7th Circ. Mootness Fee Case May Curb Frivolous Merger Suits

By **Marcie Lape, Chuck Smith and Lauren Sexton** (April 24, 2024, 4:37 PM EDT)

On April 15, the U.S. Court of Appeals for the Seventh Circuit in Jorge Alcarez v. Akorn Inc.[1] **mapped out** one way a court may evaluate mootness fees paid to individual shareholders after the voluntary dismissal of an action challenging a public company merger.

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Specifically, the Seventh Circuit held that although a district court does not have the inherent power to review a mootness fee paid to an individual shareholder following the voluntary dismissal of a suit under Rule 41(a) of the Federal Rules of Civil Procedure, it nonetheless may review the fee following intervention in the case by an absent shareholder, a Rule 60(b) motion for relief from judgment, and an evaluation of compliance by the plaintiff and their attorneys with Rule 11 of the Federal Rules of Civil Procedure.

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As the Seventh Circuit explained, should the district court find a violation of Rule 11, Rule 11(c) then gives the district court discretion to order appropriate sanctions in the event it determines that a shareholder initiated a merger challenge not for good reason but only to extract a payment from the company for the benefit of plaintiffs lawyers. Thus, while not directly articulating a standard of review for mootness fees paid to an individual shareholder, the Seventh Circuit indicated that Rule 11 provides the proper framework to evaluate the propriety of the underlying disclosure lawsuit.

The ruling in this case could be persuasive to courts outside the Seventh Circuit, encourage objections to mootness fees and reduce the number of frivolous merger challenge cases filed.

Lauren Sexton

Background to Merger Challenge Litigation

The announcement of a public company merger is almost guaranteed to attract one or more challenges by shareholder class action plaintiffs who claim that the deal disclosures are inadequate.

Plaintiffs typically assert that the target company's proxy statement contains materially false or misleading statements in violation of Section 14(a) of the Securities Exchange Act of 1934, or that the directors breached state law fiduciary duties in approving the merger and proxy statement. Often these suits are criticized as "strike suits" with little to no merit, whose primary purpose is to generate fees for plaintiffs counsel.

Only rarely is a disclosure case actually litigated. Instead, companies typically settle these suits by agreeing to additional "correcting" disclosures and paying plaintiffs counsel a modest fee. When a case is settled on behalf of a class and class members' claims are released, the settlement is subject to court approval.

Historically, federal courts approved disclosure-based settlements without much scrutiny. But in 2016, the Seventh Circuit followed the Delaware Court of Chancery's decision earlier that year in In re: Trulia Inc. Shareholder Litigation, and held in In re: Walgreen Co. Stockholder Litigation that

classwide disclosure settlements are disfavored "unless the supplemental disclosures address a plainly material misrepresentation or omission" and the release is narrowly drafted to encompass "nothing more than disclosure claims and fiduciary duty claims concerning the sale process."[2]

A year later, in Farber v. Crestwood Midstream Partners LP, the U.S. Court of Appeals for the Fifth Circuit similarly criticized disclosure-based settlements because "[t]he class members get nothing. The attorneys get their fees."[3]

To avoid judicial scrutiny over disclosure-based settlements, parties now often settle federal merger challenge cases on an individual basis, whereby the company makes additional disclosures that moot the plaintiff's claims, the individual plaintiff voluntarily dismisses their claims prior to certification of a class, no releases are exchanged and the company agrees to pay a mootness fee to the plaintiff's counsel. Under these circumstances, federal courts do not have visibility that a fee is being paid to moot the case, nor do they have an opportunity to review and police the fee.

The District Court Proceedings

This case arises from Akorn's 2017 announcement that it had agreed to be acquired by Fresenius Kabi AG. Six Akorn shareholders filed lawsuits challenging the adequacy of disclosures in the preliminary proxy statement. After Akorn filed updated proxy statements containing additional disclosures, including disclosures sought by the plaintiffs, the **plaintiffs voluntarily dismissed** their complaints in 2019 pursuant to Rule 41(a) and Akorn agreed to pay the plaintiffs' counsel a $322,500 "mootness fee."

Following the dismissal, Akorn shareholder Theodore H. Frank — an attorney who represented the shareholders who objected to the attorney fees in Walgreen and Farber — moved to intervene and force the plaintiffs' counsel to return the mootness fee.

Frank argued that the disclosure suits were meritless strike suits and a "misuse of the class action device for private gain." The district court denied his motion to intervene, but in a move that the plaintiffs called "unprecedented," the district court exercised its "inherent powers to police potential abuse of the judicial process — and abuse of the class mechanism in particular" — and required the plaintiffs to demonstrate that the disclosures they claimed credit for cured a "plainly material" false or misleading statement. The district court invited Frank to participate as an amicus curiae.

Following briefing, the court determined that the disclosures the plaintiffs sought were not "plainly material," and in fact were "worthless" to the proposed shareholder class. As a result, the court declared that the plaintiffs' cases should have been "dismissed out of hand." And because the court had earlier failed to take that action, it exercised its inherent authority to abrogate the settlement agreements and ordered the plaintiffs' counsel to return the mootness fees.

Arguments on Appeal

The District Court's Power to Review Mootness Fees After Dismissal

The plaintiffs argued the district court "overstepped the bounds of its inherent authority" and lacked jurisdiction to review the mootness fee after the plaintiffs dismissed their cases.

As amicus curiae in support of the district court's judgment, Frank argued that the court had the inherent authority to review mootness fees after dismissal and order the return of the fees in order to protect against abuses of the judicial process and the class action device. He also argued that the court should have allowed him to intervene in the case.

The Standard of Review for Supplemental Disclosures

The plaintiffs argued that, even if the district court had jurisdiction to review the mootness fee, the court applied the wrong standard. According to the plaintiffs, the Walgreen and Trulia "plainly material" standard only applies to class settlements, and a lower standard applies to the dismissal of individual claims.

The plaintiffs also argued that the district court erred by considering only the disclosures they sought

in their complaints and not the full set of additional disclosures for which they claimed responsibility.

Finally, the plaintiffs argued that the district court "misapprehended the significance" of Akorn's additional disclosures, while Frank argued that the additional disclosures were worthless by any standard.

The Seventh Circuit's Ruling

The Seventh Circuit panel, consisting of U.S. Circuit Judges Frank H. Easterbrook and Diane P. Wood, [4] held — four years after oral arguments in the case — that the district court did not have the inherent authority to reopen the merger challenge and review the mootness fee following the action's voluntary dismissal, finding that it could only reopen the case following a formal motion under Rule 60(b) of the Federal Rules of Civil Procedure, which had not occurred.

But as the Seventh Circuit pointed out, Frank had moved to intervene in the case, and, had his motion been granted, he could have filed a motion to reopen under Rule 60(b).

The Seventh Circuit then turned to whether the district court should have granted Frank's motion to intervene. After rejecting the plaintiffs' arguments that Frank lacked standing and was required to bring a derivative action, rather than personally intervene, the Seventh Circuit held that the district court erred when it addressed only Frank's proposal to intervene as of right and not his proposal to intervene permissively under Federal Rule of Civil Procedure 24(b).

The Seventh Circuit found that as an investor in Akorn whose shares' value was affected by the merger and mootness fee, as well as a member of the proposed class, Frank plainly had a claim in common with the main action. And reasoning that "class counsel and Akorn [we]re looking out for their own interests rather than those of the class," the Seventh Circuit held that "intervention [wa]s appropriate" and that Frank was "entitled to participate as a party."

The Seventh Circuit further commented that although Rule 23(e) does not require judicial approval to settle or dismiss cases brought as class actions, yet not so certified — an issue it invited the rules committee of the Judicial Conference to consider — through its mandate in Section 78u-4(c)(1), the Private Securities Litigation Reform Act supplies a mechanism for review of the underlying merit of a supplemental disclosure case and mootness fees.

That section obligates a district court upon final adjudication of any action brought under the Securities Exchange Act to make specific findings regarding compliance with Rule 11(b) of the Federal Rules of Civil Procedure by each party and each attorney representing a party as to any complaint, responsive pleading or dispositive motion. The dismissal of a suit, the Seventh Circuit reasoned, is a "judicial action" and therefore the "final adjudication of the action" irrespective of whether or not a settlement was the reason behind the dismissal.

The Seventh Circuit thus determined that, while the district court's reference to its "inherent authority" should have been to Section 78u-4(c)(1) and Rule 11, the court's reasoning holds. Frank alleged — and the district court had essentially already found — that plaintiffs' counsel had violated Rule 11 by bringing suits whose very purpose was to "needlessly increase the cost of litigation" so as to "induce Akorn to pay the lawyers to go away."

And the Seventh Circuit remarked that, under Rule 11(c)(4), the district court has "discretion over the choice of sanction" and "would be entitled to direct counsel who should not have sued at all to surrender the money they extracted from Akorn." Still, the Seventh Circuit acknowledged that, given the denial of the motion to intervene, the district court had not yet conducted the proper proceeding under Section 78u-4(c)(1) and Rule 11, including by providing notice and an opportunity to be heard, thus necessitating a remand.

In short, the Seventh Circuit outlined a path by which shareholders may challenge mootness fees by intervening in a merger challenge case and invoking Rule 11's ban on suits brought for an improper purpose, including the extraction of fees from defendants, or frivolous or unsupportable suits.

Importantly, the Seventh Circuit highlighted that judicial findings as to the propriety of these types of class actions are mandatory upon resolution, indicating that judicial scrutiny of the value of

supplemental disclosures and the corresponding validity of the lawsuits brought to force those disclosures is likely to increase. The prospect of such judicial scrutiny could reduce the number of meritless merger challenge cases filed.

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[1] Nos. 18-2220, 18-2221, 18-2225, 18-3307, 19-2401 and 19-2408.

[2] In re: Walgreen Co. S'holder Litig., 832 F.3d 718, 725 (7th Cir. 2016) (quoting and adopting the standard set forth in In re: Trulia, Inc. S'holder Litig., 129 A.3d 884, 898-99 (Del. Ch. 2016)).

[3] Farber v. Crestwood Midstream Partners L.P., 863 F.3d 410, 412 (5th Cir. 2017). The Fifth Circuit found here, however, that the objection to the settlement was untimely and declined to decide whether to adopt the Trulia standard.

[4] Judge Michael S. Kanne, the third member of the panel, died after the appeals were argued. The appeals were decided by a quorum. 28 U.S.C. § 46(d).