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Financial Projection Disclosure Requirements in M&A Deals: Preparing, Using and Disclosing Projections

Minimizing Stockholder Claims for Breach of Fiduciary Duty Due to Inadequate or Misleading Disclosures

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Financial Projection Disclosure Requirements in M&A Deals: Preparing, Using and Disclosing Projections

Minimizing Stockholder Claims for Breach
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Misleading Disclosures

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July 20, 2016

Overview

- I. Introduction
- II. Preparation and Review
- III. Delaware Case Law
- IV. Regulatory Review
- V. Practical Considerations for Board

I. Introduction

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- The Board's responsibility for financial projections:
 - A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be **fully protected in relying in good faith** upon the records of the corporation and **upon such information, opinions, reports or statements** presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member **reasonably believes** are within such other person's **professional or expert competence** and who has been selected with **reasonable care** by or on behalf of the corporation. (DGCL § 141(e))

I. Introduction

- Financial projections are required to reflect management's best estimate of the future performance of the business
- Financial advisors will rely on the projections as the basis for their fairness opinion
 - Example of common fairness opinion language: “With respect to the Company Forecasts, we have been advised by the Board, and have assumed, that they have been reasonably prepared on bases reflecting the best currently available estimates and good faith judgments of the management of the Company as to the future financial performance of the Company”
- Boards are expected to do more than just accept management's projections at face value

I. Introduction

- Two key factors that weigh heavily on the transaction process:
 - Potential litigation
 - Shareholders will often claim either: (1) defect in the sale process; or (2) disclosure is inadequate or misleading
 - Typical settlements include supplemental disclosure, payment of plaintiffs' legal expenses and, in some cases, modest modifications to the deal protections
 - As will be discussed, the legal landscape around disclosure only settlements is rapidly changing
 - SEC review of transaction-related disclosure filings
- These two factors can create unnecessary delays between signing and closing, which in turn can threaten a transaction's completion

II. Preparation and Review

II. Preparation and Review

- **Key Considerations:**
 - Who is responsible for the initial preparation of the forecasts?
 - Management Role
 - Financial Advisor Role
 - Board Role
 - Company Counsel Role
 - What are the implications of using multiple sets of forecasts?

II. Preparation and Review: Initial Preparation

Continued

- There are no set rules on how many years out projections should run
 - While often projections will cover the next 3 to 5 years, some business in unique markets or at particular points in the life cycle of the company simply will not be able to produce more than a year's worth of reasonably reliable projections
 - Although projections spanning only a one year period will likely preclude a reliable DCF valuation, courts have still found boards justified in relying on fairness opinions based on analyses that are “sensibly crafted given the limited universe of information available and the unique characteristics of the Company.” *See e.g., In re Answers Corp. S’holders Litig.*, C.A. No. 6170-VCN, 2011 WL 1366780 (Del. Ch. April 11, 2011)

II. Preparation and Review: Multiple Sets of Projections

- Not uncommon to have multiple sets of projections (e.g. base, upside and downside)
- Multiple sets of projections can help in understanding the sensitivity of the company's future performance to one or more factors (e.g. performance of a certain product line, change in a material relationship, etc.)

II. Preparation and Review: Multiple Sets of Projections

Continued

- Each set of projections is not *per se* material and subject to disclosure
 - Courts recognize that where there are multiple sets of projections, some of those projections may be overly optimistic “what-ifs”
 - See *In re Micromet, Inc. S’holders Litig.*, C.A. No. 7197-VCP, 2012 WL 681785 (Del. Ch. Feb. 29, 2012)
 - The law of disclosure should not deter aggressive negotiations by requiring the disclosure of valuations intended solely as sales pitches, and not as responsible estimates of a company’s value. Delaware case law reflects this concern and has refused to require the disclosure of bargaining ‘puff pieces.’”
 - See *In re Pennaco Energy, Inc.*, 787 A.2d 691, 713 (Del. Ch. 2001)

II. Preparation and Review: Multiple Sets of Projections

Continued

- If a set of projections are not relied on by the board or the financial advisors, they are often excludable
 - See *David P. Simonetti Rollover IRA v. Margolis*, C.A. No. 3694-VCN, 2008 WL 5048692 (Del. Ch. June 27, 2008); *Frank v. Elgamal et. al.*, 2014 WL 957550, at *34 (Del. Ch. Mar. 10, 2014)

II. Preparation and Review: Multiple Sets of Projections

Continued

- Updated projections can be a source of shareholder litigation
 - After marketing “puff pieces” to buyers in hopes of maximizing the merger price, boards may get pressure from financial advisors to come up with a set of more “realistic” or more conservative estimates of the company’s future performance on which the financial advisors can base their fairness opinions
 - Shareholders may argue that the downward adjustments don’t represent a more accurate set of projections, but rather evidence illegitimate action by directors to ensure that they are able to get the protection of a fairness opinion or to support self-interested elements of the merger on more favorable terms (e.g. the rollover of management interests into the combined company)
 - See *In re Appraisal of Ancestry.com, Inc.*, C.A. No. 8173-VCG, 2015 WL 399726 (Del. Ch. Jan. 30, 2015))

II. Preparation and Review: Multiple Sets of Projections

Continued

- Boards need to have well documented, objective reasons for downward adjustments to projections
- Boards should give careful consideration to whether or not they need to disclose the existence of the original projections

II. Preparation and Review: Multiple Sets of Projections

Continued

- Decisions involving undisclosed sets of projections are generally decided in favor of boards that:
 - Demonstrate that all projections that factored into the board's consideration have been disclosed;
 - Demonstrate that the board made a reasonable inquiry into the basis and/or methodology underlying the projections;
 - Were able to articulate why certain projections were used and disclosed; and
 - Update the proxy statement to include additional numbers relied on by the board or the financial advisors

II. Preparation and Review: Review & Reliance

- Neither Delaware courts nor the SEC have found that the review or receipt of projections by the board or financial advisors renders them *per se* material for purposes of disclosure
- Delaware will usually require some meaningful disclosure of financial forecasts in the context of the sale of a company, but there is no bright-line rule on what is required
- SEC frequently asks that projections be disclosed if the projections were shared with certain parties (e.g. buyers or financial advisors)

III. Delaware Case Law

III. Delaware Case Law

- There is no Delaware mandate to disclose financial projections in public filings
- Release of the projections is generally intended to fulfill the duty to disclose all “material” information within the board’s control
- The question becomes, “What is material?”

III. Delaware Case Law: Fair Summary

- Delaware courts generally require a fair summary of the financial advisor's substantive work, which includes:
 - Description of valuation analyses performed;
 - Key assumptions underlying those analyses; and
 - Report the resulting range in values

See *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421 (Del. Ch. 2002)

III. Delaware Case Law: Fair Summary

Continued

- Management projections are not necessarily required to be disclosed under the “fair summary” standard
 - For example, if deemed unreliable, stale or not used in the financial advisor’s opinion, may not need to disclose
- As long as there is an accurate summary of the financial advisor’s methodology and key assumptions, a company need not disclose every input required to recreate the financial advisor’s analyses
 - See *In re Trulia, Inc. S’holder Litig.*, 2016 WL 325008, at *12 (Del. Ch. Jan. 22, 2016)

III. Delaware Case Law: Free Cash Flows

- Free cash flows represent the amount of cash that a company has left from its operations to pursue opportunities that enhance shareholder value, (e.g. developing new products, paying dividends to investors, etc.)
- Free cash flows are fundamental to a DCF analysis:
 - The value of a company derived in a DCF analysis is based on the sum of the value of the future free cash flows of the company discounted to present day
 - Free cash flows, or a close proxy of the free cash flows, are necessary to evaluate whether management has taken an overly optimistic or pessimistic view of the future operating outcomes of the company
 - This has led plaintiffs to argue that the free cash flows are per se material and therefore subject to disclosure

III. Delaware Case Law: Free Cash Flows

Continued

- Delaware courts suggest that if a DCF is used as a basis for the fairness opinion, disclosure of the free cash flows will often, but not always, be required
 - “Delaware law does not require disclosure of all the data underlying a fairness opinion such that a shareholder can make an independent determination of value.”
 - *Globis P’rs, L.P. v. Plumtree Software, Inc.*, 2007 WL 4292024, at *12--13 (Del. Ch. Nov. 30, 2007)
 - “. . . I do not find that our case law supports the proposition that unlevered free cash flows must always be disclosed as a general rule. . . .”
 - *See In re Midas, Inc. S’holders Litig.*, CA 7346-VCP (Del. Ch. April 12, 2012) (Transcript)

III. Delaware Case Law: Free Cash Flows

Continued

- In contrast:
 - “. . . [W]hen a banker’s endorsement of the fairness of a transaction is touted to shareholders, the valuation methods used to arrive at that opinion as well as the key inputs and range of ultimate values generated by those analyses must also be fairly disclosed.”
 - *In re Netsmart Techs., Inc. S’holders Litig.*, 924 A.2d 171, 203-04 (Del. Ch. 2007)
 - “[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)

III. Delaware Case Law: Free Cash Flows

Continued

- Chancellor Strine has held that free cash flow forecasts are not required to be disclosed where:
 - Other forecasts were publicly disclosed;
 - The target's indebtedness was negligible; and
 - EBITDA could be calculated based on the publicly disclosed forecasts, in light of the fact that EBITDA is “essentially a very close proxy to free cash flows”
- Under these circumstances “adding the free cash flow into the mix would [not] materially change the mix of information available to stockholders.”
 - See *Cox v. Guzy*, C.A. 7529-CS (Del. Ch. June 8, 2012) (Transcript)

III. Delaware Case Law: Free Cash Flows

Continued

- “Our case law provides that, where the bankers derive unlevered, after-tax free cash flows rather than relying on management projections, the inputs on which they rely are not per se subject to disclosure. As this Court has previously noted, ‘a disclosure that does not include all financial data needed to make an independent determination of fair value is not per se misleading or omitting a material fact. The fact that the financial advisors may have considered certain non-disclosed information does not alter this analysis.’”
 - *Nguyen v. Barrett*, CA No. 11511-VCG, 2015 WL 5882709 at *4 (Del. Ch. Oct. 8, 2015) (quoting *In re Checkfree Corp. S’holders Litig.*, 2007 WL 3262188, at *2 (Del. Ch. Oct. 18, 2007))

III. Delaware Case Law: Free Cash Flows

Continued

- “[U]nlike a situation where the board provides free cash flow projections to its financial advisor, where the advisor derived the projections on its own, those projections do not have to be disclosed. To me, this is consistent with the principle that the board need not disclose every piece of information used by its financial advisor, such that an investor could conduct its own fair value analysis using that same data.”
 - *In re SeraCare Life Sciences*, CA No. 7250-VCG (Del. Ch. March 20, 2012) (Transcript)

III. Delaware Case Law: Transaction Structure

- In a stock-for-stock transaction, Delaware courts may require the disclosure of both target's and buyer's projections
 - Target's shareholders need buyer's projections so that they can fully understand the relationship between the stock they are giving up versus what the stock they are receiving in the transaction
 - See *In re S1 Corp. S'holders Litig.*, Consolidated C.A. No. 6771-VCP (Del. Ch. Aug. 19, 2011)
 - Buyer's shareholders need buyer's projections so that they can fully understand the dilutive effect of any share issuance required to execute the transaction on their portion of the buyer's free cash flows
 - See *Gaines v. Narachi*, C.A. No. 6784-VCN, 2011 WL 4822551 (Del. Ch. Oct. 2011)

III. Delaware Case Law: Mitigating Factors

- Delaware courts are less likely to require extensive disclosure of projections where:
 - The buyer offered a large premium over alternative bids;
 - The buyer was the only offer (i.e. no competing bids); or
 - The company operated in an unfamiliar or atypical industry (i.e. limited operational history or few comparable companies)

III. Delaware Case Law: Litigation Settlements

- The legal landscape around disclosure only settlements is rapidly changing
- In the past, the majority of disclosure related litigation ended in some modest supplemental disclosure and legal expenses for plaintiffs and a broad release of plaintiffs' transaction related claims for defendants
- Increasingly Delaware judges have stated that these settlements will not be rubber stamped through the system
- Parties to disclosure settlements will need to show that the additional disclosure has real value such that it justifies the release of potential future claims, and the release needs to be circumscribed commensurate with the benefits provided to the class

III. Delaware Case Law: Litigation Settlements

Continued

- Vice Chancellor Laster has stated that “we have reached the point where we have to acknowledge that settling for disclosure only and giving the type of expansive release that has been given has created a real systemic problem.”
 - *In re Aruba Networks, Inc. S’holder Litig.*, C.A. No. 10765-VCL, at 65 (Del. Ch. Oct. 9, 2015) (Transcript)
- He said further that the “repeat-process phenomenon” that has developed with respect to these kinds of cases and settlements has resulted in a “misshapen legal regime” of “harvesting-of-a-fee opportunit[ies].”
 - *Id.* at 70, 73

III. Delaware Case Law: Litigation Settlements

Continued

- Chancellor Bouchard has also stated, “[P]ractitioners should expect that disclosure settlements are likely to be met with continued disfavor in the future unless the supplemental disclosures address a plainly material misrepresentation or omission . . .”
 - *In re Trulia, Inc. S’holder Litig.*, 2016 WL 325008, at *10 (Del. Ch. Jan. 22, 2016)

III. Delaware Case Law: Litigation Settlements

Continued

- The practice of making modest supplemental disclosures in return for a broad release of shareholder claims may no longer be a viable option
- “Mootness” fees

III. Delaware Case Law: Takeaways

- In stock-for-stock transactions, projections for both parties may be subject to disclosure where both sets of projections were used to calculate an exchange ratio or render a fairness opinion
- Disclosure of comparable figures may not be enough (e.g. EBITDA in place of free cash flows)
- Risks of Disclosure
 - Consequence of a successful stockholder action on disclaimer claims could be the issuance of an injunction
 - Over disclosure can also be a problem
 - Additional liability for projections
 - Delaware courts fear that stockholders may become confused or misled when inundated with unnecessary information

IV. Regulatory Review

IV. Regulatory Review: SEC Comments & Requests for Disclosure

- There is no specific regulatory requirement to include projections in SEC filings, but it has become established practice for the SEC staff to ask for their inclusion
- There are a number of general circumstances where the staff will ask for the disclosure of projections

IV. Regulatory Review: SEC Comments & Requests for Disclosure

Continued

- 1. Projections provided to a buyer or its financial advisors**
 - Generally asked for unless the target company explains the immateriality of the target's projections in the initial filing
- 2. Projections provided to the target's financial advisors**
- 3. Going private deals**
- 4. Exchange offers and stock-for-stock mergers**

IV. Regulatory Review: SEC Comments & Requests for Disclosure

Continued

5. Material changes

- The staff may ask whether any material changes have occurred or are anticipated in the target's operations or performance or to the projections or the assumptions on which the target's financial advisor based its opinion

IV. Regulatory Review: Filing Specific Considerations

- **Proxy Statements**
 - Examples of customary language:
 - The projections were not prepared with a view toward public disclosure or compliance with the guidelines of the SEC or the American Institute of Certified Public Accountants.
 - The filer's independent public accountants have not examined nor compiled the projections, and have not expressed an opinion or assurance with respect to the figures.
 - The filer makes no representation that the financial forecasts will be achieved.
 - The projections are inherently forward-looking statements subject to standard risks and uncertainties.

IV. Regulatory Review: Filing Specific Considerations

Continued

- **Registration Statements on Form S-4**
 - Use similar disclaimers as those listed for proxy statements
 - Note that these statements may need to be tailored to the fact that both buyer's and target's projections may be included in the disclosure
- **Schedule 14D-9**
 - No requirement to disclose projections
 - Given the need to satisfy Delaware courts, however, companies often choose to disclose some form of the projections

IV. Regulatory Review: Filing Specific Considerations

Continued

- **Schedule 13E-3**
 - Boards should be aware of the heightened disclosure requirements of going private transactions and recognize that that could lead to increased pressure to disclose projections
 - Issuers are required to disclose and fairly summarized “any report, opinion (other than an opinion of counsel) or appraisal from an outside party that is materially related to the Rule 13e-3 transaction”
 - The SEC interprets this very broadly

V. Practical Considerations for Boards

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- There are no clear rules or regulations regarding the disclosure of financial projections
- Boards need to look to what the likely required disclosure will be from Delaware courts and the SEC and then comply with the requirements of the more onerous regime

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