SEVENTH CIRCUIT COURT OF APPEALS ISSUES DECISION LIMITING JUDICIAL OVERSIGHT OF MERGER LITIGATION

The United States Court of Appeals for the Seventh Circuit recently issued an important decision, *Beck v. Dobrowski*, 2009 WL 723172 (7th Cir. Mar. 20, 2009), addressing the high bar that stockholder plaintiffs must meet when they challenge corporate transactions by asserting that proxy materials are misleading, or that the transaction fails to "maximize shareholder value."

Although stockholder lawsuits challenging the substance of corporate transactions are frequently seen in state courts, they are sometimes brought in federal courts. The Seventh Circuit's decision in *Beck* should reduce concurrent federal litigation arising out of such transactions. Affirming dismissal of the complaint – and applying the United States Supreme Court's recent teaching that federal district courts must scrutinize whether a complaint is a substantial one on its face – the Seventh Circuit viewed with extreme skepticism claims by shareholders of Equity Office Property Trust ("EO") that they had been misled by disclosures in EO's proxy materials arising from the bidding contest between the Blackstone Group L.P. ("Blackstone") and Vornado Realty Trust ("Vornado") to acquire EO.

The Seventh Circuit's decision in *Beck*

- underscores the importance of the business judgment rule in protecting decisions by directors in merger transactions and, specifically, a decision by a target board of directors to agree to a termination fee that may discourage or eliminate a competing bidder;

- refuses to establish a bright line rule as to how far in advance of a shareholder vote supplemental proxy materials must be provided to shareholders, noting the relative sophistication of shareholders, the prevalence of electronic communications, the risks to a corporate transaction if there are extended delays prior to a vote, and the SEC's role in introducing rules if the current ones are ineffective; and

- confirms that state courts are best equipped to deal with claims that challenge the substantive fairness of merger transactions, affirming the district court's decision to abstain from hearing state law "breach of fiduciary duty" claims.

Factual Background and the District Court's Decision

The litigation arose from the highly public bidding contest in late 2006 and early 2007 between Blackstone and Vornado for EO, which is a REIT. After a series of dueling bids, Blackstone raised its all-cash offer to $55.50 per share in exchange for EO's agreement to a $720 million break-up fee (which was approximately 3% of the transaction value). EO's board recommended approval of the Blackstone transaction in a supplemental proxy statement mailed just six days before the final stockholder meeting. Vornado ultimately abandoned its bid – which was at $56 per EO share payable in Vornado stock and cash – citing the premium it would have to pay to offset the $720 million termination fee.

Plaintiff, an EO shareholder, commenced an action against EO's directors in federal district court in Chicago, alleging that the proxy solicitations mailed to shareholders during the bidding contest contained material omissions and false statements in violation of Section 14(a) of the Securities Exchange Act of 1934. Specifically, plaintiff claimed, among other things, that the proxy statement was misleading because defendants knew that the transaction with Blackstone was not "fair" to shareholders. That it was a "bad deal" for investors allegedly was evidenced by Vornado's increasing offers in response to Blackstone's bids. According to plaintiff, defendants then included in the agreement ever-escalating termination fees to impermissibly discourage further bids from Vornado. Plaintiff also argued that the target board should have delayed the shareholder vote to allow shareholders at least 14 days from the date the supplemental proxy materials were mailed to consider the Blackstone bid. Beyond the Section 14(a) claim, plaintiff also asserted claims for breach of fiduciary duty against the directors that challenged their conduct during the bidding contest and the terms of the Blackstone transaction generally. Notably, similar breach of fiduciary duty claims against EO's directors were pending in parallel state court proceedings brought by other EO shareholders.

The district court dismissed the complaint.

The Seventh Circuit's Decision

The Seventh Circuit affirmed the dismissal of the complaint. Writing for the panel, Judge Posner first held that the heightened pleading standards for scienter established under the Private Securities Litigation Reform Act of 1995 did not apply, noting that "Section 14(a) requires proof only that the proxy solicitation was misleading, implying at worst negligence by the issuer." Thus, "a proxy solicitation that contains a misleading misrepresentation or omission violates the section even if the issuer believed in perfect good faith that there was nothing misleading in the proxy materials."

Judge Posner next rejected the stockholder's challenge to the termination fee, namely, that the target board had improvidently agreed to the fee with Blackstone, which, in turn, had prematurely terminated the bidding by Vornado. Judge Posner held that Section 14(a) of the 1934 Act was designed to prevent misrepresentations and omissions and that the challenge to the termination fee had "nothing to do with misrepresentations" and the termination fee "was

disclosed to EO's shareholders." The Court further noted that there is nothing "to suggest that termination fees in bidding contests are generally improper under any body of law with which we are familiar." Noting the public policy implications of the claim, the Court stated that if such claims were to succeed, corporate management would be placed "on a razor's edge" because "[a]ny evidence that the plaintiff would have presented, either in this case or in our hypothetical cases, concerning the optimal strategy for EO to have pursued would have been heavy on hindsight and speculation, light on verifiable fact."

Judge Posner further noted that under the Supreme Court's 2007 decision in *Bell Atlantic v. Twombly*, defendants "should not be burdened with the heavy costs of pretrial discovery that are likely to be incurred in a complex case unless the complaint indicates that the plaintiff's case is a substantial one." The Court held that "the plaintiff's allegations that the proxy solicitations contained misrepresentations or misleading omissions were too feeble to allow the suit to go forward." Specifically, the Court noted that the complaint failed "to suggest that any shareholder was misled or was likely to be misled" or that any "shareholder drew a wrong inference" from the facts allegedly omitted from the proxy.

Judge Posner also rejected the claim that shareholders were given insufficient time to consider the rapid developments during the proxy solicitation. Plaintiff's contention that the directors should have delayed the shareholder vote to allow at least 14 – rather than six – days from the date the supplemental solicitation materials were mailed was "not a rule for a court to impose," but rather "a matter for the SEC to consider if it wants." Furthermore, if the plaintiff were to prevail on the basis of such a theory, it would "sink[] the process of corporate acquisition into a sea of molasses by requiring that every fresh offer to buy a company reset the clock for shareholder approval." The Court acknowledged the importance of providing shareholders with more time to consider how to vote on the proposed transaction, but also noted that longer delays would increase the likelihood of a transaction falling apart. The Court observed the relative sophistication of shareholders, the prevalence of electronic communications and noted that "speculators do not await the arrival of proxy solicitations by snail mail to decide how to vote their shares."

As to the breach of fiduciary duty claim, the Seventh Circuit affirmed the district court's decision to abstain from hearing the case in favor of parallel proceedings pending in state court. Judge Posner noted that other EO shareholders had brought breach of fiduciary duty claims in Maryland state courts, and that appeals of such claims were pending at the time the federal district court declined jurisdiction, stating that: "[t]he state-law issues that our plaintiff has presented to the federal court will be definitively resolved by the courts of the state whose law governs those issues, and our court would be required to defer to that resolution because state courts are the authoritative expositors of their own state's laws."

Conclusion

Stockholder class actions challenging the substance of corporate transactions are nothing new. But such lawsuits have largely raised state law issues and, in recent years, generally have been litigated in state courts. *Beck* makes clear that to the extent such transactions trigger federal claims, they will be subject to the Supreme Court's recent *Twombly* decision, and that challenges to the business judgment of a target board should be given very exacting scrutiny. Furthermore, *Beck* is welcome confirmation that, to the extent there is parallel litigation in state court, defendants should not be subject to duplicative and wasteful concurrent litigation in federal court.

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