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# Disclosure of Free Cash Flow Projections in a Merger or Tender Offer

Jacob M. Mattinson

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## I. INTRODUCTION

In what is unlikely to be the last in a long line of hotly debated cases, spanning at least the last decade, the Delaware Court of Chancery recently held that management's free cash flow[1] projections are not

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1. ARTHUR J. KEOWN ET AL., FINANCIAL MANAGEMENT: PRINCIPLES AND APPLICATIONS 45 (*Pearson Custom Publ'g, 10th ed. 2005) (defining free cash flows as "the amount of cash available from operations after paying for investments in net operating working capital and fixed assets"); SAMUEL C. THOMPSON, JR., BUSINESS PLANNING FOR MERGERS AND ACQUISITIONS: CORPORATE, SECURITIES, TAX, ANTITRUST, INTERNATIONAL, AND RELATED ASPECTS 376 (Carolina Academic Press, 3rd ed. 2008) (stating that free cash flows equal the income stream to the corporation, not accounting profits).

material.[2] By way of illustration, Company A, the acquiring corporation, is interested in acquiring Company T, the target corporation. The acquiring corporation negotiates with the target corporation and the companies agree to a first-step tender offer for all of the target corporation's shares, followed by a second-step merger. The target corporation chooses to disclose certain information to its shareholders, in anticipation of a shareholder vote on the merger, so that the shareholders can decide how to vote and whether to tender their shares. The target corporation's shareholders have an important decision to make: whether to accept the consideration offered in the tender offer in exchange for tendering their shares or to decline to tender their shares and either later accept the merger consideration as part of the proposed second-step merger or seek appraisal rights after the consummation of the merger.[3] For the target corporation's shareholders, certain information they wish for the target corporation to disclose as they make their decision is material and thus required to be disclosed.[4] Other information is simply helpful and thus not required to be disclosed.[5]

This Comment will address the issue of what disclosures Delaware law requires a company to make to its shareholders in a merger proxy or consensual tender offer situation and whether a target company's internal free cash flow projections rise to the level of materiality.[6] Chancellor Chandler of the Delaware Court of Chancery recently concluded that projected free cash flow estimates[7] are not material and disclosure of a target company's projected free cash flows are not necessary.[8] Additionally, Chancellor Chandler offered to sign an order certifying an interlocutory appeal to the Delaware Supreme Court on the issue of whether free cash flows are material and should always be disclosed as a

2. Steamfitters Local Union 447 v. Walter, No. 5492-CC, slip op. at 9 (Del. Ch. June 21, 2010) (holding that free cash flow projections are not material because they do not meaningfully alter the total mix of information available to the stockholder and are thus not required to be disclosed).

3. *See In re* PNB Holding Co. S'holders Litig., No. 28-N, 2006 WL 2403999, at *16 (Del. Ch. Aug. 18, 2006).

4. Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1171 (Del. 2000). The current disclosure rule under Delaware case law is that directors have a duty to disclose all material facts within their control that a reasonable stockholder would consider important. *Id.*

5. *Id.* at 1174. Practically speaking, however, a corporation is likely to be sued at some point during a merger regardless of what the corporation discloses.

6. *See infra* Part III.A.

7. Free cash flow estimates are management's estimates of the corporation's projected future cash flows. *See* Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., No. 5402-VCS, 2010 WL 1931084, at *2 (Del. Ch. May 13, 2010).

8. Steamfitters Local Union 447 v. Walter, No. 5492-CC, slip op. at 9 (Del. Ch. June 21, 2010).

per se rule.[9] The plaintiff in that case, however, decided not to pursue the interlocutory appeal.[10]

Several Delaware cases over the last 11 years differ on whether projected free cash flows are material information that parties to an agreement must disclose.[11] Interestingly, two judicial perspectives exist in the Delaware Court of Chancery that divide Chancellor Chandler,[12] who consistently does not require disclosure of free cash flows, from Vice Chancellor Strine,[13] who consistently requires disclosure of free cash flows.[14] The disparity in case law has led to uncertainty in the marketplace and has made difficult the board of directors', corporate officers', and attorneys' predictions regarding the materiality of projected free cash flows.[15] The judges distinguished and explained the differing results on facts that are arguably of little significance.[16] For reasons of public policy, financial theory, and clarity, along with the ease of requiring disclosure and the few accompanying negative side effects, the Delaware Supreme Court should require, by means of a rebuttable presumption, that projected free cash flows be deemed material and disclosed to stockholders in a merger proxy or tender offer.[17]

Part II of this Comment will provide a background of the foundation and formation of the law surrounding the disclosure of free cash flows in Delaware, including the standards of proof to which the parties are held. Next, this Comment delves into the major cases that form current

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9. *Id.* at 10.

10. E-mail from Lisa A. Schmidt, Director, Richards, Layton & Finger, P.A., to author (Aug. 26, 2010, 17:26 EST) (on file with author).

11. The cases in Delaware that hold that (a) disclosure of projections is not generally required are the following: Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170 (Del. 2000); Steamfitters Local Union 447 v. Walter, No. 5492-CC, slip op. (Del. Ch. June 21, 2010); *In re* Checkfree Corp. S'holder Litig., No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007); *In re* Best Lock Corp. S'holder Litig., 845 A.2d 1057 (Del Ch. 2001), and (b) disclosure of projections is required: Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., No. 5402-VCS, 2010 WL 1931084 (Del. Ch. May 13, 2010); *In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171 (Del. Ch. 2007).

12. Chancellor Chandler left the Delaware Court of Chancery in 2011. JUDICIAL OFFICERS OF THE COURT OF CHANCERY, http://courts.delaware.gov/chancery/judges.stm (last visited Nov. 11, 2011).

13. Leo E. Strine, Jr. was appointed as Chancellor of the Delaware Court of Chancery in 2011. JUDICIAL OFFICERS, *supra* note 12.

14. *Compare In re Checkfree*, 2007 WL 3262188, at *3 (holding that free cash flow projections are not material and need not be disclosed), *with Maric*, 2010 WL 1931084, at *2 (holding that free cash flow projections are material and thus are required to be disclosed to shareholders).

15. *See, e.g.*, *Steamfitters*, No. 5492-CC, slip op. at 10.

16. *See, e.g.*, *In re Checkfree*, 2007 WL 3262188, at *2 (holding that a failure to disclose all the financial data necessary for a stockholder to independently determine the fair value of his shares is not per se an omission of a material fact).

17. *See infra* Part IV.

Delaware law on materiality in this context and points out the significant differences between the decisions by Chancellor Chandler and Vice Chancellor Strine.

Part III of this Comment will explore why the current rule in Delaware is problematic. The analysis focuses on the divide in the decisions by Chancellor Chandler and Vice Chancellor Strine. This Comment will discuss the concept of the reasonable stockholder, a critical element of the materiality standard largely ignored and left undeveloped by Delaware courts, as well as the relevance of financial theory to materiality. Additionally, this Comment will briefly address public policy reasons for why a per se rule should be adopted and will discuss how materiality of free cash flow projections are treated under both the Federal Securities Laws and select European laws.

Part IV of this comment proposes a rule that projected free cash flows be disclosed to stockholders in a merger proxy or tender offer situation by means of a rebuttable presumption and discusses the implications of adopting such a proposed rule on the current merger and acquisition ("M&A") marketplace. This Comment will show that the adoption of a rebuttable presumption is favorable for the investor, is simple for companies to implement, will attract more investors to Delaware corporations, and carries few negative side effects.

## II. BACKGROUND

Directors of a Delaware corporation owe certain fiduciary duties to a Delaware corporation's stockholders.[18] One of these fiduciary duties is the duty of disclosure, also sometimes called the duty of candor.[19] Under Delaware law, directors have a duty to disclose all material facts within their control that a reasonable stockholder would consider important in deciding how to respond to the pending transaction.[20] Omitted facts are material when "a substantial likelihood [exists] that a reasonable stockholder would consider the facts important in deciding how to vote," or, alternatively, when the reasonable stockholder would view the disclosure as significantly altering the total mix of available

18. *See Skeen*, 750 A.2d at 1172; *In re Checkfree*, 2007 WL 3262188, at *2. *See also* Nagy v. Bistricer, 770 A.2d 43, 60 (Del. Ch. 2000) (finding that the director's failure to disclose material information was a breach of their duty of care).

19. The duty of disclosure is not a "separate and distinct" fiduciary duty but is subsidiary to the fiduciary duties of care and loyalty. *See Skeen*, 750 A.2d at 1172; *In re Checkfree*, 2007 WL 3262188, at *2.

20. *See, e.g.*, *Skeen*, 750 A.2d at 1171; *In re Checkfree*, 2007 WL 3262188, at *2; *In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171, 199 (Del. Ch. 2007).

information.[21] Therefore, a problem arises when a proxy statement omits or misstates information that stockholders would consider important in making a decision.[22] To determine whether information is material, the key inquiry is whether the information is merely helpful or if the information somehow rises to the level of importance or materiality.[23] Omitted facts are not material simply because a stockholder would consider the facts to be helpful in making a decision.[24] Additionally, a complaint alleging a failure to disclose free cash flows, for example, must allege that the omitted information is inconsistent with, or significantly differs from, the disclosed information.[25] Therefore, for a court to find an omitted fact to be material to the reasonable stockholder, the omitted fact must be more than merely helpful, must significantly differ from already disclosed information, and the reasonable stockholder must consider the fact important in deciding how to vote.[26]

To state a colorable disclosure claim, the plaintiff[27] bears the burden to "provide some basis for a court to infer that the alleged violations were material."[28] Additionally, the plaintiff "must allege that facts are missing from the [information] statement, identify those facts, state why they meet the materiality standard and how the omissions caused injury."[29] These two requirements place a fairly heavy burden on the plaintiff and establish a presumption of non-materiality.

Delaware courts first addressed whether disclosure of free cash flows is required in a merger proxy[30] or tender offer in *Skeen v. Jo-Ann Stores, Inc.*,[31] a case the Delaware Supreme Court decided in 2000. *Skeen* involved a two-step merger—similar to the example at the

21. *Skeen*, 750 A.2d 1170, 1172 (Del. 2000) (citing Louden v. Archer-Daniels Midland Co., 700 A.2d 135, 142 (Del. 1997)); *In re Netsmart*, 924 A.2d at 199 (Del. Ch. 2007); *In re* Best Lock Corp. S'holder Litig., 845 A.2d 1057, 1068 (Del Ch. 2001).

22. *See, e.g.*, *Skeen*, 750 A.2d at 1171, 1174 (Del. 2000).

23. *Id.*

24. *Id.* at 1174.

25. *Id.*; *In re Checkfree*, 2007 WL 3262188, at *2.

26. *Skeen*, 750 A.2d at 1174.

27. The plaintiff in this situation is a shareholder of the target corporation, alleging a disclosure violation, who faces the decision of whether to accept the consideration offered by the acquiring corporation in the tender offer or to decline to tender his shares and either later accept the merger consideration as part of the proposed second-step merger or seek appraisal rights after the consummation of the merger.

28. *Skeen*, 750 A.2d at 1173; *In re Checkfree*, 2007 WL 3262188, at *2; *In re* Best Lock Corp. S'holder Litig., 845 A.2d 1057, 1070 (Del Ch. 2001).

29. *Skeen*, 750 A.2d at 1173; *In re Checkfree*, 2007 WL 3262188, at *2; *In re Best Lock*, 845 A.2d at 1070.

30. *See* WILLIAM J. CARNEY, ESSENTIALS: MERGERS AND ACQUISITIONS 244-45 (Vicki Bean et al. eds., 2009). The proxy statement is a document soliciting shareholder approval of the merger, the purpose of which is to give shareholders enough information about the deal to allow them to make an informed vote on the transaction. *Id.*

31. Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170 (Del. 2000).

beginning of this Comment—with a first-step tender offer, in which the acquiring corporation acquired 77% of the target corporation's stock.[32] A second-step merger followed, in which the majority shareholder cashed out the minority stockholders.[33] The majority stockholders of the target corporation approved the merger.[34] The appellants alleged that the target corporation's directors needed to disclose management's projections of the target corporation's anticipated performance, specifically the free cash flow projections from 1998-2003.[35] The appellants in *Skeen*, minority shareholders of the target corporation, argued that the directors failed to provide the minority stockholders with enough financial information to allow them to decide whether to accept the merger consideration or to seek appraisal.[36]

The Delaware Supreme Court stated that the minority stockholders failed to allege any fact indicating that the omitted information was material.[37] The court held that the minority shareholders were not entitled to all the financial data necessary to make an independent determination of fair value merely because the information would be helpful.[38] Furthermore, the court noted that the appellants failed to argue that the undisclosed information was inconsistent with or significantly differed from the already disclosed information.[39] Thus, the court established an important difference between material and helpful information.[40]

The Delaware Supreme Court appeared to decide the materiality of free cash flow projections issue in *Skeen*,[41] but several subsequent cases appeared before the Delaware Court of Chancery. In 2001, the Delaware Court of Chancery again addressed the materiality of free cash flow projections in *In re Best Lock Corp. Shareholder Litigation*.[42] There, the majority shareholder cashed out the plaintiffs, minority shareholders of the target corporation, in a freezeout merger.[43] The plaintiffs alleged that the information statement was materially false and misleading because the statement improperly omitted financial projections that were

32. *Id.* at 1171.
33. *Id.*
34. *Id.*
35. *Id.* at 1173-74. The appellants argued that the disclosure of the additional financial data would help the stockholders to better evaluate whether they should pursue an appraisal. *Id.*
36. *Id.* at 1171.
37. *Id.* at 1174.
38. *Id.*
39. *Id.*
40. *Id.*
41. And, in fact, many practitioners would argue that the issue was decided in *Skeen*.
42. *In re* Best Lock Corp. S'holder Litig., 845 A.2d 1057 (Del. Ch. 2001).
43. *Id.* at 1062.

provided to the investment bank in performing its fairness opinion.[44] The court granted the defendant's motion to dismiss and held that the plaintiffs failed to show that the undisclosed information "would have assumed actual significance in the deliberations of reasonable shareholders" in deciding whether to pursue their appraisal rights.[45] The court further held that Delaware law does not require that a board disclose specific details of the analysis underlying a financial advisor's opinion.[46] The court, however, in evaluating the idea of actual significance, failed to address the concept of who is the reasonable shareholder.[47]

The Delaware Court of Chancery, in a decision by Vice Chancellor Strine in 2006, discussed the utility of free cash flow projections in a post-merger appraisal trial.[48] *In re PNB Holding Co. Shareholder Litigation*[49] involved a cash-out merger, wherein the company reclassified itself as a subchapter S corporation.[50] The court's main focus in the case involved deciding whether to subject the transaction to entire fairness review, which applies when an interested party is on both sides of the transaction.[51] The court classified pro forma income statements and projections as "soft information."[52] Vice Chancellor Strine, while recognizing that the then-current law did not hold all projections as material, stated "[p]rojections of future performance . . . are also useful, particularly in the context of a cash-out merger."[53] Although the court held that the omitted projections were not material, Vice Chancellor Strine stated that he would have found the projections to be material if management had proposed the merger shortly after the chief lending officer prepared the projections.[54] Additionally, Vice Chancellor Strine explained that

> [i]n the context of a cash-out merger, reliable management projections of the company's future prospects are of obvious materiality to the electorate. After all, the key issue for the stockholders is whether accepting the merger price is a good deal in

44. *Id.* at 1068.
45. *Id.* at 1070 (citing Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985)).
46. *Id.* at 1073 (citing *Skeen*, 750 A.2d at 1174).
47. *Id.* (stating only that "plaintiffs must show that the information missing from the Information Statement 'would have assumed actual significance in the deliberations' of *reasonable shareholders*. . . ." (emphasis added)).
48. *In re* PNB Holding Co. S'holder Litig., No. 28-N, 2006 WL 2403999 (Del. Ch. Aug. 18, 2006).
49. *Id.*
50. *Id.* at *1.
51. *Id.*
52. *Id.* at *16.
53. *Id.*
54. *Id.* at *15.

> comparison with remaining a shareholder and receiving the future expected returns of the company.[55]

The first ruling contrary to the Delaware Supreme Court's holding in *Skeen* came in 2007 from Vice-Chancellor Strine.[56] *In re Netsmart Techs., Inc. Shareholder Litigation*[57] examined the director's duty to disclose material facts when seeking stockholder approval of a merger.[58] The court held that a reasonable stockholder "would find it material to know what the best estimate was of the company's expected future cash flows" in deciding whether to accept the merger consideration or to seek appraisal rights.[59] The target corporation, Netsmart, acquired several corporations, after which private equity buyers began speaking to Netsmart management about a possible merger or acquisition.[60] Management encouraged the firm to consider a sale to one of the interested private equity buyers and encouraged the board to focus on a rapid auction process.[61] The board formed a special committee that ultimately recommended the merger.[62] Netsmart subsequently entered into a merger agreement.[63]

The plaintiffs in *Netsmart* alleged that the proxy did not disclose free cash flow estimates and that those estimates were indeed material.[64] More specifically, the plaintiffs alleged that management previously disclosed certain other, older projections but did not disclose the full or even the most accurate or recent projections.[65] The court enjoined the completion of the merger until Netsmart disclosed the most recent free cash flow projections.[66] Vice Chancellor Strine explained that "projections of this sort are probably among the most highly-prized disclosures to investors . . . [because investors] cannot hope to . . . replicate management's inside view of the company's prospects."[67]

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55. *Id.*
56. *In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171 (Del. Ch. 2007).
57. *Id.*
58. *Id.* at 177.
59. *Id.*
60. *Id.* at 175.
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.* at 176.
65. *Id.* at 199, 202. The plaintiffs argued that the disclosed projections were not the projections used by the financial advisor in preparing the DCF analysis but were an older set of projections. *Id.* The plaintiffs argued that the time frame was relevant because they were faced with making an important voting decision to which the projections directly related. *Id.*
66. *Id.* at 177.
67. *Id.* at 203.

Thus, for the first time, a Delaware court found that free cash flow projections were material and were required to be disclosed.

Adding to the disparity, later in 2007, Chancellor Chandler again ruled, at the preliminary injunction stage, that free cash flow projections are not material and are not required to be disclosed.[68] The target corporation, Checkfree, received an offer to consummate a merger from Fiserv at $48 per share, which was higher than all other offers.[69] The target corporation's board subsequently approved the merger agreement after considering the investment banker's fairness opinion and legal advice from the company's counsel.[70] The target corporation then released its proxy statement, which outlined the transaction and the investment banker's fairness opinion.[71] The plaintiffs sought to enjoin the merger and alleged that the board breached its duty of disclosure by not including management's financial projections in the proxy statement.[72] Chancellor Chandler held that failing to disclose all of the financial data necessary to make an independent determination of fair value is not necessarily misleading shareholders or omitting a material fact.[73] Citing *In re Pure Resources, Inc. Shareholder Litigation*,[74] a decision by Vice Chancellor Strine, the court said that stockholders are entitled to a fair summary of the investment bankers' substantive work.[75] Here, the court held that the proxy statement, which the plaintiffs alleged to be deficient, does, in fact, contain a fair and adequate summary of the work of the investment bankers.[76] The court further expounded that plaintiffs have the burden of explaining why disclosure of additional information would significantly alter the total mix of available information.[77] In holding that shareholders are solely entitled to a fair and adequate summary of the investment bankers' work, *Checkfree* supports a standard of less required disclosure.[78]

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68. *In re* Checkfree Corp. S'holder Litig., No. 3193-CC, 2007 WL 3262188, at *3 (Del. Ch. Nov. 1, 2007).

69. *Id.* at *1.

70. *Id.*

71. *Id.*

72. *Id.* at *2. Specifically, the plaintiffs argued that the board breached its duty of disclosure by not disclosing certain projections to the shareholders that management had prepared and shared with the acquiring corporation and its financial advisor. *Id.*

73. *Id.* (citing *In re* Gen. Motors S'holder Litig., 2005 WL 1089021, at *16 (Del. Ch. 2005)).

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

75. *In re Checkfree*, 2007 WL 3262188, at *2 (citing *In re Pure Resources*, 808 A.2d at 449).

76. *Id.*

77. *Id.*

78. *Compare Id.* at *3 (holding that a fair and adequate summary of the investment bankers' work does not include free cash flow projections), *with* Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., No. 5402-VCS, 2010 WL 1931084, at *2 (Del. Ch.

Soon after *Checkfree*, however, the Court of Chancery again reversed direction in another decision by Vice Chancellor Strine.[79] *Maric Capital Master Fund, Ltd. v. Plato Learning, Inc.*[80] involved a proposed merger wherein Thoma Bravo, LLC, sought to acquire PLATO Learning, Inc.[81] The plaintiffs contended that the proxy statement selectively disclosed certain projections and, more specifically, that the proxy did not include the estimates that management provided to the investment banker.[82] The court preliminarily enjoined the merger until further disclosures were made.[83] Importantly, Vice Chancellor Strine stated that, in his view, free cash flow estimates of a corporation are clearly material information.[84]

In the most recent of the free cash flow projection materiality line of cases,[85] Chancellor Chandler again ruled that free cash flow projections are not material.[86] The case is ongoing and involves a proposed merger where Thomas H. Lee seeks to acquire inVentiv.[87] The plaintiff argued that the failure of the proxy statement to include management's free cash flow estimates prevents the stockholders from being able to decide

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May 13, 2010) (holding that free cash flow projections are material and required to be disclosed to shareholders).

79. Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., No. 5402-VCS, 2010 WL 1931084 (Del. Ch. May 13, 2010).

80. *Id.*

81. *Id.* at *1.

82. *Id.* at *2.

83. *Id.* at *3.

84. *Id.* at *2.

85. After this Comment was written, but before publication, Vice Chancellor Noble decided another case, Gaines v. Narachi, C.A. No. 6784-VCN, 2011 Del. Ch. LEXIS 157 (Del Ch. Oct. 6, 2011), involving the disclosure of free cash flows. In *Narachi*, Vice Chancellor Noble distinguished the case from others by pointing out that the plaintiffs were not being cashed out and would remain entitled to a portion of the acquiring corporation's future cash flows. *Id.* at *4. Vice Chancellor Noble stated 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. . . . In conclusion, the Plaintiff has pled a colorable claim that the Proxy's omission of the free cash flow projections utilized by Morgan Stanley is a material omission that raises a threat of irreparable injury.

*Id.* at *5 (citations omitted).

86. Steamfitters Local Union 447 v. Walter, No. 5492-CC, slip op. (Del. Ch. June 21, 2010).

87. *Id.* at 7.

whether to vote for the merger or seek appraisal.[88] Chancellor Chandler held that, under these facts, while free cash flow information would add to the total mix of available information, that information "would [not] meaningfully alter the total mix of information available through the definitive proxy on that point."[89] Chancellor Chandler again distinguished the case from *Maric* and *Netsmart* by highlighting that inVentiv's board did not partially disclose or deliberately excise free cash flows.[90] Importantly, however, Chancellor Chandler offered to sign an order certifying an interlocutory appeal to the Delaware Supreme Court on whether, as a per se rule, disclosure of free cash flow projections are always required.[91] The plaintiff decided not to pursue the interlocutory appeal.[92] Thus, the Delaware Supreme Court is unlikely to address the issue of whether free cash flow projections are material in the near future, leaving continued ambiguity as boards of directors and attorneys decide which disclosures are necessary.

## III. ANALYSIS

This section explores why the current rule in Delaware is problematic, stressing the divide in the decisions by Chancellor Chandler and Vice Chancellor Strine. From there, this section analyzes the concept of the reasonable stockholder, the relevance of financial theory, the public policy reasons for why a per se rule should be adopted, and the treatment of free cash flow projections regarding materiality both under the Federal Securities Laws and select European laws.

### *A. Problems with the Current Rule*

The disparity in Delaware case law concerning whether free cash flow projections are material and required to be disclosed has caused confusion among the practicing bar.[93] The problem with how the law currently stands is that the law is in a state of flux and nothing is clear or easy to follow. More specifically, an attorney representing a target

88. *Id.*

89. *Id.* at 8.

90. *Compare id.* at 9 (holding that, when no partial disclosure was made, free cash flow projections are not material and not required to be disclosed), *with Maric*, 2010 WL 1931084, at *2 (holding that free cash flow projections, in a situation when there had been partial disclosure of the projections, are material and required to be disclosed to shareholders).

91. *Steamfitters*, No. 5492-CC, slip op. at 10; *see supra* note 9 and accompanying text.

92. E-mail from Lisa A. Schmidt, Director, Richards, Layton & Finger, P.A., to author (Aug. 26, 2010, 17:26 EST) (on file with author); *see supra* note 10 and accompanying text.

93. *See infra* note 96 and accompanying text.

corporation's board of directors does not know whether to disclose free cash flows when anticipating shareholder action. Additionally, according to current case law, plaintiffs are more likely to succeed when management partially discloses projections, particularly if those disclosures are outdated.[94] Because the board may violate its fiduciary duty of disclosure if partial or outdated projections are disclosed,[95] the decision of what and when to disclose becomes even more complicated.

Delaware's choice not to establish a per se rule requiring the disclosure of internal free cash flow projections has caused more confusion and complication than necessary.[96] Delaware's rule resembles a balancing test: trying not to provide shareholders with excess information while still attempting to provide all of the material information needed to take an informed action.[97] The court's fear is that an overabundance of information will burden the stockholder with excess irrelevant information through which it would be nearly impossible to sift.[98] In the case of shareholder disclosure, the balance between not disclosing enough information and an overabundance of information is delicate.[99] Thus, a board's failure to disclose material, or even potentially material information, to a stockholder could be more damaging to the stockholder than an overabundance of information.[100]

Navigating this delicate balance, the Delaware Court of Chancery held that stockholders are entitled to a fair summary of the investment

94. *In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171, 199 (Del. Ch. 2007); Paul H. Dawes & Jessica L. Hubley, *The Disclosure of Management Projections Under Delaware Law*, 1762 PLI/CORP 441, 446 (2009).

95. Dawes, *supra* note 94, at 446. Because shareholders base their decision of whether to accept the merger consideration on the disclosed information, partial or outdated disclosures can mislead the shareholders. *Id.* When partial or outdated disclosures are made, management should disclose full and updated information to comply with both Federal and Delaware law, and to avoid violating the fiduciary duty of disclosure. *Id.*

96. *See id.* at 445. Attorneys have to consider both the federal securities laws and state law disclosure requirements, along with various public policy issues that call for a fact specific analysis, with no clear outcome. *Id.*

97. *See In re* General Motors (Hughes) S'holder Litig., No. 20269, 2005 WL 1089021, at *13 (Del. Ch. May 4, 2005) ("Delaware law does not require 'directors to bury the shareholders in an avalanche of trivial information. Otherwise, shareholder solicitations would become so detailed and voluminous that they will no longer serve their purpose.'") (citing Solomon v. Armstrong, 747 A.2d 1098, 1130 (Del. Ch.1999)).

98. *See id.* at *13.

99. *See, e.g.*, *id.* at *13.

100. *See In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 360-61 (Del. Ch. 2008). An example of where a board's failure to disclose material information to a shareholder is more damaging than disclosing too much information is most apparent when there has been irreparable harm to the stockholders as a result of the board's failure to disclose information. *Id.*

bankers' substantive work.[101] The court set forth a broad, inclusive list of what falls within the "substantive work of investment bankers" including assumptions, valuation exercises, and the range of values generated with that data.[102] However, some academics maintain that a "fair summary of the substantive work performed" does not include publication and disclosure of the underlying projections.[103] Other cases in Delaware have since held that information such as underlying projections are indeed important and even material.[104]

### *B. Distinguishing Factors Between Chandler and Strine*

Vice Chancellor Strine said in *PNB*, a post-merger appraisal trial, that reliable management projections are of "obvious materiality to the [shareholders]."[105] Strine based the materiality of management projections on the importance of the decision stockholders face in deciding whether to accept the merger consideration or pursue their appraisal rights.[106] The court has since held in opinions authored by Strine that management projections are material in both *Netsmart* and *Maric*.[107] Conversely, Chancellor Chandler stated that "[a] disclosure that does not include all financial data necessary to make an independent determination of fair value is not . . . per se misleading or omitting a material fact."[108] Because these views contradict each other, with the conflicting cases arising during the same time period and within the same jurisdiction,[109] the factors on which the judges distinguished the cases are important to explore and to analyze.

First, Chancellor Chandler distinguished *Checkfree* from Vice Chancellor Strine's decision in *Netsmart* by pointing out that the proxy statement in *Netsmart* "affirmatively disclosed an early version of some

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

102. *Id.* at 449.

103. Dawes, *supra* note 94, at 448.

104. *See* Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., No. 5402-VCS, 2010 WL 1931084 (Del. Ch. May 13, 2010) (holding that free cash flow projections are material and required to be disclosed to shareholders); *In re* PNB Holding Co. S'holders Litig., No. 28-N, 2006 WL 2403999 (Del. Ch. Aug. 18, 2006) (holding that estimates of a company's future earnings, if reliable enough to aid stockholders in making an informed judgment, are material).

105. *In re PNB*, 2006 WL 2403999, at *16. *See also* Zirn v. VLI Corp., 681 A.2d 1050, 1059 n.4 (Del. 1996).

106. *See In re PNB*, 2006 WL 2403999, at *16.

107. *Maric*, 2010 WL 1931084, at *2; *In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171, 177 (Del. Ch. 2007).

108. *In re* Checkfree Corp. S'holder Litig., No. 3193-CC, 2007 WL 3262188, at *2 (Del. Ch. Nov. 1, 2007) (citing *In re* General Motors (Hughes) S'holder Litig., No. 20269, 2005 WL 1089021, at *16 (Del. Ch. May 4, 2005)).

109. *See supra* Section III.A.

of management's projections,"[110] while that was not the case in *Checkfree*.[111] An important point, helping to explain the reasoning behind the *Checkfree* decision, is that management had already disclosed estimated earnings for two years, making the plaintiff's disclosure argument less relevant.[112] Chancellor Chandler further distinguished *Netsmart* by emphasizing Vice Chancellor Strine's statement that further disclosure was required once "a board broache[d] a topic in its disclosures."[113] Chancellor Chandler also focused on the inherent unreliability of projections, and that, because of their unreliability, projections sometimes mislead shareholders and are speculative at best.[114]

As mentioned previously, *Pure Resources* set out the principle that stockholders are entitled to a fair summary of the investment bankers' substantive work.[115] Interestingly, both Chancellor Chandler and Vice Chancellor Strine rely on this principle but for opposite reasons.[116] *Checkfree*, a decision by Chancellor Chandler, stands for the proposition that a fair and adequate summary does not need to include management's projections to fulfill the *Pure Resources*' standard.[117] Chancellor Chandler attempted to set *Checkfree* apart from *Netsmart* by stating that the proxy at issue in *Netsmart* did not include such a fair and adequate summary.[118] Vice Chancellor Strine, the judge who decided *Pure Resources*, on the other hand, stated that management's internal projections are necessary for there to be a fair and adequate summary.[119] Vice Chancellor Strine maintained that the valuation methods, key inputs, and ultimate values the investment bankers generate must be fairly disclosed.[120] Because Vice Chancellor Strine focuses on the

110. *In re Checkfree*, 2007 WL 3262188, at *3.
111. *Id.*
112. *Id.*
113. *Id.*
114. *Id.* (citing *In re* PNB Holding Co. S'holders Litig., No. 28-N, 2006 WL 2403999, at *16 (Del. Ch. Aug. 18, 2006)).
115. *In re Pure Resources, Inc. S'holder Litig.*, 808 A.2d 421, 449 (Del. Ch. 2002). *See supra* notes 74-78 and accompanying text.
116. *Compare In re Checkfree*, 2007 WL 3262188, at *3 (holding that a fair and adequate summary under *Pure Resources* does not require disclosure of management's projections), *with In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171, 204 (Del. Ch. 2007) (holding that a fair and adequate summary under *Pure Resources* requires disclosure of management's internal projections).
117. *In re Checkfree*, 2007 WL 3262188, at *3. *See also In re* Best Lock Corp. S'holder Litig., 845 A.2d 1057, 1073 (Del. Ch. 2001) (stating that a board does not need to disclose the specific details of the analysis underlying the financial advisor's opinion).
118. *In re Checkfree*, 2007 WL 3262188, at *3.
119. *In re Netsmart*, 924 A.2d at 204.
120. *Id.*

importance of the decision a shareholder must make in a merger,[121] and Chancellor Chandler focuses on the level of information to which a shareholder is entitled,[122] the Delaware Supreme Court should resolve these diverging views and clarify when free cash flows are material. Such a clarification would prevent confusion among lawyers as they counsel their clients on what information is material and required to be disclosed.[123]

### *C. The Reasonable Stockholder*

Determination of materiality involves a fact-specific inquiry and "is to be assessed from the viewpoint of the 'reasonable' stockholder, not from a director's subjective perspective."[124] Delaware case law does little to elaborate or expound upon the concept of the reasonable stockholder,[125] merely mentioning that the materiality standard is objective and should be measured from the viewpoint of the reasonable investor.[126] Because the law holds materiality to a reasonable investor standard,[127] Delaware courts should develop more fully the concept of the reasonable investor to better convey when information is material.

The concept of the reasonable investor is difficult to define; however, courts and scholars have identified certain characteristics that are often attributed to the reasonable investor.[128] The first attribute of the reasonable investor is that the reasonable investor is rational.[129] Second, the concept of the reasonable investor may be broad enough to include speculators who, through their own efforts, tend to be well informed both about the market in general and their particular investments.[130] The

121. *See In re* PNB Holding Co. S'holders Litig., No. 28-N, 2006 WL 2403999, at *16 (Del. Ch. Aug. 18, 2006).

122. *See In re Checkfree*, 2007 WL 3262188, at *2.

123. *See infra* Section IV.

124. Arnold v. Soc'y for Sav. Bancorp., Inc., 650 A.2d 1270, 1277 (Del. 1994) (citing Zirn v. VLI Corp., 621 A.2d 773, 779 (Del. 1993)).

125. Stockholder is synonymous with shareholder and investor as used in this Comment.

126. *See, e.g.*, *Zirn*, 621 A.2d at 779.

127. *See, e.g.*, *id.*

128. Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 296 (2009).

129. *See, e.g.*, DeBenedictis v. Merrill Lynch & Co., 492 F.3d 209, 218 (3d Cir. 2007) (discussing the concerns of a reasonable investor and assuming that a reasonable investor engages in cost-benefit analysis). Case law supports the proposition that the reasonable investor is a rational investor, without making this view explicit. *See also* Heminway, *supra* note 128, at 296-97.

130. Heminway, *supra* note 128, at 298-99 (citing H.R. REP. NO. 73-1383, at 11 (1934); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 n.10 (2d Cir. 1968)).

Second Circuit Court of Appeals, explaining the speculator concept, stated:

> The intelligent speculator assumes that facts are available for a thorough analysis. The speculator then examines the facts to discover and evaluate the risks that are present. He then balances these risks against the apparent opportunities for capital gains and makes his decision accordingly. He is, to the best of his ability, taking calculated risks.[131]

The idea that the speculator is a calculated risk taker goes hand in hand with the idea of a reasonable investor who examines facts, pulls in data, and makes decisions based upon a reasonable calculation of the various alternatives.

Further expanding the concept of the reasonable investor, the Second Circuit Court of Appeals stated that "the . . . chartists of Wall and Bay Streets are . . . 'reasonable' investors."[132] Chartists, as the name hints, are investors that use historical data to track trends in the market, using their charts to decide where, when, and how to invest.[133] Moreover, the reasonable investor concept includes those who engage in fundamental analysis.[134] Fundamental analysis involves calculating the fair market value of a company's outstanding shares by plugging in various numbers, including the company's earnings.[135]

Additionally, several courts have found that reasonable investors are sophisticated investors who appreciate the complexity of transactions, understand that an investment involves a certain level of risk, and make calculated decisions to maximize their investments.[136] Thus, many courts view the reasonable investor as rational, sophisticated, a chartist, and potentially a speculator.[137] Because of this view, the reasonable investor can be defined as an investor who researches his decisions, knows how to perform calculations, understands the meaning and significance of the results of his calculations, and determines the inherent value of his investments when making decisions on how to invest.[138] A

131. *Texas Gulf Sulphur*, 401 F.2d at 849 n.10.

132. *Id.* at 849.

133. *See* Heminway, *supra* note 128, at 299-300 (citing Flamm v. Eberstadt, 814 F.2d 1169, 1182 (7th Cir. 1987); United States v. Gilbert, No. S80 Cr. 493-CSH, 1981 WL 1662, at *12 (S.D.N.Y. July 23, 1981)).

134. *See id.* at 300.

135. *See id.*

136. *See, e.g.*, *Flamm*, 814 F.2d at 1175; No. 84 Emp'r-Teamster Joint Council Pension Trust Fund v. Am. W. Holding Corp., 320 F.3d 920, 935 (9th Cir. 2003).

137. *See* Heminway, *supra* note 128, at 296.

138. *See id.* at 301.

reasonable investor, therefore, would use free cash flow projections in his analysis and decision making process.[139]

Discordantly, Professor Sachs argues that the reasonable investor is the "least sophisticated investor," meaning that the reasonable investor is simple and does not rationally think out his investment decisions.[140] However, while attempting to make her case, Professor Sachs concedes that sophistication and rationality are, in fact, commonly associated with the reasonable investor,[141] further strengthening the argument that the law's current view of the reasonable investor as a sophisticated, calculating investor who rationally considers all options before making an investment decision is accurate.[142] By viewing the reasonable investor as a sophisticated investor with the attributes described above, the Delaware Supreme Court is likely to find that free cash flow projections are material to the reasonable investor. By finding that free cash flow projections are material to the reasonable investor, the Delaware Supreme Court should require the disclosure of projected free cash flows in a merger proxy or tender offer.

### *D. Implications of Financial Theory*

Standard financial theory and practice base the value of stock and the corporation in general on the expected future cash flows of a corporation.[143] These free cash flow estimates, along with the appropriate discount rate, are used to discount the future value of the cash flows to determine the present value, using a discounted cash flow (DCF) analysis to calculate the net present value (NPV) of the investment.[144] The present value of the projected free cash flows is used to determine the value of the company as a going concern.[145] The going

139. *See, e.g., id.* at 300 (explaining that reasonable investors engage in fundamental analysis, which focuses on the intrinsic value of stocks. Intrinsic value is based on, *inter alia*, earnings and the factor of management).

140. Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "the Reasonable Investor" with "the Least Sophisticated Investor" in Inefficient Markets*, 81 TUL. L. REV. 473, 473 (2006).

141. *Id.* at 504.

142. *See* Heminway, *supra* note 128, at 301.

143. *See* Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., No. 5402-VCS, 2010 WL 1931084, at *2 (Del. Ch. May 13, 2010). *See generally* Nagy v. Bistricer, 770 A.2d 43, 48 (Del. Ch. 2000) (explaining that the merger consideration to be paid would be adjusted based on a to-be-obtained valuation of the target that was calculated based on management's projections, among other factors).

144. *See In re* PNB Holding Co. S'holders Litig., No. 28-N, 2006 WL 2403999, at *20 (Del. Ch. Aug. 18, 2006); KEOWN, *supra* note 1, at 147; THOMPSON, *supra* note 1, at 372; Dawes, *supra* note 94, at 448.

145. *See* MacLane Gas Co. Ltd., P'ship v. Enserch Corp., No. 10760, 1992 WL 368614, at *15 (Del. Ch. Dec. 9, 1992).

concern value is then divided by the number of outstanding shares to determine the per share value of the company.[146] Thus, free cash flows are important in valuing a company.[147]

Understandably then, a lack of free cash flow estimates creates difficulty for a stockholder who is trying to understand how the investment banker valued the company.[148] Furthermore, materially inaccurate free cash flows greatly impact the determination of whether the merger consideration is indeed a fair representation of the value of the company and the value of each share of the company's stock.[149] This analysis is relevant in a merger or tender offer context as stockholders ask themselves whether the price being offered as the merger consideration is "fair compensation for the benefits [the stockholder] will receive . . . from the future expected cash flows of the corporation if the corporation remains as a going concern."[150] The importance of projected free cash flows to an investor's analysis when deciding whether the price offered as consideration in the merger is fair strengthens the argument of materiality in favor of the Delaware Supreme Court finding that free cash flow projections are material.

### *E. Public Policy*

The overriding concern governing disclosure in Delaware is the court's effort to provide shareholders with all of the material information needed to make an informed decision while not overburdening shareholders with excess information.[151] As discussed previously,[152] the balance between not enough information and an overabundance of information is delicate and difficult to navigate.[153] While the dangers of

146. *See generally* London v. Tyrrell, No. 3321-CC, 2010 WL 877528, at *4 (Del Ch. Mar. 11, 2010) (stating that the per share value was calculated in an effort to adequately value the company).

147. *See generally In re PNB*, 2006 WL 2403999, at *20 (relating that a DCF analysis, involving free cash flow estimates, is necessary in valuing a company).

148. *See id.*

149. *See id.*

150. Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., No. 5402-VCS, 2010 WL 1931084, at *2 (Del. Ch. May 13, 2010).

151. *See In re* General Motors (Hughes) S'holder Litig., No. 20269, 2005 WL 1089021, at *13 (Del. Ch. May 4, 2005) (citing Solomon v. Armstrong, 747 A.2d 1098, 1130 (Del. Ch.1999)). The court worries that increased disclosure would lead to an overabundance of information and would burden the stockholder with a large amount of irrelevant or unimportant information through which it would be difficult to sift. *Id.*

152. *See supra* Section III.A.

153. *See, e.g., In re General Motors*, 2005 WL 1089021, at *13 ("Delaware law does not require 'directors to bury the shareholders in an avalanche of trivial information. Otherwise, shareholder solicitations would become so detailed and voluminous that they will no longer serve their purpose.'").

the target corporation's board disclosing an overabundance of information are real,[154] the board's failure to disclose material, or potentially material, information could also cause irreparable harm.[155] Therefore, in setting a disclosure standard, a court must consider the utility of the information to be disclosed to the reasonable stockholder.

In assessing utility, a court must decide whether management's free cash flow projections, which are often used by bankers in forming their fairness opinion, are material or would contribute to an overabundance of information.[156] In *Margolis*, Vice Chancellor Noble stated:

> The key assumptions made by a banker in formulating his opinion are of paramount importance to the stockholders because any valuation analysis is heavily dependent upon the projections utilized. A proxy statement should "give the stockholders the best estimate of the company's future cash flows as of the time the board approved the [transaction]."[157]

By stressing the value of projections, Vice Chancellor Noble's opinion contributes to the argument that, as a matter of public policy, future cash flow estimates are material and always should be disclosed to stockholders in a merger proxy situation.[158] The Delaware Supreme Court reasonably could conclude that the utility of free cash flow projections to shareholders outweighs the fear of providing the shareholders with an overabundance of information, leading to the court finding that free cash flows are material as a matter of public policy.

154. A large quantity of disclosed information would be, *inter alia*, difficult for a stockholder to sift through, find what information is meaningful, and make an informed decision. Given the seriousness of the situation in a merger transaction when a stockholder is likely choosing whether to relinquish ownership and turn over control of his shares, the decision of whether to tender or sell shares and how to vote on the pending transaction has added importance.

155. *See In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 360-61 (Del. Ch. 2008) (stating that a breach of the duty of disclosure leads to irreparable harm because of an inability of the court to rectify any harm after the fact, leading the court to grant injunctive relief to prevent shareholders from voting without complete and accurate information).

156. Utility, as used in this context, refers to the balance between the materiality of the free cash flow projections and the need for the target corporation to not provide the shareholders with excess information.

157. David P. Simonetti Rollover IRA v. Margolis, No. 3694-VCN, 2008 WL 5048692, at *10 (Del. Ch. June 27, 2008) (citing *In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171, 203 (Del. Ch. 2007)).

158. *Id.*

### *F. Result Under Securities Laws*[159]

Because the Delaware Supreme Court adopted the federal securities law materiality standard set forth by the United States Supreme Court, an analysis of materiality under the federal securities laws is directly relevant to the issue of materiality in Delaware.[160] The Securities and Exchange Commission (the "SEC") frequently argues that disclosure of free cash flow projections are material and are even more likely to be material when there has already been partial disclosure.[161] Thus, an attorney often must consider both federal securities law and Delaware law when evaluating whether to disclose management projections.[162]

In securities law, materiality is a question of fact.[163] Thus, for example, in a Rule 10b-5 case,[164] materiality is typically a jury question, "requiring an assessment of the inferences that a reasonable shareholder would draw from a given set of facts."[165] In evaluating the materiality of projections in a situation involving securities, the Second Circuit stated that

> material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.[166]

This broad definition of what constitutes a material fact under the securities laws explicitly leads to the inclusion of facts affecting the future of the company,[167] such as free cash flow projections.

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159. *See* Dawes, *supra* note 94, at 445 (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 446-47 (1976)). This section is relevant to the overall discussion of the materiality of free cash flow projections because Delaware adopted its disclosure rules from a securities law standard set forth by the United States Supreme Court. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985). Federal securities laws deal with the issuance of securities as well as the trading of securities that are already in the marketplace. *See* Dawes, *supra* note 94, at 445. The principal federal laws governing securities are the Securities Act of 1933 ('33 Act), 15 U.S.C. § 77a, and the Securities Exchange Act of 1934 ('34 Act), 15 U.S.C. § 78a.

160. *Rosenblatt*, 493 A.2d at 944.

161. *See* Dawes, *supra* note 94, at 459.

162. *Id.* at 445.

163. Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures That Require Investors to Calculate the Bottom Line*, 34 PEPP. L. REV. 927, 937 (2007).

164. Rule 10b-5 is a provision under the '34 Act that deals with fraudulent schemes and untrue statements concerning material facts, both made and omitted. Liability under Rule 10b-5 requires scienter, unlike liability under Section 12 of the '33 Act.

165. Padfield, *supra* note 163, at 937 (citing Marksman Partners L.P. v. Chantal Pharm., 927 F. Supp. 1297, 1305-06 (C.D. Cal. 1996)).

166. SEC v. Tex. Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).

167. *See id.*

While materiality is a question of fact, there are times when parties to a transaction are required to make certain disclosures. One example of when parties are required to disclose certain financial information is in the context of a going private transaction under Rule 13e-3 of the Securities Exchange Act of 1934.[168] These disclosures include, as the SEC states in Regulation M-A, statements of pro forma information[169] and cash flows.[170] By explicitly requiring disclosure of projections in this context, the SEC shows that free cash flows are, at least in this instance, material and important to the SEC in its evaluation of the proposed transaction. Because Delaware adopted the materiality standard from the federal securities laws,[171] the SEC requiring the disclosure of financial projections and free cash flows in certain circumstances strongly supports Delaware also requiring that free cash flows be disclosed.

To have a successful securities fraud claim, a plaintiff must prove that he relied on the material misstatement or omission in his decision to buy or sell the security in question to establish liability.[172] Also, when securities are involved, an omission or misstatement of a material fact can lead to strict liability by the seller of the security.[173] When a court finds that an omitted or misstated fact is material, which may very well be the case when free cash flows are omitted, the seller of the securities may then be liable to the purchaser.[174] An inclusion of free cash flows as part of required disclosure under the securities laws presents a compelling course for the Delaware Supreme Court to follow when it considers whether free cash flows are material information and thus required to be disclosed.

168. 17 C.F.R. § 240.13e-3 (2008).

169. KEOWN, *supra* note 2, at 107 (explaining that pro forma financial statements are a collection of financial forecasts used by corporations in budgeting and planning activities).

170. 17 C.F.R. § 229.1010 (1999).

171. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985).

172. Padfield, *supra* note 163, at 937 (citing Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988)).

173. If the security falls under Rule 10b-5 of the '34 Act, scienter is required. Under Section 12(a)(2) of the '33 Act, there is a reasonable care defense for the seller of such securities who maintains the burden of proof. Section 12(a)(1) of the '33 Act is a non-fault liability provision.

174. *See* 15 U.S.C.A. § 77l(a). Section 12(a)(2) of the '33 Act states that a person who offers or sells a security through any oral or written prospectus "which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading" is liable to the person who purchased such security from him. This is a strict liability standard when there is a material omission.

### G. *A Comparative View*

Disclosure obligations in Europe vary depending on the country and nature of the issue.[175] Some European nations promote a broad duty of disclosure and feel that shareholders should have virtually unlimited access to information about the corporation.[176] Other European nations have disclosure laws remarkably similar to that of the United States.[177] While European law does not govern United States transactions, courts in the United States can analyze the various European approaches and use them as a roadmap for U.S. transactions when beneficial.

One such European approach is found in Switzerland.[178] In the context of asset-backed securities, Swiss law requires that the prospectus "contain a summary of the transaction and a transaction overview."[179] This summary and overview must include, *inter alia*, the key elements of the transaction, be easily understood by potential investors, discuss the risks involved, and discuss the overall structure of the transaction.[180] The Swiss approach is a broad, inclusive approach to disclosure. Other countries have an approach similar to the Swiss approach, like Russia, which expanded disclosure obligations to include, *inter alia*, disclosure of significant events, including major corporate actions, changes in management, and changes in asset values or profits/losses by more than ten percent.[181] The approaches of these countries are broad because they are aimed at expanding disclosure. When applied to free cash flows, these approaches likely would regard such cash flows as a required item of disclosure.

Alternatively, the German approach to materiality and disclosure is much like the current United States approach under the securities laws.[182] In Germany, in reference to inside information, materiality is defined as information "of a kind that, if disclosed, could have a substantial effect

175. This Comment does not attempt to provide an extensive look at the disclosure duties of any one country. Rather, the focus is to provide a few insights into select European laws that the court may find applicable to the disclosure of free cash flows in Delaware.

176. *See* European Law Digests, 1 IRELAND LAW DIGEST 2.04 (describing the duty of disclosure as a duty of transparency).

177. Harmut Krause, *The German Securities Trading Act (1994): A Ban on Insider Trading and an Issuer's Affirmative Duty to Disclose Material Nonpublic Information*, 30 INT'L LAWYER 555, 566 (1996).

178. Michael S. Sackheim et al., *International Securities and Derivatives*, 33 INT'L LAWYER 449, 465-66 (1999).

179. *Id.* at 467.

180. *Id.*

181. *Id.* at 468 (citing Commission Res. No. 32 (Aug. 12, 1998)) (describing significant events as including "major corporate actions, changes in management, and changes in asset values or profits/losses by more than ten percent").

182. Krause, *supra* note 177, at 566.

on the market price."[183] Given this test of materiality, it is hard to foresee a situation when an issue of materiality would come out differently under United States law than it would under German law.[184] Additionally, German securities issuers have an affirmative responsibility to disclose "information that is new, has originated in the field of the issuer's activities, is unknown to the public, and may substantially influence the market price because it has a bearing on the issuer's asset and financial situation or its general business prospects."[185] Given its similarity to the United States system, courts in Germany have had similar problems determining where to draw the line between material and nonmaterial information,[186] such as in the case of free cash flows. A key difference between the United States and German securities markets, however, is that the number of issuers registered on the German market is remarkably low.[187]

A third view, different than that of the United States, is that of Spain.[188] Spain allows shareholders broad access to information of the corporation, maintaining certain minimum requirements that can be altered by the company's articles of incorporation.[189] Shareholders are allowed access to all "relevant documentation relating to the items on the agenda," which include, *inter alia*, "annual accounts, management reports, audit reports, complete text of proposals on resolutions submitted by the Board to the shareholders' meeting, as well as any report of the Board on such proposals."[190] Disclosure on this level usually arises in conjunction with a shareholders' meeting,[191] such as the one that would take place to vote on a merger. The only time such

183. *Id.* at 565.

184. *Compare* EC Insider Trading Directive, Council Directive 89/592 of 13 November 1989 Coordinating Regulations on Insider Dealing 1989, O.J. (L 334) 130, art. 1(1) (determining materiality by looking at "information which . . . if it were made public, would be likely to have a significant effect on the price of the [security]."), *and Krause*, *supra* note 177, at 566 (focusing on the impact that information has on the reasonable investor when determining materiality), *with* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 439 (1976) (stating that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote").

185. *Krause*, *supra* note 177, at 582.

186. *See id.* at 566. Germany also balances public policy concerns of overburdening shareholders with excess information with the difficulty for issuers in identifying what is material. *Id.*

187. *Id.* at 564 (explaining that fewer than 700 corporations are listed on the German stock exchanges).

188. Ura Mendez et al., SOCIETAS EUROPAEA, THE EUROPEAN COMPANY ACROSS EUROPE: SPAIN 7.2 (2007).

189. *Id.*

190. *Id.*

191. *Id.*

disclosure is not required in Spain is when "disclosure of the information would damage the corporate interests."[192] This approach is most closely related to that of Switzerland, with both having broad definitions of materiality and items required to be disclosed.[193] Such a broad definition of materiality most likely leads to required disclosure of free cash flows, especially upon a demand by the shareholders.

As discussed above, Swiss, Russian, and Spanish law all support a broad definition of materiality, while German law has an approach to determining materiality similar to that found in the US. Because of the broad definition of materiality adopted by the countries discussed above, free cash flows likely would be deemed material, presenting another possible course for the Delaware Supreme Court to follow as it determines whether free cash flows are material information.

## IV. PROPOSED RULE

Because of the problems with the current disclosure rule under Delaware common law and the policy considerations discussed above, this Comment proposes that the Delaware Supreme Court require, by means of a rebuttable presumption,[194] that projected free cash flows be deemed material and required to be disclosed to stockholders in a merger proxy or tender offer situation. The adoption of a rebuttable presumption ensures that stockholders have all of the material information needed to make an informed decision and that they can make their decision without over burdensome, excess information.[195]

Courts should assess materiality under Delaware law from the viewpoint of the reasonable stockholder.[196] When adopting a rebuttable presumption of materiality of free cash flow projections, Delaware should further develop the concept of the reasonable investor to provide more guidance to courts and the practicing bar. By defining the reasonable investor as a sophisticated investor who researches his decisions and determines the inherent value of his investments when making decisions on how to invest,[197] Delaware law would provide sufficient guidance to courts and attorneys as they determine whether the

192. *Id.*

193. *Compare* Sackheim, *supra* note 178, at 467 (stating that the prospectus must contain a transaction overview which provides the key elements of the transaction), *with* Mendez, *supra* note 188, at 7.2 (stating that shareholders are allowed broad access to all relevant documents).

194. The fact finder would still have the ability to decide that free cash flows are not material in a given situation and thus not require disclosure. In a large majority of cases, however, the target corporation would be required to disclose free cash flows.

195. *See supra* Section III.E.

196. Zirn v. VLI Corp., 621 A.2d 773, 779 (Del. 1993). *See supra* Section III.C.

197. *See* Heminway, *supra* note 128, at 301.

given financial information is material. In the context of free cash flow projections, the courts' finding that the reasonable investor is a sophisticated investor who makes an informed judgment concerning his vote supports the proposed rule that free cash flow projections are material. When analyzing materiality from a more thoroughly defined concept of the reasonable shareholder, the Delaware Supreme Court reasonably should conclude that free cash flow projections are material.[198]

An evaluation of the importance of free cash flow projections under financial theory further strengthens the argument in favor of the Delaware Supreme Court finding that free cash flow projections are material.[199] By clarifying the materiality standard to stress the importance of free cash flows in a stockholder's analysis, Delaware would be expounding upon and following case law found in *Weinberger* as it relates to valuation.[200] Thus, the Delaware Supreme Court reasonably could conclude that free cash flows are a key piece of the analysis a stockholder goes through in determining how to vote, finding further support for adopting a rebuttable presumption that free cash flows are material.[201]

The adoption of a rebuttable presumption ensures that the stockholders have all of the material information needed to make an informed decision while not overburdening the shareholders with excess information.[202] A rebuttable presumption is favorable for the investor, has the potential to attract more investors to Delaware corporations, and would be an easy measure for companies to implement. Furthermore, it would carry few negative side effects. The adoption of such a clear rule would prevent the confusion that currently exists as attorneys seek how to best counsel their clients and boards decide what information to disclose to stockholders.[203] Framing the rule as a rebuttable presumption allows the defendant, in situations that the court will define, to argue that

198. *See In re* PNB Holding Co. S'holder Litig., No. 28-N, 2006 WL 2403999, at *15 (Del. Ch. Aug. 18, 2006) (stating that "reliable management projections of the company's future prospects are of obvious materiality to the [shareholders]"). *See, e.g.*, DeBenedictis v. Merrill Lynch & Co., 492 F.3d 209, 218 (3d Cir. 2007) (discussing the concerns of a reasonable investor and assuming that a reasonable investor engages in cost-benefit analysis).

199. *See supra* Section III.D.

200. Weinberger v. UOP, Inc., 457 A.2d 701, 712 (Del. 1983) (stating that generally accepted valuation techniques used in the financial community can be used in appraisal and other stock valuation proceedings in Delaware).

201. *See In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171, 177 (Del. Ch. 2007) (stating that a reasonable stockholder would find projected cash flows material).

202. *See supra* Section III.E.

203. *See supra* Section III.A.

free cash flow projections in a given situation are not material and should not be disclosed.

The court's adoption of a rebuttable presumption would, however, make non-materiality a difficult burden to meet. Further, while a bright line rule is easier to follow, it may well be either over or under inclusive.[204] Because the potential benefits to shareholders who are faced with an important decision in deciding how to vote or whether to tender their shares outweighs the negative aspect of a potentially over or under inclusive rule, the adoption of a rebuttable presumption is the best option for the Delaware Supreme Court.

One method of determining whether the proposed rule is a viable option is to look at the market reaction to a given transaction, which serves as strong evidence of materiality or non-materiality.[205] If shareholders have already voted on a transaction, then, by the time a court could view the market's reaction, it is usually too late to remedy any harm.[206] To prevent harm to the shareholders, the court must adopt a solution up front that is aimed at preventing the anticipated harm. Because Delaware courts currently prefer that disclosure claims are litigated at the preliminary injunction stage, before the shareholder vote,[207] potential harm to the plaintiffs is limited. Litigating claims at the preliminary injunction stage largely avoids disclosure-based monetary damages.[208] Monetary damages, however, are not the only harm suffered by shareholders, meaning that merely requiring that disclosure claims are litigated at the preliminary injunction stage is not sufficient to prevent all harm to shareholders. For example, when a breach of the duty of disclosure falls under the fiduciary duty of care, Section 102(b)(7) of the Delaware General Corporation Law exculpates directors from monetary damages for breaches of the duty of care. Whereas harm is caused to the shareholders as a result of a failure to disclose material information, that harm is irreparable because directors are exculpated from monetary liability under Section 102(b)(7).[209] The best way for a court to prevent harm to shareholders and minimize liability on behalf of corporations, in a disclosure claim involving free cash flows, is to require, by means of a

204. Padfield, *supra* note 163, 929 (citing Basic Inc. v. Levinson, 458 U.S. 224, 236 (1988)).

205. *Id.* at 936 (citing *In re* Merck & Co., Sec. Litig., 432 F.3d 261, 269 (3d Cir. 2005)) (stating that "the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure").

206. *See In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 361 (Del. Ch. 2008).

207. *See* Dawes, *supra* note 94, at 447 (citing *In re Transkaryotic*, 954 A.2d at 360).

208. *See* Corinne Ball, Marilyn Sonnie & Anna Triponel, *The Board of Directors' Fiduciary Duties*, 1713 PLI/CORP 131, 162 (2009) (citing *In re* Netsmart Techs., Inc. S'holder Litig., 924 A.2d 171, 208 n.115 (Del. Ch. 2007)).

209. *See In re Transkaryotic*, 954 A.2d at 360-61.

rebuttable presumption, that projected free cash flows be disclosed upfront to stockholders.[210]

In addition to preventing irreparable harm to shareholders, increased disclosure by the target corporation in a merger context will likely increase the number of investors who are willing to invest in Delaware corporations. Investors will be more likely to invest in Delaware corporations because of increased predictability in the market.[211] As investors come to expect certain actions from corporations, like the disclosure of free cash flows in a merger, the market will be more stable and there will be less confusion among attorneys and management as they try to determine which items are required to be disclosed. Additionally, disclosure of free cash flow projections requires little extra effort by the target corporation's management and will result in the target corporation's shareholders making a more informed decision concerning the pending vote on the merger transaction. As long as the target corporation has been open with its shareholders, there are few foreseeable negative side effects of the additional disclosure.

## V. CONCLUSION

While disclosure of free cash flows has been a hotly debated issue in the past decade, the Delaware Supreme Court has yet to adopt a clear standard, as evidenced by the most recent advent of cases.[212] The disagreement between Chancellor Chandler and Vice Chancellor Strine of the Delaware Court of Chancery as to whether free cash flows are material has led to confusion among target corporation boards of directors and attorneys who seek to determine what financial information is material and merits disclosure.[213] By adopting a rebuttable presumption that free cash flow estimates are material, the Delaware Supreme Court would be following a path that is supported not only by Delaware case law but also by federal securities law, European law,

210. *See* discussion *supra* Section IV.

211. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 n.10 (2d Cir. 1968) (explaining that "[an investor] examines the facts to discover and evaluate the risks that are present. He then balances these risks against the apparent opportunities for capital gains and makes his decision accordingly.").

212. Steamfitters Local Union 447 v. Walter, No. 5492-CC, slip op. at 10 (Del. Ch. June 21, 2010) (offering to sign an order certifying an interlocutory appeal to the Delaware Supreme Court on whether, as a per se rule, free cash flow projections are material). *See supra* Section II.

213. *Compare In re* Checkfree Corp. S'holder Litig., No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007) (holding that free cash flow projections are not material and need not be disclosed), *with* Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., No. 5402-VCS, 2010 WL 1931084 (Del. Ch. May 13, 2010) (holding that free cash flow projections are material and thus required to be disclosed to shareholders).

financial theory, and public policy.[214] The proposed rule is favorable for the investor, would attract investors to Delaware corporations, is simple for the target corporation to implement, and would have few negative ramifications.[215] Free cash flow projections are central to the fundamental nature of the target corporation and are central to the valuation process. Viewing free cash flows in this light makes it hard for the court to find that free cash flow projections are not material to the reasonable shareholder. Most importantly, regardless of the path the Delaware Supreme Court chooses, the problems with the current rule demonstrate that the Delaware Supreme Court needs to act. The Delaware Supreme Court's adoption of a rebuttable presumption that free cash flow projections are material would resolve confusion, follow existing law, and be advantageous to Delaware corporations.

214. *See supra* Section III.
215. *See supra* Section IV.