DAMAGE QUANTIFICATION IN DELAWARE FOR BREACHES OF CONTRACT IN POST-MERGER LITIGATION

By Arthur H. Rosenbloom

Introduction

Despite vigorous attempts, through judicial decisions, and a legislative provision, to limit the number of post-merger litigation filings, the fact remains that in 2016, almost a third of the mergers and acquisitions ("M&A") in Delaware resulted in such filings.[1]

Thus, drafters of merger documents and litigators alike, ought to be mindful of damage computational approaches should plaintiffs prevail in Delaware post-merger lawsuits. Given my background as a damage consultant in complex litigations, I have concluded that damages for breaches of representations and warrantees ("reps") or covenants in M&A ought to be calculated by measuring on a dollar-for-dollar basis, those breaches that do not diminish the Target's current or projected cash flows. For those that do, I believe that damages should be measured on a price-earnings multiple ("P/E") basis or by calculating, though a discounted cash flow ("DCF") approach, the difference between pre- and post-breach cash flows.[2] Surprisingly, however, there does not appear to be any holding expressly enunciating this distinction in the relatively few Delaware cases that deal with this subject.[3] This article attempts to guide courts on when to calculate damages through a dollar-for-dollar approach versus P/E multiple or DCF approaches.

I proceed as follows: (i) generally describe the kinds of contractual breaches that give rise to post-closing M&A-related litigation; (ii) examine factors that expand or limit the amount of damages; (iii) determine how tort-based claims ought to be treated versus those sounding in contract; (iv) review Delaware case law on damages in M&A-related disputes, and describe those cases that could have benefited from a more explicit statement justifying the court's approaches to calculating damages; and (v) present my conclusions.

What kinds of contractual breaches give rise to post-closing, M&A-related litigation?

Broadly speaking, the alleged reps or covenant breaches are either financial or non-financial in nature. Examples of financial reps include Target's reps that its financial statements had been prepared consistent with generally accepted accounting principles ("GAAP"), that its working

[1] *See* Matthew D. Cain, Jill E. Fisch, Steven Davidoff Solomon, and Randall Thomas, *The Shifting Tides of Merger Litigation*, Vanderbilt University Law School Research Paper Series Working Paper 17-19 and University of Pennsylvania Law School Institute for Law and Economics Research Paper 17-6, February 2017. The authors cite two major factors for the decline in post-merger litigation filings, including holdings that Delaware courts "would no longer countenance merger litigation settlements which did not achieve substantial benefits for shareholders" and the 2015 amendment to the Delaware General Corporation Law explicitly authorizing forum selection bylaws enabling Delaware corporations to halt the filing of M&A related suits in multiple states. The authors caution that the results of their study are preliminary due to the recency of the data.

[2] Others have similarly observed. See the following slide decks: AICPA & ABA Joint Infocast, *Pitfalls to Avoid When Assessing Damages in M&A Disputes*, 45–56 (Nov, 19, 2009); ABA Section Annual Conference, *Merger and Acquisition (M&A) Litigation: Current Issues and Trends*, 40 (Apr. 25, 2013); *see also* Michael Gil & Frank Mascari, *Confusion Reigns: Applying the Multiplied Damages Exception in Representations and Warranties Insurance Policies*, BLOOMBERG BNA MERGERS & ACQUISITIONS L. REP., Jan. 25, 2016, at 2.

[3] I find it surprising that such little judicial guidance is available under Delaware law given the number of disaffected Buyers who, post-merger, assert claims against their erstwhile Targets. One can only assume that barring bench-made oral decisions, most such cases settle before trial.

capital was at a specific number subject to a post-closing balance sheet "true up," or that its accounts receivable had been properly stated with adequate reserves for non-collection provided and that inventories had been properly stated with necessary markdowns taken. Examples of non-financial reps (albeit with potentially significant financial implications) include those asserting that Target had proper title to its tangible and intangible assets (especially, in the latter instance, its intellectual property), reps concerning environmental matters, customers, tax and employment issues, and disclosures concerning actual or pending litigation.

What elements will act to expand or limit the amount of damages?

Facts matter. The principal element determining damage size is the permanent or transient character of the economic harm suffered by plaintiff. Decisions in this regard are not always easy. For example, assume Target has been found criminally liable for bribing customers to buy its product, and this had not been disclosed to Buyer. Will that black mark permanently diminish its cash flows or will it end with the firing of the miscreants? Or, to what extent can toxins leaching into the soil of Target's main plant be corrected after disclosure to Buyer in a manner sufficient to obviate the need for further environmental remediation? The persuasive power of experts will likely portend the outcome. That said, there are many other elements going into the mix on damage calculation, including the following: (i) subject to the possible impact of merger document integration provisions, (a statement that the document represents the complete and final agreement between the parties), facts that emerge during Buyer's due diligence that affect both liability and damages; (ii) Pro-Buyer or Pro-Target reps on elements such as financial statements, undisclosed liabilities, and legal proceedings[4]; (iii) other contractual provisions such as survival periods for reps that may narrow or extend statutes of limitations, caps that limit the dollar amount of recoveries, and baskets of varied types intended to minimize the size and frequency of smaller claims pursued under the terms of escrow and indemnification agreements. There also may be materiality qualifiers and materiality scrapes stating that words such as "materiality" or "material adverse effects" be scraped from certain reps. Other provisions affecting damages may include the denial of punitive, incidental, or consequential damages in such agreements and dispute resolution provisions.

Should damages for cases sounding in tort be treated differently from those sounding in contract?

Torts, such as civil fraud, give rise to damage claims for rescission or rescissory damages in addition to those for breach of contract. But once plaintiff elects not to choose these tort-based remedies and pursue money damages only, I believe that fraud and contract type damages should be treated exactly the same way, economic harm and not the gravity of defendant's misconduct being the only salient element.

What does Delaware case law teach concerning damage quantification in breach of contract cases arising from M&A transactions?

First, a word on the screening methodology from which the cases were selected. I chose cases: (i) in Delaware state courts or federal ones applying Delaware substantive law such as in diversity of citizenship matters; (ii) that were final in nature, excluding those decisions on dispositive

[4] For examples of Pro-Buyer reps, see Jenner & Block, Rep and Warranty Breaches in M&A Transactions: Common Claims and Navigating the Road to Recovery, ASSOCIATION OF CORPORATE COUNSEL, 8–10 (Feb. 10, 2015), https://m.acc.com/chapters/chic/upload/Rep-and-Warranty-Breaches-in-MA-Transactions-CLE-Materials.pdf.

motions because of presumptions of well-pleaded matters favorable to the moving party in the case of motions to dismiss and the non-moving party in the case of summary judgment motions; (iii) that arose from alleged breaches of reps or covenants in post-merger litigation; (iv) containing language that, expressly or by inference, describe whether damages were computed dollar-for-dollar, on a P/E multiple basis, or as the result of a DCF analysis.[5]

Arranged in chronological order, the cases are these:

Tam v. Spitzer[6]

Tam bought a business called Data Works, a data processing sole proprietorship, from Spitzer in May 1991. The price was $103,500 consisting of $50,000 cash and $53,500 in five year promissory notes. In April 1992, Tam brought suit alleging fraud or mutual mistake. Spitzer denied liability and counter-claimed for the balance of the price.

The Court found that as of November 1990, six months before the sale, Spitzer knew or suspected that St. Francis Hospital, its largest customer, would shortly be terminating a substantial portion of Data Works' efforts on its behalf and that St. Francis had been or would soon be terminating the entire relationship and that Spitzer's relationship with St. Francis was not amicable. None of these facts was disclosed to Tam before or after Tam acquired Data Works.

Chancery held that the purchase transaction was induced by Spitzer's materially false and misleading representations amounting to common law fraud and awarded damages under the benefit of the bargain theory; i.e. the difference between the subject property's value represented by the defrauding party and its actual value. Damages were measured by the DCF approach used by Tam's accountant to value Data Works at the time of the sale minus the revenues and expenses attributable to its St. Francis business, resulting in a value of $58,210. Tam, already having paid $59,875, Spitzer was required to pay the difference of $1,665.

Kool, Mann, Coffee & Co. v. Coffey[7]

An almost two-decade long case, two bankruptcy filings and several appeals actually boiled down to some simple issues. In 1985, a marina and houseboat rental business on Lake Cumberland Kentucky, called Lake Cumberland State Dock Inc. ("LCSDI") owned by L. Coleman Coffey and his son Robert, was sold by them to Kool Mann Coffee & Co. Inc. ("Kool Mann"). The Coffeys claimed that Kool Mann owed them the balance remaining of the $5.0 million price for the sale of LCSDI while Kool Mann asserted entitlement to set-offs against that sum because of alleged misrepresentations by the Coffeys and certain other deductions. The $5.0 million purchase price was to be paid as follows: $200,000 on closing, $800,00 with 10% interest

[5] Thus, I have excluded *Ivize of Milwaukee, LLC v. Compex Litigation Support, LLC* and its companion case *Ivize of Kansas City, LLC v Compex Litigation Support, LLC*, because the Court never provided a damage analysis as Ivize never hired the Compex employees who created most of Compex's goodwill. *Ivize of Milwaukee, LLC v. Compex Litig. Support,* LLC, C.A. Nos. 3158-VCL & 3406-VCL, 2009 WL 1111179 (Del. Ch. 2009). However, given Compex's breach of the asset purchase agreement by forming a competitive company, Ivize was awarded its counsel fees. I have also excluded *Biolife Solutions v. Endocare*, as it was a true M&A case but did not contain any discussion of valuation techniques arising from defendant's improper failure to file a registration statement. Damages were measured by market price had the defendant registered the shares. *Biolife Sols., Inc. v. Endocare, Inc.*, 838 A.2d 268 (Del. Ch. 2003).

[6] Civ. A. No. 12538, 1995 WL 510043 (Del Ch. Aug. 17, 1995).

[7] 300 F.3d 340 (3d Cir. 2002).

payable three months later ("the down payment"), promissory notes with annual payments of $150,000 carrying interest at a half point over prime and a $3.25million balloon payment due in September 1991. In December 1990, while its initial fraud case based on allegedly false financial statements against the Coffeys was still pending, Kool Mann filed for bankruptcy. A variety of trials and appeals ensued.

On the Third Circuit appeal, among other elements, the Court held that the Bankruptcy Court's finding of fraud by the Coffeys was correct. As to damages, as in Tam, the Third Circuit held that damages were to be measured by the difference between the value as represented and the true value. After so holding, and after reviewing the reports of the dueling experts, the Court proceeded to modify the Bankruptcy Court's initial findings concluding that LCSDI's post-fraud value was $1.767 million, not $2.288 million. It did so because it was persuaded by Kool Mann's expert that a downward adjusted cash flow of $188,848 on a 7.5% adjusted growth discounted at 18.5% was the correct valuation approach. Accordingly, the stock bought by Kool Mann was, by the same methodology otherwise employed by the Bankruptcy Court, $1.767 million not $2.288 million. Other adjustments were required to reduce the final award in Kool Mann's bankruptcy. The Third Circuit also held that LCSDI's $1.767 million post-fraud valuation arrived as set forth above needed to be reduced dollar-for-dollar by three of the five credits claimed by Kool Mann, the million-dollar down payment it made to the Coffeys, a recharacterization of $291,784 of interest as principal, and a $236,566 credit for certain tax savings resulting from the merger having been structured as a stock purchase rather than an asset one. Subtracting the total of these credits $1,528,350 from LCSDI's post-fraud value of $1,766,631 resulted in a $238,281 recovery from the Coffeys in Kool Mann's bankruptcy.

S. C. Johnson & Son Inc. v. DowBrands Inc.[8]

This was an appeal from the ruling of a federal district court[9] in a lawsuit brought by S. C. Johnson ("SCJ") who bought certain Latin American assets from DowBrands in 1998. Following that purchase, SCJ sued DowBrands for fraud and breach of contract based on allegations that DowBrands had impermissibly allowed products from Latin America, their intended destination, to be diverted to the U.S.

The District Court held that a non-reliance clause in the purchase agreement did not preclude a suit for fraud and that an indemnification agreement from DowBrands to SCJ, relied on by SCJ, in SCJ's defense of a patent suit by Tenneco concerning the subject's assets was not reduced to a $10.0 million basket. In so doing, the Court awarded SCJ $7.035 million in counsel fees arising from the Tenneco litigation and accepted SCJ's DCF evaluation that placed a zero value on the assets in question. It also awarded SCJ $21.948 million in damages under its fraud claim. Expectancy damages here were measured based on the value SCJ had put on those assets as a percentage (7%) of the price SCJ paid for all of the assets it acquired from DowBrands. The Third Circuit reversed on SCJ's fraud claim and granted it counsel fees but subject to the $10.0 million basket. In so ruling, it held that a broad non-reliance clause in the Purchase Agreement stating that SCJ was relying solely on its own due diligence and not on DowBrands' reps, foreclosed its liability claim despite a carve-out provision that the non-reliance language would not bar a suit for fraud. As to that carve-out language, the Third Circuit held that SCJ's claim

[8] 111 Fed. App'x 100 (3d Cir. 2004)

[9] 294 F.Supp.2d 568 (D. Del. 2003). The District Court had jurisdiction based on diversity of citizenship and applied Delaware law.

failed because having had its own suspicions about the diversions, it could not meet the reliance prong of an action in fraud.

In holding that the $10.0 million basket applied, the Third Circuit found that the section of the initial Purchase Agreement was mostly procedural in nature, and that the substantive provision that governed the defense of the Tenneco claims was clearly subject to the basket. Since counsel fees of $7.035 million fell below the basket, DowBrands owed SCJ nothing.

Cobalt Operating Systems LLC v. The James Crystal Enterprises LLC[10]

In March 2002, Cobalt Operating Systems LLC ("Cobalt") bought WRMF, a West Palm Beach radio station from James Crystal Enterprises LLC and James Crystal Licenses LLC (collectively, "Crystal"). Crystal's principal, Jim Hilliard, under pressure from bank debt he had needed to acquire WRMF and from the bonuses he had promised to the company's executives on the station's sale, contrived to expand its cash flows to justify a $70.0 million purchase price determined by a 14x cash flow multiple. He did so by falsely characterizing as revenues, advertisements that were booked but never aired (increasingly so during Cobalt's due diligence), thereby fraudulently increasing cash flow to $5.0 million from around $4.2 million. This practice breached Crystal's reps concerning the legitimacy of its financial statements and the anti-misrepresentation rep contained in the purchase agreement.

Based on testimony from Cobalt's experts, the Court determined that the station's value was only $59.0 million not the $70.0 million purchase price resulting in $11.0 million in damages. The award was payable by cancelling Crystal's pre-existing $2.0 million investment in Cobalt and $5.0 million promissory note issued by Cobalt to buy the station plus $4.0 million in cash. The Court also awarded Cobalt $180,475 in free air time credits to the advertisers who had been scammed, in addition to free air time it had previously granted to such parties. It also awarded Cobalt prejudgment interest at 7% and counsel fees payable under the terms of the indemnification agreement signed incident to the acquisition. The Court based its damage award on the theory of expectancy damages, that is, the amount of money required to put the non-breaching party in the same position it would have been in had the breach not occurred.[11]

Wavedivision Holdings LLC v. Millennium Digital Media Systems LLC[12]

Wavedivision ("Wave") and Millennium Digital Media Systems LLC ("Millennium") were broadband cable operators. Since 2000, Millennium had gone through a series of senior and junior debt financings to stay afloat in an increasingly competitive market. By 2005, its creditors insisted that it sell assets to pay down debt resulting in Millennium's asset purchase sale to Wave of its cable system in Michigan ("APA") and a unit purchase agreement ("UPA") for Oregon and Washington ("The Northwest Systems"). The letters of intent and final agreements contained a rep that Millennium would not seek transactions alternative to the Wave deal. The agreements also obligated Millennium to use its best efforts to obtain lenders' consent to the sale.

These undertakings notwithstanding, Millennium continued to pursue another refinancing deal starting the day after the Wave agreements were signed, a practice that took place for months following such date. These included a possible deal involving an Increasing Rate Note financing

[10] No. Civ.A. 714-VCS, 2007 WL 2142926 (Del. Ch. July 20, 2007); *affd* 945 A.2d 594 (Del. 2008).

[11] See also *Delaware Limousine Serv. Inc. v Royal Limousine Services Inc.*, C.A. No. 87C-FE-104, 1991 WL 53449 (Del. Super. Ct. Apr. 5, 1991).

[12] C.A. No. 2993–VCS, 2010 WL 3706624 (Del. Ch. Sept. 17, 2010).

("IRN") lead by Trimaran Fund Management ("Trimaran") who would receive none of the proceeds of the sale to Wave. Millennium also hired an investment bank ("Barrier") to help quantify outcomes in a refinancing. In July 2006, Millennium signed a refinancing agreement with its creditors and, on the same day, terminated its Wave agreement. Following that termination, Wave bought two cable systems in the first quarter of 2007 ("Rocklin" and "San Matteo") for $147.1 million. Wave sued for breach of contract, alleging violations of the non-solicitation and best efforts to secure lenders consent reps in the APA and UPA agreements.

The Court's opinion recited traditional Delaware elements for breach of contract, a contractual obligation by defendant, breach by it, and damage to plaintiff. The Court was unpersuaded by Millennium's arguments that it had a serious interest in transactions with Wave and that its conduct with its lenders was not inconsistent with such an interest. Rather, the Court held that Millennium wanted to keep the Wave deal alive only as a second-best Plan B.

In awarding breach of contract damages to Wave, the Court ruled that Wave should recover the value it had expected to receive under the APA and UPA agreements minus any costs avoided by not having to perform, here, the purchase price minus any mitigation resulting from Wave's purchase of the Rocklin and San Matteo cable systems.

Wave's expert determined damages using a 7.8x EBITDA multiple and arrived at damages of $85.5 million by determining a value for the subject systems of $332.2 million minus mitigation and other adjustments. Millennium's expert employed a DCF analysis using projections made by Wave to obtain financing for the Millennium deal and those made by Barrier, with a weighted average cost of capital of 11.75%, perpetuity growth rates of 3.3% and 3.0% for each of Northwest and Michigan, respectively, resulting in values of $63.0 million for Northwest and $77.4 million for Michigan based on Wave's projections and $54.9 million and $68.0 million for them based on Barrier's projections. These sums, ranging from $113.0 million to $140.4 million demonstrated that the value of the subject assets was worth less than the $157.0 million paid by Wave, as Barrier had concluded. Restoring Wave to what its position would have been without the breach, therefore resulted in zero damages.

In awarding Wave $14.872 million in damages, the Court observed the following: (i) Millennium's damage theory was flawed because it erroneously presumed value based on the price the subject assets would fetch if Wave sold them immediately after buying them rather than waiting for a more propitious time to sell after it had effected the changes it hoped would increase these assets' profitability; (ii) Wave's base case projections to its banks were a good starting point for assessing damages[13]; (iii) An EBITDA multiple approach should be employed because it was the most commonly used metric for buying cable companies; (iv) the 7.8x EBITDA multiple used by Wave's expert was conservative because it was at the bottom of a range of multiples and thus should be applied; (v) Wave's reasonably expected exit value in 2009 was $265.299 million, a figure that adjusted downward for corporate overhead of $34.013 million times 7.8 yields $265.299 million; (vi) from this figure, three dollar-for-dollar

[13] The Court's suggestion that base-case projections made to banks to obtain financing by which to complete a transaction are typically conservative in nature is sometimes belied by my own experience. It is my experience that those seeking third-party debt or equity financing make even their base case projections aggressive in order to secure lower interest rates on debt and more modest dilution in equity financings. On the other hand, conservative base-case projections are often used to secure reps and covenants less likely to put the recipients of the financing in technical default.

adjustments were required, one for the mitigation resulting from Wave's Rocklin and San Matteo acquisitions ($45.743 million), a second for not having to carry the cost of debt Wave would otherwise have had to incur to finance the Millennium acquisition ($44.684 million), and a third, the $157.0 million purchase price avoided plus $3.0 million of estimated closing costs. Subtracting the sum of these from the presumed exit value of $265.299 million yielded damages of $14.872 million together with pre-judgment interest starting January 1, 2010.

Hudson's Bay Luxembourg Co. S.A.R.L. v. JZ LLC[14]

This case, in which the Court held for defendant was affirmed on appeal to the Delaware Supreme Court, except as remanded for the computation of counsel fees.

In 2008, Hudson's Bay S.A.R.L. ("HBCL") acquired Hudson's Bay Company ("Hbc") from JZ LLC ("JZ") and AGZ LLC ("AGZ") for $202 million. The Stock Purchase Agreement ("SPA") in that transaction provided that Hbc's financial statements complied with GAAP and fairly and accurately presented Hbc's financial position. HBCL asserted the falsity of this rep in four respects: (i) Hbc had overstated its inventory value and was thus damaged by $9.8 million; (ii) that Hbc understated its liabilities from a loyalty program that awarded credits to customers buying its services resulting in $10.4 million in damages; (iii) Hbc failed to properly account for costs associated with Hbc's lease of Toronto retail space resulting in $3.1 million in damages; and (iv) HBCL claimed a misrepresentation that Hbc had satisfied its tax obligations. This tax claim was not tried, it having been stipulated before trial, that $1.2 million was a covered loss under an SPA provision for determining whether a breach had occurred.

Declining to proceed under other potential sources of contractual liability, HBCL based its claim solely on the grounds that Hbc had breached its GAAP related rep and that the SPA's scrape provisions removed any reference to "material", "materiality", or "materially adverse effect" in GAAP itself. The Court disagreed, asserting that no company of Hbc's size (or perhaps any size), could be expected to find every single error in its financial statements. Even assuming that the scrapes allowed HBCL to obtain indemnification under the SPA's indemnification provision, the Court held that HBCL had failed to sustain its burden of proof required to exceed the SPA's $1.5 million deductibility threshold, its only cognizable claims being the $1.2 million tax claim and $226,000 under the Toronto lease claim. The Court serially dismissed any losses from the inventory claim, the loyalty reserve claim, and the sublease claim, even if those were regarded as errors and not merely estimates. The inventory claim was dismissed because of HBCL's inability to identify the amount of cash required to be infused to make up for any shortfall. Further, Hbc's expert testified that inventory and loyalty program errors did not have an impact on the cash flow of the business. These were simply accounting adjustments that affected accounting earnings, but not the underlying cash they generated. As to the sublease claim, the Court held Hbc liable for $226,000 for repairing the exterior walls of the store as these were covered losses. However, HBCL's inability to demonstrate any other out-of-pocket expenses respecting its other subleasing related claims foreclosed any recovery on these.

Universal Enterprise Group L.P. v. Duncan Petroleum Corporation[15]

[14] C.A. No. N10C–12–107 JRJ CCLD, 2013 WL 1457019 (Del. Super. Ct. 2013), *aff'd in part*, 80 A. 3d 960 (Del. 2013).

[15] C.A. No. 4948–VCL, 72013 WL 3353743 (Del. Ch. July 1, 2013); C.A. No. 4948–VCL, 2014 WL 1760023 (Del. Ch. Apr. 29, 2014).

These two cases arose from the same facts. The later one addressed a question raised by the Delaware Supreme Court on plaintiff's appeal from an element not contained in Chancery's Final Order, whether the defense of unclean hands made recoupment unavailable.

The earlier decision ("Universal One") may be described as follows. Universal Enterprise Group L.P. and related entities ("Universal") sued Duncan Group L.P. alleging fraud and breach of contract based on reps contained in the purchase agreement. Chancery found that while Duncan knew certain reps it made were false, Universal was unable to prove reliance and hence could not establish fraud. As for Universal's breach of contract claim, for which no reliance was required, the Court held for Universal and awarded damages of $1,497,429. Because of pending bankruptcies of certain of Universal's affiliates, judgment was reserved on one count and on Duncan's counter claim.

Duncan owned 19 gas stations in Delaware and Maryland. Increasingly stringent federal and state regulatory regimes respecting underground storage tanks ("USTs") including those from the U.S. Environmental Protection Agency ("EPA"), the Delaware Department of Natural Resources and Environmental Control ("DNREC") and the Maryland Department of the Environment ("MDE") made compliance more difficult than it had been when Duncan entered the business. Among other elements, regulatory compliance mandated functioning automatic tank gauges ("ATGs") and related systems for the USTs. In the years leading to the acquisition, Duncan managed his regulatory compliance poorly with spotty records and periodic confrontations with regulators over malfunctioning ATGs and other parts of the systems, leading to numerous state citations and a consent agreement with the EPA.

Given these facts, in early 2007, Duncan decided to sell its properties and exit the petroleum industry. The sale prospectus cited numerous risk factors and required buyers to purchase all of the existing petroleum dispensing and underground tanks. Universal was one of the interested parties and, after some due diligence, the parties agreed to a $16.0 million sale price payable as follows: $500,000 at signing, $7.5 million at closing, and the remaining $8.0 million in seller subordinated notes.

The sale agreement contemplated a 60-day due diligence period that included a requirement for Duncan to supply Universal with Duncan's environmental records and reports and a rep that to Duncan's best knowledge it had received no notice from DNREC or MDE requiring it to undertake environmental or remedial actions and, that except as disclosed in documents it would further provide, the property complied with all applicable environmental laws. All of these reps were backed up by Duncan's rep that all of its reps were true and not materially misleading. However, Duncan required Universal to acknowledge that given the properties' use as retail and convenience store facilities, there were hazardous subsurface materials and that Universal should conduct its own due diligence respecting these. Duncan's no litigation rep included suits, proceedings, and investigations. Finally, Duncan acknowledged that during Universal's due diligence, there might be Duncan-related hazardous materials under or navigating from the properties. Duncan agreed to take corrective action on these issues identified during the due diligence period. Should there be a need for corrective action, Duncan would select an environmental consulting firm to develop a corrective plan and offer Universal a chance to comment or obtain input from DNREC or MDE on environmental matters raised by those entities. Payment for any needed corrective actions would be in the form of an escrow of the amount required to fund the necessary remediation.

In August 2007, Duncan retained Delta Environmental Consultants Inc. ("Delta") to perform a phase I environmental site assessment to determine Duncan's compliance with state and federal requirements as to leak detection, corrosion protection, overfill and spill prevention. Universal also instructed Delta to inspect Duncan's records and reports. Delta's work was later expanded to a phase II testing of soil and groundwater on 17 of Duncan's 19 sites that revealed soil or groundwater contamination on all of them. The combination of sloppy record keeping and contamination caused Delta to estimate a median exposure of $3.0 million and a maximum of $3.7 million. Given these facts, the sale agreement was modified obliging Duncan to remediate the environmental issues on all 17 sites and escrow $1.6 million. Any breaches of Duncan's contractual obligations would give Universal an offset right on the notes. After the closing, Duncan notified DNREC and MDE of its proposed corrective actions and Universal hired its own environmental consulting firm, Clayton Services Co. ("Clayton"). Clayton reported that Duncan's USTs on two sites were in need of repair. Universal contended that Duncan had failed to disclose these, its troubled history of DNREC and MDE investigations, and its noncompliant equipment and thus, had breached its environmental reps. Duncan denied knowledge of any agency enforcement activities and claimed that any noncompliance issues arose post-closing. Litigation ensued.

In July 2009, one of Universal's lenders called a loan, leading to Universal's bankruptcy filing. The bankruptcy trustee brought the instant lawsuit, alleging fraudulent inducement, fraudulent concealment, equitable fraud and breach of contract, seeking damages for these and rescission or rescissory damages. Batra, who controlled Universal, sought a reduction of his obligation under the notes and settled his obligation with the trustee, conveying to it Batra's interest in Universal and his claims against Duncan. At trial, Universal's trustee claimed that it had spent $533,239 in inspection and repair costs and legal fees and that DNREC had required the removal of three USTs.

Judgment was entered in favor of the trustee on the breach of contract claim for $1,497,429 and for Duncan on the fraud claims because Universal had not demonstrated the reliance required to support such a claim. Rather, it had relied on Clayton and the risk re-allocation in its favor in the revised agreement. Rescission and rescissory damages were denied because Universal had not shown a causal relationship between Duncan's alleged fraud and its damages. As to breach of contract, the Court cited expectation damages as the applicable standard. It held that the breaching promisor owed the promisee a sum representing the difference between the value the promisee had reasonably believed and its actual value. Damages were of dollar-for-dollar kind $406,293 required to inspect and repair USTs, $964,190 to remove three such tanks and $126,946 in legal fees. Finally, the Court stayed enforcement of the judgment pending a further review of Batra's then pending prayer for declaratory relief to reduce his obligation under a personal guarantee securing the notes in question and certain affirmative defenses. In its Final Order, the Court ruled that recoupment on the notes was permitted. Universal's trustee appealed, asserting that recoupment should not be allowed because of Duncan's unclean hands and the Delaware Supreme Court remanded for consideration of that issue. In Universal Two, Chancery reaffirmed its original order stating that if Universal received a reduction on the notes due to the absence of clean hands plus the $1,497,429 such a noncontractual remedy would result in a windfall for Universal and, as such, its damage award remained unchanged.

In the cases I reviewed in which damages were awarded, might the Court's rationale have been made more persuasive if it had observed the distinction between transient and non-transient damage to Target's cash flows?

In the introduction, I stated my theory that damages for breaches of reps or covenants in M&A agreements should be based on whether those breaches caused permanent damage to Target's cash flows or only temporary damage susceptible, in such instances, to remediation. In the former, I argued use of a P/E multiple or DCF approach while in the latter, dollar-for-dollar damages would suffice. Suppose then, it became the custom for Delaware courts to make findings of fact as to the permanent or transient character of the damages. Might that distinction have made the Court's damage award more persuasive? The answer is sometimes but not always and that, in one instance, I believe the Court failed to award damages when it ought to have done so.

Tam v. Spitzer

The imminent loss of all or substantially all of the business from Spitzer's major customer, known by Spitzer prior to the sale, would clearly justify the DCF approach used by Tam's accountant to measure damages without further explanation.

Kool, Mann, Coffee & Co. v. Coffey

Here, certain of Coffey's financial statements were found to have been false and fraudulent, thereby violating the Coffey's reps concerning GAAP compliance and the absence of changes in methodology concerning LCSDI's financial statements. In arriving at the $238,281 sum representing the value of Coffey's claim in Kool Mann's bankruptcy, the Court determined LCSDI's value via the DCF approach at $1,768,631 reduced by a variety of dollar-for-dollar credits to Kool Mann. In my view, these circumstances would have given rise to an opportunity for the Third Circuit, in its application of Delaware law, to have differentiated between those matters going to a permanent diminution of going concern value arrived at, among other methods by the DCF approach and the one time, balance sheet related credits unrelated to LCSDI's earning power. Thus, the reduced post-fraud value of LCSDI resulting from using the DCF approach was $1,766,631. However, there were three dollar-for-dollar adjustments representing credits due to Kool Mann: the $1,000,000 down payment made by it to the Coffeys, a $291,784 credit resulting from a recharacterization of interest as principal, and a $236,566 credit for certain tax savings. The sum of these, $1,528,350 reduced the Coffey's claim in Kool Mann's bankruptcy to $238,280.

S.C. Johnson & Son Inc. v. DowBrands Inc.

In the case description of this matter, the discussion was mostly focused on the rationale for the Third Circuit's decision. Now, however, as I proceed to discuss whether an express finding of fact as to the permanent or transient character of damages to Target's future cash flows, it is useful to consider with greater care, Chancery's damage analysis.

SCJ's DCF analysis carried the day, resulting in an award of $21.948 million in damages plus counsel fees and a conclusion that a $10.0 million basket was inapplicable. The $21.948 million figure was derived by reducing SCJ's $23.6 million valuation by 7%, that sum reflecting the ratio of the purchase price (93%) to the value of all of the assets SCJ acquired from DowBrands. Had Chancery not been reversed, (albeit on grounds unrelated to the calculation of damages), it is clear that implicit in its award was the finding of permanent damage to the assets in question (that is, zero value) as a result of the diversion. Hence, a specific finding of fact as to permanence would have been unnecessary.

Cobalt Operating Systems LLC v. James Crystal Enterprise LLC

As this case was a straight-forward earnings shortfall times a particular multiple, there would not have been a need for the Court to have drawn the distinction between transient and non-transient damages.

Wavedivision Holdings LLC v. Millennium Digital Media Systems LLC

Here was an opportunity for the Court to have differentiated between use of the 7.8x EBITDA multiple associated with Millennium's long-term values and the dollar-for-dollar approach applied to three one-time events, the mitigation of damages by reason of Wave's Rocklin and San Matteo acquisitions, elimination of Wave's carrying costs of debt required to have affected the Millennium Acquisition and the purchase price and closing costs it did not have to defray.

Hudson's Bay Luxembourg Co. S.A.R.L. v JZ LLC

Here, the Court concluded that there was no covered loss entitling HBCL to the indemnification respecting HBCL's inventory claim because HBCL could not identify the amount of cash HBCL was required to infuse into Hbc as a result of the accounting error. However, had HBCL been able to do so, I believe it could have recovered dollar-for-dollar damages in an amount required to be infused into Hbc. Further, I believe the Court got it wrong in suggesting that inventory discrepancies do not affect cash. Of course they do. They could adversely affect the cash account on Hbc's balance sheet leading to dollar-for-dollar damages. The same analysis holds true for the loyalty reserve claim and HBCL's sublease claim save for HBCL's actual cash payment of $226,000 for the wall repair.

Universal Enterprises Group LP et. al v Duncan Petroleum

The Court awarded dollar-for-dollar damages only without making a finding of fact as to whether Duncan's environmental issues adversely affected his company's present or foreseeable cash flows. Was this error? The answer is no, but only because of a statement made by the Court not elaborated on in its holding. In reciting the facts of Duncan's poor management of the company's regulatory affairs and its confrontations with environmental regulators, the Court observed that these inadequacies did "not appear to have translated into unsafe operations or environmental spills." Had they done so, it is my view that violations of Duncan`s environmental reps made in the asset purchase agreements for the individual properties would and should have resulted in damages under a P/E multiple or DCF approach. Hence, it would have made for a more understandable outcome had the Court been more specific in disclosing its rationale for dollar-for-dollar damages only.

Conclusion

I believe that the distinctions between permanent and non-permanent damages would have made for more defensible opinions in the *Kool Mann*, *Wave Division*, *Hudson's Bay*, and *Universal* cases. In *Hudson's Bay*, that distinction would have resulted in some dollar-for-dollar damages.

I respectfully suggest that the distinctions offered as to the grounds for choosing dollar-for-dollar versus P/E multiple or DCF approaches be made express in findings of fact in future judicial opinions made under Delaware law.[16]

[16] The author deeply appreciates the efforts of Jonathan Hermann, a current member of Fordham Law School's Law Review, for his outstanding case law research and editorial comments. Thanks too, to Gilbert E. Matthews of Sutter Securities for his useful editorial inputs and advice concerning the content of this article.