

Assessing, Presenting and Proving Damages for Breach of M&A Agreements

The Counsel's, the Arbitrator's and the Expert's perspectives

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Typical disputes at each stage of the deal

Deal timeline





Let's go back to the basics...



Breach

- Fault?

Causality

- Swiss law: Natural and adequate causality ("*objective and retrospective prognosis*")
- French law, Common law: Test of foreseeability

Damages

- Swiss law: *Difference Theory* (negative interests and positive interests)
- French law: *Principle of full reparation* (*damnum emergens* and *lucrum cessans*)
- Common law: Expectation, performance and reliance damages

Burden of proof: Party making the assertion

Standard of proof: Balance of probability / More likely than not / Preponderance of the evidence

Duty to mitigate?

Damages must be *certain* and *direct*

Pre-Signing Disputes: Breach of Pre-Signing Agreements, Abandonment of Negotiations

Reliance damages



Easy to assess and prove, but generally lower

VS

Expectation damages



Harder to assess and prove, but generally higher

Breach of exclusivity agreements

- Can the Claimant show with sufficient certainty that if the exclusivity agreement had not been breached, the SPA would have been concluded? On what terms?

Breach of confidentiality agreements

- Can the Claimant claim consequential damage resulting from the breach of the confidentiality agreement?

Abandonment of negotiations

Generally, only reliance damages can be awarded for *culpa in contrahendo*

Pre-Closing Disputes: Party Refuses to Close the Transaction

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Seller's perspective

- Retrospective
- More likely to claim reliance damages



Buyer's perspective

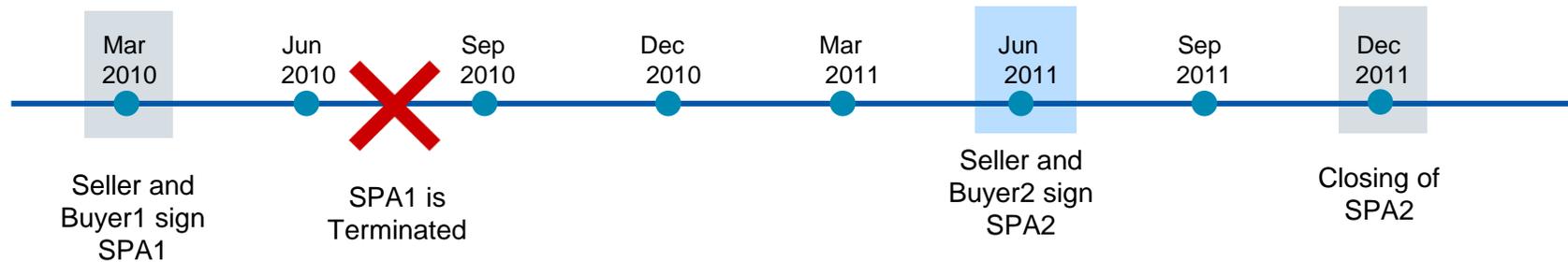
- Prospective
- More likely to claim expectation damages

Break-fee

Due to the difficulties in proving and assessing damages in the pre-signing and pre-closing phase, parties generally agree on a "Break-fee" (a liquidated damages clause)

Pre-Closing Disputes: Party Refuses to Close the Transaction The Buyer Walks Away

- **The situation:**



- **Damages:**

- Actual scenario
- Counterfactual scenario - had the contract been performed *as expected*

- **Considerations:**

- What caused decrease in Target's price?
- But-for agreed Purchase Price?
- But-for Closing Date?
- But-for Completion Accounts?
- Avoided losses under but-for scenario?

Pre-Closing Disputes: Party Refuses to Close the Transaction The Seller Decides not to Sell

- **The situation:**



- **Damages:**

- Actual scenario
- Counterfactual scenario - had the contract been performed *as expected*

- **Considerations:**

- Lost Profits
- Loss of business opportunity

Post-Closing Disputes: Breach of Representations and Warranties

SPAs generally contain detailed damage indemnification clauses on

- Definition of damages by category
- No liability for indirect or consequential damages, loss of profits ...
- Parties may specify damage calculation methods in the SPA
- *De minimis* amounts/Caps

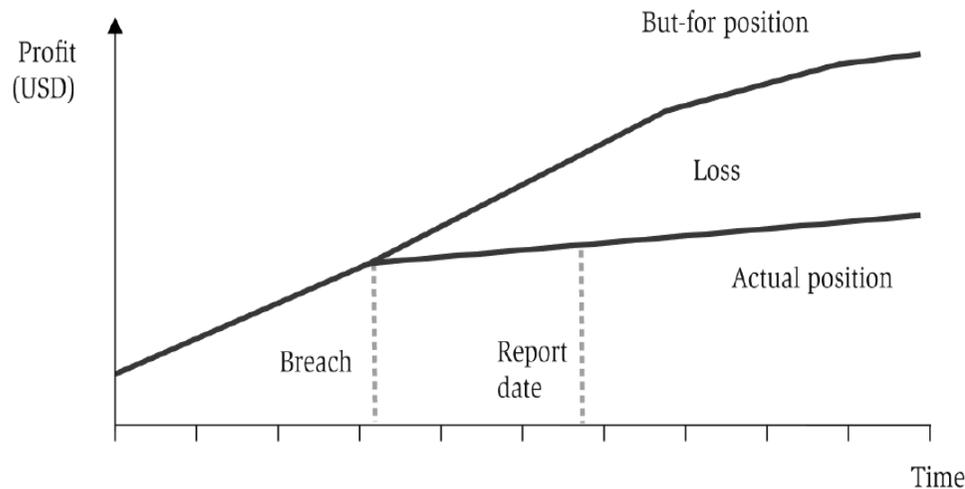
But does that solve all the problems...?



Post-Closing Disputes: Breach of Representations and Warranties

Damage

Difference between the actual financial situation of the claimant as it results from the alleged breach and the hypothetical situation, i.e., the situation in which the claimant would find itself but for the breach



Source: Chapter 12: Damages for Breaches of Representations and Warranties and Quantum of Indemnities', in Heiko Daniel Ziehms, M&A Disputes and Completion Mechanisms, Arbitration in Context Series, Volume 3, Kluwer Law International, 2018

Evaluating the "non-breach" position

- Is the hypothetical position the purchase price paid?

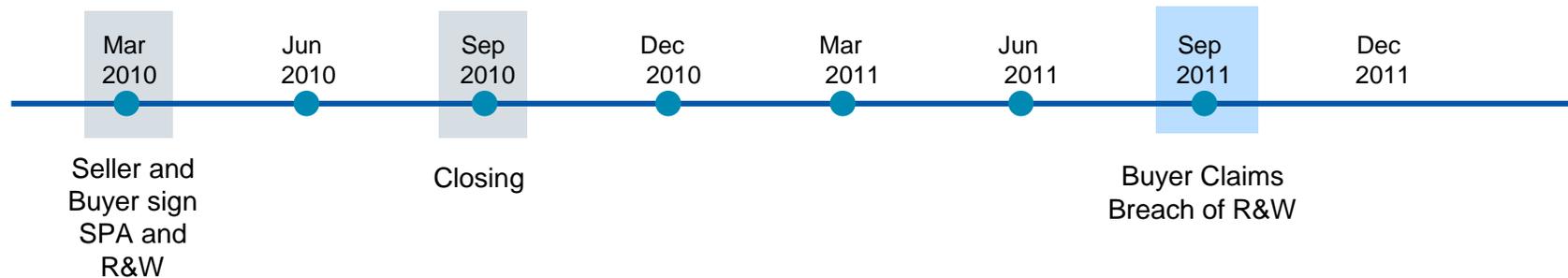
Evaluating the "breach" position

- What was the basis on which the company was bought? (Profits? Net asset value?)
- Does the breach affect this basis?
- Is there a best methodology based on the type of breach?

Post-Closing Disputes: Breach of Representations & Warranties

The Buyer finds an “unpleasant surprise”

- **The situation:**



- **Damages:**

- Difference between Buyer’s actual financial situation and the hypothetical situation, i.e., the situation the Buyer would be but-for the breach

- **Considerations:**

- How did Buyer value Target?
- Impact of breach on valuation/ purchase price?
- What was the context of the transaction (sale process, auction, competing bids)
- Was the new information material relative to the disclosed/ public information?

Post-Closing Disputes: Breach of Representations & Warranties

“Price is what you pay. Value is what you get”

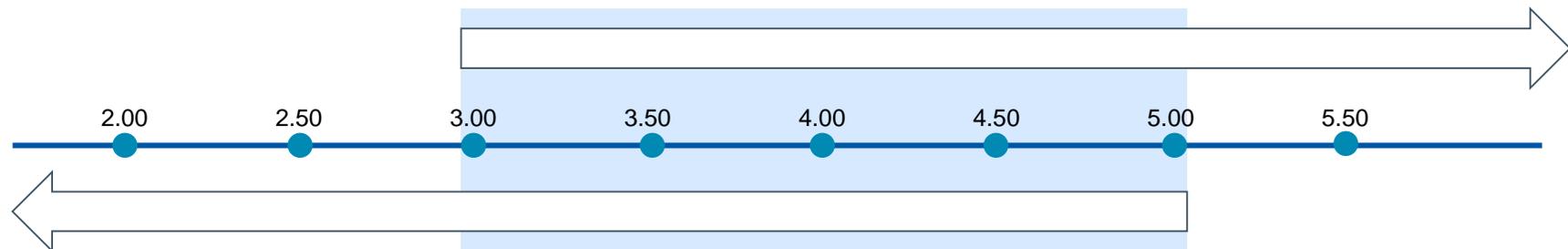
- The **Art** (the context):

- The Seller’s perspective
- The Buyer’s perspective
- The context of the transaction:
 - Competitive bidder?
 - Relative scarcity?
 - Synergies

- The **Science** (the numbers)

- Income methods (DCF) - Discounted Cash Flow
- Market methods (Transaction and Market Multiples: EV/EBITDA, Sales, P/E)
- Share price

Minimum price seller is willing to accept



Maximum price buyer is willing to pay

Post-Closing Disputes: Purchase Price Adjustments and Earn-Outs



Post-Closing Disputes: Purchase Price Adjustments and Earn-Outs

- **Disputes concerning the calculation of price adjustments and earn out amounts**

E.g.: On the one (1) year anniversary of the Closing, Purchaser shall pay to Seller a cash payment (the “Earnout”) by wire transfer of immediately available funds to the Seller Bank Account, such amount as calculated pursuant to the formulas set forth below: • 3 X EBITDA from \$10,000 to \$100,000, and • 2 x EBITDA over \$100,000

- **Disputes about the fulfillment of earn out conditions**

E.g.: Seller alleges buyer artificially influenced the factors that determine the earn-out amount

- **Disputes about accounting principles and standards**

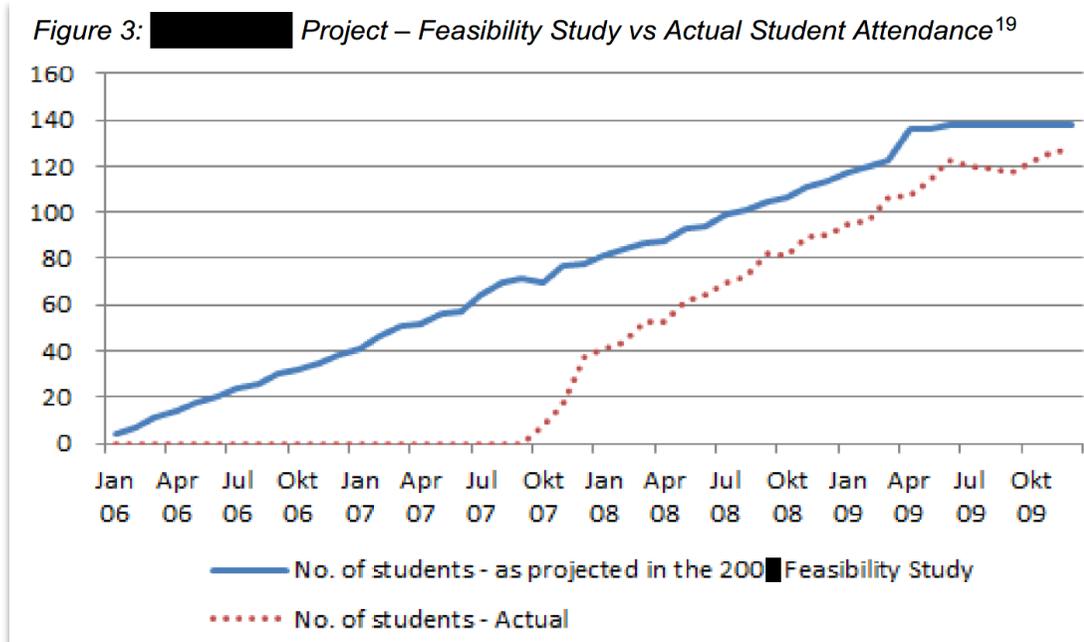
E.g.: GAAP or IFRS, value at historical costs or replacement costs

**PRACTICAL TIPS FOR PROVING AND
PRESENTING DAMAGES**

Choose wisely, choose well...

- **Choosing your expert**
 - What type of expertise do I need?
 - Accountancy?
 - Valuation?
 - Forensics expert?
- **Choosing your arbitrator**
 - Does the arbitrator have the requisite technical skills needed?
 - Industry-specific knowledge?
 - Black letter lawyer or good faith approach?

Figures speak a thousand words?



- 4.12 As shown in Figure 3, the trend of actual student attendance in 200[REDACTED] and 200[REDACTED] - although affected by delays incurred in the opening of the [REDACTED] - was in line with the initial expectations of the Feasibility Study.
- 4.13 The growth rates in student numbers for the first three years of operation observed in the Feasibility Study and in the actual results (allowing for delay) are broadly similar.

No "Expertese" Please

From the expert report...

25. First, depreciation is an accounting method used to allocate the cost of a tangible or physical asset over expectancy period. Depreciation shows the reader how much of an asset's value has been used up. Depreciating assets helps companies earn revenue from an asset while expensing a portion of its cost each year the asset is in use.
26. So, it is false that [REDACTED]'s actual cash-flow in 201[REDACTED] included the "depreciation of [REDACTED] current assets" resulting from the admission to the [REDACTED] proceedings and therefore is not even comparable to the pre-signing projections provided during the negotiations. That devaluation only had a negative economic impact on [REDACTED]'s 201[REDACTED] financial statements. The carrying value of [REDACTED]'s assets were represented in its 201[REDACTED] FS through the historical cost minus all the accumulated depreciation from 200[REDACTED]. The salvage value stood at USD [REDACTED].

....to the hearing

- 10 Mr. [REDACTED] (co-arbitrator): so what do you mean at para. 25? Depreciation doesn't matter?
- 11 Mr. [REDACTED]: yes exactly, it doesn't matter. Depreciation is non-cash, so it doesn't matter
- 12for cash flows.

Untenable Positions – Strategy or Stupidity?

11:37:56 14 DR [REDACTED]: You claim that the purchase price would have been EUR 5.1 million.
11:37:56 15 MR [REDACTED]: Yes.
11:37:58 16 DR [REDACTED]: On what basis do you calculate this price?
11:38:01 17 MR [REDACTED]: That's what I was willing to pay.



Pre-Signing Dispute

Breach of Representation



14:07:14 20 MS [REDACTED] (President): You deem that the transaction multiple should be reduced by 1% to take into account the errors in the accounts?
14:07:17 21 MR [REDACTED]: Correct. Because this issue lower the value of the business to [REDACTED].
14:07:18 22 MS [REDACTED] (President): But the SPA prohibits the revision of multiples isn't it? That's my understanding of Clause [REDACTED].
14:07:27 23 MR [REDACTED]: Yes, you are correct, it could be read that way. Well...
14:07:30 24 MS [REDACTED] (President): So what did you do it? Was it your instruction?
14:07:17 21 MR [REDACTED]: Yes

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Thank you for your attention

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