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The Dynamics of Disclosure Claims Relating to Projections and the Financial Analyses Performed by a Company's Financial Advisors

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The Duty of Disclosure

Directors' Duty of Disclosure

- "Directors of Delaware corporations are under a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992).
- "Directors must disclose all material facts within their control that a reasonable stockholder would consider important in deciding how to respond to the pending transaction." *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170 (Del. 2000).

The Definition of Material

The Definition of "Material"

- "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *Shell Petroleum, Inc. v. Smith*, 606 A.2d 112 (Del. 1992). *See also Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 143 (Del. 1997) and *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (quoting *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)).

Materiality Claims

Materiality Claims

- In order to be actionable, a Court must conclude that:
  - there is a substantial likelihood that a reasonable stockholder would consider the omitted facts important in deciding how to vote; and
  - there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the total mix of information made available.
- "Omitted facts are not material simply because they might be helpful [in determining whether to pursue appraisal]. To be actionable, there must be a substantial likelihood that the undisclosed information would significantly alter the total mix of information already provided." *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170 (Del. 2000).

The Meaning of "Significantly Alter The Total Mix of Information"

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- Plaintiffs must allege facts suggesting that the omitted information is inconsistent with, or otherwise significantly differs from, the disclosed information. "The complaint alleges no facts suggesting that the undisclosed information is inconsistent with, or otherwise significantly differs from, the disclosed information. Appellants merely allege that the added information would be helpful in valuing the company." *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170 (Del. 2000).

Are Projections Required to be Disclosed?

- **Traditional/Skeen Approach: Projections are Not per se Material.**
  - ***Skeen* (Del. 2000)** – the Delaware Supreme Court considered and rejected a claim that the Board breached its fiduciary duties by failing to disclose management's projections. "Appellants are advocating a new disclosure standard in cases where appraisal is an option. They suggest that stockholders should be given all the financial data they would need if they were making an independent determination of fair value. Appellants offer no authority for their position and we see no reason to depart from our traditional standard. . . . [plaintiffs] say, in essence, that the settled law governing disclosure requirements for mergers does not apply, and that far more valuation data must be disclosed where, as here, the merger decision has been made and the only decision for the minority is whether to seek appraisal. We hold that there is no different standard for appraisal decisions." *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1174 (Del. 2000).
  - ***In re Best Lock* (C Chandler 2001)** – "[P]laintiffs assert that the financial projections provided to Piper were improperly omitted from the Information Statement. . . . Delaware courts have held repeatedly that a board need not disclose specific details of the analysis underlying a financial advisor's opinion. Moreover, even if such facts were required to be disclosed, this information would not have altered significantly the total mix of information available to shareholders. . . . Accordingly, the motion to dismiss with regard to these claims is granted." *In re Best Lock Corp. S'holder Litig*., 845 A.2d 1057, 1071, 73 (Del. Ch. 2001).

Are Projections Required to be Disclosed?

More Recent/Court of Chancery Approach: A Company's Best estimates of its Future Financial Performance are *per se* Material and are Required to be Disclosed.

- ***Netsmart* (VC Strine 2007)** – "It would therefore seem to be a genuinely foolish (and arguably unprincipled and unfair) inconsistency to hold that the best estimate of the company's future returns, as generated by management and the Special Committee's investment bank, need not be disclosed when stockholders are being advised to cash out. . . . Indeed, projections of this sort are probably among the most highly prized disclosures by investors. Investors can come up with their own estimates of discount rates or (as already discussed) market multiples. What they cannot hope to replicate are management's inside view of the company's prospects." *In re Netsmart Techs., Inc. S'holders Litig*. 924 A.2d 171, 203 (Del. Ch. 2007).
- ***Maric* (VC Strine 2010)** – "[I]n my view, management's best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information." *Maric Capital Masterfund, Ltd. v. Plato Learning, Inc.,* 11 A.3d 1175, 1178 (Del. Ch. 2010).
  - *But see* ***Transatlantic (C Strine 2011)***. "**THE COURT:** "… I'm just saying the cases – I'm like Mr. Projections. The banks don't like me. They don't like me. But here, you've got a range, and you've got the discount rate in the range. It's actually good. I mean, people could vote no if they really believe this and vote no on it. It's not affected – if you saw a discount range of 17.7 to 24 percent, I mean, do we really have more than this? Or is it just you know you've got Strine, and he's Mr. Projection, and so we put that in here?" **MR. NOTIS:** "On that point, on the Moelis, we don't draw a distinction between coming up with a range above the deal price or below the deal price to deviate from the Court's general preference for projections. And also – "**THE COURT:** "I don't have a general preference for anything." *In re Transatlantic Holdings, Inc. S'holders Litig, C.A. Nos. 6574 & 6776 – CS* (C Strine 2011) Hearing Transcript, Aug. 22, 2011.

Other Recent Decisions on Projections

- **Not all recent Court of Chancery decisions have agreed that projections are *per se* material.**
  - ***CheckFree* (C Chandler 2007)** – "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 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." *In re CheckFree Corp. S'holders Litig.*, No. 3193-CC, 2007 WL 3262188 at *3 (Del. Ch. Nov. 1, 2007). *See also Globis Partners, L.P. v. Plumtree Software, Inc.*, 1577-VCP 2007 WL 4292024 (Del. Ch., Nov. 30, 2007).

Likelihood of Appeal

Likelihood of Appeal

- Disclosure based injunctions are rarely appealed as it is often much simpler and cheaper for transaction participants to disclose management's internal financial projections and require their financial advisors to agree to additional disclosure regarding their financial analyses if that is what is required to avoid an injunction or get an injunction lifted.
- Buyers are likely to encourage settlements that merely require additional disclosure regarding projections or details of the financial analyses underlying fairness opinions.
  - No cost to the transaction participants as a result of a disclosure based settlement other than relatively predictable levels of plaintiffs' attorneys' fees. *See* the appendices to *In re Sauer-Danfoss S'holders Litig.*, No. 5162-VCL; 2011 WL 2519210 at *14-15 (Del. Ch. Apr. 29, 2011) which indicate the ranges of attorneys' fees for disclosures of questionable quality ($75,00 to $225,000); one or two meaningful disclosures ($300,000 to $550,000); and exceptional or significant additional disclosures ($800,000 to $1,200,000).

Are Free Cash Flows Required to be Disclosed?

Are Projected Free Cash Flows Required to be Disclosed?

- ***Maric*** **(VC Strine 2010)** – "[I]n my view, management's best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information." *Maria Capital Masterfund, Ltd. v. Plato Learning, Inc.,* 11 A.3d 1175, 1178 (Del. Ch. 2010).
- ***But see Steamfitters*** **(C Chandler 2010)** – "But this isn't a case where free cash flow estimates were deliberately removed or excised from a proxy disclosure. Unlike in *Maric*, in this case no free cash flow estimates were actually provided to Goldman Sachs. The internal analyses that were approved by management for Goldman's use in this case didn't have a line item for free cash flow estimates, and so unlike the *Maric* decision, there was no deliberate excising of free cash flow numbers. And in addition, this isn't like *Netsmart*, where management undertook to disclose certain projections but then disclosed projections that were actually stale and not, therefore, meaningful. The proxy here gave management's projections that were actually used by Goldman, and those projections included net revenue, net income, EPS and EBITDA estimates for five years. . . . Now, having said all of that, and with due respect to Mr. Liebesman, who I know disagrees with me -- and I appreciate that, and respect his point of view, and can understand his point of view, frankly. And so I am quite willing, if Mr. Liebesman believes that I have erred and that there are truly reasons why in every case Delaware ought to require -- even if management hasn't produced it to the investment advisor -- that Delaware law ought to require as a per se rule that free cash flow estimates going out into the future be provided, disclosed, I would be, in the interests of clarification of Delaware law, and in the interests of perhaps leading to the creation of a bright-line rule in disclosure, which I think would be a good thing in some ways – I would be happy, Mr. Liebesman, to sign, today, an order certifying an interlocutory appeal to the Delaware Supreme Court on this question. " *Steamfitters Local Union 447 v. Walter*, No. 5492-CC (Del. Ch. June 21, 2010). *[NTD – No appeal was taken by plaintiffs]*

Recent Developments Regarding Cash Flows

- ***Gaines v. Narachi*** **(VC Noble Oct 6, 2011)** – granting plaintiffs motion for reconsideration/reargument. While not ruling on the merits of the claims, the Court found that "[a]lthough the Proxy disclosed the EBIT projections—essentially a precursor to free cash flow-used by Morgan Stanley in its DCF analysis, the Proxy did not disclose the related free cash flow estimates. This Court has stated that shareholders who are being advised to cash out are entitled to the best estimate of the company's future cash flows. While application of this standard has not always resulted in a finding that free cash flows, specifically, must be disclosed, there is a colorable argument that, in this case, free cash flows should be disclosed to meet this standard. Indeed, in Maric this Court enjoined the proposed merger until free cash flow projections were disclosed, despite the fact that the proxy already disclosed projected revenues, EBIT, and a variation of EBITDA. Finally, it should be noted that from the record it is unclear whether AMAG management provided Morgan Stanley with free cash flow projections or if Morgan Stanley derived its free cash flow estimates from the disclosed EBIT projections." *Gaines v. Narachi*, No. 6784-VCN (Del. Ch. October 6, 2011). *[NTD – atypical litigation brought by a stockholder of the Acquiror for whom the proposed merger was not an end-stage transaction.]*

Is a Fair Summary of a Financial Advisor's Financial Analyses Required to be Disclosed?

The Traditional/Supreme Court Approach – The Results of the Financial Analyses Performed by a Company's Financial Advisor are Not *per se* Material.

- ***Skeen* (Del. 2000)** – the Delaware Supreme Court considered and rejected a claim that the Board of House of Fabrics breached its fiduciary duties by failing to disclose a summary of the methodologies used and the ranges of values generated by the financial analyses performed by its financial advisor.
  - "The Information Statement included a copy of the fairness opinion given by House of Fabrics' investment banker, Donaldson, Lufkin & Jenrette (DLJ); the company's audited and unaudited financial statements through January 31, 1998; and House of Fabrics' quarterly market prices and dividends through the year ended January 31, 1998. The complaint alleges that, in addition to this financial information, House of Fabrics' directors should have disclosed: (1) a summary of "the methodologies used and ranges of values generated by DLJ" in reaching its fairness opinion; (2) management's projections of House of Fabrics' anticipated performance from 1998-2003; (3) more current financial statements; and (4) the prices that House of Fabrics discussed for the possible sale of some or all of the company during the year prior to the merger. . . . We agree that a stockholder deciding whether to seek appraisal should be given financial information about the company that will be material to that decision. In this case, however, the basic financial data were disclosed and appellants failed to allege any facts indicating that the omitted information was material."

Is a Fair Summary of a Financial Advisor's Financial Analyses Required to be Disclosed

The More Recent/Court of Chancery Approach - The Financial Analyses are *per se* Material and, Consequently, a Fair Summary of the Financial Analyses is Required to be Disclosed.

- ***Pure Resources*** cited *McMullin v Beran*, as an arguably conflicting decision of the Delaware Supreme Court six months after *Skeen*.
  - "[T]he Delaware courts have been reluctant to require informative, succinct disclosure of investment banker analyses in circumstances in which the bankers' views about value have been cited as justifying the recommendation of the board. But this reluctance has been accompanied by more than occasional acknowledgement of the utility of such information, an acknowledgement that is understandable given the substantial encouragement Delaware case law has given to the deployment of investment bankers by boards of directors addressing mergers and tender offers. These conflicting impulses were manifested recently in two Supreme Court opinions. In one, *Skeen v. Jo-Ann Stores, Inc.*, [750 A.2d 1170] the Court was inclined towards the view that a summary of the bankers' analyses and conclusions was not material to a stockholders' decision whether to seek appraisal. In the other, *McMullin v. Beran*, [765 A.2d 910 (Del. 2000)] the Court implied that information about the analytical work of the board's banker could well be material in analogous circumstances. In my view, it is time that this ambivalence be resolved in favor of a firm statement that 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, 449 (Del. Ch. 2002).

Other Recent Court of Chancery Decisions on the Disclosure of Financial Analyses

See also the following Court of Chancery decisions approvingly citing *Pure Resources:*

- ***Netsmart*** (3/07 - Strine) – "the plaintiffs have failed to persuade me that the Proxy [containing SEC style long form of summary of "the methodologies used and ranges of values generated by the financial analyses performed by Netsmart's financial advisor] does not fairly describe William Blair's work." *NetSmart*, 924 A.2d at 204
- ***CheckFree*** (11/07 - Chandler) – The *In re Pure Resources* Court established the proper frame of analysis of disclosure of financial data in this situation: "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." *CheckFree*, 2007 WL 3262188 at *2.
- ***Plumtree*** (11/07 - Parsons) – "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." [Citing *CheckFree* (quoting *Pure Resources*) and *Netsmart*]. Plumtree, 2007 WL 4292024 at *11, citing CheckFree 2007 WL 3262188 (quoting Pure Res. 808 A.2d at 449) (see also *NetSmart*, 924 A.2d at 204).
- ***Simonetti*** (6/08 – Noble) – "[S]tockholders are entitled to a fair summary of the substantive work performed by the investment bankers." [Citing *Pure Resources*]. *Simonetti*, 2008 WL 5048692 at *9 citing Pure Res. 808 A.2d at 449.

A Federal Court Followed Skeen

- *CTI Molecular Imaging* (E.D. Tenn April 26, 2005) (cont.)

  The Court: "[P]laintiff implicitly argues in its briefs and in oral argument that the Delaware Supreme Court backtracked from the *Skeen* decision it its decision issued six months later, *McMullin*, by allowing a plaintiff to proceed to trial on a disclosure claim related to an investment banker's report. The Court has carefully evaluated both decisions and has carefully considered plaintiff's argument, but the Court finds that the *McMullin* decision did not change the *Skeen* materiality analysis. First of all, the Court in *McMullin* expressly stated, "We adhere to our holding in *Skeen* that minority shareholders need not be given all of the financial data they would need if they were making an independent investment determination of fair value. . . [T]he Court in *McMullin* noted that the facts it faced involving a transaction which was led by a controlling shareholder made it a more compelling case for the application of the recognized disclosure standards. This, not a change in the materiality standard, explains why the *McMullin* court allowed the plaintiff to proceed with its claim . . . while the *Skeen* court did not. Using the standards set out in *Skeen*, the Court therefore finds that the plaintiff here has not shown any indication the investment banker's report would be inconsistent with or otherwise significantly different from the volumes of information defendants have disclosed regarding the transaction."

What Level of Detail is Required for a Fair Summary of a Financial Advisor's Financial Analyses?

- ***In re Best Lock*** – "Delaware courts have held repeatedly that a board need not disclose specific details of the analysis regarding a financial advisor's opinion. Thus, defendants need not have disclosed the basis for applying a control premium of 15%." *In re Best Lock S'holder Litig.*, No. 16281-CC 485 A.2d 1057 (Del. Ch. 2001).
- ***Globis v. Plumtree*** – "Plaintiff notes the discount rate used in the Present Value of Future Share Price Analysis was not disclosed, arguing it was "especially important because Jefferies had failed to perform a discounted cash flow analysis of the transaction. . . . The Merger Proxy states that Jefferies' summary of the Present Value of Future Share Price included as part of its calculation a "discount" based on the Capital Asset Pricing Model using the median capital-structure adjusted beta for the public company comparables". . . Globis has not alleged sufficient facts to support a reasonable inference that the omission of the discount rate was material enough to alter the total mix of information presented to the shareholders. Globis makes no argument for why the omission of the exact rate, when its derivation was disclosed, alters the total mix of information. The omission of a discount rate in this context does not constitute, per se, a disclosure violation." *Plumtree*, 2007 WL 4292024 at #12-13, internal annotations omitted).
- ***But see Steinhardt (aka Occam)*** – "The second issue that wasn't discussed this morning, but I think it's another pretty clean partial disclosure, is the accretion/dilution analysis. It's an analysis that was in the final book. It's summarized incompletely and partially in the proxy. You need to give the range. You gave the ranges for all the others, but for some reason, on accretion/dilution, you just said accretive or not accretive. So that's an incomplete summary. Stockholders are entitled to a fair summary." *Steinhardt v. Howard-Anderson*, C.A. No. 5878-VCL (Del. Ch. Jan. 24, 2011).

Recent Decisions Regarding the Level of Detail

Compare:

- ***In re Openlane, Inc. S'holders Litig.***, CA No. 6849-VCN (VC Noble Sept. 30, 2011) – In *Openlane* the Delaware Court of Chancery refused to an enjoin a transaction where it was alleged that the merger proxy did not contain a fair summary of the work performed by Openlane's financial advisors because it lacked sufficient detail, including the identity and financial metrics of the underlying transactions. "This level of detail is simply not necessary for the directors to fulfill their duty to provide a "fair summary." The Supplemental Proxy explains the methodology Montgomery employed and the resulting multiples. Providing details of all of the underlying transactions analyzed would likely inundate the reader and dilute the impact of the disclosure; further, these details are more akin to what is needed to make "an independent determination of fair value" than they are to a "fair summary."' (emphasis added); with
- ***Turberg v. Arcsight,*** CA No. 5821 VCL (VC Laster 2011) Hearing Transcript Sept. 20, 2011 – In contrast to *Openlane*, in *Arcsight*, the Delaware Court of Chancery approved a settlement, including an award of $500,000 in plaintiff's attorneys' fees, where the supplemental disclosure obtained by plaintiffs largely consisted of additional disclosure regarding certain observed trading and transaction multiples that were in the discussion materials provided to the board by the company's financial advisor but were omitted from the first draft of the merger proxy filed with the SEC. It appears that the primary differences were the supplemental disclosure of the implied multiples for each of the selected companies and transactions rather than just the selected ranges of multiples applied by the financial advisor based on that analysis as well as the supplemental disclosure of 2010 Revenue and earnings multiples and 2010 and 2011E EBITDA multiples rather than just 2011E Revenue and earnings multiples.
  - *See also* ***Steinhardt v. Howard-Anderson***, C.A. No. 5878-VCL (Del. Ch. Jan. 24, 2011).

Potential Remedies for Inadequate Disclosure
Quasi-Appraisal

- **Quasi-Appraisal**
  - ***Kahn v. Chell (aka Primedia)*** – "I think it's continuing to be somewhat surprising that despite now years of opinions, particularly from Vice Chancellor Strine, explaining that we expect these things to be disclosed, people don't disclose them. . . And so, to the extent that people are consciously or can be inferred to have been consciously leaving things out that are covered by prior decisions, that's something we're going to have to take into account on an ongoing basis; not just me, but obviously my colleagues. . . . If folks are deprived of their ability to make a valid appraisal election because of a lack of material information, then Berger versus Pubco provides a remedy and that remedy is a classwide quasi-appraisal proceeding. If it turns out that disclosures were not made in areas where Delaware law says they should be made and it was done essentially in bad faith or where bad faith could be inferred, I would think part of the remedy in that Berger-style proceeding would be rescissory damages on a classwide basis. So I am confident that if indeed this deal closes and the plaintiffs are right about the lack of disclosure, that there is some type of classwide remedy that can be administered postclosing and therefore there's no need to schedule an injunction." *Kahn v. Chell*, CA No. 6511-VCL (VC Laster 2011) Hearing Transcript June 7, 2011.

Potential Remedies for Inadequate Disclosure
Significantly Higher Attorney's Fees

Significantly Higher Attorney's Fees

In ***Turberg***, despite finding that that:

> "[plaintiff's counsel] didn't do very much. You really didn't. You got sort of standard-ish documents, 2,300 pages. You didn't take any pre-MOU depositions and you got supplementations. . . . there wasn't much done here and folks ultimately got a package . . . of disclosures, some of which are nice, none of which are earth shattering, some of which are – I'll just use the word unimpressive,"

the Court approved a settlement, including an award of $500,000 in plaintiff's attorneys' fees, and considered the alternative of awarding millions of dollars in attorney's fees for obtaining such disclosure:

> "The other alternative, I guess, would be really to be generous with [plaintiff's counsel] and to start saying, "look, you get this type of information on bankers? We're talking millions." And then if the issuer and the acquiror start thinking, "So, my goodness, we're going to have to pay millions for this," maybe they'll get their bankers to put it in in the first instance." *Turberg v. Arcsight,* CA No. 5821 VCL (VC Laster 2011) Hearing Transcript Sept. 20, 2011.