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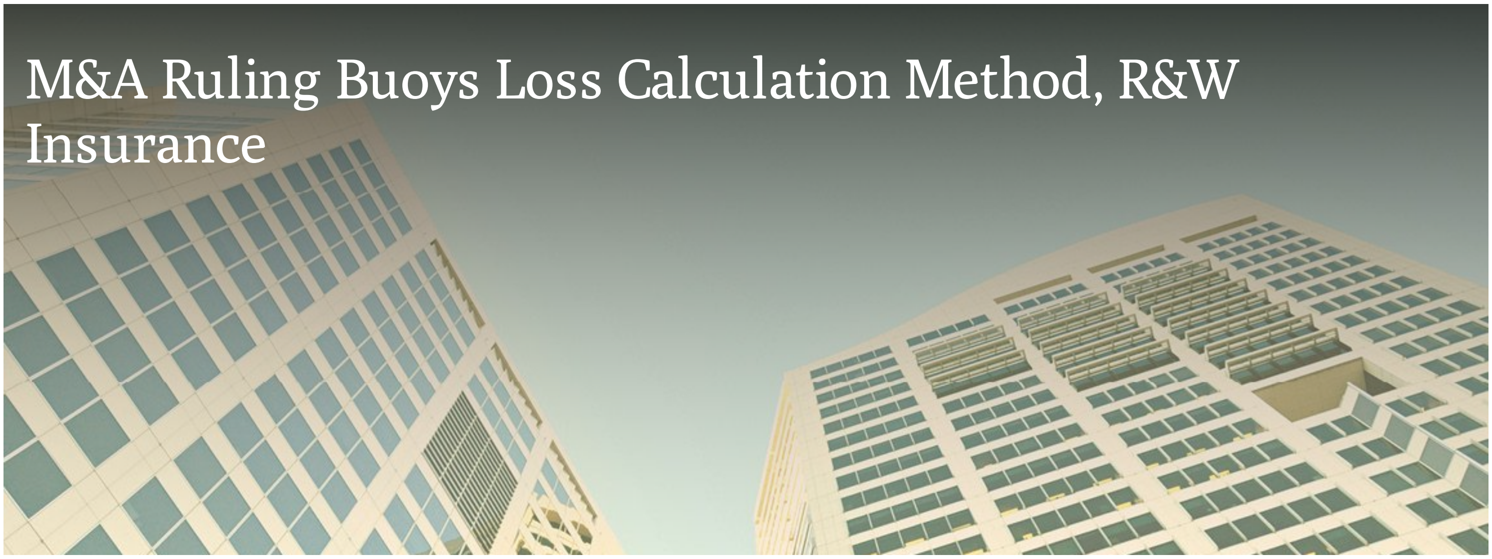
M&A Ruling Buoys Loss Calculation Method, R&W Insurance



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The recent Taylor Precision Products Inc. v. Larimer Group Inc. decision from the U.S. District Court for the Southern District of New York confirms what practitioners in the post-closing M&A dispute arena have seen in practice for years — that damages in connection with the sale of a business can be appropriately measured based upon a multiple of earnings before interest, taxes, depreciation and amortization where the breach has impaired the earning's power of the acquired business.[1]

In Taylor Precision, the buyer of a wine accessories business sued the seller, alleging, among other claims, that the seller breached the purchase agreement by failing to disclose to the buyer — despite its contractual obligation to do so — that its relationships with two key customers had soured, resulting in lost business by the time the deal closed.

After a bench trial, the court found the seller liable for breach of contract and that the breach caused the buyer to overpay for the company. After further briefing from the parties on damages, the court on Oct. 13 awarded the buyer multiplied damages based on the implied EBITDA multiple used to determine the purchase price.

The court first applied the well-settled principle that in the context of a breach of contract claim under New York law, an injured party is entitled to be put in the position it would have been in had the contract's terms been fulfilled.

In the context of a such an action between a buyer and seller, a plaintiff buyer is entitled to "benefit of the bargain" damages, which are "measured as the difference between the value of [the company it purchased] as warranted by [seller] and its true value at the time of the transaction."[2]

Accordingly, in proving damages, a plaintiff must "demonstrate the position it would have occupied had the contract been fulfilled according to its terms."[3]

In doing so, the court explained that a plaintiff need not prove damages to theoretical perfection but instead "need only show a stable foundation for a reasonable estimate of the damage incurred as a result of the breach."[4]

That exercise “necessarily requires some improvisation,” and the burden of any uncertainty as to the amount of damages falls to the breaching party.[5]

The court then turned to the buyer’s multiplied damages argument, finding that the buyer had adopted a discounted income approach to value the business at the time of the sale and that an implied EBITDA multiple of 7.55x, derived from dividing the purchase price by the trailing 12-month, or TTM,-adjusted EBITDA at closing, was appropriate.[6]

The court noted that the buyer’s expert’s multiplied damages calculation is “associated with a permanent loss in sales” from the two customers at issue.[7] The court agreed that the buyer’s damages could be reasonably estimated by applying the implied EBITDA multiple to what the TTM EBITDA would have been had the seller disclosed what it was contractually obligated to disclose.[8]

More specifically, the court agreed that the damages could be determined by calculating the TTM-adjusted EBITDA of the lost product stock-keeping units from the two customers at issue, subtracting that amount from the TTM EBITDA of the business at the time of the sale, and then applying the implied purchase price multiple to the difference.[9]

That calculation resulted in approximately $4.48 million in damages being awarded to the buyer.

Although the court adopted this component of the buyer’s damages argument, it disagreed with a separate, second component of the buyer’s proposed damages calculation in which the buyer attempted to provide a “stable foundation for a reasonable estimate” to account for the “reduction in the overall growth” of the company’s business associated with the two customers at issue.[10]

Resetting the Multiplied Damages Case Law Post-Zayo

The court’s endorsement and adoption of a multiplied EBITDA damages calculation in Taylor Precision is a significant step toward memorializing the paradigm in which litigators and financial experts who represent buyers and representation and warranty, or R&W, insurance, policyholders have been operating for some time, albeit without much authority to which to point.

Amid sparse case law on the topic is the Delaware Chancery Court’s 2018 Zayo Group LLC v. Latisys Holdings LLC decision, which sellers and certain insurance carriers have used to push back on buyers’ multiplied damages arguments.[11]

In Zayo, the court — after acknowledging that multiplied damages is an appropriate method for calculating damages when the alleged breach of the representation or warranty has caused a permanent diminution in the value of the business as a result of lost revenues into perpetuity — found that the plaintiff had not met its burden to prove that it was entitled to multiplied damages under the specific facts of that case, which involved the loss of material customers whose contracts were to expire less than one year after closing — i.e., not perpetual.

While it did not conclude that damages calculated based on a multiple of earnings are never appropriate, the court, in dicta, seemed to suggest a standard of proof for establishing loss based on such a methodology that, if taken literally, would be nearly impossible to meet.

More specifically, the court engrafted a requirement of permanence — that is, a permanent diminution in value of an enterprise caused by a breach — to permit quantification of loss based on a multiple of EBITDA.[12]

Moreover, the court faulted the plaintiff for failing to “perform a post-Closing valuation of the company it had acquired.”[13] But as the Taylor Precision court recently recognized, post-closing performance often says nothing about the calculation of loss caused by a seller’s pre-closing breach.[14]

Rather, as the Taylor Precision court explained, the amount of loss caused by a breach in an acquisition agreement is measured as the difference between the value of the company as represented by the seller, and the actual value had all representations been true.[15]

A post-closing valuation, which may be subject to fluctuating market conditions, changes in management, and a host of other factors, cannot act as a substitute for a basic benefit-of-the-bargain inquiry.

Again, the Zayo court did not hold that quantification of loss based on a multiple of EBITDA can never be appropriate, and cases decided both before and after Zayo have concluded that such a methodology can be used when properly supported.[16]

Nonetheless, Zayo has remained a stubborn thorn in the side of aggrieved buyers — and R&W insurance policyholders — who have sought to measure losses using a multiple of EBITDA. The recent decision in Taylor Precision should help put an end to continued reliance on the Zayo dicta.

Taylor Precision and the Benefits of R&W Insurance

Wholly apart from the merits of Taylor Precision, the court's decision also highlights some of the benefits afforded to purchasers who acquire R&W insurance as part of merger and acquisition transactions. Though timing varies depending on specific facts and circumstances, data suggests that most R&W insurance claims are resolved within a year of submission.

The buyer's experience in Taylor Precision provides a stark contrast. There, the acquisition underlying the dispute was completed in 2013, meaning that the purchaser had been waiting for 10 years to recover the loss arising out of the seller's breach.

The plaintiff initiated the case in 2015, staved off a motion to dismiss, participated in fact and expert discovery and motion practice, filed an unsuccessful motion for summary judgment, and, eventually, litigated an eight-day bench trial.

Thereafter, the parties engaged in post-trial briefing on the issue of damages. During this time, the purchaser incurred significant professional fees in its near decade-long pursuit of its contractual remedy.

The process for resolving R&W insurance claims — like any complicated commercial transaction — does not always run perfectly, and insurers and brokers in the R&W insurance market are continuing to hone the process to make it more efficient.

But as illustrated in Taylor Precision, litigation to recover loss arising out of breaches of representations made in acquisition agreements in the absence of R&W insurance can be far more costly and time-consuming than resolving similar matters when insurance has been obtained.

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[1] Taylor Precision Prods. v. Larimer Grp., Inc. , 2023 WL 6785802 (S.D.N.Y. October 13, 2023).

[2] Id. at *1.

[3] Id.

[4] Id. at *4.

[5] Id.

[6] Id. at *5.

[7] Id. at 2.

[8]Id. at *5

.[9] Id.

.[10] Id. at *3, 5.

[11] Zayo Grp., LLC v. Latisys Holdings, LLC , 2018 WL 6177174 (Del. Ch. Nov. 26, 2018).

[12] Id. at *34-*35.

[13] Id. at 36.

[14] See Taylor Precision, 2023 UWL 6785802, at *1.

[15] Id. at *4.

[16] See, e.g. Swipe Acquisition Corp. v. Krauss , WL 5015863 (Del. Ch. Aug. 25, 2020); Cobalt Operating, LLC v. James Crystal Enters ., 2007 WL 2142926, at *80 — 83, *91 — 97 (Del. Ch. July 20, 2007), aff'd, 945 A.2d 594 (Del. 2008).

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