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DELAWARE CHANCERY COURT ASSESSES POST-CLOSING CLAIMS OF FINANCIAL MANIPULATION AND FAILURE TO MEET FORECASTS

A recent Delaware Chancery Court opinion offers guidance with respect to contract and tort liability issues common to a range of M&A transactions. In *Osram Sylvania Inc. v. Townsend Ventures, LLC, et al.*, Vice Chancellor Parsons ruled on a motion to dismiss several post-closing claims—including for breach of contract, indemnification and fraud—arising out of the sale to Osram Sylvania Inc. ("OSI") by Townsend Ventures, LLC and its affiliates (the "Sellers") of the remaining capital stock of Encelium Holdings, Inc. (the "Company"). Given the posture of the case, the court assessed whether the alleged facts could reasonably support the related claims. This alert highlights the most notable holdings and takeaways.

ALLEGED FACTS AND CLAIMS

OSI principally alleged that the Sellers: (i) manipulated the Company's financial condition prior to and after signing, including by holding invoices for payment and shipping and billing excess product; (ii) failed to notify OSI post-signing when the Company's actual sales came in at approximately half of pre-signing forecasts; (iii) failed to disclose the departure before signing of two significant employees; and (iv) failed to disclose a significant contract obligation as a "Liability." On the basis of these facts, OSI claimed, among other things, breaches of representations and warranties in the stock purchase agreement (the "SPA"), breach of the Sellers' covenant to notify OSI post-signing of a "material adverse effect" (an "MAE"), and fraud.

HOLDINGS AND TAKEAWAYS

The following were the court's notable holdings and a few of our takeaways.

- **Financial manipulation may form the basis for an MAE.** The court refused to dismiss OSI's claim that Sellers breached their warranty as to the accuracy of the Company's financial statements. More interestingly, the court found that conceivable consequences of the alleged manipulation could be materially adverse to the Company and thus refused to dismiss OSI's claim that Sellers breached the "absence of MAE" representation. For example, "[b]illing and shipping excess products…without proper credits or discount" could materially harm the Company's financial condition "when the excess product is returned and revenues are reduced," and the allegedly manipulative restructuring of business segments could "produce[] short term financial gains at the cost of long-term viability." Although the facts were not sufficiently developed to assess whether an MAE had actually occurred, the court's attention to the potential long-term effects of the manipulation, rather than the manipulation *per se*, was consistent with the traditional standard for finding an MAE.
- **Failure to meet forecasts can indicate an MAE in certain circumstances.** The court found that the Sellers, by failing to report that sales forecasts were missed, may have breached the covenant to notify OSI of a circumstance that had, or would reasonably be expected to have, an

MAE. The holding at first seems in tension with the language in the Court's 2008 notable decision in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.* that a target's "failure to hit forecasts cannot be a predicate to the determination of an MAE in [its] business." Unlike in this case, however, the *Hexion* court assessed whether alleged events had caused the failure of an MAE closing condition and, importantly, did so after a bench trial. Here, ruling on a motion to dismiss, the court needed only to find that the alleged facts—that the Sellers learned that sales were half of their forecasted level, and that the Sellers knew such forecasts to be central to OSI's calculation of the purchase price in the transaction—could reasonably support the claim that the Sellers learned of circumstances materially adverse to, or that could result in circumstances materially adverse to, the Company's business.

In light of this case, parties seeking greater certainty on how missed forecasts will be treated are reminded to consider excluding the failure to meet forecasts from the definition of an "MAE," as is commonly done, or, conversely, negotiating for a warranty as to forecasts, though rarely done.

- **Failure to notify a buyer of missed forecasts generally will not constitute fraud.** The court found that the allegations of manipulation, false statements and other acts prior to signing could support OSI's claims of common law fraud and negligent misrepresentation. The court, however, dismissed OSI's fraud claims predicated on the Sellers' failure to disclose the missed forecasts, reasoning that because a forecast, as a statement of opinion about future results, cannot generally be fraudulent, nor can a failure to correct a forecast.

  Parties often struggle to identify enforcement mechanisms to back-up a seller's predictions of future performance. When target forecasts are central to a buyer's calculation of value, the buyer may try to negotiate for a purchase price adjustment or contingent payment arrangement.

- **"Materiality scrapes" should generally not apply to "absence of MAE" representations**. The SPA's indemnification provision contained a "materiality scrape," providing that materiality qualifiers would be ignored in determining whether the representations were breached (and in measuring the corresponding damages). The materiality scrape was not expressly inapplicable to the "absence of MAE" representation, as it often is. Accordingly, in finding that the departure of two employees prior to signing may have been material enough to find an MAE (and thus to support a breach claim), the court noted that an indemnification claim would lie even if it found the employees' departure had an immaterial adverse effect on the Company.

- **Unless expressly excluded, broad definitions of "Liabilities" may capture contract obligations.** The court held that the SPA's broad definition of "Liabilities" captured contract obligations, and thus that Sellers may have breached the "absence of Liabilities" representation by failing to account for such an obligation on the interim balance sheet or to otherwise to disclose it. Sellers should be careful to obtain an exception for contracts (and other legal obligations) when agreeing to a broad-form absence of liabilities representation.

If you have any questions concerning this client alert, please contact the following members of our mergers and acquisitions practice group:

J. D. Weinberg	New York	+1 (212) 841-1037	jweinberg@cov.com
Daniel Levine	Shanghai	+86 (21) 6036-2507	dlevine@cov.com