REPRINT

CD corporate disputes

ARBITRATING M&A DISPUTES

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HOT TOPIC

ARBITRATING M&A DISPUTES

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CD: What do you consider to be among the key developments unfolding in the M&A disputes landscape in recent months?

McDonnell: There are three key themes that we are watching closely. First, there is an increasing use of warranty and indemnity (W&I) insurance policies, which, subject to the specific policy terms, provides an indemnity to a seller for breaches of warranties given in the sale and purchase agreement (SPA). The use of W&I insurance is potentially a benefit to both parties to the SPA, providing the seller with greater clarity by removing a large part of the risk of litigation post-completion, and providing the buyer with a route to recourse against an established insurer in the event of warranty breach. The W&I policies we see are typically subject to arbitration clauses and so they are also suitable for cross-border transactions where enforcement may be a concern for either party. Second, the proliferation of sanctions and export controls, particularly against Russia, and countermeasures has resulted in market participants being more cautious about pursuing deals, particularly where transactions involve state-owned entities, or the target has a presence in territories such as Russia. Third, environmental, social and governance (ESG) matters are far more important in transactions now, both in M&A, but also in venture capital and private equity investment rounds. The greater focus on ESG matters presents more risk to sellers in disputes, particularly if the entity has not been run in a compliant way.

Bivens: As a result of the recent challenges in the M&A market, there has been an increased prevalence of valuation disparities between buyers and sellers. This gap is often closed by earn out provisions, which in any environment can be a source of disputes. Because of this backdrop, we are seeing an increased number of post-closing disputes, which can arise out of the earn out provision itself, or can also implicate other provisions of the M&A agreement. For example, especially where earn outs are key drivers of the transaction, buyers will be subject to covenants post-closing that restrict certain actions, which could be anything from preventing the buyer from selling certain assets, terminating or moving key employees out of certain positions, or any number of other actions that can impact performance of the company that is the subject of the transaction. These disputes are often negotiated, but can also materialise into arbitration and court litigation.

Ordonez: There are two main developments that seem particularly notable. First, there is a rise of W&I insurance, which aims to guarantee losses resulting from breaches of representations and warranties (R&W). Such insurance schemes may give rise to

specific issues from a litigation standpoint, with multiparty procedures or increased complexities regarding damages valuation – for instance where the clause in the transaction documents and insurance contracts differ in scope. Second, ESG considerations are an increasing issue of concern in the context of M&A deals generally, with parties tending to include extended R&W relating to compliance with ESG principles. We can therefore expect disputes related to such ESG to gain importance in the coming months and years. In the European Union (EU), it is worth noting that a proposal for an EU directive on corporate sustainability due diligence (CSDDD), building on the United Nations (UN) principles and Organisation for Economic Co-operation and Development (OECD) guidelines on responsible business, is currently under consideration and has the potential to impact deals and disputes in this area.

Bridge: Most of the coronavirus (COVID-19)-related cases based upon force majeure or material adverse change are close to wrapping up. But one of the key developments we have seen in recent months is the increasing number of ESG-related disputes. There are both public sector and private sector drivers behind the rise in ESG disputes. On the public sector front, regulators are adding additional pressure and heightening their scrutiny of ESG-related issues. From the private side, investors and consumers have increased their pushback and reaction to a company's ESG-related decisions. This pressure from government, investors and customers means that both buyers and sellers are placing increasing weight on ESG-related due diligence and ESG-related representations, warranties and indemnities. This additional weight means additional disputes as well.

"Confidentiality is often one of the key reasons for parties resorting to arbitration in the context of M&A disputes: as such, these are and remain confidential."

Melissa Ordonez, Hogan Lovells

CD: What are the main issues creating grounds for conflict? To what extent are representations and warranties and price adjustment mechanisms a common source of M&A-related disputes?

Bivens: Price adjustment mechanisms, like earn outs, do give rise to disputes. These disputes can be smaller value disputes, and sometimes are subject to specialised dispute resolution processes where an independent 'expert' – for example an accountant or valuation specialist – decides the matter rather than an arbitrator. Some can be larger value disputes and will be subject to more traditional commercial arbitration or litigation. Breaches of R&W are also a common source of post-M&A disputes, and often arise when external market conditions or other factors change the economic landscape of the transaction for the buyer, which will use breach claims to try and recoup some of the economics of the deal. Buyers often partner those claims with fraud claims to get around fixed time limitations and other restrictions on the scope of the R&W, and then the parties will also be litigating whether the fraud disclaimers in the deal documents apply.

Ordonez: From our experience, the main sources of conflicts in post-acquisition disputes are indeed disputes relating to the price, and specifically post-signing price adjustment mechanisms or in some cases earn out mechanisms, with deferred combination to be paid based on contractual parameters. These disputes often revolve around the interpretation and correct application of the agreed contractual mechanisms. However, mechanisms such as expert determination may be suitable for these disputes, which do not always lead to litigation. The other main source of conflict is breaches of R&W as well as claims for specific indemnities, in light of the importance of these stipulations for the parties, notably where an extended due diligence is difficult to implement due to business considerations. The exact scope of these R&W is therefore often a debated issue in post-M&A disputes.

"If a mediation step is written into the agreement, it often takes an inordinate amount of time to effectuate that provision in practice because the party subject to the dispute can manufacture delay."

Frances E. Bivens,
Davis Polk & Wardwell LLP

Bridge: Representations, warranties and price adjustment mechanisms are all increasingly common sources of M&A-related disputes. For example, earlier this year we saw judgment in favour

of insurers in one of the first English court reported decisions in a disputed W&I claim, arising from an M&A transaction. That case was unusual because the insurers were able to demonstrate that the buyer had actual knowledge of the matters that were the subject of the W&I claim prior to incepting the policy. On the other hand, I have seen cases where a private equity buyer has secured a substantial 100 percent recovery under a W&I policy in relation to a large transaction, involving breaches of warranty and alleged fraud. We are also seeing a number of post-completion disputes arising out of earn outs. Often the business is not performing as expected, for a variety of reasons, but sellers are pursuing claims in relation to unpaid deferred consideration, involving expert accounting determinations or alleged buyer breach of conduct provisions during the earn out period. Buyers are similarly wary about sellers gaming the system and manipulating business performance for their own benefit. I expect that we will continue to see many claims of a similar nature in the future, in the current economic climate.

McDonnell: Perhaps fuelled by the increasing use of W&I insurance, breach of warranty claims remain prevalent. Disputes relating to price adjustment mechanisms are a common feature of M&A disputes, but SPAs often have in-built alternative dispute resolution (ADR) mechanisms to address these quite specialist issues in order to avoid full-scale arbitration.

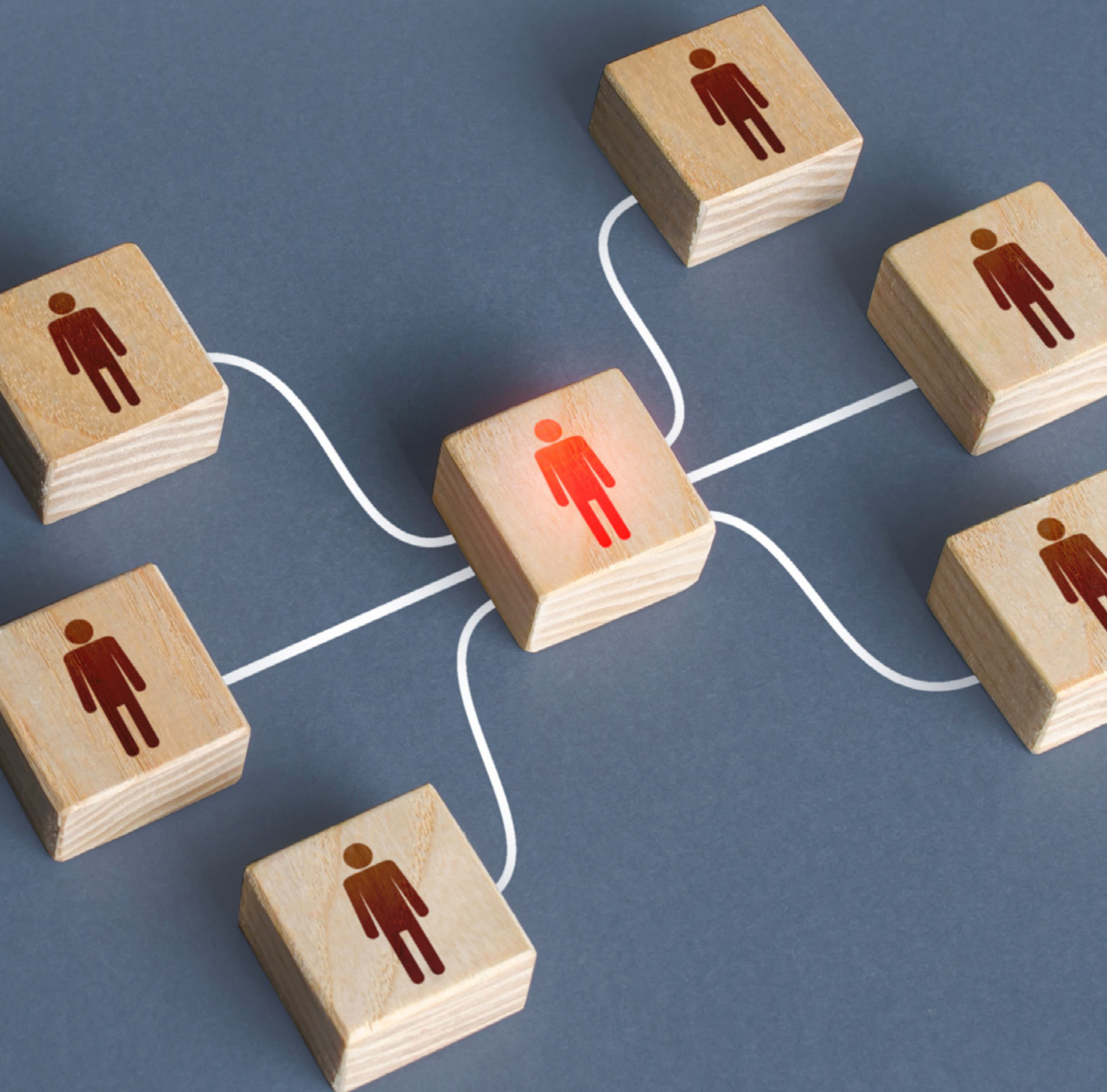
CD: How would you characterise arbitration as a suitable forum for resolving M&A-related disputes? What advantages does the process offer to disputing parties?

Ordonez: Arbitration is a particularly suitable forum for resolving M&A disputes for several reasons. First, it often guarantees the confidentiality of proceedings, which may be of importance to parties, particularly where the M&A process, including for instance price valuation, involved the disclosure of confidential business and financial information on the acquired company. Second, it enables the parties to choose their own arbitrators, possessing adequate experience of the specific sector in which the acquisition is conducted, and complex financial and accounting issues often involved in M&A disputes. Arbitration may also provide a favourable setting for the parties to engage in parallel ADR processes or amicable discussions, with arbitrations often resulting in settlements. These factors, among others, explain why arbitration has steadily risen as a means of dispute resolution for M&A transactions in recent years.

McDonnell: Arbitration is a very good forum for resolving M&A disputes, which is sought out by parties. The main institution rules, such as the rules of the London Court of International Arbitration, remain very popular. The latest version of those rules introduced several features attractive to SPA parties, such as the potential for the early determination of a dispute and the positive promotion of the use of technology, including the use of virtual hearings, to improve the arbitration experience. The principal reason for seeking arbitration remains the privacy it offers the parties, given that arbitration is a confidential process, unlike court proceedings, which are generally held in public save for in limited circumstances. There are benefits beyond privacy, though. Arbitration agreements typically provide for the parties to appoint the arbitration tribunal, which allows for the parties to select specialists in the area of the disputed issue. Arbitration also has the potential to be faster than court litigation. Parties can agree the timetable and, to some degree, the procedure to be adopted. The limiting factor is often the availability of the tribunal; historically that was limited further by the need for the tribunal to convene in the same room before a procedural or other hearing could be progressed. But the promotion of virtual hearings has improved the position further.

Bridge: Arbitration is eminently suitable for resolving M&A-related disputes. The four biggest advantages are confidentiality, the ability to choose the arbitrator, procedural flexibility and cross-border enforceability. Confidentiality is important as many companies prefer to avoid the publicity of open court. The ability to choose the decision maker is a big advantage – for example, it can be simpler to resolve a warranty claim relating to technical information when the decision maker already knows the industry or has the necessary technical certifications. With regard to procedure, parties can tailor the process to be as efficient as they would like – say by deciding certain issues on a preliminary basis. Finally, thanks to the New York Convention it is normally easier and cheaper to enforce an arbitral award in another jurisdiction than it is to enforce a court judgment.

Bivens: In the US, we principally see parties use arbitration for M&A disputes in two contexts. The first is for cross-border transactions where one party is from outside the US and does not want to consent to the jurisdiction of New York or Delaware courts, or where the US party is concerned about whether a US court judgment can be easily enforced against the non-US party. As a result of the New York Convention, foreign arbitration awards are more readily enforceable around the world than foreign court judgments. This has been and continues to



be the main driver behind the use of arbitration clauses in M&A transactions. The second context is smaller value technical disputes that can be decided quickly by time-limited arbitrations decided by an accountant or other technical specialist. There are times where this process is preferred by the parties because they can choose an expert or a referee with a particular expertise which gives the parties confidence in the outcome of that technical dispute.

CD: Could you highlight any recent M&A-related arbitrations that were notable in terms of how they were conducted and ultimately resolved?

Bridge: In a recent arbitration, a dispute arose between the date of exchange and completion of an SPA. Parties were helped to work efficiently to conduct the entire arbitration from start to finish in eight weeks, such that the award was rendered before completion and provided certainty of outcome by then.

Bivens: Recently, a large, high-profile court litigation was brought by a target company against an unrelated third party that was holding up the closing of a transaction. The buyer did not want to inherit the public dispute as part of acquiring the target company. The seller was able to convince the defendant in the court litigation to agree to have the matter resolved by confidential arbitration. The seller negotiated for the right to control the prosecution of the arbitration, and the buyer agreed to cooperate with the prosecution of the claim. It was a creative solution to an otherwise irreconcilable dealbreaking issue.

McDonnell: A typical feature of W&I disputes is the imbalance of resource between the insurer and the buyer. Well-resourced and litigation-experienced insurers often look to draw out the arbitration process, which, even with rigorous procedural guidelines, they can do by making substantial information requests, for example. The objective is to make the process as time consuming and expensive for the claimant as possible. Handling disputes will be a core part of any insurers' business, and they will often benefit from significantly reduced hourly rates offered by law firms on their selected panels. On the other hand, for the claimant, disputes are typically a rare event, and the process is unknown to them, absorbing huge amounts of management time to remedy a transaction that the claimant had good reason to hope was completed. Claimant awareness of that resource and experience imbalance is important: a clear demonstration that arbitration will be pursued is a powerful strategy for the claimant to adopt.

Ordonez: Confidentiality is often one of the key reasons for parties resorting to arbitration in the context of M&A disputes: as such, these are and remain confidential. We can, however, note from recent cases in the sector that it is increasingly key for parties to conduct comprehensive due diligence and properly document it so as to clearly delimit the boundaries of the information which was communicated prior to the conclusion of the deal. Such clear delineation of the due diligence exercise is also useful when it comes to drafting the transaction documents, in order to clearly allocate the risks through R&W depending on the information the buyer has been able to review.

CD: What steps can companies take throughout the M&A process to mitigate the need for arbitration further down the line? What contractual issues do they need to consider?

Bivens: Where the seller has the leverage to do so, we see an increased practice of sellers refusing to give any R&W. Private equity firms are the most frequent users of this approach where they can achieve that outcome, and it certainly does reduce post-closing disputes. It is also helpful for the M&A agreement to have an ironclad fraud disclaimer, with as much specificity as possible so that it is broadly enforced. One common issue that litigators see after disputes arise is that the fast pace of drafting in the days leading up to signing can give rise to conflicting provisions in the agreement. There can be more than one articulation of a fraud waiver or the edits to a complex earn out provision might make sense in one portion of the provision but make no sense in another. The risk of this happening can be exacerbated in large deals where each side has more than one law firm involved, and changes are coming from all quarters. There are also times where the inconsistency is privately identified by the lawyers for one side and raised with the client pre-signing, but there is no appetite for any

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> *David Bridge, CMS Cameron McKenna Nabarro Olswang LLP*

further changes to the agreement on the part of those leading the negotiations, so it just stands. If litigators could give one cautionary instruction to the transactional lawyers and clients it would be to do a very careful cold read of the agreement before it gets signed, and to actually push for the necessary clarifying changes, to prevent unintended disputes post-closing that derive from the inconsistency, which can be used by one party or the other down the road if their economic expectations for the deal do not get met.

McDonnell: There are three steps parties can take to mitigate the risk of arbitration. First, some consideration should be given to whether W&I insurance is suitable for the transaction. Sellers typically prefer to put the insurance in place, reducing their litigation risk and shifting the burden of indemnification for a claim to the insurer. Conversely, in certain circumstances, a buyer may want to resist the insurance, preferring instead to have the option of pursuing the seller directly in the event of a breach of warranty. If a W&I policy is used, due diligence can be undertaken to determine what the policy holder's reputation is for handling disputes, to better understand whether there is a risk of a lengthy disputes process if a claim is made against the policy. Second, consideration should be given to whether any ADR clauses are included in the SPA. Referring defined disputes to individuals with a particular qualification and agreeing to be bound by their decision from the outset, may reduce the risk of a need to engage in a full arbitration process at all. Third, at the SPA drafting stage it is important to recognise that disputes may arise, and therefore to ensure that the SPA benefits from a properly drafted and enforceable arbitration clause that the contracting party is comfortable with. Often, arbitration clauses are poorly drafted and are treated as an afterthought in the SPA drafting process.

> **"The increased use of W&I insurance is likely to become increasingly dominant in M&A disputes. These policies will typically have arbitration clauses."**
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> *Tom McDonnell, Brown Rudnick*

Ordonez: The drafting of the transaction documents is absolutely key for parties to be able to minimise the risk of conflict and arbitration

down the line. With respect to potential pre-closing disputes, the main issue generally relates to the inability to fulfil the various conditions to closing, including, for instance, regulatory approval, or drastic changes in the situation of the business to be acquired. It is therefore key for parties to stipulate carefully-defined material adverse events clauses in order to avoid uncertainty regarding whether closing conditions are satisfied. With respect to post-closing disputes, parties may find it useful to limit exposure to claims resulting from breaches of R&W by carefully delineating the scope of potential liability under these provisions. As such, it might be advisable to include specific time limits as well as specific limits on liability. Another way to try and minimise the risk of litigation in case of conflict is to include provisions requiring parties to cooperate and exchange information regarding any claims under the transaction documents.

Bridge: Every disputes lawyer has their fair share of war stories involving terrible contractual language, so the pithy response is to say 'write better contracts'. On a more serious note, I think parties need to carefully consider how they allocate risk. Most disputes arise because something unexpected happens. So the best way to militate against bad surprises is to anticipate and plan for their eventuality at the outset. Escrow arrangements, deferred consideration or provisions for speedy resolution of technical disputes – through expert determination or the like – are common contractual mechanisms to address these risks.

CD: How common is it for M&A parties to include provisions in their transaction documentation for alternative dispute resolution (ADR), either as a preliminary or parallel step to pursuing claims in arbitration?

Bridge: Arbitration is one of the most popular forms of dispute resolution for M&A deals. Our 2022 survey of M&A transactions in Europe noted an increasing trend toward arbitration, with higher-value transactions more likely to include an arbitration clause in the documentation. That said, many of the arbitration clauses I see are 'tiered' clauses, meaning that before a party can file a request for arbitration it will need to go through at least one, if not a series, of escalating ADR procedures. For example, it may first negotiate the dispute internally at a few different levels, then undertake a mediation, and ultimately resort to arbitration if the other forms of ADR have not resolved the dispute. Of course, parties can always elect to submit an existing dispute to ADR prior to arbitration, even when the contract is silent about the ADR procedure.

Ordonez: In Europe, it is common for parties to include expert determination mechanisms in their transaction documentation in order to solve disputes involving primarily a technical and financial component. In particular, in France there is a specific procedure provided for by article 1592 of the Civil Code, with the expert decision being binding and challengeable only in case of 'manifest error'. These mechanisms may be particularly suitable in transactions with relatively complex price adjustment mechanisms, and may ensure a more efficient and diligent resolution of the dispute. With respect to other ADR mechanisms, we have seen fewer examples of contractual provisions requiring these to be implemented.

McDonnell: It is common to see ADR clauses in SPAs, either to escalate disputes to a senior level within an organisation in an attempt to resolve them, or to refer issues to mediation. It is normally a condition precedent to commencing arbitration that the ADR steps are considered. These processes can provide mixed outcomes. For example, there is a growing demand for mediation, which can be very successful in some circumstances, and many arbitral bodies also promote their own sets of mediation rules, giving parties access to experienced mediators. However, there is also a risk that these clauses are used by parties with deep pockets to further prolong the litigation process, for example by engaging in a mediation process with no real intention of reaching a settlement.

Bivens: It is fairly common for parties to agree that for any dispute that arises under an M&A agreement, one party must formally notify the other about the dispute, and as of that notification date the parties have a fixed period, often 30 days, in which the parties must try and resolve the dispute by negotiation. Only after that period can an arbitration or court claim be initiated. It is less common for parties to formally agree in the M&A agreement to mediate a dispute at that stage with a professional mediator. I think there are two reasons for that. First, businesspeople believe that if there is a commercial solution to be had, it is best achieved with the businesspeople leading the negotiations, and they do not see much use for a mediator at that point because the mediator is unlikely to fully understand the underlying commercial issues faced by the parties. Second, if parties believe a mediator could be helpful, they can always agree to mediate at any point, pre- or post-filing, and often do. If a mediation step is written into the agreement, it often takes an inordinate amount of time to effectuate that provision in practice because the party subject to the dispute can manufacture delay, both during the step of choosing the mediator and in scheduling the mediation, which can also be delayed by the mediator's schedule. As a result, the aggrieved party

with the claim can be very frustrated by the delay caused by this step, which can result in a strategic disadvantage for that party and does not help the likelihood of success of the mediation.

CD: What are your expectations for the M&A disputes landscape over the months ahead? What trends do you expect to dominate this space?

Ordonez: First and foremost, we expect ESG issues to be an increasing driver of M&A disputes in the coming months and years as actors in the field continue to focus on this issue. In fact, ESG also appears to be an increasingly important factor in M&A deals altogether, with a reported strong increase in M&A deals relating to companies prioritising ESG goals in the last few months. Second, we can also expect litigation funding to continue gaining importance in the M&A dispute landscape, as it has done across several sectors in the past few years, and is now an option considered seriously by potential claimants as it allows the financial burden of litigation to be offloaded.

Bivens: Uncertain markets give rise to disputes, so we expect we will continue to see a greater than usual number of post-closing disputes. In addition to earn out disputes, we are also seeing an increased number of disputes arise over other provisions, such as indemnities, which usually get worked out but are taking longer to resolve as parties hang on to small dollar value differences rather than settling for a middle ground. And, as a corollary to the increase in disputes over earn outs, in the pharmaceutical context, there are more disputes over contingent value rights, which are effectively securitised earn outs that are transferable and can be bought and sold. The Bristol Myers Squibb case pending in the United States District Court for the Southern District of New York is an example of that and is being closely watched.

McDonnell: The increased use of W&I insurance is likely to become increasingly dominant in M&A disputes. These policies will typically have arbitration clauses and we expect that the involvement of experienced insurers as counterparties to these claims is likely to generate more arbitration in this area. We are also seeing an increase in synthetic W&I policies where sellers may be hesitant or, in sales of insolvent companies, simply unable to get a full suite of warranty coverage that would typically be expected by a purchaser. In such circumstances the warranties are not given by the sellers but separately negotiated between the purchaser and the insurer and therefore are not even set out in the SPA. While such synthetic policies were historically seen as slower to implement and more expensive, the

market is maturing significantly and reducing such disadvantages.

Bridge: Anytime that there is economic or political uncertainty, we see an increase in disputes. M&A disputes follow this same general trend. The current economic and political uncertainty, particularly in the EMEA region, will likely lead to an increase in disputes in several areas. First, given the economy, I expect to see an increase in disputes involving post-completion price adjustments. Second, I consider that W&I claims will continue to increase as, like price adjustment claims, they are another avenue for a buyer to try to reduce the purchase price. Third, I predict an increase in earn out disputes. Finally, I think we will continue to see an increase in parties seeking to avoid completing transactions based upon material adverse change claims if that is their last resort and the deal is no longer commercially viable. CD