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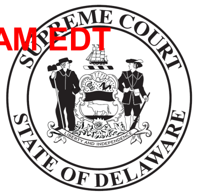

IN THE SUPREME COURT OF THE STATE OF DELAWARE

HUDSON'S BAY COMPANY LUXEMBOURG, S.A.R.L.,	
Plaintiff Below, Appellant,	No. 182, 2013
v.	On Appeal from Superior Court in and for New Castle County
JZ LLC and AGZ LLC,	C.A. No. N10C-12-107 JRJ CCLD
Defendants Below, Appellees.	

CORRECTED APPELLANT'S OPENING BRIEF

BOUCHARD MARGULES & FRIEDLANDER, P.A.
David J. Margules (#2254)
Jeffrey M. Gorris (#5012)
Jaclyn Levy (#5631)
222 Delaware Avenue, Suite 1400
Wilmington, Delaware 19801
(302) 573-3500
Attorney for Appellant Hudson's Bay Company Luxembourg, S.A.R.L.

Dated: May 29, 2013

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NATURE OF PROCEEDINGS

Appellant Hudson's Bay Company Luxembourg, S.A.R.L. (with affiliates, "HBCL") seeks an indemnity under a Stock Purchase Agreement ("SPA") by which it bought the 80% of Hudson's Bay Company ("Hbc") it did not already own. The Complaint was filed on December 10, 2010, against the indemnitors, Appellees JZ LLC and AGZ LLC (together, "JZ"). HBCL alleged Hbc failed to pay or to reserve for a $1.18 million tax, violating a tax representation – a claim to which JZ later stipulated – and three breaches of a financial statement representation (the "Financial Representation") arising from Hbc's accounting for inventory, a customer loyalty plan and a subtenant's lease default.

A bench trial was held on June 18-26, 2012. HBCL appeals from a March 11, 2013, Memorandum Opinion ("Op.;" Exhibit A, attached) in which the Court entered judgment for JZ without deciding if Hbc's accounting practices complied with Generally Accepted Accounting Principles ("GAAP"). Despite an SPA provision striking considerations of materiality, the Court held the errors did not violate the Financial Representation because they were immaterial. (Op. 25-27) Despite a broad SPA definition of "Covered Losses," the Court also held HBCL's injury did not meet a minimum loss required before an indemnity is owed because it did not prove the errors affected the price paid for Hbc or that they caused sufficient actual out-of-pocket expenditures after the transaction. (*Id.* 27-32)

SUMMARY OF ARGUMENT

1. The Trial Court erred by construing the SPA indemnity to cover only material GAAP departures, nullifying a "Materiality Scrape" which provided that, for purposes of indemnification, materiality is eliminated from the Financial Representation. As a result, the parties' intent as reflected in unambiguous contract language was not enforced.

2. The evidence establishes the Financial Representation was untrue because of Hbc's erroneous accounting for inventory, the loyalty program liability and the sublease of unused space in the Jane-Finch Mall. The evidence also establishes that HBCL suffered "Covered Losses" equal to the net asset inflation caused by the errors, plus litigation costs and interest.

3. The Trial Court also erroneously narrowed the broad SPA definition of "Covered Losses" for which indemnification is required. The Court required proof that, but for the breaches, HBCL would have paid less for Hbc or that it actually injected more post-transaction cash in Hbc than it would have done had the Financial Representation been true. The requirement is inconsistent with the unambiguous "Covered Losses" definition and with governing legal authorities. The Court also erred in failing to include proved "Covered Losses" that met the Court's restrictive definition.

STATEMENT OF FACTS

One of the world's oldest corporations, Hbc operates Canadian retail stores. (Op. 3) In March 2008, Jerry Zucker, indirect owner of 80%, told his partner, HBCL, he was dying and offered to sell his stake. (*Id.*) With Hbc "stumbling downward," HBCL worried it "would lose its 20%" stake. (*Id.* 4; A1366-67) Hbc was a "hope certificate" –unprofitable but with huge sales, it might be saved with expense cuts and new cash to reduce debt and reposition stores. (A1386-87) HBCL hoped for synergies with its Lord & Taylor chain. (A2320-21)

Through the April 25, 2008, SPA, HBCL agreed to buy Zucker out for $240 million.[1] (Op. 4) Post signing due diligence focused on cash available for debt and capital needs. (A1390) Any shortfall from expectations would force HBCL to sell assets, borrow more or invest additional equity. (A1381-82, A1392-93) The price was reset to $202 million because of falling earnings before interest, taxes, depreciation and amortization ("EBITDA"), rising debt and a deal change demanded by JZ that increased transaction tax caused HBCL to realize it needed additional cash to buy and fund Hbc. (Op. 5; A1370, A1395-96, A1401-02; A2328; A676) After closing, Hbc needed even more cash than expected, and HBCL infused $87 million in 2009. (A1428) Some of the unexpected post-closing cash requirements resulted from differences between Hbc's financial

[1] References to "GAAP" and to currency denote, respectively, Canadian GAAP and dollars.

condition as represented in the SPA and its actual condition. (A1430-33)

A. The Financial Representation and the "Materiality Scrape."

Hbc's financial statements were "the core" tool for predicting cash flow. (A1375) The SPA warrants that statements for the fiscal year ended January 31, 2008 (the "FY2007 Financials"), and the two months ended March 31, 2008, were:

> prepared in accordance with generally accepted accounting principles (subject to usual year-end adjustments in the case of the [March Statements]) consistently applied throughout the periods indicated and fairly, completely and accurately present in all material respects the financial position of [Hbc] and the results of [its] operations ….

(A517; Op. 5-6) The "heavily negotiated" Financial Representation was a critical risk allocation tool because "you don't necessarily find out all the things [in due diligence] that you are supposed to find out." (A1373-74, A1376-77, A1379-80)

HBCL need not close if Hbc did not "comply with, in all material respects," the Financial Representation and other conditions. (A550-51; Op. 6) Post-closing, the remedy was indemnity for "Covered Losses" (A543-50; Op. 6-7), defined as:

> [a]ny and all losses, liabilities, claims, fines, awards, deficiencies, damages, obligations, payments (including those arising out of any settlement, judgment or compromise related 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) ….

(A504) With Hbc "precariously perched" on cash flow availability," the post-closing indemnity was "insurance" against reporting errors. (A1410)

The indemnity's "risk allocation mechanism" modified the Financial Representation to create "a different threshold post-closing" in that "materiality is read out …." (A1406-07) Specifically, the SPA provides that:

> [i]n determining whether there has been any breach of or any inaccuracy in any representation … for purposes of Section[] 7.2.1 … and in determining the amount of any Covered Loss, any references to "material" … in such representation, warranty, covenant or agreement shall be disregarded, except where "material" … is used in Sections 1.1.53, 3.2.15 and 3.2.20 ….

(JX 1 at § 7.5.2 (A547) (the "Materiality Scrape"); Op. 7) The elimination of materiality was balanced by limiting JZ's obligation to 80% of a Covered Loss above $1.5 million, with a $20.2 million maximum liability. (A547; A508; A681)

B. The Admitted Tax Claim.

Before trial, JZ admitted the Tax Representation (SPA §§ 3.2.16.1, 3.2.16.2 (A521)) was false and a $1,181,713.02 tax was a "Covered Loss." (Op. 9, 21)

C. The Inventory Claim.

Hbc's FY2007 Financials overstated inventory by misapplying the newly adopted CICA 3031 inventory accounting standard.[2] The GAAP breach hid from HBCL the fact that Hbc's inventory contained devalued items for which it would not "recover [its] working capital investment" and on which it would "sacrifice [its] ability to make any profit."[3] (A1431)

The CICA 3031 calculation was reflected in a FY2007 Financials footnote

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[2] "CICA" is an authoritative promulgation of the Canadian Institute of Chartered Accountants.

[3] HBCL's valuation and planning models used CICA 3031 numbers. (A1400, A1403)

quantifying the impact of a change in the inventory standard from CICA 3030:

> 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).

(A473; Op. 12) JZ's experts admitted that if the CICA 3031 application was wrong, the numbers are "wrong" and the footnote "violate[s] GAAP." (A2269, A2271, A2275; A2476)

1. The Methodology

Hbc's inventory consists of millions of stock keeping units ("SKUs"), grouped in hundreds of categories set by store buyers. (Op. 10) Financial reporting was not a factor in existing groupings because the old standard, CICA 3030, did not require that GAAP "be taken into consideration." (A1631-34)

CICA 3031 changed how inventories are valued, mandating they be stated at the lower of cost and net realizable value ("NRV;" *i.e.* retail market value minus sale costs). (A1623; Op. 11; CICA 3031.07, .09 (A85)) Under both standards, cost could be calculated using the arcane Retail Inventory Method ("RIM"), in which an average margin is deducted from the expected retail price. (Op. 10-11; A1893-94) CICA 3031.22 newly required that SKUs in RIM categories have

"similar margins." (A1899; A2079-80)[4] Under CICA 3031.29A, "inventories are usually written down to [NRV] item by item," but the cost/NRV comparison may be done at the category level if grouped items serve "similar purposes" or are "interchangeable … as long as they move together or react the same way to the economy or to the customer's behavior." (A2067-68; CICA 3031.39A (A91)); Op. 11)[5] KPMG, Hbc's auditor, advised Hbc must prove its categories held "similar" items with "similar margins." (*E.g.* A270, A272, A274, A296; A1634-42)

Under CICA 3031, improper inventory groupings affect recorded value. If the cost/NRV comparison is at the level of SKUs, each below-cost SKU is written down. (A2074) When done at the group level for dissimilar items, SKUs with an above-cost NRV (adjustment prohibited) offset SKUs with a below-cost NRV (write-down required). (A2068-69; A2751) If so, inventory is "not measured at the lower of cost or NRV" and is overstated. (A2061) Hbc and KPMG knew category-level comparisons rarely result in write-downs. (A1637-38 ("rare occasions"), A1642-43; A764 (surprised if "a category … had an NRV below cost"); A272; A296)

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[4] Paule Bouchard is a partner with RSM Richter Chamberland, chairs its Professional Standards Group and oversees audit methodology, professional development and quality control. She has served on the Canadian Institute of Chartered Accountants' Inspection Committee, its international standards body, the International Accounting Education Standards Board, the Board of Evaluators (which she chaired for two years) and the Assurance Standards Board (which establishes and regulates audit standards). (A2045-47)

[5] Examples are mattresses/box springs or washers/dryers, sold together. (A2068-69)

In August 2007, "before … a lot of analysis," KPMG endorsed category-level NRV testing. (A1823) Hbc was "extremely surprised" and "uncomfortable" (A1183, A1186, A1189; A1906-07; A1645), and tests confirmed dissimilarities within groups. When SKU margins were split into cohorts (*e.g.* 0-5%, 5-10%, 10-15%), many groups had "a significant number of items in three of the buckets." (A1645-48; A303; A370) A second test compared a RIM cost estimate for entire categories to a RIM estimate for the SKUs within each, showing "fairly substantial" margin disparities. (A1649-50) KPMG advised that a difference greater than 5% violated CICA 3031.22. (A1650-51; A1900-02) With FY2006 data, fifty large categories showed a "significant deviation." (A1652-54; A1901; A401) For 2007 data, 225 total categories had a difference greater than 5%, a total deviation of "about $27 million." (A1910-12; A1927) Asked about Hbc's testing, JZ expert Karen Parsons testified: "If those statistics are accurate, then it might have indicated they needed to break up some of the categories." (A2501)

Management began work to split 50 categories "to comply with the standards." (A1901-02, A1907; A1656; A406-07; A344) KPMG told Hbc to stop because the difference over all inventory netted out to less than 5%, although scores of categories had far greater differences. (A1903-07; A16 56-57; A406-07)[6]

[6] One group was split for operational reasons. (A1657, A1902) Nothing was done to move individual SKUs with dissimilar margins. (*See* A1657)

Parsons agreed the comparison KPMG cited "tells you nothing about whether an individual category has substantially similar margins." (A2497, A2502-03)

While finalizing the FY2007 footnote, Hbc knew it had to improve the inventory method. On February 15, 2008, financial managers advised senior executives a "process" was needed "to identify inventory where [NRV] is below cost." (A424; A1663-64) Under the heading "Restatement," a January 2008 "Section 3031 – Master Document" states the footnote numbers were calculated by comparing each group's total NRV to total RIM cost. The "Prospective" section describes a "sustainability" test to be added in the future: quantitative and qualitative analyses to identify and reserve for below-NRV SKUs in positive categories. (A1664-67; A395)[7] KPMG incorrectly thought the "sustainability" test was done in FY2007. (A449-50; A1668-69; A2187) It was first done in FY2008, leading to a "more accurate" inventory value. (A1667-68, A1676-77)

2. The GAAP Breach

JZ expert Daniel Thornton agreed CICA 3031 limits the use of categories and that groupings "that [CICA 3031] says is inappropriate" violate GAAP. (A2264-66) Neither he, nor Parsons, nor KPMG evaluated the validity of Hbc's groupings. (A2266-68; A2495-96; A770-71; A1907-08)

Hbc's categories violated CICA 3031.29A by grouping items with dissimilar

[7] A375 (PX 42), Distefano Deposition Exhibit 8, was produced from KPMG's work file.

uses, prices and margins. (A2080) "Sponge Bob" toothbrushes were with saunas. (A2072) A $155 Maytag refrigerator was with a $21,000 Subzero. (A2074) Discontinued goods were with saleable SKUs, and unprofitable with profitable. (A2073) The non-compliant categories were "a misapplication … of GAAP and, therefore, it's an error." (A2092) JZ did not challenge Bouchard's conclusion that CICA 3031.29A was breached. Hbc's categories also violate the CICA 3031.22 "similar margins" requirement, as demonstrated in management's testing and the grouping of positive and negative margin goods. (A2080-82)

Bouchard used original invoiced cost, adjusted as required by CICA 3031, compared each SKU's cost to its NRV and calculated a $20.7 million reserve was needed to account for devalued inventory. (A2084-86) She deducted the reserve booked by Hbc, yielding a $9.8 million reserve understatement and inventory overstatement. (A2070-71) Parsons agreed that if actual cost is used, Bouchard's reserve calculation complied with GAAP. (A2476-77)

D. The Loyalty Plan Claim.

Hbc awards points for purchases, creating a liability for the cost of the goods or services to be exchanged for the points. (A1556-57; Op. 14) Not all points are cashed in and Hbc estimates the portion to be redeemed in the future. (A1556-58; Op. 14) Hbc's FY2007 Financials violated GAAP by understating the liability for costs related to the loyalty rewards program by failing to use management's best

estimate of the percentage of the points that would ultimately be redeemed.

1. The Redemption Rate Methodology.

From FY2001 through FY2007, annual redemption rates climbed steadily from 48% to 98%. (A1563-64; Op. 14) The increases resulted from customers accumulating enough points to satisfy redemption thresholds and changes designed to make the plan easier and more attractive. (A1564-65; Op. 14)

HBCL challenges the redemption rate used to calculate the future cost. (A2093) Hbc's rate was calculated by Director of Credit Loyalty Kevin Carkner and reviewed by then-General Manager, now-Vice President of Financial Accounting and Reporting, Douglas Tames. (A1558) The method changed each year from FY2005-FY2007. (A816) In FY2006, Hbc averaged five years of historic rates and five of projected rates, yielding 79%. (A1567, A1569-70) KPMG told Hbc in early 2007 to change its method again because it would no longer allow the use of projections to forecast future cost. (A1572) In FY2007, management averaged the rates experienced in the prior six years, an 80% rate. (Op. 14-15; A1569, A1571) The constant formula changes demonstrate "management had little faith in the methodology." (A2097)

The liability is "very sensitive" to the years averaged – a 1% change makes a "$5 million difference." (A1571, A1587; A269; Op. 15) A five-year average in FY2007 yields 86%, increasing the liability by about $30 million. (A1571)

Tames was "very uncomfortable" with the averaging, calling it "a very simplistic approach to a very complicated matter." (A1574) He criticized the inclusion of "early years which would bear no relation to the future." (A1574) Tames expressed his reservations "widely" and recommended "that we get an actuarial valuation done." (A1575)

Hbc comptroller Arthur Mitchell "had serious concerns" and agreed "the methodology wasn't sufficient." (A1583, A1585; A741-42, A744) In an August 2008 email regarding a provisional FY2008 rate, he complained, "We have no support for a $12.3 million increase or any number that you can imagine." (A686) Mitchell agreed to use an actuary for FY2008. (A1583)

Carkner also criticized the averaging method. In an April 16, 2007, email to KPMG discussing the use of a historical average, he wrote:

> I think there is more to it. While I agree that the rate to provide should not be based on future changes, I do think the rate should be reflective of current (i.e. within the current fiscal period) market conditions and loyalty value proposition. [A]s such, I think there is a management estimate component that should be part of the provision to be in accordance with GAAP if we can truly point to certain factors that indicate the long term redemption rate is something more than just the 5 year historical average.

(A268; A1579-80) Parsons, JZ's accounting expert, similarly "would consider more than just the … simple average." (A2455)

The Court found 80% "inconsistent with contemporaneous estimates" (Op. 15), which were consistently higher. (A2103-04) In 2006, Ernst & Young

("E&Y") valued the loyalty liability for an adjustment to fair value permitted in the accounting for Zucker's purchase of Hbc, finding 87.5% appropriate. (Op. 15; A1594-95) A KPMG FY2007 audit work paper used a four-year average and "calculated an average redemption rate of 88%." (A460) In early 2007, KPMG recommend a 3-year average, which would have yielded 90%. (A1588; A269)

As of the end of FY2007, Hbc had underestimated redemptions for three straight years. (A265; A1572) The actual FY2007 rate was almost 20 points higher than the 79% forecast. (A1567-68; A416) Hbc's actual FY2007 rate was "very much in line with" E&Y's projection. (A1596-97; A411)

Late in 2007, an actuarial expert told Tames and Carkner he "didn't believe that the methodology [they] were using was going to produce an accurate result" and that Hbc's rate "was low." (A1576-78; A776-77) In February 2008, Hbc began provisioning at an 82% rate for FY2008. (A563)

2. The GAAP Breach.

GAAP permits estimates, but requires "management's best estimates based on assumptions that reflect the most probable set of economic conditions and planned courses of action." (CICA 1508.04 (A122); A2062; A2410-11) Management is enjoined to "establish policies and procedures" including those for "developing assumptions as to the most likely outcome, … comparison of previous estimates to actual results and consideration by management of whether the

accounting estimates are reasonable and consistent with the entity's business plans." (CICA 5305.03 (A110); A2412) It is a "fundamental GAAP principle" that estimates be the "product of reasonable inputs, reasonable due diligence and reasonable professional judgment," as well as "the latest available reliable information." (A2412)[8]

Parsons agreed it is an error to use an estimate that "was not management's best estimate and did not reflect [known] economic conditions and [planned] courses of action," or that otherwise violates a GAAP requirement. (A2417-18) "An error would be an error," Parsons testified, "not a difference in estimates." (A2417; A2062-63, A2103-04; A2166-67)

Asked if 80% was "management's best estimate reflecting the most probable set of economic conditions and planned courses of action," Tames said:

> It didn't reflect management's expectations because KPMG had indicated that we couldn't use projections. As far as the methodology, something so simple as what we had used would be hard-pressed to refer to that as best of anything.

(A1611) Although it had proved accurate, KPMG barred management from using E&Y's rate because it considered a benchmark study of comparable programs. (A1596) Hbc accepted KPMG's advice that 80% could be used because it would not cause a ***material*** error. (A1722-23)

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[8] The "best estimate" standard does not require the best possible estimate. (*See* Op. 23) It requires ***management's*** best estimate based on a reasonably diligent and competent analysis.

JZ's Parsons rejected much of KPMG's advice on loyalty. KPMG barred Hbc from considering forecasts and future changes to the program, advice with which Parsons "specifically disagreed." (A1572; A1729-30; A2428-30) KPMG precluded consideration of benchmark studies of similar plans, data Parsons said management "should have considered." (A2429-31) KPMG barred use of the E&Y rate, advice Parsons rejected. (A1595-96; A2431)

Bouchard calculated the liability using E&Y's 87.5% rate, the only third party expert estimate available when the FY2007 Financials were issued, and found a $10.4 million loyalty liability understatement. (A2098-99; A826) Parsons had "no reason to believe" E&Y's rate "was not an appropriate rate to use" and relied on it in her own report. (A2433-34; A1231)[9]

E. The Lease Claim.

HBCL's lease claim is that the FY2007 Financials understated Hbc's liability for lease payments for an unused store because it offset the obligation with scheduled payments from a struggling sublessee that it knew was unlikely to pay in full. The GAAP violation caused HBCL to underestimate cash required for lease payments because the FY2007 Financials failed to reflect that the sublessee's payments would not cover Hbc's full lease obligation. (A1432-33)

[9] Parsons had no opinion about the appropriateness of the 80% redemption rate or of the resulting reserve. She opined only that the reserve was reasonable ***if*** added to the purchase accounting "fair value" adjustment booked when Zucker bought Hbc in 2006. (A2461) It is undisputed that management regarded the fair value increment as an accounting vestige with no impact on the redemption rate or the reserve. (A737-38; A1598; A1606; A2456-57)

A lease of non-operating property lease is a liability, reduced by revenues expected from a sublease. (A1540; A2108; CICA EIC 135(A113)) If sublease revenue expectations decline, a further provision is taken. (A1540-41; A2108-10)

1. Walia's Sublease Obligation.

Under a "Head Lease," Hbc is bound until January 2014 for rent, common area maintenance ("CAM"), taxes and repairs for unused space in Toronto's Jane-Finch Mall. (A1855-57; A168, A170, A176, A179-80; Op. 17) The Mall was in a high crime neighborhood, and the store was large, not easily dividable and poorly situated in the facility. (A750, A754-55; A2199-2200, A2202; A1852-53) Landlord consent was needed for anything other than narrowly-defined uses, a requirement the landlord used to reject proposed subtentants. (A185-86; A199 (2002 Superior Court of Justice Opinion); A755; A1854; Op. 17)

Hbc could not find a stable subtenant. (A751, A755; A1854-55) In 2003, after years of vacancy, it sublet to Walia Discount Mart ("Walia"), a deep discount department store. (A751, A756; A1854-55; A210) Walia assumed Hbc's obligations, but was to pay reduced rent until June 2008, when monthly rent would increase from $25,480 to the Head Lease rate of $40,406. (A756; A1856-57; A1543-44, A1547-48; A719; A214-15; Op. 17-18)

The Court found that "[a]round mid-2007, Walia began having difficulty making its CAM and tax payments." (Op. 18) Rent "began to arrive later and

later." (*Id*; A1857-59, A1882-83) On January 31, 2008, Walia owed Hbc $207,000. (A448; A559-60) In addition, the landlord demanded repairs it claimed would cost more than $1 million. (A276-77; Op. 18) In late 2007, the landlord advised Hbc it heard Walia "may fold." (A297; A420; Op. 18)

Hbc's real estate department "[was]n't really surprised" to hear Walia was in distress. (A1859; A759) In January 28, 2008, Hbc asked the broker who brought in Walia for help collecting arrearages. (A409-10) When the FY2007 Financials were issued, the real estate department thought Walia could only "cover 20 to 25,000 per month," far less than the rent, let alone other charges. (A1863)

2. The Failure to Book a Provision.

In April 2008, days after issuance of the FY2007 financials, Walia bounced rent checks, and Hbc took a $2 million provisional reserve. (A1544-45, A1550-51) The Court erroneously found Hbc booked the reserve in the FY2007 Financials:

> On April 2, 2008, Hbc issued its Fiscal 2007 Financial Statements. In it, Hbc booked a $2 million reserve for the Store ("Sublease Reserve"). This number reflected Hbc's estimate of its remaining lease obligation minus the present value of future payments from Walia at the reduced rent.

(Op. 19) When actually booked, the reserve reflected the expected rent shortfall, but not CAM, taxes, repair costs or the existing receivable. (A1551-53) Had Tames been aware of the facts on January 31, 2008, it would have "clearly point[ed] to the need to book a reserve at that time." (A1556)

3. The GAAP Breach

Bouchard concluded "there was clearly information available at the time of the preparation of the financial statement" showing Walia "was in no way going to be able to fulfill their full obligation." (A2108) That determination triggered an obligation to record a reserve. (A2108; A1540-42) Bouchard opined the appropriate reserve was $3.1 million – a $2.663 million rent deficiency calculated by real estate expert John Galluzzo, $226,000 for wall repairs, $20,000 for roof maintenance and the existing $207,000 receivable. (A834; A2111)

Parsons opined Hbc appropriately could have booked Bouchard's reserve. (A2466-67) Parsons said it was acceptable not to book anything because she assumed Hbc consciously decided not to do so, although she admitted there was "no evidence" Hbc's accounting department was aware of the facts available to the real estate department showing non-performance going forward. (A2469-70)

F. The "Covered Loss."

It is hard to imagine anyone would have denied HBCL suffered a Covered Loss if Hbc's financial statements overstated cash by $24.5 million. The tax misrepresentation and accounting errors had precisely that impact.

To execute HBCL's investment thesis, cash needed to pay the $1.18 million tax had to be replaced from another source. (A1381-82, A1392-93, A1429-30) The loyalty liability error understated the funds expected to be consumed by the

program going forward – also cash that would have to be replaced. (A1432) The unrecognized shortfall between Walia's sublease obligations and its expected payments inflated the anticipated cash available from the business: "Somebody's got to pay the $3.1 million to the landlord …." (A1433)

The inventory overstatement also affected cash expectations. Hbc CFO Michael Culhane explained that projecting operating performance required a forecast of inventory needed to support sales. (A2004) If the inventory available for profitable sales is overstated because of "aged stock … that is not desired by the customer, you will have an issue as far as ultimately recovering as much cash." (A2005) To make plan, stale inventory must be sold for salvage, with proceeds used to partially fund the cost of productive inventory.

Hbc's sensitivity to cash was demonstrable. In FY2008, which ended January 31, 2009, Hbc had losses of $72.3 million, and borrowings under its asset backed loan (the "ABL") increased from $525.0 to $729.5 million. (Op. 8) ABL lenders could impose a "lock-box" if borrowings rose to within $200 million of availability, causing a "death spiral" because vendors would demand cash on delivery. (A1422-23) During much of 2008-09, borrowings were close to the lock-box trigger, and hit it in August 2008, requiring a one-time waiver from lenders. (A1323-24; A2000-02) Even after an $87 million infusion in January 2009 (A129), availability was close to the trigger for much of the year.

HBCL considered the funds it would inject into Hbc as a component of the purchase price. When it became apparent Hbc would consume more cash because of falling EBITDA, rising debt and an increased tax burden, HBCL negotiated for a $38 million (15.8%) price reduction. The only reasonable inference is that HBCL would have demanded an additional decrease had it been aware of the unpaid tax, the inventory overstatement, the loyalty liability understatement and the expected shortfall in Walia's sublease payments.

In finding that the misstatements did not affect the purchase price, the Trial Court adopted the opinion of JZ expert Howard Johnson, who claimed the misstatements were "simply accounting adjustments that affected accounting earnings, but not the underlying cash that they generated," and would not have affected HBCL's valuation of Hbc had they been known. (Op. 30; A2541-43) In contrast with that broad statement, Johnson's specific testimony was far more limited. He had no opinion on the impact of the tax or lease claims. (A2553) With regard to inventory and loyalty, Johnson focused solely on the normalized EBITDA valuation metric despite acknowledging "[t]here are other measures of [Hbc's] value." (A2558)

With respect to normalized EBITDA, Johnson did virtually no due diligence. (A2576-77) The sole basis for his opinion that HBCL would have ignored the errors was an inapposite June 5, 2008, D&T report. D&T did not evaluate any

adjustments similar to the inventory claim. (*Id.* 276-78; A564) D&T warned, however, that a loyalty rate understatement ***would*** have an ongoing EBITDA impact. (A576; A2605, A2608-11)

Moreover, the report represented the views of D&T, not HBCL. (A2579, A2594-95) Johnson admitted that assessing the impact of adjustments is subjective and clients often reject their advisor's views. (A2579-81, A2584-86) Johnson did not review any ***HBCL*** documents that would give insight into how ***it*** perceived "normalized" EBITDA. (A2568-70, A2579, A2594-95)

Further, the report was generated early in due diligence, based on limited information and review. (A571-72; A2579; A1385-86) Johnson conceded D&T's views might change as a result of additional work, and that HBCL could reasonably come to different conclusions. (A2579-81) The report was "not designed to be conclusive," and HBCL didn't give "much final weight to these conclusions." (A1385-86)

Johnson acknowledged that reaching an independent conclusion about the impact of the errors on "normalized" EBITDA, would require an evaluation of the specifics of each. (A2594-95) He would also have to understand the underlying business, as well as other relevant factors. (A2584-86) He did not do the work need for such an opinion. (A2568-69; A2579-80; A2593-96)

ARGUMENT

I. THE TRIAL COURT ERRED BY CONSTRUING THE SPA INDEMNITY TO COVER ONLY MATERIAL GAAP DEPARTURES

A. Question Presented

Did the Trial Court err by holding that the Financial Representation applied only to material GAAP violations because an immaterial violation is not a GAAP violation, and despite the unambiguous "Materiality Scrape," which eliminated materiality as a consideration in determining the existence of a representation violation and in calculating the Covered Loss? (A2741-42)

B. Scope of Review

Because the proper construction of an unambiguous contract provision is a law question, the Supreme Court's review of the meaning and effect of the Materiality Scrape is *de novo*. *BLGH Holdings LLC v. enXco LFG Holding, LLC*, 41 A.3d 410, 414 (Del. 2012) ("Court reviews the trial court's interpretation of contract terms *de novo*"). The interpretation of GAAP and its application are questions of law which are examined *de novo*. *Ehlinger v. Hauser*, 785 N.W.2d 328, 338 (Wisc. 2010) (application of GAAP is question of law.); *BLGH Holdings*, 41 A.3d at 414 (law questions reviewed *de novo*).

C. Merits of Argument

The Financial Representation, in relevant part, warrants that the financial statements at issue were:

> prepared in accordance with generally accepted accounting principles (subject to usual year-end adjustments in the case of the [March Statements]) consistently applied throughout the periods indicated and fairly, completely and accurately present in all material respects the financial position of [Hbc] and the results of [its] operations …

(A517) The Materiality Scrape provides that, for purposes of indemnification, "any references to 'material' … shall be disregarded." (A547) Thus, the SPA unambiguously creates a remedy for immaterial misrepresentations.

In holding the Materiality Scrape did not eliminate materiality in assessing GAAP compliance, the Trial Court carved the Financial Representation into two distinct requirements – (1) "prepared in accordance with [GAAP]" and (2) "fairly, completely and accurately present in all material respects." (Op. 22, 24) The Court held that "material" only modified the "fair presentation" clause, and that deleting it did not affect the GAAP clause. In addition, the Court concluded the Materiality Scrape did not eliminate materiality from GAAP because GAAP does not regard an immaterial, unintentional error to be an error at all. (Op. 23, 25)

1. Immaterial Departures from GAAP are Errors.

Despite a wealth of authorities proscribing, explaining and applying GAAP, neither the Court nor JZ cited any stating that an immaterial GAAP violation is not a violation. CICA 1506, on which the Court relied (Op. 22-23), neither states nor implies that an immaterial, unintentional error "is in accordance with GAAP" – a contention Bouchard rejected as "simply wrong." (A2053) The promulgation

applies only to “changes in accounting policies, changes in accounting estimates and corrections of prior period errors” (CICA 1506.03 (A61); A2287-88; A2053-54), and states:

> Financial statements do not comply with generally accepted 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. ***Potential current period errors discovered in that period are corrected before the financial statements are completed.*** However, material errors are sometimes not discovered until a subsequent period, and these prior period errors are corrected in the comparative information presented in the financial statements for that subsequent period.

(CICA 1506.41 (A69)(emphasis added)) A discovered immaterial current error must be fixed, but a prior-period error must be corrected only if material or intentional. The CICA considers it “inconsistent for an entity to state that its financial statements are prepared in accordance with GAAP when those statements include uncorrected errors.” (*Background Information and Basis For Conclusion* CICA Handbook 1506 at .24 (A1197)) Errors are “omissions from, and misstatements in, the entity’s financial statements … arising from a failure to use, or misuse of, reliable information …,” with no materiality qualification. (CICA 1506.05(c) (A62)).

The Court equated management’s obligation to comply with GAAP in preparing its financial statements (the SPA requirement) with the materiality “safe harbor” in financial reporting, leading to a concern that issuers would be sued for

minor errors. (Op. 26) According to the Court:

> "Materiality is one of the most fundamental concepts ***underlying financial reporting***." It is "the term used to describe the significance of financial statement information to decision makers."

(Op. 25; citations omitted; emphasis added) Auditing practitioners clearly do not perceive such equivalence. Published financials are always subject to a materiality qualification, a meaningless proviso if immaterial errors are not errors. (A463; A767; A2053-55) Auditors routinely provide clients with a "statement of audit difference" listing immaterial uncorrected errors, an irrelevant and misnamed exercise if the listed errors are not errors. (A2055) *See Airgas, Inc. v. Air Prods. & Chems., Inc.*, 8 A.3d 1182, 1191 (Del. 2010) ("industry practice and understanding of similar [corporate] charter language [is] persuasive"); *Wilmington Firefighters Ass'n, Local 1590 v. City of Wilmington*, 2002 WL 418032, at *9 (Del. Ch. Feb. 15, 2002) ("court should consider all objective intrinsic evidence, including … the business context … and industry custom, to divine the term's meaning.")

The only direct support for the Court's reading came from one JZ trial expert, Thornton.[10] Despite forty years as an accounting practitioner and academic, Thornton first conceived of the argument when offered employment in this matter because, if materiality didn't apply, he "didn't have much to say."

[10] Parsons, JZ's primary accounting expert, did not opine on the subject.

(A2279-87) He thought "long and hard," describing his reasoning as "roundabout" and "convoluted." (A2280, A2285-87; A2200, A2202)

Even if Thornton's "convoluted" argument is correct, which it is not, the parties' intent is dispositive. "[W]here... technical words are employed in a sense entirely different from their technical meaning, the meaning in which they are employed will be adopted." *Radio Corp. of Am. v. Philadelphia Storage Battery Co.,* 6 A.2d 329, 334 (Del. 1939); *see also Rag Am. Coal Co. v. AEI Res., Inc.*, 1999 WL 1261376, *14 (Del. Ch. Dec. 7, 1999) ("Parties may contractually agree to any definition of 'Tax' they choose, regardless of the term's use in other contexts."). Consistent with the unrefuted testimony of the only witness on the subject, the SPA's structure and language demonstrate that the parties intended to provide a remedy for GAAP violations, whether or not material.

2. The SPA evidences a clear intent to eliminate materiality as a consideration.

Dividing the Financial Representation into distinct clauses cannot be squared with the provision's language. Each requirement after "prepared in accordance with" GAAP is a GAAP requirement, making it clear the latter are examples of the former, not separate standards. *See* CICA 1000.23 ("consistency") (A40); CICA 1400.03-.08 ("fair presentation") (A56); CICA 1000.21(a),(c)(A40); CICA 5300.21(a) (completeness and accuracy) (A104). The location of the qualifier does not mean it relates only to the items that follow it. *See Cantor Fitzgerald, L.P. v.*

Prebon Sec. (USA) Inc., 731 A.2d 823, 829 (Del. Ch. 1999) ("natural persons" qualifier in NASD rule modified all terms, even those to which it is not explicitly linked); *Paul v. Deloitte & Touche, LLP*, 974 A.2d 140, 146 (Del. 2009) (analyzing whether qualifier applied to terms preceding it, following it or all). Regardless of which terms "material" modifies, if small errors are not errors, the qualifier offends the principle that "[c]ontracts are to be interpreted in a way that does not render any provisions 'illusory or meaningless.'" *Alta Berkely VI C.V. v. Omneon, Inc.,* 2011 WL 2923884, at *5 n.25 (Del. Super. July 21, 2011) (citing *O'Brien v. Progressive N. Ins. Co.,* 785 A.2d 281, 287 (Del. 2001)).[11]

Moreover, under the Trial Court's reading the proviso "subject to usual year-end adjustments" would modify "in accordance with generally accepted accounting principles," but not the "fairly, completely and accurately" standard. Basic contract law requires the rejection of interpretations leading to such absurd results. *Osborn ex rel. Osborn v. Kemp*, 991 A.2d 1153, 1159-60 (Del. 2010).

The intent to create a remedy for immaterial GAAP errors is consistent with the structure of the SPA as a whole. A breach of the Financial Representation excused HBCL's obligation to close only if the misstatement was material. (A530,

[11] The erroneous carve-up of the Financial Representation was also reflected in the Court's conclusion that HBCL proceeded only under the "GAAP clause" and failed to timely raise a claim under the "fair presentation" clause. (Op. 22, 24-25 n.148) Even if they are considered independent, GAAP's "fair presentation" concept is a disclosure requirement, *see* CICA 1400.04 (A56) and disclosure has always been central to the case. (A1261-63, A1272-73; A2704, A2712, A2744-45; A688, A691, A692-97, A700; A1286, A1300-01).

A550) The SPA protected against nit-picking by requiring that HBCL accrue at least $1.5 million in Covered Losses before a remedy is available. (A547) Indemnification is ***capped*** at $20.2 million – well below the $30 million materiality threshold assumed by the Court. (*See* Op. 27, n.157) Moreover, the Materiality Scrape eradicates "material" from all representation; and nothing indicates an intent for it to affect this one differently. *See GMG Invs., LLC v. Athenian Partners I, L.P.*, 36 A.3d 776, 779 (Del. 2012) ("The meaning inferred from a particular provision cannot control the meaning of the entire agreement if such an inference conflicts with the agreement's overall scheme or plan."); *Bank of N.Y. Mellon v. Commerzbank Capital Funding Trust II*, --- A.3d ----, 2013 WL 1136821, at *8 (Del. Mar. 19, 2013) (in determining which phrases are subject modifier, contract "must be read as a whole and in a manner that will avoid any internal inconsistencies, if possible.").

II. THE EVIDENCE ESTABLISHES THE FINANCIAL REPRESENTATION WAS UNTRUE

A. Question Presented

Did HBCL prove violations of the Financial Representation? (A2742-45)

B. Scope of Review

The Supreme Court's determination of whether the Financial Representation was untrue is *de novo*. *Commerzbank*, 2013 WL 1136821, at *8 ("In the interest of justice and for the sake of judicial economy, we decide those issues [which Trial Court did not reach] *de novo*.").

C. Merits of Argument

Having determined the accounting claims were immaterial, and having held that only material breaches are indemnifiable, the Court did not rule on whether the three claims were GAAP violations. The evidence proves each was a breach.

The inventory accounting violated two GAAP requirements – that categories have only "similar or related items" (CICA § 3031.29A (A88)) and items with "similar margins" (*id.* .22 (A87)) – resulting in at least a $9.8 million overstatement. The Court erroneously found Hbc complied with .29A, although no JZ expert rendered such an opinion or disputed Bouchard's testimony on the subject. The Court did not address .22. (Op. 11, 13) JZ's experts admitted that use of a non-compliant method means the footnote breached GAAP because the numbers were wrong.

The loyalty liability calculation violated CICA 1508 and 5305 because it was not management's best estimate of the most probable outcome based on economic conditions and management's planned course of action and resulted in an understatement of a liability. The Court made no finding on the issue.

The failure to take a provision against the sublease violated CICA EIC 135 and resulted in the recognition of revenue Hbc did not expect to receive. The Court made no finding on the issue.

III. THE TRIAL COURT ERRONEOUSLY NARROWED THE BROAD SPA DEFINITION OF "COVERED LOSSES"

A. Question Presented

Did the Trial Court err by 1) holding HBCL suffered no Covered Loss absent proof it would have paid a specific dollar amount less for Hbc but for the errors, or proof of the exact amount of additional cash actually invested after the transaction due to the misrepresentations; and 2) failing to include proved Covered Losses, even under the Court's mistaken construction? (A2745-59)

B. Scope of Review

The Trial Court erred as a matter of law in limiting the measure of damages and misapplied the unambiguous indemnification provisions of the SPA. The Supreme Court's review is *de novo*. *Rohn Indus., Inc. v. Platinum Equity LLC*, 911 A.2d 379, 382 (Del. 2006) ("We review both the trial judge's interpretation of the Agreement's language and her legal conclusions *de novo*."); *Titan Inv. Fund II, LP v. Freedom Mortg. Corp.*, 58 A.3d 984, 2012 WL 6049157, at *3-4 (Del. 2012) (TABLE) (Trial Court erred by applying incorrect measure of damages).

The Trial Court's calculation of HBCL's Covered Loss was based on a misapplication of governing law, unambiguous contract terms and GAAP. The Supreme Court's review is *de novo*. *Kahn v. Lynch Comm's Sys., Inc.*, 669 A.2d 79, 84 (Del. 1995) ("Our review of the formulation and application of legal principles, however, is plenary and requires no deference.").

Contrary to the undisputed evidence, the Trial Court erroneous found that Hbc booked a $2 million reserve against the Jane-Finch sublease in the FY2007 Financials and that there was no evidence HBCL would have paid less for Hbc had it known of the errors, or would have injected less cash but for the errors. The Supreme Court will overturn factual findings that are not "sufficiently supported by the record and are [not] the product of an orderly and logical reasoning process." *Gamles Corp. v. Gibson*, 939 A.2d 1269, 1274 (Del. 2007).

C. Merits of Argument

The Trial Court required proof that, but for the errors, HBCL would have paid less for Hbc or invested less cash after the transaction. (Op. 28-32) The holding clashes with the broad "Covered Loss" definition requiring indemnification for ***any*** harm regardless of whether that harm is within the scope of a common law damage remedy. *See Interim Healthcare, Inc. v. Cornerstone Equity Investors, IV, L.P.*, 884 A.2d 513, 549 (Del. Ch. 2005) (differentiating between indemnity and common law "expectancy damages").

The narrow damage definition also contravenes governing law. Damages for breaches of representations include the cost of replacing missing or defective assets, or of restoring them to warrantied condition. *See Harmony Mill Ltd. P'ship v. Magness,* 1990 WL 58149, *6 (Del. Super. May 1, 1990) (awarding repair costs for untrue warranty of condition); *Frunzi v. Paoli Servs., Inc.,* 2012 WL 2691164,

*8 (Del. Super. July 6, 2012) (awarding "amount required to remedy the defect"); *Frontier Oil v. Holly Corp.*, 2005 WL 1039027, at *39 (Del. Ch. May 4, 2004) (awarding damages sufficient to restore injured party "to the position [it] would have been in had the breach not occurred."); *Ivize of Milwaukee LLC v. Complex Litig.Support, LLC*, 2009 WL 1111179, at *10 (Del. Ch. Jan. 20, 2009) (same).

Requiring proof of the actual effect on post-closing cash flows contradicts the principle that damages are measured at the time of breach. *E.g. Pharmathene, Inc. v. SIGA Techs., Inc.,* 2010 WL 4813553, *13 (Del. Ch. Nov. 23, 2010); *WaveDivision Holdings, LLC v. Millennium Digital Media Sys., L.L.C.,* 2010 WL 3706624, *19 (Del. Ch. Sept. 17, 2010); *Comrie v. Enterasys Networks, Inc.,* 837 A.2d 1, 17 (Del. Ch. 2003) (damages "measured as of the time of the breach"). Such damages can only be calculated based on changed ***expectations***. Doubts "are generally resolved against the party in breach." *R. M. Williams Co., Inc. v. Frabizzio,* 1993 WL 54423, *12 (Del. Super. Feb. 8, 1993) (quoting *Restatement (Second) of Contracts* § 352).

Each error inflated cash flow expected Hbc by understating obligations to third parties (tax and loyalty claims), overstating assets available to sell profitably (inventory claim) or overstating cash to come from third parties (lease claim). Dollar-for-dollar compensation gives Hbc "the benefit of its bargain by putting [it] in the position it would have been but for the breach." *Genencor Int'l, Inc. v. Novo*

Nordisk A/S, 766 A.2d 8, 11 (Del. Super. 2000); *Tam v. Spitzer*, 1995 WL 510043, *12 (Aug. 17, 1995); *Interim*, 884 A.2d at 548. Damages are based "on an amount equal to what the promisor, ***and especially the promisee***, believed the promise to be worth." *WaveDivision,* 2010 WL 3706624 at *19 n.133 (quoting *West-Willow Bay Court, LLC v. Robino-Bay Court Plaza, LLC,* 2009 WL 458779, *4 (Del. Ch. Feb. 23, 2009) and 24 *Williston on Contracts* § 64.2) (emphasis in original).

It is undisputed that HBCL reduced the price it would pay for Hbc when it learned there were greater than expected cash needs. The testimony that HBCL injected more cash than expected into Hbc because of the errors was also undisputed. Those uncontroverted facts prove Covered Losses even under the Trial Court's incorrect standard. The Court also erred by finding Hbc took a $2 million reserve against the Jane-Finch sublease in FY2007, and excluding that amount from HBCL's Covered Loss.

Further, the Court erroneously failed to include attorneys' fees, which are expressly part of a "Covered Loss." *See Cobalt Operating v. James Crystal Enter., LLC,* 2007 WL 2142926, at *32 (Del. Ch. Jul. 20, 2007) (attorney's fees included in indemnity for breach of representation). Although the Pre-Trial Order specified that any fee claim would be reserved until after trial (A1278), the Court entered final judgment without considering the issue.

CONCLUSION

For the foregoing reasons, Appellant respectfully requests that this Court reverse the Superior Court's judgment and enter a judgment in favor of Appellant.

/s/ David J. Margules
David J. Margules (#2254)
Jeffrey M. Gorris (#5012)
Jaclyn Levy (#5631)
BOUCHARD MARGULES
& FRIEDLANDER, P.A.
222 Delaware Avenue, Suite 1400
Wilmington, Delaware 19801
(302) 573-3500
Attorneys for Appellant

Dated: May 29, 2013

CERTIFICATE OF SERVICE

I hereby certify that on May 29, 2013, I caused a copy of the foregoing **Corrected Appellant's Opening Brief** to be served upon the following counsel by LexisNexis File & Serve:

Robert J. Katzenstein, Esquire
Robert K. Beste, III, Esquire
Smith, Katzenstein & Jenkins LLP
800 Delaware Avenue, 10th Floor
P.O. Box 410
Wilmington, DE 19899

/s/ David J. Margules
David J. Margules (#2254)