

# Client Alert

July 2013

## Addressing Attorneys' Fee Awards in Small-Cap, Public Company M&A Litigation

*A substantially similar version of this client alert was published by Steven M. Haas as Little Deals, Big Fees? Addressing Attorneys' Fee Awards in Small-Cap M&A Litigation in the May 2013 issue of The M&A Lawyer.*

With the recent proliferation of lawsuits challenging M&A transactions,<sup>1</sup> it has become increasingly common for stockholders to challenge “small-cap” transactions.<sup>2</sup> Historically, small transactions were not challenged in the absence of a direct conflict of interest, such as a management-led buyout.<sup>3</sup> Unfortunately, stockholder litigation brought against small-cap M&A deals can significantly increase the cost of the transaction. While larger companies may view the expenses associated with “deal litigation” as an accepted transaction cost, those expenses can be material relative to the value of a small-cap deal. In addition, many attorneys’ fee awards for so-called “therapeutic” benefits (*i.e.*, settlements not involving any cash or other payment to stockholders) appear to be increasingly detached from the value that stockholders place on them.<sup>4</sup> These trends are likely to harm target stockholders, as buyers factor the cost of litigation into their valuations and reduce merger consideration accordingly.

One of the challenges involved in small-cap M&A litigation is computing fee awards for plaintiffs’ counsel. Delaware courts often award attorneys’ fees in “disclosure-only” settlements in the range of \$400,000 to \$500,000 for a small number of “meaningful” disclosures.<sup>5</sup> Higher fee awards are available where

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<sup>1</sup> See, e.g., Robert M. Daines & Olga Koumrian, *Shareholder Litigation Involving Mergers and Acquisitions* (Feb. 2013 Update) (reporting that 93% of transactions with a value over \$100 million were subject to stockholder litigation); see also Matthew D. Cain & Steven M. Davidoff, *A Great Game: The Dynamics of State Competition and Litigation* (Jan. 2013).

<sup>2</sup> This article does not rely on any specific definition of what constitutes a “small-cap” company or transaction. Generally, however, this article focuses on M&A transactions with a value of \$50 million or less. Cf. *In re Netsmart Techn. S’holders Litig.*, 924 A.2d 171, 175 (Del. Ch. 2007) (referring to a \$115 million acquisition a “micro-cap company”).

<sup>3</sup> Presumably, plaintiffs’ lawyers did not see a large chance to receive a significant award in challenging small-cap M&A transactions that were negotiated at arms-length. The rapid rise of “disclosure-only” settlements, together with increased competition within the plaintiffs’ bar in M&A litigation, may be driving the perceived increase in legal challenges to small-cap transactions.

<sup>4</sup> See generally Edward B. Micheletti et al., *Valuing Therapeutic Benefits for an Award of Attorneys’ Fees Post-In re Compellent Technologies Shareholder Litigation*, 17 M&A. LAW. 1, 1 (Jan. 2013).

<sup>5</sup> *In re Sauer-Danfoss Inc. S’holders Litig.*, Consol. C.A. No. 5162-VCL, mem. op. at 35 (Del. Ch. Apr. 29, 2011); see also *In re Int’l Coal Group, Inc. S’holders Litig.*, C.A. No. 6464-VCP, trans. at 29 (Del. Ch. Jan. 30, 2012) (“Over the past few years, our law has centered around the concept that, if plaintiffs obtain one to two meaningful disclosures, the starting point for the fee award should be in the [\$]400[,000] to \$500,000 range.”); *Continuum Capital v. Nolan*, C.A. No. 5687-VCL, trans. at 98 (Del. Ch. Feb. 3, 2011) (“I start from the premise that a disclosure case is worth [\$]400[,000] to [\$]500,000.”); *In re Burlington Northern Santa Fe S’holder Litig.*, Consol. C.A. No. 5043-VCL, trans. at 62 (Del. Ch. Oct. 28, 2010) (“I think the general guideline that I use is [\$]400[,000] to [\$]500,000 for a good disclosure

plaintiffs obtain “particularly significant or exceptional disclosures.”<sup>6</sup> Such fee awards, however, can be significant in the context of a small-cap M&A transaction.<sup>7</sup>

Three Delaware bench rulings issued over the past year, all of which involved attorneys’ fees for additional disclosures and no increases in merger consideration, provide anecdotal evidence of the small-cap M&A litigation problem and the related issue of attorneys’ fee awards. In the first decision, *In re Icagen*, the court rejected the \$1.25 million fee request made by plaintiffs’ counsel and instead awarded plaintiffs’ attorney fees of \$350,000 in a settlement arising from a \$50 million transaction. In the second decision, *In re Access to Money*, the court awarded \$275,000 in attorneys’ fees in connection with the settlement of a lawsuit challenging a \$10 million transaction. In the third decision, *In re Craftmade*, the court awarded \$650,000 based on disclosures obtained in a challenge to the \$24 million sale of a delisted and deregistered company.

These fee awards are significant in light of the size of the challenged transactions. The fees in *Access to Money* and *Craftmade*, in particular, were approximately 2.7% of the value of the transactions under attack, which seems disproportionate to fee awards typically granted for disclosure-only settlements in larger transactions.<sup>8</sup> Moreover, these fee awards do not reflect the total costs imposed on the parties or the judicial system, including the defendants’ legal expenses and the time of the court. Fortunately, *Icagen* and *Craftmade* recognized the problem of granting “customary” fee awards against small-cap companies and attempted to make what the courts believed were appropriate adjustments. In addition, *Craftmade* provided tentative guidance on how Delaware courts might determine fee awards for small-cap transactions in the future. Still, the sizes of these fee awards are large and likely to incentivize plaintiffs’ firms to continue to challenge nearly every M&A transaction and generate fee awards that overstate the value placed by stockholders on “therapeutic benefits.”

## Recent Fee Awards in Small-Cap M&A Transactions

### *In re Icagen*

In *Icagen*, ten stockholder complaints were filed challenging a \$50 million merger.<sup>9</sup> As a result of the litigation, the company filed an amended Schedule 14D-9 that revealed: (i) details about how the company’s financial advisor calculated the beta (a measure of a stock’s volatility/risk) in its calculation of the company’s weighted average cost of capital/discount rate used in the discounted cash flow analysis performed in connection with the preparation of the fairness opinion rendered to the company’s board of directors; (ii) additional details regarding the assumptions underlying management’s internal projections; (iii) the company’s projected free cash flows; and (iv) that the company’s chief executive officer had initially voted against the transaction.<sup>10</sup> After the transaction closed, the plaintiffs sought a fee award of

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claim.”); *IBEW Local Union 98 v. Noven Pharm. Inc.*, C.A. No. 4732-CC, trans. at (Del. Ch. Dec. 8, 2009) (“I start from the assumption that a disclosure case is worth about [\$]400[,000], [\$]500,000 in fees.”).

<sup>6</sup> See *Sauer-Danfoss*, mem. op. at 35.

<sup>7</sup> See *id.* (discussing attorneys’ fee awards and noting that “[o]nly for a microcap company would the Court need to consider adjusting a disclosure-only award downward to avoid a punitive result”).

<sup>8</sup> By comparison, the Court of Chancery awarded an interim fee award of \$2,750,000 to the plaintiffs’ lawyers in obtaining a preliminary injunction and significant disclosures in *In re Del Monte Foods Co. S’holders Litig.*, Consol. C.A. No. 6027-VCL, mem. op. (Del. Ch. June 27, 2011), which involved a transaction with an equity value of approximately \$4 billion.

<sup>9</sup> *In re Icagen, Inc. S’holder Litig.*, C.A. No. 6692-CS, Trans. of Settlement Hearing and Ruling of the Court (Del. Ch. Apr. 5, 2012).

<sup>10</sup> See Amendment No. 4 to Schedule 14D-9 filed by *Icagen, Inc.*, with the Securities and Exchange Commission on August 24, 2011.

\$1.25 million. In support of this request, the plaintiff's counsel cited to fee awards granted in, among other challenged transactions, the \$2.8 billion sale of Gemstar-TV Guide, the \$5 billion sale of Del Monte Foods, and the \$50 billion sale of Merrill Lynch to Bank of America.<sup>11</sup>

At the settlement hearing, Chancellor Leo E. Strine, Jr., observed that "what's requested is essentially 2.5 percent of a premium-generating deal. That's a big thing . . . I'm not sure a reasonable investor would want to pay much of anything for the disclosures obtained here."<sup>12</sup> He continued that "[i]f investors are going to sue in a \$50 million case and they end up with a \$50 million deal and there's no economic change [to the deal terms], the idea that you can ignore what's at stake as a total economic thing in sizing the fee is just wrong from an economic standpoint."<sup>13</sup> Noting that the supplemental disclosures were of "modest utility,"<sup>14</sup> the court awarded "a generous fee of \$350,000."<sup>15</sup>

### **Access to Money**

In *Access to Money*, four stockholder complaints were filed in two states challenging the \$10 million sale of a company whose shares traded over-the-counter. In connection with the litigation, the company entered into a disclosure-only settlement in which it filed supplemental proxy materials to provide disclosure regarding: (i) the company's debt and equity financing alternatives; (ii) its negotiating history with the buyer; (iii) details regarding the comparable companies analysis, the comparable transactions analysis, and the discounted cash flow analysis performed by the company's financial advisor in connection with the preparation of the fairness opinion rendered to the company's board; and (iv) additional line-items from management's internal financial projections, including estimates of the company's future free cash flow.<sup>16</sup>

The court was critical of the plaintiffs' attempt to enjoin the transaction based on allegedly impermissible "deal protections" in the merger agreement. Addressing the plaintiffs' lawyer at the settlement hearing, Vice Chancellor John W. Noble observed that "if I took you up on your 'the deal protection devices were too much,' and enjoined the transaction . . . that would have been the worst thing in the world to have happened to the shareholders because it doesn't look to me like there's anybody else out there to buy [the company]."<sup>17</sup> He further noted that "[i]t seems to me like this is one of those where you ran a tremendous risk of doing a tremendous disservice to the shareholder class that you stand there to represent."<sup>18</sup>

The court also noted that the plaintiffs' requested fee award of \$450,000 was approximately five percent of the transaction's equity value and questioned the extent to which the size of the transaction should

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<sup>11</sup> See Plaintiffs' Corrected Brief in Support of Proposed Settlement and Application for Attorneys' Fees and Expenses at 23-24, *In re Icagen, Inc. S'holder Litig.*, C.A. No. 6692-CS (Mar. 19, 2012).

<sup>12</sup> See *Icagen*, trans. at 55.

<sup>13</sup> See *id.* at 57; see also *id.* at 58 ("And it would be very bad to simply say '2 1/2 percent of a deal goes to the lawyers in the case who got no economic value for the class, got disclosure that, frankly, . . . don't appear to have materially tilted the tender analysis.'").

<sup>14</sup> *Id.* at 58; see also *id.* at 54 ("I will not put the word 'material' on them.").

<sup>15</sup> *Id.* at 59.

<sup>16</sup> See Definitive Additional Solicitation Materials on Schedule 14A filed by Access to Money, Inc., with the Securities and Exchange Commission on October 13, 2011.

<sup>17</sup> *In re Access to Money, Inc. S'holders Litig.*, Consol. C.A. No. 6816-VCN, Trans. of Settlement Hearing at 8 (Del. Ch. May 31, 2012).

<sup>18</sup> *Id.* at 9.

influence its analysis.<sup>19</sup> The plaintiffs' counsel responded that he had "looked at this issue" and did not believe the requested fee was "punitive."<sup>20</sup> Ultimately, the court found that the disclosures "gave the shareholders a better understanding of why there was little choice but to approve the [proposed] transaction" and were thus beneficial to the stockholder class. Although the plaintiffs' counsel requested a \$450,000 fee award, the court awarded \$275,000 — approximately 2.75% of the transaction's value. The court did not explain the extent to which it considered the size of the transaction in making its decision.

### ***Craftmade***

Most recently, stockholders in *Craftmade* challenged the sale of a deregistered and delisted company with a \$24 million equity value. The company's initial disclosures to its stockholders about the proposed transaction did not include, among other things, the company's internal financial projections or any summary of the financial analysis performed by the company's financial advisor. After the plaintiff filed suit and sought a preliminary injunction, the company provided its stockholders with additional disclosures that mooted some, but not all, of the plaintiff's disclosure claims. The plaintiff pressed forward, and Vice Chancellor J. Travis Laster issued a preliminary injunction pending certain additional disclosures, including disclosure of the presentation provided by the company's financial advisor to its board of directors and the issuance of a press release clarifying the company's ability to respond to unsolicited acquisition proposals.<sup>21</sup>

The court found that, "[i]n the ordinary case, the degree of relief that the plaintiff obtained would easily justify a rather substantial fee."<sup>22</sup> The court recognized, however, that a large fee award would be disproportionate to the size of the transaction and the value likely placed on the disclosure by the company's stockholders. It also acknowledged that Delaware courts have not provided litigants with guidance on how fee awards might be determined in small-cap M&A transactions.

The court confronted this problem by grouping companies into two categories based on whether the transaction's value exceeded \$100 million. For transactions with a value of \$100 million or greater, the court reasoned that a customary fee award should apply. For transactions with a value less than \$100 million, however, the court explained that it would first determine a customary fee based on the benefit obtained in the litigation or settlement. It would then "scale down the fee proportionately based on where [the company's value] is versus a \$100 million transaction."<sup>23</sup> For example, if the court would ordinarily grant a \$1 million fee award but the challenged transaction had a value of only \$50 million, the court would award \$500,000 in attorneys' fees.

Applying this approach, the court concluded that the disclosures obtained in the litigation—that is, the company's voluntary supplemental disclosures as well as those made in response to the preliminary injunction—would typically support a fee award between \$2.4 million and \$2.8 million. Thus, after taking

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<sup>19</sup> *Id.* at 27-28.

<sup>20</sup> *Id.* at 28.

<sup>21</sup> See *In re Craftmade Int'l, Inc. S'holders Litig.*, C.A. No. 6950-VCL, Transcript of Oral Argument (Del. Ch. Nov. 10, 2011). The court referred to the press release as a "Fort Howard release," in reference to the 1988 decision in *In re Fort Howard Corp. S'holders Litig.*, 1988 WL 83147 (Del. Ch. Aug. 8, 1988), in which a target company issued a press release explaining how potential acquirors could submit a topping bid.

<sup>22</sup> *Craftmade*, trans. at 31.

<sup>23</sup> *Id.* at 37.

the \$24 million transaction value into account, the court awarded the plaintiff's attorneys \$650,000, or 2.7% of the transaction's value.<sup>24</sup>

### **Not Quite a New Issue: Other Small-Cap M&A Rulings**

There do not appear to have been any recent empirical studies on the prevalence of small-cap M&A litigation.<sup>25</sup> Thus, the rulings discussed above are only anecdotal evidence of small-cap M&A lawsuits. The current trend in M&A litigation generally, however, suggests that such lawsuits will continue. In addition, there are several other notable Delaware rulings involving small-cap companies. In 2009, for example, Vice Chancellor Stephen P. Lamb in *Jeffrey Benison IRA v. Critical Therapeutics, Inc.* significantly reduced a requested fee award in a \$10 million stock-for-stock merger.<sup>26</sup> There, the plaintiff had, among other things, identified that incorrect projections were inadvertently disclosed. Noting that the plaintiff's counsel obtained a "modest recovery" for the class of a "microcap size" company, Vice Chancellor Lamb awarded \$175,000 in attorneys' fees. In reaching his decision, he noted the relevance of "the size of the fee as a percentage of the value of this entity . . . at the time of the transaction."<sup>27</sup> He further stated that the requested fee of \$450,000 "would amount to something approaching or maybe exceeding five percent of the total market value of the company, *which seems grossly excessive.*"<sup>28</sup>

Likewise, in *Daly v. Ferrara*, decided in 2011, the Court of Chancery suggested that fee awards need to be assessed in light of a transaction's value.<sup>29</sup> There, Chancellor Strine told the plaintiff's counsel that "I think you should also anticipate that the overall market cap of this deal is \$20 million" and "that affects the reality of the fee."<sup>30</sup> He went on to note that "[y]ou're not going to get a fee one-twentieth of the value of the company in the deal."<sup>31</sup> Chancellor Strine did not suggest, however, what an appropriate fee might have been. Thus, the problem of small-cap M&A litigation is not necessarily a new one, but it may be an increasingly common one.

### **Implications for Small-Cap M&A Litigation**

As shown by *Icagen*, *Access to Money*, *Craftmade*, and other rulings, M&A litigation is not limited to mid-cap and large-cap transactions. As a result, M&A parties and practitioners should anticipate litigation in nearly every public company transaction. This means that the board of directors' process, the analysis done by its financial advisor, and the company's disclosures will likely be scrutinized closely by the plaintiffs' bar and subject to attack. It also means that the buyer and seller will need to factor in the costs of litigation and potential settlement in pricing the transaction. "Deal litigation" can be expensive because it typically proceeds on an expedited basis, involves electronic discovery and depositions of directors,

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<sup>24</sup> See *id.* ("So this is a \$24-to-\$25-million market cap. So what I am going to do is I am going to value it as if it were a \$100-million-plus deal, and I'm going to take a fourth of it. I'm going to give the plaintiffs 25 percent, given the fact that they are at that level on the scale going up to \$100 million. And then I think above \$100 million, I will remain transaction-size insensitive because I think that the disclosure benefit is a public good that runs across all deals regardless of deal size.").

<sup>25</sup> The study by Daines & Komrian, *supra*, studied transactions in excess of \$100 million.

<sup>26</sup> *Jeffrey Benison IRA v. Critical Therapeutics, Inc.*, C.A. No. 4039-VCL, Trans. of Settlement Hearing and Rulings of the Court (Del. Ch. Feb. 26, 2009).

<sup>27</sup> *Id.* at 61.

<sup>28</sup> *Id.* (emphasis added).

<sup>29</sup> *Daly v. Ferrara*, C.A. No. 6126-CS, Teleconference Transcript (Del. Ch. Dec. 8, 2011).

<sup>30</sup> *Id.* at 9.

<sup>31</sup> *Id.*

officers, and financial advisors, and requires the defendants to defend against a motion for a preliminary injunction or a temporary restraining order.<sup>32</sup> In addition, buyers are often named as additional defendants under aiding and abetting theories, thus further increasing the costs of the defense. Moreover, deal litigation often involves multiple venues, thereby further increasing the costs to the defendants and the legal system.<sup>33</sup>

Litigation costs may not be as significant in large M&A transactions in light of the overall value of the deal. But for small companies, litigation costs can be significantly disproportionate to the transaction's value. This has at least two negative consequences. First, a cost-benefit analysis at a small company may quickly cause it to seek a settlement rather than defend against the litigation. This, in turn, will likely lead to more lawsuits against small companies. While this is a problem endemic to M&A litigation generally,<sup>34</sup> small companies wary of using tight cash positions to defend unmeritorious litigation may be seen as easy targets for a "quick settlement."<sup>35</sup>

Second, and more important, litigation costs in small-cap M&A transactions—including attorneys' fee awards—may be more likely to adversely affect a buyer's valuation. If they do, then target stockholders are the likely losers as buyers withhold merger consideration to cover the litigation expenses. To the extent a buyer does not withhold such merger consideration, the zero-sum nature of M&A litigation means that the stockholders of the buyer or the parties' insurance carriers will be the losers when litigation is added to the cost of the transaction.<sup>36</sup> Alternatively, the increased cost attributable to the litigious state of M&A may simply discourage some buyers from pursuing acquisitions of small companies.

Finally, it should be noted that D&O coverage varies among small companies. Their policies may have high deductibles and/or low caps on coverage. Small companies would be well-advised to review their D&O policies in advance of any transaction to determine whether their coverage reflects the increased litigation risk in today's environment.

## Conclusion

Challenges to small-cap transactions are a by-product of the proliferation of M&A litigation generally. They also highlight a growing disconnect between the attorneys' fees being sought and the actual value placed by stockholders on "therapeutic benefits."<sup>37</sup> Fortunately, several Delaware courts recently have expressed concern about the size of the fee awards being requested in small-cap M&A litigation. Prior to *Craftmade*, however, Delaware courts had not indicated how such fee awards might be determined.

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<sup>32</sup> Target companies typically are obligated in engagement letters to reimburse their financial advisors for legal expenses, including those incurred in connection with being deposed and responding to discovery requests. These expenses are often not covered by the target's D&O insurance policy.

<sup>33</sup> See Daines & Koumrian, *supra*, at 3.

<sup>34</sup> *Cf. In re Transatlantic Holdings Inc. S'holders Litig.*, Consol. C.A. No. 6574-CS, teleconference trans. at 7 (Del. Ch. Feb. 28, 2013) ("I don't fault the defendants, who face an imponderable situation in which the cost of getting rid of non-meritorious claims . . . on the merits exceeds settling by giving out information which . . . doesn't possibly impair the vote.").

<sup>35</sup> See Daines & Koumrian, *supra*, at 6 (stating that 81% of settlements in 2012 were "disclosure only" and only one provided a monetary benefit).

<sup>36</sup> *Cf. In re MFW S'holders Litig.*, C.A. No. 6566-CS, mem. op. at 64 (Del. Ch. May 29, 2013) ("Ultimately, litigation costs are borne by investors in the form of higher D&O Insurance fees and other costs of capital to issuers that reduce the return to diversified investors.").

<sup>37</sup> See, e.g., *In re Art Techn. Group, Inc. S'holders Litig.*, Consol. C.A. No. 5955-VCL, trans. ruling (Del. Ch. May 16, 2011) ("I do think it's quite striking that not a single stockholder changed their vote. And I think it does call into question some of what these disclosure cases do.").

Thus, *Craftmade* took a welcome step forward in limiting excessive attorneys' fees in small-cap M&A litigation. Of course, *Craftmade* did not establish any definitive rule, and Vice Chancellor Laster noted that he would be open to better suggestions in the future.<sup>38</sup> Also, *Craftmade*'s decision to use \$100 million as a cut-off point to distinguish between small and large deals is open to debate. Still, the court recognized that attorneys' fee awards customarily awarded in large transactions can have a significantly disproportionate effect on the value of small-cap transactions, and it provided a tentative structure for addressing the issue.

None of this is to say that stockholders should be denied the right to bring suit when directors and officers breach their fiduciary duties. To the contrary, directors and officers owe fiduciary duties regardless of the size of the company, although context should matter in how those duties are discharged. There also may be reasons why small-cap transactions are more likely to generate stockholder discontent.<sup>39</sup> Plus, if there is no incentive for plaintiffs' counsel to represent stockholders in small-cap M&A transactions on a contingency fee basis, litigation may become cost-prohibitive for small stockholders.<sup>40</sup>

Nevertheless, practitioners and M&A parties should be concerned because even the attorneys' fees awarded in *Icagen*, *Access to Money*, and *Craftmade* are likely to incentivize plaintiffs' lawyers to challenge more M&A transactions, regardless of the size of the transaction or the merits of the claims. Because plaintiffs' firms operate on contingency fees, their business model is generally to bring as many suits as possible in order to increase the likelihood of receiving as many fee awards as possible. This model is increasingly becoming a "tax" on M&A transactions. While the larger plaintiffs' firms can be expected to continue focusing on mid-cap and large-cap transactions, attorneys' fee awards in the range of \$100,000 to \$400,000 are still likely to attract lawsuits from smaller plaintiffs' firms in the hope of a payout. Thus, there is a growing risk that the filing of non-meritorious claims will ultimately harm stockholder value by causing buyers to withhold consideration to account for the cost of litigation or forcing the buyer to absorb the litigation "tax." This risk is arguably greatest in small-cap M&A transactions.

## Contact

**Steven M. Haas**  
shaas@hunton.com

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<sup>38</sup> See *Craftmade*, trans. at 36 (noting that the court would "not be adverse to someone presenting a better mousetrap . . . at some future settlement hearing").

<sup>39</sup> For example, the company may be financially distressed and have stockholders who will suffer a significant loss on their investment.

<sup>40</sup> See *Craftmade*, trans. at 13-14 (argument of plaintiff's counsel that capping fees will result in "less diligent effort" from some lawyers).