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Taking a Second Look at the Corporate Benefit Doctrine

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The Delaware Court of Chancery decision in In re Quest Software Shareholders Litigation, Consol. CA No. 7357-VCG (Del Ch. Nov. 12, 2013), awarding shareholder plaintiffs $1 million in attorney fees, was largely unprecedented, not for the size of the award but for the circumstances of the court's decision. Upon announcement of a CEO-led management buyout of Quest Software Inc., the shareholder plaintiffs filed the kind of litigation that is now ubiquitous in public company mergers, alleging that the deal was a breach of the Quest board's fiduciary duties. The deal was subject to a lengthy go-shop period negotiated and initiated before litigation was ever filed. As a result of the go-shop, Dell Inc. made a superior proposal, several dollars per share above the original deal.

The plaintiffs' litigation efforts during the go-shop involved filing a motion to expedite that was repeatedly denied, and serving discovery requests that were largely unanswered. When the Quest-Dell merger was announced, the plaintiffs dismissed their case as moot. Nevertheless, the court concluded that the Dell merger was 5 percent impacted by the plaintiffs' "raptorious and unblinking oversight," and thus awarded the fee under the corporate benefit doctrine. Given the frequency with which such suits are filed following the announcement of corporate transactions, this decision calls for serious reconsideration of the corporate benefit doctrine.

The Quest Litigation

Quest's CEO, president and chairman, Vincent C. Smith, was a beneficial owner of approximately 35 percent of Quest's outstanding common stock, and a limited partner in funds and portfolio companies for Insight Holdings Group LLC. In 2011, after Insight displayed interest in acquiring Quest, and anticipating Smith's participation in any proposed buyout, the board established a special committee to oversee the potential merger process. On March 8, 2012, Quest's board of directors entered into a merger agreement with Insight, whereby Insight would purchase each outstanding share of Quest common stock for a price of $23 in cash per share. The merger agreement provided for a 60-day go-shop period with a de minimis termination fee in order to promote competing bids. Before litigation in Delaware was ever filed, the special committee's financial advisers reached out to 38 financial sponsors and 17 strategic bidders as part of the go-shop.

Thereafter, the shareholders filed breach of fiduciary lawsuits in Delaware against Quest and its directors, claiming that the board was motivated to sell to Insight because of longstanding relationships and personal financial benefits. During the pendency of the go-shop period, Vice Chancellor Sam Glasscock III repeatedly declined to grant expedited proceedings and allowed only limited litigation to proceed, in order to avoid undue interference with the go-shop process.

After extensive and hard-fought negotiation, the special committee ultimately secured a merger agreement with Dell at a per-share price $5 higher than the original deal—an aggregate benefit of $283 million to Quest's shareholders. Once Quest announced the new deal, the plaintiffs voluntarily dismissed their claims as moot, and filed an application for $2.8 million in attorney fees.

The Fee Award

Following brief discovery and a hearing on the fee motion, Glasscock awarded plaintiffs counsel $1 million in attorney fees under the corporate benefit doctrine. The corporate benefit doctrine provides for an award of attorney fees if (1) the lawsuit was meritorious when filed; (2) the corporate benefit was achieved before a judicial resolution of the action; and (3) the lawsuit was causally connected to the benefit, as in In re Sauer-Danfoss Shareholders Litigation, 65 A.3d 1116, 1123 (Del. Ch. 2011). Taking all inferences in the plaintiffs' favor, the court found that the plaintiffs' lawsuit was meritorious when filed, and noted that the deal with Dell was achieved before a judicial resolution of the suit. The court then applied a causal presumption in the plaintiffs' favor, and held the defendants to the burden of demonstrating that the litigation "'did not in any way cause'" the corporate benefit, as in United Vanguard Fund v. TakeCare, 693 A.2d 1076, 1080 (Del. 1997).

Although the chairman of the special committee testified by affidavit that the special committee designed the go-shop process to generate the highest price through a post-signing auction, that it created an innovative deal provision to ensure that Insight had no advantage in the negotiations, and that the litigation had no influence whatsoever on the sales process, the court found that the defendants were unable to carry their burden that the litigation did not cause the corporate benefit. The court conceded that "defendants may be correct" that the litigation did not affect the superior merger agreement with Dell, but found that their denial was insufficient to rebut the presumption of causation enjoyed by the plaintiffs. The court was particularly persuaded by documents evincing the special committee's awareness of litigation, noting that "the board was well aware of the eyes, raptorious and unblinking in oversight."

In deciding the appropriate amount of fees, the court found that not even a substantial portion of the achieved corporate benefit could be attributed to the litigation. By the time the lawsuits were filed, the go-shop had commenced, and the special committee had considered an innovative deal provision designed to ensure that Smith would cooperate if a superior offer emerged. The court noted that the board likely would have complied with its fiduciary duties independent of the plaintiffs' efforts.

Nonetheless, the court found that the litigation contributed 5 percent of the $283 million benefit achieved—or $14.15 million. Because the benefit was achieved "not of active litigation but of simple oversight," the court awarded approximately 7.5 percent of the benefit—or $1 million. The court calculated that this award resulted in a fee of approximately $441 per hour, including 625 hours spent researching and drafting five complaints and 339 hours addressing lead counsel issues—hours that "contributed nothing to the benefit of the class."

Creating Perverse Incentives

Lawsuits challenging merger transactions have become the rule. In 2012, plaintiffs firms filed lawsuits on behalf of shareholders in 93 percent of transactions valued over $100 million, according to a report from Cornerstone Research. As a result, corporate boards are keenly aware that their actions will be scrutinized in litigation, whether or not such litigation has already been filed. Directors often proceed from the outset of negotiations on the assumption that a transaction will almost surely draw litigation.

Given the ubiquitous nature and the typical attorney fees awards in such suits, plaintiffs counsel already have significant incentives to monitor corporate activity. Indeed, the sheer volume of such suits and the number of firms competing for the lead counsel position demonstrate that such oversight is already well compensated. Monitoring corporate activity has therefore become a baseline cost for plaintiffs firms to identify business opportunities. Plaintiffs firms are willing to incur such costs because when the monitoring process uncovers corporate wrongdoing, the firms are handsomely compensated with multipliers for the contingent nature of their work, as in In re Plains Resources Shareholders Litigation, C.A. No. 071-N, 2005 Del. Ch. LEXIS 12 (Del. Ch. Feb. 4, 2005), which held that "it is consistent with the public policy of Delaware to reward this risk-taking in the interests of shareholders."

Despite the current incentives for monitoring corporate activity, the court in Quest found that simply watchful eyes were deserving of a generous fee award. While the court downplayed the size of the award, the plaintiffs received the approximately $441 per hour for 625 hours spent researching and drafting duplicative complaints, 339 hours battling over which firm would be lead counsel, and more than 1,000 hours preparing an unsuccessful motion for expedited discovery and simple case monitoring.

Such rewards seem contrary to Delaware's stated policy of discouraging "churning of wheels and devoting unnecessary hours to litigation," as in Seinfeld v. Coker, 847 A.2d 330, 333 (Del. Ch. 2000). Indeed, as the Chancery Court recently stated in In re The Talbots Shareholders Litigation, C.A. No. 7513-CS, slip op. at 13 (Del. Ch. Dec. 16, 2013): "Plaintiffs lawyers in these circumstances are not insurance policies, to get paid for ... providing reassurance ... that what the board of directors is doing is fair and reasonable and in their best financial interests. ... You don't reward folks, typically, for just adding costs to a process by ... exposing it."

Rethinking the Corporate Benefit Doctrine

The corporate benefit doctrine was first explored nearly 50 years ago in the oft-cited Chrysler v. Dann, 223 A.2d 384 (Del. 1966). In that case, derivative litigation had progressed for two years prior to settlement, and the plaintiffs had filed a 109-page complaint "embracing 15 causes of actions and about 60 separate claims." By contrast, boilerplate complaints are now filed in nearly every public deal, making any purported causal connection between the litigation and any subsequent corporate act blurred at best.

Given this proliferation of lawsuits, the causal presumption in plaintiffs' favor no longer seems appropriate. Rather than providing a reward to plaintiffs counsel for prompting change with litigation, the corporate benefit doctrine incentivizes counsel to file frequently so that they might benefit from the presumption that any subsequent corporate acts were caused by their suit. Refining this presumption to require plaintiffs to identify a change in corporate actions that resulted from the lawsuit could reduce perverse incentives. That plaintiffs counsel in Quest obtained a windfall of $1 million for little more than the predictable filing of merger complaints should at least prompt a second look.

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