Merger and Acquisition (M&A) Litigation: Current Issues and Trends

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“Merger and Acquisition (M&A) Litigation: Current Issues and Trends”

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With the expectation that Merger and Acquisitions (M&A) deals will rebound in 2013, the panel will discuss the current environment of M&A litigation and relevant court rulings. The discussion will also focus on the dynamics of a deal, expectations of strategic buyers versus financial buyers, disputes over representations, warranties and covenants, disputes over valuation and related issues, anticipating and managing risks of post deal disputes and applicability of damages during litigation.

**Current Environment for M&A Deals**

Even though deal value decreased four percent from 2011, deal activity is expected to be greater in 2013\(^1\). With corporations flush with record levels of cash, ongoing access to capital and financing, low interest rates in the marketplace, and strong balance sheets, there is optimism that deals in 2013 will increase.

KPMG and SourceMedia conducted a survey of more than 300 M&A professionals at U.S. Corporations, private equity firms (PE), and investment funds\(^2\). “Seventy-six percent of respondents said they expected their companies to make at least one acquisition in 2013”\(^3\).

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\(^2\) Ibid.

\(^3\) Ibid.
In addition to improved consumer confidence, there are a number of factors influencing deal activity.

The primary factors motivating potential deals, include expanding geographic regions, financial buyers looking for profitable operations or gain on exit and entering new lines of business.
There isn’t an expectation that there will be a lot of mega-deals in 2013 (over $5 billion), and that middle market deals of less than $250 million will account for most of the deal activity.

But there is still a lot of caution and concern that there could be a number of factors that would inhibit deal activity:

- Slow growth in the economy
- Uncertainty surrounding tax code changes
- The European economic situation
- Regulatory considerations
- Lack of suitable opportunities
- Cost of debt financing
- Unemployment and consumer demand

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4 Ibid.
Dynamics and Life Cycle of a Deal

- **Strategy Development**
  - Development of an acquisition strategy
  - Identification of a target
  - Initial negotiation of deal terms and letter of intent
  - Consideration of risks
    - Valuation risk
    - Financial risk
    - Operating risk

- **Due Diligence**
  - This would include legal, financial and tax due diligence
    - Additional areas would include sales and marketing, facilities, human resources, environmental, regulatory compliance and anti-corruption due diligence

- **Negotiations and Structuring the Transaction**
  - Execution of the transaction agreement
  - Factors taken into consideration include:
    - Legal structure
    - Representations and warranties
    - Indemnification provisions
    - Continuity of management

**Factors Inhibiting Deal Activity**

- Recessionary fears/slow growth environment
- Uncertainty surrounding tax code changes
- Concerns about European economic situation
- Regulatory considerations
- Lack of suitable opportunities
- Availability and/or cost of debt financing
- Effect of unemployment on consumer demand
- Stock price volatility
- Other

**Source:**
KPMG 2013 M&A Outlook Survey
• Real Estate and non-business related assets
• Consideration, which can include cash, stock and/or contingent payouts
• Financing of the transaction
• Adjustments to purchase price for results of operations between the execution of the agreement and the actual closing date

• Post Closing and Integration
  o Proper planning and integration of business processes and system to assure success
  o A lot of M&A deals do not reach their potential or fail because improper post closing integration
  o Purchase Price Adjustments

Expectations of Strategic Buyers versus Financial Buyers

Strategic buyers are typically operating companies that are interested in target companies that can be strategically integrated into the buyer company. Their goal is to enhance their existing operations to increase their bottom line and increase shareholder value. Reasons for strategic acquisitions can include the following:

• Elimination of competition
• Vertical integration
  o different points on the supply chain
• Horizontal integration
  o supply new or similar product lines or enter new geographic markets
• Enhancing internal weaknesses
  o research and development, marketing, technology, expertise

Strategic buyers expect to take advantage of the synergistic benefits they can realize immediately through consolidating operations, eliminating overhead, and the economies of scale through the combination of the buyer and seller. The combined company also typically has greater access to capital to help grow and expand. The strategic buyer has a long-term investment horizon and is usually willing to pay a premium for the targeted company because of the synergies. This can be different from what a financial buyer is willing to pay.

Financial buyers which include venture capitalist, private equity (PE) firms, hedge funds and family investment offices are investors that are interested in realizing a return on their investment. They identify companies with strong management, attractive earnings growth, future growth opportunities and competitive advantages. They invest their capital, but usually leverage the transaction with as much as 80% debt. By leveraging the transaction, they can effectively deploy their capital and make investments in a number of target companies. The lender accepts a lending rate of return that is lower than what a financial buyer expects, but usually accepts options and/or warrants to compensate for their additional risk in a leveraged transaction.
Financial buyers cannot take advantage of synergies like the strategic buyer can. They are buying the expected future cash flows of the company at the time of the acquisition. Therefore they typically aren’t willing to pay a premium for the target company. The fundamental goals that differ between a financial buyer and a strategic buyer will impact the sales process, structure and outcome of the transaction.

**Disputes over Representations, Warranties and Covenants**

- **Representations and Warranties**
  - Statement of fact made to each party to allocate risk between the parties
  - Representations are made by both the buyer and the seller
  - Representations and warranties serve to:
    - Help the buyer fully understand the business
    - Set conditions for the parties’ obligations to close the deal
      - For example, a party can terminate the deal prior to closing if it finds there has been a material change in facts
    - Enable’s the buyer to recover damages if the seller makes inaccurate representation
  - Seller’s representations and warranties may cover areas including:
    - Financial reporting and accounting
      - Examples may include:
        - Financial statements are accurate and have been prepared in accordance with accepted accounting standards (i.e. GAAP, IFRS, Statutory Standards)
        - No undisclosed liabilities exist, and no contingent liabilities exist that have not already been disclosed to buyer
      - Purchase price adjustment issues for closing
      - Other issues may include:
        - Tax
        - Capitalization
        - Intellectual Property
        - Compliance with the law
        - Employment (including ERISA)
        - Material Contracts
  - Escrow accounts or insurance may be used to reduce risk to buyer

- **Covenants**
  - Enforceable “Promises”
  - May include things such as:
    - How seller will and will not operate the business until closing (including promise that seller will not sell assets between signing and closing)
    - Specific actions the parties will take to close the transaction
• Seller’s promise to inform buyer if conditions change in ways that contradict its representations or warranties
• May provide buyer with the right to conduct additional due diligence
  o From buyer’s perspective, covenants are important as they provide a way to reduce risk that the seller may decrease the value of the entity being purchased prior to closing
• Indemnification
  o Relates to breaches by the buyer and seller of representations, warranties or covenants
    ▪ For example, undisclosed liabilities
  o Seller agrees to indemnify the buyer for any losses, damages and expenses
  o In the event there is a breach, the buyer may be entitled to damages suffered
  o Ambiguous language in the transaction documents may be a focus in litigation
    ▪ For example, a covenant may be included by the seller that no material adverse change will occur in the business through the date of closing
  • Unless the contract specifically defines such change, it may be hard for buyer to prove

• Potential Post Deal Disputes
  o Personnel or Management Issues
  o Strategies and Policies
  o Issues Relating to Customers
  o Manipulation of Financial Statements
  o Contingent Liabilities
  o Indemnity

**Disputes over Valuation Issues**

There are several methodologies to value the target and assess the purchase price it will offer. There are three valuation approaches and various methodologies under each:

• Income Approach - A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.
  o Discounted Cash Flow (DCF) method
  o Single period Capitalization of Earnings (generally not used)

• Market Approach - A general way of determining a value indication 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.
  o Guideline Public Company Method
• Multiples based on guideline public company comparables (EBITDA, revenues, or assets)
  o Guideline Transactions Method
• Multiples based on actual comparable transactions in the marketplace (EBITDA, revenues, or assets)

• Asset-Based (Cost) Approach - A general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities.
  o Generally not used

From a practical standpoint, the prospective buyer typically employs one or a combination of these methodologies:

• Applying a multiple of earnings or cash flows (typically EBITDA)
• Measuring the fair value of assets
• Estimating the value based on amounts paid in other comparable transactions
• Calculating a value or adjusting the value based on information regarding potential synergies with a buyer’s existing businesses

The buyer will select a purchase price based on the latest available financial information and projected earnings obtained during the due diligence process. Prior to closing, the target company will continue to operate, which will mean that the financial information that the buyer used to develop their purchase price will be different from the actual financial information as of the closing date. Most agreements include a post closing adjustment provision to account for any changes in the financial metrics or conditions of the seller during the pre-closing period.

“This provision usually allocates the profits and losses of this preclosing period to the seller. It also protects the buyer against potential seller abuses, such as selling inventory without replacement, stretching payables to increase the cash available to the seller, or loosening credit criteria to increase sales, which can negatively affect the collectibility of such sales.

The typical post closing purchase price adjustment provision requires either the buyer or the seller to prepare a closing statement (e.g., closing balance sheet, closing net working capital, or closing EBITDA). The parties then compare this closing statement to the comparable value (e.g., net assets, net working capital, EBITDA) reflected in, or derived from, the financial statements (or other relevant statement agreed to by the parties) on which the buyer based the purchase price. Typically, if the value of the relevant purchase price adjustment has increased during the preclosing period, the buyer will pay more; if the value has decreased, the purchase price will decrease. Depending on the transaction agreement terms, the adjustment will be dollar-for-dollar or based on a multiple or formula

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of some type. Postclosing purchase price provisions usually call for dollar-for-dollar adjustments to reflect changes in net asset value or net working capital and usually call for an adjustment based on a multiple to reflect changes in EBITDA. Disputes between the parties to a transaction arise when they disagree over the amount of the purchase price adjustment (often involving several areas of dispute) as communicated through a notice of objection."6

**Disputes over Representations, Warranties, Covenants and Post Closing Adjustments**

**Post-Deal Disputes**

The most common post-deal disputes include:

- Claims of material adverse change
- Earnout Disputes (both the buyer and seller share the risk)
- Post-closing adjustments for working capital or net assets
- Indemnity or fraud claims

**Disputes Relating to Material Adverse Change:**

The sellers’ promise that no material adverse change will occur in the business through the date of closing protects the buyer in the event of a significant decline in the value of the business. Examples of material adverse changes may include:

- Loss of a significant customer, contract, or supplier
- Litigation in which the company is being sued for violation of patent rights

Not only do material adverse changes affect the operations of the business, but in some instances it may even prohibit a company from selling their product.

Buyer’s often find it difficult to prove that a material adverse change has occurred and that had this been known it would have impacted the buyer’s decision to pay the agreed upon price or purchase the company all together.

Factors that are considered when determining whether an event qualifies as a material adverse change may include the following:

- Impact of the event on the company
- Duration of the time period in which the company was impacted
- Whether other companies in the industry were also affected and to what extent
- Whether the seller knew of the event prior to entering into the transaction

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Earnout Disputes:

Buyers and sellers entering into a transaction having competing interests that impact each party’s perceived value of the company’s worth. Often times, this prohibits buyers and sellers from agreeing upon a purchase price that meets the objectives for both parties. Earnout clauses are used as a way to align the financial interests of the buyer, who does not want to pay more than a specified price, and the seller, who wants to maximize the selling price. In an earnout, a portion of the consideration paid for the company is based upon the company’s ability to achieve certain financial milestones in the future. The earnout period typically lasts 1 to 3 years, and the company’s ability to reach the earnout milestones during this time period determines whether the seller is paid an additional consideration for the company.

Earnouts can be a source of dispute for many reasons including:

- From a seller’s perspective, buyer’s control the company after closing and may make decisions that the seller disagrees with or that differ from what the company has done historically. In some instances, the seller may view these decisions as showing intent by the buyer to reduce the earnout payment due to the seller. One way this risk can be mitigated is for the seller to require the buyer to operate the company in a way that is consistent with the past during the length of the earnout period. In addition, the seller may request the authority to vote on major decisions impacting the company until the earnout period has terminated.

- From a buyer’s perspective, buyers may find it difficult to make operational changes if the seller is still involved in the management of the company. In these instances, a seller with earnout provisions will have a stronger incentive to focus on short-term goals that will maximize the earnout and may increase the risk of the business, while the buyer, who is a long-term investor, will want to manage the company to produce long-term, sustainable growth. One way the buyer can mitigate this risk is put in place controls that review and monitor the decisions made by the seller during the earnout period.

Other sources of dispute arising from earnouts may include:

- Earnout benchmarks may be financial, non-financial or both. For a buyer who integrates the acquired company into its other businesses, it often becomes difficult to evaluate the performance of the company on a stand-alone basis. One way this risk can be mitigated is for the seller to require the buyer to operate the business as a separate entity during the length of the earnout period.

- If an earnout benchmark includes multiple components, there may be a dispute as to whether the seller is entitled to some portion of the payout if the buyer partially achieves the benchmark. One way this risk can be mitigated is by putting in place a minimum hurdle after which earnout payments may be made on a sliding scale or pro rata basis.

- Earnings benchmarks based on financial metrics often include EBIT and EBITDA. Disputes often arise as to whether or not these metrics should include unusual or extraordinary expenses or income. For example, should these calculations include integration expenses from the
transaction, restructuring expenses such as inventory write-offs or bad debt expenses, or a large settlement awarded to the company from a pending litigation.

- Changes in accounting guidance that impact the calculation of the earnout.

**Disputes Relating to Post-Closing Adjustment:**

When a buyer purchases a company it is paying for what that company is worth on the day transaction is closed. However, purchase prices are negotiated based on the most recent financial statements available at that time, which may be different than the financial statements as of the closing date of the transaction. As such, post-closing adjustments are made to the purchase price to account for differences in the company’s financial statements between the date the transaction agreement is entered into and the closing date of the transaction. Working capital and net assets are the most common items that require post-closing adjustments.

Working capital adjustments often occur within a few months of the closing and compare the actual working capital of the company at closing against a target level of working capital. The target working capital is based upon the historical working capital requirements of the company and is meant to represent the company’s normalized working capital requirements.

The working capital adjustment provides protection for both the buyer and the seller. From the seller’s perspective, the purpose is to ensure they are receiving adequate consideration for the assets of the company. From the buyer’s perspective, the purpose is to ensure that after closing, the company has adequate working capital to continue operations and meet its liabilities. For the buyer, it also provides assurance that the seller didn’t accelerate the collection of receivables or delay buying inventory and paying liabilities in order to create an inflated cash balance on the closing date. Disputes often arise over the historical accounting methods used by the seller, and subsequently the calculation of working capital, compared to accepted accounting methodologies. In addition, further questions may arise if the same accounting methods were not applied consistently to all historical periods under consideration.

Another cause of dispute may be the source of financial statements used in negotiations of the transaction. Interim financial statements, most often prepared internally by the seller, are frequently used during the negotiation process in as these represent the most current financial position of the company. However, interim financial statements are often not prepared in accordance with generally accepted accounting principles, and as such certain adjustments to the interim statements are likely required and may or may not be made prior to their use in the negotiation process. To mitigate the risk of using interim financial statements, the buyer and seller should have an understanding of the potential financial consequences for relying on such statements to arrive at a purchase price. Furthermore, this may also lead to significant adjustments that are required at closing.

One way the risk of post closing adjustments can be mitigated is by permitting them to be made only if they are material, which can be defined as exceeding a specified aggregate dollar amount.
Insights and Observations regarding Merger and Acquisition 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
- Require extensive third party due diligence
- Insist on complete access to all relevant documents
- If possible, rely on 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 saleable/good condition)
- Scrutinize accounting estimates for key areas, i.e., warranty reserves, allowance for doubtful accounts
- Maximize indemnity claim caps; no cap on claims related to fraud
- Minimize basket threshold; maximize escrow

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

- If known departures from GAAP exist, consider “carving out” troubling accounts (i.e., for inventories, insist on past practice)
- Limit the buyer’s ability to make working capital claims in the indemnification proceeding
- Avoid nondisclosures that could lead to fraud claims
- Limit damages to dollar-for-dollar; maximize the basket for damages; and insist on cap on indemnification recoveries

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7 The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys (Business Valuation Resources is the copyright holder and the copyrighted material was reproduced with BVR’s written permission).
Applicability of Damages During Litigation

Damages in M&A litigation are typically based on the Benefit of the Bargain rule.

“The benefit of the bargain rule is a principle that any party who breaches a contract must pay the aggrieved party an amount that puts that person in the same financial position that would have resulted if the contract had been fully performed. It also refers to the principle that a defrauded buyer may recover from the seller as damages the difference between the misrepresented value of the property and the actual value received.”

Damages are typically calculated using two methods, the “dollar for dollar” approach and the “multiple of earnings approach”. In that the damages are based on accounting adjustments, the “dollar for dollar” method would adjust the purchase price by the exact amount of the accounting adjustment. Under the “multiple of earning approach” the adjustment to the purchase price is based on multiplying the accounting adjustment by the earnings multiplier that was used in establishing the purchase price.

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8 USLegal.com.
CASE LAW
The following are excerpts from various cases and do not contain the complete opinion

CASE LAW

1) Material Adverse Affect

Hexion Specialty Chems., Inc. v. Huntsman Corp.

Court of Chancery of Delaware, New Castle
September 19, 2008, Submitted; September 29, 2008, Decided; September 29, 2008, EFiled
C.A. No. 3841-VCL

Reporter: 965 A.2d 715; 2008 Del. Ch. LEXIS 134

Disposition: The court granted the seller’s request for an order specifically enforcing the buyer’s contractual obligations to the extent permitted by the merger agreement itself. It held that the seller was not entitled to specifically enforce the buyer’s duty to consummate the merger. It held that the issue of the solvency of the combined entity was not ripe for decision.

Procedural Posture

Plaintiffs, the buyer corporation in a merger agreement and an equity group that owned most of the buyer, brought a declaratory judgment action against defendant seller corporation. The seller filed counterclaims, including one for specific performance. The court held a trial on certain of the claims for declaratory and injunctive relief.

Overview

The court first rejected the buyer’s argument that its obligation to close the merger was excused because of a material adverse effect (MAE) in the seller’s business. The burden of proof with respect to an MAE rested on the party seeking to excuse its performance under the contract, and the evidence did not show that the seller had suffered an MAE as defined in the merger agreement. Next, the buyer had engaged in a knowing and intentional breach of the merger agreement; therefore, the liquidated damages clause in the agreement was inapplicable. A “knowing and intentional” breach, as used in the merger agreement, was the taking of a deliberate act, which act constituted in and of itself a breach of the merger agreement, even if breaching was not the conscious object of the act. Next, the court declined to reach the issue of whether the combined entity would be insolvent, as the issue was not ripe for a judicial determination. Finally, the merger agreement did not allow the seller to specifically enforce the buyer’s duty to consummate the merger. It was appropriate, however, to require the buyer to specifically perform its other obligations under the merger agreement.
Outcome

The court granted the seller’s request for an order specifically enforcing the buyer’s contractual obligations to the extent permitted by the merger agreement itself. It held that the seller was not entitled to specifically enforce the buyer’s duty to consummate the merger. It held that the issue of the solvency of the combined entity was not ripe for decision.

**HN1** For the purpose of determining whether a material adverse effect has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target’s business that is consequential to the company’s long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather

**HN2** A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. The ubiquitous material adverse effect clause should be seen as providing a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather an adverse change should be material when viewed from the longer-term perspective of a reasonable acquirer. This, of course, is not to say that evidence of a significant decline in earnings by the target corporation during the period after signing but prior to the time appointed for closing is irrelevant. Rather, it means that for such a decline to constitute a material adverse effect, poor earnings results must be expected to persist significantly into the future.

**HN3** Absent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract.

**HN5** In the context of a cash acquisition, the use of earnings per share is problematic when examining changes in the results of business operations post-signing of a merger agreement. Earnings per share is very much a function of the capital structure of a company, reflecting the effects of leverage. An acquirer for cash is replacing the capital structure of the target company with one of its own choosing. While possible capital structures will be constrained by the nature of the acquired business, where both the debt and equity of the target company must be acquired, the capital structure of the target prior to the merger is largely irrelevant. What matters is the results of operation of the business. Because earnings before interest, taxes, depreciation and amortization is independent of capital structure, it is a better measure of the operational results of the business

**HN9** It is a fundamental proposition of contract law that damages in contract are solely to give the nonbreaching party the "benefit of the bargain," and not to punish the breaching party. It is for this very reason that penalty clauses are unenforceable.

**HN11** The fundamental principle that underlies the availability of contract damages is that of compensation. That is, the disappointed promisee is generally entitled to an award of money damages in an amount reasonably calculated to make him or her whole and neither more nor less; any greater sum operates to punish the breaching promisor and results in an unwarranted windfall to
the promisee, while any lesser sum rewards the promisor for his or her wrongful act in breaching the contract and fails to provide the promisee with the benefit of the bargain he or she made.

D. 2007 Negotiations Leading To July 12, 2007 Merger Agreement

In May 2007, Huntsman, through its financial advisor Merrill Lynch & Co., Inc., [*724] began to solicit bids for the company. Apollo (through Hexion) and Basell, the world’s largest polypropylene maker, emerged among the potential buyers. Huntsman signed confidentiality agreements and began to negotiate merger agreements with both Hexion and Basell. On June 25, 2007, Huntsman rejected Hexion’s offer of $26 per share and executed a merger agreement with Basell for $25.25 per share. The same day, but after the agreement was signed, Hexion raised its bid to $27 per share. Basell refused to raise its bid, stating that its deal remained superior because it was more certain to close. On June 29, 2007, Huntsman re-entered negotiations with Hexion after Hexion further increased its bid to $27.25 per share. On July 12, 2007, Huntsman terminated its deal with Basell and signed an all cash deal at $28 per share with Hexion.

July 12, 2007 Merger Agreement

Due to the existence of a signed agreement with Basell and Apollo’s admittedly intense desire for the deal, Huntsman had significant negotiating leverage. As a result, the merger agreement is more than usually favorable to Huntsman. [*13] For example, it contains no financing contingency and requires Hexion to use its “reasonable best efforts” to consummate the financing. In addition, the agreement expressly provides for uncapped damages in the case of a “knowing and intentional breach of any covenant” by Hexion and for liquidated damages of $325 million in cases of other enumerated breaches. The narrowly tailored MAE clause is one of the few ways the merger agreement allows Hexion to walk away from the deal without paying Huntsman at least $325 million in liquidated damages.

G. April 22, 2008: Huntsman Reports Poor First Quarter Of 2008

Initially, Hexion and Apollo were extremely excited about the deal with Huntsman. Apollo partner Jordan Zaken testified at trial that Apollo really wanted the deal and that “the industrial logic was very strong.” Indeed, Hexion’s April 2007 presentation materials regarding the potential transaction with Huntsman reflect that the Hexion/Huntsman combination would create the largest specialty chemical [*725] company in the world. While Huntsman’s Pigments business had been slowing since shortly after signing, Hexion and Apollo’s view of the deal did not seem to change dramatically until [*14] after receipt of Huntsman’s disappointing first quarter numbers on April 22, 2008. Following receipt of these numbers, Apollo revised its deal model and concluded that the transaction would produce returns much lower than expected. At this time, Apollo also questioned whether Huntsman had experienced an MAE as defined in the merger agreement.

H. Apollo’s May 9, 2008 Meeting With Counsel

On May 9, 2008, Apollo met with counsel to discuss, among other things, whether an MAE had occurred. In preparation for the meeting, Apollo created three models: Run Rate, Scenario 1, and Scenario 2. The Run Rate model simply annualizes Huntsman’s poor first quarter results. [*15] Scenario 1 assumed that the full $1 billion revolver was available at closing and an equity
contribution of $445 million by Apollo. Scenario 2 removed the equity commitment and assumed a $100 million annual increase in the synergies estimate (from $250 million to $350 million) and included some of the over $1 billion in potential opportunities identified by Apollo to improve liquidity. Zaken testified that these models were created because Apollo was looking for a way to close the transaction. However, Zaken later stated that these models were prepared to help evaluate with counsel whether an MAE had occurred. Before Apollo’s May 9, 2008 meeting with counsel, there appears to have been no discussion of the potential insolvency of the combined companies. The May 9 models, while showing unfavorable returns for Apollo and tight liquidity, do not clearly show insolvency.

After its May 9, 2008 meeting with counsel, perhaps realizing that the MAE argument was not strong, Apollo and its counsel began focusing on insolvency. However, under the merger agreement, Hexion had no right to terminate the agreement based on potential insolvency of the combined company or due to lack of financing. Also, Hexion would be subject to full contract damages if it "knowingly and intentionally" breached any of its covenants. Therefore, it appears that after May 9, 2008, Apollo and its counsel began to follow a carefully designed plan to obtain an insolvency opinion, publish that opinion (which it knew, or reasonably should have known, would frustrate the financing), and claim Hexion did not "knowingly and intentionally" breach its contractual obligations to close (due to the [*726] impossibility of obtaining financing without a solvency certificate).

B. Huntsman Has Not Suffered An MAE

**HN1** For the purpose of determining whether an MAE has occurred, changes in corporate [*52] fortune must be examined in the context in which the parties were transacting. In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target’s business that is consequential to the company’s long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months. HN2 A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence. The ubiquitous material adverse effect clause should be seen as providing a "backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather [an adverse change] should be material when viewed from the longer-term [*53] perspective of a reasonable acquirer." This, of course, is not to say that evidence of a significant decline in earnings by the target corporation during the period after signing but prior to the time appointed for closing is irrelevant. Rather, it means that for such a decline to constitute a material adverse effect, poor earnings results must be expected to persist significantly into the future.

In the face of this overwhelming evidence, it is the court’s firm conclusion that by June 19, 2008 Hexion had knowingly and intentionally breached its covenants and obligations under the merger agreement. To the extent that it is at some later time necessary for this court to determine damages in this action, any damages which were proximately [*110] caused by that knowing and intentional breach will [*757] be uncapped and determined on the basis of standard contract damages or any
special provision in the merger agreement. Because of the difficulty in separating out causation of damages in such an action, the burden will be on Hexion to demonstrate that any particular damage was not proximately caused by its knowing and intentional breach. To the extent Hexion can make such a showing, those damages which were not proximately caused by Hexion’s knowing and intentional breach will be limited to the liquidated damages amount of $325 million, pursuant to section 7.3(d) of the merger agreement.

V.

Huntsman asks the court to enter a judgment ordering Hexion and its merger subsidiary, Nimbus, to specifically perform their covenants and obligations under the merger agreement. For the reasons explained below, the court finds that, under the agreement, Huntsman cannot force Hexion to consummate the merger, but that Huntsman is entitled to a judgment ordering Hexion to specifically perform its other covenants and obligations.

For the reasons explained below, the court finds that, under the agreement, Huntsman cannot force Hexion to consummate the merger, but that Huntsman is entitled to a judgment ordering Hexion to specifically perform its other covenants and obligations.

In view of these provisions, and considering all the circumstances, the court concludes that it is appropriate to require Hexion to specifically perform its obligations under the merger agreement, other than the obligation to close.

Hexion does not argue otherwise. When it is known whether the financing contemplated by the commitment letter is available or not, Hexion and its shareholders will thus be placed in the position to make an informed judgment about whether to close the transaction (in light of, among other things, the findings and conclusions in this opinion) and, if so, how to finance the combined operations. As the parties recognize, both Hexion and Huntsman are solvent, profitable businesses. The issues in this case relate principally to the cost of the merger and whether the financing structure Apollo and Hexion arranged in July 2007 is adequate to close the deal and fund the operations of the combined enterprise. The order the court is today issuing will afford the parties light of, among other things, the findings and conclusions in this opinion) and, if so, how to finance the combined operations. As the parties recognize, both Hexion and Huntsman are solvent, profitable businesses. The issues in this case relate principally to the cost of the merger and whether the financing structure Apollo and Hexion arranged in July 2007 is adequate to close the deal and fund the operations of the combined enterprise. The order the court is today issuing will afford the parties the opportunity to resolve those issues in an orderly and sensible fashion.
ORDER AND FINAL PARTIAL JUDGMENT

For the reasons set forth in the court's Opinion today's date, it is hereby Ordered, Adjudged and Decreed as follows:

1. Judgment is entered for Huntsman Corporation denying all declaratory relief sought by Hexion Specialty Chemicals, Inc. and Nimbus Merger Sub Inc. in Counts I, II and IV of the Amended and Supplemental Verified Complaint.

2. Judgment is entered for Huntsman declaring that Hexion and Nimbus have breached their obligations and covenants under Sections 5.4, 5.8, 5.12, and 5.13 of the Agreement and Plan of Merger among Hexion, Nimbus, and Huntsman, dated as of July 12, 2007 (the "Merger Agreement"), and the implied covenant of good faith and fair dealing under the Merger Agreement, and that such breaches were knowing and intentional.

3. Judgment is entered ordering Hexion and Nimbus to specifically perform their covenants under Section 5.12(a) of the Merger Agreement, and requiring that Hexion and Nimbus use their reasonable best efforts to (i) satisfy on a timely basis all terms, covenants, and conditions set forth in the
Commitment Letter (as defined in the Merger Agreement), (ii) enter into [*2] definitive agreements with respect thereto on the terms and conditions contemplated by the Commitment Letter, (iii) consummate the Financing (as defined in the Merger Agreement) at or prior to Closing (as defined in the Merger Agreement), and (iv) if necessary, enforce their rights under the Commitment Letter.

4. Judgment is entered ordering Hexion and Nimbus to specifically perform their covenants under Section 5.12(b) of the Merger Agreement, and enjoining Hexion, Nimbus and all of their respective directors, officers, principals, employees, agents, servants, attorneys, advisors, representatives, affiliates, associates, and those persons or entities acting in concert or participation with them or on their behalf, from taking any further action that could reasonably be expected to materially impair, delay, or prevent consummation of the Financing contemplated by the Commitment Letter or any Alternate Financing (as defined in the Merger Agreement), unless Huntsman provides its prior written consent of any such action.

5. Judgment is entered ordering Hexion and Nimbus to specifically perform their covenants under Section 5.13 of the Merger Agreement, including their obligation to use [*3] their reasonable best efforts to take all actions necessary and proper to consummate the Merger in the most expeditious manner practicable, but not specifically enforcing the consummation of the Merger itself.

6. Judgment is entered ordering Hexion and Nimbus to (i) start the Marketing Period (as defined in the Merger Agreement) prior to the earlier of October 1, 2008 or the second business day following receipt of applicable regulatory approvals, or (ii) waive the right thereto.

7. Judgment is entered ordering Hexion and Nimbus to specifically perform their covenants under Section 5.4 of the Merger Agreement, including their obligation to take all actions necessary to obtain antitrust approval for the Merger by October 2, 2008.

8. Judgment is entered prohibiting Hexion or Nimbus from terminating the Merger Agreement.

9. Judgment is entered prohibiting Hexion and Nimbus from continuing to breach the Merger Agreement.

10. Judgment is entered prohibiting Hexion, Nimbus, and all of their respective directors, officers, principals, employees, agents, servants, attorneys, advisors, representatives, affiliates, associates, and those persons or entities acting in concert or participation with [*4] them or on their behalf, from interfering with or impeding the performance by Hexion or Nimbus of the actions set forth above.

11. If the Closing has not occurred by October 1, 2008, the Termination Date under the Merger shall be and is hereby extended until five (5) business days following such date that this Court determines that Hexion has fully complied with the terms of this Order.

In addition to the foregoing, judgment is reserved on Counts III and IV of the Amended and Supplemental Complaint, on Counts III, IV and V of Huntsman's counterclaims, and on Huntsman's claims for monetary damages.

There is no just reason for the delay of the entry of a final order, adjudication and judgment with respect to the items set forth herein above. Accordingly, in accordance with Rule 54(b) of the Court of Chancery Rules, the orders, adjudications and judgments set forth above are intended to be and are hereby determined to be final notwithstanding the fact that certain claims for relief have been reserved for further proceedings.

IT IS SO ORDERED, this 29th day of September, 2008.

/s/ Stephen P. Lamb

Vice Chancellor
2.) Representations and Warranties

   Benefit of the Bargain-/Expectancy Damages

Interim Healthcare v. Spherion Corp.
Superior Court of Delaware, New Castle
July 20, 2004 Submitted ; February 4, 2005, Decided
C.A.No. 00C-09-180-JRS (consolidated)

Disposition: Judgment for plaintiffs in part and for defendant in part.

Procedural Posture

The court considered a suit that arose from a stock purchase agreement for the sale of plaintiff healthcare corporation by defendant seller to plaintiffs, an acquisition corporation and a limited partnership. Plaintiffs alleged the seller breached representations and warranties in the parties’ agreement by failing adequately to disclose numerous pre-sale liabilities of the healthcare corporation and by misrepresenting its financial condition.

Overview

Plaintiffs sought damages under the indemnification provisions of the agreement and expectancy / benefit-of-the-bargain damages for the difference between what they paid and the actual value at the time of the sale. They claimed they were denied the benefit of their bargain with the seller, as they purchased a company the seller represented was worth approximately $134 million when, in fact, it as worth only $90 million. The court found that in the absence of proof by a preponderance of the evidence that the seller breached a promise in the agreement in a manner that materially affected the healthcare corporation’s value at the time of sale, the court would not award expectancy damages, and no such breach occurred. The healthcare corporation’s methodology to allocate operational costs was not improper. Plaintiffs’ claims that the healthcare corporation maintained its financial records in a manner that violated the agreement were unsupported. The seller did breach the agreement by failing to disclose persistent pre-sale threats of litigation against the healthcare corporation, and plaintiffs were entitled to indemnification for losses associated with a therapy student program.

Outcome

The court found in favor of plaintiffs on counts I and II of their amended complaint and awarded damages to them in the amount of $1,070,719. The court found in favor of the seller on counts III of the amended complaint, count I of a Court of Chancery Complaint (previously transferred to the court), and on plaintiffs’ claim for expectancy damages.

HN6 A party that breaches a contract must place the non-breaching party back to the position he would have enjoyed had there been no breach.
Although the parties may, in their contract, specify a remedy for a breach, that specification does not exclude other legally recognized remedies. An agreement to limit remedies must be clearly expressed in the contract.

In a free market economy, all businesses operate under the constant risk of declining profits caused by an infinite panoply of market factors. The emergence of a superior competing product, an adverse regulatory ruling, and the unexpected insolvency of a major customer are but a few examples. Market risks also work in the opposite direction; the insolvency of, or a regulatory ruling against a major competitor, for example, may provide windfall profits. The presence of these market factors -- more prevalent in some industries (like healthcare) than others -- must be taken into consideration when attempting to measure a firm’s value. Even then, the process is by no means an "exact science.”

The theory underlying expectancy damages is as simple as it is significant: A promissee enters into a particular outcome and believes that the best possible outcome, under the circumstances, will be achieved by contracting with this particular promisor. When the promisor fails to perform as promised, the promissee becomes entitled to damages designed to compensate him or her for the harm caused by the breach. That harm, in turn, is the loss suffered by the promissee when the promisor failed to perform his or her promise -- in other words, the value to the promissee of the promise that was broken.

Delaware courts do not rescue disappointed buyers from circumstances that could have been guarded against through normal due diligence and negotiated contractual protections.

This lawsuit involves claims arising from alleged breaches of an intensely negotiated stock purchase agreement for the sale of Interim Healthcare, Inc. ("Interim") by defendant, Spherion Corporation ("Spherion"), to plaintiffs, Catamaran Acquisition Corp. ("Catamaran") and Cornerstone Equity Investors, IV L.P. ("Cornerstone") (the transaction will be referred to hereinafter as "the Sale"). The plaintiffs, Interim (as acquired), Catamaran and Cornerstone, allege that Spherion breached several representations and warranties in the Agreement by failing adequately to disclose numerous pre-Sale liabilities of Interim and by misrepresenting the financial condition of Interim in the financial statements supplied to the plaintiffs during due diligence. Plaintiffs seek damages under the indemnification provisions of the Agreement and also seek expectancy/benefit-of-the-bargain damages for the difference between what they paid for Interim [*518] and the actual value of Interim at the time of the Sale.

After a three week bench trial and posttrial submissions by the parties, this is the Court’s findings of fact and conclusion of law. In short, the Court has found in favor of the plaintiffs on Counts I and II of their Amended Complaint and awards damages to plaintiffs in the amount of $1,070,719.47. The Court has found in favor of Spherion on Counts III of the Amended Complaint, Count I of the Court of Chancery Complaint (previously transferred to this Court), and on plaintiffs’ claim for expectancy damages.

6. The Contractual Allocation of Risk and Expectancy Damages

Plaintiffs’ showcase claim is that they were denied the benefit of their bargain with Spherion: they purchased a company that Spherion represented [**100] was worth approximately $134 million when, in fact, it was worth only $90 million."
invoke what is perhaps the most basic tenet of contract law: HN6 a party that breaches a contract must place the non-breaching party back to the position he would have enjoyed had there been no breach. 296 Thus, according to the plaintiffs, Spherion must fulfill the plaintiffs’ expectancy by making up the approximately $26 million shortfall. While the plaintiffs’ expectancy argument has curb appeal, it does not withstand closer inspection………………

At its essence, plaintiffs’ claim appears to rest on the circular proposition that Interim was worth $134 million because that is what the plaintiffs paid for it. While that logic may apply to a commodity the total value of which can be realized [*550] immediately through use or sale – a barrel of oil, for example -- it does not hold true in the sale of a going concern. HN24 In a free market economy, all businesses operate under the constant risk of declining profits caused by an infinite panoply of market factors. The emergence of a superior competing product, an adverse regulatory ruling, and the unexpected insolvency of a major customer are but a few examples. Market risks also work in the opposite direction; the insolvency of, or a regulatory ruling against a major competitor, for example, may provide windfall profits. The presence of these market factors -- more prevalent in some industries (like healthcare) than others -- must be taken into consideration when attempting to measure a firm’s value. Even then, the process is by no means an "exact science." 299

[**104] In this case, the occurrence of a foreseeable risk factor, an adverse regulatory ruling, soon after the plaintiffs acquired Interim does not necessarily mean that the plaintiffs received less than what they paid for. If Spherion could have in some way entirely eliminated the risk of an adverse audit, the parties’ Agreement would reflect this protection and the price for Interim most certainly would have been higher. The representations and warranties in the Agreement, however, reflect that the parties were fully aware that a Medicare audit could occur and that Spherion would bear the risk of that loss only in certain circumstances, e.g., if Spherion failed to file its cost reports in a manner consistent with its Medicare representations and warranties.300 The expectations of both parties, therefore, were shaped by the risks of which they were aware, and the allocation of those risks as expressed in their Agreement…………

[**106] Although plaintiffs purport to link their claim for expectancy damages to alleged breaches of the Agreement, 303 much of their argument suggests that Spherion in all instances must bear the risk of loss in this transaction. 304 All things being equal, if the Agreement did not contain a contractual allocation of risk, the plaintiffs’ argument might be received more favorably. But, in the shadow of the parties’ highly negotiated Agreement, after thorough due diligence, the plaintiffs sound much like an experienced gambler asking the pit boss to allow him to take his losing bet off the table after the roulette wheel has stopped spinning. Plaintiffs had ample opportunity to negotiate for a specific representation and warranty regarding the value of the company they were acquiring. No such warranty was given, however. To the contrary, Spherion constructed the Sale of Interim as an auction, prepared pro forma financial statements peppered with disclaimers, and opened Interim’s doors to Cornerstone for due diligence. Under these circumstances, plaintiffs’ reasonable expectancy must be tied to and limited by the express promises made to them in the Agreement.

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3.) **Earn-out Payments**

**WALTER A. WINSHALL,** in his capacity as the Stockholders' Representative, Plaintiff, v. **VIACOM INTERNATIONAL, INC.,** a Delaware Corporation, and **HARMONIX MUSIC SYSTEMS, INC.,** a Delaware Corporation, Defendants.

Civil Action No. 6074-CS

**COURT OF CHANCERY OF DELAWARE, NEW CASTLE**

*55 A.3d 629; 2011 Del. Ch. LEXIS 168*

August 18, 2011, Submitted
November 10, 2011, Decided
November 10, 2011, Filed

I. **Introduction**

This is a dispute over earn-out payments. In 2006, defendant Viacom International, Inc., a media conglomerate whose portfolio includes such brands as MTV and Nickelodeon, acquired defendant Harmonix Music Systems, Inc., a company best known for creating the music-oriented video games *Rock Band* and *Guitar Hero* (the "Merger"). Under a merger agreement entered into by Viacom, Harmonix and the selling stockholders of Harmonix (the "Selling Stockholders"), including the plaintiff, Walter A. Winshall, as the representative of the Selling Stockholders (the "Merger Agreement"), Viacom promised the Selling Stockholders [***2] an up-front payment of $175 million for their shares, as well as the contingent right to receive uncapped earn-out payments based on Harmonix's financial performance in the two years following the Merger, 2007 and 2008.

About one year after the Merger closed, Harmonix released a new video game, *Rock Band,* which was an immediate success. Harmonix had already entered into an agreement with Electronic Arts, Inc. ("EA") for the distribution of *Rock Band* through March 2010, but the game's popularity caused EA to want to renegotiate the contract in order to gain a broader scope of rights to *Rock Band* and its sequels. Because of EA's interest in amending the distribution agreement, Harmonix and Page 1 Viacom allegedly had an opportunity to negotiate for an immediate reduction in distribution fees that would have potentially increased the Selling Stockholders' earn-out payments for 2008. But, at the direction of Viacom, Harmonix did not amend its contract with EA so as to immediately reduce its distribution fees. Rather, [*631] Harmonix and EA's amended agreement involved a reduction in distribution fees in upcoming years, after the expiration of the earn-out period. The revised contract granted EA a number [***3] of important new rights having nothing to do with EA's already firm right to distribute *Rock Band* during 2008. These new rights included a clarification of EA's distribution rights to *Rock Band* sequels, an expansion of EA's distribution rights to cover *Rock Band* products made for handheld gaming devices, and an obligation on the part of Harmonix to release *The Beatles: Rock Band* or a comparable product during the term of the distribution agreement with EA.

Winshall sued Viacom and Harmonix on behalf of the Selling Stockholders, alleging that Viacom and Harmonix purposefully renegotiated the distribution contract with EA so as to reduce the earn-out payments payable to the Harmonix stockholders, and thus breached the covenant of good faith and fair dealing implied in the Merger Agreement. I dismiss Winshall's claim.
Winshall would have me imply a duty on the part of Viacom and Harmonix to take any opportunity during the earn-out period to increase the earn-out payment for 2008, regardless of whether that opportunity was offered to Viacom and Harmonix in exchange for granting the counterparty rights to future assets in which the recipients of the earn-outs had no reasonable expectancy [*4] interest. Even assuming that Viacom and Harmonix intentionally forewent a possible opportunity to increase Harmonix's profits during the earn-out period, and structured the amended contract with EA so that Viacom and Harmonix could enjoy all of the benefits for themselves, Viacom and Harmonix took no steps to reduce any reasonable contractual expectation of the Selling Stockholders. It would be inequitable for this court to imply a duty on Viacom and Harmonix's part to share with the Selling Stockholders the benefits of a renegotiated contract addressing EA's right to distribute Harmonix products after the expiration of the earn-out period. The implied covenant of good faith and fair dealing is not a license for a court to make stuff up, which is what Winshall seeks to have me do.

IV. Legal Analysis

Under Delaware law, an implied covenant of good faith and fair dealing inheres in every contract. 25 The implied covenant "requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain." 26 A party is liable for breaching the covenant when its conduct "frustrates the overarching purpose of the contract by taking advantage of [its] position to control implementation of the agreement's terms." 27

The court must be mindful that the implied covenant of good faith and fair dealing should not be applied to give plaintiffs [*637] contractual protections that "they failed to secure for themselves at the bargaining table." 28 In other words, the implied covenant is not a license to rewrite contractual language just because the plaintiff failed to negotiate for protections that, in hindsight, would have made the contract a better deal. 29 Rather, a party may only invoke the protections of the covenant when it is clear from the underlying contract that "the contracting parties would have agreed to proscribe the act later complained of . . . had they thought to negotiate with respect to that matter." 30

Winshall argues that, because Viacom and Harmonix had the market power to renegotiate the Original EA Agreement, and because an opportunity presented itself whereby the amount of the 2008 earn-out payment could be increased, Viacom and Harmonix had an implied obligation under the Merger Agreement to take that opportunity. I find that Winshall has failed to allege facts that support a reasonable inference that the Selling Stockholders did not get the benefit [**23] of their bargain under the Merger Agreement. On these facts, even viewed in the light most favorable to Winshall, the Selling Stockholders could not conceivably have had a reasonable expectation that Viacom and Harmonix had a duty to renegotiate the Original EA Agreement to increase the amount of earn-out payments the Selling Stockholders would receive.

A. Winshall Has Not Alleged Facts To Support A Claim For Breach Of The Implied Covenant Of Good Faith And Fair Dealing

Keeping in mind the standard of review that I must apply at the motion to dismiss stage, I assume for purposes of this decision that, when faced with a chance to renegotiate the EA Agreement so as to either maximize the earn-out payments owed to the Selling Stockholders or so as to confer a benefit on themselves, Viacom and Harmonix chose the latter course. I also assume that, although the Original EA Agreement was not amended until October 2008, EA offered either a reduction in distribution fees for the remainder of 2008, or a retroactive reduction in distribution fees that would have covered all or part
of 2008. Winshall does not plead that the fee reduction offered by EA would have had any effect on the 2007 earn-out [**24] payment. Essentially, there was a contractual surplus available to be had because of the opportunity presented by EA’s desire to enter into a broader, more thorough agreement with Harmonix. The dispute here boils down to whether Viacom and Harmonix’s decision to take this surplus for themselves rather than use some of it to increase the potential payments to be made to the Selling Stockholders constituted a breach of the implied duty of good faith and fair dealing under the Merger Agreement.

[*638] I find that Winshall’s already tenuous argument buckles in light of two factors: (i) although Viacom and Harmonix did not accept a reduction in 2008 distribution fees, neither did they take action to increase the 2008 fees beyond what was expected under the Original EA Agreement; and (ii) it is not conceivable that the benefits conferred on Viacom and Harmonix by the renegotiation were offered in exchange for product sales in which the Selling Stockholders had a valid expectancy interest

V. Conclusion

For the foregoing reasons, Viacom and Harmonix’s motion to dismiss is GRANTED. IT IS SO ORDERED
Speaker Biographies
Presentation Merger and Acquisition (M&A) Litigation: Current Issues and Trends

Scott Meza
Greenberg Traurig, LLP
McLean, VA

Maria Kreiter
Godfrey & Kahn S.C.
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Merger and Acquisition (M&A) Litigation: Current Issues and Trends

ABA Section of Litigation
Section Annual Conference
April 25, 2013

Joseph S. Estabrook, CPA/ABV/CFF, ASA – Invotex
Maria L. Kreiter, Esquire – Godfrey Kahn, S.C.
Scott Meza, Esquire – Greenberg Traurig
Peter L. Simmons, Esquire – Fried Frank
Merger and Acquisition (M&A) Litigation: Current Issues and Trends

- With the expectation that M&A deals will rebound in 2013, the panel will discuss the current environment of M&A litigation and relevant court rulings. The discussion will also focus on the dynamics of the deal, expectations of strategic buyers versus financial buyers, disputes over representations, warranties and covenants, disputes over valuation and related issues, anticipating and managing risks of post deal disputes and applicability of damages during litigation.
Current Environment for M&A Deals

• Even though deal value decreased four percent from 2011, deal activity is expected to be greater in 2013.¹ With corporations flush with record levels of cash, ongoing access to capital and financing, low interest rates in the marketplace, and strong balance sheets, there is optimism that deals in 2013 will increase.

Current Environment for M&A Deals

- KPMG and SourceMedia conducted a survey of more than 300 M&A professionals at U.S. Corporations, private equity firms (PE), and investment funds. “Seventy-six percent of respondents said they expected their companies to make at least one acquisition in 2013.”

Current Environment for M&A Deals

Optimism on Deal Environment

- Significantly more optimistic
- More optimistic
- About the same
- Less optimistic
- Significantly less optimistic

Source: KPMG 2013 M&A Outlook Survey
Current Environment for M&A Deals

Factors Facilitating Deal Activity

- Large cash reserves/commitments
- Availability of credit on favorable terms
- Opportunities in emerging markets
- Improved consumer confidence
- Resolution of European economic crisis
- Improving equity markets
- Improved employment numbers
- Recovery of financial services sector
- Other

Source:
KPMG 2013 M&A Outlook Survey
Current Environment for M&A Deals

Primary Deal Motivators

- Expand geographic reach
- Financial buyer looking for profitable operations and/or gain on exit
- Enter into new lines of business
- Expand customer base
- Introduce new products
- Deploy capital
- Enhance intellectual property
- Other
- Bring in-house another function in the supply chain

Source:
KPMG 2013 M&A Outlook Survey
Current Environment for M&A Deals

**Deal Size Stays Small**

- Less than $250 million: 80%
- $250 million to $499 million: 20%
- $500 million to $999 million: 5%
- $1 billion to $5 billion: 3%
- Greater than $5 billion: 2%

*Source: KPMG 2013 M&A Outlook Survey*
Current Environment for M&A Deals

Factors Inhibiting Deal Activity

- Recessionary fears/slow growth environment
- Uncertainty surrounding tax code changes
- Concerns about European economic situation
- Regulatory considerations
- Lack of suitable opportunities
- Availability and/or cost of debt financing
- Effect of unemployment on consumer demand
- Stock price volatility
- Other

Source:
KPMG 2013 M&A Outlook Survey
Dynamics and Life Cycle of a Deal

• **Strategy Development**
  - Development of an acquisition strategy
  - Identification of a target
  - Initial negotiation of deal terms and letter of intent
  - Consideration of risks
    - Valuation risk
    - Financial risk
    - Operating risk

• **Due Diligence**
  - This would include legal, financial and tax due diligence
    - Additional areas would include sales and marketing, facilities, human resources, environmental, regulatory compliance and anti-corruption due diligence
Dynamics and Life Cycle of a Deal

- Negotiations and Structuring the Transaction
  - Execution of the transaction agreement
  - Factors taken into consideration include:
    - Legal structure
    - Representations and warranties
    - Indemnification provisions
    - Continuity of management
    - Real Estate and non-business related assets
    - Consideration, which can include cash, stock and/or contingent payouts
    - Financing of the transaction
    - Adjustments to purchase price for results of operations between the execution of the agreement and the actual closing date
Dynamics and Life Cycle of a Deal

- Post Closing and Integration
  - Proper planning and integration of business processes and system to assure success
    - A lot of M&A deals do not reach their potential or fail because improper post closing integration
  - Purchase Price Adjustments
Expectations of Strategic Buyers vs. Financial Buyers

- Strategic buyers are typically operating companies that are interested in target companies that can be strategically integrated into the buyer company. Their goal is to enhance their existing operations to increase their bottom line and increase shareholder value.
Expectations of Strategic Buyers vs. Financial Buyers

Reasons for strategic acquisitions can include the following:

- Elimination of competition
- Vertical integration
  - Different points on the supply chain
- Horizontal integration
  - Supply new or similar product lines or enter new geographic markets
- Enhancing internal weaknesses
  - Research and development, marketing, technology, expertise
Expectations of Strategic Buyers vs. Financial Buyers

- **Strategic Buyers**
  - Take advantage of synergistic benefits immediately realized through consolidating operations, eliminating overhead, economies of scale
  - Combined company has greater access to capital
  - Long-term investment horizon
  - Willing to pay premium for synergies
Expectations of Strategic Buyers vs. Financial Buyers

- **Financial Buyers**
  - Include: venture capitalists, private equity firms, hedge funds, family investment offices
  - Identify companies with strong management, attractive earnings growth, future growth opportunities, competitive advantages
  - Leverage as high as 80%
  - Leveraging allows financial buyers to invest in multiple target companies
  - Lender will typically accept lending a lower rate of return than what financial buyer expects, but requires options and/or warrants to compensate for additional risk of leveraged transaction
Expectations of Strategic Buyers vs. Financial Buyers

- Financial Buyers (cont.)
  - Not willing to pay premium as they cannot take advantage of synergies available to strategic buyer
  - Financial buyer is buying expected future cash flows of the company
  - Fundamental goals that differ between financial buyer and strategic buyer will impact sales process, structure and outcome of transaction
Disputes Over Representations, Warranties and Covenants

- **Representations and Warranties**
  - Statement of fact made to each party to allocate risk between the parties
  - Representations are made by both the buyer and the seller
  - Representations and warranties serve to:
  - Help the buyer fully understand the business
  - Set conditions for the parties’ obligations to close the deal
    - For example, a party can terminate the deal prior to closing if it finds there has been a material change in facts
  - Enable’s the buyer to recover damages if the seller makes an inaccurate representation
Disputes Over
Representations, Warranties and Covenants

• Representations and Warranties (cont.)
  • Seller’s representations and warranties may cover areas including:
  • Financial reporting and accounting
  • Examples may include:
    • Financial statements are accurate and have been prepared in accordance with accepted accounting standards (i.e. GAAP, IFRS, Statutory Standards)
  • No undisclosed liabilities exist, and no contingent liabilities exist that have not already been disclosed to buyer
  • Purchase price adjustment issues for closing
  • Other issues may include: tax, capitalization, intellectual property, compliance with the law, employment (including ERISA), material contracts
  • Escrow accounts or insurance may be used to reduce risk to buyer
Disputes Over Representations, Warranties and Covenants

- Covenants
  - Enforceable “Promises”
  - May include things such as:
    - How seller will and will not operate the business until closing (including promise that seller will not sell assets between signing and closing)
    - Specific actions the parties will take to close the transaction
    - Seller’s promise to inform buyer if conditions change in ways that contradict its representations or warranties
    - May provide buyer with the right to conduct additional due diligence
    - From buyer’s perspective, covenants are important as they provide a way to reduce risk that the seller may decrease the value of the entity being purchased prior to closing
Disputes Over Representations, Warranties and Covenants

- **Indemnification**
  - Relates to breaches by the buyer and seller of representations, warranties or covenants
    - For example, undisclosed liabilities
  - Seller agrees to indemnify the buyer for any losses, damages and expenses
  - In the event there is a breach, the buyer may be entitled to damages suffered
  - Ambiguous language in the transaction documents may be a focus in litigation
    - For example, a covenant may be included by the seller that no material adverse change will occur in the business through the date of closing
      - Unless the contract specifically defines such change, it may be hard for buyer to prove
Disputes Over Valuation Issues

Valuation Approaches and Methodologies

- Income Approach
  - Discounted Cash Flow (DCF) Method
  - Single Period Capitalization of Earnings Method
- Market Approach
  - Guideline Public Company Method
  - Guideline Transactions Method
- Asset-Based (Cost) Approach
Disputes Over Valuation Issues

From a practical standpoint, the prospective buyer typically employs one or a combination of these methodologies:\(^1\):

- Applying a multiple of earnings or cash flows (typically EBITDA)
- Measuring the fair value of assets
- Estimating the value based on amounts paid in other comparable transactions
- Calculating a value or adjusting the value based on information regarding potential synergies with a buyer’s existing businesses

Disputes Over Valuation Issues

- Buyer will select purchase price based on latest available financial information and projected earnings
  - Financial information relied upon will be different from financial information as of closing date
  - Post-closing adjustment provision is included to account for any changes
    - Requires either buyer or seller to prepare closing statement
    - Buyer will pay more if value of relevant purchase price adjustment has increased during pre-closing period; buyer will pay less if the value has decreased
Post-Deal Disputes

Most common post-deal disputes include:

- Claims of material adverse change
- Earn-out Disputes (both the buyer and seller share the risk)
- Post-closing adjustments for working capital or net assets
- Indemnity or fraud claims
Post-Deal Disputes – Material Adverse Change

- Sellers’ promise that no material adverse change will occur in the business through date of closing protects buyer in event of a significant decline in business value
- Examples of material adverse changes may include:
  - Loss of a significant customer, contract, or supplier
  - Litigation in which the company is being sued for violation of patent rights
Post-Deal Disputes – Material Adverse Change

- Buyer’s find it difficult to prove and that had it been known it would have impacted the buyer’s decision to pay the agreed upon price or purchase the company all together.

- Factors that are considered when determining whether an event qualifies as a material adverse change may include:
  - Impact of the event on the company
  - Duration of the time period in which the company was impacted
  - Whether other companies in the industry were also affected and to what extent
  - Whether the seller knew of the event prior to entering into the transaction
Post-Deal Disputes – Earn-outs

- Earn-out clauses used to align financial interests of buyer, who doesn’t want to pay more than a specified price, and seller, who wants to maximize selling price
- With an earn-out, a portion of consideration paid for company is based upon company’s ability to achieve certain future milestones
- Earn-out period typically lasts 1 – 3 years
Post-Deal Disputes – Earn-outs

Earn-out Disputes – Seller’s Perspective:

- Buyer controls company after closing and may make decision that seller disagrees with or that differ from what company has done historically. Seller may view these decisions at intent by buyer to reduce earn-out payment due to seller.

- Risk can be mitigated during earn-out period if seller requires buyer to operate company in a way consistent with past.
  - Seller may also request authority to vote on major decisions impacting company until earn-out period has terminated.
Post-Deal Disputes – Earn-outs

Earn-out Disputes – Buyer’s Perspective:

- May be difficult to make operational changes if seller is still involved in management of company.
- In these instances, seller with earn-out provisions will have strong incentive to focus on short-term goals that will maximize the earn-out and may increase business risk.
- Buyer (long-term investor) will want to manage company to produce long-term, sustainable growth.
- Buyer can mitigate risk by putting controls in place to review and monitor decisions made by seller during earn-out period.
Earn-out Disputes – Earnings Benchmarks:

- May be financial, non-financial or both
- If buyer integrates acquired company into its other businesses, it may become difficult to evaluate performance of company on a stand-alone basis
  - Risk can be mitigated if seller requires buyer to operate business as a separate entity during the length of the earn-out period
- If earn-out benchmark includes multiple components, dispute may arise as to whether seller is entitled to some portion of payout if the buyer partially achieves the benchmark.
  - Risk can be mitigated by putting in place a minimum hurdle after which earn-out payments may be made on a sliding scale or pro rata basis
Post-Deal Disputes – Earn-outs

Earn-out Disputes – Earnings Benchmarks (cont.):

- Earnings benchmarks based on financial metrics often include EBIT and EBITDA; disputes may arise as to whether or not metrics should include unusual or extraordinary expenses or income
  - For example, should these calculations include integration expenses from the transaction, restructuring expenses such as inventory write-offs or bad debt expenses, or a large settlement awarded to the company from a pending litigation
- Changes in accounting guidance that impact the calculation of the earn-out may also be source of dispute
Post-Deal Disputes – Post-Closing Adjustments

- Buyer is paying for what company is worth on day transaction is closed
- Purchase prices are negotiated based on most recent financial statements available at that time, which is different than financial statements as of transaction closing date
- Post-closing adjustments are made to purchase price to account for differences in company’s financial statements between date transaction agreement is entered into and closing date of transaction
- Working capital and net assets are most common items requiring post closing adjustments
Post-Deal Disputes – Post-Closing Adjustments

Working Capital Adjustments:

- Occur within a few months of closing
- Compare actual working capital at closing against target level of working capital
  - Target level is based on historical working capital requirements and is meant to represent company’s normalized working capital requirements
Post-Deal Disputes – Post-Closing Adjustments

Working Capital Adjustments:

- Provides protection for both buyer and seller
- From seller’s perspective: purpose is to ensure they are receiving adequate consideration for company’s assets
- From buyer’s perspective: purpose is to ensure that after closing, company has adequate working capital to continue operations and meet liabilities
  - Also provides assurance to buyer that seller didn’t accelerate collection of receivables or delay buying inventory and paying liabilities in order to create inflated cash balance on closing date
Post-Deal Disputes – Post-Closing Adjustments

- Disputes include:
  - Historical accounting methods used by seller vs. accepted accounting methodologies
  - Accounting methods that may not have been applied consistently to all historical periods under consideration
  - Interim financial statements used in negotiation of purchase price versus adjusted year-end financial statements
- Risk of post-closing adjustments can be mitigated by permitting adjustments to be made only if they are material, which can be defined as exceeding a specified aggregate dollar amount
Insights and Observations regarding Merger and Acquisition 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
- Require extensive third party due diligence
- Insist on complete access to all relevant documents
- If possible, rely on 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

¹The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys (Business Valuation Resources is the copyright holder and the copyrighted material was reproduced with BVR’s written permission).
Factors a buyer should consider to minimize risk (cont.):

- Obtain representations regarding key valuation assumptions
- Obtain specific representations for high-risk accounting areas (i.e. inventories are in a saleable/good condition)
- Scrutinize accounting estimates for key areas (i.e. warranty reserves, allowance for doubtful accounts)
- Maximize indemnity claim caps; no cap on claims related to fraud
- Minimize basket threshold; maximize escrow

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1The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys (Business Valuation Resources is the copyright holder and the copyrighted material was reproduced with BVR’s written permission).
Insights and Observations regarding Merger and Acquisition Disputes

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

- If known departures from GAAP exist, consider “carving out” troubling accounts (i.e. for inventories, insist on past practice)
- Limit the buyer’s ability to make working capital claims in the indemnification proceeding
- Avoid nondisclosures that could lead to fraud claims
- Limit damages to dollar-for-dollar; maximize the basket for damages; and insist on cap on indemnification recoveries

¹The Comprehensive Guide to Lost Profits Damages for Experts and Attorneys (Business Valuation Resources is the copyright holder and the copyrighted material was reproduced with BVR’s written permission).
Applicability of Damages During Litigation

Damages in M&A litigation are typically based on the Benefit of the Bargain rule.

“The benefit of the bargain rule is a principle that any party who breaches a contract must pay the aggrieved party an amount that puts that person in the same financial position that would have resulted if the contract had been fully performed. It also refers to the principle that a defrauded buyer may recover from the seller as damages the difference between the misrepresented value of the property and the actual value received.”

1USLegal.com.
Applicability of Damages During Litigation

Damages are typically calculated using two methods, the “dollar for dollar” approach and the “multiple of earnings approach”\(^1\)

- Dollar for Dollar Method — if damages are based on accounting adjustments, this method would adjust the purchase price by the exact amount of the accounting adjustment
- Multiple of Earnings Approach — adjustment to the purchase price is based on multiplying the accounting adjustment by the earnings multiplier that was used in establishing the purchase price

Plaintiffs (Hexion), the buyer corporation in a merger agreement and an equity group (Apollo) that owned most of the buyer, brought a declaratory judgment action against defendant seller corporation (Huntsman). The seller filed counterclaims, including one for specific performance. The court held a trial on certain of the claims for declaratory and injunctive relief.
2007 Negotiations Leading to July 12, 2007 Merger Agreement

- In May 2007, Huntsman, through its financial advisor Merrill Lynch & Co., Inc., [*724] began to solicit bids for the company. On July 12, 2007 Huntsman signed an all cash deal at $28 per share with Hexion (a $10.6 billion deal)
July 12, 2007 Merger Agreement

- Huntsman had significant negotiating leverage and as a result, the merger agreement is more than usually favorable to Huntsman.
- It contained no financing contingency and requires Hexion to use its “reasonable best efforts” to consummate the financing.
- In addition, the agreement expressly provides for uncapped damages in the case of a “knowing and intentional breach of any covenant” by Hexion and for liquidated damages of $325 million in cases of other enumerated breaches.
- The narrowly tailored MAE clause is one of the few ways the merger agreement allows Hexion to walk away from the deal without paying Huntsman at least $325 million in liquidated damages.
Case Law – Material Adverse Affect

April 22, 2008: Huntsman Reports Poor First Quarter of 2008

• After receipt of Huntsman’s disappointing first quarter numbers on April 22, 2008, Apollo (Hexion) revised its deal model and concluded that the transaction would produce returns much lower than expected.
• At this time, Apollo also questioned whether Huntsman had experienced an MAE as defined in the merger agreement.
Apollo’s May 9, 2008 Meeting with Counsel

- On May 9, 2008, Apollo met with counsel to discuss, among other things, whether an **material adverse effect** (MAE) had occurred.

- After its May 9, 2008 meeting with counsel, perhaps realizing that an MAE argument was not strong, Apollo and its counsel began focusing on insolvency.

- However, under the merger agreement, Hexion had no right to terminate the agreement based on potential insolvency of the combined company or due to lack of financing.

- Also, Hexion would be subject to full contract damages if it “knowingly and intentionally” breached any of its covenants.

- Therefore, it appears that after May 9, 2008, Apollo and its counsel began to follow a carefully designed plan to obtain an insolvency opinion, publish that opinion (which it knew, or reasonably should have known, would frustrate the financing), and claim Hexion did not “knowingly and intentionally” breach its contractual obligations to close (due to the impossibility of obtaining financing without a solvency certificate).
Case Law – Material Adverse Affect

Huntsman Has Not Suffered a MAE

- For the purpose of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting.

- In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy.

- The important consideration therefore is whether there has been an adverse change in the target’s business that is consequential to the company’s long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months.

- In the face of the overwhelming evidence of no MAE, it was the court’s firm conclusion that by June 19, 2008 Hexion had knowingly and intentionally breached its covenants and obligations under the merger agreement.
Huntsman Has Not Suffered a MAE (cont).

- To the extent that it is at some later time necessary for this court to determine damages in this action, any damages which were proximately caused by that knowing and intentional breach will uncapped and determined on the basis of standard contract damages or any special provision in the merger agreement.

- Because of the difficulty in separating out causation of damages in such an action, the burden will be on Hexion to demonstrate that any particular damage was not proximately caused by its knowing and intentional breach.

- To the extent Hexion can make such a showing, those damages which were not proximately caused by Hexion’s knowing and intentional breach will be limited to the liquidated damages amount of $325 million, pursuant to section 7.3(d) of the merger agreement.
Case Law – Material Adverse Affect

Conclusion

- The court first rejected the buyer’s argument that its obligation to close the merger was excused because of a material adverse effect (MAE) in the seller’s business. The burden of proof with respect to an MAE rested on the party seeking to excuse its performance under the contract, and the evidence did not show that the seller had suffered an MAE as defined in the merger agreement.

- Next, the buyer had engaged in a knowing and intentional breach of the merger agreement; therefore, the liquidated damages clause in the agreement was inapplicable.

- A “knowing and intentional” breach, as used in the merger agreement, was the taking of a deliberate act, which act constituted in and of itself a breach of the merger agreement, even if breaching was not the conscious object of the act.
Case Law – Material Adverse Affect

Conclusion (cont).

- Next, the court declined to reach the issue of whether the combined entity would be insolvent, as the issue was not ripe for a judicial determination.
- Finally, the merger agreement did not allow the seller to specifically enforce the buyer’s duty to consummate the merger. It was appropriate, however, to require the buyer to specifically perform its other obligations under the merger agreement.
- The court granted the seller’s (Huntsman) request for an order specifically enforcing the buyer’s contractual obligations to the extent permitted by the merger agreement itself. It held that the seller was not entitled to specifically enforce the buyer’s duty to consummate the merger. It held that the issue of the solvency of the combined entity was not ripe for decision.
Interim Healthcare v. Spherion Corp.
Superior Court of Delaware, New Castle
July 20, 2004 Submitted; February 4, 2005, Decided
C.A.No. 00C-09-180-JRS (consolidated)
**Reporter:** 884 A.2d 513; 2005 Del. Super. LEXIS 32; 2005 WL 280225
Introduction

- This lawsuit involves claims arising from alleged breaches of an intensely negotiated stock purchase agreement for the sale of Interim Healthcare, Inc. (“Interim”) by defendant, Spherion Corporation (“Spherion”), to plaintiffs, Catamaran Acquisition Corp. (“Catamaran”) and Cornerstone Equity Investors, IV L.P. (“Cornerstone”) (the transaction will be referred to hereinafter as “the Sale”).

- The plaintiffs, Interim (as acquired), Catamaran and Cornerstone, allege that Spherion breached several representations and warranties in the Agreement by

- Failing to adequately disclose numerous pre-Sale liabilities of Interim and by misrepresenting the financial condition of Interim in the financial statements supplied to the plaintiffs during due diligence.

- Plaintiffs seek damages under the indemnification provisions of the Agreement and also seek expectancy/benefit-of-the-bargain damages for the difference between what they paid for Interim and the actual value of Interim at the time of the Sale.

- They claimed they were denied the benefit of their bargain with the seller, as they purchased a company the seller represented was worth approximately $134 million when, in fact, it was worth only $90 million.
Case Law – Representations and Warranties
Benefit of the Bargain/Expectancy Damages

Courts Analysis

• “At its essence, plaintiffs’ claim appears to rest on the circular proposition that Interim was worth $134 million because that is what the plaintiffs paid for it. While that logic may apply to a commodity the total value of which can be realized immediately through use or sale – a barrel of oil, for example -- it does not hold true in the sale of a going concern”.

• “In a free market economy, all businesses operate under the constant risk of declining profits caused by an infinite panoply of market factors. The emergence of a superior competing product, an adverse regulatory ruling, and the unexpected insolvency of a major customer are but a few examples”.

• “Market risks also work in the opposite direction; the insolvency of, or a regulatory ruling against a major competitor, for example, may provide windfall profits. The presence of these market factors -- more prevalent in some industries (like healthcare) than others -- must be taken into consideration when attempting to measure a firm’s value. Even then, the process is by no means an “exact science.”
Courts Analysis (cont.)

- “Although plaintiffs purport to link their claim for expectancy damages to alleged breaches of the Agreement, much of their argument suggests that Spherion in all instances must bear the risk of loss in this transaction. All things being equal, if the Agreement did not contain a contractual allocation of risk, the plaintiffs’ argument might be received more favorably”.

- But, in the shadow of the parties’ highly negotiated Agreement, after thorough due diligence, the plaintiffs sound much like an experienced gambler asking the pit boss to allow him to take his losing bet off the table after the roulette wheel has stopped spinning”.

- “Plaintiffs had ample opportunity to negotiate for a specific representation and warranty regarding the value of the company they were acquiring. No such warranty was given, however. To the contrary, Spherion constructed the Sale of Interim as an auction, prepared pro forma financial statements peppered with disclaimers, and opened Interim’s doors to Cornerstone for due diligence”.

- “Under these circumstances, plaintiffs’ reasonable expectancy must be tied to and limited by the express promises made to them in the Agreement”.
Case Law – Representations and Warranties
Benefit of the Bargain/Expectancy Damages

Conclusion

- The court found that in the absence of proof by a preponderance of the evidence that the seller breached a promise in the agreement in a manner that materially affected the healthcare corporation’s value at the time of sale, the court would not award expectancy damages.
- The healthcare corporation’s methodology to allocate operational costs was not improper.
- Plaintiffs’ claims that the healthcare corporation maintained its financial records in a manner that violated the agreement were unsupported.
- The seller did breach the agreement by failing to disclose persistent pre-sale threats of litigation against the healthcare corporation, and plaintiffs were entitled to indemnification for losses associated with a therapy student program.
Case Law – Earn-out Payments

WALTER A. WINSHALL, in his capacity as the Stockholders' Representative, Plaintiff, v. VIACOM INTERNATIONAL, INC., a Delaware Corporation, and HARMONIX MUSIC SYSTEMS, INC., a Delaware Corporation, Defendants.

Civil Action No. 6074-CS

COURT OF CHANCERY OF DELAWARE, NEW CASTLE

55 A.3d 629; 2011 Del. Ch. LEXIS 168

August 18, 2011, Submitted
November 10, 2011, Decided
November 10, 2011, Filed
Introduction

- This is a dispute over earn-out payments. In 2006, defendant Viacom International, Inc., a media conglomerate whose portfolio includes such brands as MTV and Nickelodeon, acquired defendant Harmonix Music Systems, Inc., a company best known for creating the music-oriented video games Rock Band and Guitar Hero (the "Merger").

- Under a merger agreement entered into by Viacom, Harmonix and the selling stockholders of Harmonix (the "Selling Stockholders"), including the plaintiff, Walter A. Winshall, as the representative of the Selling Stockholders (the "Merger Agreement"), Viacom promised the Selling Stockholders an up-front payment of $175 million for their shares, as well as the contingent right to receive uncapped earn-out payments based on Harmonix's financial performance in the two years following the Merger, 2007 and 2008.

- About one year after the Merger closed, Harmonix released a new video game, Rock Band, which was an immediate success.

- Harmonix had already entered into an agreement with Electronic Arts, Inc. ("EA") for the distribution of Rock Band through March 2010, but the game's popularity caused EA to want to renegotiate the contract in order to gain a broader scope of rights to Rock Band and its sequels.
Case Law – Earn-out Payments

Introduction (cont.)

- Because of EA's interest in amending the distribution agreement, Harmonix and Viacom allegedly had an opportunity to negotiate for an immediate reduction in distribution fees that would have potentially increased the Selling Stockholders' earn-out payments for 2008.

- But, at the direction of Viacom, Harmonix did not amend its contract with EA so as to immediately reduce its distribution fees. Rather, Harmonix and EA's amended agreement involved a reduction in distribution fees in upcoming years, after the expiration of the earn-out period.

- The revised contract granted EA a number of important new rights having nothing to do with EA's already firm right to distribute Rock Band during 2008. These new rights included a clarification of EA's distribution rights to Rock Band sequels, an expansion of EA's distribution rights to cover Rock Band products made for handheld gaming devices, and an obligation on the part of Harmonix to release The Beatles: Rock Band or a comparable product during the term of the distribution agreement with EA.

- Winshall sued Viacom and Harmonix on behalf of the Selling Stockholders, alleging that Viacom and Harmonix purposefully renegotiated the distribution contract with EA so as to reduce the earn-out payments payable to the Harmonix stockholders, and thus breached the covenant of good faith and fair dealing implied in the Merger Agreement.
Case Law – Earn-out Payments

Illegal Analysis

- Under Delaware law, an implied covenant of good faith and fair dealing inheres in every contract. The implied covenant "requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the bargain."

- A party is liable for breaching the covenant when its conduct "frustrates the overarching purpose of the contract by taking advantage of [its] position to control implementation of the agreement's terms."

- The court must be mindful that the implied covenant of good faith and fair dealing should not be applied to give plaintiffs contractual protections that "they failed to secure for themselves at the bargaining table."

- In other words, the implied covenant is not a license to rewrite contractual language just because the plaintiff failed to negotiate for protections that, in hindsight, would have made the contract a better deal.

- Rather, a party may only invoke the protections of the covenant when it is clear from the underlying contract that "the contracting parties would have agreed to proscribe the act later complained of . . . had they thought to negotiate with respect to that matter."
Case Law – Earn-out Payments

Conclusion

- “Winshall argues that, because Viacom and Harmonix had the market power to renegotiate the Original EA Agreement, and because an opportunity presented itself whereby the amount of the 2008 earn-out payment could be increased, Viacom and Harmonix had an implied obligation under the Merger Agreement to take that opportunity”

- “I find that Winshall has failed to allege facts that support a reasonable inference that the Selling Stockholders did not get the benefit of their bargain under the Merger Agreement. On these facts, even viewed in the light most favorable to Winshall, the Selling Stockholders could not conceivably have had a reasonable expectation that Viacom and Harmonix had a duty to renegotiate the Original EA Agreement to increase the amount of earn-out payments the Selling Stockholders would receive.”

- “I find that Winshall's already tenuous argument buckles in light of two factors: (i) although Viacom and Harmonix did not accept a reduction in 2008 distribution fees, neither did they take action to increase the 2008 fees beyond what was expected under the Original EA Agreement; and (ii) it is not conceivable that the benefits conferred on Viacom and Harmonix by the renegotiation were offered in exchange for product sales in which the Selling Stockholders had a valid expectancy interest”
Case Law – Earn-out Payments

Conclusion (cont.)

- “Winshall would have me imply a duty on the part of Viacom and Harmonix to take any opportunity during the earn-out period to increase the earn-out payment for 2008, regardless of whether that opportunity was offered to Viacom and Harmonix in exchange for granting the counterparty rights to future assets in which the recipients of the earn-outs had no reasonable expectancy interest”.

- “Viacom and Harmonix took no steps to reduce any reasonable contractual expectation of the Selling Stockholders. It would be inequitable for this court to imply a duty on Viacom and Harmonix's part to share with the Selling Stockholders the benefits of a renegotiated contract addressing EA's right to distribute Harmonix products after the expiration of the earn-out period. The implied covenant of good faith and fair dealing is not a license for a court to make stuff up, which is what Winshall seeks to have me do”.

- “I dismiss Winshall's claim. For the foregoing reasons, Viacom and Harmonix's motion to dismiss is GRANTED. IT IS SO ORDERED”.
Questions?