Valuing Income Statement Breaches in Transactional Insurance Claims

Introduction

Once it has been determined that a breach of a financial statement representation in an acquisition agreement has occurred—specifically with respect to an identified income statement—the question arises as to the quantum of damages resulting from the breach. In most cases, the acquisition agreement will be governed by Delaware law. The indemnification provisions of the acquisition agreement typically will define "Loss" as "damages" resulting from the breach. A typical transactional insurance contract, insuring against the Loss resulting from any such breaches, will incorporate from the Parties' agreement not only the specified representations and warranties, but also the standards governing the determination of any breach and resulting Loss. Therefore, it is Delaware law, as applied to the Parties' own corporate agreement, that usually will control the determination of quantum of Loss resulting from an indemnifiable breach of an insured representation.

Most Buyer-Side Representation & Warranty Insurance policies define Loss—for purposes of the policy—as "loss" under the relevant acquisition agreement (generally "damages," defined by Delaware law, as stated above). In the early years of transactional insurance, insurers often sought to control the insured risk from an underwriting perspective by narrowing the scope or limiting the methods by which damages could be determined. Market pressure over time resulted in newer policy wordings that dropped some of the limitations, often leaving the references to damages to be governed by the acquisition agreement, rather than the policy. So in most instances today, at least in the experience of the undersigned authors, when there has been a breach of the financial statement representation, the insured must look to how a Delaware court would quantify the damages arising from the breach.

Valuation of Damages Resulting From an Income Statement Breach

A typical balance sheet breach may relate to an overstatement of current assets or an understatement of current liabilities, where essentially cash is short on a dollar-for-dollar basis. A breach of the income statement, on the other hand, may implicate the core earning ability of the company acquired. When there are discrepancies that may adversely affect, in whole or in part, the future earning ability of the target company, the value of the ongoing business that the purchaser expected to obtain, compared with what it actually acquired, may differ.

Delaware courts typically determine damages based on corporate fair value by receiving the testimony of valuation professionals. Reviewing an array of Delaware Chancery opinions leaves an indelible impression that the result will be controlled by the presentation of the competing valuation testimonies provided by the parties. The court has significant discretion in choosing among competing theories and testimony and may adopt parts of conclusions offered by opposing experts.

There are many methods valuation professionals can employ to assess the damages resulting from a shortfall in income reported for a key measurement period at the time of a transaction.[1] Such valuation exercises must be tailored to the specific company sold in the underlying transaction. For example, different methods would be appropriate for an operating company than would be used for a real estate holding company. And, even among operating companies—industry matters. Further, not all companies that operate in an industry have the same prospects for growth and profitability. The particular growth characteristics and outlook of an individual company within an industry makes comparable based analysis much less reliable than a method which revolves around the specifics of an individual company.

With particular regard to operating companies, excluding cases where a buyer has synergies or other enhancements to value that must be considered, an Income Approach would feature prominently, and sometimes exclusively, in the valuation report. Many times, the Income Approach is accompanied by a Market Approach either as a factor that is weighted or as a "sanity check" to the results obtained from the Income Approach.[2]

The predominant Income Approach used by the investment community is the discounted cash flow analysis ("DCF"). The key steps in a DCF are:

1. Project cash flows over a measurement period:
2. Calculate the Terminal Value;
3. Calculate the discount rate; and
4. Calculate the fair value of the company.

The starting point is a set of projections. Where an M&A transaction has occurred, there are likely to be contemporaneous projections that were used by the buyer in making its investment decision. In the case of a financial buyer, like a private equity fund, there will typically be a report to the investment committee of the fund that contains such projections. Where a strategic buyer is involved, there will ordinarily be a report to the Board of Directors of the acquirer that sets forth the projections provided to them by management of the acquirer. Where financing is obtained to provide a portion of the purchase price, projections are customarily provided to the lender.

The next step would be extracting from the projections the target company's cash from operations, subtracting capital expenditures, net of depreciation, and adding net borrowings. Terminal Value can be an expected exit from the investment or an in perpetuity growth rate starting the year after the forecast period. The discount rate is most commonly the weighted average cost of capital (WAAC). This can be derived from the internal rate of return contained in management projections, investment committee presentations or an evaluation of a private equity fund's portfolio and the terms of acquisition debt. The final step is simple arithmetic—discount the combined cash flows and Terminal Value by the WAAC.

Valuation professionals may also consider a Market Approach, including a guideline public company comparison (that uses the market capitalization of a public company which is comparable to a private company to establish the value of a private company) or a guideline company transaction method (using arm's-length, relevant transaction data to value the sale price of a company). These methods rely on the selection of truly comparable companies or transactions. If the company being valued has significantly different prospects, growth rates, capital requirements or other key differentiators, this approach can lead to very inaccurate conclusions. Therefore, the Market Approach is often weighted less, if even used more than as a confirmation of what is determined through the Income Approach.

Valuation exercises performed in this manner are not uncommon. They are routinely performed in substantial transactions. In some cases, parties to a significant acquisition must publicly disclose the valuation reports and the conclusions the parties derived from the reports. Under Regulation MA promulgated under the Securities Act of 1933, as amended, valuation reports issued to transaction parties in certain mergers are required to be filed with the SEC and disclosed in merger proxies. As a result, many examples of valuation exercises, applicable to a broad array of industries and conditions, are readily accessible.

By its very nature, a DCF analysis eliminates, for the measurement period (the forecasted years), the impact of non-recurring expenses and non-recurring declines in revenue during historical periods ending prior to the forecast period. For example, consider the case of company that manufactures products: if lightening hits the manufacturing plant and the plant is closed for two months during a historical fiscal period as a result of the electrical systems being replaced, that decline in revenue would not affect future periods after the plant is restored to normal operations. A DCF analysis likely would not be affected by such a one-time decline in revenues, whereas other valuation methodologies, such as a market-based approach, may be impacted.

The Intersection of Valuation Methodologies and Delaware Damages Law

Although Representation and Warranty Insurance (RWI) has been in existence for some time, its wide-spread use in transactions is relatively new. In addition, many of the policy forms in use call for private resolution of disputes through arbitration rather than the courts. As a result, disputes that have occurred over competing valuations of loss arising from income statement breaches typically are not reflected in Delaware court decisions, particularly in this narrow context. Nevertheless, there is precedent from non-insurance disputes demonstrating how courts approach the valuation of loss issue arising from income statement breaches in the context of operating companies.

Often, a one-size-fits-all valuation measure, such as a market-based or comparable methodology, will not be appropriate for operating companies. As such, both parties typically submit competing valuation testimony. Under these circumstances, it is likely that Delaware courts will follow past precedent, and be more willing to accept the methodologies that the courts have applied in the past when valuing operating companies or ownership in operating companies. In an oft-quoted holding by Chancellor Strine in the matter of valuing operating companies, he stated:

> [T]he DCF valuation methodology has featured prominently in this Court because ‘it is the approach that merits the greatest confidence’ within the financial community.

Cede & Co. v. JRC Acq. Corp., 2004 WL 286963, at *2 (Del. Ch. 2004) (quoting *Ryan v. Tad’s Enters., Inc.*, 709 A.2d 682, 702 (Del. Ch. 1996), *aff’d*, 693 A.2d 1082 (Del. 1997).

The DCF methodology has been analyzed and applied regularly by Delaware courts when tasked with valuing operating companies, particularly when the parties have disputed the issue of both private and public company valuations. Thus, there exists a predicate for parties to approach valuation in an RWI context that will meet the expectations of the Delaware Chancery Court or other neutrals that are obligated to follow Delaware law. The Court has explained the proper process as follows:

> Put in very simple terms, the basic DCF method involves several discrete steps. First, one estimates the values of future cash flows for a discrete period …. Then, the value of the entity attributable to cash flows expected after the end of the discrete period must be estimated to produce a so-called terminal value, preferably using a perpetual growth model. Finally, the value of the cash flows for the discrete period and the terminal value must be discounted back[.]

Andaloro v. PFPC Worldwide, Inc., 2005 WL 2045640, at *9 (Del. Ch. 2005).

Support for the DCF Methodology in Recent and Prior Case Law

There exists a great deal of Delaware precedent pertaining to operating company valuation and much of it can be read to support the application of a DCF methodology in the RWI context, particularly as it relates to damages resulting from an income statement breach. The recent case of *Owen v. Cannon*, 2015 WL 3819204, at *1 (Del. Ch. 2015) offers a detailed look at how the Court will resolve competing valuation opinions based on differing DCF analyses. There, a private company that was a flow through entity (a Subchapter S corporation), adopted a merger agreement that cashed out a minority stockholder. The primary question before the Court was whether the pricing was fair. Specifically, whether the merger price per share actually reflected the value of the company as a going concern.

The DCF analyses proffered by the parties' valuation experts featured differing treatments of key issues, including what projections to rely on during future measurement periods and the taxation of the company's shareholders. The parties' provided their own, differing calculations in support of their respective valuations, but the court ultimately undertook its own analysis. The court considered the valuation testimony of each party's expert witness, but afforded greater weight to certain aspects of the competing valuation calculations.

The circumstances underpinning the parties' revenue projections were a significant factor. While the acquiring shareholders in *Owen* had prepared a recent projection that they had used to obtain financing, they also prepared alternative, lower projections after the initiation of litigation. In presenting their case to the court, they sought to persuade the court to rely on the lower projections, thereby justifying the lower price paid to the minority shareholder. The court selected the projections that the acquiring shareholders had earlier presented to the lenders, rather than the lower projections prepared for the litigation, citing a decision by Chancellor Strine noting that projections offered to third party financing sources are typically the most reliable. *See DE Open MRI Radiology Assoc. v. Kessler*, 898 A. 2d 290, 332 (Del. Ch. 2006). In the end, the court derived a valuation figure that was in between those suggested by the parties.

The approach applied to the valuation analysis in *Owen* is generally consistent with past precedent. However, courts are not always presented with competing DCF analyses. Often, parties may offer calculations derived from other types of valuation methodologies, such as a comparable or market-based approach. When faced with competing methodologies, courts undertake an analysis to determine the reliability of each type calculation, similar to how the court in *Owen* scrutinized the reliability of the competing DCF analyses. Although the determination is typically left to the discretion of the court and is entirely fact-dependent, Delaware courts seem to favor a DCF approach over a market approach.

For example, in *In re Orchard Enterprises*, the court rejected a market-based calculation and gave "exclusive weight" to a DCF calculation when determining the valuation of a company in an appraisal action arising out of a going-private merger transaction. *In re Orchard Enterprises, Inc.*, 2012 WL 2923305, at *9 (Del. Ch. 2012), *aff'd sub nom*, *Orchard Enterprises, Inc. v. Merlin Partners LP*, 2013 WL 1282001 (Del. Mar. 28, 2013). There, holders of the company's preferred stock were owed a substantial liquidation preference, and the court reasoned that a market-based approach did not adequately account for that factor when valuing the company as a going concern. *Id.*

In the case of *Prescott Grp. Small Cap, L.P. v. Coleman Co.* the court reached a similar result. There, in an appraisal action, the court rejected a market-based approach to the company's valuation in favor of a DCF analysis, finding that the former methodology is, among other things, "inherently less reliable …." *Prescott Grp. Small Cap, L.P. v. Coleman Co.*, 2004 WL 2059515, at *21 (Del. Ch. 2004). The court also took issue with certain data used in the market-based calculation. Specifically, the court found that the EBITDA multiples used in the valuation were not derived from companies that were sufficiently comparable to the subject-company. *Id.* Further, and echoing the *Owen* court's concerns, the *Coleman* court was troubled by the fact that the EBITDA projections used in the market-based valuation were apparently prepared arbitrarily, and did not reflect "management's actual EBITDA projection …." *Id.*

A market-based approach may also be viewed with disfavor by virtue of the industry in which the subject-company operates. For example, in *Gilbert v. MPM Enterprises, Inc.*, the court, conducting an appraisal arising from a going-private merger, found that "comparable company (or guideline company) analyses [are] relatively weak compared with [] DCF valuations" where there exists a lack of sufficiently comparable companies with which to conduct the former analysis. *Gilbert v. MPM Enterprises, Inc.*, 709 A.2d 663, 668 (Del. Ch. 1997), *aff'd sub nom*, *M.P.M. Enterprises, Inc. v. Gilbert*, 731 A.2d 790 (Del. 1999). There, the subject company was in the business of manufacturing electronic-component screen printers. The guideline companies used in the market approach operated in the semiconductor manufacturing business. Given the dissimilarities in industry, and because the subject-company belonged to such a niche market, the court rejected the market approach in favor of a DCF valuation. Where a court considers projections inherently unreliable given critical changes occurring in a company's operating environment, it may change the weighting of various methods. See In re Appraisal of DFC Glob. Corp., 2016 WL 3753123, at *1 (Del. Ch. 2016) (finding that a combination of different valuation methodologies was the only way to achieve a reliable valuation figure where a company was operating in a period of turmoil caused by significant regulatory uncertainty, such that management projections and other data were not sufficiently indicative of the company's actual financial performance).

Cases Using Exclusively A Market Approach

There are cases where valuation testimony is unrebutted and the court is forced to consider different approaches based on the limited evidence before it. For example, in the case of *Cobalt Operating, LLC v. James Crystal Enterprises, LLC*, 2007 WL 2142926 (Del. Ch. 2007), a dispute arose concerning the sale of a radio station. The unrebutted testimony before the court was that the buyer was only willing to pay 14 times the previous year's cash flow. It was discovered by the buyer post-close that the target company had fraudulently billed and collected for commercials that were never aired. Since the buyer would not continue the fraud, its ability to generate cash from the operation of the radio station was reduced by about 20%.

In *Cobalt*, the valuation testimony offered by the buyer was unrebutted—the seller provided no expert testimony on valuation of its own. The valuation expert for the buyer was the principal of an investment banking firm specializing in radio station transactions, having handled the purchase or sale of over 2,000 radio stations worth an aggregate of approximately $18 billion. For this particular industry, the unrebutted testimony of this expert was that no seller of a radio station would sell for less than 12 times prior year's cash flow and no buyer would pay more than 16 times prior year's cash flow, so that for a radio station deal in a market like West Palm Beach, 14 times was the under/over and this deal was priced correctly by the parties (assuming the representation had been true).

Because only one party in *Cobalt* submitted a valuation to the court, the court's options were limited. In a valuation dispute, the court resolves the valuation issue based upon the testimony of the parties' experts. Where one side fails to submit valuation testimony, the court's analysis may be limited, ultimately affecting its disposition.

However, the courts' acceptance of the market approach is not limited to scenarios where the valuation estimate is uncontested. In *Dobler v. Montgomery Cellular Holding Co.*, 2004 WL 5382074, at *10 (Del. Ch. 2004), the court rejected both parties' DCF valuations. Like the courts in *Owen* and *Prescott*, the *Dobler* court was troubled by the unreliability of the data comprising the DCF analysis, noting that a DCF analysis "is only as good as the inputs to the model." *Id.* at *16 (internal quotation marks omitted). In *Dobler*, the court expressed concern over the fact that the valuation experts did not have financial projections prepared by company management to rely on. Instead, they prepared their own for purposes of the litigation. This, combined with the fact that the court was satisfied that the guideline companies used in the market approach were sufficiently comparable to the subject-company, led the court to find that the "[market-based] analysis is strongly indicative of [the subject-company's] fair value." *Id.*

In a Strategic Acquisition, Neither a Market Approach Nor a DCF Approach May Be Appropriate

In certain types of strategic acquisitions where the buyer plans to change the business model of a target company and seeks primarily its customer relationships, neither a market approach nor a DCF analysis may provide the most accurate valuation methodology. Strategic buyers typically have reasons for seeking the acquisition of the target company that are based on metrics other than fair value. The strategic buyer may consider this information in connection with the financing it obtains to provide part of the funds for the purchase. In such cases, an error in a historical income statement might not have much impact on the buyer.

The court's analysis in *Senare, LLC vs. DDS Holdings, Inc.*, Case No. 11-26481-CA-40 (Fla. Cir. Ct. Aug. 6, 2013), demonstrates how courts may consider a buyer's damages in the event of such a strategic acquisition. In *Senare*, the buyer contended that the seller breached the financial statement representations of a membership interest purchase agreement governed by Delaware law. Among other things, the buyer complained about the ongoing effects of certain debt held by the target company, a diabetic supply business. A recent bid had priced the target company on a basis of $400 per patient, and there was testimony by the seller that this method of valuing the business was prevalent in the diabetic supply industry. Additionally, the seller put forth testimony evidencing the buyer's plans to transform the target company from Medicare-only to a private insurance platform. As such, the seller contended that an EBITDA multiple based on a market-based analysis was not an appropriate measure of the target company's valuation.

Though the buyer's letter of intent stated that the price was conditioned on prior year EBITDA, the court held that the EBITDA multiple had come about as the end result of a price that was agreed, based on a $400 per patient basis. That price was then was divided by the EBITDA to calculate the multiple. According to the Court, the EBITDA "was the variable–never the constant–for valuation purposes." The court also noted that the buyer did not offer into evidence any comparable values for the target company, such as the value of competing medical supply businesses or any expert valuations of the target company as a going concern. As such, the price per patient was a more accurate method by which to establish the valuation. Ultimately, the court concluded that the value per patient life, i.e., the value of the platform to a strategic buyer that wanted to transform the business, was not affected by any alleged breach of a representation and warranty as to the accuracy of a financial statement.

Claims Initially Presented Often Value Loss Based on a Historical EBITDA Multiple

Given the state of Delaware valuation law, one might question why it is that claims frequently are presented in terms of a multiple of historic EBITDA. Several factors likely drive this decision. First, this method tends to state the damages from a historical income statement breach at the greatest amount. Second, it is a very simple method to employ. Third, deal parties often express a purchase price in terms of historical EBITDA in correspondence or other communications so there is some basis to assert it is an appropriate measure. And finally, a Market Approach is often used to sanity check the results obtained from an Income Approach.

Taken to its logical conclusion, a claim valued at the implied deal multiple inherently suggests that the entire purchase price was given in exchange for the income that the acquired company produced for the seller during a one year measurement period. In our experience, however, buyers are much more interested in the income and returns that the acquired company will produce for the buyer during its holding period. The historical results are only important to the extent that they shape the outlook for future periods. An analysis like those that the Delaware courts have employed in the cases discussed above values damages in a manner consistent with that point of view. Accordingly, understatements of expenses that are non-recurring, and temporary dips in revenues, should not have the impact in a forward looking valuation model that they would if the method to determine damages was merely a multiplication of an historic income statement discrepancy by the implied multiple.

Conclusion

The Delaware courts have often had occasion to determine the value of corporate ownership interests. In such cases, the courts have to make choices between competing expert valuation testimony offered into evidence. The Delaware courts have shown a strong preference for testimony that is grounded in the core earning ability of the particular company. This has been demonstrated to the satisfaction of the courts based on well-constructed DCF analyses and also by valuations that weight DCF analyses with Market Approaches. Where the buyers in M&A transactions have contemporaneous projections and other data that would be used to prepare a DCF, the variables that typically would be at issue can be narrowed. As a result, non-recurring items that drove temporary declines in trailing EBITDA leading up to a transaction are not likely to result in damage determinations of the magnitude that the application of an implied deal EBITDA multiple would have produced.

(Endnotes)

1. *See, e.g.,* AICPA, Statements on Standards for Valuation Services, VS sec. 100.31 *et seq.*

2. Sometimes, the fair market value of a company is not the most accurate metric to determine its valuation. *See, e.g.*, *WaveDivision Holdings, LLC v. Millennium Digital Media Sys., L.L.C.*, 2010 WL 3706624, at *1 (Del. Ch. 2010). In *WaveDivision*, the court sought to determine the expectation damages of a buyer when the seller violated a no-shop clause and breached the agreement by *not* selling the company to the buyer. There, the court determined that the company's fair market value was not an adequate measure of the buyer's damages. Rather, because the buyer intended to acquire the company for strategic reasons, the buyer's damages are more accurately stated by the amount it lost as a result of being deprived of the opportunity to operate and develop the business.

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