

**IN THE SUPERIOR COURT OF THE STATE OF DELAWARE**

**IN AND FOR NEW CASTLE COUNTY**

HUDSON’S BAY COMPANY )  
LUXEMBOURG, S.A.R.L., )  
 )  
Plaintiff, )  
 )  
v. ) C.A. No. N10C-12-107 JRJ CCLD  
 )  
JZ LLC and AGZ LLC, )  
 )  
Defendants. )  
 )

Date Submitted: December 10, 2012

Date Decided: March 11, 2013

**MEMORANDUM OPINION**

Decision After Bench Trial

**Verdict for Defendants**

David J. Margules, Esquire (argued), Jeffrey M. Gorris, Esquire, and Jamie L. Brown, Esquire, BOUCHARD MARGULES & FRIEDLANDER, P.A., 222 Delaware Avenue, Suite 1400, Wilmington, Delaware 19801; Attorneys for Plaintiff.

Robert J. Katzenstein, Esquire, SMITH, KATZENSTEIN & JENKINS LLP, 800 Delaware Avenue, 10<sup>th</sup> Floor, P.O. Box 410, Wilmington, Delaware 19899; David W. R. Wawro, Esquire (*pro hac vice*) (argued), Christopher M. Caparelli, Esquire (*pro hac vice*), and Jaclyn Leader, Esquire (*pro hac vice*), TORYS LLP, 1114 Avenue of the Americas, 23rd floor, New York, New York 10036; Attorneys for Defendants.

**JURDEN, J.**

## **I. INTRODUCTION**

This complex litigation arises from alleged breaches of representations set forth within a Securities Purchase Agreement. In 2008, Plaintiff Hudson's Bay Company Luxembourg, S.A.R.L., (hereinafter referred to as "HBCL" or "Plaintiff") acquired Hudson's Bay Company ("Hbc") from JZ LLC ("JZ") and AGZ LLC ("AGZ") (hereinafter collectively referred to as "Defendants") for approximately \$202 million.<sup>1</sup> The Securities Purchase Agreement (the "SPA"), executed by the parties on April 25, 2008, memorializes the terms of the sale. Pertinent to this litigation is Article 3 of the SPA, which sets forth numerous representations and warranties concerning the financial condition of Hbc.

Article 3 provides, *inter alia*, that Hbc's Financial Statements were prepared in accordance with generally accepted accounting principles ("GAAP") and "fairly, completely and accurately" present the financial position of Hbc. HBCL contends, however, that these Financial Statements were, in fact, false. Specifically, HBCL alleges that the Financial Statements contained misrepresentations in the following respects: (1) overstated the value of Hbc's inventory ("Inventory Claim"); (2) understated Hbc's liabilities stemming from a loyalty program that awarded customers credits to acquire merchandise ("the Loyalty Reserve Claim"); and (3) failed to properly account for costs related to the sublease of a Toronto retail space ("the Sublease Claim"). HBCL also claimed a misrepresentation as to Hbc's alleged satisfaction of its tax obligations ("the Tax Claim").

HBCL argues that as a result of these false representations and warranties, HBCL substantially overpaid for Hbc. As such, HBCL filed suit, seeking indemnification from Defendants for the financial loss HBCL sustained as a result of the false representations.

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<sup>1</sup> All monetary values refer to Canadian currency.

On June 18, 2012, the matter proceeded to a two-week bench trial. At trial, HBCL presented three claims against Defendants, all arising from alleged misrepresentations in Hbc's Financial Statements: (1) an Inventory Claim of \$9.8 million; (2) a Loyalty Reserve Claim of \$10.4 million; and (3) a Sublease Claim of \$3.1 million. Following trial, the parties submitted briefing and the Court held oral argument.

## II. FACTUAL

### A. **History and Acquisition of Hbc**

Hbc, Canada's oldest and largest diversified merchant retailer, was founded in 1670.<sup>2</sup> Hbc currently owns and operates hundreds of retail properties in Canada under several "banners," or retail brands, including The Bay, Zellers, Home Outfitters, and Fields.<sup>3</sup>

In March 2006, Jerry Zucker acquired Hbc through several corporate entities, including JZ and True North Retail Investments I, Inc. ("True North I").<sup>4</sup> A few months later, in July 2006, Zucker sold 20% of Hbc to NRDC Equity Partners ("NRDC"), a private equity firm interested in investing in operating companies with significant real estate holdings.<sup>5</sup>

In March 2008, Zucker contacted Richard Baker, NRDC's principal.<sup>6</sup> Zucker informed Baker that he had been diagnosed with terminal cancer and offered to sell the remaining 80% of Hbc to NRDC.<sup>7</sup> Zucker died three weeks later.<sup>8</sup>

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<sup>2</sup> Defendant JZ LLC's Proposed Findings of Fact and Conclusions of Law at ¶ 3, *Hudson's Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super. Aug. 24, 2012) (Trans. ID 46090840) [hereinafter DPF]; Plaintiff Hudson's Bay Company Luxembourg, S.A.R.L.'s Proposed Findings of Fact and Conclusions of Law at ¶ 1, *Hudson's Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super. July 27, 2012) (Trans. ID 45600841) [hereinafter PPF].

<sup>3</sup> PPF at ¶ 3.

<sup>4</sup> Transcript of Francis Casale's June 18, 2012 Morning Trial Testimony at 59-60, *Hudson's Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super.). Hereinafter, references to the trial transcript will be cited by the transcript volume, the witness' name, and the page number(s).

<sup>5</sup> *Id.* at ¶ 2.

<sup>6</sup> *Id.* at ¶ 5.

<sup>7</sup> *Id.*; PPF at ¶ 4.

<sup>8</sup> DPF at ¶ 6.

Baker, worried that NRDC would lose its 20% investment in Hbc, commenced negotiations with Rob Johnston, Hbc's then-President, to acquire the remaining 80% interest in Hbc. On April 25, 2008, JZ, True North, and certain NRDC entities entered into the SPA by which NRDC would acquire JZ's 80% interest in Hbc for \$240 million.

## **B. Due Diligence Report**

Under the terms of the SPA, NRDC had the right to conduct due diligence of True North and Hbc.<sup>9</sup> Pursuant to Section 5.1.1 of the SPA, NRDC was to be given full access to Hbc's books, accounts, records, and necessary personnel for a thirty-day investigatory period after signing the SPA.<sup>10</sup> If NRDC was not satisfied with its findings, it could terminate the agreement.<sup>11</sup>

To accomplish its due diligence review, NRDC retained Deloitte & Touche LLP ("Deloitte").<sup>12</sup> Hbc's independent auditor, KPMG LLP ("KPMG"), provided Deloitte with its audit working papers to assist in Deloitte's review.<sup>13</sup>

On June 5, 2008, Deloitte provided NRDC with a 110-page draft of its "Due Diligence Report" ("Report").<sup>14</sup> In the Report, Deloitte proposed "significant adjustments" to Hbc's reported "Normalized EBITDA" – that is, earnings before interest, income taxes, depreciation and amortization.<sup>15</sup> Deloitte also proposed adjustments to Hbc's reported "Normalized WC," or working capital.<sup>16</sup> Additionally, Deloitte flagged several "major issues" for which it

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<sup>9</sup> See SPA § 5.1.1.

<sup>10</sup> *Id.*; SPA § 5.1.2.

<sup>11</sup> SPA § 8.1.

<sup>12</sup> DPF at ¶ 12.

<sup>13</sup> *Id.*

<sup>14</sup> JX 13. Trial exhibits are cited as "JX" for joint exhibits, "PX" for plaintiff's exhibits, and "DX" for defendants' exhibits.

<sup>15</sup> *Id.* at HBCL00034542.

<sup>16</sup> *Id.*

recommended that NRDC follow-up with Hbc.<sup>17</sup> Specifically, under the heading “Significant Risks and Exposures,” Deloitte identified one major issue as an alleged understatement of Hbc’s reported liability redemption rate.<sup>18</sup>

Following receipt of Deloitte’s Report, NRDC approached JZ in an effort to renegotiate the purchase price of the remaining 80% of Hbc.<sup>19</sup> This renegotiation was fueled by Hbc’s “eroding EBITDA,” the “increasing level of debt based on Hbc’s asset-based loan,” and the findings in Deloitte’s Report.<sup>20</sup>

On June 24, 2008, the parties amended the SPA to reduce the purchase price from \$240 million to \$202 million.<sup>21</sup> On July 16, 2008, NRDC designated an affiliate – HBCL – as purchaser of JZ’s 80% interest in Hbc, and executed the amended SPA.<sup>22</sup>

### **C. The Securities Purchase Agreement**

The heart of this dispute, the SPA, in its amended form,<sup>23</sup> provides all terms and conditions regarding HBCL’s acquisition of the remaining 80% of Hbc. The Court will address only those provisions of the SPA which are relevant to the Court’s analysis.

#### **Representations and Warranties Provisions**

Article 3 of the SPA, entitled “Representations and Warranties,” sets forth certain representations and warranties concerning the financial condition of Hbc. Section 3.2.8, termed the “Financial Statement Representation,” provides, in pertinent part:

The Financial Statements have been prepared in accordance with generally accepted accounting principles (subject to usual year-end adjustments in the case of the Unaudited Financial Statements) consistently applied throughout the periods indicated and fairly, completely and accurately present in all material

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<sup>17</sup> *Id.* at HBCL00034543.

<sup>18</sup> *Id.*

<sup>19</sup> 1 Casale 138-41.

<sup>20</sup> 6 Baker 36-40; 1 Casale 93.

<sup>21</sup> JX 6.

<sup>22</sup> JX 8.

<sup>23</sup> The SPA was amended five times. *See* JX 4, 5, 6, 7, and 8.

respects the financial position of [Hbc] . . . and there has been no Material Adverse Effect since the Audited Statements Date.<sup>24</sup>

The “Financial Statements” referenced in Section 3.2.8 pertain to Hbc’s Fiscal 2007 Financial Statements and Hbc’s unaudited interim financial statements for February and March 2008 (hereinafter referred to as “Financial Statements” or “Fiscal 2007 Financial Statements”).

### **Termination Provision**

Article 8 permits HBCL to terminate the SPA under certain circumstances. For instance, pursuant to Section 8.1.1.3, HBCL may terminate the SPA, prior to closing, if JZ “failed to perform and comply with, in all material respects, all agreements, covenants and conditions hereby required to have been performed or complied with by such party prior to the time of such termination.”<sup>25</sup> In other words, HBCL could terminate the SPA if a misrepresentation was discovered *before* closing.

### **Indemnification Provisions**

If HBCL discovers a misrepresentation within one year *after* closing, Article 7 provides that Defendants shall indemnify HBCL in accordance with the terms of the SBA.<sup>26</sup> Under Section 7.2.1, HBCL can seek indemnification for all “Covered Losses” arising from, *inter alia*, “any breach of any representation or warranty.”<sup>27</sup> “Covered Losses” include:

[A]ny and all losses, liabilities, claims, fines, awards, deficiencies, damages, obligations, payments (including those arising out of any settlement, judgment or compromise relating to any Legal Proceeding), reasonable costs and expenses (including interest and penalties due and payable with respect thereto and reasonable attorneys’ and accountants’ fees and any other reasonable out of pocket expenses incurred in investigating, preparing, defending, avoiding or settling any Legal Proceeding), including any of the foregoing arising under, out

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<sup>24</sup> SPA § 3.2.8.

<sup>25</sup> *Id.* at § 8.1.1.3.

<sup>26</sup> *Id.* at § 7.1.3.

<sup>27</sup> *Id.* § 7.2.1.

of or in connection with any Legal Proceeding, Governmental Order or award of any arbitrator of any kind, or any Lay or Contract.<sup>28</sup>

Article 7 addresses the means by which to determine whether a breach has, in fact, occurred, such that HBCL may seek indemnification. Section 7.5.2 provides, in pertinent part:

In determining whether there has been any breach of or any inaccuracy in any representation, warranty, covenant or agreement for purposes of Sections 7.2.1 and 7.3.1 and in determining the amount of any Covered Loss, any references to “material,” “materially” or “Material Adverse Effect” in such representation, warranty, covenant or agreement shall be disregarded . . . .<sup>29</sup>

Section 7.5.2, termed a “Materiality Scrape,” effectively eliminates the terms “material,” “materially,” and “Material Adverse Effect,” from all provisions within the SPA in determining whether a breach has occurred. In other words, the Materiality Scrape obligates Defendants to indemnify HBCL for material and immaterial breaches of the representations and warranties set forth in Section 3.2.8, as well as those representations and warranties concerning tax obligations Section 7.5, however, caps Defendants’ indemnity obligations at \$20.2 million, with an aggregate deductible of \$1.5 million.<sup>30</sup>

#### **D. Post-Acquisition Findings**

Per the terms of the SPA, HBCL was required to identify any potential claims against Hbc by July 16, 2009.<sup>31</sup> Therefore, post-closing, HBCL engaged Deloitte to continue its due diligence review of Hbc.<sup>32</sup> HBCL also selected Deloitte to replace KPMG as its independent auditor.<sup>33</sup>

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<sup>28</sup> *Id.* § 1.1.27.

<sup>29</sup> *Id.* § 7.5.2.

<sup>30</sup> JX 8 § 2(y).

<sup>31</sup> *See* SPA § 7.1.3.

<sup>32</sup> 1 Casale 148.

<sup>33</sup> 1 Casale 122.

### **Financial Condition of Hbc Post-Acquisition**

In early 2009, following HBCL's acquisition, Hbc went through a very difficult time.<sup>34</sup> In Fiscal Year 2008, which ended January 31, 2009, Hbc reported losses of \$72.3 million, and borrowings under Hbc's asset-backed loan increased from \$525 million to \$729.5 million.<sup>35</sup> In light of these conditions, Michael Culhane, Hbc's then-Chief Financial Officer, focused on getting control of the cash flow by making "significant reductions in order to ... stop the bleeding."<sup>36</sup> Culhane's objective was to do whatever necessary to "keep the business alive."<sup>37</sup>

### **Deloitte's Due Diligence Findings**

Meanwhile, Deloitte's "due diligence team," also dubbed the "indemnity task force," was assessing Hbc's accounting for inventory as well as its loyalty program.<sup>38</sup> On January 5, 2009, Deloitte issued a "Summary of its Findings – Inventory" on Hbc's FY2007 accounting ("FY2007 Report").<sup>39</sup> The FY2007 Report identified a "basis for claiming a material misstatement with respect to inventory" in the Fiscal 2007 Financial Statements.<sup>40</sup>

### **E. Indemnification Claims**

On July 13, 2009, HBCL gave written notice to Defendants of four indemnification claims: (1) the Tax Claim; (2) the Inventory Claim; (3) the Loyalty Reserve Claim; and (4) the Sublease Claim (collectively referred to as the "Indemnification Claims").<sup>41</sup> Each claim is premised on Defendants' alleged use of accounting principles that violated Canadian Generally Accepted Accounting Principles ("GAAP").

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<sup>34</sup> 4 Culhane 63-64.

<sup>35</sup> PX 167, 186.

<sup>36</sup> 4 Culhane 65, 72-73.

<sup>37</sup> 4 Culhane 75.

<sup>38</sup> DX 43, 232, 242.

<sup>39</sup> DX 44.

<sup>40</sup> *Id.* at HBCL00191408.

<sup>41</sup> JX 14.



Ultimately, HBCL proceeded to trial on only three of the Indemnification Claims – the Inventory Claim, the Loyalty Reserve Claim, and the Sublease Claim. As to the Tax Claim, the parties stipulated, prior to trial, that Defendants’ representation about tax payments was inaccurate, and that a \$1.2 million tax bill constituted a “Covered Loss” under the SPA.<sup>42</sup>

Canadian GAAP (hereinafter referred to as “GAAP”),<sup>43</sup> set forth in the Canadian Institute of Chartered Accountants Handbook (“CICA”),<sup>44</sup> “establishes standards for financial reporting in accordance with generally accepted accounting principles.”<sup>45</sup> Specifically, GAAP includes fundamental accounting principles concerning estimates, approximations, errors and materiality.

When preparing financial statements, GAAP requires estimates that may, by their nature, be approximations.<sup>46</sup> As such, GAAP does not require estimates to be perfectly accurate.<sup>47</sup> Rather, an estimate need only “represent management[’s] best estimate of what is the . . . most probable outcome based on economic condition and planned course of action of management,”<sup>48</sup> such that the financial statements are “reasonably” free from error.<sup>49</sup> With these basic principles in mind, the Court will address each of the three remaining Indemnification Claims *in seriatim*.

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<sup>42</sup> Joint Pre-trial Stipulation and Order, *Hudson’s Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super. May 14, 2012) (Trans. ID 44249966). HBCL’s Tax Claim was premised on Defendants’ breach of certain representations and warranties concerning tax obligations. Specifically, HBCL claimed a breach of Section 3.2.16.1 of the SPA, which provides, in relevant part: “All material Tax Returns required by Law to be filed by or with respect to True North I or any of its subsidiaries have been properly prepared and timely filed . . . , and all such Tax Returns . . . are true, complete and correct in all material respects.” Additionally, HBCL claimed a breach of Section 3.2.16.2, which provides, in pertinent part: “True North I and its subsidiaries have fully and timely paid all material Taxes that are due and payable . . . and have made adequate provision in the Financial Statements for any Taxes that are not yet due and payable for all taxable periods.”

<sup>43</sup> All subsequent references to “GAAP” pertain to Canadian GAAP.

<sup>44</sup> JX 17.

<sup>45</sup> CICA 1000.01.

<sup>46</sup> CICA 1000.05.

<sup>47</sup> DX 184 at 17.

<sup>48</sup> PPF at ¶ 28.

<sup>49</sup> CICA 1000.21.

## 1. Inventory Claim

HBCL contends that Hbc's Fiscal 2007 Financial Statements significantly overstated the value of Hbc's inventory.<sup>50</sup> According to HBCL, this overstatement was the result of several issues with Hbc's inventory valuation methodologies.<sup>51</sup> Specifically, HBCL argues that Hbc used two different accounting standards to reflect inventory values. HBCL contends that Hbc's "erroneous calculation resulted in an understatement of inventory reserves, and an overstatement of inventory, of at least \$9.8 million."<sup>52</sup>

### **Valuing Inventory: CICA 3030**

Hbc's inventory consisted of millions of individual stock keeping units ("SKUs") grouped into hundreds of categories.<sup>53</sup> In valuing its inventory per CICA 3030, Hbc utilized the Retail Inventory Method ("RIM") – an "approximation" technique.<sup>54</sup> RIM "offers a simplified, cost-effective alternative of inventory valuation for department stores and other retailers selling many and varied goods."<sup>55</sup> RIM multiplies the retail value of inventory by a cost-to-retail ratio to estimate the cost of inventory at the SKU level.<sup>56</sup>

RIM values inventory based upon the expected selling price of the merchandise.<sup>57</sup> Because the selling price of merchandise may not always reflect the retail price that will eventually be realized, markdowns are required to be taken to ensure that inventory is priced at the appropriate selling price.<sup>58</sup>

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<sup>50</sup> PPF at ¶ 32.

<sup>51</sup> PPF at ¶¶ 31-67.

<sup>52</sup> PPF at ¶ 32.

<sup>53</sup> 3 Tames 16-17.

<sup>54</sup> 3 Meghani 293-94.

<sup>55</sup> DX 44 at HBCL00191427.

<sup>56</sup> 3 Tames 16-17; 4 Meghani 17-18.

<sup>57</sup> DX 44 at HBCL00191415.

<sup>58</sup> *Id.*

In its Fiscal 2007 Financial Statements, Hbc listed the value of its inventory at \$1.44 billion.<sup>59</sup> It is undisputed that this valuation was prepared in accordance with CICA 3030, the GAAP standard in effect at the time.<sup>60</sup>

### **The New Standard for Valuing Inventory: CICA 3031**

In June 2007, the CICA issued a new GAAP standard for the valuation of inventory – CICA 3031.<sup>61</sup> This new standard was to become effective for fiscal years beginning on or after January 1, 2008. Because Hbc’s fiscal year begins on February 1, Hbc’s Fiscal 2008 Financial Statements would have to be prepared in accordance with CICA 3031.<sup>62</sup>

CICA 3031 confirmed that RIM is an acceptable method for valuing inventory so long as the results approximated cost.<sup>63</sup> CICA 3031, however, made several changes to its predecessor – CICA 3030. First, inventory was required to be valued at the lower of (i) cost, or (ii) net realizable value (“NRV”).<sup>64</sup> NRV is defined as the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.<sup>65</sup> Second, in conducting the NRV-to-cost analysis, CICA 3031 limited the use of categories.<sup>66</sup> CICA 3031.29A permits the use of categories only if they group “inventory relating to the same product line that have similar purposes or end uses.”

### **Preparing for CICA 3031: CICA 1506**

In its preparation to implement CICA 3031, Hbc was required to disclose certain information in its Fiscal 2007 Financial Statements concerning the expected impact of CICA 3031. Section 1506 sets forth the specific information that Hbc was to disclose:

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<sup>59</sup> JX 2 at 3.

<sup>60</sup> PX 157 at 8; 4 Bouchard 188-89.

<sup>61</sup> JX 17 at 126-37.

<sup>62</sup> 3 Tames 22.

<sup>63</sup> CICA 3031.21.

<sup>64</sup> CICA 3031.09.

<sup>65</sup> CICA 3031.06.

<sup>66</sup> CICA 3031.29A.

30. When an entity has not applied a new primary source of GAAP that has been issued but is not yet effective, the entity shall disclose:

- (a) this fact; and
- (b) known or reasonably estimable information relevant to assessing the possible impact that application of the new primary source GAAP will have on the entity's financial statements in the period of initial application.

31. In complying with paragraph 1506.30, an entity considers disclosing:

- (a) the title of the new primary source of GAAP;
- (b) the nature of the impending change or changes in accounting policy;
- (c) the date by which application of the primary source of GAAP is required;
- (d) the date as at which it plans to apply the primary source of GAAP initially; and
- (e) either:
  - (i) a discussion of the impact that initial application of the primary source of GAAP is expected to have on the entity's financial statements; or
  - (ii) if that impact is not known or reasonably estimable, a statement to that effect.<sup>67</sup>

#### **Hbc's Compliance with CICA 1506**

In order to comply with Section 1506's disclosure requirement, Hbc included Footnote 4(a) in its Fiscal 2007 Financial Statements.<sup>68</sup> Footnote 4(a) reads, in pertinent part:

The standard is effective for the fiscal year beginning on February 1, 2008 for the Company and the Company will apply the new standard retrospectively in the first quarter of fiscal 2008. Upon implementation of this standard, the Company will record as at February 1, 2007 a decrease to opening deficit of \$32.7 million (net of income taxes) and an increase to opening inventory of \$49.1 million. Net loss for the year ended January 31, 2008 will be increased by \$6.2 million, resulting in a reduction in the closing deficit as at January 31, 2008 of \$26.5 million (net of income taxes).<sup>69</sup>

How Hbc arrived at the valuations set forth in Footnote 4(a) form the bases of HBCL's Inventory Claim. HBCL contends that the numbers contained in Footnote 4(a) are incorrect because they are premised on a calculation of inventory that violates GAAP 3031.<sup>70</sup> Specifically, HBCL argues that the inventory categories grouped items that were dissimilar in

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<sup>67</sup> CICA 1506.30, 1506.31.

<sup>68</sup> JX 2 at 11.

<sup>69</sup> *Id.*

<sup>70</sup> PPF at ¶ 32.

uses, retail prices and margins, in violation of Section 3031.29A.<sup>71</sup> Because the categories did not satisfy CICA 3031.29A, Hbc's "perform[ance] [of] NRV testing at the category level was a 'misapplication of accounting principles under GAAP . . . .'"<sup>72</sup> As such, HBCL contends that it suffered a Covered Loss of \$9.8 million.<sup>73</sup>

In response, Defendants contend that Hbc properly implemented CICA 3031 in Footnote 4(a). According to Defendants, Hbc, in consultation with KPMG, verified that its use of RIM approximated cost.<sup>74</sup> In using RIM to estimate inventory on a category-by-category basis, Defendants contend that Hbc ensured that its categories contained SKUs with reasonably similar margin characteristics.<sup>75</sup> In fact, Hbc was so confident in its composition of categories that it made no changes to its use of RIM or the composition of its categories when recording the lower of cost and net realizable value in Fiscal Year 2008.<sup>76</sup> Deloitte's audit team agreed with Hbc's decisions.<sup>77</sup> Indeed, HBCL continued to use Hbc's RIM methodology and category compositions through Fiscal Year 2008 and into Fiscal Year 2009.<sup>78</sup>

## **2. Loyalty Claim**

HBCL challenges the redemption rate used to calculate loyalty liability in Hbc's Financial Statements. Specifically, HBCL contends that the redemption rate utilized by Hbc was not "management's best estimate and [did] not reflect the most probable set of economic conditions and planned courses of action." HBCL argues that use of such an "unreliable" redemption rate resulted in a \$10.4 million understatement in loyalty liability.

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<sup>71</sup> *Id.* at ¶ 57.

<sup>72</sup> *Id.*

<sup>73</sup> 4 Bouchard 143-44.

<sup>74</sup> DPF at ¶ 65; 3 Tames 24-25.

<sup>75</sup> JX 25.

<sup>76</sup> DX 130, 281.

<sup>77</sup> DX 49; DX 130.

<sup>78</sup> *See* DX 52 and 2 Casale 5-8.

## **Background of Loyalty Program**

Under Hbc's Loyalty Program, customers accrue points by purchasing Hbc products that can be redeemed for a range of catalogue merchandise offers, gift cards and other products and services.<sup>79</sup> A liability representing the estimated cost of future redemptions of the Hbc Rewards points is recorded at the time of sale when reward points are issued to members.<sup>80</sup> Hbc records a loyalty liability reflecting the points outstanding that Hbc estimates will be redeemed, as well as the estimated cost per point (the "Loyalty Liability" or "Loyalty Reserve").<sup>81</sup>

Hbc's first Loyalty Program was established in the 1980's for the Zeller's banner.<sup>82</sup> In 2001, the Loyalty Program was expanded to all banners. From 2001 to 2007, the annual redemption rates ("ARR") – that is, the percentage of points redeemed in a year (regardless of when the points were issued) relative to the points issued during that year – climbed steadily.<sup>83</sup> Hbc attributed this increase to the fact that it would take some time for customers to amass enough points before they reach a threshold that enables them to redeem their points.<sup>84</sup> Additionally, around 2005 to 2006, Hbc implemented programs that made redeeming points both easier and more attractive.<sup>85</sup>

## **Fiscal 2007: Fair Value of Loyalty Liability**

In its Fiscal 2007 Financial Statements, Hbc recorded a Loyalty Liability of \$109.7 million<sup>86</sup> based on an estimated 80% ARR.<sup>87</sup> This was a one-percent increase from its Fiscal

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<sup>79</sup> 2 Tames 100-01; JX 14 at 8.

<sup>80</sup> JX 2 at 9; JX 14 at 8.

<sup>81</sup> DX 14 at 8.

<sup>82</sup> 2 Tames 106.

<sup>83</sup> *Id.*

<sup>84</sup> 2 Tames 108-09.

<sup>85</sup> *Id.*

<sup>86</sup> PX 72 at HBCL00052100; 3 Tames 118.

<sup>87</sup> 2 Tames 115; JX 34; JX 35 at HBCL00040024.

2006 Financial Statements, which had an estimated 79% ARR.<sup>88</sup> That one percent increase in ARR equated to a \$5 million change in its Loyalty Reserve.<sup>89</sup> Hbc arrived at its 80% ARR by taking a simple average of the previous six years' annual redemption rates.<sup>90</sup> This method was approved by KPMG, Hbc's independent auditor at the time.<sup>91</sup>

### **Contemporaneous Estimates Inconsistent**

Hbc's estimated redemption rate, however, was inconsistent with contemporaneous estimates. For example, in 2006, Ernst & Young ("E&Y") performed "a valuation of [Hbc's] identifiable intangible assets," including loyalty liability, in connection with JZ's acquisition of Hbc.<sup>92</sup> E&Y issued its report, estimating the fair value of the Loyalty Liability, as of February 28, 2006, to be between \$108 million and \$134 million, with a midpoint of \$121 million.<sup>93</sup> In rendering that estimate, E&Y determined 87.5% to be the appropriate redemption rate.<sup>94</sup> HBCL contends that E&Y's reported redemption rate was more reliable than Hbc's 80% estimated redemption rate.

### **Issues Revealed in Deloitte's Due Diligence Report**

Deloitte also recognized that Hbc's estimated redemption rate appeared to be understated. As part of its June 5, 2008 Due Diligence Report,<sup>95</sup> Deloitte flagged Hbc's Loyalty Liability ARR as an issue for further follow-up.<sup>96</sup> Specifically, the report provided: "Several factors have been identified which indicate that [Hbc's] loyalty redemption rate of 80% may be

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<sup>88</sup> 2 Tames 111.

<sup>89</sup> 2 Tames 115, 131; PX 11.

<sup>90</sup> 2 Tames 113-115.

<sup>91</sup> DPF at 28.

<sup>92</sup> JX 12.

<sup>93</sup> *Id.* at HBCL00014292.

<sup>94</sup> *Id.*

<sup>95</sup> JX 13.

<sup>96</sup> *Id.* at HBCL00034543.

understated.”<sup>97</sup> In addition, the report noted, “[W]e understand that [Hbc] has forecast a potential increase of \$12.3 million in loyalty liability in FY08 in recognition of higher redemption rates (this adjustment has not been made).”<sup>98</sup>

### **HBCL Deems 80% Redemption Rate Unreliable**

Notwithstanding Deloitte and E&Y’s findings, Hbc determined that an 80% redemption rate was a reasonable estimate and that its estimating methodology complied with GAAP. HBCL, however, contends that Hbc’s estimated redemption rate was neither reliable nor reasonable and, therefore, violated the definition of a GAAP “estimate.”<sup>99</sup> According to HBCL, GAAP requires that an estimate “represent management[’s] best estimate of what is the . . . most probable outcome based on economic condition and planned course of action of management . . . . An estimate . . . also needs to be based on all information that is available and, obviously, information that is reliable.”<sup>100</sup> HBCL further argues that Hbc’s proffered redemption rate runs in direct contravention to GAAP’s mandate that estimates “be the product of reasonable inputs, reasonable due diligence and reasonable professional judgment.”<sup>101</sup> As such, HBCL seeks to recover \$10.4 million – the amount by which Hbc’s Loyalty Liability was underrated due to Hbc’s allegedly low estimate.<sup>102</sup>

### **3. The Lease Claim**

HBCL contends that Defendants failed to account for a liability stemming from the anticipated default by a sublessor of property for which Defendants were obligated. HBCL argues that under GAAP, Defendants were required to account for the lease of non-operating

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<sup>97</sup> *Id.*

<sup>98</sup> *Id.*

<sup>99</sup> PPF at ¶ 85; 4 Bouchard 167; 5 Bouchard 42-43.

<sup>100</sup> PPF at ¶ 28.

<sup>101</sup> *Id.*

<sup>102</sup> PX 157 at 43.



property as a liability. Hbc's Financial Statements, however, failed to account for this sublease, resulting in a \$3.1 million understatement of liability.

### **The Lease**

In 1998, Hbc, through its Zellers banner, acquired Kmart Canada, which operated a store in the Jane Finch neighborhood of Toronto.<sup>103</sup> As part of that acquisition, Hbc assumed an existing lease (the "Lease") between Kmart (the "Store") and the landlord, Brad-Jay Investments,<sup>104</sup> which ran through January 2014.<sup>105</sup> The terms of the Lease permitted the Store to be sublet, but required the landlord's consent if the Store was used for anything other than a department store or automotive service center.<sup>106</sup> Hbc immediately sought to find a subtenant because it operated a Zellers in a better location across the street.<sup>107</sup>

### **The Sublease**

In April 2003, Hbc entered a sublease (the "Sublease") with Walia Discount Mart ("Walia"), a discount department store.<sup>108</sup> Walia would commence rent payments on June 1, 2003, with the Sublease terminating in January 2014. Pursuant to the terms of the Sublease, Walia was responsible for paying base rent (according to a schedule set forth in the Sublease), and for reimbursing Hbc's payments of common area maintenance ("CAM") annually and property taxes semi-annually.<sup>109</sup>

The Sublease's payment schedule provided that Walia would pay a reduced monthly rent of \$25,480 for five years (until June 1, 2008), at which point Walia would pay the full

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<sup>103</sup> Rogers Depo. at 3-4; 3 Shaw 252-56.

<sup>104</sup> *Id.*

<sup>105</sup> JX 9.

<sup>106</sup> *Id.* §§ 19.00, 19.01.

<sup>107</sup> Rogers Depo 31-32.

<sup>108</sup> JX 10.

<sup>109</sup> *Id.* at HBCL00175498-500.

monthly rent of \$40,406 through the end of the Sublease term – January, 2014.<sup>110</sup> Hbc established a reserve for the difference between the rent it owed under the Lease and the rent it received from Walia under the Sublease.<sup>111</sup>

### **Walia Experiences Financial Trouble**

Around mid-2007, Walia began having difficulty making its CAM and tax payments.<sup>112</sup> Hbc allowed Walia to space out the obligations into monthly, post-dated checks to help them catch up.<sup>113</sup> But Walia's rent payment began to arrive later and later after less than a year. In early September 2007, Dan Rogers, Hbc's Senior Vice President of Real Estate & Development, met with Leo Doucet, a representative of the landlord, to discuss buying out the remainder of the Lease.<sup>114</sup> Shortly thereafter, Doucet contacted Rogers, claiming that Hbc was responsible for various repairs to the Store totaling approximately \$1.02 million.<sup>115</sup> This estimate was later increased to \$1.62 million.<sup>116</sup>

By email dated October 25, 2007, Doucet informed Rogers that he heard "rumors" that Walia was having financial difficulties and "may fold."<sup>117</sup> On February 12, 2008, Rogers received another letter from Doucet, disclosing new rumors that Walia "wanted out [of its sublease] due to dismal performance."<sup>118</sup> On March 31, 2008, Hbc's real estate department sent a letter to Walia, reminding them of the impending rent increase in two months.<sup>119</sup>

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<sup>110</sup> 3 Shaw 256-57, 262; 2 Tames 86-88; DX 144 at 17; JX 10 § 4.01.

<sup>111</sup> PX 74 at HBCL00095706.

<sup>112</sup> 3 Shaw 257-259, 264, 282.

<sup>113</sup> 3 Shaw 274; DX 295.

<sup>114</sup> Rogers Depo. at 44.

<sup>115</sup> PX 18.

<sup>116</sup> JX 51.

<sup>117</sup> PX 30.

<sup>118</sup> PX 51.

<sup>119</sup> DX 182.

On April 2, 2008, Hbc issued its Fiscal 2007 Financial Statements.<sup>120</sup> In it, Hbc booked a \$2 million reserve for the Store (“Sublease Reserve”).<sup>121</sup> This number reflected Hbc’s estimate of its remaining lease obligation minus the present value of future payments from Walia at the reduced rent.<sup>122</sup>

### **Sublease Reserve Deemed Insufficient**

On April 4, 2008 – just two days after the Fiscal 2007 Financial Statements were issued – the first of three Walia CAM and property tax checks bounced.<sup>123</sup> By May 8, 2008, Walia was almost \$291,000 dollars in arrears.<sup>124</sup> Nevertheless, on August 1, 2008, an internal Hbc memo concluded that the \$2 million Sublease Reserve remained appropriate.<sup>125</sup> This conclusion was based, in part, on Hbc’s belief that it was not responsible for some of the alleged repairs.<sup>126</sup>

By the end of fiscal year 2008, Hbc adjusted its reserve on the Sublease to account for the entire Sublease obligation, plus the costs associated with the exterior wall and roof repairs.<sup>127</sup> The Sublease Reserve was increased to \$4.6 million.<sup>128</sup>

In February, 2009, the landlord of the Store sued Hbc for exterior wall repairs.<sup>129</sup> The parties settled this dispute and the repairs were completed in late 2009 for \$230,000 dollars.<sup>130</sup> Meanwhile, in March of 2009 – after Hbc had already more than doubled its Sublease Reserve to cover possible repairs – Hbc’s roofing consultant advised Hbc that the roof did not need to be

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<sup>120</sup> JX 2.

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*; PX 74.

<sup>123</sup> PX 73; DX 296 at HBCL00011517.

<sup>124</sup> JX 51.

<sup>125</sup> JX 50.

<sup>126</sup> *See* DX 170 and 179.

<sup>127</sup> 2 Tames 97-99.

<sup>128</sup> *Id.*

<sup>129</sup> DX 170.

<sup>130</sup> 3 Shaw 273.

repaired during the terms of the Lease.<sup>131</sup> Walia continues to this day to sublet the Store, though currently under a different name.<sup>132</sup>

HBCL claims that Hbc's Financial Statements failed properly to account for Walia's anticipated default under the Sublease.<sup>133</sup> According to HBCL, "[T]here was clearly information available at the time of the preparation of the financial statement that showed that Walia . . . was in no way going to be able to fulfill their obligations under the lease."<sup>134</sup> HBCL seeks to recover \$3.1 million, consisting of \$2,663,000 for the lease deficiency, \$226,000 for the wall repairs, \$20,000 for roof maintenance, and \$207,000 for CAM and realty taxes.<sup>135</sup>

In response, Defendants argue that the estimates contained in the Financial Statements, concerning the Sublease Reserve, complied with GAAP.<sup>136</sup> According to Defendants, GAAP requires that a reserve have "an appropriate basis of measurement," such that a reasonable estimate can be made of the account involved.<sup>137</sup> Furthermore, and contrary to HBCL's contention, a reserve need not account for the risk that an obligor may default on an obligation.<sup>138</sup> At the time the Financial Statements were issued, "Walia was current in paying monthly rent; it was satisfying its CAM and tax obligations through post-dated checks; and its receivables balance with Hbc had been reduced relative to the prior year."<sup>139</sup> Therefore, according to Defendants, Hbc's Financial Statements correctly accounted for the Sublease Reserve.

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<sup>131</sup> JX at 46; 3 Shaw 271.

<sup>132</sup> Defendant JZ LLC's Letter in Response to the Court's Letter Dated October 5, 2012 at Tab 8, *Hudson's Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super. Nov. 30, 2012) (Trans. ID 48059617) [hereinafter JR].

<sup>133</sup> PPF at ¶ 108.

<sup>134</sup> 4 Bouchard 181.

<sup>135</sup> PPF at ¶ 110.

<sup>136</sup> DPF at ¶ 198.

<sup>137</sup> DPF at ¶ 199 (citing CICA 1000.44).

<sup>138</sup> DPF at ¶ 198.

<sup>139</sup> DPF at ¶ 200.

**F. “Covered Losses”**

HBCL contends that as a result of the remaining three Indemnification Claims, HBCL sustained “Covered Losses,” including: (1) the Inventory Claim of \$9.8 million; (2) the Loyalty Reserve Claim of \$10.4 million; and (3) the Sublease Claim of \$3.1 million.

**G. Trial**

Prior to trial, the parties stipulated that Defendants breached a representation as to tax obligations – the Tax Claim.<sup>140</sup> The parties agreed that the \$1.2 million tax bill constituted a “Covered Loss” under the SPA.<sup>141</sup> On June 18, 2012, HBCL proceeded to trial on the three remaining Indemnification Claims.

**III. ANALYSIS**

The Court’s analysis focuses on two central issues. First, the Court must determine whether HBCL has proven by a preponderance of the evidence that Defendants breached representations or warranties set forth in the SPA. Specifically, HBCL must prove that Defendants’ Financial Statements breached the Financial Statement Representation.

If HBCL demonstrates that Defendants did, in fact, breach the Financial Statement Representation, HBCL must then show that it is entitled to indemnification. To accomplish this, HBCL must prove that the alleged damages it sustained, as a result of the Inventory Claim, the Loyalty Reserve Claim, and the Sublease Claim, constitute “Covered Losses” under the SPA.

**A. Materiality**

The Financial Statement Representation, set forth at Section 3.2.8 of the SPA, provides, in pertinent part:

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<sup>140</sup> Joint Pre-trial Stipulation and Order at 14, *Hudson’s Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super. May 14, 2012) (Trans. ID 44249966).

<sup>141</sup> *Id.*

The Financial Statements have been prepared in accordance with generally accepted accounting principles (subject to usual year-end adjustments in the case of the Unaudited Financial Statements) consistently applied throughout the periods indicated and fairly, completely and accurately present in all material respects the financial position of [Hbc] . . . and there has been no Material Adverse Effect since the Audited Statements Date.

In simple terms, the Financial Statements must: (1) be prepared in accordance with GAAP; and (2) fairly, completely and accurately represent in all materials respects the financial position of Hbc.

In determining whether a breach of the Financial Statement Representation has, in fact, occurred, Section 7.5.2's "Materiality Scrape" directs that the words "material," "materially," and "Materially Adverse Effect" be "scraped" from Section 3.2.8.<sup>142</sup> Therefore, to prove a breach of the Financial Statement Representation, for purposes of indemnification, HBCL need only demonstrate that the Financial Statements either: (1) were not prepared in accordance with generally accepted accounting principles consistently applied throughout the period; or (2) did not fairly, completely and accurately present in all respects the financial position of Hbc ("Fair Presentation Clause").

HBCL, however, elected not to pursue a breach claim under either the Fair Presentation Clause of the Financial Representation Statement. Rather, HBCL's breach claim is based solely upon Defendants' alleged failure to prepare the Financial Statements in accordance with GAAP. HBCL argues that the Financial Statement Representation was breached because the Financial Statements contained errors, in violation of GAAP.

### **Errors Defined Under GAAP**

GAAP 1506 addresses the effects of "errors" in financial statements. Section 1506.41 provides, in pertinent part: "Financial statements do not comply with generally accepted

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<sup>142</sup> SPA § 7.5.2.

accounting principles if they contain either *material errors or immaterial errors made intentionally* to achieve a particular presentation of an entity's financial position, financial performance or cash flows."<sup>143</sup> An extension of this rule necessarily dictates that *immaterial errors made unintentionally* do not violate GAAP.

Here, HBCL alleges neither a material error nor an intentional error.<sup>144</sup> HBCL's breach claim is premised solely on immaterial and/or unintentional errors contained in the Financial Statements. Such errors, HBCL argues, do, in fact, violate GAAP.

In advancing this argument, HBCL contends that Section 7.5.2's "Materiality Scrape" applies not only to the SPA's Financial Statement Representation, but also to GAAP. In other words, the words "material," "materially," and "Materially Adverse Effect" would be scraped from the SPA *and* GAAP. Such an interpretation would then permit HBCL to seek indemnification, not only for all immaterial errors, but for any estimate contained in the Financial Statements that deviates from the "best" estimate. This interpretation runs contrary to the plain language of GAAP and of the "Materiality Scrape."

### **Basic Principles of Contract Interpretation**

Where the language of a contract is clear and unambiguous, the Court must construe the contract terms by their ordinary and usual meaning.<sup>145</sup> "Contract terms themselves will be controlling when they establish the parties' common meaning so that a reasonable person in the

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<sup>143</sup> CICA 1506.41 (emphasis added).

<sup>144</sup> See Transcript of Post-Trial Oral Argument at 81, *Hudson's Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super. Dec. 7, 2012) (Trans. ID 48754680) [hereinafter Transcript] ("Bouchard's calculation is not a material misstatement. The \$9.8 million is not material. And we've never claimed that it is.") and *id.* at 84 ("If there's no materiality threshold, we win on every claim.").

<sup>145</sup> *GMG Capital Invs., LLC v. Athenian Venture Partners I, L.P.*, 36 A.3d 776, 780 (Del. 2012) (citing *Paul v. Deloitte & Touche, LLP*, 974 A.2d 140, 145 (Del. 2009)). See also *Rhone-Poulenc Basic Chems. Co v. American Motorists Ins. Co.*, 616 A.2d 1192, 1196 (Del. 1992) ("Ambiguity does not exist where the court can determine the meaning of a contract 'without any other guide than a knowledge of the simple facts on which, from the nature of the language in general, its meaning depends.'").

position of either party would have no expectations inconsistent with the contract language.”<sup>146</sup>

Upon a finding that the contract clearly and unambiguously reflects the parties’ intent, the Court must refrain from destroying or twisting the contract’s language, and confine its interpretation to the contract’s “four corners.”<sup>147</sup>

### **Materiality “Scraped” from SPA Representations**

In the case *sub judice*, the Court finds the terms of the SPA to be clear and unambiguous.

Section 7.5.2 of the SPA provides, in pertinent part:

In determining whether there has been any breach of or any inaccuracy in any representation . . . for purposes of [indemnification] and in determining the amount of any Covered Loss, any references to “material,” “materially” or “Material Adverse Effect” in such representation . . . shall be disregarded . . . .

A plain reading of the Section 7.5.2 directs this Court to disregard (or “scrape”) any references to “material,” “materially,” or “Material Adverse Effect” from any representation set forth in the SPA. Clearly, the “Materiality Scrape” applies to the warranties and representations provided in the Financial Representation Statement for purposes of indemnification. Specifically, Section 7.5.2’s “Materiality Scrape” modifies the Fair Presentation Clause “scraping” the offending language. But HBCL has not invoked the Fair Presentation Clause in its efforts to recover damages.<sup>148</sup>

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<sup>146</sup> *GMG Capital Invs*, 36 A.3d at 780 (citing *Eagle Indus., Inc. v. DeVilbiss Health Care, Inc.*, 702 A.2d 1228, 1232 (Del. 1997)).

<sup>147</sup> *Doe v. Cedars Academy, LLC*, 2010 WL 5825343, at \*5 (Del. Super. Oct. 27, 2010); *O’Brien v. Progressive Northern Ins. Co.*, 785 A.2d 281, 288-89 (Del. 2001).

<sup>148</sup> Following trial, the Court asked the parties to address the implications the “Materiality Scrape” on the Fair Presentation Clause of the Financial Statement Representation. Letter to Counsel at 2, *Hudson’s Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super. Oct. 5, 2012) (Trans. ID 46830243). In response, Plaintiff stated: “We are not aware of any testimony construing or applying the ‘fair representation’ clause” of the Financial Statement Representation. Letter to The Honorable Jan R. Jurden from David J. Margules in Response to Court’s Questions Regarding Trial Evidence at 2, *Hudson’s Bay Co. Luxembourg, S.A.R.L. v. JZ LLP*, N10C-12-107 JRJ CCLD (Del. Super. Nov. 30, 2012) (Trans. ID 48055817). At post-trial oral argument, Plaintiff confirmed that no trial testimony or post-trial briefing focused on the Fair Presentation Clause: “And I apologize to the Court that we didn’t really focus on the [Fair Presentation Clause] and didn’t bring it up in the briefing, but we indicated in the letter that we were going to rely on some additional authorities.” Transcript at 19. Thereafter, Plaintiff briefly presented some argument on the Fair Presentation Clause. *Id.* at 19-20. In response,



## “Materiality” Inherent in GAAP

HBCL’s argument is based solely on “scraping” either: (1) the words “material” and “materially” from within GAAP itself and/or (2) the *concept* of materiality from GAAP generally.<sup>149</sup> The Court rejects Plaintiff’s argument for several reasons.

“Materiality is one of the most fundamental concepts underlying financial reporting.”<sup>150</sup> It is “the term used to describe the significance of financial statement information to decision makers.”<sup>151</sup> Information is material only if it is probable that its omission or misstatement would influence or change a decision.<sup>152</sup> Thus, “[m]ateriality is a matter of professional judgment in the particular circumstances.”<sup>153</sup>

To adopt Plaintiff’s interpretation of the “Materiality Scrape” would render GAAP virtually meaningless. Materiality is deeply engrained in almost every aspect of GAAP.<sup>154</sup> Indeed, materiality is the standard by which the compliance of financial statements with GAAP is determined. “Financial statements do not comply with generally accepted accounting principles if they contain either material errors or immaterial errors made intentionally to achieve

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Defendants argued that Plaintiff brought its case under the GAAP Clause and should not be permitted to change the theory of its case after trial. “The fact is that HBCL chose to present and try this case as under the first clause of that rep and warranty, the violation of GAAP. Every claim presented by Ms. Bouchard was a claim that the inventory valuation in the note 4A was a violation of GAAP, that the loyalty reserve was a violation of GAAP, that the failure to reserve for Jane-Finch in ’08 was a violation of GAAP. No issue was raised as to the meaning or effect of the fair representation aspect of the rep and warranty.” *Id.* at 144. To the extent HBCL has attempted at the eleventh hour (post-trial) to present a claim under the Fair Presentation Clause, the claim was not properly presented either before or during trial and the Court will not countenance the prosecution of the claim now. *See Those Certain Underwriters at Lloyd’s London v. Nat’l Installment Ins. Servs.*, 2008 WL 2133417 (Del. Ch. May 21, 2008); *Laird v. Buckley*, 539 A.2d 1076 (Del. 1988); and *Bellanca Corp. v. Bellanca*, 169 A.2d 620 (Del. 1961) (discussing the trial court’s responsibility to use its discretion when balancing the goal of encouraging disposition with the danger of prejudicing the opposing party when amending pleadings under Rule 15).

<sup>149</sup> *Id.*

<sup>150</sup> BRUCE MACKENZIE ET AL., *WILEY IFRS 2012: INTERPRETATION AND APPLICATION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS* 877 (9th ed. 2012).

<sup>151</sup> CICA § 1000.17.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> 5 Thornton 115.

a particular presentation of an entity's financial position, financial performance or cash flows.”<sup>155</sup>

Further, the Court cannot adopt HBCL's interpretation of the “Materiality Scrape” on public policy grounds. BCL's interpretation would render any and all errors – material and immaterial, intentional and unintentional, even known and unknown – to be violations of GAAP. The plain language of GAAP rejects such an interpretation. No company of Hbc's size (perhaps any size) can reasonably be expected to find every single error in its financial statements – such a task would be cost prohibitive.

Moreover, HBCL's proffered interpretation runs contrary to well-established contract principles. According to HBCL, any reference to materiality – no matter how minute or how far removed – requires the Court to leave the four corners of the SPA, find that referenced usage, scrape it, and then reinterpret the contract and the referenced source for purposes of indemnification. This includes more than mere accounting principles. HBCL agreed that its interpretation of the “Materiality Scrape” would also include “references” to “material” and “materially” found within SEC regulations.<sup>156</sup> This Court declines to rewrite GAAP or SEC regulations without clear and unambiguous language agreeing to such within the SPA. Had the parties intended the “Materiality Scrape” to apply with equal force to GAAP – thereby removing materiality from GAAP – they would and should have included such language to that effect. But such language was not included.

In sum, the Court finds that, for purposes of indemnification, Section 7.5.2's “Materiality Scrape” applies only to the representations or warranty set forth in the SPA. In reaching this conclusion, the Court rejects HBCL's argument that the “Materiality Scrape” removes any

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<sup>155</sup> CICA § 1506.41.

<sup>156</sup> Transcript at 20-21.

reference to the words “material,” “materially,” or “Material Adverse Effect” in GAAP. Therefore, to be entitled to indemnification, HBCL must prove that GAAP was violated by showing a *material* error in the Financial Statements. HBCL concedes that it cannot.<sup>157</sup>

## **B. Damages**

Even assuming, *arguendo*, that the “Materiality Scrape” applies to GAAP, such that HBCL can seek indemnification for *any error* contained in Hbc’s Financial Statements, HBCL has still failed to demonstrate that it sustained sufficient damage to exceed the SPA’s \$1.5 million deductible threshold. The record establishes that HBCL has sustained approximately \$1.4 million in “Covered Losses” – \$1.2 million Tax Claim and \$230,000 Sublease Claim. Therefore, HBCL cannot seek indemnification.

### **Distinguishing Between Estimates and Errors**

In determining whether HBCL is entitled to indemnification, the Court must undertake a two-step inquiry. First, the Court must determine whether HBCL has established that Hbc’s Financial Statements contain an error, as opposed to an estimate. If HBCL establishes the existence of an error, the Court must then determine whether HBCL has demonstrated that it suffered damages of at least \$1.5 million as a result of the error.

In distinguishing between an error and an estimate, the Court is guided by GAAP. GAAP recognizes that due to the uncertainties inherent in the business world, many items in financial statements cannot be measured with precision, but instead, must be estimated. Indeed, “[t]he use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.”<sup>158</sup>

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<sup>157</sup> See, e.g., *id.* at 81 (“Bouchard’s calculation is not a material misstatement. The \$9.8 million is not material. And we’ve never claimed that it is.”). Moreover, neither the claims individually nor in aggregate approach HBCL’s audit team’s \$30 million materiality threshold and no lower threshold has been presented to the court.

<sup>158</sup> CICA § 1506.33.

An estimate becomes an error, if, for example, it results from “the effects of mathematical mistakes, mistakes in applying accounting principles, oversight or misinterpretation of facts, and fraud.”<sup>159</sup> Under the circumstances here, in determining whether an estimate rises to the level of an error, GAAP provides that materiality be the “sole criterion.”<sup>160</sup> Thus, to “scrape” materiality from GAAP, as urged by HBCL, makes every estimate but the “best” a recoverable error.<sup>161</sup> Such an interpretation renders GAAP meaningless. Nevertheless, for purposes of the damages analysis only, the Court will assume that the estimates at issue were, in fact, errors.

### **“Covered Losses” Defined**

The Court must next determine whether HBCL has proven by a preponderance of the evidence that these “errors” caused HBCL to suffer “Covered Losses.” Specifically, for example, assuming *arguendo* no materiality, HBCL could have demonstrated that, had it known of the existence of these “errors” in Hbc’s Financial Statements, it would have engaged in further negotiations regarding the purchase price.<sup>162</sup> Or, again assuming *arguendo* no materiality, HBCL could have demonstrated that it had to pay “cash out of [their] pockets” as a result of the alleged errors.<sup>163</sup> The Court finds that HBCL has not met its burden.

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<sup>159</sup> *Id.* § 1506.05(c).

<sup>160</sup> *See* CICA § 1508.09 (“The materiality of the effect of the measurement uncertainty on the financial statement is the sole criterion for determining whether disclosure of measurement uncertainty in according with paragraphs 1508.06 and 1508.07 would be made.”) and *id.* § 1508.10 (“There is a degree of uncertainty associated with the measurement of many amounts recognized in financial statements. In many cases, however, such uncertainty is not material. A decision about whether a measurement uncertainty has a material effect on the financial statements is a matter of judgment. Management would consider information such as the range of reasonably possible amounts; whether the difference between the recognized amount and the outer limits of the range of reasonably possible amounts is material or whether the recognized amount could change by a material amount; the impact of other reasonably possible amounts on the entity’s economic resources, obligations (e.g., debt covenants) and equity / net assets; and the possible timing of the impact. A judgment about the materiality of measurement uncertainty would be made considering the effect that a different reasonably possible amount would have on the financial statements.”).

<sup>161</sup> *See, e.g.*, Transcript at 45-46, 56, and 160 and PPF at ¶¶ 28, 30, 85, 90, and 130.

<sup>162</sup> *See, e.g.*, Transcript at 158.

<sup>163</sup> *See, e.g., id.* at 80.

Per Section 7.2.1 of the SPA, Defendants are only obligated to indemnify HBCL “from and against any Covered Losses suffered by [HBCL] resulting from or arising out of ... any breach of any representation or warranty.” “Covered Loss” is broadly defined in the SPA as:

[A]ny and all losses, liabilities, claims, fines, awards, deficiencies, damages, obligations, payments (including those arising out of any settlement, judgment or compromise relating to any Legal Proceeding), reasonable costs and expenses (including interest and penalties due and payable with respect thereto and reasonable attorneys’ and accountants’ fees and any other reasonable out of pocket expenses incurred in investigating, preparing, defending, avoiding or settling any Legal Proceeding), including any of the foregoing arising under, out of or in connection with any Legal Proceeding, Governmental Order or award of any arbitrator of any kind, or any Lay or Contract.<sup>164</sup>

It is clear to the Court that an unexpected \$1.2 million tax liability constitutes a “Covered Loss” under the SPA. It is equally clear that an unknown \$230,000 lease liability must be accounted for as a “Covered Loss.” The Court, however, is unable to see how HBCL sustained “Covered Losses” as a result of the Inventory Claim, the Loyalty Reserve Claim, or the Sublease Claim.

#### **No Covered Loss Arising from Inventory Claim**

HBCL’s Inventory Claim is premised on Hbc’s alleged use of faulty estimates, or “errors,” in Footnote 4(a) of its Financial Statements. Footnote 4(a) estimates the potential impact of CICA 3031 on future financial statements. HBCL, however, has failed to articulate how and to what extent this alleged “error” led to HBCL “substantially overpa[ying] for [Hbc]” or taking “cash our of [their] pockets.” The only testimony offered by HBCL that touched on damages arising from the Inventory Claim was that of Francis Casale, HBCL’s Chief Financial Officer during the relevant time period. Casale, however, was unable to identify the amount of

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<sup>164</sup> SPA § 1.1.27.

cash that HBCL was required to “infuse” into HBCL as a result of the accounting “error” relating to inventory.<sup>165</sup>

Rather, the Court finds that the evidence more readily establishes that HBCL suffered no damages as a result of the alleged inventory “errors.” In reaching this conclusion, the Court accepts the testimony of Howard Johnson, Defendants’ expert. Johnson opined that HBCL “did not incur an economic loss on account of” the accounting discrepancies relating to inventory.<sup>166</sup> According to Johnson, the alleged inventory “errors” did not have “an impact on the cash flow generating ability of the business. These were simply accounting adjustments that affected accounting earnings, but not the underlying cash that they generated.”<sup>167</sup> Johnson continued, “[T]he alleged overstatement of inventories and understatement of the loyalty reserve are financial accounting matters that had no impact on normalized EBITDA,” on which the purchase price was negotiated.<sup>168</sup>

#### **No Covered Loss Arising from Loyalty Reserve Claim**

Likewise, HBCL has failed to prove that it sustained any “Covered Losses” as a result of the alleged accounting “errors” forming the basis of the Loyalty Reserve Claim. HBCL articulates no basis for concluding that use of the alleged “erroneous” 80% redemption rate, as opposed to a higher rate, affected the purchase price or led to “cash out of [their] pockets.” Casale, again, was the only HBCL witness to touch on damages. As with the Inventory Claim, Casale testified that he was unsure as to how much cash was infused in Hbc as a result of this alleged “error.”<sup>169</sup> Plainly, HBCL has failed to establish any “Covered Losses” attributable to the Loyalty Reserve Claim. Rather, as testified to by Johnson, HBCL suffered no economic loss

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<sup>165</sup> 2 Casale 47.

<sup>166</sup> 6 Johnson 238-40.

<sup>167</sup> *Id.*

<sup>168</sup> *Id.*; 6 Baker 33.

<sup>169</sup> 2 Casale 47.

attributable to the loyalty reserve “error.”<sup>170</sup> As noted by Johnson, this “error” “affected accounting earnings, but not the underlying cash that they generated.”<sup>171</sup>

### **No Additional Covered Loss Arising from Sublease Claim**

Under the Sublease Claim, HBCL seeks to recover \$3.1 million, consisting of \$2,663,000 for the lease deficiency, \$226,000 for the wall repairs, \$20,000 for roof maintenance, and \$207,000 for CAM and realty taxes.<sup>172</sup> It is undisputed that the \$226,000 in repairs to the exterior walls of the Store constitutes a “Covered Loss” under the SPA.<sup>173</sup> Beyond that repair, HBCL has failed to demonstrate that the remaining fees are “Covered Losses.”

As to the lease deficiency, John Galluzzo, HBCL’s real estate expert, testified that he did not know the amount of any “out of pocket payment to date.”<sup>174</sup> Additionally, HBCL presented no evidence demonstrating that it incurred costs to replace the roof. Nor was any evidence presented that HBCL had to cover the \$207,000, booked as a receivable, for CAM and property taxes.<sup>175</sup>

Moreover, at oral argument post-trial, the Court again asked HBCL to identify how the purchase price was affected by the alleged “errors,” and to quantify the “Covered Losses” it sustained.<sup>176</sup> In response to the Court’s inquiry, HBCL stated: “[W]hen you’re pricing the deal, you have to put a value on that.”<sup>177</sup> HBCL’s response fails to address the Court’s query. Viewing the evidence in its entirety, the Court finds that HBCL has failed to meet its burden in

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<sup>170</sup> 6 Johnson 238-40.

<sup>171</sup> *Id.*

<sup>172</sup> PPF at ¶ 110.

<sup>173</sup> DPF at ¶ 203.

<sup>174</sup> 5 Galluzzo 90.

<sup>175</sup> In its post-trial briefing, HBCL did not indicate whether it was required to pay out-of-pocket for the roof maintenance fee and/or the CAM/property taxes. Record evidence seems to suggest that, at least, the CAM/property taxes may have been written off by Hbc as uncollectible. See JX 14 at 9. In any event, the Court finds that HBCL has failed to demonstrate that such fees constitute “Covered Losses.”

<sup>176</sup> Transcript at 157-60.

<sup>177</sup> *Id.* at 158.

establishing that it suffered “Covered Losses” as a result of the Inventory Claim, Loyalty Reserve Claim, and remaining Sublease Claim.

**Deductible Not Met**

In light of the Court’s finding that HBCL failed to demonstrate that it sustained any “Covered Losses” arising from the Inventory Claim and the Loyalty Reserve Claim, HBCL has failed to meet the threshold deductible. Pursuant to Section 7.5.1 of the SPA, HBCL is entitled to indemnification only if its “Covered Losses” aggregate \$1.5 million. HBCL’s proven damages (the Tax Claim of \$1.2 million and Sublease Claim of \$226,000), however, fail to meet the deductible threshold. Therefore, HBCL is not entitled to indemnification from Defendants.

**IV. CONCLUSION**

Based on the foregoing, judgment is entered for Defendants.

**IT IS SO ORDERED.**

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Jan R. Jurden, Judge