Tailor-Made—Unique Dispute Resolution Clauses in M&A Agreements

By Richard Hall and Matthias M. Pitkowitz

I. Introduction

Some of the largest and most heavily negotiated M&A agreements sometimes, if not frequently, find their way into court. Curiously, during the negotiation of these agreements, comparatively little attention normally is paid to the mechanisms governing such disputes. The dispute resolution clause used in earlier deals—whatever its choice of judicial or arbitral forum—frequently remains untouched, or is only lightly negotiated.

Given the frequency of disputes, it is problematic for counsel not to consider their clients' interests in negotiating these dispute resolution clauses. It is also odd, given that M&A lawyers are very familiar with the idea of finely tuning each M&A agreement to achieve optimal outcomes. Because this is an issue at the border of corporate law and litigation, the overspecialization of counsel is likely one of the causes of the failure to consider these clauses in the M&A agreement. Another explanation may be inertia: why would anybody spend time on negotiating—what currently appear to be—boilerplate provisions, especially if a significant risk of error may be involved?

But not everyone is sitting tight. Parties have already discovered some value behind toying with dispute resolution provisions. For example, it is now standard to include accounting expert arbitration clauses governing disputes relating only to purchase price adjustments.[1] Similarly, some parties have carved out disputes over escrow and other provisions to be decided by an arbitral tribunal.[2] Additionally, experienced disputes practitioners, including those in international arbitration and litigation practices at major law firms, often advise their corporate colleagues on dispute resolution clauses in pending deals. But the idea has yet to catch on in the wider M&A community. This article will argue that the use of clearly delineated and innovatively structured dispute resolution mechanisms (DRMs) specifically tailored to address various types of likely disputes would more effectively resolve disputes between the parties.

II. One Size Does Not Fit All

An analysis of recent U.S. M&A agreements shows that the main area of focus for parties addressing dispute resolution in their agreements is to decide on the inclusion of a **choice of forum** clause (included in 80% of public deals and 73% of private deals), a **choice of law** clause (in 100% of deals; Delaware law in 55% of public deals and 22% of private deals), or an **arbitration clause** for the entire agreement (2% of public deals, 20% of private deals).[3] The chosen DRM, be it litigation or arbitration, will generally apply to the entire agreement (other than to any purchase price adjustment dispute), without any particular regard to the suitability of such mechanism for the substantive issue in dispute or the properties of the dispute itself. This assumes that the chosen DRM fits all shapes and sizes of disputes.

This, however, is unlikely to be an accurate or beneficial assumption. Disputes arising out of different clauses in the agreement will have different **characteristics**, which will likely be addressed with varying degrees of effectiveness by different DRMs. A tailor-made DRM seems needed. Arbitration may prove to be the better option for the resolution of more disputes that are currently sent to arbitration.

III. Tailoring DRMs

To overcome the one-size-fits-all-treatment, we encourage parties to take the following steps to more efficiently tailor the dispute resolution process to their needs. First, parties should **identify likely disputes** arising out of their M&A agreement and specific provisions therein and the characteristics of these likely disputes (*see* Section III.A. below). Second, parties should think about **suitable DRMs** to address each of the identified disputes (*see* Section III.B. below).

In the following, we look at some of the most frequent disputes arising in both public and private M&A transactions as well as the likely interests of each party in these disputes, with the goal of highlighting how certain issues could be more effectively addressed in the dispute resolution clause(s).

A. Most Likely Disputes and Their Characteristics

When seeking to identify likely disputes, parties should consider the following questions: What are the most likely remedies sought in the dispute? Is the client going to be the plaintiff or the defendant? Does the client want speedy resolution? What is nature of the claims? Below is an account of likely disputes for typical M&A transactions and potential implications for DRMs.

1. Public M&A

In public M&A transactions, disputes are most likely to relate to a failure to close the transaction or to the lack of compliance with deal protection provisions. In both instances the remedy is non-monetary. In disputes arising out of a party's **failure to close**, the likely plaintiff will be the target, seeking specific performance against a buyer allegedly suffering from "buyer's remorse." The plaintiff target will have an interest in having the dispute addressed with extreme speed—both to enforce the deal and to increase its leverage in negotiations that likely are running in parallel to the legal proceedings. Seventh-three

percent of U.S. public M&A agreements[4] contain a *contractual* provision explicitly providing for the remedy of specific performance[5] to force the buyer to close the transaction.[6] Disputes will typically be fact specific.

The other likely dispute arising in public M&A is over a party's non-compliance with **deal protection** provisions. Deal protection provisions are designed to ensure that there are no interferences from unsolicited bidders. Typical deal protection provisions include "no-shop" provisions (preventing the target from soliciting interest of other prospective bidders), "no-talk" provisions (preventing the target from negotiating with other bidders once approached), termination provisions (permitting the target to terminate the acquisition agreement to pursue a superior proposal),[7] a stock option to acquire a certain percentage of the target's stock,[8] an option to acquire some of the target's most valuable assets for a steep discount if the agreement is terminated[9] and a termination fee (typically between 3% and 5% of the target's market value). The acquiror will be the likely plaintiff in such disputes and both parties will want to resolve them very quickly. The remedy sought by the acquiror will be for injunctive relief or specific performance.

2. Private M&A

In private M&A transactions, disputes are most likely to arise in connection with purchase price adjustments (PPA) or earn-outs, post-closing non-compete or non-solicit claims, post-closing indemnity / representations and warranties claims or a failure to close.

Private M&A transactions often include a mechanism to adjust the purchase price after signing or, in the case of earn-outs, making payments contingent on post-closing performance, to account for changes in the acquired company's balance sheet or performance between signing and closing and thereby avoid giving the buyer or seller a windfall.[10] In disputes over PPAs, the acquiror is the likely plaintiff, seeking to make adjustments to the balance sheet. In earn-out disputes, the seller will be the likely plaintiff. Disputes will likely be as to the correct application of accounting principles to relatively settled facts, which is why accountants are frequently involved in the resolution of these disputes. As noted above, it is quite customary for PPAs and earn-outs to have their own, separate DRM, with the accounting issues set aside for accountants and other issues sometimes already reserved for other DRMs.[11]

Non-compete and **non-solicit** covenants restrict the seller from competing with the target or the acquired business and from soliciting employees and customers of the target company or the acquiror, respectively, for a certain period of time after closing in order to protect the underlying value of the transaction. The most likely plaintiff is the acquiror trying to enforce the covenant restrictions imposed on the seller. The plaintiff acquiror usually wants matters resolved with speed and the likely remedy will be non-monetary (preliminary injunction).

In disputes involving post-closing **indemnity provisions** or **representations and warranties**, the remedy sought by the plaintiff, namely the acquiror, will be for monetary damages due to breach of a representation or warranty, or the applicability of an indemnification provision, issues as to which an arbitrator is well suited.

A **failure to close** by the buyer will involve substantially similar issues as those discussed under Section II.A. above.

B. Finding a Suitable DRM

To identify suitable DRMs available to parties to resolve the disputes identified in the process described above, parties should consider the following:

- Most importantly, location of assets and need to nationally or internationally enforce decisions
- The need for an agile and speedy adjudication of the dispute
- Desire for speedy resolution of monetary disputes
- The need for precedent
- Benefits of confidentiality
- Involvement of third parties (shareholders, financing sources) that have key interests in the dispute
- Efficacy of grant of needed injunctive relief
- Ability to select adjudicator with knowledge of substantive law / expertise in certain area.

IV. Creating More Efficient Dispute Resolution Clauses

All the foregoing suggests that M&A lawyers should move beyond the simple "accounting expert for PPAs and court proceedings for everything else" to consider the introduction of several DRMs into the same agreement, including the greater use of arbitration, sending disputes arising out of different clauses or certain types of disputes to different decision-making bodies where the disputes likely to arise call for such delineation. To make sure that each of these DRMs can operate at its full intended scope and capacity, a few principles should be followed to ensure that multiple DRMs do not interfere with each other. Thus, each DRM should be **simple**, clearly **delineated** from others and create the right **incentives**. A "simple" DRM will be less likely to be misconstrued even if looked at by different decision-making bodies; "clear delineation" will help avoid disputes about the applicable DRM, reducing the risk of disagreement over which decision-making body should hear the case; a look at the "incentive structure" created by the DRM will help avoid unintended issues. Furthermore, parties should weigh the risks and efficiency implications associated with including several, individualized DRMs against those of a unitary dispute resolution clause in the agreement. Only if the rewards outweigh the risks should multiple DRMs be included in the M&A agreement.

A. A Bifurcated Dispute Resolution Clause (Pre-Closing versus Post-Closing)

One possible mechanism is to send all pre-closing disputes to a specified court (for example, the Delaware Chancery Court) and all post-closing disputes to an alternative forum. This bifurcated DRM would comply with all three DRM principles, with particular advantages when it comes to clear delineation.

Aggregating the information discussed above, **pre-closing** disputes are likely to have one or both parties seeking to resolve the dispute with extreme speed. Most likely, pre-closing disputes (failure to close, non-compliance with deal protection provisions) will be addressed through injunctive relief / specific performance, and rarely through damages. This article is not an adequate place to consider as a general matter the relative speed and reliability of court versus arbitration. Suffice it to say, however, that most U.S. M&A lawyers would—given reputation for speed, reliability and transparency—rather trust the courts and especially the Delaware Chancery Court in such cases. All things considered, it seems reasonable to allocate all pre-closing disputes to the courts.

Post-closing disputes (PPAs, non-compete or indemnity / breach of R&W), on the other hand, are more likely to be for monetary damages (in two out of three cases) and less likely to require injunctive relief. Structured properly, parties may benefit from sending these post-closing disputes to an alternative forum such as arbitration. Generally speaking, arbitration has many advantages, including, for example, confidentiality of proceedings or the award; ability to appoint expert arbitrators knowledgeable not only in the applicable law, but also in a particular industry or sector in which the signatories operate, who are familiar with the economics of the deal or even the nature of contract negotiations between parties in similar M&A transactions; ability to choose internationally neutral arbitrators, procedures and rules[12] (which may be particularly appealing to non-U.S. parties or U.S. parties who would otherwise be subjected to the jurisdiction of a foreign court); the ability to avoid creating legal precedent; and the ability to limit access to discovery, punitive damages as well as fees and expenses.

In addition, there may be advantages to **including an arbitration clause** even in a heavily arbitration-resistant area like **public M&A**, where an arbitration clause is currently included in only 2% of deals.[13] Arbitration should be seriously considered in all transactions where cross border enforcement is likely because arbitration promises simplified **international enforcement** of the award. Once rendered, an "award will be directly enforceable by court action, both nationally and internationally."[14] International treaties governing the recognition and judicial enforcement of arbitral awards (such as the New York convention[15]) are widely accepted around the world, making enforcement faster and easier than that of court decisions, for the enforcement of which only few reciprocal treaties exist.[16] All this may be especially beneficial in typical post-closing disputes.

B. Clause-by-Clause Allocation

Another model could be to assign disputes over specific clauses to specific DRMs, or specific clauses to one DRM and 'everything else' to the default DRM. This probably would create a greater issue of delineation, particularly if one considers the implications of counterclaims. We note, however, that the frequently used allocation of "PPAs to accountant-arbitrators, everything else to court" largely follows this model, and the history of disputes over "who should decide what" in this area is limited.[17] The risk of such disputes can be reduced by clearly defining the scope of each DRM—with the possibility of introducing an overarching DRM covering only disputes relating to the scope of all other DRMs.

C. Split Remedy

Yet another possible model would be to split remedies themselves into different DRMs. For example, equitable remedies could be addressed by the courts, remedies at law by an arbitral tribunal. This approach has the benefit that all requests for equitable remedies, whether pre- or post-closing, could be heard by speedy courts with enforcement powers (keeping in mind that the rules of many renowned arbitration institutions now provide for emergency arbitration, which can significantly speed up equitable relief in arbitration). This approach may, however, raise delineation issues because not all courts may trust the contractual stipulation by the parties that conventional damages will not be adequate (as Delaware courts readily do in requests for specific performance[18]), raising the question of whether the court would deny its own jurisdiction once it decides that it would want to award a remedy at law, or would find that it is itself competent deciding on this remedy. Similarly, delineation would suffer as it is unclear how courts and tribunals would react if a plaintiff sought both remedies simultaneously and if permanent rather than just interim relief is sought in court, pursuit of claims in both forums simultaneously may lead to inconsistent results. Parties would have to weigh the risk associated with this approach against the gains of having each remedy heard by the forum they prefer.

Although this third model at first sight seems unattractive because of the delineation question, we do note the implicit parallel with the very common selection of "Delaware courts" as the exclusive forum. From any perspective, the Delaware Court of Chancery, the Delaware State Superior Court and the Delaware Federal District Court are very different—all of which could be the competent forum under the general Delaware choice of forum clause. There is a history of forum litigation among parties to contracts with Delaware forum clauses based on the remedy sought.

D. Forum Shopping Clause

An M&A agreement could provide both a choice of forum clause as well as an arbitration clause. Disputing parties could be given the choice between either mechanism, but once one mechanism is selected—by one party filing a claim—the other mechanism would be automatically excluded (either perpetually or only for the specific claim brought—although the latter will likely cause conflicts with the principle of delineation).

Given the fairly wide variety of claims possible after closing, it may be efficient to give parties a choice between both mechanisms and let them select the most favorable judicial or arbitral forum for their dispute. The principles of delineation and proper incentivization might be negatively affected by (frivolous) forum-defining preemptive claims by the likely defendant. The arguably limited risk of such frivolous claims (and related enforcement issues outside of the U.S.) should be weighed against the benefits of having available a choice of several forums. While fairly complex, this structure—if finely tuned to the particular situation of the parties—could enable the plaintiff to choose the most efficient forum for a specific claim at the time a dispute arises.[19]

V. Conclusion

As the examples above indicate, the structure—and success—of most non-standard DRMs will depend heavily on the specific situation of the parties. It is arguably an onerous task to make a point for individualized dispute resolution clauses in this article by providing examples based on sweeping generalizations. Yet, guided by the principles outlined in this article, parties and their counsel will find considering alternatives to boilerplate language on a case-by-case basis to be a valuable exercise. This could potentially lead to a more careful selection of DRMs, a more thoughtful choice between court and arbitration and, consequently, to a more efficient dispute resolution process.

Endnotes

1. Such clauses are included in 25% of public M&A deals and in 89% of private M&A deals in the U.S. *See* Cogan, *Managing Disputes Through Contract: Evidence from M&A*, 2 Harv. Bus. L. Rev. 23 (forthcoming 2012).
2. *See, for example*, the arbitration clause in Section 9.07 of Merger Agreement dated as of December 21, 2010, among Teradata Corporation, Aprimo, Inc. and TDC Merger Sub, Inc.
3. Cogan, *Managing Disputes Through Contract: Evidence from M&A*, *2* Harv. Bus. L. Rev. 23 (forthcoming 2012).
4. *Id.*
5. *See, for example: United Rentals, Inc. v. Ram Holdings, Inc.*, 937 A.2d 810 (Del. Ch. 2007); *True North Communications Inc. v. Publicis, S.A.*, 711 A.2d 34, 44 *et seq.* (Del. Ch. 1997), *aff'd*, 705 A.2d 244 (Del.1997).
6. Another, even if not quite as popular an option, is the selection of liquidated damages (termination fee) as a contractual remedy. Whether specific performance or damages is the preferred remedy in a contract should depend on the parties' expectation of the concerns of the relative importance of a tendency for underperformance arising from money damages versus increased renegotiation costs and potential for overperformance with specific performance. *See* Yair Listokin, *The Empirical Case for Specific Performance: Evidence from the IBP-Tyson Litigation*, Yale Law School Legal Scholarship Repository 470 (2005).
7. Sean J. Griffith, *Deal Protection Provisions in the Last Period of Play*, 71 Fordham L. Rev. 1899, 1901 (2003).
8. Kimberly J. Burgess, *Gaining Perspective: Directors' Duties in the Context of No-Shop and No-Talk Provisions in Merger Agreements*, 2001 Colum. Bus. L. Rev. 431 (2001).
9. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 (Del. 1986).
10. David Herrington / Jerilin Buzzetta, *Purchase Price Accounting Arbitration: Why Courts Sometimes Find That Disputes About Purchase Price Are Not Subject To Purchase Price Arbitration*, 26-10 Mealey's International Arb. Rep. 16 (2011).
11. See discussion in *Viacom Int'l, Inc. v. Winshall*, Civ. No. 7149-CS (Del. Aug. 9, 2012) on whether the Resolution Accountants selected to resolve Earn-Out disputes were acting as arbitrators or experts, given that § 2.4(c) of the Merger Agreement specifically provided that they "shall be deemed to be acting as experts and not as arbitrators." The court found that the Resolution Accountants were acting as arbitrators as defined in the FAA, independent of nomenclature in the Merger Agreement ("I do not accept Viacom's argument that I should conclude that the Resolution Accountants had less authority because they did not go to law school").
12. Gary B. Born, International Commercial Arbitration 73 (Volume I, 2009).
13. Cogan, *Managing Disputes Through Contract: Evidence from M&A*, 2 Harv. Bus. L. Rev. 23 (forthcoming 2012).
14. Nigel Blackaby et al. in Redfern and Hunter on International Arbitration 1.92 (2009).
15. Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958.
16. The Hague Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters would, if successfully ratified by sufficient signatories, create an effective enforcement framework for court judgments. *See also* Nigel Blackaby *et al.* in Redfern and Hunter on International Arbitration 1.93 (2009). However, this treaty has not yet been ratified by many countries.
17. *But see Viacom Int'l, Inc. v. Winshall*, Civ. No. 7149-CS (Del. Aug. 9, 2012); *HDS Inv. Holding Inc. v. Home Depot, Inc.*, Not Reported in A.2d (2008).
18. Compare, for example, *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (2008).
19. Note that particular care should be taken if the choice is given to only one party to ensure enforceability of the arbitration option in the likely jurisdictions.

Richard Hall, RHall@cravath.com, is a partner at Cravath, Swaine & Moore LLP and the Practice Leader of the Firm's Mergers and Acquisitions practice. Mr. Hall's practice focuses on mergers and acquisitions, particularly in the international arena and natural resources sector, and corporate governance advice. He has also advised in the areas of unsolicited activity, takeover defense and in general corporate matters.

Dr. Matthias M. Pitkowitz, MPitkowitz@cravath.com, is a corporate associate at Cravath, Swaine & Moore LLP where he advises clients on a diverse range of corporate matters. Dr. Pitkowitz is the founder and an organizer of the annual Columbia Arbitration Day at Columbia Law School and is a member of the International Commercial Disputes Committee of the New York City Bar Association.