

Arbitration of International M&A Disputes



Bernd Ehle



Matthias Scherer

This article focuses on international arbitration in M&A disputes, its advantages, its effects and its procedural particularities

Bernd Ehle

LALIVE
Geneva, Switzerland
Email: behle@lalive.ch

Matthias Scherer

LALIVE
Geneva, Switzerland
Email: mscherer@lalive.ch

Introduction

Mergers and acquisitions ('M&A') are complex business transactions, in particular when they take place cross-border. They typically involve numerous corporate entities and lengthy, multifaceted agreements. As there is a multitude of specific problems and complications related to M&A transactions, it is inevitable that some deals result in disputes; all the more so since there is usually a considerable amount of money at stake.¹

Arbitration has indeed emerged as the preferred method to resolve M&A related disputes, and today M&A is one of the fields of international business law with the highest proportion of arbitration agreements.²

Advantages of Arbitration in M&A Disputes

Practice has shown that today, parties almost invariably agree on arbitration for the resolution of their disputes arising out of M&A.³ Besides the more general arguments that speak in favor of arbitration (such as flexibility and finality of the arbitral award), there are a number of advantages which are of particular importance in the M&A context, especially when compared to state court litigation:

1 The parties have the right to choose their own

arbitrators. Dealing with M&A disputes often means dealing with complicated valuation and accounting issues. The persons who decide the dispute must be knowledgeable about the industry and economic matters. State court judges may not always be qualified in this respect.⁴

- 2 Parties to an M&A deal usually strive to keep the fact of their dispute discreet and thus avoid publicity. They are also anxious to safeguard any confidential information *vis-à-vis* competitors.⁵ Before state courts, confidentiality is not assured.
- 3 In disputes arising out of international transactions, it is important that the parties are free to choose the language of the proceedings. Court proceedings will invariably require the use of local language, whereas arbitration leaves room for the parties' discretion.⁶
- 4 Arbitrations often take place in a more amicable and business-like manner than litigation before state courts. Moreover, because economic aspects play a more central role, they frequently result in settlements.⁷

Arbitration at Various Stages of M&A Transactions

The following section gives an overview, as well as a few practical examples, of the stages in mergers and acquisitions at which disputes may and do occur.

The Negotiation Stage: Pre-closing Disputes

M&A transactions usually begin with initial exploratory talks, an information memorandum, the signing of preliminary agreements and a negotiation phase which include due diligence investigations and discussions about the framework for the transaction.

Memorandum of Understanding or Letter of Intent
Once the parties agree on the essential terms of the transaction, they typically wish to draw up and sign a Memorandum of Understanding ('MOU') or a Letter of Intent in which they outline the envisaged deal structure. Such 'pre-contracts' are often identified expressly as non-binding, but may create a quasi legal relationship which imposes certain obligations upon the parties, namely the duty to negotiate and act in good faith. Non-compliance with such duty may give rise to a dispute,⁸ and may cause the deal-makers to consult their lawyers in particular on the binding nature of their 'agreement' and on how to enforce any obligation of the other party at that stage of the negotiations.

In order for such disputes to be resolved by means of arbitration, the MOU or the Letter of Intent needs to contain an arbitration agreement, which is not invariably the case. Alternatively, the parties may agree to submit the dispute to arbitration after it has arisen.

Confidentiality and exclusivity agreements
MOU and Letter of Intent typically comprise agreements on a period of exclusive negotiations between the parties and on confidentiality regarding both the fact of the negotiations and the information that is being exchanged, in particular during the due diligence and in particular if the potential buyer is a competitor. Such clauses are often linked to contractual penalties and, typically, disputes will revolve around the aggrieved party's right to ask for damages or rapid injunctive relief.

Due diligence

The outcome of any due diligence is critical to the parties' further negotiations and generally has far-reaching consequences for the deal. The due diligence process therefore frequently gives rise to disputes. The most common area of controversy is the scope of the pre-contractual duties of disclosure of the seller. Questions that may arise concern the completeness of the information provided by the seller in the data room and the obligation of the seller to disclose certain sensitive information or difficulties at that early stage, without having been expressly asked to do so by the buyer.

The Post-Closing Stage: Disputes Arising from Merger/Purchase Agreements

Most M&A disputes arise after closing, *ie*, after the parties have signed the merger or purchase agreement and transferred the assets.⁹

Representations and warranties

Post-M&A arbitrations frequently result from claims of the buyer based on contractual representations and warranties. Many of the seller's representations about the target company

concern the correctness of its financial statements, the absence of liabilities other than those reflected in its latest balance sheet, the seller's title to the assets and compliance with applicable laws.¹⁰

An important source of disputes are ambiguous or incomplete representations and warranties which allow the buyer to easily claim that the seller is liable for breach of contract or misrepresentation. On the other hand, the seller may ask that certain claims be excluded by reference to independent assessments made by the purchaser or its knowledge gained in the due diligence process. If representations and warranties turn out to be inaccurate, *eg* certain assets on the balance sheet are inexistent or over-valued, the purchaser will claim damages or an adjustment of the price.¹¹ Disputes may also arise over representations as to pending or threatened litigation.¹²

Earn-out clauses—Price adjustment

Purchase agreements often provide for a provisional price combined with an 'open-ended' adjustment mechanism. The most common post-M&A disputes, by far, relate to earn-out provisions and purchase price adjustment calculations.

Earn-out clauses provide for an additional purchase price that the seller will receive, based upon the future earnings of the target over a stipulated period (earn-out period). Unsurprisingly, such clauses frequently end up being a bone of contention between the parties when the future performance does not meet the buyer's expectation.

Purchase price adjustment clauses may provide for an adjustment mechanism based upon a change in a specified benchmark, such as the net asset value of the target company, between the date of the financial statements that were used to negotiate the purchase price and the closing balance sheet upon which the purchase price is ultimately determined.¹³ The following recent example demonstrates the kind of complications that can originate from purchase price adjustment clauses.

In an international arbitration administered by the Zurich Chamber of Commerce under a contract subject to German law, the claimant company had sold its shares in the defendant company to the defendant and its holding company. The defendant then changed its articles of association and increased its share capital by issuing new shares to a third company. The arbitral tribunal was required to interpret the price increase clause included in the share purchase agreement. It ruled that, although the clause did not expressly cover the increase of share capital, such increase nevertheless constituted a betterment that came under the scope of application of the price increase clause. Consequently, the arbitral tribunal ordered the defendants to pay additional amounts on the purchase price plus interest to the claimant. The defendants' motion to set the award aside was

