

## **M&A Post-Closing Claims for Breaches of Reps and Warranties: Strategies for Pursuing or Defending Recovery**

Identifying Trouble Spots That Risk Post-Closing Losses, Impede Recovery, or Undermine Defenses

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## Merger and Acquisition Post-Closing Claims for Breaches of Reps and Warranties: Strategies for Pursuing or Defending Recovery

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# Overview

- Introduction
- Trouble Spots: Common Sources of M&A representations and warranties breach claims
- Impediments to Recovery on Claims
- Strategies and Best Practices for pursuing claims and defending claims
- Measuring Damages in Representation and Warranty Disputes
- Q&A

# Introduction

- For purposes of our discussion today, we are assuming a transaction between sophisticated parties involving the sale of a private company
- R&Ws, together with indemnification obligations, are used to allocate certain known and unknown losses incurred post-closing, sellers generally negotiate for a more limited package that is targeted to specific risks identified in the business being sold
- In 2021 R&W remained stable from 2019-2020, inclusion of both “no other reps” and “non-reliance” more than doubled since 2015 to 65% of deals as a result of a steep increase in R&W insurance
- **Approximately 49% of claims made by buyers are based on breaches of seller’s R&Ws (2020 SRS Acquiom M&A Claims Insights Report)**
- **Approximately 7% of R&W claims are breaches of f/s reps, 32% tax, 8% capitalization, 4% regulatory compliance, 5% customer contracts (2020 SRS Acquiom M&A Claims Insights Report)**

# Trouble Spots: Which representations and Warranties are likely to be the Subject of a Claim?

- Improper target accounting practices (reps concerning financial statements)
- Undisclosed or inaccurately described actual or threatened litigation or other disputes
- “No undisclosed liabilities” and Rule 10b-5 representations
- Unpaid taxes (reps concerning taxes and stand-alone tax indemnification provision)
- Intellectual property issues, including infringement of the target’s IP and improper maintenance of target’s registered IP
- Violations of law by the target (reps concerning compliance with law generally and compliance with specific regulations applicable to the target’s business)

# Trouble Spots: Which representations and Warranties are likely to be the Subject of a Claim? cont.

- Employee benefit plan liabilities, including liabilities triggered by the sale of the target to the buyer
- Issues with target's contracts, including breach of contract allegations made by customers, suppliers, other
- Undisclosed labor and employment issues (rise in “#MeToo” reps)
- Environmental issues
- Issues with target's tangible assets, including undisclosed liens and other encumbrances
- Discussion of COVID-19 related reps and warranties trending (labor and employment, material contracts, tax, data privacy, insurance, litigation)

# Practical Law's Pro Buyer Financial Statements Representation



**Financial Statements.** Complete copies of the Company's audited financial statements consisting of the balance sheet of the Company as at [DATE OF FISCAL YEAR END] in each of the years [YEAR 1], [YEAR 2] and [YEAR 3] and the related statements of income and retained earnings, stockholders' equity and cash flow for the years then ended (the "**Audited Financial Statements**"), and unaudited financial statements consisting of the balance sheet of the Company as at [DATE OF MOST RECENT QUARTER END] and the related statements of income and retained earnings, stockholders' equity and cash flow for the [three-/six-/nine- month] period then ended (the "**Interim Financial Statements**" and together with the Audited Financial Statements, the "**Financial Statements**") [are included in the Disclosure Schedules/have been delivered to Buyer].

# Practical Law's Pro Buyer Financial Statements Representation



The Financial Statements have been prepared in accordance with GAAP applied on a consistent basis throughout the period involved, subject, in the case of the Interim Financial Statements, to normal and recurring year-end adjustments (the effect of which will not be materially adverse) and the absence of notes (that, if presented, would not differ materially from those presented in the Audited Financial Statements).

The Financial Statements are based on the books and records of the Company, and fairly present [in all material respects] the financial condition of the Company as of the respective dates they were prepared and the results of the operations of the Company for the periods indicated. The balance sheet of the Company as of [DATE OF MOST RECENT FISCAL YEAR END] is referred to herein as the “**Balance Sheet**” and the date thereof as the “**Balance Sheet Date**” and the balance sheet of the Company as of [DATE OF MOST RECENT FISCAL QUARTER END] is referred to herein as the “**Interim Balance Sheet**” and the date thereof as the “**Interim Balance Sheet Date**”. The Company maintains a standard system of accounting established and administered in accordance with GAAP.

# Financial Statements: “Fair Representation” Representation

## ABA Deal Points Study (2020 and Q1 2021)

### ➤ “FAIRLY PRESENTS” IS GAAP QUALIFIED

The financial statements fairly present (and the financial statements delivered pursuant to Section [ ] will fairly present) the financial condition and the results of operations, changes in shareholders’ equity and cash flows of [Target] as at the respective dates of and for the periods referred to in such financial statements, ***all in accordance with GAAP.*** [ABA Model Asset Purchase Agreement]

### ➤ “FAIRLY PRESENTS” IS NOT GAAP QUALIFIED

The Financial Statements (i) fairly present the consolidated financial condition and the results of operations, changes in shareholders’ equity, and cash flows of [Target] as at the respective dates of, and for the periods referred to in, the Financial statements, and (ii) were prepared in accordance with GAAP, subject, in the case of the Unaudited Financial Statements, to normal recurring year-end adjustments. [ABA Model Stock Purchase Agreement, Second Edition]

### ➤ “Fair Representation” included in 97% of deals

➤ Of those deals which included “fair representation”, representation is not GAAP Qualified in 83% of deals (as compared to 85% in 2018-2019 and 82% in 2017-2018)

# Practical Law's Pro Buyer Undisclosed Liabilities Representation



**Undisclosed Liabilities.** The Company has no liabilities, obligations or commitments of any nature whatsoever, asserted or unasserted, known or unknown, absolute or contingent, accrued or unaccrued, matured or unmatured or otherwise ("**Liabilities**"), except (a) those which are adequately reflected or reserved against in the Balance Sheet as of the Balance Sheet Date, and (b) those which have been incurred in the ordinary course of business consistent with past practice since the Balance Sheet Date and which are not, individually or in the aggregate, material in amount.

Sellers attempt to limit “liabilities” by:

- Defining “Liabilities” to those required to be disclosed on a balance sheet prepared in accordance with GAAP
- Using a knowledge qualifier, 2.0% in 2021, 0.7% in 2020, 1.6% in 2019 according to SRS Acquiom 2022 M&A Deal Terms Study (SRS 2022)
- Using a dollar threshold to limit risk
- Excluding liabilities addressed by other representations and warranties

**TREND: Buyer friendly 70% of deals (SRS 2022)**

# “No Undisclosed Liabilities” Representation

## ABA Deal Points Study (2020 and Q1 2021)

- “No undisclosed liabilities” rep included in 92% of deals (decrease from 99% in 2018 – 2019)
- Of those deals which included rep, 98% were not knowledge qualified (about the same as 99% in 2018-2019)
- Of those deals which included rep, 58% included “all liabilities” as opposed to 42% which included GAAP liabilities (down slightly from 62%/38% in 2018-2019)

# Compliance with Laws Representation

## **Practical Law's Pro Buyer Compliance with Laws Representation:**

[Except as set forth in Section [ ] of the Disclosure Schedules,] the Company has complied, and is now complying, with all Laws applicable to it or its business, properties or assets.

## **ABA Model [APA] Compliance with Laws Representation:**

[To the Sellers' knowledge], the business of Target [has been and] is being conducted in compliance with all applicable laws.

## **According to ABA:**

- Rep is included in 99% of deals (consistent since 2006)
- Covers present and past compliance in 19% of deals (trending down from 31% in 2014)
- Is knowledge qualified 2% of the time (same as 2018 - 2019)

## **According to SRS 2022 M&A Deal Terms Study:**

- Covers past and present 94% of time
- 87% include “notice of violation” in 2021

# “10b-5”/Full Disclosure Representation



## ABA Deal Points Study (2020 and Q1 2021)

### “10b-5” Formulation

No representation or warranty or other statement made by [Seller] in this Agreement, the Disclosure Letter, any supplement to the Disclosure Letter, the certificates delivered pursuant to Section [ ], or otherwise in connection with the Contemplated Transactions contains any untrue statement of material fact or omits to state a material fact necessary to make the statements in this Agreement or therein, in light of the circumstances in which they were made, not misleading. [ABA Model Stock Purchase Agreement, Second Edition]

### Full Disclosure Formulation

Seller does not have Knowledge of any fact that has specific application to Seller (other than general economic or industry conditions) and that may materially adversely affect the assets, business, prospects, financial condition or results of operations of Seller that has not been set forth in this Agreement or the Disclosure Letter. [ABA Model Asset Purchase Agreement]

# “10b-5”/Full Disclosure Representation cont.

## **ABA Deal Points Study (2020 and Q1 2021)**

- 93% of deals had no rep included
- 7% had 10b-5 formulation only
- Of deals with 10b-5 rep, 33% were knowledge qualified

## **SRS 2022**

- Of deals with 10b-5 rep only, 25% were knowledge qualified
- Of deals with both 10b-5 and full disclosure reps, neither rep was knowledge qualified in 67% of deals
- Only full disclosure rep was knowledge qualified in 20% of deals
- Both reps knowledge qualified in 7% of deals
- Only 10b-5 knowledge qualified in 7% of deals

# Impediments to Recovery

## Identifying Sources of Recovery: Where is the Money?

- Escrows (amount and time period for escrow release)
- Holdbacks
- Earnouts (set-offs)
- Guarantees (principal selling stockholders)
- R&W Insurance Policy

# Impediments to Recovery cont.

## Contractual Impediments

- Survival periods of Representations and Warranties
- Caps and Baskets (tipping basket, true deductible, mini-basket)
- Materiality/knowledge qualifiers (materiality scrapes)
- Carefully defined “Losses” in Indemnification Provision
- Limitations on Damages Provisions
- Exclusive Remedies Provisions
- Anti-Sandbagging Provision

## Common Law Impediment: Statue of Limitations

# Strategies and Best Practices for Pursuing Claims

## Preparing the Indemnification Claim Notice

- Identify breaches of representations on which indemnification claim is based
- Buyers typically err on side of caution and make an indemnification claim for all issues that arise, regardless of their size, particularly if the basket has not yet been met
- Describe in reasonable detail the issue that is subject of the claim
- Specify the representations on which claim is based
- Include language reserving right to later provide additional information and to make additional claims

# Strategies and Best Practices for Pursuing Claims, cont.

## Describing the Indemnification Claim

- List in notice all of the seller's representations that are arguably breached by the issue on which the claim is based
- Buyer is often better off alleging that an issue is a breach of a fundamental representation, rather than a non-fundamental representation, since the former is often not subject to a basket or indemnification cap and generally has longer survival period
- In asset deals, better to characterize an issue as an excluded liability rather than a breach of seller's representations, since baskets generally do not apply to excluded liabilities and there is usually either no cap or a much higher cap
- If there is a separate tax indemnification section, better from procedural and substantive perspective to use that provision for any tax-related issues rather than breach of tax rep since under former, buyer may be able to control the IRS audit or other dispute with the taxing authority (rather than buyer being entitled to assume defense)

# Strategies and Best Practices for Pursuing Claims cont.

## Specifying Losses

- Buyer to determine whether and how to include consequential and indirect damages in claim amount in light of any consequential damages waiver language
- May be advisable for buyer to state that the amount of losses specified in claim notice is an estimate, subject to later revision
- Reserve right to revise loss amount based on additional information which may be learned after claims notice is submitted

# Strategies and Best Practices for Pursuing Claims cont.

## Third Party Claims

- Typically seller has right to assume the defense of third-party claims with an attorney reasonably acceptable to buyer
- Buyer generally has right to participate in defense at its own expense and if seller fails to diligently prosecute, buyer can take over defense
- Typically seller is prohibited from assuming defense if:
  - Conflicts of interest
  - Third party seeks injunction or other equitable relief
  - Claim involves criminal allegations
  - Claim involves key supplier or customer of buyer
- Restrictions on ability to settle

# Strategies and Best Practices for Pursuing Claims, cont.

## Direct Claims

- Requirement of seller to provide written response to buyer's indemnification claim notice, with supporting documentation, within specified period of time (deemed concession provision)
- Mandatory negotiation periods
- Advisable to expressly state during negotiation of claim that such materials are being provided in connection with settlement negotiations and are subject to any resulting evidentiary privileges

# Strategies and Best Practices for Defending Claims

## Considerations for Defending Claims

- Anti-sandbagging provisions
- Overlooked consequential damages waivers
- Set-offs for insurance proceeds, taxes or other third party recoveries received by the buyer relating to the issue that is subject to the claim
- Cross-reference disclosure schedule provisions (provisions which provide that disclosure of an issue in connection with any of the seller's representations also applies to other representations made by seller so long as it would be apparent to a reasonable buyer that the disclosure also applied to the other representations)
- Attached financial statements may qualify as disclosure of issue of buyer (accrual of liability, disclosure in financial notes)
- Express non-reliance provisions to limit representations
- Entire agreement/merger provisions to limit representations

# Measuring Damages in Representation and Warranty Disputes

# Damage Considerations

- Benefit of the Bargain
- Determining the Purchase Price
- Measuring the Diminution in Value
- Investment Value versus Fair Market Value
- Information to Consider
- Case Study

# Benefit of the Bargain

# Benefit of the Bargain Damages

## Benefit of the Bargain (Expectation Damages):

The difference between the amount plaintiff reasonably expected to receive and the actual amount received.<sup>1</sup>



<sup>1</sup> Litigation Service Handbook, Sixth Edition Exhibit 4.4

# Benefit of the Bargain Damages

## Dollar-for-Dollar

- Finite period
- One-time effect that does not impact future periods

## Diminution in Value

- Permanent impairment
- Perpetuity (effects future periods)

# Measuring Damages: Dollar-for – Dollar Example

## ■ 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

- 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 million to \$740 MM

# Measuring Damages: Diminution in Value

- Understand how the purchase price was determined
- Understand how the alleged breach would affect the purchase price (e.g., an undisclosed loss of a major customer(s) could affect the projections of revenue)
- Understand the business model of the acquired company
  - How are customers acquired?
  - Is the growth potential of all customers created equal? What if growth potential for the major customer(s) is different from other customers?
  - Can the lost customer(s) earnings be replaced with new customers?
  - If so, how long will it take for the business to recover the lost customer earnings?

# Measuring Damages: Diminution in Value (cont.)

- Are the projected cash flows affected, the risk contemplated for the business or both?
  - Does the lost revenue from the major customer affect the risk contemplated for the business?
- Are there synergies or premiums that need to be considered as part of the analysis?
- What has been communicated about the financial performance of the acquired company post-closing?

# Determining the Purchase Price

# The Purchase Price

Reflection of investment value specific to transacting parties

Reflects “**bargained for**”:

- Anticipated stream of future earnings or cash flows
- Measure of capital necessary to support operation in the normal course
- In theory, a negotiated purchase price between sophisticated parties would approximate fair market value



# The Purchase Price: Valuation Approaches

How did the buyer value the anticipated earnings?

- Income approach- projections of future cash flows for a discrete period, determination of terminal value or exit value, converted to an indication of value based on a discount rate
- Market approach- development of multiple(s) from publicly traded companies or transactions that are deemed comparable to the company being acquired which are applied to the company's most recent financial metrics (e.g., TTM EBITDA) to develop an indication of value
- Cost approach- A general way of determining an indication of value using methods based on the value of assets net of liabilities

# The Purchase Price: Other Considerations

- Did the transaction involve offers from multiple parties (e.g., auction process)?
- Were there other considerations involved in negotiating the purchase price? (e.g., reduction in purchase price based on concessions in the purchase and sale agreement)
- Is there contingent consideration as part of the purchase price? (e.g., earnout based on revenue targets)

# The Purchase Price: Risk and Return

## ■ Income Approach

- The discount rate is the cost of capital that is a percentage return which equates expected economic income with present value
- The discount rate reflects the time value of money and the risk-profile of the expected economic stream

## ■ Market Approach

- Market multiples reflect investors' expectations for a company's future growth and potential margin improvement

# Measuring the Diminution in Value

# Measuring Diminution in Value

- Reduction in valuation metric (e.g., EBITDA) multiplied by the implied multiple based on the purchase price (e.g., purchase price divided by EBITDA)
- Determine the effect of the alleged misrepresentation by adjusting the valuation model used to determine the purchase price
  - Changing financial projections as a result of the alleged breach.
  - The valuation model may determine an expected IRR based on a purchase price versus coming to a purchase price.
  - Does the alleged misrepresentation warrant adjustments to the riskiness (e.g., discount rate) used to assess the transaction?

# Measuring Diminution in Value

- Sometimes breaches may result in damages over multiple periods but not necessarily “into perpetuity.”
  - For example, if customers are acquired based on short-term contracts (e.g., 3 years), would damages from the lost customer last into perpetuity?

# Measuring Diminution in Value: Multiple Approach

## ■ Assumptions:

- Post-closing buyer discovers that major customer reduced business resulting in a \$10MM reduction in EBITDA
- Potential reduction known to Seller during negotiations, but not disclosed
- Purchase price of \$750 MM
  - EBITDA of \$150 MM
  - 5x Multiple
- Damages calculated as  $\$10\text{MM} \times 5 = \$50\text{ MM}$

# Measuring Diminution in Value: Multiple Approach

- Challenges with using a Multiple Approach:
  - Implicitly assumes that other assumptions would not change (e.g., growth rates, cost, risk) in determining purchase price
  - Does not consider other information that would demonstrate whether there was truly a diminution in the value of the business

# Measuring Diminution in Value: Adjusting the Valuation Model

## ■ Assumptions:

- Post-closing buyer discovers that major customer reduced business resulting in a \$10MM reduction in EBITDA
- Through discovery, the buyer's valuation model is provided that provides projections of revenue and gross margins for each major customer.
- Purchase price of \$750 MM
  - EBITDA of \$150 MM
  - 5x Multiple
- Damages calculated by adjusting the base year lost sales from the \$10MM EBITDA in the valuation model which results in a reduction of value of \$40MM for the business.

# Investment Value vs. Fair Market Value

# Investment Value vs. Fair Market Value

- Investment Value is the value to a specific buyer while Fair Market Value is the value to a hypothetical buyer
- The purchase price paid in an M&A transaction is the value to a specific buyer
- Would this purchase price reflect the value to a hypothetical buyer?
  - Multiple bids as part of an auction
  - Inclusion of synergies
  - Consideration of valuation approaches

# Information to Consider

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# Information to Consider

- Understanding the business that was acquired
  - Historical financial information provided to the buyer
  - Confidential Information Memorandum
  - Due Diligence Reports
  - Correspondence between the parties regarding aspects of the business
  
- Understanding how the purchase price was determined
  - Valuation models prepared by the buyer
  - Investment committee or management presentations
  - Correspondence between the parties regarding purchase price negotiations or questions around management projections
  - Purchase and Sale Agreement

# Information to Consider (cont.)

- Understanding how the purchase price was determined
  - Bids received by other interested third parties
  - Correspondence regarding the indemnification claim
- Understand how the business performed after the acquisition
  - Financial results post-acquisition
  - Financial projections of the acquired business post-acquisition
  - Management presentations

# Case Study

Zayo Group LLC v. Latisys Holdings LLC

# Zayo Group v. Latisys Holdings

- In February 2015, Zayo acquired Latisys for \$675 million.
  
- Zayo alleged that Latisys breached section 4.12 of the SPA regarding the following material contracts:
  - Toshiba
  - Add2Net
  - Echopass
  - ITC
  - Lexis Nexis

*Source: Memorandum of Opinion, Zayo v. Latisys Case 12874-VCS*

# Zayo Group v. Latisys Holdings

- Key provisions of the SPA include:
  - Section 4.12(b)- no notice that any party to a Material Contract intends to cancel, terminate, materially modify or refuse to perform such Material Contract
  - Section 10.1(c)- damages subject to cap of \$30.375 million
  - Section 10.1(c)- not obligated to indemnify until damages reach \$3.375 million (“Basket”)

*Source: Memorandum of Opinion, Zayo v. Latisys Case 12874-VCS*

# Zayo Group v. Latisys Holdings

- The Court had determined Latisys did not breach Section 4.12 of the SPA but also considered question of whether Zayo proved damages.
- Zayo's expert calculated damages of \$22 million based on the implied EBITDA multiple of the transaction and the lost EBITDA from the five material contracts.
- Latisys' expert calculated damages after the Basket under three scenarios that resulted in zero or de minimus damages
  - Out-of-pocket (lost revenue through remaining contract term)
  - Out-of-pocket assuming optional renewal period
  - Allocation of value based on MRR from Material Contracts

*Source: Memorandum of Opinion, Zayo v. Latisys Case 12874-VCS*

# Zayo Group v. Latisys Holdings

- When discussing Plaintiff's damage calculation, the Court noted:
  - Benefit of the bargain (expectancy) damages measure the difference between the as-represented value of a transaction (typically the purchase price) and the value the purchaser actually received.
  - The benefit of the bargain methodology is appropriate for calculating damages only 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) and the business has thereby been permanently impaired.

*Source: Memorandum of Opinion, Zayo v. Latisys Case 12874-VCS*

# Zayo Group v. Latisys Holdings

- The Court noted Plaintiff's damage calculation fell short as:
  - Plaintiff's expert admitted at trial that all of the Material Contracts at issue expired in less than one year
  - Zayo made no effort to prove a diminution of value into perpetuity
  - Zayo did not perform a post-Closing valuation of the company it had acquired
  - To the extent Zayo knew contracts were near expiration or month-to-month as of Closing, there was no basis for Zayo to claim expectancy damages beyond one month's monthly recurring revenue ("MRR")

*Source: Memorandum of Opinion, Zayo v. Latisys Case 12874-VCS*

# Zayo Group v. Latisys Holdings

- The Court noted Plaintiff's damage calculation fell short as (cont.):
  - There is no evidence that Zayo actually based its purchase price on a multiple of EBITDA
  - The EBITDA multiple used for the analysis lacked any foundation in the evidence and ultimately was unpersuasive
- The Court noted that Latisys' expert proffered three credible damages scenarios, each tied to the evidence, proving that realized damages would not exceed the Basket.

*Source: Memorandum of Opinion, Zayo v. Latisys Case 12874-VCS*

# Questions

