SEVENTH EDITION

THE COMPREHENSIVE GUIDE TO ECONOMIC DAMAGES

EXCERPT

Edited by
Jimmy S. Pappas,
William Scally,
and Steven M. Veenema

BVR
What It's Worth

SEVENTH EDITION

The Comprehensive Guide to Economic Damages

VOLUME TWO

Edited by

Jimmy S. Pappas, William Scally, and Steven M. Veenema

BVR
What It's Worth
111 SW Columbia Street, Suite 750, Portland, OR 97201
(503) 479-8200 • www.bvresources.com

What It's Worth

Managing Editor/Desktop Editor: Monique Nijhout-Rowe

Senior Copy Editor: David Solomon

Chair and CEO: David Foster

President/Publisher: Lucretia Lyons

Chief Revenue Officer: Lisa McInturff

PRINT ISBN: 978-1-62150-252-4
PDF ISBN: 978-1-62150-253-1
PRINT ISSN: 2694-4863
PDF ISSN: 2694-4871

Table of Contents

VOLUME ONE

Note: The title page for each chapter contains a detailed table of contents for that chapter.

VOLUME TWO

Note: The title page for each chapter contains a detailed table of contents for that chapter.

About the Editors

Jimmy S. Pappas, MSA, CPA, CFE, CFF, ABV, is a partner in Marcum LLP's Boston office and the national leader of the firm's forensics practice. He has more than 25 years of experience advising legal counsel, management, and boards of directors on accounting, internal control, and complex financial matters related to internal investigations, civil and criminal litigation, and corporate governance. He has served clients, including *Fortune* Global 500 companies, in various industries.

Pappas is frequently appointed as a testifying expert in disputes involving accounting, fraud, corruption, and economic damages matters. He has testified on behalf of regulatory agencies such as the U.S. Securities and Exchange Commission and has advised plaintiffs and defendants in civil and criminal litigation. His litigation experience includes, in part: securities fraud, bankruptcy fraud, shareholder disputes, breach of contract, failed investments, business interruption claims, valuation disputes, post-acquisition disputes, and accounting malpractice.

In addition, he conducts corporate internal investigations on issues relating to financial statement fraud, corruption, misappropriation of assets, and internal control failures and advises organizations on antifraud and anticorruption compliance programs.

Pappas maintains an active role within the industry and is frequently engaged to speak on compliance, regulatory, and economic damages matters at national and international conferences.

He is a Certified Public Accountant (CPA), a Certified Fraud Examiner (CFE), Certified in Financial Forensics (CFF), and Accredited in Business Valuations (ABV). He holds a Bachelor of Arts in political science from Amherst College and a Master of Science in accounting from Bentley University.

William Scally, CFA, is a partner in the Business Valuation and Litigation Support practice of Marcum LLP in Boston. He is also the national firm leader of Marcum's Litigation Advisory Services Practice. He earned a Bachelor of Science in control systems engineering from the United States Naval Academy as well as a Master in Business Administration from Boston College. He is a Chartered Financial Analyst (CFA) charter holder and has more than 20 years of professional experience advising clients on a broad range of business issues.

As a valuation specialist, Bill provides financial, economic, and statistical services to companies, with a focus on equity and debt valuation, business enterprise valuation, business model due diligence, and contract compliance. He has significant experience applying valuation principles to assist companies pursuing strategic initiatives and to analyze economic damages pursuant to government and commercial litigation disputes. Applications include the valuation of closely held businesses, patent infringement, trade secret misappropriation, joint venture disputes, breach of contract, business and asset impairment analyses, and purchase-price disputes. His experience includes engagements across a broad array of industries, including private equity and early-stage ventures, service, software, technology, manufacturing, financial services, life sciences, and healthcare.

Bill has been qualified as an expert witness and has testified on matters involving business enterprise valuation, trade secret, trademark, patent, partnership, employment, personal injury, and contract disputes. He formerly worked in the Forensic Services Advisory practice of a "Big Four" accounting firm in Boston.

Steven M. Veenema, Esq., is a shareholder in the Boston office of the law firm of Murphy & King PC. He helps clients resolve complex business disputes both in and out of court, focusing primarily on issues arising among shareholders in closely held companies, litigation over intellectual property and unfair competition, and employment-related matters for both employers and employees. Veenema has advised companies, board members, and individual employees and shareholders across industries, including finance, high-tech, real estate, and retail, and also has significant experience litigating matters involving commercial leases, insurance coverage, securities fraud, construction projects, and mergers and acquisitions. His intellectual property practice includes representing clients in court and before the Patent and Trademark Office and the Trademark Trial and Appeals Board in trademark prosecution, maintenance, and protection. Before joining Murphy & King, Veenema practiced at Brown Rudnick LLP, an international law firm headquartered in Boston. Before and during law school, he worked at Copyright Clearance Center Inc., a copyright licensing collective located in Danvers, Mass. Veenema received his J.D. from Suffolk University Law School in Boston.

Acknowledgments

The ability to create a text with deep insights into the breadth of issues that affect financial damages requires the talents of many individuals, and no group is more qualified than this group of contributing authors. They are specialists in the particular area they have written about. We thank each of them for the time and energy they put into helping others gain from their insights by participating in this book.

Contact information for each of the contributing authors can be found below; each of their biographies can be found in the section starting on page xv.

Doug Bania, CLP (Chapter 38)
Nevium Intellectual Property Consultants
415 Laurel St.
Suite 341
San Diego, CA 92101
www.nevium.com

Neil J. Beaton, CPA/ABV/CFF, CFA, ASA
(Chapters 13 and 20)
Alvarez & Marsal Valuation Services
1111 Third Ave.
Suite 2450
Seattle, WA 98101
www.alvarezandmarsal.com

Richard F. Bero, CPA, CVA (Chapters 32, 33, 34, and 35)
The BERO Group
N16 W23217 Stone Ridge Drive
Suite 150
Waukesha, WI 53188
www.berogroup.com

Jared J. Bourgeois, CPA/ABV, CFE, CAMS (Chapter 47)
PricewaterhouseCoopers Advisory Services LLC
1 N. Wacker Drive
Chicago, IL 60606
www.pwc.com

Pamela Coyle Brecht, Esq. (Chapter 22)
Pietragallo Gordon Alfano Bosick & Raspanti LLP
1818 Market St.
Suite 3402
Philadelphia, PA 19103
www.pietragallo.com

Shane A. Brunner, Esq., CPA (Chapter 35)
Michael Best & Friedrich
1 S. Pinckney St.
Suite 700
Madison, WI 53701
www.michaelbest.com

Brian Buss, CFA (Chapter 39)
CBIZ Forensic Consulting Group LLC
401 B St.
Suite 2150
San Diego, CA 92101
www.cbiz.com

Christopher V. Carani, Esq. (Chapter 33)
McAndrews, Held & Mallowy Ltd.
500 W. Madison St.
34th Floor
Chicago, IL 60661
www.mcandrews-ip.com

Thomas Cauley Jr., Esq. (Chapter 50)
Sidley Austin LLP
1 S. Dearborn
Chicago, IL 60603
www.sidley.com

Larry Chiagouris, Ph.D. (Chapter 37)
BrandMarketing Services Ltd.
P.O. Box 1070
Boca Grande, FL 33921
Brandmarketingltd.com

Kevin L. Chlarson, Esq. (Chapter 10)
McBrayer
500 W. Jefferson St., Suite 2400
Louisville, KY 40202
www.mcbrayerfirm.com

Charles D. Cowan, Ph.D. (Chapter 49)
Analytic Focus LLC
11467 Huebner Road
Suite 200
San Antonio, TX 78230
www.analyticfocus.com

Michael A. Crain, DBA, CPA/ABV, CFA, CFE
(Chapters 1, 14, and 29)
Florida Atlantic University
Center for Forensic Accounting
Boca Raton, FL 33431
business.fau.edu/CfFA

Kaufman Rossin, CPAs
3310 Mary St.
Suite 501
Miami, FL 33133
kaufmanrossin.com

Ryan Cram, CVA (Chapter 29)
Seigneur Gustafson LLP
940 Wadsworth Blvd.
Suite 200
Lakewood, CO 80214
www.cpavalue.com

Stephen P. Davidson, Esq. (Chapter 50)
Aon M&A and Transaction Solutions
1 Liberty Plaza
165 Broadway
29th Floor
New York, NY 10006
www.aon.com

Anthony Dragone, Esq. (Chapter 50)
Aon M&A and Transaction Solutions
1 Liberty Plaza
165 Broadway
29th Floor
New York, NY 10006
www.aon.com

Jennifer Drake, Esq.
Aon M&A and Transaction Solutions
20 Bay St.
Toronto, Ontario M5J 2N9
www.aon.com/canada

Rachel J. Eisenhaure, Esq. (Chapter 3)
Kenney & Sams
144 Turnpike Road
Suite 350
Southborough, MA 01772
kslegal.com

Christian W. Fabian, Esq. (Chapters 47 and 50)
McDermott Will & Emery LLP
444 West Lake St.
Suite 4000
Chicago, IL 60606-0029
www.mwe.com

Tyler Farmer, Esq. (Chapters 9, 13, and 20)
Harrigan Leyh Farmer & Thomsen LLP
999 Third Ave.
Suite 4400
Seattle WA 98104
www.harriganleyh.com
tylerf@harriganleyh.com

Elizabeth S. Fenton, Esq. (Chapter 44)
Ballard Spahr LLP
919 N. Market St., 11th Floor
Wilmington, DE 19801-3034
www.ballardspahr.com

Mark S. Fenzel, Esq. (Chapter 10)
Middleton Reutlinger
401 S. Fourth St.
Suite 2600
Louisville, KY 40202
www.middletonlaw.com

Madison Field, CFE, CVA (Chapters 40 and 41)
Postlethwaite & Netterville
8550 United Plaza Blvd.
Suite 1001
Baton Rouge, LA 70809
www.pncpa.com

John Garaffa, Esq. (Chapter 45)
Butler Weihmuller Katz Craig LLP
1818 Market St.
Philadelphia, PA 19103
www.butler.legal

Daniel K. Gelb, Esq. (Chapter 4)
Gelb & Gelb LLP
900 Cummings Center
Suite 207-V
Beverly, MA 01915
www.gelbgelb.com

Richard M. Gelb, Esq. (Chapter 4)
Gelb & Gelb LLP
900 Cummings Center
Suite 207-V
Beverly, MA 01915
www.gelbgelb.com

David H. Glusman, CPA/CFF, FABFA, Cr.FA, CFS
(Chapter 22)
Marcum LLP
1601 Market St.
4th Floor
Philadelphia, PA 19103
www.marcumllp.com

Joseph S. Goode, Esq. (Chapter 26)
Laffey, Leitner & Goode LLC
325 E. Chicago St.
#200
Milwaukee, WI 53202
www.llgmke.com

Alice G. Gosfield, Esq. (Chapter 22)
Law Offices of Alice G. Gosfield & Associates PC
2309 Delancy St.
Philadelphia, PA 19103
www.gosfield.com

Robert P. Gray, CPA/ABV/CFF, CGMA, CFE (Chapter 10)
Gray Schrupp & Associates PLLC
6907 Lavendale Ave.
Dallas, TX 75230

Rick Hoffman, CPA/ABV (Chapter 36)
Lone Peak Valuation Group
6955 Fort Union Blvd.
Cottonwood Heights, UT 84121
www.lonepeakvaluation.com

Jeffrey L. Baliban, MA Econ, CPA/ABV/CFF, CDBV (Chapter 43)
Capital Forensics Inc.
1530 E. Dundee Road
Suite 333
Palatine, IL 60074
www.capitalforensics.com

Daniel E. Johnson, Esq. (Chapter 23)
Covington & Burlington LLP
850 10th St., NW
Washington, DC 20001-4956
www.cov.com

Leon Kaplan, Ph.D. (Chapter 37)
116 Copperfield Drive
Lawrence, NJ 08648-2583

Michael Kaplan, CPA/ABV/CFF, CVA, MAFF (Chapter 16)
Neumeister & Associates LLP
3900 W. Alameda Ave.
Suite 1200
Burbank, CA 91505
www.neumeistercpa.com

Robert B. Kester, CPA/ABV/CFF (Chapter 10)
Blue & Co, LLC
2650 Eastpoint Parkway
Suite 100
Louisville, KY 40223
www.blueandco.com

Robert D. ("Rob") King, CPA/ABV/CFF (Chapters 40 and 41)
Postlethwaite & Netterville
103 Madison Plaza
Hattiesburg, MS 39404
www.pncpa.com

James A. (Jim) Koerber, CPA/ABV/CFF (Chapters 40 and 41)
Postlethwaite & Netterville APAC
P.O. Box 18170
Hattiesburg, MS 39404
www.pncpa.com

Adam Lawyer, CPA/ABV/CFF (Chapter 25)
Partner
FORVIS LLP
100 Throckmorton St.
Suite 1600
Fort Worth, TX 76102
www.forvis.com

Mark M. Leitner, Esq. (Chapter 26)
Laffey, Leitner & Goode LLC
325 E. Chicago St.
Suite 200
Milwaukee, WI 53202
www.llgmke.com

Sean T. Malone, Ph.D. (Chapter 48)
Analytic Focus LLC
11467 Huebner Road
Suite 200
San Antonio, TX 78230
www.analyticfocus.com

Kenneth Mathieu, CPA/ABV/CFF (Chapters 47 and 50)
Charles River Associates
1 S. Wacker Drive
34th Floor
Chicago, IL 60606
www.crai.com

Patrick A. McGeehin, CPA (Chapter 23)
FTI Consulting
6903 Rockledge Drive
Suite 1000
Bethesda, MD 20817
fticonsulting.com

Renee McMahon (Chapter 50)
Charles River Associates
1 S. Wacker Drive
34th Floor
Chicago, IL 60606
www.crai.com

Robert S. Mercado, CPA, CCIFP (Chapter 24)
Marcum LLP
555 Long Wharf Drive
8th Floor
New Haven, CT 06511
www.marcumllp.com

Kyle Anne Midkiff, CPA, CFE, CFF (Chapter 44)
Marcum LLP
1601 Market St.
4th Floor
Philadelphia, PA 19103
www.marcumllp.com

Joseph Natarelli, CPA (Chapter 24)
Marcum LLP
555 Long Wharf Drive
8th Floor
New Haven, CT 06511
www.marcumllp.com

Greg Naviloff, CPA/ABV, CFF, CFE (Chapter 42)
RSM US LLP
80 City Square
Boston, MA 02129
www.rsmus.com

Autumn N. Nero, Esq. (Chapter 32)
Perkins Coie
33 E. Main St.
Suite 201
Madison, WI 53703-3095
www.perkinscoie.com

Nicholas Oldack, ASA (Chapter 30)
Marcum LLP
555 Long Wharf Drive
8th Floor
New Haven, CT 06511
www.marcumllp.com

Dr. Gabriela Orsak (Chapter 49)
Analytic Focus LLC
11467 Huebner Road
Suite 200
San Antonio, TX 78230
www.analyticfocus.com

Vipul Patel, Esq. (Chapter 50)
Aon Transaction Solutions Practice
200 E. Randolph
Chicago, IL 60601
www.aon.com

Steven M. Platau, J.D., CPA (Chapter 8)
John H. Sykes College of Business
The University of Tampa
3627 S. MacDill Ave.
Tampa, Florida 33629
steve@platau.com

Thomas W. Reinke (Chapter 50)
Marcum LLP
1601 Market St.
4th Floor
Philadelphia, PA 19103
www.marcumllp.com

Peter Resnick, CPA, CFF, CFE (Chapter 42)
Charles River Associates
200 Clarenden St.
Boston, MA 02116-5092
www.crai.com

George P. Roach (Chapters 17, 18,19, and 46)
George Roach Litigation Consulting
7233 Fm 1181
Ennis, TX 75119
gproach@sbcglobal.net

Mark Roesler, Esq. (Chapter 28)
CMG Worldwide
9229 Sunset Blvd.
Penthouse 950
West Hollywood, CA 90069
www.cmgworldwide.com

Eric H. Rumbaugh, Esq. (Chapter 34)
Michael Best
790 N. Water St.
Suite 2500
Milwaukee, WI 53202
www.michaelbest.com

Ronald L. Seigneur, CPA/ABV, ASA, CVA (Chapter 27, 29)
Seigneur Gustafson LLP
940 Wadsworth Blvd.
Suite 200
Lakewood, CO 80214
www.cpavalue.com

Evan Sherwood, Esq. (Chapter 23)
Covington & Burlington LLP
850 10th St., NW
Washington, DC 20001-4956
www.cov.com

Daniel Small, Esq. (Chapter 5)
Holland & Knight LLP
701 Brickell Ave.
Miami, FL 33131
www.hklaw.com

Rebekah Smith, CPA/CFF, CVA, MAFF (Chapter 16)
GBQ Consulting
230 West St.
Suite 700
Columbus, OH 43215
www.gbq.com

Edward (Ted) Stockton (Chapter 26)
The Fontana Group
3509 N. Campbell Ave.
Tucson, AZ 85719
www.fontanagroup.com

Robin Banck Taylor, Esq. (Chapter 41)
Butler Snow LLP
1020 Highland Colony Parkway
Suite 1400
Ridgeland, MS 39157
www.butlersnow.com

Stacey Udell, CPA/ABV/CFF, CVA (Chapter 11)
HBK Valuation Group
220 Lake Dr. E. Suite 205
Cherry Hill, NJ 08002
www.hbkcpa.com

J. Lott Warren, Esq. (Chapter 41)
Butler Snow LLP
1020 Highland Colony Parkway
Suite 1400
Ridgeland, MS 39157
www.butlersnow.com

Kevin R. Yeanoplos, CPA/ABV, ASA (Chapter 21)
Brueggeman and Johnson Yeanoplos PC
Tanque Verde Place
7363 East Tanque Verde Road
Tucson, AZ 85715
www.bjyvalue.com

Timothy York, CPA/ABV (Chapter 25)
FORVIS LLP
4350 Congress St.
Suite 900
Charlotte, NC 28209
www.forvis.com

Chapter 47.
Post-Acquisition Disputes and Related Damages

CONTENTS

Chapter 47.
Post-Acquisition Disputes and Related Damages

By Kenneth Mathieu, CPA/ABV/CFF; Jared Bourgeois, CPA/ABV, CFE; and Christian Fabian, Esq.

1.0 Introduction

It is not uncommon for parties to an otherwise smooth merger-and-acquisition (M&A) transaction to find themselves mired in disputes post-closing. M&A disputes commonly arise related to post-closing adjustments to the purchase price, including working capital adjustments and earnout payments. In addition, buyers may allege post-closing that the seller breached certain representations and warranties, resulting in alleged damages based on the buyer having received less than what it "bargained for."

Working closely with legal counsel, accounting, financial, and valuation practitioners may be able to assist buyers and sellers in examining the issues arising in post-acquisition disputes, either as a consulting expert, expert witness, or neutral arbitrator. To assist practitioners, this chapter outlines the transaction process, types of post-closing adjustments to the purchase price, and various types and methods for quantifying damages, including a case study.

2.0 Overview of the Transaction Process

Below is an overview of the transaction process for a private M&A deal, whether structured as an asset or a stock acquisition.

2.1 Deal Negotiation; Key Transaction Terms

Companies are bought and sold typically for either financial or strategic purposes. Financial buyers, such as private equity firms, are commonly interested in exiting their investment over a discrete time horizon, while strategic buyers tend to integrate the acquired company into their operations and attempt to create value through the realization of synergies. Typically, there is a period of due diligence during which the buyer analyzes the target company and determines an appropriate purchase price and deal terms, including the preferred deal structure. The agreed-upon terms are usually memorialized in a nonbinding letter of intent, which is used as a starting point for drafting a sale and purchase agreement (SPA) between the parties. SPAs are highly negotiated and complex contracts that contain numerous provisions relating to the transaction and the rights and obligations of the parties. Common SPA provisions include the purchase price, a working capital adjustment mechanism, and the parties' respective representations and warranties, covenants, and indemnification obligations.[1]

Representations and warranties in the SPA typically function, among other things, as a means for the seller to provide the buyer assurances about the business and to allocate risk between the parties. The due diligence process is rarely perfect, and there are cost-versus-benefit considerations for both parties as to the level of due diligence performed. Examples of common assurances from the seller include:

1 In addition, the SPA will usually set forth the governing law.

- Financial statements of the target company "fairly present" the financial condition and the results of operations of the business and are prepared in accordance with generally accepted accounting principles (GAAP), consistently applied;
- Material information with respect to the business (e.g., litigation, environmental hazards, status of key customer relationships, and significant contracts) has been disclosed;
- There has been no material adverse change (or effect);[2] and
- The business has been operated in the ordinary course.

Qualifiers such as materiality and knowledge are often inserted into representations and warranties in an SPA to limit their scope.[3] In addition, the representations and warranties typically are given only as of certain dates, such as the signing date of the SPA and the closing date. The buyer's knowledge (i.e., "sandbagging") or seller's disclosure before closing of an inaccuracy or breach of a representation or warranty may also affect the buyer's ability to recover from the seller for a breach of a representation or warranty.[4] Exceptions to representations and warranties are typically included in disclosure schedules to the SPA.[5]

Covenants in an SPA address both pre- and post-closing obligations of the parties. Preclosing covenants often address access to information for due diligence, nonsolicitation of other buyers or competing offers, efforts of the parties to close the transaction and guardrails for the operations of the business until the transaction is closed. Post-closing covenants typically involve limitations on certain activities, such as restricting solicitation of employees or business relationships and restricting competition with the target business.

Indemnification provisions contain important protections for the parties. A typical SPA will provide for indemnification for breaches of representations and warranties, covenants, and other specific items (e.g., taxes and pending litigation). Indemnification will often be the exclusive remedy for any such breach, subject to certain exceptions. The operative indemnification language varies (e.g., indemnify, hold harmless, pay, and reimburse).[6] Reliance on representations and warranties may be limited to the representations contained in the contract, and, other than certain fundamental representations, those are usually subject to time limitations (e.g., representations generally survive for 12 to 18 months after closing). Limitations on the amount of liability for indemnification are usually included in the form of eligible claims (de minimis), baskets and thresholds, caps, and setoffs (e.g., tax benefits and insurance proceeds) and may be subject to carve-outs (e.g., knowing and intentional fraud).[7] A number of deals, particularly those involving private equity sponsors, increasingly use representations and warranty insurance (RWI) as a means of shifting a seller's indemnification risk for representations and warranties to insurers. Whether a claim for indemnification is brought against a seller or an insurer under a RWI policy, the underlying considerations in proving the breach and quantifying the loss are similar.

2 *Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), *aff'd*, No. 535 (Del. Dec. 7, 2018) (buyer validly terminated the merger agreement under the material adverse effect clause and also on the basis that seller incurably breached the ordinary course covenant).

3 *Ivize of Milwaukee, LLC v. Compex Litig. Support LLC*, 2009 WL 1111179, at **9-10 (Del. Ch. April 27, 2009) (representations not limited by "knowledge" unless expressly stated).

4 *Gusmao v. GMT Group, Inc.*, 2008 WL 2980039, at *5 (S.D.N.Y. Aug. 1, 2008) (distinguishes between closing with knowledge of facts the seller disclosed and when the seller is not the source of the buyer's knowledge).

5 *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14, 60 (Del. Ch. 2001) (disclosure schedules explicitly provided that an exception taken for purposes of one representation and warranty was deemed taken for all relevant representations and warranties).

6 *Majkowski v. Am. Imaging Mgmt. Servs., LLC*, 913 A.2d 572, 589 (Del. Ch. 2006) (while modern authorities confirm that the terms "indemnify" and "hold harmless" have little, if any, different meanings, a distinction is sometimes made in litigation).

7 *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715, 748 (Del. Ch. 2008) ("knowing and intentional breach" is the taking of a deliberate act even if breaching was not the conscious object of the act).

To address potential disputes proactively, the SPA (and the RWI policy) may define recoverable losses and/or damages (e.g., out of pocket and diminution in value). The indemnification provisions (or RWI policy) commonly address issues such as:

- The parties who are liable, the extent of their liability, and the authority to deal with claims (e.g., seller's representative);
- The indemnified parties (e.g., the buyer, the buyer's affiliates, and target company in a stock purchase);
- Duty to mitigate;
- Sources of recovery (e.g., setoff, escrow, letter of credit, and insurance); and
- Specified types of damages may be waived (e.g., incidental, consequential, and punitive).[8]

2.1.1 Determining the Purchase Price

The purchase price is the reflection of the "investment value" specific to the buyer[9] and the highest and best use of the assets for the seller. The assets, or expected future economic benefits, typically "bargained for" in a transaction include the anticipated stream of future earnings or cash flows and the items reflected in the target company's balance sheet, such as the working capital necessary to operate the target business in the normal course. The purchase price often incorporates the buyer's synergy assumptions (e.g., cost-cutting due to economies of scale, lower cost of goods due to increased purchasing power, etc.) resulting in a premium over the "intrinsic value" of the target.[10] The buyer may pay for some, but not all, synergies because there is a risk they will not be achieved. In a competitive bidding situation, all other factors being equal, the buyer with the highest level of anticipated synergies will likely offer the highest price.

2.1.2 Purchase Price: Valuation Approaches[11]

The three primary valuation methods commonly used to calculate the value of an asset are the asset, market, and income approaches. The market and income approaches (or variations thereof) are the most common valuation methods in M&A deals, and the asset approach is often used in liquidation scenarios.

The market approach is defined as "a general way of determining a value of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold."[12] The market approach uses a financial metric from either the income statement or balance sheet and compares it to either the equity value or market value of invested capital to calculate a multiple. The most commonly known financial metric is the price-to-earnings multiple, or PE ratio, that is often cited in relation to publicly traded stock prices. The most common ratio used for transaction purposes is market value of invested capital (MVIC) to earnings before interest, taxes, depreciation, and amortization (EBITDA). It is common to analyze the EBITDA multiple for both publicly traded companies similar to the subject company and for guideline transactions in the industry.

8 Glen D. West and Sara G. Duran, "Reassessing the 'Consequences' of Consequential Damage Waivers in Acquisition Agreements," 63 *Bus. Law.* 777 (May 2008).
9 "Investment value" is the value to a particular investor based on individual investment requirements and expectations. *International Glossary of Business Valuation Terms*, 2010 edition; available as a free download at sub.bvresources.com/freedownloads/bvglossary10.pdf.
10 Intrinsic value is the value that an investor considers, on the basis of an evaluation of available facts, to be the "true" or "real" value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise price and strike price of an option and the market value of the underlying security. *International Glossary of Business Valuation Terms.*
11 Since the focus of this chapter is not business valuation, this section will introduce basic valuation concepts but not provide an in-depth discussion, which is beyond the scope of this book.
12 *International Glossary of Business Valuation Terms.*

The income approach is "a general way of determining a value indication of a business, business ownership interest, security, or tangible asset using one or more methods that convert anticipated economic benefits into a single amount."[13] The two common income methods are: (1) the capitalization of earnings; and (2) the discounted cash flow (DCF). The DCF valuation method (or variations thereof) is commonly used in transactions because it allows the buyer to forecast future financial results based on certain assumptions to estimate the investment value.

The asset, or cost, approach may be used if the buyer intends to liquidate the assets of the target company. As M&A disputes are less common in this scenario, this chapter does not provide an in-depth discussion of the asset valuation approach.

The buyer, who may have incorporated its strategic plans into the valuation approaches, then determines a range for a reasonable purchase price and makes an offer to the seller. The seller then determines the intrinsic value of the business and other offers to evaluate the buyer's offer. The negotiation process culminates in the execution of a SPA with various terms addressing the purchase price as well as adjustments to the purchase price based on the financial performance of the target between the signing and closing or after closing, if an earnout based on future performance is included as a portion of the purchase price.

2.2 Post-Closing Adjustments to the Purchase Price

2.2.1 Working Capital Adjustments

SPAs typically contemplate an adjustment to the purchase price subsequent to the transaction's closing to reflect differences between the financial condition of the business "bargained for" and the financial condition of the business the buyer received at the closing. This adjustment recognizes that assets and liabilities of the target necessarily change during the period between the signing of the SPA and the closing as a result of normal operations. In addition, the adjustment attempts to protect the buyer against "looting of the business" and the seller from giving the buyer a windfall for activities occurring between the signing and closing.

The post-closing adjustment is usually calculated by subtracting working capital (as defined in the SPA) at closing from the working capital on the reference date, or from an otherwise agreed-upon "target" level of working capital (often referred to as "target working capital").[14] For example, if the target working capital as defined in the SPA is $100 million, but the closing date working capital is only $95 million, the buyer would receive a $5 million reduction to the purchase price.

2.2.2 Earnout Payments

Earnouts are another type of post-closing adjustment that impact the total purchase price in the form of contingent payments to the seller based on the business achieving certain negotiated performance targets during a specified period after closing.[15]

Earnouts may appeal to buyers because they may protect the buyer from initially overpaying for the business at closing, motivate the seller whose management remains involved in the business post-closing, and bridge a gap in valuation between the parties stemming from anticipated future performance of the target business. For buyers, earnouts may effectively amount to seller financing, which reduces the amount of cash that must be paid at closing.

13 Ibid.

14 Although the post-closing adjustment is typically based on changes in working capital, the SPA will often set forth the accounts to be included (or excluded) when determining working capital for the purpose of the post-closing adjustment and any specific rules to be applied when determining working capital.

15 *Comet Sys., Inc. Shareholders' Agent v. MIVA, Inc.*, 980 A.2d 1024 (Del. Ch. Oct. 22, 2008); *LaPoint v. AmerisourceBergen Corp.*, 2007 WL 2565709 (Del. Ch. Sept. 4, 2007), *aff'd*, 956 A.2d 642 (Del. 2008).

Earnouts may appeal to sellers because they permit them to realize additional value for their business and provide a degree of control in capturing such additional value when management continues to be involved in the business post-closing. Buyers and sellers alike may have aversions to earnouts for several reasons:

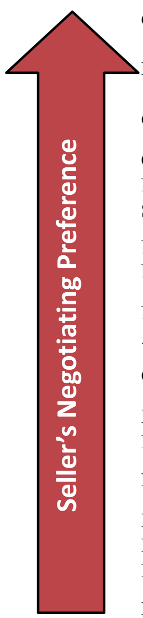
- Possible entanglements between the parties in business operations post-closing;
- Difficulty of administration and accounting post-closing;
- Challenge of negotiating for all contingencies; and
- Fear of post-acquisition disputes.

Buyers in particular may not prefer an earnout arrangement if it restricts full integration of the target with its existing operations. Further, a buyer may not be interested in compensating the seller based on the buyer's enhancements to the operations and profitability of the business. Similarly, sellers may not prefer an earnout because it leaves the seller exposed to the risk that additional value from the business may not be realized under the buyer's ownership.

Earnout payments are calculated based on the nonfinancial and/or financial performance of the target company against certain agreed-upon benchmarks. For example, the parties may decide to base the earnout on the total output of a manufacturing facility over the 12 months following closing or on the company's achievement of a research and development milestone. More commonly, however, parties select financial benchmarks, such as net revenue, earnings before interest and taxes (EBIT), EBITDA, net income, earnings per share (EPS), or cash flows.[16]

Sellers typically prefer earnings measures that appear higher on the income statement and are more objective, such as revenue. Buyers, on the other hand, typically prefer earnings measures that appear lower on the income statement and reflect the deduction of certain operating and potential nonoperating expenses, as depicted in Exhibit 1.[17]

Exhibit 1. Buyer and Seller's Negotiating Preference



Gross revenues	$XXX
Less: Returns	(XXX)
Net revenues	**XXX**
Less: Cost of goods sold (COGS)	(XXX)
Gross margin	**XXX**
Operating expenses	(XXX)
Pension costs	(XXX)
Stock option expense	(XXX)
Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA)	**XXX**
Depreciation	(XXX)
Amortization	(XXX)
Operating income (loss) (EBIT)	**XXX**
Interest expense	(XXX)
Income tax expense	(XXX)
Net income from continuing operations	**XXX**
Income/(loss) from discontinued operations	XXX
Income/(loss) from extraordinary items	XXX
Income/(loss) from accounting changes	XXX
Net income (loss)	**$XXX**

16 In some instances, the parties may elect to base the earnout on balance sheet measures, such as net equity.

17 Although GAAP no longer requires extraordinary and unusual items to be identified in financial statements, practitioners may nevertheless need to inquire about these types of items in discussions with management when performing EBITDA and valuation-related analyses.

Earnout payments may be made over set intervals (e.g., every 12 months) and for a set period of time (e.g., for two years post-closing), as agreed upon by the parties, and are commonly calculated based on one of three methodologies:

1. Fixed payment based upon achieving a benchmark.

   For example, "upon achieving FDA approval for XYZ, Buyer shall pay Seller $5 million."

2. Payout based on a percentage of performance.

   For example, "the annual Earnout Amount shall be calculated as 0.5% of Adjusted Net Revenues."

3. Payout based on a multiple of performance.

   For example, "the annual Earnout Amount shall be calculated as 5.5 times Adjusted EBITDA for 202X."

Payment of the earnout may be made in cash or stock. If payment is made in stock, the SPA will define the date on which the stock's value will be measured (e.g., date of closing or date of issuance). If the stock price is set as of closing, both buyer and seller bear risks of fluctuation in the stock price between the closing and the payment date.

The SPA, or a separate earnout agreement, may include covenants by the buyer to operate the business consistent with past practice or some other standard. Sellers desire continued operations that maximize the potential earnout and minimize the risk of manipulation. Buyers, on the other hand, desire to limit the influence of the seller on its operation and integration of the business. To the extent the seller's management will be retained to operate the business, the buyer will seek to ensure that management does not operate the business solely to maximize the earnout. For example, buyers may seek to ensure that the retained management personnel neither take excessive risks nor fail to invest in the business. The parties may also negotiate a bespoke definition of EBITDA, which may, for example, exclude certain revenues and costs. In addition, the SPA may include covenants requiring the buyer to make certain investments in the business (e.g., to continue funding product development), depending on the circumstances.

2.3 Disputes Over Post-Closing Adjustments to the Purchase Price

2.3.1 Working Capital Disputes

Disputes involving the post-closing working capital adjustment often focus on differences between the buyer's and seller's interpretation and application of the agreed-upon accounting principles, e.g., "GAAP, consistently applied" or, increasingly more common over the past several years, a hierarchy of specific and general accounting policies and, in certain cases, agreed-upon exceptions and methodologies for calculating working capital. Common areas of balance sheet scrutiny include:

- Accounts receivable/allowance for doubtful accounts;
- Inventory/reserves for inventory;
- Accounts payable;
- Accruals and contingencies (e.g., benefits accruals, warranty accruals, and litigation); and
- Any areas requiring management estimate/judgment.

Although the SPA may require that the closing balance sheet (and closing net working capital) be prepared in accordance with GAAP based on the facts and circumstances as of closing, the buyer or seller may argue that subsequent events corroborate their respective positions. For example, a buyer may allege that, subsequent to closing balance sheet date, bad debts in excess of the reported allowance for doubtful accounts corroborate that the allowance was understated and that an adjustment to increase the allowance is required to comply with GAAP. In response, a seller may argue that the allowance was prepared in accordance with GAAP because it was based on what was known as of the closing and the change in circumstances occurred later.

Subsequent events that occur after the closing date, but prior to the end of the preparation period, or the review period allotted to the buyer or seller to submit any objections to the closing balance sheet, are more likely to be probative than events occurring after the close of such review period. To avoid potential confusion regarding the impact of subsequent events in the preparation of the closing balance sheet, the parties may include a specific policy among the agreed-upon accounting principles to clarify the cutoff procedure and role of post-closing information and events (e.g., based on information available through the review period but solely to the extent related to events as of immediately prior to the closing).

When the closing date balance sheet does not conform to the agreed-upon accounting principles, the question may arise about whether the target net working capital statement also violates the agreed-upon accounting principles and needs to be adjusted accordingly. When the buyer contends that the target net working capital was not calculated properly, the issue of whether the dispute is properly deemed a post-closing adjustment (which attempts to compensate for changes in certain assets and liabilities prior to closing) or a claim for breach of a representation (discussed further below) arises.

The SPA may prescribe that the target net working capital statement must be prepared in accordance with GAAP, consistently applied, or it may define the target net working capital as a single amount, without any representations as to how the amount was determined. In the former case, the seller may argue that both the target and closing date net working capital statements must be restated to conform to GAAP. In response, the buyer may argue that it bargained for the target net working capital amount and that permitting such dual adjustments materially alters the deal terms.

If the buyer and seller are unable to settle their closing net working capital dispute, the SPA usually provides a detailed process for presenting and resolving disputes regarding the working capital (or other post-closing) adjustments. For example, many SPAs include provisions for engaging a neutral accountant to resolve the dispute. The SPA may specify whether the neutral accountant shall be acting as an "arbitrator" or "as an expert only and not as an arbitrator." The parties should consult with counsel on this distinction and how it may be understood in different jurisdictions.[18] The buyer and seller commonly each submit a position statement, including supporting calculations and documentation outlining the reasoning and basis for their respective positions, to the neutral expert or arbitrator. In addition, there may be a provision in the SPA for rebuttals, interrogatories, and possibly a hearing before the neutral expert or arbitrator. Most arbitrations result in a decision that is binding upon the parties and may be a more cost-effective way to resolve disputes than traditional litigation.

2.3.2 Earnout Disputes

Disputes involving earnouts commonly arise in three areas: (1) measurement of the business's performance; (2) post-closing accounting; and (3) post-closing conduct of business.

18 *Penton Business Media Holdings, LLC v. Informa PLC*, 2018 WL 3343495 (Del. Ch. July 9, 2018) ("Although parties could give an expert the authority to interpret a contract, here they did not. Instead, the court must interpret the contract to determine what the accountant can consider."); *Agiliance Inc. v. Resolver SOAR LLC*, C.A. No. 2018-0389-TMR (Del. Ch. Jan. 25, 2019) (the parties agreed to arbitration).

2.3.2.1 Earnout Disputes Over Measurement of Performance

The question often arises about which costs should be included when measuring the target's performance against earnout benchmarks. If the earnout will be measured based on the business's financial performance, the SPA or earnout agreement may specify that the relevant measure of earnings be prepared according to "GAAP, consistently applied"; however, the governing documents may provide no additional detail. Absent clear language regarding the measurement of the earnout in either the SPA or earnout agreement, parties may find that they disagree with how various costs should be treated in the post-closing period, including the following:

- Transaction costs;
- Intercompany overhead allocations;
- Discontinued operations;
- Extraordinary items;
- Post-closing capital investments;
- Depreciation expense; and
- Goodwill amortization.

As an example of the impact these expense items may have on the measurement of the earnout, consider the following fact pattern: The buyer acquired the target business in Year 1 for $100 million. The acquisition included an earnout in the following year such that the seller would receive additional consideration if the target achieved a net income of at least $7.5 million that year. Now, consider the following:

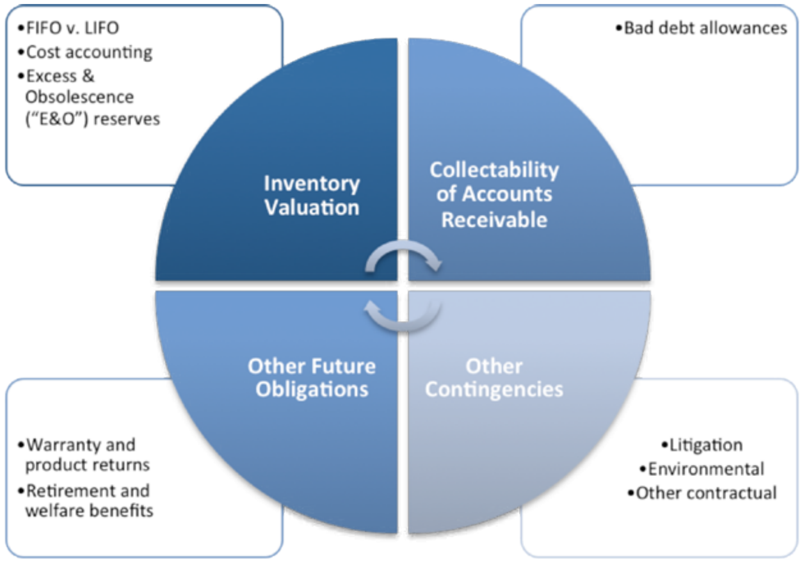
- As part of the acquisition, the buyer incurred certain costs and interest expenses associated with financing post-closing. As a consequence of these expenses, net income for the year after closing (Year 2) fell below the $7.5 million threshold.
- As part of the acquisition, the buyer recorded goodwill of $10 million. During Year 2, the buyer determined that $5 million of goodwill was impaired based on projected future cash flows and the carrying value of assets. As a consequence of the $5.0 million impairment charge, net income in Year 2 was only $4.0 million—or $3.5 million below the threshold.
- Post-closing, the buyer initiated a new depreciation policy that shortened the useful lives of its assets and increased the company's Year 2 depreciation expense (i.e., a change in estimate accounted for prospectively under GAAP). The buyer asserts that the change is warranted and that the seller had artificially enhanced earnings historically by exaggerating useful lives of equipment.

Legal and financial advisors to the buyer or seller may be asked to analyze the other party's claims and the financial advisors may be asked to quantify the difference in the earnout calculation based on various scenarios.

2.3.2.2 Earnout Disputes Over Post-Closing Accounting Methodologies

Many agreements include a covenant to continue accounting for the target's activities "in accordance with GAAP, consistently applied" with its historical accounting policies. Accounting-related disputes arise from the adoption of an alternative to historical accounting policies (e.g., an alternative GAAP consistent with the buyer's accounting or a change

Exhibit 2. Areas of GAAP That Are Prone to Dispute in Earnouts



to historical accounting that was not GAAP) or changes to conform to newly promulgated GAAP. Exhibit 2 highlights some of the more common areas of GAAP that are prone to dispute in earnouts.

As an example of the impact that changes in accounting methodology may have on the measurement of the earnout, consider the following fact pattern: The buyer acquired the target business in Year 1 for $50 million. The acquisition included an earnout in Year 2 such that the seller would receive additional consideration based on the business's EBIT in Year 2. Now, consider the following:

- Post-closing, the buyer undertook an extensive review of inventory and concluded that reserves for obsolescence were understated by $3.5 million. As a consequence of the $3.5 million expense recognized in Year 2 related to stating the inventory at the lower of cost or market in accordance with GAAP, the business suffered negative EBIT of $1.0 million. The seller asserts a deviation from past practice. The buyer argues that the seller's past practice was not compliant with GAAP.

- Post-closing, the buyer reviewed the seller's assessment of various litigation proceedings and decided that the liability for contingent losses the seller accrued was too low and increased it by $2.0 million. As a result, Year 2 EBIT was $2.0 million less than it otherwise would have been. The seller argues that no new information became available to warrant a change to the estimate of contingent losses under GAAP. The buyer asserts that its calculation of the contingent liability is a better estimate than the one the seller prepared.

Financial advisors to the buyer or seller may be asked to opine on the appropriate application of GAAP, consistently applied, and to quantify the difference in the earnout calculation based on various scenarios.

2.3.2.3 Earnout Disputes Over Post-Closing Operation of Business

When the buyer operates the business post-closing, sellers pay particular attention to the following factors that may have a material impact on the earnout:

- The buyer's perceived management of the business to minimize future performance measures and, in turn, the earnout;

- The buyer's alleged deviation from consistent historical operating norms;
- The buyer's alleged failure to invest in the business/provide for adequate capital;
- The buyer's alleged failure to pursue opportunities;
- The buyer's alleged impairment of earnout due to discontinuation of business; and
- The buyer's alleged shifting of sales or customer relationships from the acquired company to other buyer-related entities.

As an example of disputes that may arise under the buyer's operation of the business post-closing, consider the following fact pattern: The buyer acquired the target business in Year 1 for $250 million. The acquisition included an earnout such that the seller would receive additional consideration based on the business's net cash flow in Year 2. Now, consider the following:

- Post-closing, the buyer elected not to pursue the renewal of a contract with a key distributor, resulting in a 15% decline in sales. The seller later learned that the contract was eventually renewed, however, but it was outside the earnout period.
- To realize cost savings post-closing, the buyer elected to buy out the contracts of two members of senior management for $2.0 million, resulting in only $400,000 of salary and benefits avoidance in the earnout period;
- Post-closing, the buyer accelerated research and development spending related to new products; and
- Post-closing, the buyer transferred customer relationships with $20 million in revenue to another operating company.

When the seller or its former management operates the business post-closing, the buyer will pay particular attention to the seller's perceived management of business to *maximize* performance measures and, in turn, the earnout. As an example of disputes that may arise under the seller's operation of the business post-closing, consider the following fact pattern: The buyer acquired the target business in Year 1 for $75 million. The acquisition included an earnout in Year 2 such that the seller would receive additional consideration based on the business's net sales. Now, consider the following:

- The seller's management made large sales to customers who were ultimately unable to pay their bills. The buyer alleges that the seller's management knew the customers would be unable to pay.
- The seller's management provided abnormally high bonus and other incentives to its sales team to bolster net sales in Year 2, albeit at lower margins. The buyer alleges a deviation from the seller's normal operating procedures.

Legal and financial advisors to the buyer or seller may be asked to analyze the other party's claims and the financial advisors may be asked to quantify the difference in the earnout calculation based on various scenarios.

As with working capital disputes, the SPA or earnout agreement will likely specify the dispute resolution procedures, which commonly include engaging a mediator or neutral arbitrator to adjudicate the matter.

3.0 Breach of Contract Claims in Post-Acquisition Disputes

In addition to purchase price adjustment-related disputes, there are two general areas of breach of contract disputes in M&A transactions: (1) alleged inaccuracy of financial information; and (2) failure to disclose material information.

1. The financial information disputes often involve whether the financial statements provided to the buyer "fairly present" the financial condition and results of operations of the target company, or otherwise comply with the representations in the SPA, typically GAAP applied on a basis consistent with past practice. Common areas of dispute related to the financial statements are the application of period-end accounting procedures, activity occurring subsequent to the balance sheet date, the use of accounting estimates, and the materiality of necessary adjustments. To the extent the seller misrepresented the business's historical performance, the buyer may allege that it received less than what it "bargained for."

2. Disputes relating to the failure to disclose material information often involve the due diligence activities and seller representations and warranties because the buyer typically relies on the information the seller provided to develop strategic forecasts and determine the purchase price. For example, the seller may fail to disclose material contingent liabilities or the loss of a major customer, which may have reduced the buyer's offer.

Post-closing disputes may involve significant amounts and often involve accounting issues.[19] For example, assume the estimated closing balance sheet included $50 million in gross inventory and inventory valuation reserves of $5 million but, after closing, the buyer determined the reserve should be $15 million due to the slow-moving and obsolete nature of certain inventory. Accordingly, the buyer may argue that the seller did not fully disclose the condition of the inventory and/or overstated its value, which may give rise to a claim for breach of the financial statement representation.[20] Such a claim may allow for an award of damages that is greater than the amount of the alleged overstatement. This type of claim does not require proof of "fault," and contracts often provide for indemnification related to the breach of a representation or warranty. Indemnification provisions, however, are often subject to limitations, including both maximum and minimum limits on damages, which further reflect risk allocation between the parties.

Under the same fact pattern, the buyer also may allege that the seller *intentionally* withheld or misrepresented information related to the inventory condition and assert a claim based on fraud. This type of claim is based in tort rather than contract law, and, therefore, the buyer is not seeking to enforce contract rights. To prove fraud, the buyer typically must prove scienter (e.g., a knowing or reckless false representation) by the seller. This type of claim often is asserted to avoid contractual limitations on damages or as a basis for rescission of the contract.

The potential for a fraud claim highlights the importance of an integration clause, which provides that the contract is the complete and final agreement between the parties and that any prior agreements are superseded.[21] Such provisions may be enforced and serve to preclude a party from recovering based on alleged representations that are not contained in the SPA. In addition, although the SPA may contain a clause that purports to limit the seller's liability for representations contained in the contract that are proven to be false, such a limitation may be deemed unenforceable as against "public policy" with respect to intentional misrepresentations.[22]

Other potential claims include the breach of implied duty of good faith and fair dealing, which requires a party to refrain from arbitrary or unreasonable conduct that prevents the other party from obtaining the benefits of the bargain.

19 *OSI Sys., Inc. v. Instrumentarium Corp.*, 892 A.2d 1086 (Del. Ch. 2006); *Brim Holding Co., Inc. v. Province Healthcare Co.*, 2008 WL 2220683 (Tenn. Ct. App. May 28, 2008).
20 *DCV Holdings, Inc. v. ConAgra, Inc.*, 2005 WL 698133, at *10 (Del. Super. Ct. March 24, 2005), *aff'd*, 889 A.2d 954 (Del. 2005).
21 *Progressive Int'l Corp. v. E.I. DuPont de Nemours & Co.*, 2002 WL 1558382, at *7 (Del. Ch. July 9, 2002).
22 *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006).

3.1 Determination of Damages in Breach of Contract Claims

Contract-based damages awards are generally designed to put the nonbreaching party in the position it would have been if there had been no breach. They are often referred to as "expectancy damages," which give the nonbreaching party the "benefit of the bargain."[23] Damages must be calculated with a reasonable degree of certainty, have a causal link to the breach, and may not be speculative, as the following two cases demonstrate:

- In *Interim Healthcare, Inc. v. Spherion Corporation*,[24] the buyer requested expectancy damages based on the difference between the purchase price of $134 million and the alleged value of $90 million. The court rejected the buyer's request for expectancy damages as inconsistent with the parties' agreed-upon risk allocation and further concluded that the alleged diminution in value did not result from a breach of the contract.

- In *Cobalt Operating, LLC v. James Crystal Enterprises, LLC*,[25] the seller misrepresented its cash flows and the buyer relied on a cash flow multiple in determining the purchase price. The court awarded damages based on the difference between the price paid and the value of the target as determined by applying the multiple to the actual cash flows.

3.2 Types of Damages

- *Direct damages* are the natural and probable result of the breach.

- *Incidental damages* are the costs and/or expenses related to mitigating a breach or enforcing legal rights under the contract.

- *Consequential damages* do not typically arise as an immediate, natural, and probable result of the breach but from the interposition of an additional cause, such as the nonbreaching party's dealings with third parties.

- *Tort damages* are usually intended to compensate a party for its losses and must be reasonably related to the harm for which compensation is being awarded.

- *Punitive or exemplary damages* are intended to punish a wrongdoer and to deter similar conduct in the future. The conduct must be outrageous or egregious. Punitive or exemplary damages are very rarely awarded in M&A transactions.

- *Rescission* essentially voids the transaction and places the parties in the position they would have been if the transaction had not been consummated. If it is not practical to actually rescind or unwind the transaction, *rescissory damages* are intended to be the financial equivalent of rescission. This remedy may be appropriate in cases of misrepresentation, mistake, fraud, unconscionability, etc.

- *Contractual limitations on damages* as agreed upon by the parties must be clearly expressed in the SPA. Absent fraud, courts will generally respect the parties' allocation of risk with regard to damages. A contract may set forth terms that dictate the minimum and/or maximum amount of damages subject to indemnification. The parties may also agree to waive their right to certain types of damages, such as consequential or punitive damages.

---

23 *Ivize of Milwaukee, LLC v. Compex Litig. Support, LLC*, 2009 WL 1111179, at *10 (Del. Ch. April 27, 2009).
24 884 A.2d 513, 549-52 (Del. Super. Ct. 2005), *aff'd*, 886 A.2d 1278 (Del. 2005).
25 2007 WL 2142926 (Del. Ch. July 20, 2007), *aff'd*, 945 A.2d 594 (Del. 2008).

3.3 Measuring Damages

Dollar-for-dollar damages are often associated with issues that have a one-time, nonrecurring impact on the business, such as obligations or liabilities relating to environmental issues or lawsuits. However, if such obligations or liabilities would reduce the projected earnings, it may impact the buyer's valuation model.

Benefit of the bargain damages (also known as *expectancy damages*) reflect the diminution in value resulting from the breach and are often measured by the difference between what a party reasonably expected to receive and what it actually received.[26] Factors to consider when calculating such damages include:

- Whether the buyer received the value the seller represented;
- Whether the buyer knew of inaccuracies or breaches;
- What portion of the alleged diminution in value resulted from the breach as opposed to other causes; and
- Post-closing performance and the issues driving that performance.

3.3.1 Dollar-for-Dollar Example

A manufacturing company purchased a competitor's subsidiary for $750 million. The target company had annual EBITDA of $150 million, resulting in a transaction multiple of five times EBITDA. Six months after the transaction closed, the buyer paid $10 million related to environmental remediation costs. This contingent liability was not recorded on the financial statements or disclosed to the buyer prior to closing and was known to the seller.

The buyer did not contemplate this cost in its valuation; however, it is a nonrecurring cost and will not impact future earnings. In addition, the inclusion of this cost does not impact the buyer's valuation model; therefore, an appropriate measure of damages is likely dollar-for-dollar to reflect the benefit to the seller related to the misrepresentation of (or failure to disclose) the contingent liability. This results in a reduction of the purchase price by $10 million, to $740 million.

3.3.2 Benefit of the Bargain Example

An automobile parts supplier purchased a privately held competitor from the owners for $500 million. The target had annual EBITDA of $100 million, resulting in a purchase price multiple of five times EBITDA. A significant customer gave notice just prior to closing that it would not be renewing its contract, and the existing contract ended six months after closing. This customer historically contributed $5 million to EBITDA, and the customer's notice to the seller was not disclosed to the buyer. Assuming that the failure to disclose this information was a breach of the SPA, the considerations relevant to determine damages may include the value of the customer to the business (i.e., contribution margin, operating profit, or customer EBITDA), the target company's customer turnover rate, and the expected duration of the impact.

In this scenario, assuming the customer was one of the large auto manufacturers, there may be a material impact on the value of the business because the customer will be difficult to replace. As a result, the buyer may claim damages of $25 million, the deal multiple times the decline in EBITDA. In response, the seller likely will respond that the buyer assumed the risk of losing customers; the success of the claim may turn on the seller's scienter, i.e., whether the seller knew the customer would not renew and had an obligation to disclose such information to the buyer.[27]

26 *Litigation Services Handbook*, 6th edition, Sec. 4.4.

27 The court, in *Zayo Group, LLC v. Latisys Holdings, LLC*, C.A. No. 12874-VCS (Del. Ch. Nov. 26, 2018), addressed a similar fact pattern regarding whether disclosure was required when a customer "failed to renew" as opposed to "terminated" its contract. Zayo claimed that Latisys failed to disclose that customers had given notice of their intent not to renew their contracts, or to renew the contract under different terms. Latisys argued that it had no obligation to disclose the nonrenewals to Zayo. The court found in favor of Latisys under the specific language of the agreement ("the customer's election not to allow automatic renewal of its contracts did not constitute a 'cancellation' or 'termination'

4.0 Pitfalls to Avoid in Assessing Breach of Contract Damages

It is important to analyze the SPA and contemporaneous documents to understand the buyer's and seller's basis for the transaction. Both the seller and buyer will likely have a range of valuations and strategic options that were considered. Review of depositions and interviews, if available, will supplement the documents reviewed to obtain a more robust understanding of the deal structure.

It is also important to consider the interplay between the working capital and indemnity claims to assess situations involving potential double recovery. The expert should consult with counsel on these issues and other matters requiring contract interpretation because legal damage remedies will be an important consideration in evaluating the issue of recovery.

5.0 General Process for Resolving Post-Acquisition Disputes

The SPA will often set forth a mandatory process for resolving disputes, such as requiring that disputes be submitted to arbitration or mediation. The contract may also provide for separate legal and accounting arbitrations, depending on the issues in dispute.[28] It is common for an accounting arbitrator to resolve accounting-related disputes, while the courts or an arbitrator with relevant legal experience will likely adjudicate issues of law. The parties often disagree, however, with regard to the classification of a particular dispute (e.g., accounting or legal), which can have a significant impact on the available remedy.[29]

Rather than requiring arbitration, some contracts set forth a specific forum for judicial resolution by requiring that all disputes be filed in a specific court and/or state and that each party consents to the exclusive jurisdiction of that court or state.

The contract may contain additional provisions relating to dispute resolution, such as a waiver of a jury trial, entitlement of the prevailing party to an award of attorneys' fees and costs, and a contractual limitations period.

6.0 Case Study

Facts: A private equity firm (the buyer) acquired various gas technology businesses (the business) from a multibillion-dollar publicly traded company (the seller) on October 31, in Year 1, and commenced operations as a global manufacturer of propane and cryogenic tanks, high pressure cylinders, valves, and pressure gauges for gas applications. In entering this $340 million acquisition ($300 million in cash plus a $40 million earnout), the buyer relied on various representations and warranties of the seller set forth in the stock and asset purchase agreement (SAPA).

The buyer alleged it did not receive the benefit of its bargain by expending $300 million for the business due to:

- The seller's overstatement of the value of inventory;
- The inability to produce cylinders; and
- The misstatement of noninventory working capital accounts.

of those contracts.… That Latisys did not disclose the status of renewal negotiations with [the customer], or efforts to secure a new contract (albeit on different terms), therefore, cannot constitute a breach of [the agreement].").

28 *OSI Sys., Inc. v. Instrumentarium Corp.*, 892 A.2d 1086 (Del. Ch. 2006).

29 Ibid.

Role of the financial expert. To compute the benefit-of-the-bargain damages arising from the alleged breaches by the seller of the following contractual obligations:

- The seller had maintained accurate books and records and internal accounting controls to provide reasonable assurance that the financial statements of the business could be prepared in accordance with GAAP;
- The seller had fairly presented the financial condition of the business in accordance with GAAP as modified by the SAPA (e.g., the "Agreed Accounting Principles") in the balance sheets and income and cash-flow statements included in the financial statements and books and records the parties used to negotiate the purchase price;
- The tangible property of the business was reasonably suited for the purposes for which it was presently used on the closing date; and
- The seller had provided good, usable, and salable inventories and carried those inventories on its books and records in accordance with GAAP at the lower of cost or market value on a FIFO basis, with appropriate reserves for excess, obsolete, and slow-moving items.

6.1 Opinion No. 1

The expert determined that the seller's written accounting policies and internal controls regarding inventory and its execution of these policies and controls were inadequate to ensure the proper presentation of inventories in accordance with GAAP as of the closing date.

The seller had policies relating to inventory, but the policies allowed for significant management discretion and override when determining the allowance for excess and obsolete inventory. There was also deposition testimony and interviews with employees that corroborated management pressure to maintain low levels of reserves. The buyer was aware of the low reserve levels and obtained a strong representation in the contract from the seller that *all* inventory was good, usable, and salable.

6.2 Opinion No. 2

The seller failed to value net inventories appropriately on a FIFO basis at the lower of cost or market in accordance with GAAP as of the closing date because inventories were overstated by approximately $14.4 million on the closing date.

The expert determined the overstatement of inventories based on an independent review of: (i) an inventory analysis the seller and the buyer performed; (ii) the inventory aging and usage schedules at five divisions; and (iii) a visual inspection of the inventory. In particular, each division had unique raw materials, work in progress (WIP), and finished goods inventory requiring five separate and distinct approaches to determine the inventory reserve in accordance with GAAP.

6.3 Opinion No. 3

If the seller had valued net inventories as of the closing date, in accordance with GAAP, the resulting impact on trailing 12-month (TTM) EBITDA would have been a decrease of approximately $2.4 million, and, based on the buyer's valuation approaches at the time of the acquisition, it would have paid approximately $17.2 million to $18.6 million less for the business.

The buyer alleges the business it purchased and funded was materially different from the business the seller represented. The buyer alleges it did not receive the benefit of its bargain. As evident in the deal documents and based on discussions with the buyer's representatives, it considered three primary approaches in determining the price to offer the seller for the business as follows:

1. The purchase price as a multiple of the TTM EBITDA as of the closing date;

2. The level of debt that could be borrowed based on a multiple of TTM EBITDA and the resultant capital structure; and

3. The rate of return to be realized upon exiting the business in the future.

These approaches to value adhere to accepted valuation principles and are generally accepted in the private equity community. The *International Private Equity and Venture Capital Valuation Guidelines* discusses the most widely used methodologies (which include earnings multiples and discounted cash flows from the investment) and states that "[p]rivate equity risk and the rates of return necessary to compensate for different risk levels are central commercial variables in the making of all private equity investments."[30]

The buyer considered each of three approaches mentioned above under two primary sets of assumptions: (1) the base case; and (2) the value creation (VC) case. In his deposition, an employee of the buyer stated, "We primarily focused on our forecast returns in the model under both the base case and the management case or the VC—also called the management case, the value creation plan or the VCP." Accordingly, benefit-of-the-bargain damages were calculated under both cases to demonstrate the range of gross damages based on the buyer's expectations in pursuing the acquisition. Adjusting the purchase price using the three approaches discussed above results in a reduction of $17.2 million, to $18.6 million.

6.4 Opinion No. 4

If the buyer had known of the seller's alleged breaches of its representation regarding the suitability of a specific cylinder manufacturing plant, based on the buyer's valuation approaches at the time of the acquisition, the buyer would have paid approximately $13.1 million to $14.1 million less for the business at the time of acquisition.

Prior to the transaction, the seller received an order for 40,000 cylinders from a foreign customer valued at $9 million. This order was the first major order for this type of cylinder in significant volume. However, the plant could not produce cylinders cost-effectively due to a production yield of 50%. Initially, the customer rejected 70% of the cylinders. As a result, the customer sent an employee to assist the seller in solving the production problems, which resulted in an improvement to 50% production yield. Ultimately, the customer canceled the order and billed the seller $697,487 for the incremental cost incurred to acquire the cylinders from another supplier. This cancellation occurred several months before the transaction was consummated.

The inability to produce cylinders was not disclosed to the buyer. As evident in the management presentations and various due diligence documents, international expansion was a key success factor in the strategy of the buyer. As a result, the inability to penetrate the foreign cylinder market would have significantly impacted the price the buyer would have offered for the business. The buyer forecasted international cylinder division sales and gross profit to range from $35.4 million to $44.1 million and $5.3 million to $6.6 million, respectively, from the end of Year 1 through the next seven years. Based on these forecasts and the buyer's expectation of foreign sales, $15.7 million of foreign cylinder sales were assumed in the TTM revenue estimate as of the closing date, resulting in TTM EBITDA of $1.8 million. Adjusting TTM EBITDA by $1.8 million using the three approaches discussed above results in a purchase price reduction of $13.1 million, to $14.1 million (see Exhibits 3 and 4).

30 *International Private Equity and Venture Capital Valuation Guidelines*, September 2009 edition; seca.ch/items/13710/995/7741186225/final_doc_prostand_ipev09.pdf.

6.5 Case Conclusion

The total adjustment to TTM EBITDA the buyer relied on due to misrepresentations of the seller is $4.4 million, as shown in Exhibit 5.

The decline in TTM EBITDA caused a significant impact on the buyer's forecast, as shown Exhibit 6.

As a result, the total adjustment to the purchase price due to the misrepresentations of the seller that the buyer relied on is $47.5 million (see Exhibit 7).

Exhibit 3. Impact of Inventory Misstatement on Purchase Price

	Base Case		Value Case	
Valuation Approach:				
TTM	$	(17.0)	$	(17.0)
Financing		(16.9)		(16.9)
Return on Investment		(17.8)		(22.0)
Average	**$**	**(17.2)**	**$**	**(18.6)**

Exhibit 4. Impact of ISO Type 2 Cylinders on Purchase Price

	Base Case		Value Case	
Valuation Approach:				
TTM	$	(12.9)	$	(12.9)
Financing		(12.8)		(12.8)
Return on Investment		(13.5)		(16.6)
Average	**$**	**(13.1)**	**$**	**(14.1)**

7.0 Insights and Observations Regarding M&A Disputes

The ability to minimize risk to the buyer and seller in the transaction process is essential to avoiding a dispute. The factors a buyer should consider to minimize risk are:

- Avoid overpaying for the business based on synergies;
- Avoid earnouts, when practical, to mitigate litigation risk and entanglements with seller;
- Require extensive third-party due diligence;

Exhibit 5. Total Adjustment to TTM EBITDA Relied on by the Buyer

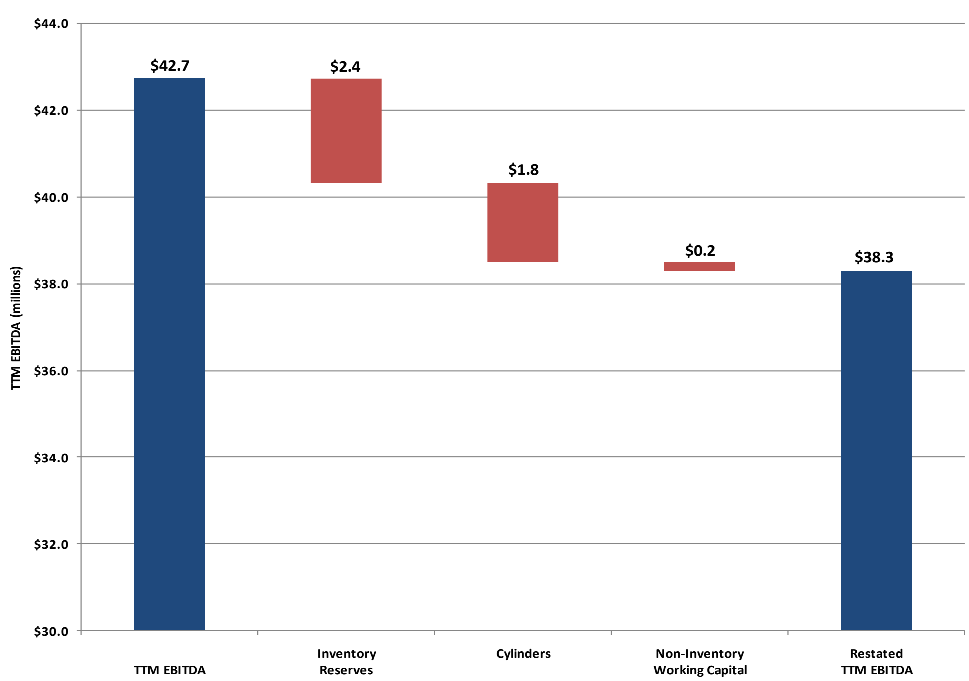


Exhibit 6. Decline in TTM EBITDA

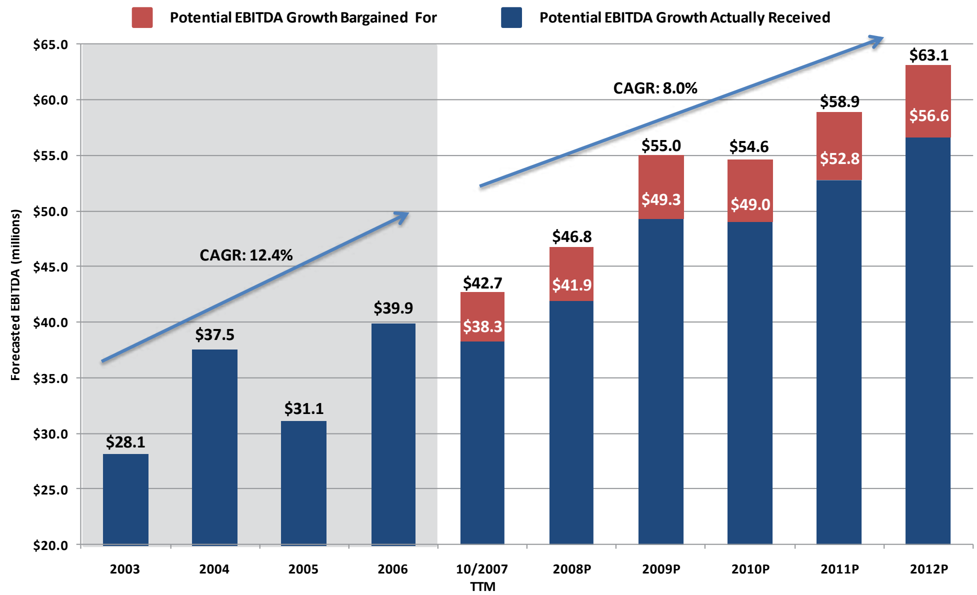
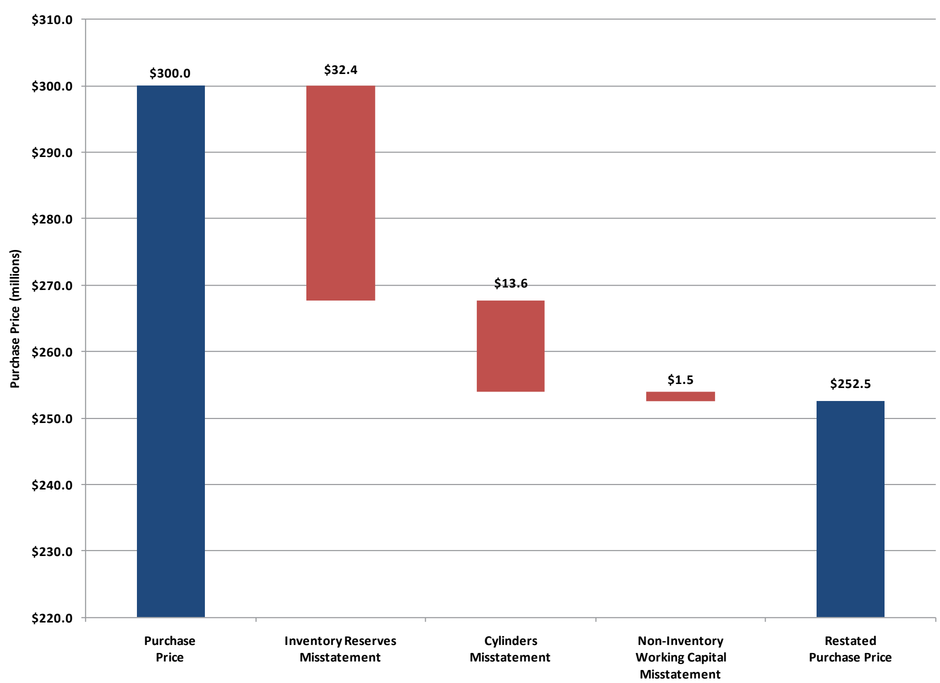


Exhibit 7. Total Adjustment to the Purchase Price



- Insist on complete access to all relevant documents;
- Obtain key seller representations (i.e., inventories, key customers, and audited financial information);
- Due diligence materiality thresholds may be used as proxy for materiality amounts in post-closing disputes;
- Obtain representations regarding key valuation assumptions;

- Obtain specific representations for high-risk accounting areas (i.e., inventories are in a salable/good condition);
- Scrutinize accounting estimates for key areas (i.e., warranty reserves and allowance for doubtful accounts);
- Maximize indemnity claim caps;
- No cap on claims related to fraud;
- Minimize basket threshold;
- No eligible claims (de minimis*)* threshold; and
- Maximize escrow.

The seller has other means to minimize its risk in the process, such as:

- If there are known departures from GAAP, consider "carving out" troubling accounts (i.e., for inventories, insist on past practice), making specific exceptions to the agreed-upon accounting principles for the transaction and/or establishing certain stipulated items (e.g., stipulated reserves that will not be revisited post-closing);
- Consider a "collar" (i.e., a range) in which no working capital adjustment will be made if falling within the collar;
- Consider an estimated working capital adjustment at closing to help minimize the amount of any post-closing working capital adjustment;
- Limit representations and warranties to those expressly set forth in a specific section of the SPA and include customary nonreliance and integration clause language;
- Limit post-closing survival of representations and warranties, and the time for bringing claims, to the shortest period practicable;
- Avoid nondisclosures that could lead to fraud claims;
- Make indemnification the exclusive remedy;
- Limit damages to dollar-for-dollar and disclaim consequential and other extraordinary damages and damages based on a multiple of EBITDA;
- Maximize the basket for damages; and
- Insist on a cap on indemnification recoveries and/or require the buyer to obtain an RWI policy.

8.0 Conclusion

Ultimately, the structure of a transaction is based on the relative bargaining position of the parties and often involves a significant amount of "give and take," resulting in less favorable terms relating to certain areas in consideration for more favorable terms in another part of the transaction. Although the final deal structure and transaction terms agreed upon by the parties are the culmination of extensive efforts, contracts may be imperfect and may not address every possible issue. As a result, disagreements regarding the contract terms, as well as the parties' alleged failure to comply with such terms, often result in the types of disputes discussed in this chapter.