Cross-border M&A Disputes

When I was asked by the editor of *Arbitration.ru* to prepare an article on cross-border M&A disputes, I hesitated to accept. I have been advising on M&A transactions for most of my long career, in London and in Moscow, so what made me hesitate?

Much of the information about cross-border M&A deals and disputes is private and highly confidential. Many deals are not announced, particularly if none of the parties involved is subject to public disclosure requirements. Many disputes go to arbitration which is confidential. It is different with public company takeovers on internationally accessible stock exchanges but most of these are not very relevant for the Russian market. The best legal know-how tends to be protected within the confines of international law firms. It is different with public company takeovers on internationally accessible stock exchanges, but these are not very relevant for the Russian market. There are some published works on M&A of varying weightiness, but most focus on how to do the deals and relatively few on disputes. Of course, I could rely on my own knowledge and experience, but to prepare a piece for this kind of publication I felt I needed to be able to support it from external sources. I quickly began to realize why the editor asked me to do the piece - because it is not easy.

Fortunately, I have been able to find a few appropriate sources, so here goes. I would point out, however, that an important factor which makes possible generalisation about M&A disputes is the availability of warranties and indemnities (**W&I**) insurance (sometimes called representations and warranties – R&W – insurance) in recent years, so that there are claims records.

In the interest of keeping this article reasonably short, I will present only an outline of the main areas of dispute. I will not deal with public company M&A for the above-indicated reason or with any very specialist subject peculiar to a particular jurisdiction such as Delaware disclosure requirements. A wide range of common law and civil law jurisdictions are potentially involved. I shall therefore focus on general issues relating to the kind of transaction usually governed by a sale and purchase agreement (**SPA**) for the whole outstanding capital of a target company. I will not deal with partial acquisitions or joint ventures which might be governed (in addition to an SPA or Subscription Agreement) by e.g. a Shareholders Agreement or a Joint Venture Agreement).

Timing – pre-completion, interim period and post-completion

Pre-completion and interim period

Before signature of a deal, there is usually no binding legal relationship between the parties except, in many cases, a confidentiality or non-disclosure agreement. This sometimes provides also for an exclusivity period which gives the prospective buyer negotiating rights and possibly entitlement to a break fee if the deal is abortive. If the exclusivity period expiries without a deal being done, the break fee, if there is one, could become contentious. If it looks like the prospective buyer will not ultimately make a binding offer, the seller may look around again before the end of the exclusively period and have an awkward situation to manage if another potential buyer is interested. However, usually these issues are settled between the parties without going to dispute resolution.

A more common area for disputes if no deal is agreed may be with the seller's financial adviser, often an international investment bank or M&A boutique. The financial adviser is usually remunerated by a relatively small *per diem* fee and a large success fee if the deal materialises. What happens if the financial adviser's exclusivity expires but a deal materialises afterwards with one of the buyers introduced by the adviser? Such matters rarely go to court or arbitration, but I can attest from experience that they do arise and financial advisers do consider taking action.

In some jurisdictions there can be obligations imposed by law to act in good faith in a pre-contractual situation. The nature of the good faith obligation and consequences of breach depend on the jurisdiction concerned, and part of the job of the prospective buyer's lawyers is to advise on how to avoid or minimise the risks. There are also jurisdictions where the parties need to take care that pre-contractual exchanges such as a term sheet do not in some way become legally binding.

Where a deal is signed and there is a gap between contract and completion – usually because of need to obtain regulatory or board approvals – there may be an issue as to whether adequate efforts were made to obtain the approval(s). There can also be an issue over conduct of the company's affairs during the interim period while the seller remains in control – the deal documentation will usually cover this, but there can be a problematic situation if something unexpected arises. Again, claim for the interim period are rare – if there is a problem it is much more likely to come up post-completion when the interim period conduct may be part of the issue.

The most obvious situation in which a dispute may arise would be if a deal is signed but not completed. In most cases, there is a reason, such as a condition not being met, of which both parties are aware and accept as being unfulfilled without consequences. However, there can be contentious issues particularly if the drafting is unclear or ambiguous. If the SPA contains a "Material Adverse Change" provision and a messy adverse situation arises during the interim period, there may be scope for dispute as to whether the situation does or does not fit within the wording (which may have been negotiated heavily and, as a result, not be as clear as might have been desirable). Again, most such matters are settled between the parties and rarely reach the stage of formal proceedings.

Post-completion

Most claims arise after completion. It is, of course, only after completion that the buyer is in control of the acquired company and able to evaluate it directly and in detail on a day-to-day basis. Also, if the buyer feels that it has overpaid – or otherwise suffers buyer's remorse – it may try to claw back some of the price it has paid through post-completion claims.

If there is a holdback or escrow arrangement, then the amounts concerned may become vulnerable. One of the reasons W&I insurance has become popular in recent years is that it helps to avoid or minimise the need for such devices.

Price disputes

In many transactions, the price is clearly expressed in the SPA and is payable on completion. However, where there may be variations (or potential variations) in the target company's performance before completion which are material to the pricing (e.g. where pricing is based on a multiple of earnings in the period to completion), the parties may agree on an overall figure but it may only be practical to evaluate performance fully and arrive at the final price with hindsight.

Completion Accounts

One of the most common ways of dealing with this is for the SPA to provide for a set of completion accounts to be prepared and verified after completion, when full information of the position as at the completion date is available. The SPA will then usually provide a detailed basis on which the completion accounts are to be prepared. A popular approach is to use a so-called "debt free, cash free" basis because it has the advantage for the seller of making it easier to compare competing bids. However, despite the relatively simple phrase, there are often complex factors to be considered requiring careful drafting and, as always in such situations, the devil is in the detail. Deep understanding of accounting conventions and practices may be required on the part of the draftsman. In cross-border transactions, there may be differences in approach between the parties arising from their respective national backgrounds, and it may be essential for international accounting firms to be engaged by both sides in order to bridge these. Nonetheless, and despite everyone's best efforts there may be scope for misunderstanding which persists even after completion.

In most cases, the parties themselves, together with their respective accountancy advisers, will be able to settle the completion accounts. If not, the SPA usually provides for expert resolution of any dispute. It is rare for lawyers to get involved, but if there are ambiguities in the wording of the SPA, the parties may end up in proceedings. There can be issues as to the arbitrability of the dispute if expert determination is the primary mechanism for resolution.

Locked Box

In recent years, the “locked box” mechanism has often been used instead of completion accounts in order to reduce the scope for post-completion disputes. With the locked box approach, a date is chosen (often one which coincides with the date of the last full audit) for the pricing valuation, with completion taking place long enough afterwards for the parties to have fully got to grips with the accounts as at the valuation date and agreed the price, with no need to reopen it afterwards. This reduces the prospect for disputes as there is then only the period between the valuation date and completion to be reviewed afterwards. Often the SPA contains provisions to avoid “leakage” and other possible upsets to the “locked box” package.

This does not mean the scope for disputes has been eliminated entirely, particularly if the period between the valuation date and completion is relatively long. Indeed, if the pre-contractual negotiations are prolonged so that the next audit date gets close, the parties may consider postponing the valuation date till afterwards and using the fresh audit numbers. However, in practice, having negotiated for so long based on the previous set of figures the parties may be reluctant to start all over again.

In a country like Russia there is often a need for anti-monopoly approval (and sometimes other consents) after finalisation of the SPA, delay may not be wholly avoidable.

Earn-out

In some deals the focus is less on the past and more on the future, the initial purchase price being relatively low and the buyer undertaking to pay additional amounts to the seller after completion depending on the target company’s performance or, sometimes, if there is an on-sale of the company at a higher price. The team in control of the company after completion may be tempted to use techniques that reduce the profits during the earn-out period but will deliver for them when the erstwhile owner is out of the picture. It can sometimes be difficult to determine and prove (to the relevant legal standard) what the problem is, in others it may be more obvious. Again, the devil is often in the detailed drafting of the SPA. There was an English case which turned on an anti-avoidance provision that did not necessarily envisage the specific behaviour or technique used but which proved to be effective in court.

Other disputatious pricing issues

If there is a squeeze-out of minority shareholders or an ongoing joint venture with pre-emption provisions or put/call options, there may also be disputes over pricing. As previously indicated, these issues are beyond the scope of this article - I am just noting that they can arise.

Representations, warranties and indemnities – and fraud

Legal practice in the UK and the US and that of other common law jurisdictions long ago established the practice of including (in the body of the SPA or in an attachment) a long list of assurances in the form of representations, warranties and indemnities, subject to the disclosures in the disclosure letter. The practice has been modified in recent years to include only warranties and indemnities. This has arisen partly because it became so common to provide that the contract could not be rescinded for misrepresentation that the point of including representations was to a significant extent lost.

Other legal systems often also make a similar distinction between statements which, if untrue, should give the buyer rights to be put back into the position it was in before entering into the transaction and others give rise only to a right to damages. In cases where the first remedy is provided for in the drafting, it is often, in practice, not possible to go back to square one – once the company is transferred to the new owner it may be changed in such a way that giving it back is not feasible or appropriate. In such cases, the legal system usually provides that damages should be paid instead.

In practice, many civil law jurisdictions have evolved to provide warranties and indemnities, with similar effects as in common law systems.

However, fraud, if it occurs, is usually treated as an exceptional situation in most jurisdictions, and it is not usually possible to contract out of liability for fraud, including fraudulent misrepresentation.

Fraud is often difficult to prove because, of its nature, it is hard to detect. Also, the primary focus of the parties during the negotiation of the SPA is usually on civil remedies. Although there are civil law remedies for fraud, it is also usually a criminal offense in most countries, and therefore the burden of proof is, in practice, usually high even in a civil case.

Many a dispute has arisen out of the information provided and statements made to the buyer in the due diligence phase or afterwards or from the way the information was presented – for example in the way that the accounts have been prepared or that relationships with customers have been presented. It may involve giving false information but can also include failing to give information or failing to correct information which was (or was thought to be) correct when given. There are also, in many systems, opinions or forward-looking statements are treated differently than statements of fact.

Because so many M&A disputes are settled and others arbitrated without public disclosure, it has in the past been difficult in the past to develop any kind of reliable feel for which areas most give rise to the most claims.

However, AIG, the insurance company, has for a few years now been publishing an annual report of its claims experience with W&I insurance. The 2019 report indicates that they had claims on approximately 20 per cent of their policies issued and, of these, "severe" claims (over $10 million) on 19% of the claims received.

According to the AIG report relating to its international experience, the most common ground for claims -19% of the total – concerned financial statements. Given the focus of buyers and sellers on the financial statements (as indicated above in the discussion of price disputes) this is hardly surprising. Financial statements aggregate financial information and often provide only limited detail. There is an understandable tendency by the in-house accounting team preparing the accounts to try to present them in the best light to impress management. Indeed, in the run-up to many private company M&A deals, the staff of the company do not know of the prospective sale in advance and the management are at pains for them not to find out because of the potential impact on morale within the company. This can make it difficult for the management themselves to get to grips with the information or for the seller of the target company shares to get access to the information. There may, of course, be instances of the books being "cooked" in a more malevolent way, but, as with fraud, it is often difficult to prove a malevolent motive. Of course, this begs questions about the role of the auditors generally which is controversial in many "Western" countries currently.

Another big area for claims is tax – 18% of the total, mainly corporate income tax and employee and sales taxes. Again, this is hardly surprising. In many countries, the tax authorities have a long period in which they can claim for unpaid tax – six years is common. This inevitably introduces a degree of uncertainly into the financial affairs of any company which has not recently had a tax audit. The accounting staff, auditors and advisers of the target may be doing a conscientious job of providing for the tax liabilities they van foresee, but it happens not infrequently that when the tax inspectors review the same financial records during their tax audit they look at them from a different angle and see things that are not apparent to the staff and others involved on behalf of the company.

A third major area for claims is compliance with laws – 15%. This mainly affects regulated sectors such as health and pharma and financial services, but regulation applies to a wide range of businesses. Again, there are can be malevolence involved, but in most cases the problem is not of that level.

These three areas take up 53% of the pie chart. Material contracts take up another 13% and the remainder consists of employee-related, intellectual property, litigation, operations-related, environmental and fundamentals (e.g. good title). It surprises me that litigation is only 7% but that may just indicate that sellers have good appreciation of their disputes and are also good at imparting the information to their buyers.

Measure of damages

In most jurisdictions, it is accepted in respect of a warranty claim that the measure of loss is the difference between the value of the shares as warranted and their true value. However, this can be

difficult to determine in markets which are illiquid or in which there is only limited liquidity (or little comparability between companies even in the same market sector). This usually requires expert evidence, but in such circumstances, it can be difficult to find suitable experts or to compare their evidence, and this in turn makes presentation (and, for the judge or arbitrator, evaluation) of the expert evidence difficult.

There may also be issues over the basis for valuation. There is a world of difference between asset value which may be relevant for deals based on asset value and those based on a multiple of income (EBIT or EBITDA). Determining what basis for valuation is appropriate is often at issue an M&A dispute. In some business sectors there are standard methods of valuation but other there may be widely different approaches to valuation even in the same industry or service sector, The SPA may or may not give indications, and, if it does, interpretation of them may be disputed. The valuation approach used by the buyer may or may not be appropriate from the point of view of the hindsight that may be brought to bear in the dispute and it may not be clear what the relevance of it is to the issue of damages in proceedings. Issues of this kind can be particularly complex in cross-border deals where different national approaches to valuation may be relevant.

Procedural requirements

SPA's for M&A deals usually provide for claims thresholds and baskets, caps on liabilities and time frames within which claims must be made. There may also be statutory limitations that apply if there are none specified in the SPA. Although the limitations in the SPA may seem relatively standard when is being prepared, in practice it is not always straightforward for claimants to comply with them and a surprising number of cases which come to court – including on arbitrations - concern compliance with technical details of this kind.

Arbitration clause - governing law of the agreement and law of the seat

In many deals, there is no issue between the parties as to what the governing law of the SPA should be – they may simply accept that the national law of the country in which the transaction takes place should apply or they may mutually agree on that of another country which they are used to applying in M&A deals.

If arbitration is to be used for dispute resolution, the law of the seat will govern the procedural aspects and care should be taken that this is readily compatible with the substantive governing law of the SPA, so that awkward conflict of laws issues don't arise.

Where there is a choice as to the substantive governing law or as to the seat, the lawyers advising need to take care to avoid unintended consequences. The second part of *The Guide to M&A Arbitration* published by Global Arbitration Review and edited by Amy C Klaesener contains a compendium summarising the substantive laws applicable to M&A deals in a variety of jurisdictions globally. It is surprising how different they are on certain points. In some jurisdictions, for example, consumer protection laws apply to M&A deals unless excluded. In others, there are legislative disclosure requirements which are very favourable to the buyer unless excluded.

The extent to which pre-contractual communications between the parties is relevant to the interpretation of the agreement may also vary a great deal from jurisdiction to jurisdiction, and there may be issues as to the admissibility of evidence. There can also differences between jurisdictions as to what matters are substantive and which are procedural. If the substantive law and the law of the seat are the same or at least compatible, there are likely to align effectively without problems, If they take materially different approaches there can be problematic gaps or issues of characterisation.

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