Delaware – Law Firms

The Last Word On Disclosure Of Projections Under Delaware Law

The Editor interviews ***Michael B. Tumas*** *and* ***Michael K. Reilly****, partners in the Wilmington, Delaware law firm of Potter Anderson & Corroon LLP.*

Editor: It is settled Delaware law that directors have a duty to disclose to shareholders all material information in their possession when seeking stockholder approval of a merger transaction. What have the Delaware courts had to say about materiality of financial projections recently?

Tumas: Over the past year the Delaware Court of Chancery has issued three decisions and one bench ruling on whether certain types of information, particularly financial projections, are material and thus must be disclosed to the shareholders. As an initial matter, it should be noted that under Delaware law information is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. These four rulings, *Netsmart, CheckFree, Globis Partners* and *BEA Systems*, indicate that a context-specific analysis, and not a single legal standard, is necessary to determine whether projections are material in a specific case under Delaware law.

Editor: What was established Delaware law prior to these four rulings?

Tumas: The Delaware courts have not stated definitively whether "soft information," including pro forma statements underlying financial projections, and even raw data used by directors and their financial advisors, represents material information that must be disclosed to shareholders.

The Court of Chancery took a step in that direction in 2002 in *Pure Resources – In re Pure Resources, Inc. Shareholders Litig*. 808 A2d – where the issue was a target corporation's failure to disclose *any* of the substantive portions of the work performed by the target's financial advisor in a schedule issued in response to a tender offer by a controlling shareholder. In finding a reasonable probability of success on the disclosure claims, the Court promulgated a clear statement that shareholders are entitled to a *fair summary* of the substantive work performed by the investment bankers where the board has relied upon the bankers advice in formulating the board's recommendation to the shareholders as to how to vote on a merger or whether to tender.

Reilly: Under the *Pure Resources* standard, it would be material to know three primary pieces of information in any fair summary of the substantive work performed by the financial advisor: the basic valuation exercises undertaken by the financial advisor, the key assumptions relied upon by the financial advisor in performing the valuation exercises, and the range of values generated thereby. *But* it remained unclear after *Pure Resources* whether financial projections or other raw data must be included in that summary.

Editor: Please tell us about the *Netsmart* case.

Reilly: In *Netsmart – In re Netsmart Technologies, Inc, Shareholders Litig.,* 924 A.2d 171 – Vice Chancellor Strine issued a limited injunction delaying a stockholder vote on a going private transaction. The Court considered, among other things, two claims relating to the omission of projections in the disclosures. Vice Chancellor Strine first declined to hold omission of preliminary "stay the course" financial projections material since the final proxy statement included updated numbers that were more current and more bullish, and therefore more reliable. On the second disclosure claim, however, the Court cited *Pure Resource's* fair summary doctrine and found that the corporation *was* required to disclose final revenue and earnings projections relied upon by its financial advisor and its board of directors.

With respect to the second disclosure claim, the Court found it important that, although earlier versions of the projections had been disclosed in the proxy statement, the final projections underlying the financial advisor's fairness opinion had never been disclosed. The Court concluded that once a board had broached a topic in its disclosures a duty attached to provide information that was materially complete and unbiased by the omission of material facts.

Tumas: It is worthy of note that Vice Chancellor Strine found that the stakes are higher for the corporation's shareholders in a cash-out merger, having been presented with the financial advisor's fairness opinion and having been asked to vote on matters of vital importance to the corporation's future prospects, than in other types of transactions. The need for the disclosure of reliable projections is, therefore, heightened in cash-out mergers.

Editor: And *CheckFree?*

Tumas: Eight months after *Netsmart*, Chancellor Chandler decided *CheckFree – In re CheckFree Corp. Shareholders Litig.,* 2007 WL 3262188. At issue was the omission of certain projections in a target corporation's disclosures relating to a merger transaction. The plaintiff shareholders moved to enjoin the merger, arguing that the target corporation's proxy statement failed to disclose underlying financial projections used by its financial advisor to render its fairness opinion.

In denying the injunction, Chancellor Chandler focused first on whether the board's failure to provide cash flow projections shared with the buyer and relied upon by the target corporation's financial advisor represented a material omission. While the plaintiff cited disclosure decisions pertaining to appraisal actions for the proposition that directors were required to disclose all of the data underlying the financial advisor's fairness opinion, Chancellor Chandler refused to recognize a *per se* rule requiring the disclosure of such data in every case. Deciding instead that the shareholders must show that additional disclosures would alter the total mix of information available to shareholders, the Court determined that the correct legal standard remained the fair summary standard articulated in *Pure Resources*.

The Court then distinguished *Netsmart*, noting that the proxy statement at issue in that case contained a partial disclosure and therefore further disclosure was required. Perhaps more important, the proxy statement at issue in *CheckFree* warned that the financial advisor had interviewed members of the target corporation's management team in order to understand the risk factors that threatened the accuracy of the projections. The Court reasoned that these admittedly incomplete projections in the proxy statement were not material and might, in fact, be misleading.

Editor: What does *Globus Partners* add to the discussion?

Reilly: A few weeks after Chancellor Chandler issued his opinion in *CheckFree*, Vice Chancellor Parson weighed in on the disclosure debate. In *Globus Partners – Globus Partners, L.P. v. Plumtree Software, Inc.,* 2007 WL 4292024 – a plaintiff shareholder alleged that the absence of meaningful projections of the target corporation's future performance was a material omission. Finding that the omission of projections was material only if the projections were reliable, the Court rejected the disclosure claim because the plaintiff did not 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. Instead, the plaintiff merely focused on challenging the financial advisor's judgment that the projections were unreliable and unhelpful. The Court found that such criticisms do not constitute a sufficient basis for a disclosure claim.

Editor: And *BEA Systems*?

Tumas: Most recently, in a bench ruling, the Court denied a motion to enjoin a shareholder vote despite allegations of the material omission of certain underlying financial data. The financial data at issue in *In re BEA Systems, Inc. Shareholder Litig.,* C.A. 3298, Lamb, V.C. included, among other things, projections that the financial advisor had used to prepare a preliminary discounted cash flow analysis prior to the emergence of the acquirer, certain synergy estimates and high- and low-case sensitivity analyses. The Court refused to find such information material because it was not reliable, could mislead shareholders rather than inform them in this specific case, and had not been relied upon by the financial advisor and the board. It is very noteworthy that the Court stated that the fact that something is included in materials that are presented to a board of directors does not, *ipso facto*, make that something material.

Editor: What are the practical implications of these rulings? Is the disclosure of projections required?

Reilly: *Netsmart, CheckFree, Globis Partners* and *BEA Systems* lead to one unified conclusion: that a context-specific analysis is required to determine whether projections must be disclosed in a particular situation.

Tumas: A number of lessons can be drawn from this conclusion.

First, *Pure Resources* continues to be the starting point for determining whether projections must be disclosed. That is, a fair summary of the substantive work performed by a financial advisor must be disclosed. There is no checklist of the types of information underlying the financial advisor's opinion that must be disclosed, however. Whether the fair summary requirement has been satisfied in a particular situation, therefore, must be decided on a case-by-case basis.

Second, only projections that are *material*, not those that are merely helpful, must be disclosed. The recent case law is clear that projections are not material unless they are reliable. Projections that are unreliable or misleading need not be disclosed. If they are reliable, however, their materiality is significantly heightened at least in the context of cash-out or going private merger transactions.

The materiality of projections is heightened in cash-out merger transactions where the shareholders are being asked to evaluate whether to accept the merger consideration or to continue as shareholders of the corporation. The materiality of projections is heightened uniquely in going private transactions, and particularly where key managers seek to remain as executives and will receive options in the corporation once it goes private. Although not addressed in the recent cases, it follows that the materiality of a *buyer's* projections is heightened in stock-for-stock merger transactions, in which the target corporation's shareholders must evaluate the price to be paid in the form of the buyer's shares.

If projections are reliable, disclosure may not be required if they are of questionable utility to the shareholders. For example, the Court in *Netsmart* found that certain "stay the course" projections were not material because they were in fact more pessimistic and therefore actually demonstrated that the merger consideration was fairer than the proxy statement implied.

Any unique circumstances should be considered when determining whether projections are material. In *Netsmart*, for example, the Court found that the projections were particularly important, and thus of heightened materiality, because the corporation's unique market niche made a comparable company analysis less useful.

Projections relied upon by the target corporation's financial advisor and board, as well as those shared with bidders, are more likely to be material and thus to require disclosure. Those facts standing alone do not necessitate disclosure, however, as the projections must still be reliable and otherwise material in the particular circumstances.

Finally, the partial disclosure of financial projections that fail to offer the estimate of a corporation's future financial performance triggers a broader fiduciary obligation to supplement the proxy with materially complete information. Once a board opens the door to partial disclosure, more complete information may be necessary.

Editor: Is there anything that either of you would like to add?

Reilly: If I may summarize, the Delaware courts have not articulated a rote legal standard or checklist providing clear guidance whether projections must be disclosed in a particular situation. Rather, a context-specific analysis is required to determine whether projections must be disclosed. Pending further guidance from the courts, practitioners should focus on whether the disclosure provides a fair summary of the substantive work performed by the corporation's financial advisor and relied upon by the corporation's board and whether that fair summary requires the disclosure of reliable projections in the specific circumstances at issue.

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