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Dispute Resolution as a Part of Your Merger or Your Acquisition Agreement

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DISPUTE RESOLUTION AS A PART OF YOUR MERGER OR YOUR ACQUISITION AGREEMENT

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I. INTRODUCTION

Often overlooked until invoked, the dispute resolution provisions of an acquisition agreement frequently mirror the terms of a lawyer’s last deal. Yet such provisions—including purchase price adjustment clauses, the terms of governing earn-out disputes, and the contract sections outlining the indemnification claims process—often have long-term economic ramifications on the buyers and sellers. In working with corporate lawyers over the years, we have noted that corporate lawyers understand (and give intense thought to) the leverage their clients have, what their clients hope to accomplish in a transaction, and what makes long-term economic sense in drafting an agreement and negotiating more advantageous deal terms. In this article, we hope to bring the same analytical intensity to dispute resolution provisions.

While every deal is different and perspectives will vary between buyers’ and sellers’ counsel, we have attempted to inform practitioners of the issues that can arise depending on how the parties design their dispute resolution provisions. Accordingly, we have first set out our views on the current transactional environment and its implications on deal leverage and terms. Then, we have described each of the key deal provisions that we believe fall under the broad rubric of “dispute resolution” provisions. In particular, we have analyzed: (i) Purchase Price Adjustments; (ii) Earn-outs; and (iii) Indemnity for Breach of Representations and Warranties.

Next, using examples from our own matters and published cases, we have set out many of the potential disputes that arise under each provision. Some of these issues are negotiated thoroughly in the first instance. For example, should a purchase price adjustment provision call for the consistent application of generally accepted accounting principles or simply the consistent application of the accounting principles typically em-

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ployed by the target? Should an earn-out provision based on future earnings make special arrangements for sellers who are no longer in control of the business? We attempt to provide sound advice regarding best practices in acquisition agreements, however, the fact still remains: disputes over purchase price adjustments, earn-outs, and representations and warranties remain commonplace.

In an effort to help professionals craft provisions that streamline the resolution of these potential disputes, we have analyzed the extent to which such provisions are misunderstood or misapplied. For example, standard provisions in acquisition agreements often call for the arbitration of indemnification claims based on breaches of representations and warranties. But, when such provisions call for both the expedited provisions of the American Arbitration Association Commercial Arbitration Rules and the application of the Federal Rules of Civil Procedure, it can lead to inconsistent results. In other instances, parties choose the savings that result from a single arbitrator without considering whether it would be helpful to provide the arbitrator with a neutral expert or the perspective of two other panelists, given that such proceedings are typically not appealable. Indeed, lawyers often reflexively choose arbitration without considering how litigation in court can be streamlined—whether through a trial by magistrate, consent to limited discovery, or even application to a pre-trial court mediation program, like that offered by the Delaware Court of Chancery. Throughout this section, we have attempted to provide our own thoughts and insight on how to bolster the standard dispute resolution clauses that are prevalent in acquisition agreements.

Finally, we have included a case study that demonstrates, with hypothetical facts, the perils of multiple dispute resolution provisions in an acquisition agreement. As we conclude in our case study, separate provisions can result in the same or similar issues being litigated at the same time, in multiple forums, and may result in inequitable recoveries by one party over the other. Accordingly, we recommend that parties consider a unified dispute resolution procedure under which multiple disputes can be consolidated and single disputes handled efficiently.

II. CURRENT DEAL ENVIRONMENT

The last several years have seen the acquisition market spurt to life, sputter, lose steam, and then slowly recover again. In 2011, private equity deals were large and frequent in the first half of the year, but slowed down considerably in the second half, purportedly due to “the sovereign debt crisis, deficit reduction impasse and a growing concern about a slowing

economy.”¹ Ultimately, for the entire year, deal activity was basically flat, although the total dollar-value of the transactions increased by 18%.²

In 2012, on the other hand, although experts were predicting more robust deal activity, actual results have not met expectations.³ Indeed, the United States economy itself appears to be re-gaining steam, which ought to bode well for the deal market in 2012. According to the Wall Street Journal, the United States “economy grew at its fastest pace since the first-half of 2010 during [the] final three months of last year,” although consumer spending outpaced corporate spending.⁴ Public companies report sitting on over \$2 trillion in cash and the credit markets appear to be easing.⁵ Accordingly, Ernst & Young has concluded that “we expect to see dealmaking pick-up in the first quarter of 2012.”⁶ Yet, by mid-year, lawyers were reporting that deal value in 2012 is down forty percent over 2011.⁷

The deal environment will have an impact on the relative leverage parties will have in negotiating transactional components. For instance, with financing difficult to come by and buyers looking for bargains in tight economic times, more buyers have insisted on so-called “earn-out” provisions (described more fully below) in which a portion of the purchase price is contingent upon future earnings. Sellers eager for a liquidity event in a tough market have been forced to either accept such provisions or hold on to their companies. Sellers with more options in the market will have more leverage to avoid such provisions altogether. And, if financing becomes less difficult to obtain, buyers may also be eager to avoid earn-outs, as

1. See, e.g., *Ernst & Young Says Fundamentals Will Finally Prevail Over Uncertainty to Get Deals Rolling in 2012* (Dec. 7, 2011), <http://www.ey.com/US/en/Newsroom/News-releases/Ernst-and-Young-says-fundamentals-will-finally-prevail-over-uncertainty-to-get-deals-rolling-in-2012> (hereinafter “Deals Rolling”).

2. *Id.*; see also Shira Ovide, *M&A Market Barely Above Water for 2011*, WSJ BLOGS (Dec. 6, 2011), <http://blogs.wsj.com/deals/2011/12/06/ma-market-barely-above-water-for-2011/> (“The M&A market was on a tear in the first half of [2011], with heaps of deals large and small. Through July, the dollar value of M&A activity worldwide was 16.9% higher than in the year-earlier period, according to Dealogic. . . . Since then, corporate deal making has hit turbulence, particularly for big-ticket deals that require large doses of debt financing. From August through November, the value of deals announced worldwide has slipped nearly 22% from the same stretch of 2010, including a 14.3% decline in November, according to Dealogic.”) (alteration in original).

3. See *supra* note 1; see also Stephen F. Arcano et al., *Midyear Outlook: Uncertainties Dampen Deal Activity but Underlying Indicators Provide Bases for Optimism*, SKADDEN, ARPS, SLATE, MEAGHER & FROM LLP, (June 19, 2012), available at www.skadden.com/index.cfm/contentID=siteitemID2792.

4. Ben Casselman & Josh Mitchell, *Recovery Doesn't Feature Typical Snapback in Growth*, WALL ST. J., (Jan. 27, 2012), available at <http://online.wsj.com/article/SB10001424052970203363504577185313667095068.html>.

5. See *Deals Rolling*, *supra* note 1.

6. *Id.*

7. VIPAL MONGA, *M&A OUTLOOK FOR 2012 IMPROVES*, Jan. 9, 2012, available at <http://blogs.wsj.com/cfo/2012/01/ma-outlook-for-2012-improves/>, See *supra* note 3.

they are often the source of post-closing disputes. Similarly, buyers have more leverage to structure buyer-friendly dispute resolution clauses when deal activity is slow than in more robust times in which sellers have more options. The deal climate will, accordingly, impact buyers' and sellers' ability to structure any of these provisions in the most advantageous manner.

III. DRAFTING AROUND POST-CLOSING DISPUTES

In the acquisition context, post-closing disputes revolve around three primary issues: (i) adjustments to the purchase price due to variances in certain financial metrics; (ii) the amount or availability of an "earn-out" based on meeting certain financial goals; and (iii) the breach of a representation or warranty.⁸ These disputes can include accounting, valuation, and indemnification claims and can result in damages or adjustments that constitute a material and a significant percentage of the purchase price. Accounting disputes typically relate to the calculation of working capital or net assets at the closing date, while valuation disputes typically relate to alleged misrepresentations in the due diligence process that impact the value of the subject company.⁹ Indemnification claims vary significantly depending upon the nature of the transactions.

Parties frequently litigate over the proper forum in which to resolve such issues, whether one or more of these issues can be consolidated, whether disputes have been raised in a timely fashion, and whether funds set aside to deal with a specific type of post-closing dispute can be applied to another dispute. We have provided an overview of each issue, and the applicable dispute resolution provision, below.

A. Purchase Price Adjustments

Parties employ a "purchase price adjustment" mechanism in order to address the possibility that the target company's performance may differ from the parties' expectations between the date of signing and the closing date.¹⁰ Such adjustments typically relate to the difference between a target company's "working capital, net assets or net worth" as estimated on a certain date prior to or as of closing (either the most recent financial statements or "estimated" or "preliminary" financial statements) and as calculated after closing ("final" financial statements are sometimes audited).¹¹

8. ROMAN L. WEIL, MICHAEL J. WAGNER, & PETER B. FRANK, 25 LITIGATION SERVICES HANDBOOK: THE ROLE OF THE FINANCIAL EXPERT, at 6-13 (4th ed. 2007).

9. *Id.* at 7.

10. See, e.g., Alyssa A. Grikscheit & Gavin D. Solotar, *Key Issues in Drafting and Negotiating Acquisition Agreements*, in DRAFTING AND NEGOTIATING CORPORATE AGREEMENTS 2012, at 183 (PLI, Course Handbook 2012); see also Roman L. Weil et al *supra* note 8, at 3 (discussing postclosing adjustments).

11. See Alyssa A. Grikscheit & Gavin D. Solotar, *supra* note 10; see also Roman L. Weil et al., *supra* note 8, at 3-4.

1. Identify Financial Metrics

The target amount in a deal involves a negotiation between the parties and can be a defined amount, a calculation, or the target company's balance sheet at a date prior to closing.¹² It goes without saying that the parties must be clear as to which financial metrics they intend to include in any subsequent adjustment, and the basis on which those metrics are to be measured. The most common purchase price adjustment is based on the level of working capital (the change in current assets minus current liabilities from those in the preliminary financial statements), but other adjustment mechanisms may involve measuring tax liabilities, shareholders' equity and net book value.¹³

2. Identify Accounting Principles

A purchase price adjustment provision must also clearly identify the accounting principles that are to govern. In a privately-held company, it may be that the sellers did not keep all accounts according to generally accepted accounting principles ("GAAP").¹⁴ Accordingly, the parties will want to be clear about the manner in which the accounting has been handled. One method of addressing this is simply to require that both the preliminary and final financial statements be prepared according to the accounting principles *consistently applied* by the company over a period of years.¹⁵ Of course, this is a recommended qualifier regardless of whether the accounting is prepared according to GAAP, as GAAP is subject to interpretation and it is possible for the same account to be recorded differently and yet still be GAAP-compliant.¹⁶

Another method of addressing potential accounting differences is to include a schedule as an exhibit to the acquisition agreement that describes the accounting principles applied to the accounts at issue. Such a schedule can avoid later misunderstandings and may be necessary in order to ensure that the opening balance sheet is prepared in a manner that is consistent with the target company's historical practices.¹⁷ If there is a particular area of the target company's financial statements that do not meet

12. Roman L. Weil et al., *supra* note 8, at 3-4.

13. See, e.g., Leigh Walton & Kevin D. Krebs, *Purchase Price Adjustments, Earnouts and Other Purchase Price Provisions*, 2005 A.B.A. Sec. Bus. L. 979, *6.

14. See Roman L. Weil et al., *supra* note 8, at 3.

15. See *id.* at 7-9.

16. See Leigh Walton & Kevin D. Krebs, *supra* note 13, at 9-10; see also Roman L. Weil et al., *supra* note 8, at 9-10 (explaining GAAP may recognize more than one method as appropriate).

17. Even the best of intentions can sometimes result in a dispute. We are aware of one dispute, involving millions of dollars, revolving around whether excess inventory is the same as obsolete and slow moving inventory. The dispute arose because the addendum to the SPA fixed the amount of reserves for the OBSOLETE and SLOW MOVING inventory, but did not mention EXCESS inventory. That agreement was negotiated by the CFO of the seller, a former audit partner at a Big Four audit firm.

this standard, it is wise to carve out any specific accounts and discuss the ramifications with the buyer. For example, if the reserves on inventory and the related value of the inventory are of concern, the buyer and seller may agree on the dollar value of inventory to be included in the financial statements prior to closing. The buyer will likely thoroughly inspect the inventory before agreeing to any amount.

Disputes related to the target company's financial statements may arise for a number of reasons, with the most common reason being that the closing financial statements do not comply with the manner in which the target company consistently has applied GAAP in the past.¹⁸ A common basis for this claim is the use of events that occurred subsequent to the balance sheet date or closing to refute amounts reflected on the closing balance sheet. This type of claim frequently involves target management's judgment, such as in setting bad debt reserves for accounts receivable and valuation-related reserves for inventory.¹⁹ For example, if the buyer sells the target's inventory significantly below the amount reflected on the balance sheet, the buyer may claim that the inventory reserves were insufficient and should be increased to an amount that would result in the inventory balance being consistent with the selling price. The seller may take the position that the estimate was reasonable and it should not have to pay for the buyer's pricing decisions after the close. The buyer may argue that the seller was motivated to include a lower inventory reserve than reasonable simply to increase the purchase price.

The application of period-end closing procedures can also give rise to material difference in account balances. The contractual representation that the financial statements be prepared consistent with past practice typically is interpreted to mean the most recent (preferably audited) financials, such that the normal period-end close procedures are reflected in the balances. For example, if a target company accrues employee bonuses throughout the year based on expected results and amounts already earned, the target's management may not have updated these bonuses to reflect the most recent company performance and expectations, perhaps because of a singular focus on the transaction or, perhaps, to show fewer liabilities. If this accrual is not calculated and updated as of the closing date, the financial statements could be materially misstated.

3. Identify Who Does What

As a point of negotiation, buyers often want to prepare the preliminary financial statements as part of their efforts to understand the target's business.²⁰ On the other hand, sellers are wise not to cede control over preparation of the preliminary financial statements if they want to ensure that the target company's accounting principles are consistently applied in the

18. See Roman L. Weil et al., *supra* note 8, at 8-9.

19. See *id.* at 10-11.

20. See *id.* at 13-14.

preliminary financial statements.²¹ In order to avoid manipulation by either side—either in the process or preparing the preliminary or final financial statements—the parties may wish to retain an independent accounting firm to assist in the process of preparation. At the very least, in order to avoid disputes—particularly in privately held companies in which interim financial statements may be prepared with less care than final financial statements—buyers should get comfort that they understand the accounting principles that will be implicated in any purchase price adjustment.

4. Identify Valuation Metrics

The failure to properly identify valuation metrics in purchase price adjustment provisions also can give rise to disputes. For instance, in *Continental Tire N.A. v. Titan Tire*, the parties used a purchase price adjustment mechanism to cover adjustments in “the market value of the assets transferred” to the buyer’s pension plan from the seller’s pension plan.²² Despite the fact that a purchase price adjustment mechanism was provided for, a dispute arose over the definition of “market value,” necessitating litigation.²³ Although the court held that the appellant’s arguments over the market value definition were without merit, it required lengthy litigation to resolve the dispute because of the lack of good definitions and a meaningful dispute resolution provision.²⁴

5. Identify Whether the Purchase Price Adjustment Is Subject to Setoff

In *Westinghouse Credit Corp. v. D’Urso Westinghouse*, a group of supermarkets were sold to a buyer for a purchase price of approximately \$44,000,000.²⁵ The purchase price was paid for in part by an \$8,200,000 note and a cash payment of \$35,000,000, of which \$4,250,000 was set aside in an escrow to protect the buyer in case it was entitled to a purchase price adjustment in its favor.²⁶ Over the next several years after closing, the buyer defaulted on the note, entered bankruptcy, and received an arbitral award for a purchase price adjustment of approximately \$2,300,000.²⁷ During this time, the seller received a judgment of approximately \$720,000 against the buyer on a lease issue related to the transaction.²⁸ Westinghouse, a successor-in-interest to the buyer, petitioned the court to compel the seller to order the escrow agents to release the \$2.3 million purchase

21. *See id.*

22. *Continental Tire North America v. Titan Tire Corp.*, No. WM-09-010, 2010 WL 1223981, at *3-6 (Ohio Ct. App. March 31, 2010).

23. *Id.* at *2-3

24. *Id.* at *2-3, 5-6.

25. *Westinghouse Credit Corp. v. D’Urso*, 278 F.3d 138, 141-42 (2d Cir. 2002).

26. *Id.* at 142.

27. *Id.* at 142-143.

28. *Id.* at 143.

price adjustment award due to Westinghouse.²⁹ In response, the seller sought to satisfy and extinguish the purchase price adjustment award by recoupment of, or setoff against, its judgment on the note and the lease.³⁰

The court found that the escrow provision, as written, only protected the buyer and held that neither recoupment nor setoff permitted the seller to satisfy and extinguish the purchase price adjustment award.³¹ Recoupment was inapplicable because, although the parties' claims arose from a single contract, the business was transacted in discrete and independent units as evidenced by the different forms of security assigned to discrete parts of the transaction.³² Further, the seller could not set off against the amount it was due because the right of set off requires mutual debts, "due to and from the same persons in the same capacity."³³ There was a lack of mutuality here because Westinghouse asserted its claim in the capacity of a trust beneficiary while, in contrast, the seller's claim, which was based on the remaining balances on the note and the lease judgment, was in the capacity of an unsecured creditor.³⁴ Perhaps all of this could have been avoided had the purchase price adjustment provision been clear as to whether any adjustment was subject to setoff or recoupment.

Each issue will of course be hotly negotiated. Irrespective of diligence in the drafting and negotiation process, disputes are inevitable due to the uncertainties and number of variables. Accordingly, the dispute resolution provision is of critical importance, as will be discussed in further detail below.

a. *Earn-outs*

As the credit markets have tightened and the economic climate has become more uncertain, buyers and sellers have turned to using earn-outs in an attempt to bridge the gap between the parties' perception of value, financing constraints, and risk sharing.³⁵ Earn-outs provide a method of payment based on the subsequent performance of the business and are commonly based on a financial metric involving some level of revenue or

29. *Id.* at 144.

30. *Id.*

31. *Id.* at 144, 146-50.

32. *Id.* at 146-49

33. *Id.* at 149-50.

34. *Id.*

35. Maryann A. Waryjas, *Negotiating the Acquisition Agreement*, in DRAFTING CORPORATE AGREEMENTS 2004, at 509 (PLI, Course Handbook 2004); see also ORION CAPITAL GROUP, *Using Earn-Outs to Bridge the Price Gap Even in Poor Economic Times*, http://www.orioncg.com/newsletters/earnouts_1.php (last visited March 18, 2012) ("Earn-outs tend to increase in popularity when interest rates increase because buyers can spread payments over several years."); C. Dahl & S. Richmond, *Earn-Outs: A Worthwhile Tool for Dealmakers?*, MIRIUS' E-NEWSLETTER, http://www.imakenews.com/rcwmirus/e_article000148659.cfm (last visited March 18, 2012) ("This is a challenging time for parties working on M&A transactions, requiring more innovative deal making.").

profit, calculated by the buyer and subject to an audit by the seller.³⁶ For instance, parties may decide that the seller will receive an earn-out when revenues exceed expenses by a certain amount, or when net revenue (revenue minus expenses) reaches a certain target.

The determination of items to include when calculating revenue and expenses for purposes of the earn-out, however, can be the source of disagreement amongst the parties, particularly when the contract does not clearly define the accounts that the parties intend to include in calculating revenue and expenses. In addition, because GAAP is subject to interpretation, the parties should identify specific areas that may be subject to a wider interpretation and clearly define the manner in which such issues must be accounted for in a schedule to the contract.³⁷ For example, construction-related revenue and earnings recognition or estimation of warranty expenses each are complex areas of accounting that may be subject to many interpretations for the same situation.

Earn-outs are tricky. To begin with, buyers and sellers likely will be at odds over how to ensure that the earn-out milestones are, or can be, met.³⁸ For instance, if the buyer takes control over the target, the buyer may be incentivized to make investments immediately after the close, reducing the earn-out, only to reap the rewards of the investment after the earn-out period expires.³⁹ Another issue for the seller is the buyer's ability to maintain the separate books and records of the acquired business. Consolidation of accounting departments and operational activities may leave the parties unable to obtain accurate information upon which to calculate the earn-out and may make it difficult or impossible for the buyer to maintain the target separate from its existing operations so that the parties can accurately measure the target's financial performance.⁴⁰ On the other hand, if the seller remains in control after the acquisition (in a situation in which the seller stays on as an officer, for instance) the seller may limit expenditures to the point of jeopardizing the long-term prospects of the business in order to maximize the earn-out.⁴¹

A buyer may even determine—after making an acquisition—that the target does not fit the buyer's long-term strategic plans. However, an earn-out provision can prevent or inhibit the buyer from divesting the acquired business. One way to address this issue would be for the seller to require “an acceleration or modification of the earn-out upon the sale of the buyer's business or the disposition of assets or change in the buyer's business that would adversely affect the seller's chances for obtaining the earn-out.”⁴² If the parties could pre-negotiate an agreeable liquidated damages

36. See Roman L. Weil et al., *supra* note 8, at 11.

37. See *id.* at 12.

38. See *id.* at 11-13.

39. See *id.* at 12-13.

40. See *id.* at 12.

41. See C. Dahl & S. Richmond, *supra* note 35.

42. *Id.*

sum for an early sale, perhaps the buyer could maintain sufficient flexibility to sell—providing the economics made sense. Otherwise, buyers must be vigilant that their post-closing actions not run afoul of implied obligations of good-faith and fair dealing.⁴³

Further, the parties may even disagree over the determination of whether the earn-out metrics have been achieved.⁴⁴ As with a purchase price adjustment provision, the accounting principles used for measuring the earn-out milestones will be of critical importance.⁴⁵ It also is important for the parties to specify whether the earn-out calculation will take into account certain elements of revenue or capital expenditures, as the sellers probably should neither get credit for, nor bear the expense of, the buyer's new initiatives.⁴⁶ Finally, the parties will have different views about how to calculate the payment amount—whether with a flat amount or a sliding scale over a certain threshold.⁴⁷ Once this last issue is negotiated, however, disputes usually arise over whether the threshold has been met.⁴⁸

Such issues will have to be negotiated specifically—and parties may even wish to include a stipulated rider of accounting principles—but experience suggests that even the most well-negotiated earn-out provision will give rise to a dispute. As Delaware Vice Chancellor Laster stated in his decision in *Airborne Health, Inc. v. Squid Soap*: “an earn-out often converts today’s disagreement over price into tomorrow’s litigation over outcome.”⁴⁹

b. *Representations and Warranties*

In an acquisition, parties will make a variety of representations and warranties.⁵⁰ Representations and warranties are intended to be confirmatory and to allocate risk between the parties.⁵¹ They are confirmatory to the extent they verify the buyer’s understanding of the target company’s business. They allocate risk to the extent that the seller must indemnify a buyer—a so-called indemnification agreement—if it turns out, after clos-

43. *Sonoran Scanners, Inc. v. Perkinelmer, Inc.*, 585 F.3d 535, 541 (1st Cir. 2009).

44. *See* Roman L. Weil et al., *supra* note 8, at 12-13.

45. *See id.*

46. *See id.* at 13.

47. Leigh Walton & Kevin D. Krebs, *supra* note 13, at 17.

48. Parties will also want to negotiate the length of the earnout period, but this issue is rarely in dispute post-closing. For a more extensive discussion of the problems that can arise with an earnout, see Leigh Walton & Kevin D. Krebs, *supra* note 13, at 16-17, Maryann A. Waryjas, *supra* note 35, at 509-512.

49. 984 A.2d 126, 132 (Del. Ch. 2009).

50. Roman L. Weil et al., *supra* note 8, at 3, 6.

51. Stuart M. Litwin, *Drafting Acquisition Agreements*, in 913 DRAFTING CORP. AGREEMENTS 7, 9 (PLI 1996).

ing, that any of the buyer's representations or warranties have been breached.⁵²

A seller can be asked to make a representation and warranty about the nature and quality of financial statements, the lack of undisclosed liabilities, and about any number of issues about the target's business.⁵³ There are two key questions about representations and warranties. The first is whether the seller has to make absolute warranties about the truthfulness of its representations or whether the seller can qualify its warranties based on its actual knowledge.⁵⁴ A buyer should avoid any such qualification, as it allows the seller to avoid its indemnification obligation by arguing that the seller simply was not aware of the issue that falsifies its warranty.

The second key question is whether any breach of warranty allows the buyer to obtain indemnification or, prior to closing, to walk away from the transaction.⁵⁵ In many transactions, parties agree to a "basket" or "deductible" that serves as a threshold for when the buyer can seek indemnification or walk away.⁵⁶ A potential litigation issue can arise if the representations and warranties are qualified by "materiality" and there is a deductible. If the acquisition agreement is not precise, a buyer that discovers one or more breached warranties after closing can be faced with both: (i) a deductible that it must reach before recovering, and (ii) arguments by the seller that no warranty can be the subject of an indemnification claim unless it has been independently materially breached. These issues can be addressed by skilled litigation counsel—but may be better addressed beforehand in the parties' acquisition agreement.

When an acquisition agreement includes both a deductible and a materiality provision, litigation counsel for a buyer will have to argue that "materiality" is somehow qualified. For example, counsel may argue, in the context of a transaction in which the purchase price is based on the net worth of the target company, that every dollar adjustment that would have altered the purchase price would have been "material." Or, counsel may argue that every warranty-related misstatement is *per se* material after the deductible is met. However, the better course likely would have been to simply leave the materiality qualifier out of an indemnification provision when there is a deductible. In other words, buyer's counsel should argue that because of reliance on the warranties in setting a purchase price any post-closing breach of a warranty would result in a dollar-for-dollar recovery to the buyer once the deductible is met, even if any single breach of

52. *Id.* Of course, the representations and warranties also give the buyer the right to walk away. See Maryann A. Waryjas, *supra* note 35, at 518-19, Roman L. Weil et al., *supra* note 8, at 3.

53. See Roman L. Weil et al., *supra* note 8, at 3 (discussing examples of representations and warranties).

54. Maryann A. Waryjas, *supra* note 35, at 519, Roman L. Weil et al., *supra* note 8, at 5.

55. Maryann A. Waryjas, *supra* note 35, at 519.

56. *Id.*

warranty would have an otherwise immaterial impact on the target company's overall financial condition.

An additional issue that must be negotiated in indemnification agreements is whether there should be a limitation on liability.⁵⁷ Seller's counsel will seek the lowest possible limitation, while buyer's counsel will want to keep as much risk with the seller.⁵⁸ Parties often limit liability both in terms of the number of years after the transaction closes in which the seller can be held responsible and the maximum dollar amount of such potential liability. Parties also frequently seek to ensure that certain issues, such as liability for unpaid taxes or hazardous environmental conditions, remain with the seller no matter how high the dollar amount or how long it takes for them to arise.

Damage claims that arise from breaches of representations and warranties can involve the historical financial statements the buyer relied upon to determine the purchase price. As a result, the buyer may make a "benefit-of-the-bargain" claim and allege damages based on the valuation methodology employed and demand a downward adjustment of the purchase price. Determining the appropriate purchase price in a transaction is a complex process and typically results in a range of amounts depending upon the valuation approaches and the buyer's assumptions regarding future use of the assets. Typically, the buyer builds a valuation model based on information from the seller, including the seller's own projections of the company's future performance. The buyer uses the valuation from its model to determine a price, or range of prices, it is willing to pay for the target company.

Market and income approaches to valuation are commonly used to value the subject company and rely heavily upon the financial statements provided by the seller. The market approach to valuation is defined in the *International Glossary of Business Valuation Terms* as

A general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.⁵⁹

The market approach generally uses a form of a multiple of the purchase price divided by a financial metric, such as EBITDA or Revenue. The resulting multiple is compared to publicly-traded company multiples that are deemed similar to the subject company and multiples of competed transactions in the same or similar industry.

The income approach to valuation is defined in the *International Glossary of Business Valuation Terms* as

57. See Roman L. Weil et al., *supra* note 8, at 3, 5.

58. *Id.*

59. *International Glossary of Business Valuation Terms, Appendix B*, AMERICAN INST. CPAs (Apr. 23, 2010), available at http://www.aicpa.org/interestareas/forensicandvaluation/resources/standards/downloadabledocuments/international_glossary_of_bv_terms.pdf.

A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.⁶⁰

The income approach generally involves forecasting future cash flows and discounting them back to the valuation date in order to determine a purchase price. A typical method of forecasting is to start with the historical financial results and prepare a cash flow projection for the target business as a standalone entity. In addition to the stand-alone forecast, the buyer adjusts the forecast for anticipated changes as a result of control of the business as well as anticipated synergies and often prepares multiple forecasts assuming worst, base, and best cases to develop a range of potential purchase prices.

When using the market and income approaches discussed, the buyer relies upon the historical financial results provided by the seller to determine the purchase price. If these financial statements do not comport with the representations of the seller it could have a material impact on the buyer's purchase price and, accordingly, could give rise to indemnification claims. Because small financial statement changes can have significant valuation impacts (imagine an 8-times multiple being applied to a \$100,000 accounting adjustment), parties should also consider clarifying whether they intend for the seller's liability for a breach of an accounting warranty to include the full impact of that breach on the purchase price.

IV. RESOLVING POST-CLOSING DISPUTES

A. *General Considerations*

Acquisition agreements typically have different dispute resolution processes for different types of disputes. In fact, some practitioners use a separate process for purchase price adjustments, earn-outs, and indemnification claims. Below, we have set out the typical processes for resolving such claims, identified many of the issues that arise with such claims, and have made several suggestions for unifying or otherwise strengthening the typical boilerplate dispute resolution process.

B. *Typical Dispute Resolution Provisions*

It is common for an acquisition agreement to specify separate dispute resolution provisions for the purchase price adjustment process, on the one hand, and indemnification and earn-out claims, on the other hand.⁶¹ Purchase price adjustments are perceived to be narrow disputes that can be resolved by an "independent accountant," whereas disputes over earn-outs and indemnification are perceived to involve a broader range of issues and matters of law that require resolution of disputed facts, application of the law, and more. Yet, in litigation, one thing is clear: there is no such thing as a simple dispute. Clauses that are too narrow or too broad

60. *Id.*

61. Roman L. Weil et al., *supra* note 8, at 6.

lead to unnecessary and collateral disputes that are anything but streamlined. Efficient dispute resolution requires prior planning. Accordingly, below, we have analyzed: (i) the perils of an overly narrow dispute resolution clause, and (ii) how to streamline a dispute resolution clause in arbitration or litigation.

C. Narrow Dispute Resolution Provisions Lead to Ancillary Litigation

A “typical” provision for resolving purchase price adjustment disputes “is to designate a firm of independent accountants to review the closing date financial statements.”⁶² After designation, the parties must then consider and address a number of issues. For example, the parties must consider whether they want the independent accountants to review only disputed provisions, or the entire set of financial statements. In addition, the parties must specify whether the accountant should resolve disputes over whether the preliminary, or target, financial statements were prepared in a manner consistent with historical accounting practices. Sellers, in particular, may want such a provision in order to address errors in the closing financial statements that are carried over from the opening financial statements. Without a specific provision to the contrary, such errors are typically treated as the “consistent application” of earlier period accounting principles and, as a result, outside of the independent accountant’s authority to address.

The parties also need to consider whether the accountants will actually arbitrate disputes—including considering testimony—under a particular set of rules, or if they simply will apply their expertise to come up with an appropriate set of financial statements. In many instances, parties use a standard, narrow purchase price adjustment dispute resolution clause—leaving many, if not all, of the details to be fleshed out in a subsequent dispute. A narrow arbitration clause, however, can lead to expensive collateral litigation over a number of issues, as the following cases demonstrate.

1. Substantive Arbitrability

One of the most noteworthy issues that leads to collateral litigation is the question of whether the parties have or have not delegated an issue to the arbitrator. This issue, known as “substantive arbitrability,” is decided by a court unless the parties have “clearly and unmistakably intended otherwise.”⁶³ By contrast, an arbitrator decides issues of procedural arbitrability, which concern whether the parties have complied with the terms of the arbitration clause.⁶⁴ Examination of some case law on this issue

62. Maryann A. Waryjas, *supra* note 35; *see also* Roman L. Weil et al., *supra* note 8, at 14.

63. *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83 (2002) (quoting *AT&T Technologies, Inc. v. Communications Workers*, 475 U.S. 643, 649 (1986)).

64. *Id.*

demonstrates that, at the very least, parties should think through the issues in advance that they want the independent accountant to be able to resolve.

A Delaware case, *Avnet, Inc. v. H.I.G. Source, Inc.*, typifies the significant, but perhaps unnecessary, collateral litigation spawned by substantive versus procedural arbitrability questions.⁶⁵ In *Avnet*, the parties executed an acquisition agreement and included in the purchase price adjustment provision a four-step process to adjust and finalize the purchase price with specific deadlines for each step.⁶⁶ The final step in the process provided that an accounting firm would review and resolve “all matters . . . that remain in dispute relating to [the final purchase price].”⁶⁷

More than a year after the deadline expired, the plaintiff, Avnet, initiated the first step of the purchase price adjustment process by delivering a Closing Balance Sheet.⁶⁸ The defendant, HIG Source, objected to the untimely submission but proceeded to negotiate.⁶⁹ After the parties failed to reach an agreement, Avnet filed a complaint seeking an order compelling HIG Source to arbitrate pursuant to the arbitration clause in the purchase price adjustment provision.⁷⁰ Finding that the issue was one of substantive arbitrability, the court held that the court itself must decide whether the dispute was arbitrable because Avnet did not act within the clear time requirements of the purchase price adjustment provision subject to the arbitration clause.⁷¹ In other words, where parties enact a specific process that is subject to arbitration, and one or both parties do not follow that process, a court and not an arbitrator may end up determining whether the parties agreed to arbitrate the issue.

Additional Delaware cases, *Nash v. Dayton Superior Corp.*⁷² and *HDS Inv. Holding, Inc. v. Home Depot, Inc.*,⁷³ provide similar examples of collateral litigation that result from a narrow arbitration clause in a purchase price adjustment provision. In each case, the respective agreements contained a very specific purchase price adjustment provision coupled with a narrow arbitration clause applying only to the purchase price provision.⁷⁴ As in *Avnet*, a party in each case acted in a manner outside the strictures of their respective purchase price adjustment provisions, causing litigation over whether the court or an arbitrator would decide whether the issue

65. No. 5266-VCP, 2010 WL 3787581 (Del. Ch. Sept. 29, 2010).

66. *Id.* at *2.

67. *Id.*

68. *Id.* at *2-3.

69. *Id.* at *3.

70. *Id.*

71. *Id.* at *6-11.

72. 728 A.2d 59 (Del. Ch. 2008).

73. No. 3968-CC, 2008 WL 4606262 (Del. Ch. Oct. 28, 1998).

74. *Nash*, 728 A.2d at 60; *HDS Inv. Holding*, 2008 WL 4606262, at *2-5.

was arbitrable.⁷⁵ In each case, the court treated the issue as one of substantive arbitrability reserved for the court itself to decide.⁷⁶

Finally, the question of substantive arbitrability can require the parties to litigate in multiple forums simply to decide whether a court or an arbitrator has the power to resolve a dispute. As the Delaware Supreme Court opined in *James & Jackson, LLC v. Willie Gary, LLC*, a court should actually refer the question of substantive arbitrability to the arbitrator “in those cases where the arbitration clause generally provides for arbitration of all disputes and also incorporates a set of arbitration rules that empower arbitrators to decide arbitrability.”⁷⁷ Absent precision in drafting, the question of whether an arbitration clause is sufficiently broad to provide for arbitration of all disputes, including a dispute about whether a dispute is arbitrable, can take the parties first to court and then to an arbitrator—causing delay and unnecessary expense. Other Delaware precedent suggests that any agreement that refers the parties to either JAMS or AAA arbitration (the rules of which allow an arbitrator to decide whether a dispute is within her authority) can require all disputes to be referred to arbitration, even if the arbitration clause otherwise appears narrow.⁷⁸ As a result, parties should consider whether they want an arbitrator to decide whether disputes between the parties belong in arbitration; if not, the parties should make it clear that the question of substantive arbitrability is to be decided by a court. A suggestion for parties who prefer arbitration but do not want all disputes that may ever arise between them to be arbitrated is to specifically limit the arbitrator’s authority to disputes specifically arising out of the acquisition agreement.

2. Arbitration, Followed by Litigation

One recent case, *Thule AB v. Advanced Accessory Holdings Corp.*, demonstrates the sort of collateral litigation that can erupt absent a single, unified dispute resolution provision.⁷⁹ In *Thule*, a case from the Southern District of New York, the buyer and seller negotiated a contract containing a purchase price adjustment provision, a very broad indemnification provision, and an escrow.⁸⁰ The indemnification provision and relevant definitions in the agreement provided that the defendant would indemnify the plaintiff from essentially all losses that might have arisen from the de-

75. Nash, 728 A.2d at 61, 63-64; HDS Inv. Holding, 2008 WL 4606262, at *8-9.

76. Nash, 728 A.2d at 63-64 (whether new items could be inserted into the closing balance sheet in an untimely manner under the agreement was not clearly arbitrable); HDS Inv. Holding, 2008 WL 4606262, at *8-9 (whether an arbitrator could consider a revised closing statement submitted later than the time allotted in the purchase price adjustment provision was an issue for the court to decide given that the arbitration provision limited the arbitrator to resolving disputes regarding the calculation of the “Applicable Amount”).

77. 906 A.2d 76, 80 (Del. 2006).

78. See *McLaughlin v. McCann*, 942 A.2d 616, 625 (Del. Ch. 2008).

79. No. 09 Civ. 00091(PKC), 2010 WL 1838894, at *2-3 (S.D.N.Y. May 4, 2010).

80. *Id.*

pendant's failure to perform or fulfill any of its covenants or agreements.⁸¹ The parties also created the escrow account to provide indemnity payments for any of the buyer's losses arising out of the agreement.⁸²

In the somewhat unique set of facts in *Thule*, the buyer sought indemnity for the seller's failure to pay a purchase price adjustment award obtained through arbitration, which led to litigation in federal court over whether any indemnification award could be paid out of the escrow.⁸³ Ultimately, the buyer obtained summary judgment on its claim because of the breadth of the indemnity language in the agreement.⁸⁴ However, the arbitration and litigation—involving two large international law firms—were undoubtedly extensive and costly.

3. Advice to Reduce Collateral Litigation

As *Thule* demonstrates, rather than streamlining the post-closing dispute resolution process, a limited arbitration clause (or separate dispute resolution provisions for purchase price adjustments and other claims) in an acquisition agreement may lead to unnecessary collateral litigation, costing time and money. Accordingly, we suggest a broad dispute resolution clause that gives the institution tasked with dispute resolution the authority to decide a sufficient range of issues that would allow it to resolve any disputes while avoiding collateral litigation.

In particular, we recommend a unified post-closing dispute process, in which the purchase price adjustment process is connected with all other post-closing mechanisms, such as any indemnification and escrow provisions. For instance, if, as in *Thule*, a buyer obtains a purchase price adjustment but is unable to collect it from the seller, it is in the best interests of all parties that the collection of that award be handled in an efficient manner. Accordingly, we recommend drafting these provisions with reference to one another, such as by including a specific reference that the failure to pay a purchase price adjustment is an indemnifiable loss. Additionally, we recommend having a unified dispute resolution procedure under which disputes are first referred to a single gatekeeper—an arbitrator, a mediator, or a neutral counselor—who has the obligation and authority to address any initial issues, refer disputes to the proper forums (whether an independent accountant or the well-thought-out arbitration or litigation process described below), and consolidate them as needed.

81. *Id.*

82. *Id.* at *3.

83. *Id.* at *3-4.

84. *Id.* at *5-12; *Thule AB v. Advanced Accessory Holdings Corp.*, No. 09 Civ. 00091(PKC), 2010 WL 2287012, at *2 (S.D.N.Y. June 1, 2010) (granting the plaintiff's motion for reconsideration and summary judgment to the plaintiff).

D. *Well-Crafted Arbitration or Litigation Provisions Streamline Dispute Resolution*

Often, earn-outs and indemnification claims are covered under the same dispute resolution clause. In an effort to “streamline” disputes, parties frequently choose to refer all such disputes to arbitration.⁸⁵ Yet, parties are well-advised to consider whether, in fact, their standard-form dispute resolution clauses actually expedite the resolution of disputes. Because any post-closing dispute resolution process is only as “streamlined” as the parties decide in advance—through even-handed negotiations that do not take into account the “leverage” either side may believe it has in an actual dispute—we recommend more carefully tailored dispute resolution clauses that set actual parameters and boundaries on pre-hearing discovery, briefing, and even the manner in which a trial or arbitration will be conducted. As the documents and information typically are the property of the buyer post-closing, including a clause that allows access to the books and records for the seller may also assist in streamlining discovery issues.

1. The Well-Thought-Out Arbitration Provision

a. *Which Arbitration Rules?*

Many practitioners reflexively choose arbitration as a dispute resolution mechanism and, in doing so, specify the Commercial Arbitration Rules of the American Arbitration Association (“AAA”), including the rules on “Expedited Procedures,” while also incorporating the Federal Rules of Civil Procedure.⁸⁶ However, the AAA’s Expedited Procedures leave the scope and scheduling of pretrial procedures to the advocacy of the parties. As a result, a litigant motivated to extend the post-closing dispute resolution process can do so by prevailing on the arbitrator to allow needless discovery. Because the parties will have incorporated the Federal Rules of Civil Procedure into their agreement without limitation, many arbitrators will feel compelled—in order to effectuate the parties’ intent—to conduct a longer proceeding than the parties intended when choosing the “Expedited Procedures.”

Furthermore, there is an inherent ambiguity in blindly incorporating the Federal Rules of Civil Procedure into rules of arbitration that provide, in Rule 21, for the arbitrator to exercise discretion “consistent with the expedited nature of arbitration” as to what discovery should be exchanged. In our opinion, the Federal Rules of Civil Procedure should never be incorporated in the entirety, specifically because (as discussed above) it creates an ambiguity as to whether the parties intended a truly “streamlined” procedure or something akin to federal litigation with Rule 26 disclosures, interrogatories, requests to admit, and the like. Rather, we

85. Leigh Walton & Kevin D. Krebs, *supra* note 13.

86. AM. ARB. ASS’N, COMMERCIAL ARBITRATION RULES AND MEDIATION PROCEDURE, available at http://www.adr.org/aaa/ShowProperty?nodeId=/UCM/ADRSTG_004103&revision=latestreleased.

advise parties to incorporate only specific rules that they perceive will assist them in expeditiously resolving a dispute, such as Rule 30(b)(6)'s requirement for a "corporate" deponent.

An alternative option is to use the JAMS Comprehensive Arbitration Rules and Procedures.⁸⁷ These include Rules 16.1 and 16.2, which limit discovery to the exchange of documents (including constraints on document requests and e-discovery), one fact witness for each side, expert reports, and depositions. Under the JAMS rules, the single fact witness becomes more like a Rule 30(b)(6) witness under the Federal Rules of Civil Procedure—a witness who is prepared to testify to all issues in the case, even on issues about which the witness had no percipient knowledge. While such a procedure puts a burden on the litigators to prepare one key witness, it has the benefit of shortening discovery—and, potentially, the arbitration hearing—considerably. These rules also provide for an early, dispositive motion, which may obviate the final hearing altogether.⁸⁸

For a buyer, the party bringing the claim, it is not clear that these provisions are necessarily helpful. The buyer has access to the data, the opportunity to shape its claims in advance, and ought to have a handle on all applicable facts, making factual discovery (except into the other side's defenses, which may or may not be fact-intensive) less necessary. The seller, on the other hand, may have an incentive to try to disrupt the buyer's business integration efforts by promulgating document requests that require significant effort despite the JAMS rules' limitations on such requests. Regardless, it is clear that having pre-defined limits on discovery is preferable to allowing a litigator to argue to an arbitrator who has no prior familiarity with the target's business that he or she be allowed extensive pre-hearing discovery. In our experience, arbitrators will be reluctant to foreclose a party from obtaining discovery, in the absence of a compelling indication of the parties' intent to engage in only narrowly constrained discovery, as long as the party can present a compelling need for such discovery.⁸⁹

Whether choosing the JAMS or AAA rules, parties who seek a streamlined dispute resolution proceeding through arbitration are well advised to: (i) incorporate only selectively, if at all, the Federal Rules of Civil Pro-

87. JAMS, COMPREHENSIVE ARBITRATION RULES & PROCEDURES, *available at* <http://www.jamsadr.com/rules-comprehensive-arbitration/#Rule%2016.1> (including Optional Expedited Arbitration Procedures) (last accessed on January 27, 2012).

88. When either the buyer or seller is a Delaware corporation, the parties also can elect to mediate and arbitrate before the Delaware Court of Chancery, allowing them to access some of the most experienced judges in the country for merger & acquisition related disputes in a more informal, streamlined setting. DEL. CODE tit. 10, §§ 347, 349 (2003).

89. A buyer may wish to use the JAMS Streamlined Arbitration Rules and Procedures, which use a single arbitrator, have no discovery other than the good faith exchange of documents and data that is "relevant to the dispute or claim" within 14 days of the claim being filed. The procedure is beneficial to the buyer, as the buyer will be the plaintiff and already will have a good sense of the documents needed to support its claims and the factual basis for those claims.

cedure in order to avoid any ambiguity about their intent; and (ii) pre-negotiate discovery limits into the acquisition agreement, such as (1) “no more than three depositions per side absent good cause shown,” (2) “electronic discovery from no more than three custodians per side absent good cause shown,” and (3) “the parties are limited to a single, pre-hearing submission of not more than 15 pages, absent good cause shown.”

b. *Baseball Arbitration*

Another way to streamline post-closing disputes is to participate in so-called “baseball arbitration.” In sports arbitration, the parties (typically a player and a team) each propose a salary and present their cases about market value to an arbitrator. Ultimately, the arbitrator picks one of the two salaries as the “more reasonable,” and the team has an opportunity to pick up or waive the player. In the case of 27-year old Antti Niemi, the star net-minder behind the Chicago Blackhawks’ 2010 Stanley Cup victory, an arbitrator sided with Niemi and the Blackhawks waived him immediately.⁹⁰ In the commercial setting, however, so-called baseball arbitration (used even in hockey) allows the parties to streamline the dispute resolution process, typically without such seemingly disastrous (for Chicago Blackhawks fans, anyway) results.

In baseball arbitration conducted in the commercial context, the parties would provide the arbitrator with their respective numbers and the support for them. Because the parties know that the arbitrator is going to be deciding on the reasonableness of the overall number, they would be encouraged to take reasonable positions—something that, in and of itself, can streamline litigation. In addition, when each party knows the other party’s “number,” it can make settlement more likely, as the economics will then stand out above the histrionics of the litigation.

Baseball arbitration can be used for all aspects of post-closing disputes—purchase price adjustment, earn-outs, and indemnification claims. This does, in some instances, encourage parties to wrap all disputes into one, in order to have as many grounds as possible to support a presentation of an overall deal-price reduction or increase to the arbitrator. In short, baseball arbitration provides another option to deal lawyers looking for creative ways to streamline post-closing disputes.

c. *Setting the Arbitration Panel*

Another issue that arises in arbitration is whether to have one or three arbitrators. A single arbitrator has the benefit of being relatively cost-effective. The downside, however, is that a single arbitrator may lack the expertise or perspective to understand complex accounting or industry-specific arguments. A three arbitrator panel, on the other hand, is expen-

90. See Chris Kuc, *Blackhawks Drop Niemi, Sign Goalie Turco*, CHICAGO BREAKING SPORTS (Aug. 2, 2010, 10:58 AM), <http://archive.chicagobreakingsports.com/2010/08/blackhawks-drop-niemi-sign-goalie-turco.html> (last accessed on Jan. 1, 2012).

sive and makes scheduling hearing dates more difficult—often leading to long delays between hearing dates.

Accordingly, parties should consider including a dispute resolution provision that allows a single arbitrator the ability to retain one or more neutral experts. The costs of a neutral expert can be limited to a specific dollar amount or the costs can be apportioned to the losing party as a disincentive to taking outrageous positions in litigation. A dispute resolution provision with a single arbitrator and a neutral expert could be used to address all post-closing disputes as well. Such a mechanism would provide the parties with additional efficiency, as only one team of professionals would have to get “up to speed” on the target’s accounting principles, key business drivers, and other factors in order to resolve any disputes over purchase price adjustments, earn-outs, and indemnification claims.

A three-arbitrator panel, of course, has some advantages. Most notably, multiple perspectives in the decision room often are better than one particularly if a case is complex and interpretation of the facts may be aided by having a multi-disciplined panel (a lawyer, an accountant, and a businesswoman, for example). In addition, because a tripartite panel typically includes two party non-neutrals (at least in its inception), it often will have at least one member who is predisposed to see things your way. If considering a three-arbitrator panel, parties ought to consider specifying in the acquisition agreement that each party will pick a single arbitrator and then have those two “non-neutrals” pick the neutral arbitrator, who should serve as the panel chairman. Such an approach should also favor tight deadlines, in which the parties each have five business days to pick their non-neutrals and the non-neutrals, in turn, have ten days to pick the neutral arbitrator. Finally, with a three-arbitrator panel, parties should consider requiring that the chairman be the only one needed to deal with discovery issues (*i.e.*, all three panelists are not needed until the actual hearing). Again, such advance planning will result in a far more streamlined process as compared to simply identifying a set of arbitration rules.

Ultimately, for simplicity, we suggest that the dispute resolution clause elect a single arbitrator. The arbitrator should be given authority to retain one or more neutral experts, depending on the subject or subjects of the post-closing dispute, and the costs for such experts should either be borne by the non-prevailing party or be shared by the parties.

d. *Third-Party Discovery in Arbitration*

Third-party discovery is another issue to consider when drafting a dispute resolution clause. If the parties contemplate needing discovery from third parties—whether they be true third parties or people that will leave the target company and no longer be available after closing—consider an agreement that the parties will cooperate in obtaining needed third-party discovery. There is a split of authority as to whether the Federal Arbitration Act (“FAA”) authorizes (and whether federal courts can enforce) subpoenas commanding third parties to appear and testify before an arbi-

tration panel.⁹¹ Given the lack of clear authority on the point, parties would be well served to include a provision requiring the parties to work together to procure third-party discovery.

e. Appellate Review of Arbitration

While many people prefer arbitration because it leads to a final, binding verdict, anyone who has participated in arbitration knows that a final, binding, and incorrect verdict is unsatisfying. Yet there are few, if any, options for appellate review of an arbitration award. Under the FAA, a court may vacate or modify an arbitrator's award in the narrowest of circumstances allowed by the FAA.⁹² Further, "[r]eview of arbitration awards under the FAA is extremely deferential."⁹³

The FAA authorizes vacation of an arbitrator's award in the following limited circumstances: (1) "the award was procured by corruption, fraud, or undue means," (2) "evident partiality or corruption [by] the arbitrators," (3) certain specific misconduct, or (4) "where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made."⁹⁴ Further, an award may be modified where there is: (1) evident material miscalculation, (2) evident material mistake, (3) an award was made upon a matter not submitted, or (4) an "award . . . imperfect in matter of form

91. See *Alliance Healthcare Servs., Inc. v. Argonaut Private Equity, LLC*, 804 F. Supp. 2d 808, 810–11 (N.D. Ill. 2011), for a description of the circuit split. The Sixth and Eighth Circuits have held that the power to compel pre-hearing discovery from a third party is implicit in the power of an arbitrator to compel production of documents from a third party for a hearing. See also *In re Sec. Life Ins. Co. of Am.*, 228 F.3d 865, 870–71 (8th Cir. 2000); *Am. Fed'n. of Television and Radio Artists, AFL-CIO v. WJBK-TV (New World Communications of Detroit, Inc.)*, 164 F.3d 1004, 1009 (6th Cir. 1999). The Second and Third Circuits have ruled to the contrary. See *Life Receivables Trust v. Syndicate 102 at Lloyd's of London*, 549 F.3d 210, 212 (2d Cir.2008); *Hay Group., Inc. v. E.B.S. Acquisition Corp.*, 360 F.3d 404, 408–09 (3d Cir.2004). The Fourth Circuit has read section 7 of the FAA in more or less the same way as the Third, though it has suggested that an arbitration panel may subpoena a non-party for prehearing discovery upon a showing of a 'special need.' See *COMSAT Corp. v. Nat'l. Sci. Found.*, 190 F.3d 269, 275–76 (4th Cir.1999). There is no Seventh Circuit authority directly on point. All of these decisions aside, the Court agrees with the Second Circuit that "[a]ny rule there may be against compelling non-parties to participate in discovery cannot apply to situations . . . in which the non party is 'summon[ed] in writing . . . to attend before [the arbitrators] or any of them as a witness and . . . to bring with him . . . [documents] which may be deemed material as evidence in the case.'" (citing *Stolt-Nielsen SA v. Celanese AG*, 430 F.3d 567, 577–78 (2d Cir. 2005)).

92. *Hall Street Assoc. LLC v. Mattel, Inc.*, 552 U.S. 576, 586–589 (2008); *Johnson v. Wells Fargo Home Mortg., Inc.*, 635 F.3d 401, 416 (9th Cir. 2011); *Cat Charter, LLC v. Schurtenberger*, 646 F.3d 836, 842–843 (11th Cir. 2011).

93. *Southco, Inc. v. Reell Precision Mfg. Corp.*, 331 Fed. Appx. 925, 928 (3rd Cir. 2009) (alteration in original); see *Citigroup Global Markets, Inc. v. Bacon*, 562 F.3d 349, 352–58 (arguing that the Supreme Court's *Hall Street* opinion eliminated all non-statutory grounds for vacatur under the FAA).

94. 9 U.S.C. § 10 (2006) (alteration in original).

not affecting the merits of the controversy.”⁹⁵ Notably, it is unclear if “manifest disregard” of the law by the arbitrator survives the Supreme Court’s *Hall Street* opinion as a non-statutory exception for *vacatur*, as the Supreme Court specifically avoided deciding the issue in *Stolt-Nielson S.A. v. AnimalFeeds Int. Corp.*⁹⁶ Regardless of whether any non-statutory bases of *vacatur* or modification survive *Hall Street*, an arbitral award is very difficult to modify or vacate through appellate review.

Yet, there are options for appellate review WITHIN arbitration—by a new panel of arbitrators. For example, the JAMS rules include an alternative appellate process.⁹⁷ An “out” for further review, even if by a panel of arbitrators, can be more attractive to a buyer than simply losing an indemnification claim. Accordingly, we recommend at least discussing the possibility of an alternative appellate procedure with the client or your deal team. One way to structure this would be for the parties to provide for appellate review within arbitration as an option, but to require the party seeking to invoke the appellate procedure to bear the costs of the appellate panel as an economic deterrent to invoking the appeal process lightly.

f. *Advice for Structuring an Arbitration Provision*

If parties prefer arbitration over litigation, we recommend the following:

- Appointing a single arbitrator with the ability to retain neutral experts;
- Limiting discovery, absent good cause shown;
- Agreeing to cooperate on third-party discovery;
- Considering baseball arbitration and/or appellate review of the arbitration award.

2. The Well-Thought-Out Litigation Provision

There is a plethora of evidence to support lawyers’ predilection against litigation—litigation is expensive, time-consuming and often leads to counter-intuitive results. But, arbitration is not inexpensive, as parties have to pay both their lawyers and the arbitrators. Arbitration also can lead to results that are both counter-intuitive and, more importantly, non-appealable. Trial lawyers all over the country have explored options to streamline litigation, in order to capture the best of this country’s original adversary system.

95. 9 U.S.C. § 11 (2006).

96. 130 S. Ct. 1758, 1768 n.3 (2010) (refusing to decide whether “manifest disregard” survives *Hall Street*); see *Countrywide Fin. Corp. v. Bundy*, 113 Cal. Rptr. 3d 705, 716-20 (Cal. Ct. App. 2d Dist. 2010) (collecting cases and discussing the Federal Circuit Court split over whether “manifest disregard” survives *Hall Street*).

97. See JAMS, *OPTIONAL ARBITRATION APPEAL PROCEDURES* (2003), <http://www.jamsadr.com/rules-optional-appeal-procedure/> (last accessed on Feb. 6, 2012).

a. *Consent to Trial By Magistrate*

One option that has been well-publicized is trial by a United States Magistrate Judge.⁹⁸ In such cases, a magistrate judge can tailor briefing and discovery to be (i) streamlined and (ii) focused narrowly on the issues the magistrate believes need to be addressed. Magistrates also often have more flexibility to hear matters quickly.⁹⁹ Parties can obtain a speedy trial and still preserve the right to appeal, if necessary.¹⁰⁰ Ultimately, trial before a magistrate judge allows a hybrid approach, by combining some elements of summary judgment with a trial setting that can also benefit the parties. In the Delaware Court of Chancery (a frequent forum for merger-related disputes), the parties can elect to a final adjudication by a master, a position akin to a magistrate judge.¹⁰¹ In our experience, choosing either a magistrate or master offers a streamlined, efficient method of resolving a wide variety of disputes before very skilled judges who can hear the parties on an expedited basis—even when disputes arise during the course of litigation—and provides quick, well-reasoned, relief.

b. *Pre-Trial Agreements*

Another approach is to agree to litigate a dispute but to include a pre-trial agreement, perhaps as a rider, with the acquisition agreement. In a recent series of articles, a United States Magistrate Judge and two senior trial lawyers have proposed pre-trial agreements as a means of avoiding the bulk of discovery that is “unnecessary, distracting, and expensive.”¹⁰² They recommend involvement by “lead counsel” in discovery, in order to avoid picayune disputes and ensure that discovery is keenly focused on adducing evidence needed at trial. In addition, they suggest early suit agreements that limit the number and length of depositions, agreements to avoid objections at depositions, and limitations on the custodians from whom electronically stored information will be produced, among other things.¹⁰³

c. *Advice for Streamlining Post-Closing Litigation*

The above agreements are the types at which an arbitrator helps the parties arrive early in a case—largely by forcing the parties to articulate

98. The Hon. Morton J. Denlow, *Should You Consent to the Magistrate Judge? Absolutely, and Here's Why*, Vol. 37, No. 2 LITIGATION 3 (Winter 2011).

99. *See id.* at 6 (“Parties who consent to have their case tried before a magistrate judge will generally be able to receive a firm early trial date.”).

100. *See id.* at 4 (“An appeal from a judgment by a magistrate judge in a consent case goes ‘directly to the appropriate United States Court of Appeals . . . in the same manner as an appeal from any other judgment of a district court.’ 28 U.S.C. § 636(c)(3).”).

101. *See* DEL. CODE tit. 10, § 350 (2009).

102. *See* Stephen D. Susman & Johnny W. Carter, *Better Litigating Through Pre-trial Agreements*, Vol. 38, No. 1 LITIGATION, 22 (Fall 2011); *see also* The Hon. Jeffrey Cole, *A Judge Comments*, Vol. 38, No. 1 LITIGATION, 23 (Fall 2011).

103. Stephen D. Susman & Johnny W. Carter, *supra* note 102, at 23-25.

their cases in an initial meeting. Surely parties can hash these issues out themselves, in advance, and set out parameters designed to narrow litigation. Accordingly, we recommend that, in drafting a dispute resolution that refers to litigation, the following points be included:

- Consider consent to a trial before a magistrate or master;
- Limit depositions to no more than 2 or 3 per side—including one “corporate representative;”
- Limit electronic discovery to the extent feasible;
- Require that discovery disputes be resolved between lead trial counsel, perhaps in a phone call; and
- Agree to voluntarily meet and confer about identifying and agreeing to a mutual production schedule for potentially relevant data.

V. CONCLUSION

Parties to an acquisition ought to carefully think through post-closing dispute provisions. Care should be given to (i) defining the purchase price adjustment process, (ii) setting out the metrics for an earn-out, (iii) determining whether or how to qualify circumstances under which the buyer can receive indemnification and (iv) the circumstances in which parties can access the escrow account for damages. The parties should also give equal thought and attention to the process by which disputes over these issues will be resolved after closing.

In particular, we recommend a unified dispute resolution process, in which all disputes are referred to a single point of contact, whether it be an arbitrator, a mediator, or a neutral counsel, for (i) resolution of procedural issues and disputes and (ii) referral of the dispute or disputes to the proper forum, including an independent accountant, an arbitrator, or the court system. We also recommend that the process by which disputes are resolved, whether it be arbitration or litigation, be well thought out in advance.

To the extent that the parties are able, they should agree in advance that for all post-closing disputes: (i) discovery will be constrained; (ii) data will be exchanged voluntarily; (iii) the parties will cooperate as necessary in obtaining third party discovery; and (iv) disputes will be resolved by lead counsel. Other mechanisms that we recommend are the introduction of baseball arbitration or an appellate procedure into arbitration and consent to trial by a magistrate judge in ordinary litigation. In short, we recommend that parties to an acquisition agreement put as much thought into negotiating their dispute resolution provisions as they do the other terms of the agreement.

1. Case Study – Mobile Solutions Co.

Overview of the Parties

Seller: Global Telecom, Inc. (“GTI” or “Seller”), a large telecom company

Target: Mobile Solutions Co. (“MSI” or the “Company”), a mobile phone subsidiary of GTI

Buyer: New Age Capital (“NAC” or “Buyer”), a private equity firm

Overview of the Transaction

- Seller provided an offering memorandum containing detailed information regarding the history, financial situation, and prospects of the Company. During the past twelve months, the Company had sales of \$500 million, EBITDA of \$100 million and net income of \$50 million.
- Buyer analyzed the memorandum, conducted due diligence, and made an offer of \$500 million—or 5 times the Company’s trailing twelve months (“TTM”) EBITDA, plus an Earn-Out totaling 5 percent of the Company’s EBITDA during the first three years subsequent to Closing.
- Seller accepted the offer and a Purchase and Sale Agreement (“PSA”) was executed on December 1, 20X1.
- The PSA established a Target Net Working Capital of \$150 million based on the Company’s balance sheet as of September 30, 20X1 and stated that the Estimated Closing Date Net Working Capital and Final Closing Date Net Working Capital must be prepared in accordance with generally accepted accounting principles (“GAAP”), consistent with Seller’s past practices as reflected in the Target Net Working Capital.
- The transaction closed on December 31, 20X1.
- At Closing, Seller calculated the Estimated Closing Date Net Working Capital amount at \$165 million, resulting in a \$15 million increase to the Estimated Purchase Price at Closing (i.e., \$165 million Estimated Closing Date Net Working Capital less \$150 million Target Net Working Capital); therefore, Buyer paid Seller \$515 million (i.e., \$500 million plus \$15 million).
- One month after Closing, Buyer delivered to Seller its calculation of the Final Closing Date Net Working Capital of \$140 million, or \$25 million less than the Estimated Closing Date Net Working Capital prepared by Seller.
- Two weeks after receiving Buyer’s Final Closing Date Net Working Capital, Seller notified Buyer of its objection to Buyer’s accounting of three line items; namely (i) inventory reserves, (ii) accrued warranty expense, and (iii) accrued EPA fine, resulting in a \$25 million dispute.

Overview of the Parties’ Working Capital Dispute

The following table summarizes the differences between the Target Net Working Capital per the PSA, Seller’s preparation of the Estimated Clos-

ing Date Net Working Capital, and Buyer's preparation of the Final Closing Date Net Working Capital.

Summary of Working Capital Dispute				
(\$millions)				
	Target Net	Seller's	Buyer's	
	Working Capital	Estimated	Final Closing	Disputed
		Closing Date Net	Date Net	Amount
		Working Capital	Working Capital	
Accounts receivable	\$ 95.0	\$ 101.0	\$ 101.0	\$ -
Inventory, net of reserves	190.0	195.0	190.0	(5.0)
Accounts payable	(124.0)	(121.0)	(121.0)	-
Accrued warranty	(11.0)	(10.0)	(25.0)	(15.0)
EPA fine	-	-	(5.0)	(5.0)
	<u>\$ 150.0</u>	<u>\$ 165.0</u>	<u>\$ 140.0</u>	<u>\$ (25.0)</u>

The PSA established Dispute Resolution Procedures to resolve the parties' net working capital dispute through an Accounting Arbitrator.

Overview of Buyer's Indemnification Claim

Both Buyer and Seller provided each other with certain representations and warranties in the PSA, including Seller's representation and warranty that the Target Net Working Capital as well as financial statements provided in the due diligence process were prepared in accordance with GAAP, consistently applied. The PSA identified the State Court as the agreed-upon venue for resolving contractual issues between the parties, including indemnity claims.

Buyer alleged that Seller breached its GAAP representation and warranty by failing to prepare its Target Date Net Working Capital and the income statement upon which Buyer based its purchase price in accordance with GAAP. Buyer alleged that Seller's misrepresentations resulted in an overstatement of TTM EBITDA of \$20 million. Although the PSA was silent as to how the parties determined the Purchase Price of \$500 million, Buyer alleged it was based on five times TTM EBITDA. Accordingly, Buyer notified Seller of its \$100 million indemnity claim to reduce the purchase price from \$500 million to \$400 million, as summarized in the table below.

Summary of Buyer's Indemnity Claim				
(\$millions)				
<i>TTM results of operations:</i>	Purchase Price per the PSA	Summary of Buyer's Claim	Difference	
Revenue	\$ 500.0	\$ 500.0	\$	-
COGS	(365.0)	(365.0)		-
Warranty expense	(10.0)	(25.0)		(15.0)
Inventory reserve expense	<u>(25.0)</u>	<u>(30.0)</u>		<u>(5.0)</u>
EBITDA	100.0	80.0		(20.0)
Multiple	<u>5.0</u>	<u>5.0</u>		<u>5.0</u>
Purchase Price	\$ 500.0	\$ 400.0	\$	(100.0)

Overview of Earn-Out Dispute

Litigation to resolve the parties' working capital dispute and Buyer's indemnification claim have continued for more than a year following the Closing Date. Buyer and Seller had differing calculations of the Company's EBITDA for the twelve months ended December 31, 20X2, as summarized in the table below, resulting in a dispute regarding the amount of the first Earn-Out Payment. The PSA identified the State Court as the agreed-upon venue for resolving contractual issues between the parties, including earn-out disputes.

Summary of the Parties' Year 1 Earn-Out Dispute				
(\$millions)				
<i>TTM results as of 12/31/X2:</i>	Seller	Buyer	Difference	
Revenue	\$ 550.0	\$ 550.0	\$	-
COGS	(410.0)	(410.0)		-
Warranty expense*	(10.0)	(25.0)		(15.0)
Inventory reserve expense*	<u>(25.0)</u>	<u>(30.0)</u>		<u>(5.0)</u>
EBITDA	105.0	85.0		(20.0)
Earn-Out Percentage	<u>5%</u>	<u>5%</u>		<u>5%</u>
Earn-Out Payment	\$ 5.3	\$ 4.3	\$	(1.0)

** Note: These numbers likely would have changed since the Closing Date (i.e., December 31, 20X1), but for simplicity and consistency, we will assume they stayed the same.*

Discussion of Each Claim

2. Accrued Warranty Expense (\$15 million)

Working Capital Dispute – Buyer's Position

Seller historically estimated its warranty expense accrual at 2% of annual sales. Buyer calculated a warranty expense accrual of 5% based on the Company's actual warranty expense incurred during the two months subsequent to the Closing Date. Buyer alleged that a 5% warranty ex-

pense accrual should be applied to TTM revenue to establishing the Final Closing Date Net Working Capital amount in accordance with GAAP. Buyer alleged that Seller's historical accrual was understated and, therefore, inconsistent with GAAP and the PSA. Buyer's claim results in a \$15 million working capital claim, as summarized in the table below.

Summary of the Parties' Warranty Expense Accrual Dispute			
(\$millions)			
<i>TTM results as of 12/31/11:</i>	<u>Seller</u>	<u>Buyer</u>	<u>Difference</u>
Revenue	\$ 500.0	\$ 500.0	\$ -
% of revenue	2%	5%	
Warranty expense accrual	\$ (10.0)	\$ (25.0)	\$ (15.0)

Working Capital Dispute – Seller's Position

Seller's position uses a warranty accrual of 2% of sales which is consistent with past practice and is GAAP-compliant. This 2% reflects the historical experience of the Company's warranty expenses over the past 5 years. The Company has also received an unqualified opinion on its financial statements in each of the past 5 years and 2% of sales was used to calculate warranty expense in each of these financial statements receiving unqualified opinions.

Buyer's calculation of warranty only includes two months of data, and during those two months there was a recall on model BM4022. When warranty expenses relating to this model are removed from Buyer's calculation, warranty expense from 8/15/12 to 10/15/12 is 2% of sales. This recall is an extraordinary item that is infrequent and unusual and does not truly reflect the actual warranty expense.

Indemnification Claim – Buyer's Position

In addition to the argument presented above, Buyer's analysis of the warranty expense accrual as of the Closing Date implies an overstatement of TTM EBITDA of \$15 million. Buyer alleges the purchase price was established based on a five times multiple of TTM EBITDA and, therefore, that it overpaid Seller by \$75 million (i.e., \$15 million x 5).

Indemnification Claim – Seller's Position

In addition to the GAAP-based argument above, from a valuation perspective Buyer's 5% warranty expense accrual is a one-time, unusual item that will not impact future cash flows into perpetuity. As a result, the damages should be limited to the dollar amount of the claim and not based on the valuation multiple. Buyer has already claimed this in the working capital proceeding and is attempting to recover twice for the same claim.

Earn-out Calculation – Buyer’s Position

The improper accounting for warranty expense, as stated above, overstated Company’s EBITDA by \$15M in the year following the purchase agreement. Buyer does not owe Seller 5% of this overstated EBITDA or \$750,000.

Earn-out Calculation – Seller’s Position

As stated above, the warranty expense is properly stated based upon historical, normalized results. Therefore, the proper accounting is to reserve 2% of sales, not 5%, and Buyer owes Seller and additional \$750,000.

3. Inventory Reserves (\$5 million)

Working Capital Dispute – Buyer’s Position

When a customer brings in a malfunctioning mobile phone under warranty, it is the Company’s policy to give the customer a refurbished phone, and then to refurbish the customer’s malfunctioning phone. The Company has calculated the value of these refurbished phones to be 50% of the cost of a new phone. According to GAAP inventory needs to be stated at the lower of cost or market. Buyer discovered that at auctions (which has a large market for refurbished mobile phones), that sales of refurbished phones for the models AP5656, GD2512, and RS8857 (the Company’s 3 bestselling mobile phone models) were being sold at 10% of their initial value. Therefore Seller needs to increase inventory reserves from 50% to 90% of new cost for its AP5656, GD2512, and RS8857 models. This increased reserve equates to a \$5M decrease to inventory.

Working Capital Dispute – Seller’s Position

Seller’s presentation of the reserve is consistent with past practice and GAAP. Seller uses a 50% reserve because this is the value of the phone to the Company. Seller does not resell the refurbished phones of these models as these refurbished phones are only given to customers who come in with warranty claims and, therefore, the value of these phones is the ability for the Company to service warranties, and Buyer’s analysis of a 90% reserve is incorrect.

Buyer also assumes that this auction data is a market for mobile phones. GAAP states that the principal market (the market with the greatest volume for the asset) should be used when measuring fair value, and if there is no principal market, then the most advantageous market (the market with the best price for the asset) be used. Buyer’s auction data is neither the principal market nor the most advantageous market for the 3 disputed models of mobile phones.

Indemnity Claim – Buyer’s Position

In addition to the argument presented above, Seller’s understatement of inventory reserves resulted in an understatement of COGS and an over-

statement of the TTM EBITDA by \$5M causing Buyer to overpay for the Company by \$25M.

Indemnity Claim – Seller’s Position

Based on the same arguments in the working capital proceeding, a 50% reserve is appropriate. Therefore, the COGS and the TTM EBITDA are stated in accordance with GAAP consistently applied with past practice.

Earn-out Claim – Buyer’s Position

The improper accounting for warranty expense, as stated above, overstated Company’s EBITDA by \$5M in the year following the purchase agreement. Buyer does not owe Seller 5% of this overstated EBITDA or \$250,000.

Earn-out Claim – Seller’s Position

Based on the same arguments in the working capital proceeding, the accounting for inventory reserves prepared by Seller above is consistent with GAAP consistently applied with past practice.

4. EPA Fine (\$5 million)

Working Capital Dispute – Buyer’s Position

Buyer asserts that Seller failed to disclose and accrue the \$5M EPA fine. The information that was known or knowable to the Seller at the time of the closing date of the balance sheet was sufficient that under GAAP the fine should have been accrued. In other words, although the \$5M fine was probable and could be reasonably estimated, Seller did not accrue the fine.

Working Capital Dispute – Seller’s Position

The Company had never been audited by the EPA or any other similar organization and the audit was ongoing. The amount of the fine was not known or knowable at the time of the transaction and the Company could not have reasonably estimated the amount of the fine. The Company properly disclosed the EPA audit in the financial statements according to GAAP.

Case Study Observations

The purpose of this case study is to demonstrate how the same issues and arguments can result in three separate proceedings resulting in costly and protracted disputes. In addition, it is possible for the results of the proceedings to overlap, creating a potentially inequitable overall result. For example, if the Buyer wins the inventory reserve argument in both the working capital and indemnity claims, is there an element of double recov-

ery? Due to the possibility of conflicting decisions from the different venues, the timing of each of the proceedings must be orchestrated so as to minimize conflicts and inconsistencies.

The case study illustrates how well-thought-out drafting of the dispute resolution clauses in the PSA can minimize the costs associated with resolving what is essentially the same dispute in multiple venues. The parties may want to consider consolidating all disputes into a single venue, as discussed above.