Measuring Damages in an M&A Dispute

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Agenda

- Determining the Purchase Price
- Types of Claims
- Contractual Provisions Limiting Damages
- Determination of Damages
- Measuring Damages
- Case Study

Determining the Purchase Price

The Purchase Price

- Reflection of investment value specific to the transacting parties
- Reflects “bargained for”:
  - Anticipated stream of future earnings or cash flows; and
  - Balance sheet, working capital necessary to conduct operations in the normal course.
- Often incorporates buyer’s synergistic considerations

Purchase Price: Valuation Approaches

- Market approach (financial element x multiple)
  - Earnings measurement (*e.g.,* EBITDA) or balance sheet measure (*e.g.,* assets) depending on business
  - Multiple – Based on multiples used by guideline comparable companies
- Income approaches
  - Discounted cash flow (DCF) valuation
  - Required internal rate of return (IRR) based on DCF projection
- Cost approach
  - Not applicable in most deals

Types of Claims

Breach of Contractual Representations and Warranties

- Representations and warranties reflect allocation of risk between the parties
- No showing of fault or intentional conduct is required
- Contracts often provide for indemnification with respect to breach of a representation or warranty
- Indemnification provisions are often subject to limitations, which further reflect risk allocation between the parties

Misrepresentation and Fraud

- Claim is based in tort rather than contract
- Not seeking to enforce contract rights
- Typically requires *scienter* (*e.g.*, knowingly or recklessly disregarding that what was represented was false)
- Often asserted to avoid contractual limitations or as a basis for rescission of the contract

Misrepresentation and Fraud (cont.)

- Importance of an integration clause

  Progressive Int'l Corp. v. E.I. DuPont de Nemours & Co., 2002 Del. Ch. LEXIS 91 (Del. Ch. July 9, 2002)

- Interplay of contractual limitations and fraud claims

  ABRY Partners V, L.P. v. F&W Acquisition LLC, 891 A.2d 1032 (Del. Ch. 2006)

Contractual Provisions Limiting Damages

Contractual Limitations on Damages

- An agreement to limit damages or remedies must be clearly expressed
- Absent fraud, courts will generally respect the parties' allocation of risk with regard to damages
- Parties may agree to waive their right to certain types of damages, such as consequential or punitive damages

Contractual Limitations on Damages

- Limitations on amounts are usually included
  - Eligible claims (*de minimus)*
  - Baskets and thresholds
  - Caps/ceilings
  - Setoffs (*e.g.*, tax benefits, insurance proceeds)
- Limitations may be subject to carve outs (*e.g.*, knowing, intentional, fraud)

  Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008) ("knowing and intentional breach" is the taking of a deliberate act even if breaching was not the conscious object of the act)
- Losses/damages may be defined (*e.g.,* out of pocket, diminution in value)

Determination of Damages

Contract Damages

- Damage awards are generally designed to put the non-breaching party in the position it would have enjoyed had there been no breach
- Often referred to as "expectancy damages," which give the nonbreaching party the "benefit of the bargain"
  - *Damages* must be calculated with reasonable certainty and not be speculative
  - *Damages* must flow from the breach and be reasonably foreseeable

    Ivize of Milwaukee, LLC v. Compex Litig. Support, LLC, 2009 Del. Ch. LEXIS 55 (Del Ch. Apr. 27, 2009)

Expectancy Damages

- *Interim Healthcare, Inc. v. Spherion Corp.*, 884 A.2d 513 (Del. Super. Ct. 2005), *aff'd*, 886 A.2d 1278 (Del. 2005)
  - Buyer requested expectancy damages based on the difference between the purchase price of $134 million and the alleged value of $90 million
  - Buyer's reasonable expectancy must be tied to the express provisions of the contract
  - Court rejected buyer's request for expectancy damages as inconsistent with the agreed upon risk allocation

Expectancy Damages (cont.)

- *Cobalt Operating, LLC v. James Crystal Enterprises, LLC*, 2007 Del. Ch. LEXIS 108 (Del. Ch. July 20, 2007), *aff'd*, 945 A.2d 594 (Del. 2008)
  - Seller misrepresented its cash flows
  - Buyer relied on a cash flow multiple in determining the purchase price
  - Court awarded damages based on difference between price paid and value of the target as determined with actual cash flows

Tort Damages

- Damages are usually intended to compensate a party for its loss
- Damages must be reasonably related to the harm for which compensation is being awarded

Punitive or Exemplary Damages

- Intended to punish a wrongdoer and to deter similar conduct in the future
- The conduct must be outrageous or egregious
- Alleged bad faith or improper conduct generally must rise to the level of an independent tort, which itself would support an award of punitive damages

Measuring Damages

Benefit of the Bargain Damages

"The benefit of the bargain measure awards the plaintiff the difference between the gain had the misrepresentations been true and what the plaintiff actually received."[1]

[1] Litigation Services Handbook, Fourth Edition, 18.7

Assessing the Benefit of the Bargain

- Did the buyer receive the value represented by the seller?
- Were misstatements of the financial statement known to the buyer?
- If the seller misstated the financial statements, the buyer may not have received the benefit of its bargain.

Measuring Damages: Dollar-for-Dollar - Example #1

- Assumptions
  - $10 MM of undisclosed and unrecorded one-time liability associated with environmental remediation costs
  - Potential liability known to seller during negotiations, but not disclosed
  - Not probable/reasonably estimable at time of negotiations or at time of close
  - Purchase price of $750 MM
    - EBITDA of $150 MM
    - 5x Multiple

Measuring Damages: Dollar-for-Dollar – Example #1 (cont.)

- Observations on measuring damages:
  - Buyer did not contemplate these costs in its valuation
  - Based on fact pattern, non-recurring impact on future earnings
  - Appropriate measure of damages likely dollar-for-dollar to reflect gain Seller would have received “but for” misrepresentation/failure to disclose
  - Reduce purchase price by $10 MM to $740 MM
  - Buyer may claim its future projections were impacted and assert damages “at the multiple”

Measuring Damages: Benefit of the Bargain - Example #2

- Assumptions
  - Significant customer lost just prior to closing
  - Customer loss not disclosed to the buyer

Measuring Damages: Benefit of the Bargain – Example #2 (cont.)

- CPA should consider:
  - Value of the customers to the business (*i.e.* contribution margin, operating profit, or customer EBITDA)
  - Target company’s customer turnover rate
  - Can a lost customer be replaced?
  - Will loss impact only a few periods or extend into perpetuity?

Compare and Contrasting Arguments Regarding the Benefit of the Bargain Claims (Buyer's Perspective)

- Damages should be determined as the difference between what was bargained for and what was actually received
- Acquired a balance sheet and a future earnings stream (usually at an interim date)
- Entitled to damages based on material misstatements of the (interim) balance sheet and future earnings stream it acquired less any recovery in the working capital proceeding
- Asserts misstatements which can be shown to affect future periods which are likely recoverable at the valuation multiple
- Assert claims which are one time in nature, however, will claim that buyer's EBITDA projections were impacted and therefore, may be recoverable at the valuation multiple

Compare and Contrasting Arguments Regarding the Benefit of the Bargain Claims (Seller's Perspective)

- The buyer is limited to dollar-for-dollar damages only
- Irrespective of buyer's view that claims affect future periods or modify buyer's EBITDA projections, seller will generally argue that the buyer is only entitled to dollar-for-dollar damages
- In some instances, seller may agree that claim is subject to only an adjustment of the first year of buyer's projections
- The working capital adjustments are limited to dollar for dollar and they may preclude any other accounting claims

Case Study

Facts of the Case

- Valassis and ADVO are in the direct mail advertising business. Each company had sales in excess of $1B. The combined entity will exceed $2.65B in sales.
- Late in 2005 Valassis commenced merger discussions with ADVO.
- On July 7, 2006, Valassis and ADVO signed the Stock Purchase Agreement (“SPA”), whereby Valassis would pay $37/share in cash.
- ADVO was trading at $25/share on as of July 7, 2006.

Facts of the Case (cont.)

- Prior to the signing of the SPA, ADVO represented:
  - Operating income forecast for FY2006 of $68 MM;
  - The integration of its SDR computer system was progressing as planned; and
  - The April & May 2006 financial statements were materially correct.

Facts of the Case (cont.)

- AFTER the signing of the SPA:
  - ADVO disclosed that April and May 2006 financial statements were misstated by $2.6 MM;
  - On August 10, 2006, ADVO adjusted its $68 MM forecasted operating income to $54.8 MM, nearly identical to an internal April 2006 forecast of $54.5 MM;
  - Actual FY operating income ending 9/30/06 were $37.9 MM, some $30 MM below expectations.
- Negotiations stalemated. On October 31, 2006 Valassis filed suit for fraud and to rescind the transaction.

Assignment

- Did Valassis obtain the benefit of its bargain?
  - Evaluate the business as bargained for versus as received.
  - Was the misrepresentation unknown to the buyer?

Demonstration of Dramatic Downturn

ADVO's Recent Operating Income is Below the Historical Mean

Declined 70% From Q1 2006 to Q4 2006

Source: Quarterly amounts through Q3 2006 from ADVO's 10-Q and 10-K filings. Q4 2006 from ADVO's November 16, 2006 press release. Q1, Q2, Q3, and Q4 2006 amounts include add-backs of $1.5M, $2.3M, $2.0M, and $2.2M for stock option expense amounts, respectively. Q3 and Q4 2006 amounts include add-backs of $2.9M and $4.5M of merger and litigation costs, respectively, as well as adjustments for $6M of client credits.

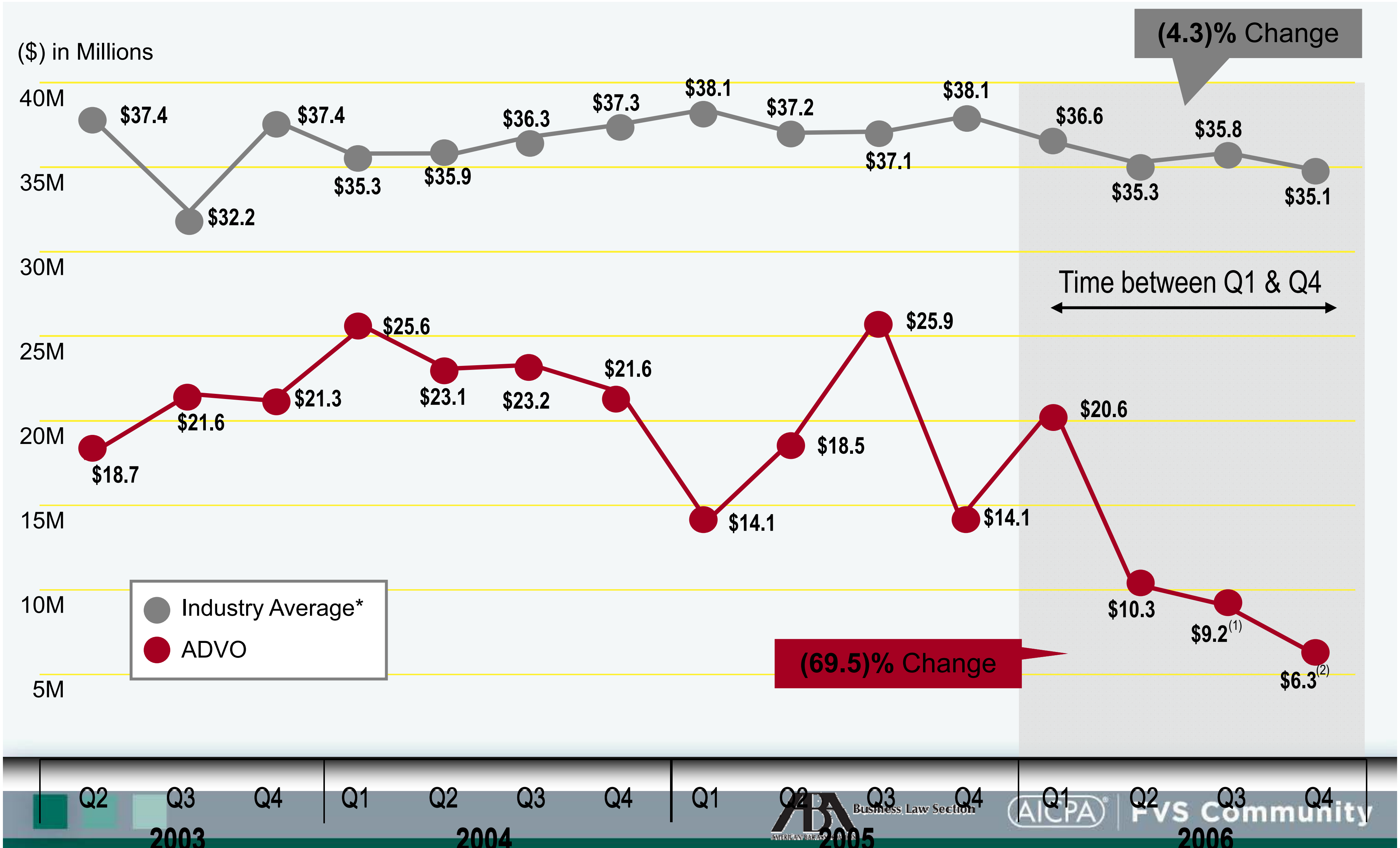
ADVO's Material Misrepresentation

ADVO's Fiscal Year 2006 Operating Income Forecasts

Source: Original Budget and Actual from Scott Harding memo to Board of Directors, dated November 17, 2006. 4/14/06 from Kerr Exhibit 3 ADVO00115301 to 00115302. 5/4/06 from ADVO Board of Directors Meeting "FY06 Forecast Update", dated May 4, 2006. 5/10/06, 6/23/06, and 8/10/06 amounts taken from ADVO Financial Reports distributed on the corresponding date. All forecasts include deductions for one-time charges and additional costs.

ADVO Operating Below Industry Expectations

ADVO's Performance is Disproportionate to the Industry



Includes Harte Hanks, Catalina Marketing, and Valassis.

(1) Deducted $6M client credit; added $1.6M in merger and litigation costs, added $0.9M in strategic initiatives (2) Added $6M client credit, $4.5M in merger and litigation costs, $1.5M in strategic initiatives

Source: 10-Q's and 10-K's were used for all companies and are adjusted for non-recurring charges.

Market Approach Guideline Company Analysis

- A multiple of EBITDA was utilized based on the comparable companies.
- Valassis initially priced ADVO:
  - Bargained for - 11 times EBITDA
  - As received - 9 times EBITDA
- The multiple of EBITDA approach included a control premium.

Valassis Did Not Receive the Benefit of its Bargain

Purchase Price Overpayment Calculation	
In Millions (except multiples)	9.0x Multiple
Pre-Signing Forecasted Fiscal '06 Op. Income - Misrepresentation	$68.0
Less: Pre-Signing Forecasted Fiscal '06 Op. Income – Realistic	(54.5)
Operating Income Misrepresentation	**$13.5**
% of Misrepresented Operating Income	***19.9%***
ADVO '06 EBITDA (Valassis/Bear Stearns Projection)	$119.0
Less: Misrepresentation	(13.5)
Corrected ADVO '06 EBITDA	$105.8
EV/EBITDA Purchase Price Multiple	9.0x
Adjusted Enterprise Value	$950
Less: Actual Enterprise Value Purchase Price	1,291.3
Purchase Price Overpayment	**$(341.8)**
% of Actual Purchase Price	***26.5%***

Income Approach Discounted Cash Flow Valuation

- The forecasted cash flows and discount rate were adjusted to reflect the downturn in the business.
- Valassis revised the revenue assumptions downward which translated into a revised cash flow analysis.
- The DCF valuation assumed control cash flows.

Change in DCF Analysis Based On Facts Known as of August 2006

Historical ($ inMillions)	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
						Valassis Original Forecast (as of July)					
EBIT	$ 97	$ 80	$ 82	$ 80	$ 69	$ 66	$ 74	$ 90	$ 94	$ 98	$ 105
% Margin	*8.5%*	*7.1%*	*7.1%*	*6.4%*	*5.0%*	*4.5%*	*4.9%*	*5.8%*	*5.8%*	*5.8%*	*6.1%*
% Growth		*-17.5%*	*2.5%*	*-2.4%*	*-13.8%*	*-4.3%*	*12.1%*	*21.6%*	*4.4%*	*4.3%*	*7.1%*
Free Cash Flow							53	55	48	50	59
Discounted Free Cash Flow							$50	$48	$38	$36	$39
Present Value of Terminal Value											868
Present Value of Cash Flows											212
Present Value of Free Cash Flow (1)											**$1,080**

Historical	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009***	**2010***	**2011***
						Valassis Revised Forecast (as of August)					
EBIT	$ 97	$ 80	$ 82	$ 80	$ 69	$ 51	$ 50	$ 62	$ 64	$ 66	$ 68
% Margin	*8.5%*	*7.1%*	*7.1%*	*6.4%*	*5.0%*	*3.5%*	*3.4%*	*4.2%*	*4.2%*	*4.2%*	*4.2%*
% Growth		*-17.5%*	*2.5%*	*-2.4%*	*-13.8%*	*-25.5%*	*-3.7%*	*25.6%*	*3.0%*	*3.0%*	*3.0%*
Free Cash Flow							40	39	34	36	42
Discounted Free Cash Flow							$38	$34	$26	$26	$28
Present Value of Terminal Value											524
Present Value of Cash Flows											152
Present Value of Free Cash Flow (2)											**$676**

** Litvak assumption based on Valassis revised projection trend. (1) Using discount rate of 9.5% and terminal growth rate of 4.75%. (2) Using discount rate of 10.0% and terminal growth rate of 4.5%.*
Source: Historical amounts from Bear Stearns Fairness Opinion Supporting Analysis dated July 5, 2006. Valassis Original Forecast from "Summit 6-6-06.xls" file. Valassis Revised Forecast from "Combined Model.xls."

Valassis Did Not Receive the Benefit of its Bargain ADVO Misled Valassis into Overpaying by $300 - $400 Million (($) in Millions)

Multiple of EBITDA Based on Guideline Companies		
Value at July 5, 2006 (1)		$1,291
FY 2006 EBITDA (3)	$105.5	
Multiple	9.0x	
Value at August 10, 2006		950
		($342)

Income Approach (Free Cash Flow)	
Value at July 5, 2006 (2)	$1,080
Value at August 10, 2006 (2)	676
	($404)

Source:(1) Bear Stearns Fairness Opinion Supporting Analysis dated July 5, 2006. (2) From Litvak's Change in DCF Analysis on as shown on Slide 9. (3) From Litvak's Corrected ADVO '06 EBITDA for April as shown on Slide 6.

Questions ?