plaintiff attorneys to file suits.

Longer term, legislation to rein in perceived abuses in M&A litigation is a possibility, albeit a distant one.

Bernstein Litowitz's Jerry Silk noted that M&A cases lack "a regime like we have in the Private Securities Litigation Reform Act. In this explosion we're seeing in M&A, you can have multiple jurisdictions with M&A litigation on the same deal, and there is really no way to organize those cases, no way for the court to empower an investor that has the largest holdings in the company, or to empower the law firm that will do the best job. One way to get M&A litigation under control is to have a method to consolidate these cases and get one single leader in change."

While consolidating cases may be desirable, achieving that goal would be a challenge since M&A-related litigation spans state and federal courts. Requiring that these cases be tried in federal court might be a first step, but Kevin LaCroix warns that "mandating that the cases had to be in federal court would not necessarily 'control' them, at least not with just a forum designation statute like CAFA." CAFA – the Class Action Fairness Act of 2005 – requires class action suits with an amount in controversy of more than $5 million and a class comprised of people from more than one state to be tried in federal court.

Mr. LaCroix suggests that a cap on attorneys' fees would likely result in fewer cases being filed, but notes that, from a practical standpoint, it would be difficult to achieve uniformity across state and federal courts. A solution spanning multiple jurisdictions is not likely to happen unless these cases are more widely perceived as being abusive. "I suppose if the numbers of these cases continues to grow and if publicity surrounding this phenomenon were also to continue grow, a coalition of forces might come together to try to craft some type of statutory solution," he said, "but I don't think we are there yet."

This Advisen QuickNote was written by David Bradford, editor-in-chief, dbradford@advisen.com.

A recording of Advisen's 2010 Securities Litigation Wrap-Up Webinar, as well as a copy of the slides, can be downloaded at Advisen's website, the Advisen Corner Store: http://corner.advisen.com/reports_topical_sec_lit_q42010_blurb.html. A copy of Advisen's year-end report on securities litigation trends, 2010 a Record Year for Securities Litigation: An Advisen Quarterly Report - 2010 Review, sponsored by Kaufman Dolowich Voluck & Gonzo, is available at the same location.