Key Takeaways

Skadden

International M&A Disputes

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On June 27, 2018, Skadden hosted a webinar titled "International M&A Disputes." Topics included the ability of one party to an M&A agreement to force a closing by seeking specific performance of the agreement, the use of expert determination in post-closing disputes, issues that may arise in connection with post-closing claims for indemnification based on breaches of representations and warranties, and valuation and buyout issues that arise in certain types of cross-border M&A transactions. The Skadden speakers were Julie Bédard, Michael A. Civale, Gregory A. Litt and Timothy G. Nelson.

Ms. Bédard, head of Skadden's International Arbitration Group for the Americas, kicked off the webinar by discussing the ability of one party to a merger or acquisition agreement to force a closing of the transaction. She noted that parties often include specific performance clauses in their M&A contracts, in which the parties agree that irreparable harm will occur if there is a breach of the agreement and that monetary damages will not suffice to compensate for the breach. She explained, however, that under New York and Delaware law, such a clause is not sufficient by itself to guarantee an award of specific performance. Ms. Bédard explained that history matters in this regard — specifically, English legal history in which the remedies for breach of contract were split between damages and equitable remedies and a primacy was placed on damages as a remedy. In this light, a court will continue to have discretion as to whether damages are an adequate remedy and whether the party seeking to force a closing will suffer "irreparable harm" if the closing does not take place. Ms. Bédard further commented that there are cases involving enforcement of an arbitration award where one party argued that, under New York public policy, the arbitration tribunal was not permitted to award specific performance. The New York courts rejected this argument. She also noted that specific performance may not be available where the contract includes a termination fee clause if the court or arbitrator determines that the parties intended the termination fee to govern in case of a breach, rather than specific performance.

Mr. Civale, a partner in Skadden's M&A practice, commented that specific performance is likely the preferable remedy from the perspective of a buyer purchasing a unique asset. He explained that negotiations concerning specific performance clauses have become more involved, in particular as a result of the private equity and financing arrangements that buyers often have in place. For example, where the buyer is a private equity company, it will not want to proceed to buy the company if its financing arrangements fall through. Finally, Mr. Civale noted that the parties should negotiate which

party has the right to force closing and under what circumstances, and which party has the right to walk away and under what penalties (*e.g.*, subject to a termination fee).

Mr. Litt, a partner in Skadden's international litigation and arbitration practice, turned to a discussion of expert determination in the context of M&A transactions and post-closing disputes. He explained that while M&A agreements typically include a general submission to arbitration or litigation, they often also include an expert determination clause for resolving certain clearly defined disputes that can be anticipated prior to signing and would benefit from specific expertise. Expert determination provides for a technical expert, often an accountant, to decide an issue where a court or arbitrator may not have the same expertise, with a potentially speedier process because the issues are limited and experts are not required to apply the same level of due process. However, Mr. Litt also noted that in the international context, expert determinations are less likely to be immediately enforceable than arbitration awards, which usually are covered by a treaty on enforcement (*e.g.*, the New York Convention).

The most common kinds of disputes that are submitted to expert determination in the M&A context are purchase price adjustments and post-closing balance sheet adjustments. Other disputes that are frequently addressed by an expert include fair market valuations, earn-out disputes and allocation of tax benefits. Mr. Litt noted that the strength of an expert procedure arises from situations where there is a technical answer to a question that the expert can determine from the material submitted. Disputes that require the exercise of business judgment, such as disagreements over business plans in a joint venture, are less suited to expert determination.

Mr. Litt also explained the importance of clarifying what disputes go to arbitration or litigation, and what disputes go to expert determination. He highlighted two recent cases that addressed questions of whether a particular dispute should be submitted to an expert.

In *Chicago Bridge & Iron Co. v. Westinghouse Electric Co.*, 166 A.3d 912 (Del. Sup. Ct. 2017), Chicago Bridge sold a business to Westinghouse, and the parties agreed to a post-closing adjustment process to "true up" the working capital after closing. The working capital was to be determined in a manner consistent with generally accepted accounting principles (GAAP) consistently applied based on past accounting principles, with disputes submitted to an independent auditor. After closing, Westinghouse claimed that Chicago Bridge should pay $2 billion to shore up the working capital based on an assertion that the business' historical accounting practices had not been GAAP compliant. Chicago Bridge sued in Delaware, arguing that Westinghouse's claims were actually representation and warranty claims, which already had been extinguished per the parties' agreement. The Delaware Supreme Court agreed, holding that arguments that the historical financial statements did not comply with GAAP could not be heard by the independent auditor, and that only claims based on changes in circumstances between signing and closing could be submitted. In support of this finding, the court relied on the fact that the representations and warranties had been extinguished, but it also cited the limited role and truncated procedure of the auditor. The court viewed this as evidence that the auditor was not meant to have an expanded scope of jurisdiction.

Mr. Litt also discussed *Alstom v. General Electric Co.*, 228 F. Supp. 3d 244 (S.D.N.Y. 2017), in which the contract for sale of a subsidiary contained an International Chamber of Commerce (ICC) arbitration clause and an accounting expert clause. After closing, GE prepared a working capital statement as required by the contract and Alstom responded with extensive objections. GE commenced arbitration, and Alstom responded by seeking a determination in court that the issues should be decided by the expert accountant. Observing that the arbitration clause carved out matters submitted to the expert, the court relied on the general position under U.S. law that the scope of an arbitrator's jurisdiction is for the court to decide unless the parties delegate it to the arbitrators, and determined that it was appropriate for the court, not the arbitral tribunal, to decide whether the objections should be submitted to the expert.

The court then held that Alstom's objections, despite being quite extensive and including legal considerations, must be presented to the accounting expert in the first instance. The court noted that the fact that the disputes related to more than "bean counting" did not prevent the accountant from deciding them. The court also noted the agreement's clause providing that remedies are cumulative, so the fact that there might be overlap with representation and warranty claims was not an obstacle. The court left it to the accountant to decide whether any of these issues were not appropriate for expert determination and should be left for a later arbitration.

Mr. Civale noted that expert determination and dispute resolution are not boilerplate clauses in M&A agreements. He recommended discussing with clients during the drafting phase the timing and cost of dispute resolution options and the forum in which the issue will be best resolved for that particular client and situation. He cautioned that these clauses may unintentionally end up giving a strategic advantage to one side during a later dispute. Finally, he recommended consulting with dispute resolution colleagues in drafting those agreements.

Ms. Bédard picked up the discussion with issues that arise with some frequency in post-closing disputes involving breaches of representations and warranties. First, she addressed claims for "diminution in value." Depending on the language of the contract, the seller may dispute whether a claim based purely on the reduction in value on an asset on the books is indemnifiable as a "diminution in value," where there is no associated cash expense. Second, she pointed out several clauses that may affect the scope of claims that can be raised. The inclusion of de minimis claims, whether small claims can be aggregated and whether there is a requirement that materiality be demonstrated can have a significant impact on the claims a buyer may bring. For instance, de minimis claims may require substantial investigation to determine whether the buyer may bring a claim. Third, Ms. Bédard explained that clauses providing that indemnification claims may be brought only if designated seller representatives knew about the potential breach of the applicable representation may be outcome-determinative. As a practical matter, it may be difficult for the buyer to prove that the seller had knowledge. For example, the buyer may need internal emails obtained during discovery showing there was knowledge on the part of the seller. If the level of knowledge required under the contract is constructive knowledge (*i.e.*, "should have known") rather than actual knowledge, there may be a battle of the experts to demonstrate that knowledge. Lastly, she noted that a buyer's review of the books after closing may result in the identification of some assets that are overvalued and others that are undervalued. The question that arises is whether the claims for diminution in value of some assets may be offset by the increase in value of other assets.

Mr. Civale commented that the scope of the definition of damages should not be treated as standardized language during negotiations. The specific inclusion, exclusion or being silent on words like "diminution in value," consequential damages, multiple of earnings and others will greatly impact the scope of damages that can ultimately be recovered. In addition, he recommended that the cost of investigating a claim or defense should be specifically considered and negotiated so there are no surprises.

Mr. Nelson, a partner in Skadden's international litigation and arbitration practice, continued the program by addressing valuation and buyout issues, which often arise in connection with shareholder agreements.

On the topic of shareholder agreements, Mr. Nelson noted that disputes, including valuation issues, can arise where assets are located in "problem" jurisdictions where there are rule-of-law concerns and where a local shareholder has physical possession of key assets. Second, he noted that currency controls may create problematic issues, particularly in jurisdictions like India where there historically were currency restrictions that potentially impact the ability to negotiate "put" protection. A third example of a cross-border issue is where local laws (in the place of incorporation) impose mandatory tender offer requirements, *e.g.*, where one shareholder's stake increases above a certain level. Fourth, Mr. Nelson pointed out so-called "Russian roulette" clauses that exist in some private shareholder agreements by which, when there is a deadlock among shareholders, the recalcitrant party has a buyout right. Finally, contractual anti-dilution regimes are an area that may lead to shareholder disputes.

Mr. Nelson distinguished between cases where there is a dispute over whether the relevant event (*e.g.*, the legal right to a buyout) has arisen or been triggered, and cases in which only the number is in play, *i.e.*, it is agreed that a buyout right exists but there is disagreement on value. Where the actual value is contested, the first question will be to identify what is being valued (*i.e.*, only shares or asset value). Mr. Nelson highlighted some of the points on which valuators in a shareholder dispute can disagree, such as whether to apply a minority discount, control premium or adjustment for illiquidity of shares. Mr. Nelson addressed the importance of the method and forum for the valuation. For example, he described a "baseball" system where each side produces a valuation and a third party appointed (per the contract) produces its own valuation. The valuation closest to the third-party valuation is sometimes selected as the final number; alternatively, the valuation will be the midpoint of that "closest" valuation and the third-party valuation. This system is thought to provide an incentive to all parties to produce a reasonable valuation.

Mr. Nelson pointed out that often parties in a buyout agreement will specify the metrics to determine the value of the shares, *e.g.*, fair market value, EBITDA-driven (earnings before interest, taxes, depreciation and amortization), multiples or DCF-driven (discounted cash flow). Mr. Nelson recommended including a set valuation date in the clause to avoid an additional area of dispute later. He also noted the importance of identifying who does the valuation — a bank, an accounting firm, a valuation firm or an individual accountant — and identifying where the parties obtain the data in order to perform the valuation. He noted that if the data comes internally (*e.g.*, from the company or its chief financial officer) and one party does not have access to that data, it may have difficulty verifying the information it receives. Mr. Nelson closed by pointing out that once there is a valuation number, the practicalities of enforcing the valuation may lead to unintended consequences and delays.

Mr. Civale noted that negotiating clauses regarding valuation may turn out to be very material for the client. For example, metrics such as control premiums and illiquidity discounts are material to the ultimate valuation, and if the contract is silent on them, the valuation firm could end up having to set those parameters as part of its decision-making process.