

## Why Mergers & Acquisitions-related Litigation is a Serious Problem

A significant trend in corporate and securities litigation is the dramatic growth of lawsuits stemming from M&A litigation. These lawsuits, often referred to as merger objection claims, are not only becoming more common, but also more costly.

To better understand the escalation of merger-related litigation and provide relevant context, we will first review the current and historical landscape of traditional securities class action litigation. We will then discuss the implications of M&A litigation.

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### **The Traditional and Current Securities Class Action Litigation Environment**

Traditionally, most discussions of securities litigation were focused primarily (and sometimes exclusively) on securities class action litigation, as these lawsuits have historically been the most frequent and the most severe management liability exposures facing corporate directors and officers.

More recently, the relative significance of securities class action litigation as a percentage of all corporate and securities litigation has shifted. As the insurance information firm Advisen has well documented, securities class action litigation activity as a percentage of all corporate and securities litigation has declined dramatically over the past several years. For instance, in 2010, securities class action lawsuits represented less than 16% of all corporate and securities lawsuit filings. One reason for this relative decline is the growth in M&A litigation filings.

A recurring question is whether overall securities class action litigation filings are declining. Usually, this discussion focuses exclusively on the absolute number of annual new securities class action lawsuit filings. In 2010, depending on the source to which you are referring, the absolute number of new lawsuit filings either declined compared to historical averages (Cornerstone Research study) or held steady or perhaps grew (NERA Economic Consulting study). The reasons these studies reach different conclusions is a worthy topic for another *InSights* newsletter. But regardless of the conclusions about the absolute number of annual lawsuit filings, the key fact often missing from the analysis is a consideration of how the absolute number of filings relates to the changing number of publicly traded companies.

The fact is that since 1999, the number of U.S. companies listed on NYSE and NASDAQ has declined every year. If you refer to the annual data from the World Federation of Exchanges, the number of U.S. companies listed on the NYSE and NASDAQ has declined from 7,854 in 1999 to about 5,000 in 2010 – a decline of about 36%.

# InSights

#### Inside:

The Exploding Growth in  
M&A-related Litigation

Page 2

Discussion

Page 4

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When the absolute number of annual lawsuits is compared to the declining number of companies trading on U.S. exchanges, it is clear that the frequency of securities class action lawsuit filings has not declined, but arguably increased, and at a minimum, is at least holding steady.

But while frequency has not declined, median severity has increased. According to the December 14, 2011 NERA Economic Consulting study, in 2010, the median securities class action settlement was \$11 million, which is well over double the 1999 median settlement of \$5.0 million and triple the 1996 median settlement of \$3.7 million. Inasmuch as the median settlement dipped to \$8.7 million in 2011, the last three year's average median settlement was \$9.67 million. These figures are not adjusted to account for the effect of economic inflation, but nevertheless reflect a substantial increase.

In short, even amidst the changing litigation landscape in which securities class action lawsuit filings have declined as a percentage of all corporate and securities litigation, the threat of securities class action litigation remains a very serious litigation exposure for publicly traded companies and their respective directors and officers.

### ***The Exploding Growth in M&A-Related Litigation***

M&A litigation has escalated not only in terms of the absolute number of lawsuits filings but also relative to the number of merger transactions. As recently as ten years ago, there were only a handful of M&A lawsuits filed each year. For example, in 2001, there were only four M&A lawsuits filed – in 2010 there were 341 suits filed (up from “only” 191 in 2009). In the four year period ending in 2010, the annual number of merger-related lawsuit filings has increased over 600%.

These numbers are even more startling when it is considered that these lawsuit filings are increasing even as the number of merger transactions are declining. The number of merger target companies declined in each of the three years from 2008 to 2010, yet the absolute number of merger-related lawsuits increased in each of those three years. In 2010, there were 214 fewer companies targeted for mergers than there were in 2007, representing a decline of over 37%. Yet the number of merger-related lawsuits filed in 2010 was more than triple the number filed in 2007. Today, one out of every two companies announcing an acquisition is sued, and that is true whether or not the acquisition is friendly or hostile, whether or not the board of the target company has accepted or rejected the proposed acquisition.

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There are a host of possible explanations for these filing trends. First, as M&A litigation has largely been brought in state courts as opposed to federal courts, the plaintiff bar avoids the strict procedural hurdles and standards for the appointment of lead plaintiff's counsel as enacted by the Private Securities Litigation Reform Act of 1995. The second explanation is that a changing case law environment has made securities class action litigation more challenging for plaintiffs (for example, as a result of the U.S. Supreme Court's holdings in the *Tellabs* and *Dura* cases). In addition, the declining number of public companies over the past several years translates into there being fewer prospective securities class action litigation targets. These developments may have encouraged plaintiffs' lawyers to seek out an alternative business model.

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In the M&A litigation arena, the plaintiffs' attorneys have found relatively easy money. These cases often involve a quick resolution (due to the fact that the parties are highly motivated to complete the underlying transaction) and the settlements often include the payment of plaintiffs' attorneys' fees, which average around \$400,000 per case.

The surest sign that M&A litigation represents an attractive proposition for the plaintiffs' bar is the heightened level of lawsuit filings. Increasingly, the announcement of a merger can trigger multiple separate lawsuits filed by separate plaintiffs' firms in multiple separate jurisdictions, producing complicated procedural and jurisdictional issues and also adding dramatically to the cost of litigation. In insurance terms, M&A litigation has become a *high frequency and high severity risk*.

On the defense expense front, these cases often involve high stakes and short fuses – a recipe for an explosion of legal fees. When you add in the additional expense involved when there are multiple cases in multiple jurisdictions, the expenses multiply. Further, when you consider the fact that these cases are continuing even after the underlying merger transaction has closed, the defense costs can increase exponentially. Much of the time, these defense expenses are borne by the target company's D&O insurer. The D&O insurers not only absorb the sometimes massive defense expenses, but the plaintiffs' fees as well, as fees are likely a covered component of the case settlement.

The plaintiffs' fees alone can often be staggering. In the August 2010 Morgan Kinder lawsuit, the plaintiffs' fee requests amounted to as much as \$50 million (that is, 25% of the \$200 million settlement). The plaintiffs' fee request in the September

2011 Del Monte settlement was \$22.3 million.

It should be emphasized that the plaintiffs' fee request can be substantial even where there is otherwise no cash component to the settlement. For example, in the April 2010 XTO Energy settlement, which had no cash component, the plaintiffs' fee request was \$8.8 million. Similarly, the September 2009 Pepsi Bottling settlement contained a \$7.7 million settlement fee request.

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Oftentimes the settlement of these cases involve significant cash payments. Indeed, the settlements in many of these cases resemble in magnitude the settlements of securities class action lawsuits. In many instances, where these settlement amounts are not designated as an increase in the acquisition price, these settlement amounts may be insurable.

- August 2011 Kinder Morgan case settled for \$200 million
- September 2011 Del Monte case settled for \$89 million
- May 2010 ACS case settled for \$69 million
- February 2011 Intermix Media settled for \$45 million

Furthermore, there are signs that the competition between jurisdictions could further exacerbate this situation. At the November 2011 Columbia Law School conference, various observers commented on the question of whether the Delaware courts, the traditional forum for this type of litigation, were losing "market share" to other jurisdictions' courts, as plaintiffs' lawyers believe they can do better elsewhere. As Alison Frankel discussed in a November 14, 2011 post on her *Thomson Reuters News and Insight* blog, this debate compelled one Delaware jurist to conduct a visual demonstration to try to prove that plaintiffs' lawyers can expect to recover substantial fees in Delaware courts. It is an obvious concern if Delaware's judges feel obliged -- in order remain competitive in the jurisdictional competition and to try to preserve declining market share -- to prove that plaintiffs' lawyers will be rewarded for resorting to the state's courts.

### **Discussion**

As mentioned above, the new M&A litigation trend represents both a high frequency *and* a high severity risk. The severity risk is particularly acute given the exacerbating effects of escalating defense expenses and rising plaintiffs' attorneys' fees. Increasingly, M&A litigation is a recurring and expensive proposition for which D&O insurers are picking up increasingly larger tabs.

An important point that should not be lost is the detrimental effect that the elevated risk of M&A related litigation and the ongoing risk of securities class action litigation represents to both directors and officers and D&O insurers. When all of the factors

are considered – including the declining number of public companies and the increasing absolute number of lawsuits – it is apparent that publicly traded companies today face a significantly increased risk of serious corporate and securities litigation.

Indeed, the probability of a U.S.-exchange listed company facing a merger objection claim or a securities class action lawsuit in 2010 was more than double what the equivalent probability was as recently as 2006, as the number of public companies has declined and the number of lawsuits has increased. To be specific, the probability in 2006 that any given public company would get served with a merger lawsuit or securities class action lawsuit was 2.8%; while the equivalent probability in 2010 was 5.7%. The probability of any given company being involved in serious corporate and securities litigation has never been greater.

Further, there is an apparent misconception in the industry that M&A litigation represents a significant risk only to the D&O insurance carrier providing primary limits. Given the previous comments, the risk is not confined to the primary D&O carrier. The defense expenses, the plaintiffs' fees and the M&A related indemnity exposure represents a risk for all of the carriers in a company's D&O insurance program. M&A litigation increasingly involves a threat of a flame-through loss, increasingly approaching the order of magnitude of securities class action litigation.

With both increasing frequency and severity, the casual observer might well assume that pricing for D&O insurance would also be escalating. This assumption would, however, fail to take into account the iron laws of supply and demand. There are more D&O insurers now than there were ten years ago, representing in the aggregate much greater levels of insurance capacity, while at the same time, there are many fewer public companies. This means that there are increasing numbers of D&O insurers pursuing a decreasing number of public company D&O insurance buyers.

It might well be asked how long this combination of circumstances in the D&O insurance marketplace can continue. We offer no predictions but rather provide a potentially chilling observation - the insurance industry rarely changes as an act of will – it usually changes only as a matter of necessity. We may have reached the point of necessity.

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**About the Author**

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