

Fraud in Schedules  
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The schedules which accompany deal documents are not merely afterthoughts; they are critical elements that define and limit the representations, warranties and covenants that the parties have made to one another. A decision in the California Court of Appeal this past February offers a sobering example of why schedules need to be prepared with the same degree of care and attention to completeness and detail as any other substantive deal provision.

The case, *Vega v. Jones, Day, Reavis & Pogue*, involved the acquisition of MonsterBook.com by Transmedia Asia Pacific, Inc. Monsterbook.com merged into Transmedia, and the former shareholders of MonsterBook received Transmedia shares. As it turned out, though, the value of the Transmedia shares that the MonsterBook shareholders received was heavily diluted because Transmedia agreed, before the merger was consummated, to issue \$10 million in floorless convertible preferred stock to an outside investor. To make matters worse, the MonsterBook shareholders had consented in advance to Transmedia's new financing, but Transmedia had failed to disclose accurately the terms of the financing when it sought and obtained that consent.

The issuance floorless convertible preferred, sometimes known as "toxic stock", "death spiral convertibles" and "junk equity," is a last-resort financing measure. Anecdotal evidence suggests that bankruptcy is the likely follow-on to a death-spiral round. In the case of MonsterBook, as the market value of Transmedia common shares fell, the conversion ratio for the death-spiral shares increased, which subjected the former MonsterBook (and now Transmedia) common shareholders to substantial and rapid dilution.

Transmedia's lawyers had first prepared a schedule to the merger agreement that "clearly described and properly disclosed the 'toxic' provisions" of its \$10 million preferred investment. According to the court, though, the lawyers knew that a full disclosure of the toxic terms of the financing would have "killed the acquisition [of MonsterBook]", and if that acquisition were not consummated, then Transmedia would not have obtained the death-spiral financing and would have gone out of business. The lawyers then drafted a different, "sanitized" version of the schedule that omitted the description of the toxic provisions. It was the second, scrubbed version that went out to MonsterBook and its lawyers.

The answer to the question, "Was a material fact omitted?" is self-evident from the lawyer's behavior. The measure of materiality is whether a reasonable investor, looking at the total mix of information, would consider the omitted information important in determining whether to buy, sell or hold. Here, the lawyer appears to have omitted the information precisely because it was material. To be sure, a skeptical and diligent MonsterBook shareholder or lawyer could have found out that Transmedia had agreed to a death-spiral round. After all, the terms of the financing were disclosed in the company's amended certificate of incorporation and were filed in the Delaware Secretary of State's office. The problem, though, lies in the primary purpose of a schedule. Schedules are drafted because the parties intend one another to rely on their contents; their inclusion obviates the need to perform an independent search for the materials covered in the schedules. When combined with the boilerplate merger and integration clauses found in almost every deal document, the schedules (as incorporated into representations, warranties and covenants) tell the unalterable story of what the parties have agreed. The schedules should be clear and objective statements that reflect the parties' deal and their understandings. (It would be

an entirely different story if the selling shareholder had actually known of the death-spiral terms. Then, even if the schedule had been misleading, there would have been an issue as to whether the shareholder had relied on the schedules.)

The Monsterbook case reflects the true dynamic of negotiations over schedules: the parties negotiate with one another over the scope of the schedules through their lawyers. The statements that they make to one another, regardless of whether the words are uttered by lawyers or by clients, need to be made with care, for the listener can be expected to rely on those statements.

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