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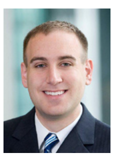
Recent Developments: Delaware Law and Disclosures Relating to Financial Advisors in Substantial Transactions

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Corporate boards rely upon financial advisors to perform essential functions in major transactions, including designing, implementing and overseeing sale processes, as well as evaluating and ultimately opining on the fairness of the consideration offered to the target company's stockholders. Given the importance of the financial advisor's role in substantial transactions, legal challenges to such transactions often focus on disclosures concerning the foundation of the financial advisor's fairness opinion, the financial advisor's fee structure and potential conflicts of interest.

Legal challenges to corporate transactions often play out before the courts of the State of Delaware, which have issued several recent decisions addressing such financial advisor-specific issues. This article will analyze and discuss the significance of several recent decisions issued by the Delaware Court of Chancery addressing the materiality and disclosure of (1) potential conflicts of financial advisors and (2) an acquiring company's own projections, to the extent provided to and considered by its financial advisors.

The Duty of Disclosure Under Delaware Law

Delaware law has long recognized a duty of disclosure, derived from the fiduciary duties of loyalty and due care, owed by corporate directors to their company and its stockholders. In the context of a substantial corporate transaction where the board is requesting stockholder action, the duty of disclosure requires that the directors "disclose fully and fairly all material information within the board's control[.]"[1] A plaintiff challenging a transaction on the basis of omitted or inadequate disclosures must demonstrate "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."[2] Where stockholders seek injunctive relief to prevent the consummation of a challenged transaction, disclosure issues are typically the centerpiece of such request, as material disclosure deficiencies are best remedied through injunctive relief rather than post-transactional awards of monetary damages.[3]

Potential Conflicts and Fees

Though questions regarding financial advisor compensation and independence are certainly not new to Delaware courts,[4] the issue was recently brought to the fore in *Del Monte*, wherein Vice Chancellor Laster wrote,

> [b]ecause of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, this Court has required full disclosure of investment banker compensation and potential conflicts.[5]

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The specific alleged conflict in *Del Monte* was the participation of the Del Monte board's financial advisor (Barclays Capital) in the buy-side financing (so-called "staple" financing) of the acquisition of Del Monte by a group of private equity firms. The Court's decision did not focus upon the disclosure of this potential conflict–indeed, Barclays' participation in the buy-side financing had been disclosed to Del Monte's stockholders–but rather the Court's concern that such participation potentially affected the integrity of the sale process and Barclays' advice to the Del Monte board.

Several months before *Del Monte*, Vice Chancellor Laster addressed a stockholder challenge to a transaction premised, in part, upon the target company's alleged failure to adequately disclose its financial advisors' significant prior work for the acquiror. In *In re Art Technology Group Shareholders Litigation*, plaintiffs sought to preliminarily enjoin the stockholder vote on the acquisition of Art Technology Group (ATG) by Oracle Corporation, claiming in part that ATG's proxy statement failed to disclose extensive prior work that its financial advisor, Morgan Stanley, had performed for Oracle. In the section concerning Morgan Stanley's fairness opinion, the proxy provided that "[i]n the two years prior to the date of its opinion, Morgan Stanley has provided financial advisory services for [ATG] and Oracle and has received fees in connection with such services." Plaintiffs argued that this statement was incomplete and misleading as discovery had revealed an extensive amount of advisory and financial services work performed by Morgan Stanley for Oracle over the previous five years and comparatively minimal work for ATG.

Vice Chancellor Laster expressed his discomfort with the proxy's terse disclosure of Morgan Stanley's prior work for Oracle "given the magnitude of the fees on the Oracle side," and found the lack of disclosure of such prior work "material."[6] The Vice Chancellor reasoned that knowledge of Morgan Stanley's "historical buy-side work ... might cause ... a stockholder to believe that Morgan Stanley had some interest in pleasing the buyer or maintaining good relations to the buyer."[7] On that basis, the Vice Chancellor enjoined the stockholder vote and ordered ATG to disclose

> (i) the aggregate compensation paid by Oracle to [Morgan Stanley] during each of 2007, 2008, 2009, and 2010 and (ii) a description of the nature of the services provided by Morgan Stanley to Oracle.[8]

Vice Chancellor John Noble has also recently addressed the materiality of disclosures concerning significant, prior work by a target's financial advisor for the buyer. In *In re Ness Technologies, Inc. Shareholders Litigation*,[9] the stockholder plaintiffs challenged a merger on the partial basis that the proxy lacked detail regarding prior work that the financial advisors for the target board (and special committee thereof) had performed for the buyer.[10] Vice Chancellor Noble authorized expedited discovery regarding that disclosure, reasoning that

> [i]f the amount of business that one of the financial advisors has done with [the buyer] or its affiliates is material, then the failure to disclose fully the extent of that business could violate the duty of disclosure. By contrast, if the amount of business involved is not material to either financial advisor, then the existing disclosures would likely be adequate.[11]

Vice Chancellor Noble also provided recent guidance on disclosure issues involving the structure and amount of a financial advisor's compensation. In *In re Atheros Communications, Inc. Shareholder Litigation*,[12] plaintiffs sought to preliminarily enjoin Qualcomm Incorporated's acquisition of Atheros Communications, Inc., alleging, among other things, that Atheros's proxy statement failed to fully or adequately disclose the fee arrangement between Atheros's board and its financial advisor, Qatalyst Partners. The proxy statement disclosed that Qatalyst would

> be paid a customary fee, a portion of which is payable in connection with the rendering of its opinion and a substantial portion of which will be paid upon completion of the Merger.[13]

Vice Chancellor Noble held this disclosure to be inadequate because it failed to divulge the amount of compensation that Qatalyst would receive, and "perhaps more importantly" that 98 percent of the fee was contingent upon the completion of the Qualcomm merger.[14] While noting that there is nothing inherently wrong with a financial advisor receiving a fee contingent upon the occurrence of a transaction,[15] the lack of disclosure in this instance was problematic because "the differential between compensation scenarios may fairly raise questions about the financial advisor's objectivity and self-interest."[16] Although the Vice Chancellor declined to draw a bright line rule providing for disclosure of contingent fees above or below any specific ratio, he held that it was

> clear that an approximately 50:1 contingency ratio requires disclosure to generate an informed judgment by the shareholders as they determine whether to rely upon the fairness opinion in making their decision to vote for or against the Transaction.[17]

More recently, in *In re Orchid Cellmark Inc. Shareholder Litigation*,[18] Vice Chancellor Noble distinguished *Atheros* in the context of a challenge to a tender offer. Plaintiffs alleged inadequate disclosures concerning the terms of the financial advisor's engagement agreement, which allegedly restricted the scope of the financial advisor's engagement and "facially excluded" a potential transaction involving the sale of the company's U.K. operations.[19] Vice Chancellor Noble disagreed with plaintiffs' interpretation of the engagement agreement, finding that it pertained to a broader range of possible transactions and would "arguably" cover such a sale.[20] In the absence of any evidence that the company would have attempted to avoid paying the financial advisor's fee in relation to such a sale, Vice Chancellor Noble held that "unlike the terms of engagement in *Atheros*, the terms of the financial advisor's engagement here do not create an unavoidable conflict of interest that requires a curative disclosure."[21]

Disclosure To An Acquiror's Stockholders Of Projections Provided To Its Financial Advisor

In two recent opinions, the Court of Chancery has provided guidance concerning the potential materiality of an acquiror's projections in the context of a strategic acquisition upon which the acquiror's stockholders are entitled to vote. It is long-settled that stockholders of Delaware corporations are entitled to a "fair summary" of the substantive work performed by a board's financial advisors in the context of a merger vote or tender offer.[22] At minimum, such summary should generally include a description of the valuation exercises underlying the financial advisor's fairness opinion, the "key assumptions" used in performing such exercises, and the range of values thereby generated.[23] Although a "fair summary" under Delaware law does not require the disclosure of projections provided to or relied upon by the company's financial advisor in every instance,[24] the Court of Chancery has consistently suggested–at least in the context of target company stockholders being asked to vote on a cash-out transaction–that projections of future performance provided to or relied upon by the financial advisor are "clearly" material to the stockholders' decision.[25]

The utility and materiality of cash flow estimates and projections in the cash-out context is readily apparent, as stockholders must decide whether to stay the course or, alternatively, to accept the offer on the table and thereby forsake an interest in future cash flows.[26] But the materiality of such projections to an acquiror's stockholders in voting upon a stock issuance in connection with a proposed acquisition is less clear. In the course of negotiating or validating an appropriate exchange ratio, an acquiror may consider its projections alongside those of the target. In doing so, an acquiror may render its own projections material to its stockholders' assessment of such ratio, especially where projections are relied upon by the acquiror's financial advisor in opining on the fairness of the projections.

In *In re S1 Corporation Shareholders Litigation*,[27] Vice Chancellor Parsons considered a stockholder challenge to the preliminary proxy statement issued by S1 Corporation in connection with a stock-for-stock merger with Fundtech, Ltd., following which S1's stockholders would own approximately 55 percent of the merged entity.[28] In connection with the contemplated merger, S1's stockholders were required to approve various proposals, including the issuance of shares to Fundtech's stockholders pursuant to the exchange ratio specified in the S1-Fundtech merger agreement. S1's financial advisor, Raymond James, used and considered certain projections and cash flow estimates in rendering its opinion that the exchange ratio was financially fair. S1 had provided Raymond James with its own projections through 2016; Fundtech's internal projections through 2012; and S1's projections for Fundtech from 2012 through 2016.[29] Plaintiffs sought to enjoin the vote on the S1-Fundtech merger on the basis, among others, that S1 had failed to disclose such projections and free cash flow estimates in its preliminary proxy. S1 and its board opposed expedition, arguing that S1's projections for Fundtech were necessarily speculative and, in any case, the projections were immaterial to S1's stockholders in the context of S1's proposed stock-for-stock acquisition of Fundtech, which differed significantly from the context in which Delaware courts had previously required disclosure of financial projections.

In granting plaintiffs' motion for expedited proceedings, Vice Chancellor Parsons acknowledged that this was not the "standard situation" wherein projections must be disclosed, *i.e.*, one in which stockholders face the end of their investment.[30] He noted, however, that S1 was asking its stockholders to dilute themselves through a stock issuance, and that a "very important aspect" of such decision, that a stockholder "would want to know," is the propriety of the exchange ratio and projections underpinning the financial advisor's fairness opinion.[31] On the limited record and facts presented, Vice Chancellor Parsons held that the omitted projections were "beyond relevant" and might be material, and therefore plaintiffs were entitled to expedited discovery as to that claim.[32]

Vice Chancellor Noble addressed a similar fact pattern in *Gaines v. Narachi*,[33] in which a stockholder of AMAG Pharmaceuticals, Inc., sought to preliminarily enjoin AMAG's proposed merger with Allos Therapeutics, Inc., pursuant to which AMAG stockholders would own 61 percent of the resultant entity. Morgan Stanley had provided AMAG's board with a fairness opinion concerning the exchange ratio under the proposed merger. The stockholder plaintiff alleged that AMAG's proxy statement omitted material information by failing to disclose the forecasted free cash flows that Morgan Stanley had used in performing its discounted cash flow analysis.[34] Vice Chancellor Noble initially denied plaintiff's motion for expedited proceedings, holding that such disclosure claims were not colorable. In subsequently granting plaintiff's motion for reconsideration, the Vice Chancellor acknowledged that the predicate rationale for requiring disclosure of free cash flow estimates is absent in relation to a strategic acquisition, as the acquiror's stockholders are not being cashed out.[35] Vice Chancellor Noble nevertheless concluded that plaintiff's claims were sufficiently colorable to warrant expedited treatment, and therefore ordered the parties to supplement the record regarding the nature and source of the cash flow estimates and to submit briefs addressing their materiality.[36]

Conclusion

In light of the decisions discussed, corporate directors should remain vigilant and attentive to their financial advisors' potential conflicts and, where such conflicts arise, ensure their adequate and appropriate disclosure. Further, Delaware corporations–including those pursuing strategic acquisitions–should approach the provision of projections and cash flow information to their financial advisors with the expectation that public disclosure of the information may ultimately be required, as a financial advisor's reliance upon the information may undercut any contention that it is immaterial to the stockholders' consideration of the merits and adequacy of the proposal before them.

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[1] *Gantler v. Stephens*, 965 A.2d 695, 710 (Del. 2009) (quoting *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992)).

[2] *Id.*

[3] *See In re Staples, Inc. S'holders Litig.*, 792 A.2d 934, 960 (Del. Ch. 2001) ("[O]ur cases recognize that it is appropriate for the Court to address material disclosure problems through the issuance of a preliminary injunction that persists until the problems are corrected.").

[4] *See, e.g.*, *Khanna v. McMinn*, 2006 BL 63915 (Del. Ch. May 9, 2006) (finding that plaintiff had sufficiently pled reasonable doubt that transaction was valid exercise of business judgment where financial advisor had provided bridge loan to target); *In re Toys "R" Us, Inc. S'holders Litig.*, 877 A.2d 975, 1000 (Del. Ch. 2005) (addressing potential conflict of target's financial advisor who had expressed a desire to provide buy-side financing).

[5] *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 832 (Del. Ch. 2011).

[6] Oral Argument on Plaintiffs' Motion for a Preliminary Injunction and Rulings of the Court, *In re Art Techs. S'holders Litig.*, C.A. No. 5955-VCL (Del. Ch. Dec. 20, 2010) at 101-2.

[7] Telephone Conference on Supplemental Disclosure Language and Rulings of the Court, *In re Art Techs. S'holders Litig.*, C.A. No. 5955-VCL (Del. Ch. Dec. 21, 2010) at 11.

[8] Order Granting Preliminary Injunction, *In re Art Techs. S'holders Litig.*, C.A No. 5955-VCL (Del. Ch. Dec. 21, 2010) at ¶2 (citation omitted).

[9] 2011 BL 204411 (Del. Ch. Aug. 3, 2011).

[10] *Id.* at *2-*3 and n.3.

[11] *Id.* at *10.

[12] 2011 BL 61366 (Del. Ch. Mar. 4, 2011).

[13] *Id.* at *22.

[14] *Id.*

[15] *Id.* at *24 ("The Court does not imply that Qatalyst has committed a wrong here because of the contingent fee arrangement; it simply observes that the incentives are so great that the stockholders should be made aware of them and that this contingent fee structure is material to their decision to support or oppose the Transaction."); *see also In re Alloy, Inc. S'holder Litig.*, 2011 BL 264198 (Del. Ch. Oct. 13, 2011) (citing *Atheros*).

[16] *Atheros*, 2011 BL 61366, at *23.

[17] *Id.* at *24.

[18] 2011 BL 212934 (Del. Ch. May 12, 2011).

[19] *Id.* at *28.

[20] *Id.* at *28-*29.

[21] *Id.* at *29.

[22] *In re Pure Resources, Inc. S'holders Litig.*, 808 A.2d 421, 449 (Del. Ch. 2002).

[23] *Id.*

[24] *See, e.g., In re 3Com S'holders Litig.*, 2009 BL 281639, at *5 (Del. Ch. Dec. 18, 2009); *Ryan v. Lyondell Chemical Co.*, 2008 BL 165121 , at *59 n.120 (Del. Ch. July 29, 2008), *rev'd on other grounds*, 970 A.2d 235 (Del. 2009); *In re CheckFree Corp. S'holders Litig.*, 2007 BL 148076, at *6-*7 (Del. Ch. Nov. 1, 2007).

[25] *See, e.g., Maric Capital Master Fund, Ltd. v. Plato Learning, Inc.*, 11 A.3d 1175, 1177-79 (Del. Ch. 2010); *David P. Simonetti Rollover IRA v. Margolis*, 2008 BL 147542, at *23-*24 (Del. Ch. June 27, 2008).

[26] *See, e.g., In re Netsmart Techs., Inc. S'holder Litig.*, 924 A.2d 171, 203 (Del. Ch. 2007) (emphasizing the importance of projections when stockholders are "[f]aced with the question of whether to accept cash now in exchange for forsaking an interest in [the company's] future cash flows"); *In re PNB Holding Co. S'holders Litig.*, 2006 BL 92554 (Del. Ch. Aug. 18, 2006) (same).

[27] Transcript Ruling on Motion for Expedited Proceedings, Consolidated C.A. No. 6771-VCP (Del. Ch. Aug. 19, 2011).

[28] *Id.* at 8.

[29] *Id.* at 24.

[30] *Id.* at 28.

[31] *Id.* at 17-18.

[32] *Id.* at 28. The preliminary injunction hearing was cancelled after Fundtech accepted an alternative transaction and the merger agreement was terminated, thereby mooting plaintiffs' claims.

[33] 2011 BL 260347 (Del. Ch. Sept. 30, 2011), *motion for reconsideration granted*, 2011 BL 270597 (Del. Ch. Oct. 6, 2011).

[34], 2011 BL 260347 at *2.

[35] *Id.* at *4-*5

[36] *Id.* at *6-8.