

Breed versus AlliedSignal

On 23 March, 2006 a Florida jury cleared AlliedSignal (now Honeywell) of all fraud charges in a complex civil case which lasted seven years and in which the plaintiffs claimed damages of US\$375 million.

The case turned on the interpretation of company accounts and due diligence processes. Both sides hired armies of top forensic experts to fight the case. Each spent over US\$1 million on forensic fees alone. This spring the six-member jury returned a verdict in less than a day, finding no liability against Allied and awarding no damages. The case is now officially over and there will not be an appeal.



Eugene Assaf, Kirkland & Ellis

Craig Primis, Kirkland & Ellis

The dispute originated in October 1997 when Allied (now a US\$28 billion conglomerate called Honeywell) sold an airbag and seatbelt business called SRS to Breed Technologies for US\$710 million.

Two years later Breed filed suit in a Florida state court asserting claims of fraud, negligent misrepresentation, and fraudulent transfer by Allied in connection with the acquisition.

Taking interest and punitive damages into consideration, the final penalty payable by Allied could have reached US\$800 million.

Breed claimed that Allied had misrepresented the potential of the unit and blamed Allied for a share of the new owner's financial difficulties.

One month later Breed filed for Chapter 11 bankruptcy. It had fallen a long way from being the world's number three maker of car seat belts.

The running of this bankruptcy process in parallel to the civil litigation further complicated the situation.

Breed emerged from bankruptcy in 2001 and relocated to Sterling Heights, Michigan, where it renamed itself Key Safety Systems, Inc. But the civil litigation against Allied was to grind on for several years.

The crux of Breed's claim was that Allied had committed a sophisticated financial and accounting fraud to overstate the actual and projected earnings of the division Breed acquired. This year the jury rejected that claim.

Eugene Assaf of Kirkland & Ellis was one of Allied's lead counsel. Assaf commented: "The question was: What were the financials? That was the lynchpin."

A hometown jury

Allied's lawyers spent six years fighting to avoid the case being heard in Breed's home state of Florida, appearing in front of a total of 17 judges in numerous state and district courts.

"We spent five or six years fighting over where the case should be tried," says Assaf. "We fought against it but in the end the case had to be tried there."

Breed had been a big employer in Florida, and the Kirkland team realised they would be faced by a 'hometown jury'. Putting on a 'human face' was therefore vital to winning over the jurors.

Assaf and his colleagues on Allied's legal team, which was led by Kirkland colleague Steven McCormick, argued in court that Breed's management had been informed about the erosion of market share that Allied was suffering due to increased competition

from bigger and more powerful companies in the seat belt business. The forensics team on the defendant's side played a vital role by retrieving accounting records and other documents from Allied around the time of the sale, and the equivalent records from Breed.

Breed also had a battery of top forensic experts doing a similar job, and much of the case came down to a consideration of the documentary evidence.

Selecting the forensic team

The defendants interviewed a number of people and firms in its search for experts, says Assaf. The plaintiffs had already hired an impressive team from FTI Consulting, headed by Charles Lundelius, a senior managing director in the forensic and litigation consulting practice.

Lundelius has over 20 years of case experience and amongst other achievements is author of the book: 'Financial Reporting Fraud: A Practical Guide to Detection and Internal Control'.

Allied chose forensic accounting expert Dana Northcut to spearhead its effort. Northcut has a PhD in accounting and currently teaches at the University of Chicago.

Craig Primis, part of the 13-strong Kirkland team, says: "We were looking for someone with technical proficiency in synthesising all the information in accordance with Generally Accepted Accounting Principles (GAAP)."

"We also wanted a lead expert who could present well to a jury," says Primis. The need to present a human face to a 'hometown jury' was paramount.

"Northcut has a folksy southern accent, which helped," adds Primis.

Generally, Assaf says there are certain forensic firms which Kirkland has confidence in, when going through these selection processes. "We prefer firms who give it to you straight rather than present an overly rosy picture of the case," he says.

A key witness

Larry Bossidy had been chairman and CEO of Honeywell but by the time of the trial had been retired for some years. As somebody without an axe to grind, therefore, his testimony carried a lot of weight with the jury.

The Kirkland team also called other former members of Allied's executive team who now had nothing to do with the company. Crucially, they also relied heavily on the due diligence report compiled by Ernst & Young on behalf of Breed during the year in which it was considering the acquisition of Allied.

"The report was the central battleground of the case," says Assaf. "Did it represent disclosure of the key things? Did it put Breed on awareness of the key issues?"

Case study

Kirkland's strategy was to insist that Allied had told the truth, and to use Breed's own records to help prove it. The jury was being deluged with a huge amount of complicated data. The idea therefore was to keep things as simple as possible.

Regulatory implications

One key source of evidence in the case was the correspondence and other communications between Breed and the Securities and Exchange Commission (SEC).

Assaf says: "This correspondence was critical evidence."

Litigation trusts

At the time Breed's Chapter 11 bankruptcy closed in 2001, the debtor assigned the case against AlliedSignal to a litigation trust called the AlliedSignal Recovery Trust.

Breed had described the claim against Allied, which totalled approximately US\$375 million before interest and punitive charges, as the single largest asset of the bankrupt estate. Jones Day represented Breed in connection with the case, although not the larger bankruptcy, and then continued as counsel to the Recovery Trust.

The Trust was supervised by a group of large beneficiaries, which formed a Beneficiaries Committee. The Beneficiaries Committee was represented by Wachtell Lipton.

Litigation and accounting fees and expenses

Both launching and defending these large civil cases does not come cheap. According to testimony in the Delaware bankruptcy court, Jones Day incurred approximately US\$34 million in fees to prosecute the case against Allied.

Jones Day also fronted expenses of US\$9 million on behalf of the Recovery Trust.

Junk bonds

A side issue is the activity of the holders of Breed's junk bonds. At the time of the SRS transaction, Breed took out a US\$900 million loan, for which Nationsbank and Prudential Securities were the lead agents.

Six months later, in April 1998, Breed refinanced its debt, reducing its bank debt to US\$650 million and issuing US\$330 million in high yield, subordinated debt.

The subordinated bondholders held a stake in the Breed case against Allied but also filed their own fraud case against Allied, Nationsbank/BofA, Prudential, and Breed's executives.

Allied and the banks won dismissal of the bondholders' claims, but the bondholders continue to press securities fraud claims against Breed's executives in federal court in New York.

Conclusion

What are the main lessons to be learnt from the case? Assaf of Kirkland & Ellis says: "There is an increasing trend for bankruptcy courts to use litigation trusts to finalise a deal."

Due diligence may become even more important in M&A, says Assaf. Businesses can find themselves prosecuting or defending claims years after a deal, and it may all hinge on whether the due diligence was adequate or not.

Due diligence also plays a big part in the pricing of a deal, says Assaf. As deals become bigger in size, they will inevitably attract more attention, which in turn could lead to more litigation or accusations of fraud from dissatisfied parties.

Breed versus AlliedSignal Firms & Faces

Breed

Forensic accountants/investigators

Breed Technologies hired FTI Consulting as its expert witness in the case. Breed's key witness on forensic accounting issues was **Charles Lundelius**. Lundelius had a large team of accountants working under his direction.

Lundelius leads the FTI securities transactions and market regulation group, specialising in financial institutions consulting.

With 20 years of experience in the securities, investment banking and insurance industries, Lundelius provides expert testimony and advice on securities valuation, investment management and insurance matters.

Breed also retained **Robert Hamada**, the Dean Emeritus of the University of Chicago Business School on valuation issues.

Hamada is affiliated with Lexecon, an economic consulting firm that is now part of FTI. Hamada took Lundelius's revised estimates for projected earnings and recalculated the value of the SRS division assuming Lundelius's estimates were accurate.

Finally, Breed used **Professor Charles McDonald**, an accounting professor from the University of Florida. McDonald has also published a textbook in the field of accounting. McDonald offered opinions about AlliedSignal's accounting and compliance, or non-compliance, with Generally Accepted Accounting Principles (GAAP).

AlliedSignal

Forensic accountants/investigators

AlliedSignal's forensic accounting expert was **Dana Northcut**, who has a PhD in accounting and currently teaches at the University of Chicago.

Northcut is affiliated with the economic consulting firm Chicago Partners, where he worked closely with **Jonathan Arnold**, a University of Chicago PhD.

Northcut and Arnold have since moved from Chicago Partners to Analysis Group of Boston.

Northcut rebutted Lundelius's testimony and offered the expert opinion that AlliedSignal's projections, and the assumptions on which they were based, were accurate.

On valuation issues, Allied offered **Dr Mark Zmijewski**, the Deputy Dean of the University of Chicago Graduate School of Business and an expert in accounting and valuation. Zmijewski, who also is affiliated with Chicago Partners, testified that the purchase price Breed paid for SRS was well within the appropriate range of value for the business.

Finally, Allied offered **Stephen Platau**, an accounting professor from University of Tampa, to rebut the testimony of Dr McDonald. Platau testified that Allied's accounting complied with GAAP.

Jury consultants

Allied retained **Rick Fuentes** of R & D Strategic Solutions as a jury consultant.

"We work with jury consultants and focus groups, since the issues can be very technical," says Kirkland's Assaf. "This is critical in this day and age."

Fuentes helped Kirkland conduct jury exercises in which Kirkland could test out its key themes and evidence on mock jurors and receive feedback as to what was effective and what was not.

These exercises helped Kirkland focus its message and helped the legal team to present very complicated business and accounting concepts in the simplest, most effective way possible to the jury, which was unfamiliar with such concepts prior to being selected for the panel in this case.