IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

GEOFFREY CHAMBERS and ROBERT WHEELER,	)	
Plaintiffs,	)	
v.	)	C.A. No. 354
GENESEE & WYOMING INC.	)	
Defendant.	)	

MEMORANDUM OPINION

Date Submitted: July 1, 2005
Date Decided: August 11, 2005

Ronald A. Brown, Jr., Esquire, PRICKETT, JONES & ELLIOTT, P.A., Wilmington, Delaware, *Attorney for Plaintiffs.*

Albert H. Manwaring, IV, Esquire, PEPPER HAMILTON LLP, Wilmington, Delaware; Laurence Z. Shiekman, Esquire, and Stuart D. Lurie, Esquire, PEPPER HAMILTON LLP, Philadelphia, Pennsylvania, *Attorneys for Defendant.*

STRINE, Vice Chancellor

This case requires me to interpret contractual language in two identical stock option agreements (the "Agreements") that exist between each of the plaintiffs, Geoffrey Chambers and Robert Wheeler, and the defendant, Genesee & Wyoming, Inc. ("Genesee"). The Agreements arose in the context of Genesee's buyout of Chambers and Wheeler from a joint business venture in 1999. Genesee had been a partner with Chambers and Wheeler in that joint venture, called Genesee Rail-One, from its inception until 1999 when it bought them out.

As is sometimes the case when buyers and sellers cannot agree on the value of an income-earning asset, Chambers, Wheeler and Genesee included terms in the Agreements that were tied to the performance of Genesee Rail-One going forward, specifically to its EBITDA as defined in the Agreements.[1] EBITDA, however, can be a slippery concept, and it is this indefiniteness — plus the characteristic divergence in the sellers' and the buyers' interests that arises all too often in calculating whether the targets in "earn-out" contracts were achieved — that has led to the current conflict.

Roughly, the Agreements provided that Chambers and Wheeler should receive additional compensation, in the form of Genesee options, if Genesee Rail-One hit a certain level of EBITDA, a trigger of $9 million CAD,[2] in any of the five years, 1999-

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[1] EBITDA is an acronym generally understood to signify Earnings Before Interest, Taxes, Depreciation and Amortization. Some accounting texts maintain that there is no commonly understood definition for EBITDA, despite its common use in corporate financial parlance. Even Genesee's expert acknowledges this point. *See* Rosen Decl. Ex. A at 5 ("A standard, generally accepted definition of EBITDA does not exist.")

[2] As described below, several of the players in this drama are Canadian companies, or have a base of operations in Canada. As a result, some of the cash figures referred to in this opinion are in Canadian dollars and some are in U.S. dollars. To distinguish between the two, I will use the

2003, following their departure from Genesee Rail-One. If that amount was realized in any year, Chambers' and Wheeler's options were to vest. Since the 1999 buyout, Genesee Rail-One's publicly-reported, balance sheet EBITDA has exceeded $9 million CAD in four of the five years in question, 2000, 2001, 2002, and 2003.[3] Yet, Genesee maintains that it is not obligated under the Agreements to vest the options because, it asserts, EBITDA *as defined in the Agreements* has not exceeded $9 million CAD in any year.

The discrepancy arises because Genesee has separately calculated — by making adjustments to its reported, balance-sheet EBITDA — an EBITDA specifically for use in determining whether Chambers' and Wheeler's options have vested. As adjusted by Genesee, its revised EBITDA, has never crossed the annual $9 million CAD trigger. The essential questions therefore become, whether Genesee's adjustments were proper under the Agreements, and as a result, whether the $9 million CAD trigger was reached in any of the five years covering the agreements entitling Chambers and Wheeler to their options at the agreed price.

The key facts in the record are undisputed and the parties have therefore both moved for summary judgment. In this opinion, I find that Genesee's calculation of

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naked "$" symbol when referring to U.S. Dollars, and include "CAD" along with the "$" symbol following a figure measured in Canadian dollars.

[3] Chambers and Wheeler filed their complaint in April 2004, before receiving figures for 2003. They later received those figures and now argue that the trigger was also reached in 2003. Because Genesee made additional adjustments to the EBITDA in 2003, over and above the adjustments made to the 2000-2002 figures; because the nature of these additional adjustments have not been fully briefed or argued by the parties; and because, most critically, I find the information regarding 2003 to be superfluous to deciding the pending motions, I do not consider the 2003 results, but focus on the 2000 through 2002 results.

EBITDA for purposes of the Agreements is flawed in at least two respects. Correcting just one of these miscalculations, independently, is sufficient to push Rail-One's EBITDA above the $9 million trigger in at least one year, 2001. Correcting both of these adjustments results in attainment of the $9 million CAD threshold in 2000, 2001, and 2002. As a result, I conclude that the options owed to Chambers and Wheeler have vested.

I. Factual Background

This is a story about the Railroad. In 1996, plaintiffs Chambers and Wheeler formed Rail-One with the intention of entering the short line railway business in Canada.[4] Short lines own a limited amount of track, perhaps one line, as compared to larger railroads that own entire networks. In order to facilitate their entry into the industry, Chambers and Wheeler sought a partnership with a more established player, and found a match in the defendant, Genesee & Wyoming, Inc. Genesee is a Delaware corporation whose shares trade on the New York Stock Exchange. It operates over 8,000 miles of track through short line and regional railroads in the United States, Canada, Mexico, Australia and Bolivia. A deal was eventually agreed upon — Rail-One and Genesee[5] each took equal positions of 47.5% in a new joint venture, Genesee Rail-One.[6]

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[4] Together, Chambers and Wheeler owned 100% of Rail-One.

[5] Genesee took its position in the joint venture through its 100% owned subsidiary, GWI Canada, Inc. For purposes of this opinion, the distinction between these entities is not critical, and I will therefore collectively refer to them as "Genesee." Similarly, although Chambers and Wheeler took their position in Genesee Rail-One through their jointly held entity, Rail-One, I will continue to refer to them wherever possible, along with Rail-One collectively, as "Chambers and Wheeler" to avoid any confusion between their entity, Rail-One, and the joint venture, Genesee Rail-One.

[6] An individual named Barry Scott owned the remaining 5% of Genesee Rail-One.

Over the months following its founding, Genesee Rail-One acquired two operating subsidiaries, the Huron Central Railroad, Inc. ("Huron") in June or July of 1997 and the Quebec-Gatineau Railroad, Inc. ("Quebec-Gatineau") in November 1997. Genesee Rail-One functioned as the jointly-held holding company for these two subsidiaries until April 1999. Chambers and Wheeler were the active managers of the joint venture, Genesee Rail-One, with Chambers serving as President and Wheeler serving as CFO. Both also served on its board of directors. Together, they handled the day-to-day operations of Genesee Rail-One.

But the venture also benefited from being part of the Genesee family. Specifically, Genesee & Wyoming Railroad Services, Inc. ("Railroad Services"), another subsidiary resting beneath the Genesee umbrella, provided a number of centralized services to Genesee's various operating subsidiaries, including Huron and Quebec-Gatineau. These services included, for example, information technology services and specialized accounting services. Genesee Rail-One paid a "management fee" to cover the costs for the services that Railroad Services provided to Huron and Quebec-Gatineau. By approximately the beginning of 1998, this fee was $15,000 per month or $180,000 annually.[7]

[7] Note, this charge is measured in U.S. dollars and is approximately equal to $279,000 CAD annually, depending on the exchange rate. At some point in 1998, the amount of this charge was reduced to $5,000 ($7,537 CAD) per month in recognition of Genesee Rail-One's financial difficulties. The parties dispute whether this charge was returned to the $15,000 monthly level in January of 1999, before Chambers and Wheeler departed, or whether sometime after their departure, the amount was retroactively increased to $15,000 beginning in January 1999, and a lump sum adjustment made to cover the discrepancy. This dispute is not material to this decision.

Later, in November 1998, Genesee Rail-One sought to expand its operations by acquiring another operating subsidiary, Mirabel Railway. But, Mirabel was ultimately acquired by Genesee because Genesee Rail-One could not obtain sufficient financing. Nonetheless, Mirabel's operations were essentially assumed by Quebec-Gatineau, which paid Mirabel a flat rate for the use of its track under a contract dated November 13, 1998. This payment represented the only income for Mirabel, which in a practical, if not technical, sense was subsumed into Quebec-Gatineau. Although the evolution of that relationship provides some fuel for the parties' dispute,[8] the heat generated shines little light on the path to resolution. I therefore move on to the crux of the dispute — Genesee's buyout of Chambers and Wheeler and the language of the attendant Agreements.

By the end of 1998, Genesee Rail-One was experiencing some financial difficulties. When acquiring Quebec-Gatineau back in 1997, Genesee Rail-One had financed the acquisition, in part, with a loan from the Bank of Nova Scotia. Having failed to generate sufficient revenue from operations to cover the loan payments, Genesee Rail-One defaulted. Chambers and Wheeler by that point had apparently grown tired of their adventure in the railroad business and began negotiating with their partner, Genesee, to buy them out of the business. Those negotiations culminated in the sale of Chambers and Wheeler's interests in Genesee Rail-One to Genesee on or about April 15, 1999.

[8] The payments to Mirabel and their accounting in the EBITDA calculation are a bone of contention between the parties. Because the cross motions can be decided on other grounds, I need not, and therefore do not, chew on that issue here.

The sale involved several distinct components, including that: 1) Chambers and Wheeler, through their jointly held entity Rail-One, were to receive a return of their initial capital contribution to the joint venture, or approximately $320,000; and 2) Chambers and Wheeler, again through Rail-One, were to receive $1,000,000 in four equal installments of $250,000 over the next four years. Neither party disputes that all of these payments have been made by Genesee as agreed.

Most importantly for our purposes, both Chambers and Wheeler also negotiated the Agreements that are the source of contention here. The Agreements provide that each would have the right to purchase 40,000 shares of Genesee stock at $8.625 per share if, subject to some limitations, "on or following the 90th day following the end of any calendar year between and including 1999 and 2003 in which GRO [Genesee Rail-One] generates EBITDA in excess of CDN $9,000,000 . . . ."[9] These options, if vested by the triggering EBITDA threshold, could be exercised up until the end of 2013.[10] In this case, the parties debate whether this $9 million CAD trigger was reached in any of the relevant years.

Chambers and Wheeler have alleged, and Genesee has not denied, that as a result of subsequent stock splits and pursuant to the adjustment provisions in paragraph 9 of the Agreements,[11] each, if entitled to options under the Agreements, would now currently hold the right to purchase 135,000 shares at $2.555 per share. Over the past year,

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[9] Agreements at ¶ 3(b).
[10] *Id*. at ¶ 4(d). Other provisions would govern in the event that Genesee was sold before the options otherwise expired. *Id*. at ¶¶ 4-5.
[11] Agreements at ¶ 9.

Genesee's stock has traded within a few dollars of $25.00 per share on the New York Stock Exchange. To put this dispute in perspective, the math suggests that if they are successful here, each will be entitled to pay approximately $345,000 for stock worth in the neighborhood of ten times that amount, netting Chambers and Wheeler over $3 million each, if they choose to sell immediately, and constituting by far the single largest element of the compensation they obtained for selling their shares in Genesee Rail-One in 1999.

Chambers and Wheeler do not allege that Genesee Rail-One exceeded the EBITDA trigger in 1999, but do allege that the trigger was met in each of the following years, 2000, 2001, and 2002.[12] It is undisputed that, by one calculation of EBITDA — that reported in Genesee's public filings — Genesee Rail-One surpassed the $9 million CAD trigger in each of 2000, 2001 and 2002, with EBITDAs of $9.315 million CAD in 2000, $9.988 million CAD in 2001, and $9.918 million CAD in 2002.

But, Genesee contends that these EBITDA values, drawn from its consolidated balance sheets, are inflated and are not the appropriate values for analysis under the Agreements. Accordingly, starting with its publicly reported figures, it adjusted its consolidated balance sheet EBITDAs to arrive at what it considered to be the appropriate EBITDA values under the Agreements. These adjusted values repeatedly fell just shy of the $9 million CAD trigger, yielding $8.575 million CAD in 2000, $8.887 million CAD in 2001, and $8.374 million in 2002.

[12] As noted previously, I do not consider the 2003 results in this opinion.

In each year, Chambers and Wheeler were provided with a reconciliation of the disparate EBITDA values showing the consolidated balance sheet figure, the adjustments, and the resulting adjusted EBITDA.[13] They challenge the propriety of these adjustments and allege that it is not a coincidence that the adjusted EBITDA somehow manages to marginally miss the trigger in every year. Additionally and relatedly, Chambers and Wheeler contend that one of the expenses included in Genesee's publicly recorded EBITDA figures for Genesee Rail-One is inappropriate under the Agreements, and they therefore seek an adjustment of their own to reincorporate this figure.

The Agreements themselves provide definitions of several terms that both sides look to in order to support their interpretation. Because the analysis that follows is based on the contractual language of the Agreements, I first offer the reader the pure, unvarnished language of the Agreements defining the relevant terms that figure prominently in the discussion that follows:

> "**EBITDA**" means Revenue from the Operations of HCR [Huron] and QGR [Quebec-Gatineau], less Operating Expenses, plus Depreciation and Amortization.

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[13] The financial documents provided to Chambers and Wheeler reflecting these figures are attached as exhibits B, C and D to the Complaint, and the relevant pages included in those emails and faxes, containing financial information, are also included as exhibits L, M and N to the Appendix Containing Exhibits to Def. Ans. Br. The figures in these documents themselves are not disputed, but their appropriateness to the analysis under the Agreements is contested. I refer to these documents as the 2000, 2001 or 2002 EBITDA Reconciliations, respectively, throughout the remainder of this opinion.

I also note that the 2000 EBITDA Reconciliation refers to the $9.315 million CAD EBITDA starting figure as "EBITDA as per Financial Statements reported to the Board," while the 2001 and 2002 EBITDA Reconciliations refer to their respective starting figures of $9.988 million CAD and $9.918 million CAD as "EBITDA as per Consolidated Financial Statements." Because I assume that the Genesee board reviews its company's consolidated financial statement, and because neither party has suggested that this difference in moniker is significant, I treat these terms as representing the same base EBITDA figure in each of the respective years.

> "**GRO**" means Genesee Rail-One, Inc.
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> "**GRO Expenses**" means expenses incurred by GRO in providing business support services to HCR and QGR. These expenses may include specific charges for services provided by GWI [Genesee] for work performed exclusively for GRO but will not include general charges or allocations of costs by GWI to GRO.
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> "**HCR**" means Huron Central Railroad, Inc.
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> "**QGR**" means Quebec Gatineau Railroad, Inc.
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> "**Operations**" means the economic activity of HCR and QGR related to railroad freight business and services, including transport of rail freight, rail car leasing and repair, automotive unloading compounds, and product reload centers.
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> "**Operating Expenses**" means expenses incurred in the normal course of business by HCR and QGR to support Operations including GRO Expenses excluding losses on sale of asset and interest expense.
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> "**Revenue**" means income generated by HCR and QGR from Operations excluding gains on sale of assets, interest income, and extraordinary income.[14]

Both sides concede that the Agreements' definition of EBITDA, as shaped by the other defined terms that it incorporates, must govern the contractual calculation, but as I discuss below, they disagree about how this paper definition comes to life in the real world exercise of calculating whether Genesee attained results in any year that entitle Chambers and Wheeler to their options.

II. Legal Analysis

The summary judgment briefs revolve around three discrepancies, only two of which I address in this opinion. Because the dispute arises as a result of cross motions

[14] Agreements at ¶ 3(a) (emphasis in original).

for summary judgment, I apply the well-settled standards for such motions in analyzing the parties' contentions. To prevail, each moving party must show that there is "no genuine issue as to any material fact" and that they are "entitled to judgment as a matter of law."[15] In examining the record, I must draw every reasonable inference in favor of the non-moving party,[16] and accept the non-moving party's version of any disputed facts.[17] But where, as here, the task before the court is the interpretation of contractual language, the court should initially focus solely on the language of the contract itself. If that language is unambiguous, its plain meaning alone dictates the outcome.[18] In the endeavor to distill a contract's meaning, "the language of an agreement, like that of a statute, is not rendered ambiguous simply because the parties in litigation differ concerning its meaning,"[19] rather, it is for the court to determine whether the contested provisions are "reasonably or fairly susceptible of different interpretations or may have two or more different meanings."[20] That the parties have filed cross motions for summary judgment does not alter this standard.[21]

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[15] Ct. Ch. R. 56(c). *See, e.g., Acro Extrusion Corp. v. Cunningham*, 810 A.2d 345, 347 (Del. 2002).
[16] *Id*.
[17] *Merrill v. Crothall-American, Inc.*, 606 A.2d 96, 99-100 (Del. 1992).
[18] *Pellaton v. The Bank of New York*, 592 A.2d 473, 478 (Del. 1991).
[19] *City Investing Co. Liquidating Trust v. Cont'l Cas. Co.*, 624 A.2d 1191, 1198 (Del. 1993).
[20] *Rhone-Poulenc Basic Chems. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1196 (Del. 1992).
[21] *United Vanguard Fund, Inc. v. TakeCare, Inc.*, 693 A.2d 1076, 1079 (Del. 1997). I note that the recent amendment to Ct. Ch. R. 56, adding section 56(h) *Cross Motions*, though seemingly relevant, in fact does not bear on my determination here. Each party has argued that, if it is not entitled to summary judgment, it has at least raised sufficient questions of material fact that the other party's motion must be denied. Rule 56(h) only applies where "parties have filed cross motions for summary judgment *and have not presented argument to the Court that there is an issue of fact material to the disposition of either motion.*" (emphasis added). Only then shall the court "deem the motions to be the equivalent of a stipulation for decision on the merits based on

A. The General Charge

In calculating its consolidated balance sheet EBITDA for public reporting purposes, Genesee included a fixed, monthly charge for services that it provided to Genesee Rail-One. This charge, fixed at $180,000 annually, obviously bears a striking resemblance to the "general charges or allocations of costs by GWI to GRO" that the definition of "GRO Expenses" contained in the Agreements explicitly removes from the calculation of EBITDA.[22] Chambers and Wheeler therefore contend that this charge should be excluded from the calculation of EBITDA, an allegation that, if correct, will increase Genesee Rail-One's annual EBITDA as calculated under the Agreements for 2000-2002 by approximately $279,000 CAD. That figure, when added to the adjusted EBITDA of $8.887 million CAD in 2001, is sufficient to exceed the $9 million CAD EBITDA trigger under the Agreements for that year. This allegation is therefore, in and of itself, outcome-determinative. If Chambers and Wheeler prevail on it, they are entitled to their options under the Agreements.

Genesee, with the support of its accounting expert, Lawrence S. Rosen, argues that the $180,000 fee is appropriately included on two main grounds. First, Genesee contends the $180,000 fee has been charged since before Chambers and Wheeler left active management of Genesee Rail-One, and therefore in the absence of their having specifically disavowed its appropriateness, they somehow acquiesced to its continuation.

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the record submitted with the motions." Ct. Ch. R. 56(h). Because both sides have alleged that there are outstanding issues of fact material to the resolution of the other's motion, Rule 56(h) does not apply by its own terms. I therefore apply the traditional standards that have evolved in our jurisprudence for considering cross motions for summary judgment.

[22] Agreements at ¶ 3(a).

Second, Genesee argues that actual services were provided to Quebec-Gatineau and Huron by Rail Services — Genesee's subsidiary that provides central services to its operating railroad subsidiaries — for that payment. If Genesee had not provided these services, Genesee Rail-One, or its subsidiaries Quebec-Gatineau and Huron, would have needed to obtain them elsewhere, for a cost. Therefore, to not include the fee, Genesee argues, artificially inflates the profit generated by Genesee Rail-One and, if permitted, allows Chambers and Wheeler to obtain a windfall by avoiding one of the fundamental rules of accounting — that profits should be matched with the expenses incurred to obtain them in the period in which they occur.[23] Genesee implicitly argues that such a computation is unfair.[24]

But fairness, in some moral sense, is not the question here. This is a context as purely commercial as one can imagine, in which the issue is how to interpret an earn-out provision in a contract between former business partners. To decide this matter we need not turn to Rawls for moral guidance, or even to fundamental accounting principles, we need to focus on contract law. When one does so, it is clear that Genesee is wrong as a matter of law.

In explaining why, I begin and end with the plain language of the contract itself. Where that language is clear and unambiguous, the "parties' intent [in contracting] is ascertained by a reasonable reading of the plain language," construing the document as a

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[23] *See* CICA Handbook, Section 1000.51, as of March 1996 (quoted in Rosen Decl. Ex. A at 7).
[24] Def. Ans. Br. at 18. ("Plaintiffs' conclusion relies on the premise that [Genesee Rail-One] should not have to pay for the assets it uses in the course of its operations; Plaintiffs' apparent position is that [Genesee Rail-One] should simply get the use of these assets for free.") (citations omitted).

whole.[25] If the language is accessible in this manner, there is no need to go outside it searching for the parties' intent; the clear, simple and unambiguous language is given force and effect.[26] Here, the plain language of the Agreements states:

> "**EBITDA**" means Revenue from the Operations of HCR [Huron] and QGR [Quebec-Gatineau], *less Operating Expenses*, plus Depreciation and Amortization. . . .
>
> "**Operating Expenses**" means expenses incurred in the normal course of business by HCR and QGR to support Operations *including GRO Expenses* excluding losses on sale of assets and interest expense.[27]
>
> "**GRO Expenses**" means expenses incurred by GRO in providing business support services to HCR and QGR. *These expenses may include specific charges for services provided by GWI [Genesee] for work performed exclusively for GRO but will not include general charges or allocations of costs by GWI to GRO*.[28]

What Genesee did was to impose a monthly general charge to Genesee Rail-One supposedly as an allocation of services that Genesee, as a parent, provided through Rail Services to Genesee Rail-One. This, of course, is the very essence of a discretionary general overhead charge, attributing to the child a portion of the on-going costs the parent incurs to run its overall corporate family.[29] In saying this, I do not at all imply that such an allocation is improper as a general accounting matter. It is often a fair and sensible

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[25] *Sussex Equipment Co. v. Burke Equipment Co.*, 860 A.2d 812 (Table), 2004 WL 2423841 (Del. 2004) (quotations omitted).
[26] *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 342-43 (Del. 1983).
[27] Agreements at ¶ 3(a) (emphasis added).
[28] *Id*. (emphasis added).
[29] *See, e.g.*, Clyde P. Stickney & Roman L. Weil, *Financial Accounting: An Introduction to Concepts, Methods, and Uses*, G-16 (8th ed. 1997) (defining central corporate expenses as, "[g]eneral overhead expenses incurred in running the corporate headquarters and related supporting activities of the corporation. Accounting treats these expenses as period expenses. . . . Line of business reporting must decide how to treat these expenses — whether to allocate them to the individual segments and, if so, how to allocate them.").

way to allocate costs of backbone services whose use by various subsidiaries varies, but within relatively tolerable bounds.

The problem for Genesee is that it signed a contract whereby such general charges could not be counted against the EBTIDA definition used to determine Chambers' and Wheeler's eligibility to receive the options. The inescapable conclusion of reading the contractual definitions as a whole is that general charges or allocations of costs from Genesee to Genesee Rail-One will not and cannot be included in the calculation of Genesee Rail-One's EBITDA under the Agreements. With the plain language pointing to exclusion of the general charge, the burden falls to Genesee to rebut this reading or, at least to demonstrate some ambiguity. It has failed to do so.

Genesee's argument that Chambers and Wheeler knew that Genesee had charged a general overhead payment to Genesee Rail-One before they left is irrelevant. Of course, Chambers and Wheeler knew of the general overhead charge as a result of their management and board positions at Genesee Rail-One. But leaving their position of day-to-day management of the company, it was prudent for them to negotiate limits on charges that were not easy for them to monitor going forward, like, for example a general management fee. That would prevent any manipulation of such a fee.

Furthermore, that, by the Agreements' plain language, Chambers and Wheeler achieved an EBITDA calculation that excluded otherwise justifiable general allocations of headquarters services does not generate an unconscionable result, even if it results in a contractual EBITDA that differs from economic reality to some extent. The exclusion of general charges and allocations was part of an arms-length contract for which Genesee

received valuable consideration. In short, nothing in Genesee's arguments, that the general charge or allocation was historic and known to Chambers and Wheeler or that the exclusion of the general charge should somehow offend the court's moral sensibility, refutes, or even responds to, the basic point that the language of the Agreements clearly excludes general charges and allocations, such as the management fee.

In this same vein, Genesee misconstrues Chambers' and Wheeler's argument in the broader sense. They are not quibbling about whether Genesee could charge Genesee Rail-One a general charge. They are simply saying their Agreements excluded such a charge from the EBITDA calculation. That is, Chambers and Wheeler have nowhere alleged that the payments to Genesee should not have taken place or were in any way inappropriate in a larger sense.[30] They concede that the services provided by Genesee were necessary to the operations of Quebec-Gatineau and Huron, and that these services had to be obtained from either Genesee or some other provider. They do not contest that these charges were to cover specific services. Instead, what Chambers and Wheeler properly allege is that the charges, as opposed to the services themselves, are general, and as such are specifically excluded from the EBITDA calculation as defined in the Agreements. Genesee's response misses this logical nuance as it repeatedly asserts that the charges were for specific services; the technical legal counter argument to this assertion is, "so what." The Agreements do not say that charges for "specific services"

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[30] Genesee's intimations on this point are unavailing. *See* Def. Ans. Br. at 21 n. 17 ("One would have suspected that if such an expense was inappropriate, Plaintiffs would have raised some objection to the transfer pricing charges when they managed [Genesee Rail-One]"). This, of course, misses the critical distinction — paying the charges is not objectionable; counting them as part of the EBITDA calculation under the Agreements is.

will be included; it says unambiguously that "specific charges" may be included, but that "general charges or allocations" will be excluded. That Genesee, who had complete control of the process of charging after Chambers' and Wheeler's departure, chose to continue to make the easier choice, from a calculation and tracking perspective, of simply imposing a general charge, was exactly that: its choice. But choices have consequences and the consequence here is that the general charge cannot be counted in the calculation of EBITDA under the Agreements.

Perhaps sensing the lack of logical heft in its position, Genesee's litigation posture on this issue is even more extreme. For trial, Genesee hired an accountant as an expert who attempted to endorse Genesee's efforts, years after-the-fact, to calculate retroactively what the itemized charges to Genesee Rail-One would have been if Genesee had bothered to calculate the services that Rail Services provided to Quebec-Gatineau and Huron with precision at the time. Even these post-hoc efforts by Genesee admittedly involve prorating the portions of the salaries of Genesee employees supposedly spent on Genesee Rail-One matters.[31] These efforts, according to Genesee's expert, produce a "reasonable reflection of the costs" in question and are therefore "preferable" to a flat monthly charge.[32] Well . . . maybe to an accountant being paid expert fees. To a court faced with

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[31] *See* Rosen Decl. Ex. A at 9. To the extent that Genesee seeks to somehow distinguish "prorating" from "allocating" as prohibited in the Agreements, this linguistic legerdemain is not persuasive.

[32] *Id.* Not surprisingly, Genesee's efforts find that the value of the services provided to Huron and Quebec-Gatineau exceeded the monthly charge imposed for those services, and, when properly incorporated, lead to an even lower EBITDA then that initially reported. *See* Rosen Del. Ex. A Appendix A (calculating revised EBITDAs by year and showing $8.455 million CAD for 2000, $8.676 million CAD for 2001, and $8.007 for 2002). It is these revised, adjusted EBITDAs that Genesee espoused in its briefs. Def. Ans. Br. at 16.

upholding these Agreements, they are an unreliable, after-the-fact, litigation construct designed to relieve a party that assessed a general overhead charge of the contractual consequences of its decision. To permit Genesee a second bite would not only be contractually improper, it would be inefficient.

There are always choices to be made in accounting treatment and earn-out contracts are already enough of a boon to litigation practices. Indulging the post-hoc reconstruction of accounting books and records that could have been, but were not, contemporaneously created and used to account for certain economic activity, in the common context of earn-out disputes, threatens to generate costly and complicated proceedings with resulting judicial determinations that would not reliably recreate the actual past. To do so would not only burden public resources, but would also increase the litigation costs of the contracting parties whose business partners unilaterally decided to scrap their contemporaneous accounting decisions in favor of a law-suit inspired reimagining of history. It is for this very reason, among others, that in reviewing accounting choices this court looks not to what might have been, but to what was. Genesee chose to account for its services with a general charge to Genesee Rail-One. Such a charge is expressly and unambiguously not included in the calculation of EBITDA under the Agreement. Chambers and Wheeler thus became entitled to receive their options 90 days after the end of 2001.

B. The Labor Adjustment

Although I find the general charge issue dispositive, out of an overabundance of caution I also consider the largest of Genesee's adjustments. In each of 2000, 2001 and

2002, Genesee reduced Genesee Rail-One's EBITDA as reported on its consolidated balance sheet by an amount that it asserts was attributable to, "Labor: Capitalized costs . . . which would not have been capitalized under previous management."[33] With this justification, Genesee reduced the EBITDA under the agreement from the consolidated balance sheet EBITDA by $506,705 CAD in 2000, $886,918 CAD in 2001, and $1.308 million CAD in 2002.

Chambers and Wheeler argue that these charges — the "Disputed Labor Costs" — do not fall within the contractual definition of Operating Expenses which includes only "expenses incurred *in the normal course of business* by HCR and QGR to support Operations."[34] They argue that these very large labor expenditures were clearly not in the "normal course" but were exceptional, long-term, investments in infrastructure, encouraged and heavily subsidized by the Canadian government, that cannot reasonably be included as expenses in the general sense. That is, Chambers and Wheeler say that these factors warrant giving the Disputed Labor Costs the investment-specific accounting treatment that Genesee actually gave them in its publicly reported financials — the capitalization, rather than the expensing, of the Disputed Labor Costs. In each of 2000, 2001, and 2002, the reversal of Genesee's deduction of these Disputed Labor Costs would increase the calculated EBITDA over the $9 million CAD trigger under the Agreements, causing the options to vest. Thus, this objection constitutes an independently outcome-determinative analysis that, if found in Chambers' and Wheeler's

[33] *See* 2000-2002 EBITDA Reconciliations.

favor, will require that judgment be entered for them and that they receive their disputed options.

Chambers and Wheeler have provided unrebutted evidence that the Disputed Labor Costs were not within the "normal course" and therefore should not have been deducted as operating expenses. The dramatically increasing Disputed Labor Costs that were capitalized reflected a new initiative at Genesee Rail-One to dramatically refurbish large sections of its railroads during the 2000 through 2003 time period. To that end, for the first time in 2000 Genesee Rail-One began to budget substantial resources to the capital improvement of its assets and decided, concurrently, to begin capitalizing the labor costs associated with those projects. From 2000 through 2002, Genesee Rail-One took advantage of a Canadian government program designed to assist in the maintenance of infrastructure by providing grant money to contribute to major refurbishment projects. This government grant program specifically excluded routine maintenance projects. Genesee Rail-One received large amounts of money from the Canadian government through this program for the years 2000 through 2002 — $472,000 CAD in 2000, $618,320 CAD in 2001 and $772,192 CAD in 2002.[35] The program was apparently discontinued for 2003.

Genesee claims that the Dispute Labor Costs should be expensed for purposes of calculating EBITDA under its Agreements with Chambers and Wheeler. Its odd justification for deviating from its own voluntary decision to capitalize the Disputed

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[34] Agreements at ¶ 3(a).
[35] *See* Cert. of Ronald Brown Exs. 31-33, GWI 5504, GWI 5526, GWI 5546 (including checks to Quebec-Gatineau from the Government of the Canadian province, Quebec, for these amounts).

Labor Costs is its, as we shall see, unsupported and literally unprovable contention that Genesee Rail-One would have expensed the Disputed Labor Costs if those costs had been incurred when Chambers and Wheeler were its management. Consistency, Genesee says, should drive the contractual calculation.

In analyzing Genesee's excuse for deviating from its own accounting treatment of the Disputed Labor Costs as capital expenditures, I once again look to the plain language of the Agreements in the first instance.[36] The language of the Agreements make no provision for the strained rationale that Genesee attempts to rely upon. Instead, the documents state that:

> "**EBITDA**" means *Revenue from the Operations* of HCR [Huron] and QGR [Quebec-Gatineau], less Operating Expenses, plus Depreciation and Amortization. . . .
>
> "**Operations**" means the *economic activity of HCR and QGR related to railroad freight business and services*, including transport of rail freight, rail car leasing and repair, automotive unloading compounds, and product reload centers.

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[36] *Hibbert v. Hollywood Park, Inc.*, 457 A.2d 339, 342-43 (Del. 1983). Although I rely on the unambiguous meaning of the language of the Agreements in making my determinations here, I note that even under less linguistically driven summary judgment standards, Genesee's position is unpersuasive. Where one party has met its initial burden to show an absence of material facts to be resolved, "the burden shifts to a non-moving party to demonstrate that there are material issues of fact." *Moore v. Sizemore*, 405 A.2d 679, 680-81 (Del. 1979) (citations omitted). That burden, it seems to me, is even more stark where, as here, that non-moving party controls the very documents that establish whether or not the contractual condition has been met. In this sense, the non-moving party's burden echoes Genesee's contractual burden. Where a party to a contract has sole discretion to determine "whether the condition in fact has occurred, that party must use good faith in making that determination." *Gilbert v. El Paso Co.*, 490 A.2d 1051, 1055 (Del. Ch. 1984), *aff'd* 575 A.2d 1131 (Del. 1990). Similarly, where the moving party seeking summary judgment has met its initial burden, the non-moving party that controls the relevant documentation is obligated to provide any documentation that suggests the existence of an outstanding issue of material fact. Genesee fails to meet this burden.

> “**Operating Expenses**” *means expenses incurred in the normal course of business by HCR and QGR to support Operations* including GRO Expenses excluding losses on sale of assets and interest expense.[37]

In preparing its public financial statements, Genesee chose, for rational business reasons,[38] to capitalize the Disputed Labor Costs associated with these new projects. The reason it did so is plain, the Disputed Labor Costs were expended as unique, non-recurring expenses necessary to a long-term capital investment. Because of that reality and the long, useful life of the resulting improvements, Genesee could credibly account to the public for these Disputed Labor Costs as capital investments and report a higher EBITDA. But, the same reasons it could do so also demonstrate that the expenses were not within the contractual definition of Operating Expenses as they were outside the “normal course.”

In defense of its position that it can capitalize the Disputed Labor Costs for reporting to the public, but expense them for purposes of calculating Chambers’ and Wheeler’s eligibility for options, Genesee understandably does not rely on the language of the Agreements. Genesee points to no language in the Agreements that specifically requires the adjustment, rather, its expert tells us, that “[t]he consistent application of

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[37] Agreements at ¶ 3(a) (emphasis added).

[38] Much has been made in the briefing, and little of it factually supported on either side, of the differences between U.S. and Canadian GAAP (Generally Accepted Accounting Principles) and the implication of those differences for the accounting choice to capitalize or expense the labor costs associated with capital improvement projects. In brief, it appears that Canadian GAAP permits either choice, while U.S. GAAP requires that associated labor costs be capitalized. Whether, as Genesee maintains, it chose to begin capitalizing labor costs at Genesee Rail-One to bring it in line with its U.S. subsidiaries, or whether Genesee Rail-One’s choice was driven by the common (and income-increasing) business practice of capitalizing large non-recurring expenses designed to improve the value and life of its existing assets, the point remains that the shift to capitalizing labor costs was done for Genesee’s own rational business reasons.

[Genesee Rail-One's] accounting policy is necessary to preserve the comparability and trend of [Genesee Rail-One's] performance over the relevant period and remain faithful to the Stock Option Agreement[s]. Consistency in accounting principles is implied in the context of a *temporal* evaluation of performance."[39] Thus, once again, Genesee suggests that I elevate a somewhat squishy accounting principle over and above the most relevant language of the Agreements themselves. That language requires that Genesee provide evidence that these special, non-recurring Disputed Labor Costs were made in the normal course. It has failed to do so.

Moreover, the accounting doctrine of consistency cannot carry the weight that Genesee would have it bear. Indeed, even Genesee's expert concedes that the importance of consistency amounts to an assumption under the terms of the Agreements when he begins his analysis by stating "[p]resumably, the CAD$9,000,000 figure reflects an implicit assumption that labor costs would be expensed."[40] But, of course, it is usually not difficult to reason your way to the conclusion you desire when you assume it from the get-go.

Even assuming the appropriateness of the making an adjustment in the name of consistency, the evidence supporting Genesee's contention that Chambers and Wheeler expensed special, non-recurring labor costs while at Genesee Rail-One is insubstantial. Despite my request for supplemental briefing on this question, Genesee could adduce evidence of only $76,367 (presumably CAD) in materials costs for what appears to be

[39] Rosen Decl. Ex. A at 13 (emphasis in original).
[40] Rosen Decl. Ex. A at 12.

routine maintenance that was capitalized in 1998.[41] Because there is no reference to related labor expenses, Genesee, through its employee Mr. Duchesne, assumes that the associated work was done by Genesee Rail-One employees and was therefore expensed.[42] There is nothing in the record confirming this assumption. Second, Genesee points to a 1999 expense that includes $328,642 (presumably CAD) in materials that were capitalized and $150,695 in labor charges that were expensed. Notably, these charges were incurred after Chambers and Wheeler had left Genesee Rail-One,[43] and they therefore provide no insight into their management choices.

Likewise, before 2000, no funds were budgeted for capital improvements at Genesee Rail-One, but from 2000 through 2003 several millions of Canadian dollars were budgeted in connection with the ongoing refurbishment projects supported by the Canadian government. All these factors, in addition to the fact that expenditures increased several fold over past years, support Chambers' and Wheeler's contention that the 2000 through 2002 Disputed Labor Costs were materially different than those before 2000, and would similarly have been expensed by Chambers and Wheeler had they remained as active managers of Genesee Rail-One. In other words, it is likely that almost any manager confronted with the prospect of making expensive, albeit heavily

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[41] *See* Supp. Cert. of Ronald A. Brown, Def. Obj. and Resp. to Pl. First Set of Interrogatories Directed to Def. at 2-3 (identifying $36,560 spent on a "rail project" and $7,575 spent on "other related expenses" by Huron in 1998 and $32,232 spent in 1998 by Quebec-Gatineau on "repairing railway crossings." Genesee asserts that all labor costs associated with these projects were expensed); *see also* Duchesne Dep. at 22-24 (acknowledging that all itemized charges seem to relate to material costs).

[42] *See* Duchesne Dep. at 22.

[43] *Id*. at 29; *see also* GWI 6141 (showing that the 1999 charges were incurred between June 28 and October 31, 1999, after Chambers and Wheeler had ceased active management in April 1999).

subsidized, capital improvements that would depress reported earnings if expensed immediately, would capitalize them if that could credibly be done. To make such a decision about an explicitly-budgeted, multi-year capital project would not be foolishly inconsistent, in any Emersonian sense, even if the company had made a different decision as to much smaller sums in one year in the recent past. The widely disparate magnitude of the two decisions alone justifies the differential treatment.

For that reason, Genesee's claim that it was simply being consistent with what Genesee Rail-One had done under Chambers and Wheeler is unconvincing, unsupported, and implausible. It is also entirely speculative as no one can know what Chambers and Wheeler would have done if the major refurbishment program subsidized by the Canadian government was undertaken during their managerial tenure. But, if they had been confronted with the prospect of making large, government subsidized, non-recurring, special labor charges for capital improvements during their tenure, there is no rational reason to suspect that Chambers and Wheeler would not have capitalized these costs and every rational reason to predict that they would have.

Indeed, Genesee's supposedly rigorous insistence on consistency is not, alas, adhered to in its own accounting practices. According to its expert, "[t]he alternative of permitting accounting changes to affect reported results from period to period is, in our view, illogical and unreasonable."[44] But, of course, Genesee made exactly this type of "inconsistent" change when it decided, as a matter of business judgment, to begin capitalizing the labor charges associated with its substantial refurbishment projects in its

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[44] Rosen Decl. Ex. A at 13.

publicly reported financial statements going forward. In noting Genesee's shift, I do not fault its publicly reported financial statements. It seems entirely responsible to capitalize the Disputed Labor Costs, which were in connection with rehabilitation of severely damaged tracks, as distinct from regular railway maintenance. What Genesee cannot do, however, is disavow its representations to the government of Canada, presumably required to obtain those grants, i.e., that the work would not include routine maintenance, and now claim that the Disputed Labor Costs were made in the normal course.[45] Genesee's own accounting choice, and the undisputed difference in the budgeting, magnitude, and duration of the Disputed Labor Costs over the prior, minor labor costs that Genesee implausibly claims are comparable, demonstrate that the Disputed Labor Costs were not "operating expenses" within the contractual definition. As a result of their exclusion from the plain language definition of "operating expenses," these labor expenses for 2000, 2001, and 2002 need to be reversed for calculating the contractual EBITDA. With that recalculation done to make the contractual EBITDA consistent with Genesee's publicly reported accounting decisions, the contractual EBITDA hit the $9 million CAD trigger in each of those years.

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[45] *See* Duchesne Dep. at 37-38. When shown a document taken from a Canadian government web site relating to current assistance programs that distinguishes between "Rehabilitation" and "Regular railway maintenance" and notes that eligible projects would include "rehabilitation of the track and structures, excluding regular maintenance," Duchesne agreed that the 2000-2002 program similarly targeted major renovations, excluding routine maintenance work. *Id.*; *see also* Supp. Cert. of Ronald A. Brown Ex. 4 at 1; Ex. 5 at 2.

III. Conclusion

With two separate justifications for the granting of Chambers' and Wheeler's motion for summary judgment, I decline to wade further into the various issues presented in this dispute.[46] Because Genesee has calculated the disputed EBITDA in the first instance, all of the other debated adjustments have been calculated in its favor in the original computations. Having found not one, but two separate missteps in those calculations, either one of which is sufficient, upon recalculation, to entitle Chambers and Wheeler to their options, and recognizing that any other revisions to the calculation as a result of further exploring disputed points in the calculations could only result in further adjustments in Chambers' and Wheeler's favor, I find that each of the two calculation problems discussed above is an independently sufficient reason to grant Chambers' and Wheeler's motion for summary judgment.

For the all the reasons discussed above, judgment shall be entered for the plaintiffs, Chambers and Wheeler. The attorneys shall prepare a final order conforming to this opinion within 10 days, providing a plan for the award of the disputed options.

[46] Separately, and just as a further aside, Genesee's position becomes even less tenable when one recalls that the Disputed Labor Costs that it deducts as an expense in calculating EBITDA under the Agreements is not something that it paid entirely out of its own pocket; the Canadian government footed a fair chunk of the bill.