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## Evidence and Quantification of Damages in M&A Contracts

Nobody intends and desires disputes in M&A transactions. However, due to the high purchase prices paid controversies ranging from post-contractual discussions to renegotiations or procedural disputes before a court or arbitral tribunal are more common than suspected.

### Ten percent of all M&A transactions lead to contentious situations

Recent studies show that around ten percent of all M&A transactions are controversial in one way or another. Around two-thirds of the participants of a recent study on M&A disputes expect an increase in disputes and renegotiations in the future. The current economic conditions and compliance regulations allow many market participants no other choice. Waiving several million euros purchase price (-recovery) is most often not an alternative. Long-term experience proves an average purchase price reduction of 5-10% for vigilant investors. Nevertheless, in practice adjustments of 50% and more occur. This brings the issue of post-M&A disputes more and more to the focus of companies, private equity funds, legal and financial advisors. Even if conflicts in M&A transactions can be diminished through an intensive due diligence and excellent legal advice in contract negotiations, they cannot be totally prevented. How to prevent controversies? And finally, what to do if it comes to a dispute?

### Providing evidence in M&A disputes

The success of a claimant in a legal dispute significantly depends on whether the claimant is able to expose and prove the facts justifying his or her claim. Espe-



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cially in complex M&A disputes, the opposing parties often underestimate the difficulty in presenting the evidence. If after lengthy proceedings a legal dispute, requiring large amounts of human and financial resources, is lost only due to the fact that the court or arbitral tribunal did not consider the relevant facts to be proven justly, there will be great disappointment. However, the sale and purchase agreement (“SPA”) can partially set the right course to prevent a defeat due to evidentiary problems. This will be discussed in greater detail below.

#### ■ Basic principles of the distribution of burden of proof

According to the generally accepted basic rule of the distribution of burden of proof, the claimant bears the burden of proof for the legal facts justifying the claim and the respondent bears the burden of proof for the legal facts deferring or barring a claim. This means that the party bearing the burden of proof

- has to present the facts as precisely as necessary, so that the respective right can be deemed as established;
- has to elucidate the facts of the case and denote the pieces of evidence;
- has to bear the consequences of the judgment in case the facts of the case remain unclear at any point.

#### ■ Specific features of complex M&A disputes

In complex M&A disputes, often only a closer look reveals that the disputes are not based on solely one issue but on many different issues at a time, which then all have to be demonstrated and proven. If, for example, a buyer claims the breach of a balance sheet guarantee granted by the seller in the SPA due to the incorrectness of a single item on the balance sheet, this item can probably be sourced from a variety of individual facts which then also have to be examined individually. Or, if a seller of a firm guarantees for the buyer to present an excerpt from a database referring to a smaller number of customers in order to prove the breach of a guarantee. The database may be poorly maintained. Under certain circum-

stances it is therefore necessary that 1,000,000 customer contracts are provided in physical form and reviewed to verify that they comply with the customer's definition. Guarantees, especially related to a bulk business, can be problematic regarding aspects of proof.

In order to avoid unpleasant surprises in case of a dispute, the parties should conduct a reality check before agreeing to a guarantee and should ask themselves how the compliance with or breach of a guarantee could actually be proven. This especially applies to fiercely negotiated and less standardized guarantees. In such cases it is recommended to consult a litigator who will quickly recognize possible pitfalls of such guarantees. A litigator can also provide helpful advice on where it makes sense to explicitly agree on the reversal of the burden of proof in a contract.

### ■ Distribution of the burden of proof and wording of contracts

From a substantive legal point of view, besides some explicit legal provisions, the distribution of the burden of proof in German law mainly depends on the wording of the respective contracts. If, for example, a condition for a claim, whose factual requirements generally have to be explained and proven by the claimant, contains wordings such as *"unless, that..."* or *"..., if not..."*, it is thereby expressed that the respondent has to explain and provide proof for exceptions and limitations introduced by such wordings.

English contracts often contain the conjunction *"provided that..."*. In legal proceedings it is then occasionally controversially discussed whether this term is used to describe a limitation or if it rather expresses an additional factual requirement or condition. In the first case, the respondent would have to bear the burden of outlining and proof. In the second case, however, the claimant would be responsible for demonstrating and proving the relevant facts. To avoid such discussions, the parties should not use the conjunction *"provided that..."* but rather undisputed expressions clearly regulating the distribution of the burden of proof.

The examples given above show that even the shortest terms can have a high impact on the distribution of the burden of proof. During contract negotiations,

a litigator can therefore already provide useful support regarding the wording of contracts and thus might help to optimize the future situation in legal proceedings.

### ■ Proof of the will of the parties

A dispute often also arises when questioning what the parties really wanted when they agreed upon a certain contract clause. Then the legally relevant meaning of the clause has to be determined by interpretation. The initial basis for interpretation is the wording of the declaration. Nevertheless, a court will not limit its interpretation to the wording of a clause, but rather in a second step will consider the surrounding circumstances at the time the agreement was made.<sup>1</sup> Amongst other things, a court is interested in the purpose of the parties' intended respective legal transaction and the historical development and origins of the contract clause.

Thus it is essential to always carefully document the course of negotiations, for example by taking handwritten notes, by recording minutes of hearings or conference calls and filing e-mails and drafts of contracts (so-called “*mark-ups*”). In possible future legal proceedings such documents can help to prove what had been intended, which party had originally suggested, prevented or modified the clause and what the clause's meaning should ultimately be. Therefore such documents should definitely be stored carefully.

All the more, it is essential to make sure that notes taken and e-mails written during the process of the transaction contain careful and undisputable wordings. In particular, e-mails written by the management during the transaction process can quickly fall into the hands of the buyer after closing. So if, for example, one of these e-mails mentions that one of the business premises of the target could be compared to a “ticking time bomb” or that the risks related to a specific product are “existence-threatening”, the buyer could use this to construct a case of willful deception on the part of the seller – even if this e-mail was of a harmless nature.

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<sup>1</sup> See BGH NJW-RR 2000, 1002, 1003.

### ■ Proof of willful deception

In M&A disputes we more and more frequently observe situations in which the buyer claims that he has willfully – thus intentionally – been deceived by the seller. Such a claim enables the buyer to lever out contractually agreed liability limitations of the SPA (as for example so-called caps and de-minimis clauses) and to rely on legal bases for claims which are actually excluded in the contract. Especially relevant in real life are claims due to failures during contract negotiations (*culpa in contrahendo*) regarding a breach of disclosure obligations as well as the challenge of a decision due to willful deception (§ 123 BGB). These become relevant in the case of intent, because liability for intent cannot be excluded in a contract.<sup>2</sup>

However, the buyer can only lever out the contractual liability limits if he is able to prove the facts and circumstances justifying a case of willful deception. So he either needs to explain and prove that the seller actively and willfully deceived him by making objectively false statements, or – what actually more often is the case – that the seller answered the potential buyers' questions without due examination and therefore incorrectly, due to pressures felt during the transaction process. If the seller has withheld information subject to his disclosure obligations, a certain relaxation of the burden of proof will take effect to the benefit of the buyer. Whereas the seller needs to prove when and how he disclosed the necessary information, it is up to the buyer to disprove such assertions.<sup>3</sup> In case information subject to the disclosure obligations is withheld by the seller, the buyer is obliged to prove that the adversary was aware of the respective information subject to the duty of disclosure during the signing of the contract.

If the buyer wants to abrogate the contractual limits of liability based on the argument of intent, a promising outcome will generally only arise if he is able to prove the intent of the seller. In that sense, he is required to do more in order to prove the intentional breach of a duty of the seller than what is required of him according to the statutory regulations. According to these regulations, the seller

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<sup>2</sup> Section 276 para. 3 German Civil Code (BGB).

<sup>3</sup> BGH NJW 2001, 64.

has to explain and prove that he did not act intentionally (see section 280, para. 1, sentence 2 German Civil Code).

### ■ Preservation of evidence at the time of closing

At the time of closing, the seller usually loses access to all of the target company's data as well as to its employees. This means that he simultaneously loses important pieces of evidence for a possible lawsuit. Therefore a seller should check and carefully document the status quo of a target company at the time of closing or, respectively, at other relevant key dates (so-called *pre-closing due diligence*). Additionally, the seller should make sure that the share and purchase agreement grants certain information rights and access rights to him in order to be prepared in case a dispute arises. In this respect, it should also be considered that the buyer's obligation to provide information can be limited, e.g. because the seller could abuse such information for purposes other than the contract – e.g. for competition.<sup>4</sup> If need be, such information might then only have to be disclosed to an expert who is obliged to observe confidentiality.<sup>5</sup>

At the time of closing the buyer is granted unlimited access to the target for the first time. He should then immediately inform himself. In particular, he should check the compliance with the catalogue of guarantees and warranties from the share and purchase agreement and document the situation exactly at the effective date (so-called *post-closing due diligence* or "*price test*"). It is advisable to closely inspect issues which were heavily disputed during contract negotiations and for which the seller perhaps did not want to give a guarantee. Here, the buyer should make sure that the seller has provided him with correct information on the actual situation.

### ■ Documents in the sphere of the opposing party

Despite respective precautions included in the SPA and other measures of preservation of evidence, it cannot be neglected that in a lawsuit such documents

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<sup>4</sup> BGH NJW 1966, 1117.

<sup>5</sup> BGH LM § 260 Nr. 6.

located in the sphere of the opposing party, of all things, will be crucial. Documents useful to the seller for calculating purchase price adjustments may, for example, be located at the target company or, conversely, documents useful to the buyer containing information on false statements made by the seller regarding the object of purchase, can be in the possession of the seller.

In this respect, it is necessary to know that the German procedural law provides certain possibilities to force the opposing party to submit such documents in legal proceedings. While a court order for the submission of documents in state legal proceedings is only possible within relatively narrow bounds,<sup>6</sup> several rules of arbitration allow orders for submission of documents without any limitations.<sup>7</sup> Especially in international arbitration, the parties therefore often refer to the *IBA Rules on the Taking of Evidence in International Arbitration*. These try to consolidate the different approaches of the Continental European Legal System and the Common Law System regarding so-called discovery orders by attaching certain conditions to the disclosure of documents.<sup>8</sup> In this way, excessive and seemingly boundless discovery procedures as known from the US can be avoided.

The choice of the dispute settlement mechanism as well as the organization and design of the rules applicable to certain arbitral proceedings can therefore be crucial to setting the right course for being able to better demonstrate and prove one's own claims in the upcoming proceedings and efficiently reaching a result at the same time.

### **The proof of damages in practice**

The fundamental objective of every damage assessment is to restore the injured party, i.e. put them in a position they would have been in without the injuring event. However, this relatively simple principle of damage determination must

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<sup>6</sup> See sections 142, 421 German Code of Civil Procedure (ZPO).

<sup>7</sup> See e.g. section 27.1 DIS Rules of Arbitration; section 25.1 ICC Rules of Arbitration.

<sup>8</sup> See section 3 IBA Rules on the Taking of Evidence in International Arbitration.

be adjusted depending on the jurisdiction and the underlying SPA. And these adjustments may be relatively complicated.

Moreover, not each and every damage can be determined and can certainly not be proved in the same way. A flawed purchase price adjustment or the violation of a balance sheet warranty can be relatively „easily“ identified and documented on the basis of closing accounts, financial data, financial statements and due diligence documents. In cases of suspected balance sheet manipulation, fraud or an „unlawful sugarcoated“ business plan however, the evidence is much harder to find. In this second category of damages, most often forensic e-mail reviews and interviews of key personnel are required in addition to the regular data analysis. In practice e.g. the e-mail from an accountant to a colleague or the thoughtless statement of an operating manager have been the sought after evidence for purchase price reductions worth millions of euros. In this respect, from the seller's view it is advisable to document the information exchanged and the related communication as comprehensively as possible.

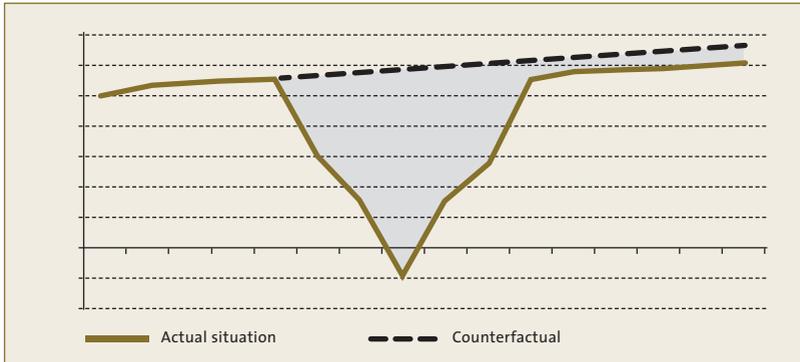
#### ■ Damage quantification – often incorrectly calculated

In case an M&A related dispute has occurred, there is not only the need for evidence, but also the question of how to quantify the compensation. If, for example, a provision was omitted in the balance sheet, even some experienced litigators still believe that the damage represents „only“ the shortfall in the account balance – leading to a euro-for-euro indemnity. Nevertheless, interest rate effects, taxes, ensuing damages and mitigations can quickly accumulate to deviations of +/- 40% and more compared to the simplified euro-for-euro approach. Whenever you are confronted with material accounting errors and high impact breaches of balance sheet guarantees, it is advisable to opt for a more precise approach to quantify damages.

The most commonly used form of damage assessment is the „but-for-analysis“. It represents the actual situation (including the damage) compared to the counterfactual (without damage). The following chart corresponds to the compensation as the difference between the cash flows with and without damage (gray area; see Fig. 1).

But-for-Analysis

Fig. 1



Compensation as the difference between the cash flows with and without damage (gray area).

The “but-for-analysis” takes into consideration even the above mentioned indirect effects like taxes, interest, ensuing damages and mitigations. If confronted with larger indemnifications the „but-for-analysis“ is most often the preferable approach due to its greater accuracy.

Purchase price multiples have a special status in M&A disputes. Is e.g. the damage related to the normalized EBIT or EBITDA, which was the basis for the purchase price derived by a EBIT/EBITDA multiplier, then the question arises whether the damage is to be compensated only once or several times (equal to the EBIT/EBITDA multiplier). This is an extremely interesting question not just from a legal perspective. A remarkable leverage effect for the buyer can be noted if the data is able to support the reimbursement of damages based on a multiplier. Even relatively minor EBIT/EBITDA adjustments suddenly lead to large compensations. Sellers should watch out in the SPA for having to reimburse damages several times over.

### Tips from the daily M&A practice

First of all, the importance of being advised by experienced legal counsels and litigators cannot be stressed enough. They do not only copy text modules, but

also consider the interactions of the contractual passages. They already set the stage for the best possible burden of proof in the case of subsequent legal proceedings or arbitrations.

From the buyer's perspective, revealing the purchase price determination in the purchase agreement can also reveal transparency. From the perspective of the seller, the SPA should permit access to the relevant documents in case of a dispute. Due to the increasing number of post-M&A disputes, the storage of documents and especially the documentation of the deal communication are becoming ever more important. It has to be noted that some post-M&A lawsuits solely fail on the necessary evidence.

For larger disputed amounts it is advisable for buyers and sellers to verify whether the damage was even calculated correctly. Were tax effects, interest, mitigations and consequential damages included? Practice shows that there is still a great need for raising awareness.

It can be assumed that the trend to exercise and enforce rights of SPAs and hence related disputes will further increase in the future. Due to the immense economic importance that is accompanied by many of these disputes, this consequence is more than understandable and should come as no surprise.

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