Kluwer Arbitration Blog

The Rise of M&A Arbitration

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With cross-border M&A growing from $31 billion in 1985 to over $1.2 trillion in 2019, there is no doubt that there is a global appetite for such deals. While parties involved in M&A transactions generally expect to close deals smoothly and proceed with their respective businesses in peace, reality shows that disputes inevitably arise and parties have to take this into consideration when drafting the deals by opting for either national court litigation or arbitration. M&A arbitration has risen in popularity in parallel to the growth of the deals and can cover all the moments of a transaction. According to the statistics issued by various arbitration institutions, (i) shareholders' agreements, (ii) share purchase agreements and (iii) joint venture agreements represent a substantial part of their caseload. For instance, these agreements represent 14% of the cases administered by the LCIA in 2019. According to the SIAC's 2019 Annual Report, corporate disputes amounted to 29% of all disputes in 2019, making it the most popular sector. This rise in popularity is understandable given that some of arbitration's advantages fit particularly well with the structure of M&A transactions. These include confidentiality, the possibility of appointing experts in the field as arbitrators and ease of enforcement. Furthermore, arbitration manages to keep up with national court practices in order to fit the specific needs of its users, as can be seen in the recent introduction of injunctive relief in the ICC rules. This introduction is paramount to M&A disputes, as there may be a need for relief on an urgent basis in order to compel or prevent one of the parties from taking action that may have consequences regarding the valuation of the target.

The COVID-19 pandemic and the associated restrictions introduced across the world have undoubtedly had an effect on M&A transactions, the sectors most affected being aviation, tourism, retail & clothing and food & beverage. 2020 will be remembered as a year in which major M&A deals fell through, such as Victoria Secret's aborted acquisition by Sycamore, or other near failures such as the acquisition of Tiffany by LVMH, which nearly broke down and was only completed after the parties agreed on a discount of the price per share. The following sections consider the main types of M&A arbitrations that are seen in practice and the impact that the prevailing sanitary situation is likely to have on them.

Representations and warranties

A representation is an assertion of a past or existing fact, given by one party to induce another party to enter into an agreement. A warranty is a promise that the assertion of existing facts or

future facts are or will be true, along with an implied promise of indemnity if the assertion is false. The distinction is important as it leads to different remedies. Whereas misrepresentation may allow the buyer to rescind the contract and claim damages on the grounds that it entered into the agreement without having had a clear representation of reality, a breach of warranty would allow the buyer to claim damages, but not to rescind the contract.

In any case, representations and warranties can cover a company's financial statements, existing contracts, legal compliance or, more recently, the existing or potential impact of the pandemic on the course of business.

Disputes can occur in the period between the signing and closing of the deal, where representations and warranties serve as a closing condition (also known as "bringing down the RW"), or after the closing where the buyer may allege that there has been a misrepresentation or a breach of warranty. We expect that many arbitration proceedings will centre around such breaches, due to the pandemic disrupting either the status quo of target companies or the projected results estimated by the seller at the time of signing.

Pre-closing covenants

Pre-closing covenants are frequently invoked grounds for refusing completion of the deal. These covenants regulate the business operations of a target company between the signing of a deal and its closing. They guarantee to the buyer that the seller will continue to operate in the ordinary course of business. During a pandemic, buyers have argued that the cost-cutting measures taken by sellers amount to breaches of these covenants. Conversely, other buyers have argued that the failure to take such measures amounts to a breach.

It is not surprising to witness a variety of arguments, as the disruption caused by the pandemic has stirred buyers into seeking ways of exiting the deals that they had agreed upon before the pandemic. This will lead sellers to initiate proceedings to seek completion of the deals. The existence of interim relief and the possibility of appointing emergency arbitrators in the various institutional rules are strong arguments in favour or arbitration (note that Amazon requested such measures recently). We expect to find more issues regarding deals signed before the pandemic and fewer regarding deals signed afterwards, since parties will be more aware of the issues relating to the pandemic in the drafting process.

MAE clauses

Typically, such clauses are found in acquisition agreements and make the absence of a Material Adverse Effect ("MAE") a condition precedent to completion of the transaction. In other words, one party can refuse to complete the deal if the other party has suffered an MAE between the signing of the agreement and the closing of the acquisition, leading the agreement to be considered null and void. MAE clauses are to be considered among the most popular substantive topics to be addressed in an arbitration dispute.

In general, few clauses reference pandemics or public health crises as MAE events. Oftentimes, there are carve-out provisions found in the contract, expressly allocating general market risks to a

specific party or, in other words, changes or occurrences that the parties have agreed do not constitute an MAE, and will therefore not excuse the buyer's performance.

Warranty and indemnity insurances

While this type of insurance has been on the market for some time, an increased recourse to warranty and indemnity insurance has been witnessed in the last few years. In short, the buyer agrees with an insurer that in the event of a breach of representations and warranties by the seller, the insurer will indemnify the buyer.

The insurer will want to have access to as much information as possible in order to assess whether it may take the risk and sign the insurance policy. Requests for arbitration will be directed towards the insurer should there be a breach of representations and warranties from the seller. Most notably, in the context of the pandemic, insurers will be extremely attentive to the drafting of the agreements, proposing as many COVID-19 related exclusions as possible. These exclusions can be general in the sense that any loss related to COVID-19 will be excluded from the insurance, or they can be decided on a case-by-case basis which focuses on certain specific risks, such as those to the general supply chain. We expect that the arbitrations that are going to arise in this period will relate to the interpretation of the wording of the insurance policy, and more specifically whether the insurance policy in question covers the risk undertaken by the buyer. In this case, arbitration can prove to be a very useful means of settling the dispute, as many arbitral rules such as those of the ICC or LCIA contain clear provisions on the consolidation and joinder of proceedings.

Earn-out clauses

Business valuation is of paramount importance in M&A transactions. Parties can choose the locked-box mechanism whereby the price is fixed at the date the deal is signed, and is based on past performances of the target company, which remains the same at the date of the closing. However, in the context of the pandemic, buyers will be very reluctant to agree to locked-box mechanisms and will thus rely on earn-out clauses.

An earn-out is a contractual provision stating that the seller will obtain additional compensation in the future if the business achieves certain financial goals. These goals can relate to the EBITDA (Earnings before interest, taxes, depreciation, and amortization), net income or other financial or non-financial metrics. As the mechanism of an earn-out is often complicated when put into practice, this will lead to a rise in disputes.

Typically, disputes relate to the performance indicator that is to be taken into consideration. Another possible contention would be that a buyer has prevented the achievement of the performance target. Indeed, in the latter case there is a certain risk of manipulation from the buyer since the seller no longer has the power to influence the course of the target's business. In the context of the COVID-19 pandemic, there will be many valuation issues and having experts in the field as arbitrators can help in finding the best solutions.

Conclusion

M&A arbitration's recent rise in popularity looks set to continue. Even prior to the COVID-19 pandemic, the advantages of arbitration over litigation had made themselves clear. Now, with the number of disputes set to continue to rise, there is no doubt that this trend will gather further momentum.

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