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DISCLOSURE HOT TOPICS IN M&A LITIGATION

In M&A litigation, plaintiffs frequently seek an injunction, alleging that disclosures were inadequate or misleading in various ways. In resolving such claims, the courts frequently find that additional disclosures would not be material, but in some cases – notably those involving alleged conflicts of interest, financial projections, and the assumptions and analyses underlying financial advisors' fairness opinions – they have required additional disclosures. The authors discuss the cases and their teaching for the drafting of disclosures in M&A transactions.

By Deborah S. Birnbach and Morgan R. Mordecai *

For the fourth consecutive year, shareholders filed suit in more than 90 percent of M&A deals valued over $100 million.[1] In 2013, 94 percent of M&A deals were challenged by shareholders.[2] It is nearly inevitable nowadays that litigation will follow a merger with an average of approximately five lawsuits being filed per transaction in 2013,[3] generally in multiple jurisdictions.

Although merger litigation continues to be on the rise, recent court opinions demonstrate increasing skepticism toward M&A suits as a reaction to the ever expanding volume of transaction-related litigation. In denying a motion for expedited proceedings, Vice Chancellor Laster of the Delaware Court of Chancery noted, "I don't think for a moment that 90 percent – or based on recent numbers, 95 percent of deals are the result of a breach of fiduciary duty. I think that there are market imbalances here and externalities that are being exploited."[4]

Recent decisions signal that courts are attempting to curb wasteful litigation and refusing to award plaintiffs' counsel significant fees for alleged benefits to stockholders from disclosure-only settlements, as opposed to settlements with substantive improvements to deal terms. "All supplemental disclosures are not equal"

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[1] Olga Koumrian, *Shareholder Litigation Involving Mergers and Acquisitions: Review of 2013 M&A Litigation*, Cornerstone Research 1, *available at* http://www.cornerstone.com/Publications/Press-Releases/Shareholder-Lawsuits-Filed-in-90-Percent-of-M-and-A-Deals; *see also* Olga Koumrian, *Settlements of Shareholder Litigation Involving Mergers and Acquisitions: Review of 2013 M&A Litigation*, Cornerstone Research 1, *available at* http://www.cornerstone.com/Publications/Press-Releases/Shareholder-Lawsuits-Filed-in-90-Percent-of-M-and-A-Deals.

[2] *Id*.

[3] *Id*.

[4] Transcript of Record at 12, *Stourbridge Invs. LLC v. Bersoff*, No. 7300-VCL (Del. Ch. Mar. 13, 2012).

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because a disclosure is material only if there is a substantial likelihood that it would be viewed by a reasonable investor as significantly altering the total mix of available information.[5] Put another way, if a company discloses the process used by the board of directors in arriving at a transaction decision, and fairly summarizes the financial advisor's analyses underlying the fairness opinion, as well as the company's projected financial statements underlying those analyses, plaintiffs will demand more. If the company discloses what the directors discussed, plaintiffs will complain they didn't disclose what was not discussed. If the company discloses what was not considered, plaintiffs will complain they didn't disclose why. You get the picture.

Absent meritorious transaction-process challenges arising from fiduciary breaches, challenges to the sufficiency of disclosures in proxy statements or tender offer recommendation statements remain the primary allegations supporting requests for injunctive relief. Plaintiffs seek temporary injunctions delaying stockholder votes or tender offers until allegedly material information is disclosed. In order to avoid risk, litigation cost, or both, parties frequently reach settlements whereby supplemental disclosures are made that enable deal certainty and timing. Court approval of these class action settlements usually occurs post-closing, and plaintiffs' counsel seeks an award of attorneys' fees commensurate with the supposed "benefit" conferred upon the stockholder class by the supplemental disclosures, among other factors.[6]

Plaintiffs typically allege various categories of material omissions that would so significantly alter the total mix of information, say plaintiffs, that stockholders are unable to decide whether to tender their shares, how to vote on a merger, or whether to seek appraisal of their shares where appraisal is an available remedy. Therefore, the allegation goes, the court must enjoin the vote or tender offer so that stockholders can get this critical information in order to make their decision on the proposed transaction. What types of information are frequently alleged to be materially omitted such that a stockholder cannot possibly make an informed decision without those critical facts?

- Deal Process: Plaintiffs commonly allege that disclosures fail to include information concerning whether or not a board took a particular action or discussed a particular strategy. "A plaintiff does not state a disclosure claim by asking whether or not something happened. Omitting a statement that the board *did not* do something is not material, because requiring disclosure of every material event that occurred *and* every decision not to pursue another option would make proxy statements so voluminous that they would be practically useless."[7] (E.g., the company did not disclose why the board did not consider re-engaging with bidder Company X after receiving the five preliminary indications of interest.)[8]

[5] *In re Compellent Techs., Inc. S'holder Litig.*, No. 6084-VCL, 2011 WL 6382523, at *26 (Del. Ch. Dec. 9, 2011), citing *In re Sauer-Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1136 (Del. Ch. 2011); *see also In re Transatlantic Holdings Inc. S'holders Litig.*, No. 6574-CS, 2013 WL 1191738, at *1 (Del. Ch. Mar. 8, 2013) (rejecting a disclosure-only settlement, finding that the plaintiffs failed to show that the disclosures were material to the Transatlantic stockholders, including how the additional disclosures "were in any meaningful way of utility to someone voting on the merger"); *see also In re PAETEC Holding Corp. S'holders Litig.*, No. 6761-VCG, 2013 WL 1110811, at *6 (Del. Ch. Mar. 19, 2013) (noting that the need for close judicial scrutiny in the approval of a settlement notwithstanding an uncontested fee request, is "especially true" where there is a disclosure-only settlement as there is a risk that "both the plaintiffs and the defendants have agreed to trivial disclosures as the path of least resistance to a desired end: for the defendants, the release of claims without significant cost, and for plaintiffs, access to fees and costs").

[6] *In re Sauer-Danfoss Inc. S'holder Litig.*, 65 A.3d at 1135-41.

[7] *Id*. at 1132 (internal quotation marks omitted).

[8] For example, in *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 735 (Del Ch. 1999), plaintiffs' complaint posed 10 questions related to *why* the director defendants failed to do things, such as: canvass the market, prevent a certain transaction, and consider a piecemeal sale of the company's assets. Plaintiffs contended that the failure to describe *why* the board chose not to take particular courses of action constituted a breach of the duty

- Fairness Analysis and Projections: Plaintiffs often take issue with the financial advisor's fairness opinion and disclosures concerning why a particular valuation methodology was or was not used, or for more details about that analysis. Delaware courts have consistently stated that "[a]sking 'why' does not state a meritorious disclosure claim" and "[a] quibble with the substance of a banker's opinion does not constitute a disclosure claim."[9] Similarly, where projected financial information is disclosed by the issuer, plaintiffs complain that certain line items or other assumptions underlying the free cash flows should have been disclosed as well, or earlier versions of projections, or alternate sensitivity cases of the projections with varied assumptions.[10] (E.g., the company did not disclose why the bankers failed to use common methodology X when determining the range of discount rates to apply to the unlevered free cash flows in the discounted cash flow analysis.)[11]

- Conflicts of Interest: Plaintiffs frequently allege that directors or financial advisors had other interests that created a conflict in the hope that their complaint will survive scrutiny. As a corollary to that "defective process" claim, plaintiffs also allege that the disclosures are not materially complete as to all the facts surrounding those purported conflicts.[12] (E.g., the company did not disclose why director X was not selected for the special committee.)

Allegations of material omissions involving conflict of interest, financial projections, and the assumptions and analyses underlying financial advisors' fairness opinions continue to receive the most traction in recent cases, whereas other disclosure omissions have been found immaterial, contributing little relevant additional information to shareholders. Whether this trend will deter meritless cases remains to be seen, but an understanding of these cases is necessary to anticipate evolving disclosure objections and avoid injunctive risk. This article summarizes the common allegations of material disclosure omissions, and, to aid in drafting disclosures and defending alleged claims of omissions, examines the recent parsing of when enough is enough.

The Inevitable, Immediate Challenge

Immediately – sometimes within the hour – after a company announces a proposed merger, plaintiffs' firms issue press releases and posts on various news and investor forums indicating that they are investigating potential breaches of fiduciary duties in connection with the transaction. Complaints are filed within a matter of days in the rush to the courthouse, often with only the press release and merger agreement available for review by stockholders.

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of disclosure. *Id*. The court rejected this argument, explaining that "requiring disclosure of every material event that occurred *and* every decision not to pursue another option would make proxy statements so voluminous that they would be practically useless." *Id*.

[9] *Sauer-Danfoss*, 65 A.3d at 1131, 1133 (internal quotation marks omitted); *see also In re Micromet, Inc. S'holders Litig.*, No. 7197-VCP, 2012 WL 681785, at *13 (Del. Ch. Feb. 29, 2012) ("Under Delaware law, 'a complaint about the accuracy or methodology of a financial advisor's report is not a disclosure claim.'") (internal citation omitted).

[10] The law "rejects the proposition that disclosure of the detailed facts and specific analyses underlying a financial advisor's valuation methodology is automatically mandated in all circumstances." *In re Dataproducts Corp. S'holders Litig.,* No. 11164, 1991 WL 165301, at *8 (Del. Ch. Aug. 22, 1991).

[11] *In re Genentech, Inc. S'holders Litig.*, No. 11377, 1990 WL 78829, at *9 (Del. Ch. June 6, 1990) (denying plaintiffs' request for disclosure of sales and revenue projections for each individual drug in the corporation's pipeline, because such disclosure would not have affected the "total mix of information presently before the shareholders[,]" and because "[s]uch information is of no use unless it has been combined and then properly discounted. This has been done, and disclosed, in the form of the long range projections. In addition, while such disclosures might be of marginal benefit, they are more likely to cause a great deal of harm due to their highly speculative and uncertain nature. To minimize such potential harm, the figures sought by plaintiffs would necessarily have to be qualified so heavily that their already marginal value would decrease. Genentech should not be forced to make such disclosures.") (citation omitted).

[12] In *TriQuint*, plaintiffs alleged disclosure violations regarding potential management conflicts of interest. The court noted that the board's supplemental proxy disclosures included additional information on this point, including conversations regarding management retention and board composition. Accordingly, the court found that plaintiffs failed to submit a colorable argument "that additional information beyond this and related supplemental disclosures would alter the total mix of information available to TriQuint shareholders in considering the merits of the proposed merger." *In re TriQuint Semiconductor, Inc. S'holders Litig.*, No. 9451-VCN, 2014 WL 2700964, at *5 (Del. Ch. June 13, 2014).

These complaints allege breaches of fiduciary duty against the board of directors, and generally, claims against the target company, as well as the acquiror for aiding and abetting these alleged breaches. Notwithstanding that the issuer has not yet disclosed its description of the process, plaintiffs inevitably allege that the disclosures are deficient. Although these complaints give multiple ways that the directors were allegedly derelict in their duties relating to the disclosures (often encompassing both duty of care and duty of loyalty), these "placeholder" complaints often precede any disclosure of the board's process, the target's financial projections, or the fairness opinion and analyses of the financial advisor, which are disclosed in the relevant SEC filings.

After the company files its preliminary proxy statement or tender offer recommendation statement, the class action complaints are then amended to include far more detailed allegations of the alleged omissions. Essentially, following this pattern of "the board disclosed it did X but did not disclose whether or why it did or didn't do Y," the amended complaints quote extensively from the company's lengthy disclosures and demand allegedly "crucial" details underlying the disclosed process, financial statement projections, and financial advisor's fairness analysis.

Analyzing Materiality of Alleged Omissions

Although certain false or misleading statements are alleged to violate Section 14 of the Securities Exchange Act of 1934, the overwhelming majority of these cases allege a breach of fiduciary duty rather than claims under the federal securities laws. There are no hard and fast rules about the information that must be disclosed in order to protect a company from shareholder litigation; materiality is a facts-and-circumstances test rather than a bright-line rule. Under Delaware law, to state a claim for breach of fiduciary duty based on material omissions, plaintiffs must (i) allege that specific facts are missing from the disclosures; (ii) identify those facts; (iii) state why the alleged omissions are material; and (iv) how the omission caused plaintiffs' injury.[13] Moreover, if plaintiffs seek a preliminary injunction to compel additional disclosures about the transaction, they must demonstrate: "(i) likelihood of *irreparable* harm to the plaintiffs in the absence of an injunction; (ii) the likelihood of *plaintiffs' success* on the merits of the underlying claim; (iii) a *balance of the harms* plaintiffs would suffer in the absence of an injunction against the harms defendant would suffer by the issuance of the injunction; and (iv) the *public interest*."[14]

The critical inquiry by the court is materiality. Similar to the federal securities laws, "[o]mitted facts are not material simply because they might be helpful[,]"[15] and, given the heft of most proxy statements and tender offer disclosures, directors are not required to disclose "speculative information which would tend to confuse stockholders or inundate them with an overload of information."[16] "[T]o establish the materiality of an omitted fact, a plaintiff must show a substantial likelihood that the omitted facts would have assumed actual significance in the deliberations of a reasonable stockholder because, if disclosed, those facts would have significantly altered the total mix of information available to the stockholders."[17]

Courts will also analyze the materiality of a disclosure for the purpose of valuing a supplemental disclosure made as part of a settlement. For example, in *Sauer-Danfoss*, the plaintiff made numerous claims regarding deficient disclosures in a Schedule 14D-9 relating to projections and the financial advisor's analysis. The underlying transaction was ultimately abandoned, but only after the defendants supplemented their Schedule 14D-9 to add the additional sought-after disclosure. Plaintiffs' counsel sought fees and expenses of approximately $750,000 based on the disclosure claims mooted by the amended schedules. The Court of Chancery awarded $75,000, finding that only one of the 12 mooted disclosure claims would have supported a material omission. The court explained that "[a]ll supplemental disclosures are not equal," and surveyed previous Delaware fee awards to determine the proper fee based on the "quality" of the supplemental disclosures.[18] The court described meaningful disclosures as those related to "previously withheld projections or undisclosed conflicts faced by fiduciaries or their advisors."[19] The court indicated that less material disclosures, such as those related to details of

[13] *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1173 (Del. 2000).

[14] *In re CheckFree Corp. S'holders Litig.*, No. 3193-CC, 2007 WL 3262188, at *1 (Del. Ch. Nov. 1, 2007).

[15] *Skeen*, 750 A.2d at 1174.

[16] *Wayne County Emps. Ret. Sys. v. Corti*, 954 A.2d 319, 330 (Del. Ch. 2008) (denying preliminary injunction) (citing *Arnold v. Soc'y for Savings Bancorp.*, 650 A.2d 1270, 1280 (Del. 1994)).

[17] *Id.* (internal citation omitted).

[18] *Sauer-Danfoss*, 65 A.3d at 1136.

[19] *Id.*

the negotiation process or details of the discount rates used in a fairness opinion, warranted much lower awards.[20]

Conflicted Bankers

Recent shareholder litigation relating to material omissions has received the most traction when based on conflicts of interest. Undisclosed conflicts of directors and officers, or financial advisors can be material. Although not all alleged conflicts omissions are equal, recent case law highlights the importance of identifying and addressing potential conflicts of interest early in a transaction, and developing a strong process and detailed disclosures as a means of protecting the company from future litigation related to such conflicts.

Del Monte, El Paso, and Rural Metro

The Delaware Court of Chancery has been closely scrutinizing the actions of investment banks in M&A transactions over the past several years and the court has been sharply critical where it perceived conflicts. *Rural Metro*[21] is the most recent in a growing line of cases, including *Del Monte*[22] and *El Paso*[23], in which investment banks have been criticized for alleged conflicts. Underlying these cases is the theory that a bank advising a selling company can have interests that diverge from those of its client, and that a deal process can be tainted when a selling board does not take steps to vet and mitigate those potential conflicts, or when a bank pursues its diverging interests without making appropriate disclosures to the board.

Banker conflicts can arise in multiple ways. When a sell-side bank also seeks to provide buy-side financing for certain bidders, bankers can potentially be conflicted. In *Del Monte*, the court found that the financial advisor's failure to disclose pertinent information to the company's board raised a number of concerns. Specifically, the financial advisor did not disclose to the company's board (i) its preemptive efforts to market the company prior to engagement; (ii) that after the earlier process terminated, it paired up with two private equity firms, in violation of its confidentiality agreements with Del Monte, to prepare an indication of interest; (iii) its desire to provide buy-side financing (in addition to the sell-side fee it would stand to earn); and (iv) that it was the architect of the team bid submitted by the private equity firms to the company in fall 2010. The advisor also sought authorization from the company regarding this buy-side financing only after working with a private equity firm to develop financing.[24]

Without this information, the board, in turn, did not include this relevant information in its proxy statement and the court found that Del Monte's proxy statement initially contained disclosures that were false and misleading. After discovery in the litigation, Del Monte was able to effectively "moot" the pure disclosure claims by issuing a supplement to its proxy, including additional information about the financial advisor's actions. *Del Monte* demonstrates the continued sensitivity of courts to conflicts of interests and disclosure of potential conflicts with respect to financial and other advisors. Ultimately, the court approved an $89.4 million dollar settlement to resolve the claims in this case based on the improper management of the merger, and awarded plaintiffs' counsel fees and expenses in excess of $25 million dollars.[25]

The *El Paso* litigation raised similar concerns and stemmed from a proposed acquisition of El Paso Corporation by Kinder Morgan, Inc. In this case, the banker was on both sides of the transaction due to its ownership of approximately 19 percent of Kinder Morgan stock (worth approximately $4 billion) and control of two board seats at the same time as it was advising the El Paso board on a proposed spin-off of El Paso's oil, natural gas, and exploration business.[26] Unknown to El Paso's board, the lead banker advising El Paso failed to disclose that he personally owned approximately $340,000 of Kinder Morgan stock.[27]

Although El Paso hired a second financial advisor to provide the fairness opinion due to the banker's

[20] *Id*. at 1143; *see also Micromet,* 2012 WL 681785, at *10-11 ("The duty to disclose is not a mandate for prolixity. Instead, balanced against the requirement of complete disclosure is the pragmatic consideration that creating a lenient standard for materiality poses the risk that the corporation will bury the shareholders in an avalanche of trivial information, a result that is hardly conducive to informed decision-making.") (internal citation omitted).

[21] *In re Rural Metro Corp. Stockholders Litig.*, 88 A.3d 54 (Del. Ch. 2014).

[22] *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

[23] *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432 (Del. Ch. 2012).

[24] *Del Monte*, 25 A.3d at 833-36.

[25] Transcript of Record at 1, *Del Monte*, No. 6027-VCL (Del. Ch. Dec. 1, 2011).

[26] *El Paso*, 41 A.3d at 434.

[27] *Id*.

perceived conflicts, the court determined that the disclosure of the banker's actual conflicts did not cure underlying process concerns in this case. In particular, the court found it highly problematic that the fairness opinion fee [for the second banker] was also contingent on El Paso selling to Kinder Morgan.[28] Unlike the *Del Monte* case, here, the court concluded that a preliminary injunction was not appropriate because the "stockholders should not be deprived of the chance to decide for themselves about the merger[.]"[29] The court later approved a $110 million dollar settlement of the investor lawsuit to compensate the shareholders for what the court described as a deal "tainted by disloyalty."[30]

Other conflicts have arisen when a bank has simultaneously pursued other deals in the same industry, as was the case in *Rural Metro*. In a 91-page post-trial opinion, Vice Chancellor Laster of the Delaware Court of Chancery found the financial advisor liable for aiding and abetting breaches of fiduciary duties by the board of Rural/Metro Corporation in connection with the company's 2011 sale to an affiliate of Warburg Pincus LLC ("Warburg").[31] The court concluded the proxy statement contained false and misleading information about the banker's incentives by failing to describe: (i) how it used the initiation of the Rural Metro sale process to seek a role in the acquisition financing of a sell-side engagement for another company in the industry; (ii) the banker's receipt of more than $10 million for its part in the second company's acquisition financing; and (iii) the banker's lobbying of Warburg to provide buy-side financing after Warburg delivered its bid and while the banker was developing a fairness opinion.[32]

Disclosure of Potential Conflicts

After *Rural Metro*, investment banks are likely to continue to be increasingly targeted in deal litigation. Boilerplate provisions in engagement letters warning of potential conflicts are likely to be viewed by courts as insufficient to protect investment banks from liability for failure to affirmatively disclose true conflicts to their clients. Moreover, *Rural Metro* serves as a reminder to boards of their disclosure obligations, as the court stressed that "[i]nformation that bears on whether an investment bank faces conflicts of interest is material to stockholders when deciding how to vote on a merger and whether to seek appraisal."[33]

Although it is difficult to determine the precise line at which enough is enough in terms of a seller meeting disclosure obligations, given the current skepticism from courts related to conflicts of interest, directors must inform themselves and meaningfully understand their advisor's role. If the financial advisor agreed in the engagement letter not to participate in any financing absent the board's express consent, the company might disclose that term of their financial advisor's engagement. Delaware courts have required disclosure of circumstances that may affect the amount of weight stockholders assign to an investment bank's fairness opinion, including fee arrangements and whether the banker has done previous work for the buyer. For example, in *Globis Partners*, the court found it satisfactory that the company disclosed that the fees paid to its financial advisor were "customary" and "partially contingent," given that the plaintiff had not alleged that the bank received exorbitant or otherwise improper fees.[34] However, in subsequent cases, the court has required even greater disclosures of fee arrangements. Specifically, in *Atheros*, the court found the board's disclosure to be inadequate when it stated that a "substantial portion" of the banker's fee was contingent. Given that 98 percent of the banker's fee was contingent in this case, the court found that this "exceed[ed] both common practice and common understanding of what constitutes 'substantial,'" and held that the percentage of the contingent fee structure was material to stockholders' decision to support or oppose the transaction.[35]

Similar to fee arrangements, the court has required that a banker's interest in the transaction be disclosed. In *Simonetti*, the court required disclosure of the banker's holdings of notes and warrants of the target company, and the value of these holdings.[36] Two years later, in connection with a transaction between Art Technology Group, Inc. and Oracle Corporation, the court under certain facts required the disclosure of (i) the

[28] *Id*. at 442.

[29] *Id*. at 452.

[30] Transcript of Record, *In re El Paso Corp. S'holder Litig*., No.6949-CS (Del. Ch. Feb. 29, 2012).

[31] *Rural Metro*, 88 A.3d at 99.

[32] *Id*. at 104-07.

[33] *Id*. at 105.

[34] *Globis Partners, L.P. v. Plumtree Software, Inc.*, No. 1577-VCP, 2007 WL 4292024, at *13 (Del. Ch. Nov. 30, 2007).

[35] *In re Atheros Commc'n, Inc. S'holder Litig*., No. 6124-VCN, 2011 WL 864928, at *8 (Del. Ch. Mar. 4, 2011).

[36] *David P. Simonetti Rollover IRA v. Margolis*, No. 3694-VCN, 2008 WL 5048692, *8 (Del. Ch. June 27, 2008).

annual compensation paid to the target's banker by the buyer over the prior four years and (ii) a description of services the banker had performed for the buyer.[37]

While these cases are highly fact-specific and do not purport to outline blanket rules, boards should be cognizant of courts' increasing focus on conflict-of-interest issues when drafting disclosures. Although hard and fast rules regarding the type and extent of information that should be disclosed are limited, boards should consider disclosing information related to (i) the board's work in determining the lack of conflicts with potential bidders; (ii) the historical work that the financial advisor has done for the buyer in the recent past; (iii) a description of these projects; (iv) the amount of fees paid to the advisor by the buyer;[38] (v) the dollar amount of fees paid to the advisor by the target; and (vi) the structure of the fee arrangement for the transaction to avoid potential claims related to non-disclosed conflicts of interest. Given that potential conflicts can arise after a financial advisor is retained, boards should continue to analyze potential conflicts during the course of a transaction to prevent claims that the transaction process was tainted.

Financial Projections

In addition to these conflict-of-interest issues, the disclosure (or non-disclosure) of management's projections underlying bankers' fairness opinions is a frequent claim. While Delaware courts will generally require some meaningful disclosure of financial forecasts if they are critical to the analyses performed by the board or financial advisor, Delaware law has not imposed a bright-line rule requiring disclosure of all projections received by either an advisor in preparing its fairness opinion or a board in approving or rejecting a proposed merger. Rather, a context-specific analysis is required to determine when enough is enough.

In *Netsmart,*[39] the court granted a preliminary injunction halting a merger vote until the board of directors revised certain disclosures in its proxy statement related to financial projections. Specifically, the plaintiffs' successful disclosure claim was based on Netsmart's failure to include the final projections that were used by Netsmart's financial advisor in performing its discounted cash flow analysis as described in the proxy statement.[40] Although the proxy statement included a summary of its financial advisor's valuation analysis, including a set of projections used by the company in its solicitation of interest in acquiring Netsmart and a set of projections provided by the acquiror to potential lenders in an effort to finance the transaction, neither of these projections took into account Netsmart's subsequent acquisition of its largest direct competitor and management's best estimate of the company's future cash flows. Moreover, these were not the projections ultimately used by Netsmart's financial advisor in performing its fairness opinion analysis, and the *Netsmart* court was troubled by the excising of these additional projections.[41]

The defendants argued that the final cash flow projections were not material because they had not been provided to potential purchasers and were too speculative to require disclosure.[42] However, the court held that these projections were material to Netsmart's stockholders and noted that "[o]nce a board broaches a topic in its disclosures, a duty attaches to provide information that is materially complete and unbiased by the omission of material facts."[43] Although the court did

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[37] Transcript of Record at 1, *In re Art Techs. S'holders Litig*., C.A. No. 5955-VCL (Del. Ch. Dec. 21, 2010) ("*ATG*"). FINRA Rule 5150(a)(3) specifically requires financial advisors delivering fairness opinions in connection with a merger to specify all material relationships with each of the merger parties during the previous two years. In *ATG*, the court mandated a four-year period because ATG's financial advisor had also performed work for Oracle for a number of years.

[38] FINRA Rule 5150(a)(3) provides: "If at the time a fairness opinion is issued to the board of directors of a company the member issuing the fairness opinion knows or has reason to know that the fairness opinion will be provided or described to the company's public shareholders, the member must disclose in the fairness opinion . . . any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the member and any party to the transaction that is the subject of the fairness opinion."

[39] *In re Netsmart Techs., Inc. S'holder Litig*., 924 A.2d 171 (Del. Ch. 2007).

[40] *Id*. at 202-204.

[41] *Id*.

[42] *Id*. at 202.

[43] *Id*. at 203; *but see, e.g.*, *CheckFree,* 2007 WL 3262188 at *3 ("Although the *Netsmart* Court did indeed require additional disclosure of certain management projections . . . the proxy in that case affirmatively disclosed an early version of *some* of management's projections. Because management must give materially complete information "[o]nce a board broaches a topic in its disclosures," the Court held that further disclosure was required . . . . Because [the *CheckFree*] plaintiffs have

not enjoin the merger in this case because it did not want to provide grounds for the acquiror to terminate the deal, it mandated that the company disclose the relevant financial projections to its stockholders prior to the vote on the merger and signaled that courts will be carefully scrutinizing the level of disclosure of financial projections in the future.

Courts have identified a number of principles for boards to take into consideration when determining when enough is enough in terms of the disclosure of financial projections. First, the partial or incomplete disclosure of financial projections that fail to offer a clear picture of a corporation's future financial performance may trigger a duty to supplement the proxy with materially complete information. As plaintiffs frequently argue, this issue was initially addressed by the court in *Netsmart* and was reiterated in *Maric Capital* when the court took issue with the fact that the company selectively removed the free cash flow estimates from the projections provided to the company's stockholders.[44]

Second, cases suggest that projections relied upon by the target corporation's financial advisor and board for its analysis of fairness, as well as those shared with bidders, are more likely to be material and thus to require disclosure. For example, in *Maric Capital*, the court found the proxy statement disclosures to be inadequate, in part, because the company had selectively disclosed projections relating to the company's future performance but had excised the free cash flow estimates that had been provided to the company's financial advisor.[45] A month later, in *Steamfitters Local Union 447 v. Walter*, the court reached the opposite conclusion and held that the disclosure of free cash flow projections was unnecessary in that case.[46] The court distinguished *Maric*, explaining that there the free cash flow estimates had been given to (and used by) the financial advisor. Here, however, the company's financial advisor provided its fairness opinion based on projections of the company's net revenue, net income, earnings per share, and EBITDA estimates for five years but had not been provided with cash flow estimates.[47]

Even when a plaintiff demonstrates that certain projections have been shared with a target corporation's financial advisor and board this does not, however, uniformly mean that these projections are material and therefore subject to disclosure. In *Midas*, the court declined to grant the plaintiffs' motion to expedite discovery although plaintiffs argued that the omission of free cash flow projections from the board's recommendation statement, which projections were provided to the financial advisor, were material.[48] The court stated that "there is no per se duty to disclose financial projections furnished to and relied upon by an investment banker."[49] The court distinguished *Netsmart* and *Maric* and explained that "the mere fact that some issue may have proved material in a past case cannot endow that issue with talismanic properties or reduce it to a magic word forever after."[50] The court emphasized that "context matters" for these challenges and explained that in *Midas* the plaintiffs made no allegation that the other disclosures made, which included five-year projections of sales, adjusted EBIT, and EBITA, "[were] insufficient to allow shareholders to decide whether the price being offered for their shares [was] adequate."[51]

Another lesson gleaned from recent cases involving the adequacy of disclosures related to financial projections is that projections that are unreliable or misleading need not be disclosed. This concern often arises in the technology and life sciences industries where companies may be focused on pre-commercial pharmaceutical development or other technological developments that do not lead to immediate cash flow. The court addressed unreliable projections in *Micromet* and was not persuaded that the company's failure to disclose (i) the financial advisor's "sum of the parts"

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footnote continued from previous page…

failed to establish that management's projections constitute material omitted information, they have failed to demonstrate a likelihood of success on the merits of their claim and, therefore, I deny their motion for a preliminary injunction on this ground.").

[44] *Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc.*, 11 A.3d 1175, 1176-77 (Del. Ch. 2010).

[45] *Id*. at 1178.

[46] Transcript of Record at 8-9, *Steamfitters Local Union 447 v. Walter*, No. 5492 (Del. Ch. June 21, 2010).

[47] *Id*.

[48] Transcript of Record at 17, *In re Midas, Inc. S'holders Litig.*, C.A. 7346-VCP (Del. Ch. Apr. 12, 2012) (Transcript).

[49] *Id*.

[50] *Id*. at 18.

[51] *Id*. at 6, 18; *see also* Transcript of Record at 9, *Cox v. Guzy*, C.A. 7529-CS (Del. Ch. June 8, 2012) (denying a motion to expedite where plaintiffs had alleged that the board's recommendation statement improperly omitted the free cash flow line from management's projections, despite including numerous other line items from those projections).

discounted cash flow analysis, which was not relied upon by the financial advisor in providing its fairness opinion and (ii) management's "upside case" projections provided to the company's financial advisor but described as "very optimistic and, in fact, not realistic" was sufficient to show a reasonable probability of success on a breach of fiduciary disclosure claim.[52] The *Micromet* court noted that "not all analyses produced by financial advisors and given to the Board are required to be disclosed under Delaware law" and reiterated that "[i]n Delaware only that information that is material must be disclosed."[53]

The disclosure of unreliable projections was also addressed in *Globis Partners* and *Howard-Anderson* where the court reiterated the principle that boards are not required to disclose unreliable projections. In *Globis Partners*, the plaintiff alleged that the absence of "meaningful projections" of the target corporation's future performance was a material omission.[54] The court rejected this disclosure claim and explained that the plaintiff failed to allege that the target corporation "had reliable projections or any other facts that reasonably would call into question the veracity or adequacy of this aspect of [the] disclosure."[55] In *Howard-Anderson*, the court similarly denied summary judgment as to a disclosure claim when there was conflicting evidence regarding the reliability of the company's 2012 projections, which had been omitted from the proxy statement.[56]

Companies should, however, take care to reconcile management's projections with the free cash flows used in the financial advisor's discounted cash flow analyses. During an April 19, 2012 American Bar Association Financial Adviser Task Force meeting, Vice Chancellor Laster "suggested that a fair summary of the discounted cash flow analysis should include the financial projections that were used and any key assumptions."[57] Specifically, he advocated for the disclosure of (i) the value attributable to the discrete projection period; (ii) the value attributable to the terminal value; (iii) an explanation of how the terminal value was calculated; (iv) the range of discount rate(s) used; (v) specific disclosure of the cost of debt; (vi) specific disclosure of the cost of equity; (vii) the components used to generate the cost of equity; and (viii) any weightings applied to the various factors. Although a company is not required to "do the math" for the shareholders,[58] Vice Chancellor Laster explained that these details allow shareholders "to 'kick the tires'" of the DCF analysis.[59]

Challenges to Disclosures Underlying Financial Advisor's Analyses

In addition to challenging the projections made and disclosed by company management, plaintiffs also frequently challenge disclosures of the financial advisor's fairness opinions and the valuation analyses underlying these opinions. In general, shareholders are entitled to a "fair summary" of the analyses underlying the fairness opinion, which may include "the basic valuation exercises that the [financial advisors] undertook, the key assumptions that they used in performing them, and the range of values that were thereby generated."[60]

Although companies are required to provide this "fair summary," they do not have to disclose the detailed procedures by which their financial advisors came to their fairness opinions. However, plaintiffs often challenge the sufficiency of the information provided and claim that it is less than the "fair summary" to which they are entitled. For example, in *Globis Partners,*[61] the

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[52] *Micromet*, 2012 WL 681785, at *12-13.

[53] *Id*. at *12; *see also Genentech*, 1990 WL 78829, at *9 (denying plaintiffs' request for disclosure of sales and revenue projections for each individual drug in the corporation's pipeline, because such disclosure would not have affected the "total mix of information presently before the shareholders," and because the "figures sought by plaintiffs would necessarily have to be qualified so heavily that their already marginal value would decrease.") (citation omitted).

[54] *Globis Partners*, 2007 WL 4292024, at *13.

[55] *Id*.

[56] *Chen v. Howard-Anderson*, 87 A.3d 648, 688 (Del. Ch. 2014).

[57] Summary of ABA Financial Advisor Task Force Meeting, April 19, 2012, *available at* http://apps.americanbar.org/dch/committee.cfm?com=CL560045.

[58] As described in more detail in the following section, under the *Pure Resources* standard "stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely." *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421 (Del. Ch. 2002).

[59] Summary of ABA Financial Advisor Task Force Meeting, April 19, 2012, *available at* http://apps.americanbar.org/dch/committee.cfm?com=CL560045.

[60] *In re Pure Res., Inc. S'holder Litig.*, 808 A.2d 421, 449 (Del. Ch. 2002).

[61] *Globis Partners, L.P. v. Plumtree Software, Inc.*, No. 1577-VCP, 2007 WL 4292024 (Del. Ch. Nov. 30, 2007).

plaintiff took issue with the financial advisor's fairness opinion and argued that the company "should have disclosed the discount rate used, the reasons for using different sets of comparable companies in different analyses, and additional details regarding the private companies used in the analyses."[62] The court ultimately determined that enough was enough, explaining that: (i) although the proxy did not disclose the discount rate used, the proxy disclosed the "derivation" of the discount rate; (ii) the justifications for using different companies in different sets of comparable companies were easily inferred from the proxy; and (iii) details about the private companies were unnecessary because plaintiff did not need the ability to "confirm the accuracy of [the] analysis."[63]

Similarly, in *CheckFree*, the court reiterated that "an adequate and fair summary" of the substantive work done to derive the fairness opinion is sufficient. The *CheckFree* plaintiffs alleged that the board breached its duty to disclose by not including management's "raw" financial projections for the company.[64] Plaintiffs argued the financial advisor used these projections in performing a discounted cash flow analysis, which was one of the financial analyses it used in deriving its fairness opinion.[65] The court explained that Delaware law does not require the disclosure of "all financial data needed to make an independent determination of fair value," nor is there a "checklist" of things that must be disclosed relating to a fairness opinion.[66] Accordingly, it held that the proxy statement contained an adequate and fair summary of the work the financial advisor did to come to its fairness opinion when it detailed the various sources the financial advisor relied on in coming to its conclusions, explained some of the assumptions and calculations management made to come to its estimates, noted exactly the comparable transactions and companies the financial advisor used, and described management's estimated earnings and EBITDA for 2007 and 2008, and the range of earnings derived from management estimates for 2009.[67]

Going Forward

An understanding of the most recent cases and the ever-shifting bar regarding the sufficiency of disclosures are necessary to anticipate evolving objections to M&A deals. Plaintiffs' firms look for more creative ways to challenge these transactions and consistently look to the content of the disclosures to support their requests for injunctive relief. They continue to bring suits in jurisdictions with less experience with Delaware law. Latching on to cases where a particular omission was found to be material, plaintiffs seek to stretch a category of disclosure to extend to new facts where the total mix of information would not support the materiality of the omission. Statistically, regardless of the quality of disclosures or the compliance with law and regulations, the disclosures will be attacked. There are not many bright lines when contemplating whether additional disclosure is required. Do not hesitate to say that enough is enough. ■

[62] *Globis Partners*, 2007 WL 4292024, at *12.

[63] *Id*. at *12-13.

[64] *CheckFree,* 2007 WL 3262188, at *2.

[65] *Id*.

[66] *Id*. at *2-3.

[67] *Id*.

CLE QUESTIONS on Birnbach/Mordecai, *Disclosure Hot Topics in M&A Litigation.* Please circle the correct answer to each of the questions below. If at least four questions are answered correctly, there is one credit for New York lawyers (nontransitional) for this article. Complete the affirmation and evaluation and return it by fax to RSCR-CLE, 212-876-3441, or by e-mail attachment to rscrpub@att.net. The cost is $40, which will be billed to your firm. To request financial aid, contact us by e-mail or fax, as provided above.

1. In one recent case (the Sauer-Danfoss Shareholder Litigation), the court found that the directors should have disclosed why the board did not consider re-engaging with company X after receiving five preliminary indications of interest. **True** **False**

2. In another, older case (the Genentech Shareholder Litigation), the court denied plaintiffs' request for disclosure of sales and revenue projections for each individual drug in the company's pipeline. **True** **False**

3. In the *Del Monte* case, the court held that the company's financial advisor failed to disclose to the board its activity in seeking to provide buy-side financing for the acquisition, and the company's proxy statement, which did not include this information, was false and misleading.
True **False**

4. In the *Netsmart* case, the court found proxy disclosures were deficient because the projections did not take into account Netsmart's acquisition of its largest direct competitor and management's best estimate of the company's future cash flows. **True** **False**

5. In the *Micromet* case, the court held that the proxy disclosures were deficient for failing to include the financial advisor's "sum of the parts" discounted cash flow analysis and management's "upside case" projections provided to the advisor. **True** **False**

A F F I R M A T I O N

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