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SEC Issues Updated Disclosure Guidance for Forward-Looking Projections in the Context of Business Combinations

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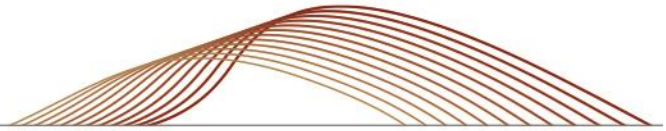
M&A Transactions Routinely Face Shareholder Lawsuits

Over the past few years, a significant percentage of M&A transactions have generated costly shareholder lawsuits in which plaintiffs and their attorneys attempt to identify disclosure deficiencies in proxy statements, registration statements, tender offer statements, and other public filings, and use these alleged deficiencies to claim that the transaction is unfair. The usual goal of these lawsuits is to enjoin approval and completion of the transaction and/or seek monetary damages.

A more recent theory advocated by the plaintiffs' bar in such cases is the claim that financial forecasts and projections are materially deficient if they have not been reconciled back to the nearest and most directly comparable financial measure presented in accordance with Generally Accepted Accounting Principles (GAAP). Such forward-looking financial measures, which are routinely provided to a financial advisor by a party to a transaction in order to enable the advisor to prepare a fairness opinion, are required to be disclosed in SEC filings under Item 1015 of Regulation M-A. While some companies provided GAAP reconciliations of these forecasts and projections, many others have not. This latter group typically has foregone reconciliation because the definition of "non-GAAP financial measures" (as defined in both Item 10(e)(5) of Regulation S-K and Item 101(a)(3) of Regulation G) does *not* include financial measures that are required to be disclosed by SEC rules, such as the aforementioned mandate in Regulation M-A. Despite this regulatory rubric, legal counsel for shareholders of many M&A targets have nonetheless initiated lawsuits alleging that the inclusion of such forward-looking financial information without reconciliation to GAAP is a materially misleading omission, in violation of SEC disclosure rules. A number of these cases have been resolved by "disclosure only" settlements in which the defendant entity remedies the lawsuit by updating their filings with GAAP reconciliations and paying the plaintiff's attorneys' fees.

The SEC Clarifies its Reporting Requirements

To address these reporting inconsistencies and disclosure-related lawsuits, on October 17, 2017 the SEC issued one new and one revised Compliance & Disclosure Interpretation (C&DI). In sum, these C&DI's clarify and confirm that forward-looking financial measures can be presented in SEC filings without GAAP reconciliation when such measures either (i) were provided to a financial advisor in connection with the proposed business combination for the purpose of rendering a fairness opinion *and* the disclosure of this financial information is required by federal regulation or by state or foreign



law, including case law, or (ii) are disclosed in certain enumerated preliminary disclosures regarding the transaction.

The SEC's new interpretative guidance, C&DI Question 101.01, clarifies that financial measures provided to a financial advisor are excluded from the definition of non-GAAP financial measures and are not required to be reconciled to the most directly comparable GAAP measure if:

- "the financial measures are included in forecasts provided to the financial advisor for the purpose of rendering an opinion that is materially related to the business combination transaction; and
- the forecasts are being disclosed in order to comply with Item 1015 of Regulation M-A or requirements under state or foreign law, including case law, regarding disclosure of the financial advisor's analyses or substantive work."

Prior to this interpretative guidance, there arguably was some ambiguity as to whether projections provided to a financial advisor for the purpose of preparing a fairness opinion required reconciliation to GAAP. Plaintiffs in lawsuits challenging business combination transactions utilized that potential ambiguity as a foothold to argue that the disclosures which omitted the reconciliations were deficient. While not binding legal authority, the new C&DI helps to head off such arguments by plaintiffs as it clarifies and confirms that reconciliation is not required in the identified circumstances.

The SEC also revised C&DI 101.02 to clarify when and where non-GAAP financial measures can be disclosed without reconciliation in connection with preliminary disclosures related to business combination transactions:

> "There is an exemption from Regulation G and Item 10(e) of Regulation S-K for non-GAAP financial measures disclosed in communications subject to Securities Act Rule 425 and Exchange Act Rules 14a-12 and 14d-2(b)(2); it is also intended to apply to communications subject to Exchange Act Rule 14d-9(a)(2). This exemption does not extend beyond such communications."

Here, the SEC identifies the limited, specific types of preliminary communications related to business combination transactions in which a reporting person can disclose non-GAAP information without reconciliation. In other words, standalone financial forecasts and projections that are included in registration statements, proxy statements, and tender offer statements for some reason other than because they were given to a third-party financial advisor to obtain a fairness opinion *would* require reconciliation to GAAP in accordance with Item 10(e) of Regulation S-K.

Practical Effects of the SEC's Guidance

Parties to a potential business combination can now lean on the SEC's interpretive guidance to save time and expenses when crafting the required disclosures that must accompany a proposed transaction. The SEC's clarified position should reduce this type of litigation claim.

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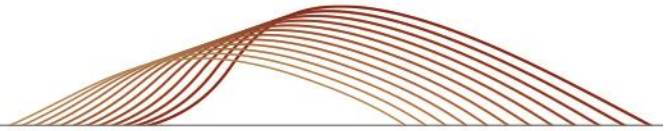

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Orange County Paul Hastings lawyers:

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