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Practical remarks on some of the most common issues in M&A arbitration

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According to the Financial Times (April 6, 2016), the total value of abandoned deals this year reached its highest since the start of the financial crisis. Pursuant to this source, the most recent aborted mega-deal is the Pfizer and Allergan merger, which will cost Pfizer a *break-up fee* of $400m, plus other expenses of $150m.

The FT's article seems to imply that the termination of the Pfizer-Alergan deal has been amicable, but it is not unusual that M&A transactions (both aborted and completed ones) become contentious and, obviously, the more significant the transaction is, the more likely it is that the parties are prepared to fight.

Given the advantages of arbitration (neutrality and specialization of the arbitrators, finality, enforceability pursuant to the New York Convention, flexibility, less scope for procedural gamesmanship, etc.), it seems logical that parties to large international M&A transactions tend to refer their potential disputes to arbitration, rather than to state courts. It also seems that standard arbitration clauses are far more usual than *ad hoc* arbitration agreements. However, it is not obvious that in all cases standard clauses serve the interests of the parties better than bespoke arbitration agreements.

Below is a list of some of the main issues around which M&A arbitration usually takes place, excluding the early stages of a typical deal, in which an agreement to arbitrate is not so common.

This list may can be helpful to foresee the types of disputes that parties may come across and to decide in each particular case whether to go for an *ad hoc* or a standard arbitration agreement.

Signing

- *Interim period*

Once the *Sale and Purchase Agreement* (*SPA*) has been signed but before closing has taken place, the purchaser has not taken over target yet, and so the seller must conduct target *in the ordinary course of business*. This means that the seller (or target or both) undertake specific obligations, both *positive* and *negative* (*prohibited actions*). It is not unlikely that the parties have different views as to what *ordinary course* is and how to react to *extraordinary events*. Purchaser's consent may be required for certain decisions and, again, a dispute may arise as to whether the purchaser is *unreasonably* withholding its consent. *Emergency arbitration* or a *fast track arbitration* could be ideal solutions to overcome the impasse.

- *Material Adverse Change* or *Event (MAC* or *MAE)*

SPAs usually provide that *completion* is conditional on no *MAC* or *MAE* having occurred. *SPAs* and financing contracts related to the acquisition tend to define what a *MAC* or *MAE* is, but they do so in general terms. By definition, a *material adverse event* is an extremely rare event, and so it is difficult to find arbitral or judicial precedents on this matter. Therefore, if something really extraordinary happens, the parties will probably dispute about whether a *MAC* or *AME* has happened. If the purchaser wants to withdraw from the deal, can it do it without an arbitral or judicial declaration that a *MAC* has happened? Does the purchaser run the risk of having to compensate the seller if eventually the court finds that a *MAC* had not taken place?

What type of compensation would it have to pay (transaction costs, loss of profit, etc.)? Again, an *emergency arbitration* could be a suitable solution for these disputes.

- *Conditions precedent* (*CPs*)

The *SPA* may provide that closing is conditional on a number of *CP*s, and some of them may prove problematic. For instance, the waiver of a *change of control provision* by a party to one of target's key contracts may be given with conditions not contemplated in the SPA. Purchaser and seller may then argue about the fulfilment of the *CP* and in that case, it is essential for both parties to settle the dispute expeditiously.

- Competition clearance with conditions or commitments (structural and behavioral)

As with *CPs*, parties can disagree as to the acceptability of the conditions or commitments to be undertaken in order to obtain competition clearance. In that case, the parties may discuss different solutions, including an outright termination of the deal or ways to rebalance the transaction (e.g., an adjustment of the price). *Fast track arbitration* could be a useful tool to avoid a long period of uncertainty as to which party is finally going to own target. A situation like that can be seriously prejudicial to target because managers may see themselves as interim, while nobody feels responsible for taking decisions.

Another area in which arbitration can play an important role is disputes as to the subsequent fulfilment or breach by the purchaser (or by target) of the competition commitments. In this case, arbitration will take place between the purchaser or target and their customers or competitors.

It is also usual that the *SPAs* provide that the parties must carry out certain acts *immediately before or on completion* (e.g., POAs, shares certificates, letters of resignation, waivers of certain third party rights, termination of certain contracts, repayment of loans or debts, release of guarantees, etc.) and, as it happens with the *CPs* and the competition commitments, there is obvious room for discrepancies between the seller and the purchaser that need to be resolved quickly.

Completion

Once closing has taken place, the purchaser has taken over target and thus the uncertainty disappears. Therefore, when a dispute arises at this stage it is less critical to obtain a fast decision.

Price adjustment

SPAs can provide that the price is adjusted by reference to *net worth*, *capital expenditure*, *working capital* or *net debt* as of the date of completion, or to the performance of target post completion (*earn-out*). Alternatively, the price can be based on a *locked box mechanism* (see below). Controversies often arise in both cases.

Indeed, disputes about the correctness of *completion accounts* are typical (mainly, about the drawing up of the accounts and the calculation of the *net worth, working capital* or *net debt price adjustments*).

In the case of *earn-out clauses*, parties tend to dispute about the application of the *agreed accounting policies* or of the *GAAP*, the right calculation of the *EBITDA* or whether the seller (when it continues running the company) or the purchaser (when it has already taken over target) have *manipulated* or *distorted* the relevant metric (e.g., by granting unusual discounts or payment conditions to influence the turnover, by generating non-recurring income or expenses, by making incorrect valuations of

the inventory or the WIP, by applying inappropriate criteria for accruals or for revenue or expense allocations, etc.). The way in which the *contractual good faith principle* is treated by the law of the contract is fundamental in these disputes.

Another problem which sometimes arises in arbitration disputes is the lack of a proper *cost accounting* in target or the occurrence of a post completion merger of target and another company (and the subsequent intertwining of target's accounting with that of the other company). In both instances, arbitrators will have to deal with complicated accounting problems, related in particular to the *earn-out* and the *put* and the *call options* (see below).

Put and call options

Often times, the seller does not sell its whole stake in target, and the parties grant each other *put* and *call options* (or *tag* or *drag along rights*) over the shares that the seller has not sold. In those cases, the most likely disputes are about whether or not the *triggering event* of the options or of the *drag* or the *tag* have happened, or about the same issues as in the price adjustment and the *earn-out*. Sometimes the very right to exercise the options or their price depends on whether the seller (who is also a manager) is a *good or* a *bad leaver*, and then the dispute will relate to the *good* or *bad leaver* notions.

Representations and warranties (Reps). Indemnities

Once the purchaser has taken over target, it usually carries out a *post-completion due diligence,* which may result in a breach of the *Reps*, but the seller may claim that the *post-closing due diligence* has been done *abusively*, i.e. that its main or only purpose was to trigger a claim under the *Reps* (e.g., unearthing or prompting hidden liabilities which otherwise could have become time barred). The arbitrator will then find himself before a difficult decision.

Claims under the *Reps* may also relate to over-valued assets, insufficient provisions, facilities non-compliant with health and safety or environmental regulations, social security or tax liabilities, insufficient legal title to assets (e.g., IP rights), lack of compliance with laws and regulations in general, competition violations, etc.

Indemnities may lead to similar problems.

When confronted with a claim of this sort, the seller may argue that the matter is subject to *pre-judiciality*, that is to say that there needs to be a previous administrative or state court ruling declaring the existence in target of a tax or social security liability, an antitrust violation, an environmental or product liability, etc. Absent a specific regulation in the *SPA*, the arbitrator will therefore need to take a decision on the *pre-judiciality* issue.

The problem with *pre-judiciality* in general is when the law of the seat does not refer to it at all, because in that case the personal liability of the arbitrators can be at stake if they decide to suspend the arbitral proceedings until a ruling on the *pre-judicial* matter is rendered. But, at the same time, if they decide not stay the arbitration, but to render a decision, the subsequent state court ruling can be contradictory to the arbitral award, paving the way for a challenge of the award.

Other typical issues at this stage relate to the following matters, which are not always properly or fully regulated by the *SPA*:

- *Locked box clauses*: the arbitrator will have to decide whether the event at hand amounts to a *leakage* or is a *permitted leakage*.

- *Disclosure letters*: the discussion may relate to whether too broad or unspecific disclosures are acceptable as a valid defense for the seller, as opposed to *issues specifically* or *fairly disclosed*.

- Whether the *purchaser's actual knowledge* of the issue at hand can prevent a claim.

- Whether the *Reps'* claim actually overlaps with contractual price adjustment mechanisms. Under certain circumstances it may be difficult to determine whether a specific matter has to be referred to expert determination (see below) or to arbitration. In addition, the arbitrator should be wary of making the seller pay twice for the same issue.

- *Third party claims*: which party (the seller, the purchaser or target) should lead target's defense *vis-à-vis* the third party claim, and to what extent should the other party have an influence or a say in the defense?

- Time limits and contingencies that have detected but not crystalized yet: in which circumstances should they trigger the seller's liability? When the arbitrator decides that the seller must compensate the purchaser for them, should the arbitral decision anticipate the consequences if eventually it emerges that the contingency is never going to materialize?

- *Escrow*: the parties may agree that part of the price is held *in escrow*, as a guarantee for any amounts payable under the *Reps*. Disputes can arise as to the gradual release of the amounts *in escrow* or appropriation of the same by the purchaser. When the *escrow* is held by an *escrow agent*, attention should be paid to the interplay of the *escrow agreement* and the *SPA.*

- Consolidation of different claims of the same or different category.

- *Damages*: standard of proof and quantification.

- Whether damages should include not only the *actual loss* but also *consequential losses*, *loss of profit*, *loss of opportunities*, *loss of post-closing synergies*, *projections*, *multiples*, *reputational damage*, etc. Not all of these categories have the same meaning or even exist in the different legal systems.

- *Liquidated* and *punitive damages* and their interplay with the general damages notion.

- *Caps* and *baskets* relating to the seller's liability.

- *Management's Reps*: when the managers of target have also given *Reps* to the purchaser (usually in a separate document), the substantive and procedural interplay of both sets of *Reps* may pose difficult issues.

- *Reps' insurance*: when the seller or the purchaser has taken out a *Reps insurance*, as above, delicate substantive and procedural matters may arise, in particular when the insurer provides additional coverage, above the seller's liability cap.

- *Anti-reliance*, *entire agreement* and *sole remedy clauses*: the question here may be to what extent these clauses can really trump any possible claim, however serious the breach is, even including *tortious claims*. In certain jurisdictions this may pose problems of *public policy*.

- *Tortious claims*: usually it is not clear that they fall within the arbitration agreement (e.g., pre-contractual or extra-contractual *misrepresentations*), unless the arbitration agreement refers to disputes concerning extra-contractual claims. An analogy can be drawn from the ECJ judgement of 21 May, 2015 (Cartel Damage Claims Hydrogen Peroxide SA vs Akzo Nobel NV et al), where the European Court ruled that jurisdiction clauses contained in contracts may encompass non-contractual disputes "provided that those clauses refer [also] to disputes concerning liability incurred as a result of an infringement of competition law".

Post-completion covenants

Arbitration relating to *post-completion covenants* usually relate to the following matters:

- *Transition period* services to be rendered by target to the seller or by the seller to target or to the purchaser.

- Seller's services or labour contracts: when they are intimately linked to the *SPA*, would the disputes related to them be arbitrable, even in case the relationship between the seller (who is an individual) and target were governed by labour law? Could there be *pre-judiciality*?

- *Non-compete* and *non-solicitation* obligations: same issues as above can arise.

- Confidentiality obligations.

Expert determination

Expert determination (implicit or explicit) clauses are common in *SPAs* and pose a number of complex and long discussed issues, including:

- Is it advisable that the SPA provides for arbitration for general claims and for *expert determination* for specific issues (e.g., *price adjustment*, *earn-out*, price of *put* and *call options*)?

- How should both mechanisms interplay? What types of disputes fall within the *expert determination* clause in the first instance and which ones can be referred directly to arbitration?

- Who should appoint the expert: the parties, the arbitrator, the judicial court? How should conflicts be dealt with? Should the engagement letter be signed on or before *completion*? What happens when one party refers the matter to the expert and the other brings an arbitration claim?

- Expert's assignment usually relates to facts and calculations, but sometimes there are legal issues which the expert must face to render his determination: should they be carved out from the expert's assignment and deferred to the arbitrator? In that case, should *interim measures* be adopted?

- How should the expert conduct the determination process? Should the expert be bound by the *due process principles*? Legal nature and effects of the expert determination: when the parties have agreed that the determination will be final and binding, does that mean that the expert determination amounts to and has the effects of an arbitral award? Can a legal entity (e.g. an accounting firm) be an arbitrator? In what circumstances can the determination be challenged?

Should the challenge be brought before the arbitrator or a state court? According to conventional wisdom, the determination can be challenged when is manifestly unjust or arbitrary, when it contains serious material errors or when the expert has grossly departed the *lex artis* or from the instructions given by the parties. What is to be considered a serious material error or a gross departure from the *lex artis* or the parties' instruction?