IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

VALASSIS COMMUNICATIONS, INC., a Delaware corporation, and MICHIGAN ACQUISITION CORPORATION, a Delaware corporation,

Plaintiffs,

v.

ADVO, INC., a Delaware corporation,

Defendant.

ADVO, INC., a Delaware corporation,

Counterclaim-Plaintiff,

v.

VALASSIS COMMUNICATIONS, INC., a Delaware corporation, and MICHIGAN ACQUISITION CORPORATION, a Delaware corporation.

Counterclaim-Defendants.

C.A. No. 2383-N

PUBLIC VERSION

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REPLY PRETRIAL BRIEF OF VALASSIS COMMUNICATIONS, INC. AND MICHIGAN ACQUISITION CORPORATION

MORRIS, NICHOLS, ARSHT & TUNNELL LLP
Kenneth J. Nachbar (#2067)
Alan J. Stone (#2677)
Megan Ward Cascio (#3785)
Susan Wood Waesco (#4476)
1201 N. Market Street
P.O. Box 1347
Wilmington, DE 19899-1347
(302) 658-9200
Attorneys for Plaintiff/Counterclaim-Defendants Valassis Communications, Inc. and Michigan Acquisition Corporation

OF COUNSEL:

Eric Landau
Steven J. Aaronoff
Shawn M. Harpen
Travis Biffar
McDERMOTT WILL & EMERY LLP
18191 Von Karman Avenue, Suite 500
Irvine, CA 92612-7107
(949) 757-7162

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SUPPLEMENTAL STATEMENT OF FACTS

On July 5, 2006, four men convened in the offices of Wachtell, Lipton, Rosen & Katz at the building known as Black Rock, 51 West 52nd Street in New York. To a man, each of them knew that the $1.3 billion Merger Agreement between ADVO and Valassis was not final, and at least two of them knew that they would be in constant contact with Valassis' attorneys that evening to try to finalize that Agreement. (That effort bore fruit at 6:00 a.m. on July 6, the next day, when Valassis sent signed copies of the Agreement to ADVO.) As each of these men knew, the announcement of that Agreement, and the 50% premium that Valassis had agreed to pay, would send the price of ADVO's shares soaring on the New York Stock Exchange.

The four men meeting in Black Rock on July 5 had an important piece of information that Valassis did not have. The information was that ADVO's April/May financial statements had overstated ADVO's operating income for those two months by at least $1.5 million – at least 20%. The four men knew that Valassis' willingness to enter into a transaction with ADVO was dependent on Valassis' review of ADVO's April/May financial statements – Valassis had said in a letter to ADVO's Board, dated June 13, 2006, that its willingness to make an offer was "predicated" on "Review of the combined April/May financial statements. . . ." They had to know that the overstated $7.4 million April/May operating income number that they had given to Valassis had implications that reached beyond its magnitude. ADVO, haunted by a decline in its cherished Zone Products line, had produced flat operating income (at best) for some time. Then, the first quarter of 2006 showed a significant uptick. But the second quarter again showed a decline. ADVO told Valassis that its second quarter decline was the result of cancellations by satellite providers and, critically, that ADVO had a program in place to fix the problem. This explanation made ADVO's April and May operating income all the more critical,

as it was the barometer of where the company was going – proof of whether the program ADVO had put in place to halt to its Zone Products decline was working. The $7.4 million of operating income that ADVO told Valassis had been achieved in April and May, when coupled with a report purporting to show strong Zone Products booked revenue for the balance of 2006 (that proved to be false), indicated that ADVO had bounced back from its weak second quarter and was essentially on target to meet its earnings forecast for the balance of 2006. The April/May actual results were a strong indicator to Valassis that ADVO's plans were working. Subtract the $1.5 million overstatement from those results, and ADVO was 20% below forecast – information that would have been a red flag to Valassis that (i) ADVO's turnaround was not successful and (ii) ADVO was having serious difficulties tracking its actual performance.

The issue confronting the four men in Black Rock was: "Should we tell Valassis?" Mr. Epstein, ADVO's CFO, had repeatedly urged that disclosure be made. Nevertheless, these four men knowingly and intentionally decided not to tell Valassis of the 20% overstatement of operating income. They now say that they viewed that overstatement as "immaterial," despite the fact that it was $1.5 million out of $7.4 million of operating income. (Later, the misstatement would grow to $2.6 million, and then to $6.6 million or more.) They now argue that $1.5 million was immaterial in a deal of $1.3 billion, overlooking the fact that there was no deal for $1.3 billion, only a proposed deal for that amount predicated on the very financials they knew to be wrong. Using their logic, they could have concluded that virtually any number was immaterial. If $1.5 million is immaterial in comparison to $1.3 billion, then so too is $7.5 million, or, for that matter maybe even $15 million.

To a man, they answered the question of whether to tell Valassis with a "no," despite the fact that two of them had just been (or soon would be) on the telephone with Al

Schultz of Valassis discussing other matters regarding the proposed merger, despite the fact that one of them took the time to call ADVO's CFO about their decision, and despite the fact that two of them would be on the telephone with Valassis' counsel most of the night finalizing the Merger Agreement.

The four men were the CEO of ADVO, Scott Harding; the Chairman of ADVO, John Mahoney; the longtime outside counsel to ADVO, Stephen Palmer; and special counsel to ADVO, Eric Robinson, a partner at Wachtell, Lipton.

True enough, throughout the night of July 5, Messrs. Palmer and Robinson were in frequent contact with Valassis' lawyers. Not a word of the now deep-sixed problem was spoken. And, the next day, Valassis signed the Merger Agreement not knowing about it. When Mr. Epstein, who had been urging that the overstatement be disclosed, called Mr. Robinson on July 6 to ask him if he had told Valassis of the overstatement, Mr. Robinson laughed.

Then, in August – after Valassis learned that ADVO had missed its third quarter operating income forecast by 30% and hired an independent third party (KPMG) to do a forensic audit – these same four men shut down Valassis' access to information. As they were to point out in a letter sent to Valassis, when one clicks on KPMG's website, one discovers that KPMG's forensic audit services are concerned with "Fraud and Misconduct Investigations." None of these men could afford that investigation, given the events of July 5 and the other problems that they knew were lurking just below the surface. And when Valassis told them in August that, unless it could gain sufficient access to investigate further, it could not go forward with the deal, the four men responded that the law of Delaware, and particularly the *IBP* case, precluded any claim Valassis might have. *In re IBP S'holders Litig. v. Tyson Foods*, 789 A.2d 14, 63 (Del. Ch. 2001).

We know of no jurisdiction that condones such behavior; and certainly the law of Delaware does not. This case is not *IBP*. Were ADVO's attempt to force it into that mold accepted, *IBP* would become a license to lie. The sneering sarcasm of ADVO's Opening Pretrial Brief, replete with its uncited assertions of "fact," also offers no justification for such conduct. As Rufus Choate remarked "Neither irony or sarcasm is argument." In any event, sarcasm is too thin of a blanket to mask ADVO's repeated lies.

Apparently, the sole point of ADVO's brief is that Valassis knew enough to be on notice of potential problems inside of ADVO, and was skeptical of ADVO's assurances that all was well. Both of the propositions are correct, but are no legal answer to Valassis' charges. Of course Valassis did its homework, and of course it knew of potential problems within ADVO and was skeptical of ADVO's explanations. But Valassis does not claim that when ADVO said, "Don't worry. It's okay," Valassis blindly accepted those assurances.

To the contrary, Valassis was skeptical and repeatedly pressed ADVO for *data* to support its upbeat claim. ADVO eagerly provided that data, in the form of its "actual" results from April/May and its report of actual Zone Products bookings. That data was false. The April/May data was known to be false at the highest level inside of ADVO, and a deliberate decision was made not to tell Valassis of its falsity. The Zone Products data was known within the highest level inside ADVO to be unreliable, yet it was given to Valassis with no caveat as to its suspect provenance. ADVO also told Valassis that the May close "went well," another lie. ADVO now asserts that it told Valassis that the billing problem created by ADVO's SDR system was a "nightmare," implying that Valassis should have known that the April/May numbers might be wrong, but the record will show that ADVO said only that it had difficulty inputting orders in the first two weeks of April – a problem that ADVO repeatedly told Valassis had been

overcome. Valassis was not told of the daily spreadsheets cataloging the major problems haunting the April/May close, nor was it shown the "best document" to describe the status of the SDR system, an Operating Committee presentation describing SDR's many ongoing deficiencies.

ADVO now says that Valassis should not have and did not in fact rely on ADVO's projections. But they omit to say that ADVO's investment banker, Citigroup, specifically informed the ADVO Board in a written presentation that Valassis would rely on such forecasts to compute its indicative range, and pointed out that the forecast that Valassis had at that point (May 3) was higher than ADVO's management's then current forecast (which itself had been revised upward against the judgment of ADVO's operational management, who believed that the cuts mandated by the CEO would jeopardize future growth). Rather than give Valassis the operation managers' forecast, or even the CEO's upwardly revised forecast, the ADVO Board directed management to increase the CEO's forecast further upward, to bring it into conformity with the one Valassis already had. Tellingly, this direction was made not during the financial presentation by ADVO's management, but rather in the midst of Citigroup's presentation about what Valassis might be enticed to pay. Worse still, management determined that it could not make the Board-directed cuts; yet the increased forecast was nonetheless placed in the data room. And of course, Valassis was never told how the revised forecast came about.

Was ADVO's forecast bought wholesale by Valassis? Of course not. But it was a factor, as Citigroup had told ADVO's Board it would be, and the false *data*, the so-called "actuals" given to Valassis, certainly supported it. Unknown to Valassis, the real forecast for that time period, the one prepared from the ground up, showed drastically less operating income

– $54 million, not $68 million – a number a great deal closer to the disastrous results actually achieved by ADVO in its fiscal year just ended.

Now that ADVO's fiscal year is complete, the results for 2006 show that indeed a MAC has occurred. ADVO earned only 20% of its forecasted operating income in the second half of its fiscal year. Even accepting all of ADVO's dubious adjustments, its miss for the year was $14 million. This is clearly material, despite the statistical legerdemain now being employed by ADVO. Since ADVO released its third quarter results, analysts have cut ADVO's 2007 earnings projections substantially, and Ben Schneider, ADVO's Director of Profitability and Analysis, has testified that if the merger were no longer in the cards, ADVO's stock might trade as low as the mid-teens. Schneider 259. In short, events have cut the value of ADVO by nearly 50%.

If that is not material, nothing ever will be.

Predictably, ADVO seeks to excuse its own deceit by asserting that the false information it deliberately provided to Valassis was not material, that Valassis did not rely on it, that ADVO's problems will not be durationally significant and, in general, that this case is just like *IBP* – that Valassis has "buyer's remorse" and that Valassis' complaints are mere pretext for escaping a deal that it no longer wants.

The evidence will show that this case is the *opposite* of *IBP*. Unlike in *IBP*, where "[i]n the face of a grandstand full of waving red flags, Tyson sped into the final round of the negotiation process" (789 A.2d at 78), Valassis here took the time to carefully investigate each of the red flags that it properly identified. As ADVO's own brief points out, Valassis did

not blindly accept ADVO's appearances or forecasts – instead, it sought *data*. AOB 3, 25.[1] ADVO provided that data. The data was false. ADVO knew that, and Valassis did not. Moreover, contrary to ADVO's claims (AOB 36), Valassis *did not* adjust its model downward based upon ADVO's representations. Rather, undisputed evidence will show that in early June 2006, Valassis' model forecast operating income for the third and fourth quarters at $10.5 million and $10.4 million, respectively. As a result of the *data* provided by ADVO to Valassis during the next four weeks, including the inflated April/May financial results and erroneous Zone Products report, Valassis increased its third and fourth quarter forecasted operating income to $16.5 and $15.0 million, respectively. These upward adjustments also allowed Valassis to be comfortable with its forecast for 2007 and beyond, and are what allowed it to proceed with its bid for ADVO. Had ADVO told Valassis the truth, Valassis never would have bid at the levels that it did.

Finally, this is *not* a case of buyer's remorse. The only "remorse" that it has is that a deceitful merger partner provided it with false data that caused it to offer a price significantly above the value of the company.

This is also *not* a situation where an offer price a few dollars higher than the real value is immaterial. To the contrary, Valassis must finance the acquisition, and overpaying for the acquisition dramatically increases financing costs.

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[1] ADVO's Opening Pretrial Brief is cited as AOB ___." Valassis' Opening Pretrial Brief is cited as VOB ___."

ARGUMENT

I. ADVO'S ACTIONS DEFRAUDED VALASSIS.

ADVO's theme in its Opening Pretrial Brief is that because Valassis was skeptical during due diligence, no fraud could have occurred. This approach, when viewed with the undisputable facts, actually demonstrates the fraud. Valassi *did* have concerns and expressed skepticism about ADVO's financial soundness. Instead of ignoring those concerns, Valassis investigated ADVO and asked question after question designed to uncover the truth about ADVO's financial condition. In response, ADVO provided false information for the exact purpose of reassuring Valassis that its concerns and skepticism were unfounded, knowing all the while that Valassis placed great importance on receiving this information as a condition of agreeing to proceed with its acquisition of ADVO, and ultimately to increase the price it was willing to offer. ADVO's plan worked – Valassis' concerns about the financial health of ADVO were allayed by "actual" financial results demonstrating that ADVO had turned the corner and had implemented changes that successfully addressed the problems that affected its second quarter results. As demonstrated below and in Valassis' Opening Pretrial Brief, the information is undeniably material, and ADVO cannot hide behind so-called "anti-reliance" language to escape the consequences of defrauding Valassis.

A. ADVO Knowingly Made False and Misleading Representations of Material Facts and Concealed Material Facts.

ADVO does not deny that any of the misstatements alleged by Valassis were made because it cannot – its own witnesses admit them. Instead, ADVO seeks to downplay the misrepresentations by focusing on Valassis' concerns with ADVO's ability to meet its financial projections before ADVO made the misrepresentations that are central to the fraud, namely: (1)

that the April/May financial results showed "actual" operating income of $7.4 million; (2) that Zone Products bookings were $64.8 million for the third quarter, demonstrating that ADVO's efforts to improve this area of its business had achieved success; and (3) that, although there had been some issues with SDR in the beginning of April, by the time of the May monthly close, any significant problems had been fixed and the SDR was operating well. ADVO also misidentifies the factual misstatements of which Valassis complains in an attempt to characterize them as speculation about future prospects. However, as detailed below and in Valassis' Opening Pretrial Brief, Valassis does not complain about the reliability of ADVO's forecasts; Valassis' complaint is instead that ADVO knew that Valassis was skeptical about ADVO's financial forecasts, and that ADVO overcame that skepticism by providing false factual data to demonstrate the accuracy of the forecasts.

1. ADVO's False Financial Information.

ADVO's misrepresentations regarding its financial information are many. First, ADVO presented Valassis with a financial forecast for the fiscal year 2006 projecting operating income of $68.6 million. Given ADVO's disappointing second quarter, Valassis was skeptical of ADVO's ability to meet this forecast. In response, ADVO assured Valassis that it had a high degree of "visibility" into the remainder of 2006 and 2007. Ans. ¶¶ 1, 23; Barbieri Ex. 17 at 17. However, it is undisputed that ADVO neglected to tell Valassis that ADVO's forecast was not based on realistic assumptions, but instead was the result of a directive from its Board and CEO on May 3 to increase operating income twice, first by nearly $11 million, and then by an additional $8 million, and that when management attempted to achieve the Board-directed expense cuts, no department was able to find those cost savings. Consequently, the forecast could not be trusted. Epstein 333; Barbieri Ex. 14; Callahan Ex. 34. ADVO similarly failed to

tell Valassis that, just two weeks before ADVO assured Valassis of its "High Degree of Visibility," Stephanie Molner, ADVO's head of Sales and Service, told ADVO's Board that sales productivity and data visibility were experiencing "setback[s] and challenges." Harding Ex. 6 at ADVO000988196.

Second, when Valassis continued to question ADVO's forecast and express skepticism, ADVO compounded its misrepresentations about its financial condition by presenting Valassis with supposedly "actual" combined financials for April and May. Ans. ¶ 39; Epstein 122. ADVO knew that it was important that the April and May financial results demonstrate that it was on target with its forecast because Valassis had not only repeatedly requested the financial results, but had expressly made the receipt of them a condition to its offer to acquire ADVO. Harding Ex. 11. Those "actual" results demonstrated that ADVO was only $600,000 off its projections for combined April and May operating income. Harding Ex. 12 at ADVODR00014003. However, it is undisputed that ADVO failed to disclose to Valassis that it was aware that its operating income could be off by as much as $3 million (or 40% for April and May) because it was unable to reconcile its postage expenses, among other issues. Citigroup Ex. 35 at ADVO00998663. Instead, ADVO represented that these were actual numbers, without caveats or exceptions.

In fact, ADVO deliberately concealed its knowledge that it had additional postage expenses not accounted for in the "actual" April/May financial results. ADVO does not deny that on June 23 its CFO, Jeff Epstein, wrote a note to the April/May financials indicating that there were postage expense inaccuracies, nor does it deny that Epstein was insistent that the information be communicated to Valassis. Furthermore, ADVO admits that immediately upon learning that the information had not been provided to Valassis, Epstein tracked down ADVO's

counsel and CEO to rectify the situation. AOB 40. By this time, ADVO expected that it would have at least $1.5 million of additional postage expense for April and May, which would directly affect the operating income for those months. Harding Ex. 13 at ADVO00575555. These conversations occurred on July 5, hours before Valassis signed the Merger Agreement. Epstein believed that Valassis would want to know of the additional postage expense because of the impact it would have on ADVO's operating income. Epstein 136-37; 152-53. ADVO's CEO, Chairman and outside counsel overrode Epstein and induced Valassis to sign the Merger Agreement, never even hinting that financial information ADVO had provided to Valassis as reflecting "actual" results was in fact false.

Third, when, with only two days left in the quarter, Valassis asked ADVO how ADVO's full third quarter was shaping up, ADVO represented that it was "on track." Ans. ¶ 42; Hutter 166. However, it is undisputed that ADVO failed to disclose that it had no way of knowing whether this statement was true because serious defects in its SDR system prevented it from receiving reliable financial data. Specifically, ADVO failed to inform Valassis that (i) its financial analysis and planning department had repeatedly complained about the lack of visibility to ADVO's financial information contained in its new EDW database, (Gant 58-60; Schneider 79-81) (ii) that numerous order entry errors had caused ADVO to overcharge clients by as much as $33 million, (Callahan Ex. 40) (which later resulted in $6 million of downward billing adjustments for invoices generated in the third quarter being charged against fourth quarter earnings), or (iii) that its computer systems had myriad defects (Epstein 98-99) (including the inability to reconcile postage and print expenses), and the manual workarounds were unreliable. *See, e.g.*, Epstein 111-14. Instead, ADVO spoke with confidence regarding its third quarter.

2. ADVO's Misstatements Regarding its Zone Products Business.

Zone Products, ADVO's most profitable business, had been experiencing a decline that negatively impacted ADVO's financial performance. Knowing that the Zone Products business was an area of concern for Valassis, ADVO repeatedly emphasized the efforts it had in place to strengthen the business, including the "Ultimate Promotion" and the EDW system's ability to increase visibility of Zone Products inventory of available ad space from 8 weeks to 52 weeks to provide efficiency in selling Zone Products. Schultz 220-25; Compl. ¶ 25; Ans. ¶ 25. Valassis spent significant time in due diligence exploring the Zone Products business and asked repeated questions to investigate whether ADVO's initiatives were showing real results. Epstein 36-37, 473, 482-83. ADVO was all too happy to provide data to demonstrate that its Zone Products business had improved, including presenting a report on May 30, 2006 demonstrating the amount of Zone Products sold as of May 24 for the fourth fiscal quarter (Keegan Ex. 21) and data of "actual" net bookings/revenues for Zone Products as of June 15 showing that the actual bookings for Zone Products were $4.4 million higher than forecasted. Barbieri Ex. 17; Harding Ex. 12 at ADVODR00014013. Although ADVO had informed Valassis on May 18 that it believed that approximately $10 million of the Zone Products revenue was "at risk," by June 25 it was telling Valassis that it had successfully addressed the problems with its business and now only expected $1.2 million of risk. Barbieri 401; Epstein 488.

While presenting its impressive success in addressing its previous Zone Products slippage, ADVO never revealed to Valassis that none of the data supposedly demonstrating that success was reliable. ADVO never told Valassis that it internally knew that the reliability of the data for Zone Products, or the interpretation of that data, was questionable. Gant 138-39. ADVO also never told Valassis that problems with the Zone Products data were so bad that it

required a meeting in early to mid-June between ADVO's CEO Harding, CFO Epstein, Executive Vice President in charge of Zone Products Molnar, CIO Gant and ADVO's Manager of Enterprise Reporting Kris Barnard, to discuss the issues with the confusion over bookings and revenue data, data discrepancies, the lack of visibility to Zone Products inventory and cancellations in the SDR system, or that the Zone Products team was frustrated. Gant 140-42. ADVO also never mentioned to Valassis that in June its Zone Products data was so unreliable with respect to accounting for bookings and cancellations that within a period of weeks, revenues fluctuated by around $6 million. Gant 137-42; Schneider 154-56.

3. ADVO's Misrepresentations About Its SDR Computer System.

The evidence will show that Valassis repeatedly requested information about ADVO's SDR system and the progress of its implementation during due diligence. Although ADVO informed Valassis that SDR had been a "nightmare" for a *few weeks in April*, it specifically reported to Valassis that "the May close went well." Mitzel Ex. 12 at VAL022856; Lieblang Ex. 26 at ADVODR00012614. In reality, the May close was a nightmare. ADVO's CFO Jeff Epstein testified that it was "far more difficult" than any previous monthly close since he had joined ADVO. Epstein 389-90. Things were so bad that ADVO initiated a daily spreadsheet just to keep track of the problems that SDR was causing in reconciling financial data, including issues that directly affected the financial results, such as the postage and print expenses, and inability to invoice sales tax surcharges and the inaccurate client invoices that later resulted in client credits of $6 million attributable largely to April and May. *See, e.g.*, Gant Ex. 18; Gant Ex. 20. No version of this spreadsheet was provided to Valassis; it was instead told that the May close "went well."

In response to requests for information about the status of SDR, ADVO reported that the system was working, and that the only problems were minor issues as employees learned new processes for conducting their work. ADVO never revealed the problems it was having with visibility into financial information or Zone Products inventory, the reliability of the financial data coming from EDW, or that order entry errors were causing tens of millions of dollars of erroneous invoices through the third quarter. Ms. Gant reported that SDR had no abnormal issues and never disclosed the danger that ADVO could be reporting erroneous financial information. ADVO also withheld a document that was prepared for ADVO's Operating Committee detailing the myriad defects with the SDR system. *See* Gant Ex. 8. Not until after Valassis signed the Merger Agreement did ADVO confess that the data emanating from its SDR and EDW systems was "erroneous," "flawed" and "corrupt." Groe 709-12; Mitzel 719; Epstein 129; Ans. ¶ 2.

B. ADVO's Fraudulent Disclosures and Nondisclosures Were Material.

Understanding that it cannot run away from the misstatements and omissions it made, ADVO argues fervently that its falsehoods should be forgiven because they were not material. AOB 54-55, 59, 64-67. ADVO claims that its fraudulent misrepresentations and omissions were immaterial for two reasons: (1) Valassis' only reason for purchasing ADVO was the long-term potential of the two companies; and (2) the undisclosed postage and print expenses were minor compared to the overall scope of the deal. These assertions, however, mischaracterize Valassis' approach to the merger negotiations and discount the overall impact of the $1.5 million dollar discrepancy on both the April/May financial results and Valassis' willingness to acquire ADVO.

First, although long-term considerations inspired Valassis to pursue the transaction, ADVO's near-term financial results and its short-term projections significantly affected the price Valassis was willing to pay for ADVO. This make sense – favorable near-term results increase the immediate value of the company, facilitate financing, and are indicative of what longer term prospects are actually achievable. Valassis' concern about near-term results is reflected in the facts. First, after initially indicating its willingness to pay between $38-40 per share in March (Ans. ¶ 19), Valassis reduced that number to $35.25 per share (subject to due diligence) due to ADVO's disappointing second quarter results. Ans. ¶ 36; Citigroup Ex. 25. On June 22, Valassis increased its offer to $36.25 per share, but expressly conditioned that offer on receiving the April/May financial results, the third and fourth quarter projections and additional information about the status of SDR. Harding Ex. 11 Plainly, the near-term results and projections *were* important to Valassis. Finally, after learning that the April/ May results reflected only a $600,000 shortfall in operating income (Harding Ex. 12 at ADVODR00014003), that Zone Products were $4.4 million over forecast in the third fiscal quarter, trending only $1.2 million below the forecast for the year, (Barbieri 401; Epstein 488), that SDR was experiencing no abnormal issues (Lieblang Ex. 26 at ADVODR00012614) and all financial processing was running through SDR, and that ADVO was "on target" or "on track" to meet its third quarter projections (Ans. ¶ 42; Hutter 166), Valassis increased its offer to $37 per share. Ans. ¶ 44. This does not reflect the actions of a company focused solely on long-term projections.

Second, the $1.5 million in understated postage expense was not minor when viewed in the proper context. Using the logic set forth in ADVO's Opening Pretrial Brief (AOB 55), if ADVO had understated postage by $7.4 million in April and May, this would still be immaterial because it is small compared to the $1.3 billion dollar deal and the nearly $800

million per year ADVO spends on postage and print. ADVO's argument dictates this result even though a $7.4 million overstatement would have erased all profit for that two-month period. The law is to the contrary. *See S.C. Johnson & Son, Inc. v. DowBrands, Inc.*, 295 F. Supp. 2d 568, 585, 592 (D. Del. 2003), *rev'd on other grounds*, 111 Fed. Appx. 100 (3d Cir. 2004) (Ex. A hereto) (rejecting defendants' argument that a misstatement of approximately 1% of revenues was legally immaterial, instead holding that profits should be considered in a materiality analysis, and that the errors in the sellers' financial statements were material because the buyer "calculated the value of the business based on a discounted cash flow and the misstated business "accounted for over 10% of DowBrands' global operating income").

Understandably, Valassis would have viewed the postage expense in terms of its effect on operating income, rather than its impact on postage expense alone. The postage error overstated operating income by 20% for April and May and resulted in a $2.1 million shortfall from operating income projections (prior to the revelation of an additional $200,000 of postage expense, the $900,000 print expense, the $300,000 of sales tax expense and the millions of dollars of overstated billings). Harding Ex. 13 at ADVO0057555. "Most investors would consider it significant, no matter what the mix of information available, that a company was not earning as much as it was claiming to earn." *Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 830 (8th Cir. 2003) (Ex. B hereto). In addition, the SEC has recognized a "rule of thumb" of a 5% misstatement of net income as an initial step in evaluating materiality, and has suggested that even a smaller percentage misstatement may be material when evaluated in light of all relevant considerations. SEC Staff Accounting Bulletin ("SAB") No. 99, 64 Fed. Reg. at 45150 (1999). Thus, when placed in the proper context, the $1.5 million additional postage expense (reflecting

a 20% misstatement of operating income for the relevant April/May period) was a significant nondisclosure.

Further, in addressing the $1.5 million postage discrepancy, ADVO refuses to acknowledge the importance that Valassis placed on the April/May results. *See Shore Builders, Inc. v. Dogwood, Inc.*, 616 F. Supp. 1004, 1017 (D. Del. 1985) ("A misrepresentation is material if . . . 'it is likely to induce a particular' purchaser 'to manifest his assent.'"); *see also Ganino v. Citizens Utilities Co.*, 228 F.3d 154, 163 (2d Cir. 2000) (determining that "materiality" for purposes of federal securities violations includes a quantitative and qualitative assessment). "'Qualitative factors may cause misstatements of quantitatively small amounts to be material.'" *Ganino*, 228 F.3d at 163 (quoting SEC Staff Accounting Bulletin ("SAB") No. 99, 64 Fed. Reg. 45150, 45152 (1999)). As noted earlier, ADVO knew that Valassis considered ADVO's April/May results vital in crafting its offer – so important, in fact, that Valassis conditioned its June 13 offer on receiving this data. Harding Ex. 11. It stands to reason that the accuracy of those numbers was equally vital to Valassis in crafting its "walk-away" price to propose to ADVO. Thus, even if the court considers the undisclosed postage to be quantitatively inconsequential in terms of the overall deal, Valassis considered it material and ADVO knew this.

ADVO also isolates the $2.6 million in postage and print from ADVO's other fraudulent statements and nondisclosures. A court, however, must examine "the 'total mix' of information made available" when determining the "materiality" of certain information. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). The other non-disclosures, including the SDR-related problems with providing accurate financial information, client invoicing and crediting and sales tax invoicing (Epstein 365-66; Schalck Ex. 23 at VAL02589) and the

misinformation about Zone Products bookings would have revealed significant problems with the data used in ADVO's financial results. Gant 138-39.

Although Valassis was skeptical concerning ADVO's future prospects and the health of the SDR system, it was reassured at every turn that things were fine. Had ADVO disclosed the $1.5 million additional expense in postage and the other data-integrity related issues, further questions would have been raised concerning ADVO's results and projections, success of the SDR implementation and adequacy of ADVO's internal controls. *See Gebhardt*, 335 F.3d at 829-30 (noting that defendant's nondisclosure that its subsidiary was intentionally overstating its earnings was not immaterial as a matter of law in part because the disclosure would have raised other questions in the minds of investors concerning management). These questions inevitably would have uncovered at least some of the problems with the April/May results and third quarter projections. As it turned out, ADVO misstated another $200,000 of postage expense, $900,000 in print costs in its April/May results and had $300,000 of uncollected sales tax. Ans. ¶ 66. Further, ADVO later determined that it overstated third quarter income and revenue by $6 million due to erroneous billings. Epstein 365-66. As it appears that most of the erroneous billings occurred in April and May, ADVO's true operating income was at best negligible, and may actually have been negative, for those months. Undoubtedly, disclosure of the $1.5 million postage error would have "significantly altered the 'total mix' of information made available" to Valassis in determining whether to purchase ADVO. *TSC Indus.*, 426 U.S. at 449.[2]

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[2] Any doubt on this point must be construed against ADVO – it is the party who deliberately decided not to tell Valassis about the error.

C. Valassis Justifiably Relied on ADVO's Misrepresentations.

1. Valassis Was Justified In Relying On The Misinformation ADVO Provided During Due Diligence.

ADVO argues in response to uncontroverted evidence that it made material misstatements of fact regarding its financial information that its actions are excusable because Valassis should not have relied on this information and, ADVO asserts, did not rely upon it. ADVO also incorrectly argues that so-called "anti-reliance" language in the NDA, data room logon screens and the Merger Agreement permitted it to make material misstatements.

Predictably, ADVO focuses its arguments on Valassis' initial concerns in May prior to ADVO taking steps to pacify Valassis' skepticism by specifically giving false financial data, misstated Zone Products reports and erroneous reports about the current state of the SDR implementation. AOB 56-57. ADVO is correct that prior to receiving this information, Valassis did question ADVO's ability to meet its financial forecast. Valassis was also aware of the issues ADVO had experienced with Zone Products in its second fiscal quarter. Valassis further questioned the impact that the implementation of SDR would have on ADVO's business. The flaw in ADVO's argument is that Valassis did not dismiss or ignore these concerns, but instead asked specific questions about ADVO's financial condition, Zone Products business and SDR to investigate further these issues. In response, ADVO provided Valassis with specific assurances described above. Valassis asked for financial results for April and May and was given "actual" results demonstrating that ADVO was close to its forecast. Valassis requested information on Zone Products and was given documents showing that it was recovering. Valassis questioned the progress of SDR's implementation and was told that after initial issues, it was operating without any abnormal issues. In fact, ADVO countered each "warning" identified in its pretrial brief (*see* AOB 56-57) with specific data and information designed to prove to Valassis that the

potential problems had been resolved. As intended, Valassis was reassured and proceeded with, and even increased, its offer to purchase ADVO.

ADVO's attempts to challenge Valassis' reliance on the April/May financial results are likewise without merit. ADVO's position is that those financial results were "interim, unaudited, internal, [and] monthly and yet to be vetted" and therefore suggests that Valassis' reliance was unjustified. AOB 56. Despite ADVO's lawyers' pejoratives, ADVO's CEO, Epstein, was clear: April/May was not a "soft" close. Epstein 472-73. ADVO knew that Valassis was going to rely on the April/May financials and it provided these results without ever saying they were "interim," "internal," "not yet vetted" or otherwise unreliable. To the contrary, ADVO told Valassis that the April/May financials represented the "actual" results of a normal close that "went well." Since the April/May results were the same format of detailed information ADVO produced each month for its use in tracking its business, without a specific qualification from ADVO, Valassis would have had no reason to believe that the April/May financials were anything other than "actual" results or were in any way unreliable. In fact, ADVO deliberately hid the note to the financial results that indicated that outstanding questions existed as to the accuracy of the postage expenses reported in the results.

Valassis' reliance on ADVO's misstatements and omissions was justified because it was based on information ADVO provided in response to specific requests.[3] ADVO therefore knew that Valassis deemed this information to be important, yet ADVO did not warn Valassis that the information was incorrect or incomplete. Valassis asked specific questions and expected

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[3] As explained above, Valassis is not claiming that it relied on misstatements in ADVO's forecasts and therefore much of ADVO's argument that Valassis' reliance was misplaced is irrelevant. *See* AOB 60-61. Instead, Valassis argues that ADVO provided false statements of fact to demonstrate to Valassis that ADVO's forecasts were achievable.

that it was receiving true answers. It is incredible for ADVO now to argue that Valassis should have discredited and refused to rely on these answers due to general information about ADVO's business that was contradicted by the later, specific misrepresentations ADVO made.

Moreover, ADVO's argument that Valassis did not rely upon ADVO's false information is simply incorrect. ADVO asserts that Valassis' own models and projections did not take into account the false financial information and other misstatements and therefore demonstrate that Valassis did not rely on ADVO's fraudulent conduct. The record demonstrates the opposite. While Valassis discounted ADVO's projections, the amount of the discount shrunk drastically precisely because ADVO provided data (false data, as we now know) to address the concerns that Valassis raised. ADVO was projecting $18.6 and $19.1 million of operating income, respectively, for its third and fourth fiscal quarters. Valassis' forecast in early June -- before receiving ADVO's false assurances -- projected third and fourth quarter operating income of $10.5 and $10.4 million, respectively. VAL002313-16 After Valassis made these projections, ADVO provided Valassis with its "actual" April/May results, favorable Zone Products reports, and assurances (just before the third quarter close) that the third quarter was "on target." While there were numerous intermediate iterations of Valassis' forecast as it learned new information, by the time Valassis signed the Merger Agreement on July 6, as a result of the new data provided by ADVO, Valassis had increased its third quarter forecast from $10.5 million to $16.5 million, and increased its fourth quarter forecast from $10.4 million to $15.0 million. VAL039077-081. In addition, the draft letter prepared by Groe for Schultz to consider sending to ADVO does not demonstrate Valassis' lack of reliance on ADVO's misrepresentations and omissions. Mr. Groe drafted the letter expressing certain concerns, but Valassis did not send the letter because the issues raised in the letter were resolved through due diligence. Schultz 470-72. However,

Valassis was prevented from learning this information by the misstatements and misrepresentations ADVO made to convince Valassis that ADVO was worth $37.00/share.

In an apparent attempt to undermine Valassis' reliance on ADVO's forecasts and projections, ADVO asserts that if the April/May financials were really that important to Valassis, Valassis would have sought a representation or warranty in the Merger Agreement regarding those financials. ADVO further claims that Valassis "deliberately" decided not to ask for such a representation or warranty. AOB 7, 56.

The only thing deliberate about ADVO's point, is that it is a deliberate misstatement of the record. As Valassis' counsel testified (and ADVO's counsel undoubtedly knows), in a public deal, it is not customary to seek a representation and warranty with respect to an acquired-company's monthly financial statements or internal projections and forecasts, as those documents are not available to the public. Leder 51-53. If such a representation and warranty was sought, as pointed out by Valassis' counsel, it is likely that a schedule would have to be prepared and possible that such schedule would thereafter be disclosed. *Id.* at 52, 54. As stated by Valassis' counsel, that is the sole reason that a representation and warranty regarding ADVO's monthly financials or forecasts and projections was not sought. *Id.* at 54.

2. <u>ADVO Cannot Hide Behind "Anti-Reliance" Provisions.</u>

ADVO mistakenly believes that it was permitted to lie to Valassis and then hide behind "anti-reliance" language in the NDA, data room logon screen and the Merger Agreement. First, the law does not allow parties to avoid the consequences of making material false misstatements of fact. As this Court has stated "[t]o the extent that [an agreement] purports to limit the Seller's exposure for its own conscious participation in the communication of lies to the Buyer, it is invalid under the public policy of this State." *Abry Partners V, L.P. v. F&W*

Acquisition LLC, 891 A.2d 1032, 1064 (Del. Ch. 2006). As demonstrated above, ADVO made clear misstatements and omitted other factual information in response to specific inquiries from Valassis in an attempt to induce Valassis to purchase ADVO at an unjustified price. Those actions are not excusable under Delaware law.

Second, and more fundamentally, ADVO cannot rely on the specific so-called "anti-reliance" provisions here because they lack clear language disclaiming reliance on ADVO's statements made during due diligence. As explained in more detail in Valassis' Opening Pretrial Brief (VOB 55-58), the NDA, data room logon screen[4] and Merger Agreement do not include "anti-reliance" language, and Valassis did not agree that it was not going to rely on the veracity of the information being provided in due diligence. Indeed, the NDA specifically notes that the purpose of providing information was to assist Valassis in evaluating whether to enter into a transaction with ADVO. The agreements at most create a murky issue of the purpose and meaning of the "disclaimer" of representations and warranties. As *Abry*, written after each of the cases relied on by ADVO, instructs, "[i]f parties fail to include unambiguous anti-reliance language, they will not be able to escape responsibility for their own fraudulent representations made outside of the agreement's four corners." 891 A.2d at 1059. The agreements, therefore, offer ADVO no refuge.

D. ADVO Intended to Induce Valassis to Enter into the <u>Merger Agreement Through its Misrepresentations.</u>

ADVO struggles with its lies and deception and offers the argument that there is no evidence that it intended to deceive Valassis. Its actions show otherwise. The intent to

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[4] ADVO does not explain how the data room logon screen is applicable as it is excluded by the integration clause of the Merger Agreement.

deceive is clear here because ADVO knew the statements were false or had insufficient basis to trust that they were true when made. *See Lord v. Souder*, 748 A.2d 393, 402 (Del. 2000) ("There is of course no difficulty in finding the required intent to mislead where it appears that the speaker believes his statement to be false. Likewise there is general agreement that [intent] is present when the representation is made without belief as to its truth, or with reckless disregard whether it be true or false. Further than this, it appears that all courts have extended it to include representations made by one who is conscious that he has no sufficient basis of information to justify them").

ADVO asserts several incredible excuses for its failure to inform Valassis that the April/May financial results did not reflect an addition $1.5 million of postage expense that would reduce operating income for those months by 20%. None of these excuses are remotely believable. First, ADVO claims that the original June 23 note to the April and May financials indicating that the postage expenses were incorrect was not provided to Valassis because it was lost in the email traffic. AOB 31. If that were true, then Messrs. Hutter and Barbieri would not have needed to consult with the CEO of ADVO on whether to inform Valassis of this information when they "forgot" to mention it on a call with Messrs. Groe and Mitzel. Hutter 198-99; Barbieri 154. They would have simply called Valassis back and cleared up the error. The fact that Mr. Harding instructed Messrs. Hutter and Barbieri not to communicate this information shows ADVO's intent to hide it.

Second, the intent to deceive Valassis is obvious from the behavior of the participants to the decision on July 5 – on the eve of signing the Merger Agreement – not to inform Valassis that ADVO had failed to include $1.5 million of postage expense in the April and May financial results. Each of Messrs. Harding, Mahoney, Palmer and Robinson knew from

Mr. Epstein's drafting of the July 5 update to his note, and his communications to them, that Mr. Epstein felt strongly that this information needed to be provided to Valassis. Those men overruled Mr. Epstein and made a conscious decision not to inform Valassis of the error. The only possible reason why they would make that decision was to continue to mislead Valassis about the financial condition of ADVO. They knew that Valassis had false information about ADVO's April/May results – which Valassis had repeatedly requested as a requirement to increase its offer – yet they deliberately chose not to correct that false information. It is clear on this record that ADVO had the deal it wanted and was not going to risk that deal by revealing information that ADVO had overstated its operating income by at least 20% and was experiencing accounting errors as a result of its vaunted new computer system.

ADVO cannot hide behind the advice of counsel to argue that it had no intent to deceive Valassis. First, the two attorneys to the conversation on July 5 testified that they gave no advice and that the decision not to tell Valassis was made by Messrs. Harding and Mahoney. Palmer 46-50; E. Robinson 140-44. Second, it is too late for ADVO to hide behind legal advice. At depositions, ADVO asserted privilege over legal advice given regarding the postage expense issue and prevented full exploration of the issue. E. Robinson 144-46. ADVO cannot now use that same legal advice as proof of its innocence. *See* Motion in Limine re: Legal Advice, filed December 4, 2006.

ADVO's other misrepresentations are likewise so blatant that intent to deceive is easily inferred. In each situation ADVO provided information in response to requests from Valassis without informing Valassis of any of the negative facts or providing any warnings or caveats. ADVO provided Valassis with financial projections that were not based in reality. Contrary to ADVO's argument that the "forecasts ... were created to reflect the way

management intended to run the business, employing reasonable revenues and cost assumptions" (AOB 60), ADVO's revised May forecast was in fact the result of a directive from the CEO, Scott Harding, to increase the forecast by nearly $11 million, and an additional directive from the Board to increase operating income by another $8 million, at a time when Valassis was actively seeking to buy the company. ADVO failed to inform Valassis that the projections were not the result of ADVO's ordinary budgeting process or that ADVO had not been able to support the costs savings necessary to meet those numbers, then hid the Board minutes that would have revealed these facts. Callahan 203, 228; Callahan Ex. 34.

With respect to the misrepresentations about SDR, Ms. Gant admits that ADVO was in "sales mode" and that her presentations about SDR were "upbeat." Gant 65-66. ADVO never provided Valassis any of the daily spreadsheets of the SDR-related issues impeding the May closing. ADVO also never provided Valassis with the one document that best evaluated SDR's performance in June. ADVO never warned Valassis not to trust its Zone Products data, even though it was clear by mid-June that the information was unreliable. Instead, ADVO provided reports that SDR was running without abnormal issues, the May closing went well and Zone Products had turned the corner and had increased bookings. All of these statements are contradicted by the information ADVO withheld. There is no way that ADVO simply was mistaken or forgot to provide full and fair information on each of these situations in the face of repeated requests. The only possible explanation for these repeated and blatant misstatements and omissions was that ADVO wanted to hide its problems from Valassis to convince Valassis to purchase ADVO at an inflated price.

E. Valassis Was Harmed By ADVO's Misconduct.

The harm here is evident. Had Valassis been informed of the true condition of ADVO, it would not have agreed to pay $37.00/share of ADVO's stock. ADVO does not argue otherwise in its Opening Pretrial Brief.

II. ADVO'S BUSINESS HAS SUFFERED A MATERIAL ADVERSE CHANGE.

From fiscal 2002 through the second quarter of fiscal 2006 (*i.e.*, the last publicly announced results prior to the signing of the Merger Agreement), ADVO's operating income averaged just over $19 million per quarter. ADVO's predictions for the remainder of 2006 were almost exactly in line with this history: ADVO predicted operating income of $37.1 million for the third and fourth quarters of fiscals 2006, after accounting for certain one-time "initiatives." Valassis initially discounted these forecasts heavily, projecting operating income of just over $20 million for the third and fourth quarters combined. VAL002313-16. However, as a result of data presented by ADVO to Valassis – specifically, "actual" April/May financial statements, "actual" booked Zone Products orders and an assurance that the June quarter was "on track," Valassis increased its forecast for operating income in the second half of 2006 to $31.5 million. VAL039077-81. As all of the witnesses at trial will concede, operating income for 2007 and beyond was based upon the operating income that was or would be achieved in fiscal 2006.

ADVO's *actual* operating income for the third quarter of 2006 was just $6.7 million. While the third quarter results were initially reported at $12.7 million, ADVO subsequently admitted that reported results included $6 million of non-existent revenue, and that operating income was therefore overstated by $6 million. Epstein 365-66. Adding back $2.3 million in third quarter charges associated with the merger, operating income after merger-related expenses was $9 million.

For the fourth quarter of fiscal 2006, ADVO reported an operating loss of $5.7 million. Schneider 4. Adding back the $6 million charge for inflated third quarter revenues and the reported $4.5 million in merger and litigation related expenses, ADVO's operating income for the fourth quarter was $4.8 million. Thus, operating income for the second half of 2006, *after* adjusting for merger-related expenses, was just $13.8 million. In other words, even after adjusting for merger-related expenses, ADVO missed its own operating income target by 62.8%, and it missed Valassis' more conservative target by over 56%.

ADVO, Valassis and the investing community all expect these earnings shortfalls to continue into 2007 and beyond. While ADVO will no doubt struggle mightily to adhere to its prior 2007 operating income forecast, its witnesses have already effectively admitted that their forecast will need to be lowered significantly. *See* AOB 62-63. Similarly, the Wall Street analysts who follow ADVO stock have significantly lowered their estimates of ADVO's 2007 operating income based upon ADVO's second half results. Valassis' financial advisor, Bear Stearns, has stated that, in view of the erroneous information provided to it, it may no longer be appropriate for parties to rely on its fairness opinion. And, even ADVO's own witnesses concede that absent the Merger Agreement, ADVO's stock would trade as low as the mid-teens, a 38% decline from the closing of ADVO's stock on the day before the announcement of the Merger Agreement. Yet, ADVO asserts the highly counterintuitive argument that none of these changes are material, and that they do not constitute a material adverse change under the terms of the Merger Agreement. ADVO's claim is without merit.

A. <u>ADVO's Earnings Drop Cannot be Dismissed As a Result of "Known Events."</u>

ADVO's first attempt to dismiss the stunning drop in its financial performance is that the drop was the result of "known events" and therefore cannot constitute a material adverse change. This argument is both legally and factually incorrect.

Legally, as pointed out in Valassis' Opening Pretrial Brief, there were two material adverse change clauses in the Merger Agreement: Section 3.01(g) and Section 6.02(c). Section 3.01(g) provides that (i) except as disclosed in ADVO's SEC Documents, (ii) except as disclosed in ADVO's Disclosure Schedule, and (iii) except for liabilities incurred in connection with Merger Agreement, the following is true:

> Since the date of the most recent financial statements included in the Filed Company SEC's Documents, the Company and its Subsidiaries have conducted their respective businesses in all material respects only in the ordinary course consistent with past practice, and there has not been any Material Adverse Change . . .

Palmer Ex. 14 Section 3.01.

The second MAC Clause of the Merger Agreement, the condition to closing, is subject only to a single exception. It states in pertinent part as follows:

> (c) <u>Material Adverse Change</u>. Except as disclosed in Section 3.01(g) of the Company Disclosure Schedule, since the date of this Agreement, there has not been any Material Adverse Change.

Palmer Ex. 14 Section 6.02(c).

As to the MAC Clause in Section 3.01(g), ADVO says that, if a risk was disclosed in ADVO's prior securities filings, the actual occurrence of that risk can never constitute a Material Adverse Change. This argument proves far too much. For example, ADVO's Form 10-K for fiscal 2005 states that ADVO faces uncertainties that include (but are not limited to)

"general changes in customer demand and pricing, the possibility of consolidation in the retail sector, the impact of economic and political conditions on advertising spending and the Company's distribution system, postal and paper prices, possible governmental regulation or legislation affecting aspects of the Company's business, the efficiencies achieved with technology updates, fluctuations in interest rates and other general economic factors." ADVODR00000481-00000544 at ADVODR00000501. In other words, revenues could go down, or expenses could go up. Acceptance of ADVO's position would render the MAC Clause in Section 3.01(g) (as well as all of the other representations and warranties in the agreement) surplusage, as there is *no event* that could affect ADVO's business that was not encompassed within this broad disclaimer.

The more appropriate reading of the introduction to Section 3.01 is that, except for events already reported in ADVO'S SEC documents – as opposed to possible future risks that have not yet materialized – there has no been Material Adverse Change. Thus, the "filed document" exception to Section 3.01 covers, *inter alia*, subsequent developments reported in a Form 10-Q and any matters disclosed in a Form 8-K filed after the most recent 10-Q. Put differently, an adverse development is not excepted merely because the possibility that it could occur is disclosed in a SEC filing. Rather, the exception applies only to adverse developments that are reported to have already occurred.

The MAC Clause in Section 6.02 conspicuously omits any general reference to matters disclosed in SEC filings. The reason for this is clear: that clause relates only to changes from the time of the Merger Agreement forward. Obviously, things that happen after the signing of the Merger Agreement cannot be disclosed in an SEC filing *before* the signing of the Merger Agreement. Thus, there was no point in including the exception that appears in Section 3.01.

It is of course true that *risks* disclosed prior to the signing of the Merger Agreement may come to fruition after the signing of the Merger Agreement, and if the parties had intended what ADVO asserts – that any risk disclosed in an SEC filing could not give rise to a MAC – they would have included the "except as disclosed in the Company's SEC Documents" language in Section 6.02 as well as in Section 3.01. But the parties did not do so.

Thus, under ADVO's reading of the contract, if a possible risk is disclosed in the Company's SEC Documents and comes to fruition before the Merger Agreement is signed, but is not disclosed until after the Merger Agreement is signed, there can be no MAC. On the other hand, if the identical risk is disclosed in the Company's SEC Documents, but it comes to fruition after the Merger Agreement is signed, there can be a MAC. This reading obviously makes no sense – from the standpoint of a rational buyer (or a rational seller), it should make no difference whether a material adverse event occurs prior to the signing of the Merger Agreement, but is not disclosed, or whether it occurs only after the Merger Agreement is signed. In either case, the buyer is not getting what it bargained for.

Read properly, the only events that are excepted from warranty in Section 3.01 that, since ADVO's most recent Form 10-Q, there has been no material adverse change are those that have occurred prior to the signing of the Merger Agreement and have been disclosed, either in a securities filing or on Schedule 3.01(g) – not those that could some day occur, but as far as is disclosed to the buyer, have not occurred yet. If the parties had intended the construction urged by ADVO – that any disclosed risk could by definition never give rise to a MAC – they would have included in Section 6.02 the "except as disclosed in the Company's SEC documents" language that appears in Section 3.01. As noted above, the parties did not do so. This is strong evidence that the parties never intended to include in the definition of a Material Adverse

Change (*i.e.*, exclude from the exception) matters that were disclosed in securities filings as possible risks but came to fruition only after the Merger Agreement was signed.

ADVO's argument is also factually erroneous. It asserts that the shortfall in operating income is the result of a "high occurrence of zone products cancellations . . . expenses associated with the March 26 launch of SDR and expenses related to three non-recurring cost-cutting initiatives." AOB 63. This is simply false. Total shortfall in zone products revenues was approximately $6 million. Keegan 67. A $6 million revenue miss cannot explain a $23.3 million miss in operating income. Nor are expenses associated with SDR a material factor, as 2006 IT expenses were just $2 million above the forecast amount. Gant 85. Finally, the cost-cutting initiatives explain no part of the revenue miss. As Ms. Gant and Mr. Epstein each made clear, and the documents plainly demonstrate, $37.1 million forecast of operating income for the second half of 2006 was *after* reduction for these initiatives. Gant 204; Epstein 319-20; Epstein Ex. 21 at ADVO00852294. Accordingly, even if the Court were to accept ADVO's erroneous argument that occurrence of matters previously identified as risks cannot constitute a MAC, the facts here would still establish that a MAC occurred.

B. No Part of ADVO's Earnings Shortfall can be Attributable to Valassis' Actions.

ADVO next attempts to blame the victim, claiming that Valassis' own "wrongful refusal to close" has caused ADVO's earnings miss. There is no merit to this claim. Obviously, Valassis' actions cannot have affected the third quarter results, because the third quarter was over before the Merger Agreement was even signed. As to the fourth quarter, Valassis' allegedly "wrongful" actions did not occur until, at the earliest, late August, just a month before the close of the fourth quarter. ADVO's sales generally have a lead time of at least several months.

Epstein 369-70. Accordingly, Valassis' allegedly wrongful actions in late August cannot have caused ADVO's disastrous performance in the second half of fiscal 2006.

C. ADVO's Second Half Earnings Miss Was Clearly Material.

As part of ADVO's continuing campaign to jam this case into the *IBP* template, it contends that the "challenges facing ADVO are, at most, short-term," and quotes language from *IBP* that a material adverse change must "threaten the overall earnings potential in a durationally-significant manner" and that a "short-term hiccup in earnings" should not suffice. AOB 64-65.

This case is nothing like *IBP*. Although the Court there found the case to be "a close one" (789 A.2d at 68), such that the Court reached its conclusion "with less than the optimal amount of confidence" (*id.* at 71), the factors that drove Court's conclusion in *IBP* are noticeably absent here. For example:

- The *IBP* Court noted that "IBP never provided Tyson with *quarterly* projections." 789 A.2d at 68 (emphasis in original). Here, the opposite is true. Not only did ADVO furnish Valassis with a quarterly forecast, but given ADVO's "turn around" story, Valassis specifically and clearly focused on ADVO's April/May financials, and ADVO knew that it was doing so.
- In *IBP*, the target "had a very sub par first quarter" but had begun to recover by the Agreement's termination date. 789 A.2d at 68, 70. Here, ADVO has had three consecutive disastrous quarters – Q2, Q3 and Q4 2006 – and there are no *results* indicating any immediate recovery.[5]

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[5] ADVO's witnesses will no doubt testify they expect an imminent turnaround. In view of ADVO's poor record of prediction, the Court's observation from *IBP* is apt:

> In view of IBP's demonstrated incapacity to accurately predict near-term results, Tyson says with some justification that I should be hesitant to give much weight to IBP's assurance that it will perform well for the rest of the year.

(continued . . .)

- Tyson's arguments were unaccompanied by expert evidence that identified the domunition in IBP's value or earnings potential as a result of its first quarter performance. 789 A.2d at 69. Here, Mr. Litvak will testify that ADVO's performance for the second half of 2006 has substantially reduced ADVO's value.

- After IBP's disappointing earnings, Tyson's financial advisor still concluded that a purchase of IBP at the merger price was within the range or fairness and a great long-term value for Tyson. 789 A.2d at 70. Here, in contrast, Valassis' financial advisor, Bear Stearns, has stated that it may no longer be appropriate for parties to rely on its fairness opinion. Blackman Ex. 44.

- IBP was in a cyclical business. 789 A.2d at 70. There is no evidence of any cyclicality in ADVO's business.

- The consensus of the analyst community in *IBP* was that the Company would fall short of earnings projections by less than .20 per share, or about 10% of forecast. Here, in contrast, the Morningstar consensus for ADVO's 2007 earnings per share has dropped from $1.81 to $1.25 per share, a decline of over 30%, and the estimates for 2008 have dropped from $1.89 to $1.65 per share, a decline of nearly 13%. ADVO's projections were for $1.65 per share in 2007, and $2.10 per share in 2008. Thus, the Wall Street consensus is that ADVO will miss its 2007 earnings target by 54% and its 2008 earnings target by 51.4%.

- In *IBP*, the company publicly stated its expectation that it would meet (or nearly meet) its full-year projection. *Id.* at 20. Here, ADVO has not made, and will not make, any such public announcement, because it knows it would not be true.

In short, ADVO told Valassis that it had overcome recent problems in its business and was poised for growth. This has turned out simply not to be true. Since the Merger Agreement was signed, ADVO has had two consecutive poor quarters, and the consensus is that ADVO's woes will continue for at least the next two years. This case is *not IBP*.

(. . . continued)

789 A.2d at 71.

ADVO next contends that, even under the model developed by Valassis' financial advisor, Bear Stearns, $37 per share is still within the range of fairness if one substitutes *actual* fourth quarter results for the results forecast by Bear Stearns. This claim, however, is premised on the assumption that ADVO's woeful 2006 performance will have no effect on its performance in 2007 and beyond, a premise that ADVO's witnesses, Valassis and analysts have unanimously rejected.

ADVO next asserts that during the last six quarters ADVO's average operating income was $16.7 million with a standard deviation of $4.6 million, and that ADVO's Q3 and Q4 2006 deviations from prior performance were "barely more than one standard deviation from expectation" and therefore not significant. AOB 66-67. This ham-handed exercise in statistical manipulation proves no such thing; indeed, ADVO's analysis, when applied properly, proves that ADVO's woeful second half performance *is* material. ADVO's isolation of just six prior quarters as the "relevant" period for historical comparison skewed its computation of the mean and standard deviation of historical operating income, and appears to be a deliberate attempt to hide the materiality of ADVO's earnings miss. But even accepting ADVO's statistical computations, ADVO's third quarter 2006 earnings miss was $11.3 million from forecast ($18 million forecast less $6.7 million achieved) and $10 million below ADVO's mean quarterly earnings, more than two standard deviations (as computed by ADVO) below the mean and below forecast.[6] ADVO's fourth quarter miss was $18.8 million, or four standard deviations below the mean, after adjusting for the $6 million charge relating to the third quarter.[7]

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6 In a statistical sleight of hand, ADVO ignores the fact that its reported third quarter earnings were overstated by $6 million. Simultaneously, it dismisses the $6 million from its fourth quarter (where it was reported) on the ground that it was a "non-recurring item[]." AOB 67. If one adds back $2.3 million of merger-related expenses, third (continued . . .)

In fact, however, since fiscal 2002, ADVO's operating income has averaged $19.05 million, or $76.2 million per year, almost exactly what ADVO forecast in 2006 before deducting for strategic initiatives. Using this more appropriate historical sample, the standard deviation of ADVO's quarterly earnings was just under $3.3 million. Using this larger and more appropriate sample, ADVO's third quarter revenue of $9 million (after adjusting for merger-related expenses) was $9 million below forecast and $10 million below its historical average, approximately three standard deviations below expected results. ADVO's fourth quarter operating income of $4.8 million (after adjusting for merger-related expenses) was more than $14 million below forecast[8] and its historical average, and thus more than *four standard deviations* below expectations. For normal distributions, 99.73% of results are within three standard deviations of the mean. Thus, the likelihood of a result three standard deviations below the mean is 1.35 out of 1,000. For normal distributions, 99.9937% of results are within four standard deviations of the mean. Thus, the likelihood of a result four standard deviations below the mean is 3.15 of out 100,000. The probability of operating income falling three standard deviations below the mean in the third quarter, and then falling four standard deviations below the mean in the next quarter, is thus approximately 4.5 in 100,000,000, or about 1 in 23 million.

(. . . continued)

quarter operating income was $9 million, which is still three standard deviations below the historical mean and nearly three standard deviations below ADVO's forecast.

7 Computed as forecast operating income of $19.1 million, less reported operating income of ($5.7 million) plus $6 million charges related to the third quarter. Even if one adds back $4.5 million of merger related expenses incurred in the fourth quarter, the operating income miss is still $14.3 million, more than three standard deviations below ADVO's calculated mean.

8 As noted previously, the second half forecast *already took into account* one-time strategic initiatives and the accounting change relating to FAS 123. *See* p. 30, *supra*.

It is fair to say that ADVO's performance in the second half of 2006 was likely not a result of normal fluctuations, but instead the result of a fundamental change in ADVO's business.

Finally, there is no merit to ADVO's claim that ADVO's earnings announcements cannot have been material because the price of ADVO and Valassis stock did not drop upon the announcement of those earnings. ADVO's stock, of course, is being propped up by the possibility that Valassis will be required to pay $37 per share to acquire it.[9] ADVO's stock is affected by myriad considerations, including its own financial performance, the likelihood that Valassis will be required to consummate the ADVO merger, and the market's changing views of the desirability of such a merger. In view of all of these moving parts, it is impossible to claim (as ADVO does) that the lack of significant movement in *Valassis'* stock price upon the announcement of *ADVO's* disappointing earnings proves that the earnings miss was not material.

D. ADVO's Woes Are Substantially Disproportionate to Those Affecting the Industry.

Finally, ADVO seeks to assert that ADVO's earnings woes are the result of factors affecting the industry generally and, therefore, are excepted from the MAC Clause.

The data does not support this contention. ADVO's earnings for 2006 were 64% below the Wall Street estimate, and 2007 consensus earnings estimates have now been reduced by over 30%. The performance of other participants in the industry has not been down by nearly this amount. Moreover, as Valassis' expert, Steven J. Silver, will testify, the direct mail and shared mail industries indicate a generally favorable market environment. ADVO's peer companies have seen their quarter-on-quarter operating income decline slightly – from 2% to 8%

[9] We note, however, that ADVO's stock is not trading close to $37 – an indication that there is substantial uncertainty that ADVO will prevail in the litigation.

-- while ADVO's quarter-on-quarter operating income since the signing of the Merger Agreement has declined by approximately 60% in each quarter. Clearly, ADVO is not merely experiencing industry-wide factors. As Mr. Silver will testify, ADVO's problems are attributable to factors that are unique to it, including, in particular, continuing softness in its Zone Products business. These problems cannot be attributed to industry-wide factors. Finally, the return of an assets analysis of ADVO's expert, performed appropriately, confirms that ADVO's problems were disproportionate to the industry. Between 2006 and 2006, ADVO's return on assets declined by 39%, while that of ADVO's competitors declined by an average of just 1%.

III. ADVO HAS BREACHED ITS REPRESENTATIONS AND WARRANTIES UNDER SECTION 3.01(e)(iii), (e)(iv) AND (g).

As set forth in the Valassis' Opening Pretrial Brief, ADVO has breached its representations and warranties that it maintained sufficient internal controls to comply with applicable law, that its disclosure controls and procedures were reasonably designed to ensure that material information was reported accurately, that it has conducted its business in all material respects only in the ordinary course consistent with past practice, and that there was not any "demand letter, or Order of any Governmental Entity or Arbitrator outstanding against" ADVO.

ADVO's Opening Brief asserts only that, while it has experienced "challenges" concerning its internal controls, ADVO and its outside accountants "successfully designed controls to meet those challenges." AOB 70.

ADVO represented not only that it maintained an adequate system of controls, but also that its controls were sufficient. As Valassis' expert Joseph Szmandzinski will testify, those representations and warranties are not true. The proof is in the quality of ADVO's reported earnings. Its Form 10-Q publicly filed for the third quarter of 2006 overstated revenues, and

therefore overstated ADVO's reported $12.7 million operating income by $6 million, or nearly 50%. Such "controls" are plainly not adequate.

Faced with this fact, ADVO again seeks refuge in the argument that its Form 10-Q for the second quarter of 2006 warned that the company's ability to maintain internal controls "may be negatively impacted" by the company's implementation of SDR, and that in all events, the inadequacies of its internal controls are not material. AOB 70. These arguments have been addressed above. *See* page 30, *supra*. They are no more convincing when applied to the lack of internal controls than when applied to ADVO's misreporting of its financial results.

IV. ADVO BREACHED ITS OBLIGATION TO PROVIDE VALASSIS WITH REASONABLE ACCESS TO INFORMATION.

In late July ADVO announced earnings that were 30% below the forecast that it had told Valassis just two days before the end of the quarter was "on track." Valassis understandably had questions, and consistent with its position in late June, it wanted data, not words. The need for data was only accentuated when ADVO's words explained to Valassis that the data provided to Valassis in June had been "corrupt," "flawed" and "garbage in garbage out." Valassis needed to know why ADVO had been so far off its forecast, and why its data was corrupt. Under the circumstances, full access was reasonable. That access was not provided.

ADVO now asserts that it "made extraordinary efforts to accommodate Valassis' requests until the eve of the lawsuit." AOB 71. ADVO's position is pure flummery. As detailed in Valassis Opening Brief, ADVO denied Valassis access to the data and the personnel it needed. VOB 72. ADVO's counsel concluded (erroneously) that Valassis' motivation was to find a way out of the deal, and concluded incorrectly that it could therefore block Valassis' access. In fact, ADVO had scheduled its shareholder vote on the merger for September 13, 2006, and it

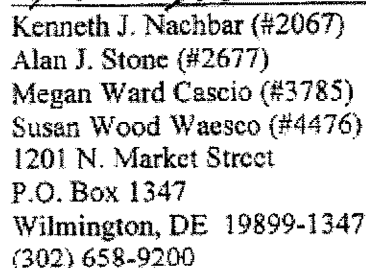
evidently hoped that if it stalled, it could force Valassis to close on September 15 without providing Valassis with the contractually-mandated access that it needed to understand ADVO's true financial position. The proof of the unreasonableness of ADVO's position is that Valassis' fears were well founded: After denying access to Valassis, ADVO was forced to disclose that its third quarter results were overstated by $6 million as the result of improperly recorded revenues. ADVO evidently hoped to make this disclosure after it was a wholly-owned subsidiary of Valassis.

The parties' contract did not permit this type of tactical stalling. It required that ADVO provide Valassis with reasonable access. In the circumstances existing in July and August, the limited access provided by ADVO was grossly insufficinet. By its actions, ADVO breached Section 5.02(a) of the Merger Agreement.

CONCLUSION

For the reasons stated in Valassis' pretrial briefs, as well as the evidence to be presented at trial, Valassis is entitled to the relief requested in its Amended Complaint.

MORRIS, NICHOLS, ARSHT & TUNNELL LLP



Kenneth J. Nachbar (#2067)
Alan J. Stone (#2677)
Megan Ward Cascio (#3785)
Susan Wood Waesco (#4476)
1201 N. Market Street
P.O. Box 1347
Wilmington, DE 19899-1347
(302) 658-9200
Attorneys for Plaintiff/Counterclaim-Defendants Valassis Communications, Inc. and Michigan Acquisition Corporation

OF COUNSEL:

Eric Landau
Steven J. Aaronoff
Shawn M. Harpen
Travis Biffar
McDERMOTT WILL & EMERY LLP
18191 Von Karman Avenue, Suite 500
Irvine, CA 92612-7107
(949) 757-7162

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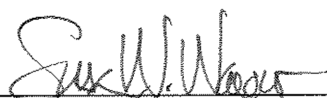
CERTIFICATE OF SERVICE

I hereby certify that on December 7th, 2006 I electronically filed and caused to be served by LexisNexis E-filing the foregoing **Public Version of the Reply Pretrial Brief of Valassis Communications, Inc. and Michigan Acquisition Corporation** upon the following counsel:

Gregory P. Williams
Evan O. Williford
Richards Layton & Finger
One Rodney Square
920 North King Street
Wilmington, DE 19801



Susan Wood Waesco (#4476)