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by Ethan Klingsberg

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Multiple and often inconsistent sets of internal financial reports and forecasts are a fact of life for many companies on the auction block. Corporations commonly have a variety of reports and forecasts that have been prepared for different purposes and audiences, at different times, by different in-house groups, and using different assumptions and raw data. During periods of ordinary course activity, this state of affairs may well contribute to the efficiency of the enterprise. But, in connection with a sale process, the existence of conflicting sets of internal financial reports and forecasts can give rise to claims of breaches of fiduciary duty by a target company's directors and of fraud against the target. Recent case law provides practical guidelines for managing these risks.

Fiduciary Duty Risks for Target Boards

In the LBO of Dr. Pepper Bottling Holdings, reviewed by the Delaware Court of Chancery this past year, no less than four sets of projections emanated from management in connection with the sale process.[1] But the board gave only the most conservative or "downside" case to its banker to use in preparing its fairness opinion and appeared to rely solely on this downside case in its own deliberations. Moreover, the company disclosed only the downside set of projections in its proxy statement. Plaintiffs claimed that the use of only that set of projections which made the merger consideration appear most favorable to the target shareholders constituted a breach of duty – both in the conduct of the board's deliberations and in the disclosure to the shareholders in the proxy statement. Indeed, plaintiffs pointed out, if an upside case had been used in the valuation analyses supporting the banker's fairness opinion, the merger price would have fallen below the value range that these analyses generated. Plaintiffs further bolstered their allegation that the board acted irresponsibly by pointing out that target management had shared the multiple cases with the sophisticated private equity fund acquiror, which in turn had endorsed the upside case and used it to solicit equity co-investors. Defendants failed in their efforts to dismiss the case before trial, but were fortunate enough to produce evidence at trial that the downside case, in fact, represented the sole set of projections in which the board and, more importantly, the CEO upon whom the board justifiably relied for expertise, believed. Accordingly, the court concluded that the board had fulfilled its duties both in reaching its decision to approve the merger and in its disclosures to shareholders.

The lesson of the Dr. Pepper saga is that boards, as well as bankers who will be delivering fairness opinions, would do well to engage in a thorough questioning of management before accepting a given set of projections as the basis for analyzing the adequacy of merger consideration. Key questions include:

- What is the universe of internal projections that exist for any and all purposes?
- How up-to-date is each of these sets of projections?
- For what purpose was each prepared?
- What assumptions underlie each of these projections?

- If there are multiple sets of projections, what explains the differences between them?
- Which sets of projections does management currently believe, in good faith, to be the best forecasts?
- Taking into account the degree of uncertainty, would it be prudent to rely upon multiple sets of projections or sensitivities so that both upside and downside scenarios are taken into account?
- Are there risks and recent developments that have not been taken into account in the projections?

The results of this exercise may be to send management back to derive yet another set of projections to draw upon the best information reasonably available. Or, in rare cases, it may even be appropriate for a board to turn to experts other than management if there is a reasonable basis for the board to doubt the reliability of management's forecasts. The objective should be to establish (or create) a set of forecasts, which may well include upside and downside sensitivities, upon which the board feels comfortable relying in good faith.

Pressure on boards to have a coherent understanding of the company's internal projections may increase further as requirements to disclose projections evolve. The Delaware courts and the SEC staff have yet to arrive at a clear set of guidelines as to when targets are obliged to disclose their projections in merger proxy statements, other than a consensus that they are generally required in transactions involving a conflict of interest, such as where a controlling stockholder is using cash consideration to take private a publicly listed subsidiary.[2] But it is not inconceivable that the future will see a Delaware decision or formal position by the SEC staff that requires more widespread disclosure of projections in merger proxy statements. Moreover, even today, one of the most common elements of a settlement with plaintiffs' counsel challenging the adequacy of disclosure in a merger proxy statement is the inclusion of previously undisclosed projections in a supplement. Against this background, it is all the more advisable for a target board, before it approves the merger and relies on a fairness analysis, to make the necessary inquiries and have a coherent and orderly vision of the company's internal projections.

Risks of Fraud Claims Against Targets

Another risk of multiple and inconsistent sets of target company financial reports or forecasts is that they may serve as the basis for a fraud claim by an acquiror. Two recent cases with different outcomes provide guidance on how to avoid this risk.

In the sale of Genesco, the proposed acquiror, seeking to avoid closing the acquisition, asserted a fraud claim based on the failure of the target to furnish its most recent monthly financial report during the due diligence process immediately prior to the execution of the merger agreement.[3] The report, it turned out, portrayed discouraging news not entirely included in the financial reports that the target had previously provided. Acquiror had expressly asked for this new monthly report, but the target and its advisors had responded, truthfully at the time of their response, that the report was not yet available. Acquiror failed to ask again for the monthly report before signing the merger agreement. Ironically, target management generated this new monthly report, with its discouraging news, one week after the request and at a time when the acquiror was apparently focused on negotiation of an increase in the merger consideration, rather than completing and bringing down to-date its due diligence.

Another example arose in the sale of Merrill Lynch's energy commodities trading business, where the team overseeing the sale provided the acquiror initially with financial reports about recent performance that were inconsistent both with the finance department's internal financial reports, which were never disclosed, and a second set of financial data, which the team provided later in the diligence process.[4] It turned out that the initial financial reports were materially inaccurate.

The *Genesco* tale ended with the court rejecting the fraud claim, while the *Merrill Lynch* story ended with a holding that the facts appear to state grounds for a valid fraud claim. At first glance, the key fact in *Genesco* appears to have been the failure of the acquiror to resubmit a request for the monthly financial report in question after it had become available. But it turns out that the diligence effort by the acquiror in *Merrill Lynch* had flaws as well. A close reading of these two cases shows that a seller and its advisors may be at risk in the future if they take away from *Genesco* a lesson that targets may withhold pertinent data unless a timely request has been submitted.

In both cases, the courts asked the same question to determine whether or not the fraud claims were valid: Did the acquiror justifiably rely on the absence of any misstatement or omission by the seller? In *Genesco*, the answer was, No. But in *Merrill Lynch* the answer was, Yes, subject to remand to the trial court to confirm one factual predicate. The answers derived not from the conduct of the parties, but from the specific contractual language negotiated in each transaction. In *Genesco*, the merger agreement made quite clear that the seller made no representation relating to, and therefore acquiror had no grounds to rely on, having received all the recent monthly financial reports material to an understanding of the company. By contrast, in *Merrill Lynch*, the contract contained more buyer-favorable language to the effect that there were not material inaccuracies in the financial reports that had been provided to the acquiror. Thus, in *Genesco*, the contract opened the door to placing the burden and consequences on the acquiror for its failure to follow-up its own due diligence inquiries. But in *Merrill Lynch*, the court observed that the finding at trial that the diligence effort of the acquiror "lacked pizzazz" did not defeat the fraud claim, because of the contract's language. Specifically, the *Merrill Lynch* court held that the language in the sale contract, which defined the scope of the accurate financial data being provided by Merrill Lynch to the acquiror, placed the burden on the seller to identify the inaccuracies and permitted the acquiror to prevail on a fraud claim even though the trial showed that the acquiror's team had engaged in diligence "without pizzazz". The court in *Merrill Lynch* concluded that the fraud claim should prevail so long as the trial court, on remand, concludes that the acquiror did not act with "recklessness or knowing blindness" – quite a low bar.

The language of the contract ultimately shapes how a sell-side deal team should manage the risk of fraud claims arising from the seemingly inevitable existence of inconsistent financial data within the possession of the target. Accordingly, it is imperative for the sell-side lawyers negotiating the merger agreement neither to be divorced from the diligence process nor to fail to understand what internal reports the client has provided and has refrained from providing to the prospective acquiror. Only when this coordination between the lawyers overseeing the contract and the facts of the diligence process exists can intelligent decisions be made to manage the diligence process and/or negotiate language in the merger agreement to assure that the actual or potential existence of inaccurate or inconsistent financial reports does not come back to haunt the target after signing.

1 *Crescent/Mach I P'ship v. Turner*, C.A. Nos. 17455-VCN, 17711-VCN, 2007 WL 1342263 (Del Ch. May 2, 2007).

2 *Compare In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007) (requiring merger proxy statement to include disclosure of projections used by target board in evaluating LBO) *with In re CheckFree Corp. S'holders Litig.*, C.A. No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007) (holding that management's projections need not be disclosed in a merger proxy statement containing fulsome disclosure of analyses underlying fairness opinion).

3 *Genesco, Inc. v. Finish Line, Inc.*, No. 07-2137-II(III) (Tenn. Ch. Dec. 27, 2007).

4 *Merrill Lynch & Co. vs. Allegheny Energy, Inc.*, 500 F.3d 171 (2d Cir. 2007).

Mr. Klingsberg is a partner at Cleary Gottieb Steen & Hamilton LLP.