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A Record-Breaking Year in M&A: The Consequences for Damages in Post-M&A Dispute Resolution in Arbitration

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2021 was a record-breaking year for mergers and acquisitions (M&A). The total global deal value amounted to USD 5.9 trillion, an increase of 64% compared to 2020 and the highest ever recorded, driven by high valuations and fuelled by access to cheap financing. The market was strong across corporate and financial buyers. The year saw many auction processes, bidding wars, aborted deals and the increasing importance of special purpose acquisition companies (SPACs), which reportedly accounted for about 10% of global M&A volumes. While the M&A market declined in the first half of 2022, in part because of renewed disruptions caused by the COVID?19 pandemic as well as the shocks to markets caused by the war in Ukraine, the recent surge in deal volumes, combined with exceptionally high valuations in 2021, have already led to a wave of post-deal disputes.

Most of these disputes are resolved in arbitration: according to one recent estimate, more than 75% of Sale and Purchase Agreements (SPAs) have arbitration clauses, a particularly high percentage among commercial disputes.[1)] Statistics published by arbitration institutions show, further, that shareholder, share purchase, or joint venture agreements represent a significant fraction of their overall caseload. For example, these types of agreements represented 14% of the cases administered by the LCIA in 2021.

This is against a background of steady, long-term growth in arbitration more generally. Using reported figures from international arbitration institutions, FTI Consulting recently estimated that international arbitration filings worldwide grew steadily at more than 3% a year from 2010 to 2019, and increased 9.9% in 2020. Thus a record year for M&A, already driving related disputes, met with an acceleration in the rise in popularity of arbitration, placing M&A disputes among the most relevant types of disputes in arbitrations in this period.

Following on from a post last year that discussed the types of M&A dispute that have emerged from the COVID?19 pandemic, this post examines the impact of the recent exceptionally high valuations on damages quantification when M&A transactions end in disputes.

To be clear, a period of high valuations does not necessarily mean that markets, or individual acquisition targets, are overvalued. However, it does mean an increased scope for disappointment by parties in M&A transactions. Buyers are often left disappointed when the acquisition target falls short of the expected returns that were priced into the bid. Similarly, sellers can be disappointed in cases where a significant shortfall against expectations means lower earn-out payments. Disappointment breeds disputes.

Identifying the Correct Counterfactual in Post?M&A Disputes

Post-M&A disputes arise from different types of (alleged) breaches of contractual or non-contractual obligations. Each of these breaches can result in the affected party seeking remedy through the arbitration process. The different types of breaches, in turn, can be associated with different counterfactuals, and therefore approaches to the measurement of damages. The differences start to matter more if price is different from value, as this can make the identification of the correct counterfactual more important.

The first example is a claim for warranty breach, where the price paid is often rebuttably presumed to be the same as the value as warranted.[2)] These claims often compare what was promised to what was delivered, or the deductions in the purchase price that would be needed to cure the broken warranty.

A second example is a claim in tort, such as a fraudulent misrepresentation. Damages for tort claims are sometimes calculated as the difference between the true value of an asset and the price paid.[3)] This can be a different comparison of actual and counterfactual from that in contractual claims, and the mechanics of the damages quantification suggests that the difference matters more as price and value differ.

A third type of claim relates to the culpa in contrahendo doctrine, which is often associated with yet another measure of damages. Culpa in contrahendo plays a role in many M&A disputes in civil law jurisdictions. These *claims often relate to* alleged misrepresentations during the contract negotiations. Culpa in contrahendo claims can lead to damages awards for the 'negative interest', often calculated as the difference between the price actually paid and the price a purchaser would have paid in a hypothetical scenario in which all information had been disclosed truthfully.

Seller-friendly markets, in which multiple bidders compete for a limited number of quality targets, can mean tightly managed auction processes and more often 'light' approaches to the buy-side due diligence. Both factors can make it easier for sellers to be less than forthcoming with information, and it is easy to see how this could lead to an increase in claims for misrepresentation and in fact this is a feature of many of the current generation of M&A disputes.

When Does it Matter if Price and Value Differ?

If the price paid for a target is assumed to be equal to its value, then the comparison of actual and counterfactual positions results gives the same absolute difference in each of the three examples (although in culpa in contrahendo claims, the two scenarios are reversed, often leading to confusion about the counterfactual). Even if the difference is the same, however, this does not necessarily mean that damages are the same, for a number of reasons: warranty claims are often subject to contractual limitations that may not apply to fraud or culpa in contrahendo claims[4)]; differences in valuation dates may lead to substantially different damages amounts; and a culpa in contrahendo claim may include elements of lost profits that are sometimes contractually excluded from warranty breach claims.[5)]

Why Might Price and Value Differ?

Price and value need not always be the same, and there can be situations in which a buyer pays more, or less, than an asset's value. In that case, the identification of the correct counterfactual starts to matter.

Why do value and price differ in some instances, and perhaps more so in periods of high valuations? In other words, why is someone willing to pay more or accept less than an asset is worth? This is a complex question for which we can look to agency theory and behavioural economics for explanations.

Agency theory in economics suggests that the separation of ownership (the shareholders) and control (management) of a firm can result in a strategic misalignment, or conflict, of interests. For example, it has been observed that managers have incentives to cause their firms to grow beyond the optimal size.[6)] This can lead them to pursue M&A transactions that do not deliver the value that the acquirer paid for. Thus a firm can overpay, even when management (the agent) acts rationally, but self-interestedly, leading to management ultimately acting against the interests of the shareholders.

Behavioural economics, on the other hand, suggests the same outcome (overpaying) can occur as a result of nonrational, or boundedly rational, behaviour when a party agrees a price that is not justifiable by reasonable assumptions. Behavioural economists have examined the conditions in which such outcomes occur. These include behavioural biases such as overconfidence, or the competitive motive to 'win' rather than to seek one's own gain.[7)] For example, consider a scenario in which a bidder who – in the event it loses in an auction process – would fail to acquire a technology essential to maintaining its competitive position; the bidder faces a trade-off between accepting the loss in competitive position or winning the auction and overpaying, and from there the bidding process may spiral into an outcome that is not justifiable with rational assumptions.[8)] A seller-friendly market appears more likely to breed such conditions than a buyer-friendly market.

Conclusion

There was a 'white hot' M&A market in 2021, with strong sellers running tightly managed auction processes and with novel structures. Such a market can create an environment in which buyers come under significant pressures, commitments can escalate more easily, and there can be cases where price exceed value.

If things go wrong after an M&A deal, claims are likely to be made through the arbitration process: a high proportion of post-M&A disputes are resolved through arbitration, and arbitration worldwide is growing steadily.

Depending on the alleged breach being remedied, this can have important consequences for the identification of the correct counterfactual in subsequent disputes and the valuation of damages in post-M&A arbitrations.

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References

?1 Elsing/Pickrahn/Pörnbacher/Wagner, *M&A-Streitigkeiten vor DIS-Schiedsgerichten* (C.H. Beck, 2022)

?2 Adam Kramer, *The Law of Contract Damages*, 2nd ed. (Hart Publishing, 2017), 227.

?3 For example, *Glossop Cartons and Print Limited v Contact (Print & Packaging) Limited* [2021] EWCA Civ 639.

?4 For example, OLG Munich, 03.12.2020 – 23 U 5742/19.

?5 Wächter, *M&A Litigation*, 3rd ed. (RWS Verlag Kommunikationsforum GmbH, 2017), 551.

?6 Michael C. Jensen, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review* 76 (2), 71–92.

?7 Max H. Bazerman and Don A. Moore, *Judgment in Managerial Decision Making*, 8th ed. (Wiley, 2013), 123 – 131. Even in instances where it can be shown, however, that prices cannot be justified by reasonable assumptions — for example, when observing two prices that are each based on a set of assumptions where movements in the prices and assumptions produce a contradiction — it can be difficult to identify which of the two prices is irrational.

?8 See Bazerman and Moore, 130–31.

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