Kluwer Arbitration Blog

CBAr 21st International Arbitration Conference: Disputes arising under M&A Contracts

Marcio Vasconcellos (King & Spalding) · Tuesday, October 18th, 2022

In line with its overarching theme of "*Arbitration, Corporate Law & ESG*", on September 29, 2022 the CBAr's 21st International Arbitration Conference hosted a panel on disputes arising under M&A contracts. Julian Chediak moderated a prolific, technical, and practical discussion with Gabriel Buschinelli, Rodrigo Octávio Broglia Mendes and Jennifer Permesly regarding various aspects of M&A disputes and their connection to Brazilian law and practice. The panel flowed seamlessly from the hyper-technical to the practical and provided their views on some of the key issues in M&A disputes.

Anglo-Saxon Origins of M&A Contracts and its Influence on M&A Disputes

Essential to the discussion of M&A contracts is their origin under Anglo-Saxon legal systems, according to which words and phrases like "*due diligence*", "*reps/warranties*", "*earn-out*", "*valuation*", "*EBITDA*", "*sandbagging*", "*caps*" or "*baskets*" have become common parlance for transactional attorneys around the world, regardless of their native language. The same is true in Brazil, where transactional lawyers routinely use this *lingua franca* in the context of a legal system that does not always embrace the consequences that follow the language. Somewhat like trying to fit a square through a round hole, the legal practice of transactional law in Brazil has incorporated legal concepts that are as foreign to the Brazilian legal system as the language itself, and often without the theoretical support to back it up.

The panel addressed the influences of the American legal system in M&A contracts in Brazil, both for cross-border cases and domestic disputes. As Mr. Buschinelli clarified, M&A contracts were designed to discipline all consequences that may arise from the agreement as a closed universe, but in Brazil this universe requires a coexistence with Brazilian law. Mr. Broglia noted that due to their origin and rapid expansion to legal systems very distinct from their Anglo-Saxon origins, M&A contracts following the American model have become almost a *transnational* practice, which inevitably requires some level of adaptation when incorporated into the context of Brazilian law. True to the influence of the American system in corporate transactions around the world, Ms. Permesly provided an overview of the current practice in New York regarding disputes involving purchase price adjustments and earn-out mechanisms.

Legal Bases for Liability in M&A Disputes Under Brazilian Law

Addressing the technical and taxonomical equivalency for M&A concepts that do not find their origins in Brazil, Gabriel Buschinelli discussed the legal bases for liability under Brazilian law on multiple corporate law issues, especially pertaining to breaches of representations and warranties and intentional misrepresentations. Because these agreements do not originate under Brazilian law, they of course do not find an immediate equivalency under the classical Brazilian taxonomy, and as a result there are various bases for liability depending on the particular obligation or breach at hand.

According to Mr. Buschinelli, all liability devices deal with the essential problem of asymmetry of information. The goal is to permit information to flow from the seller to the buyer, and to ensure that this information is fully reflected in the purchase price. According to Gabriel, the main problem when dealing with these types of issues is the "gatling gun" approach, when disputing parties raise various corporate issues without regard for the appropriate remedies resulting in each case. The key, according to Gabriel, is to establish a connection between the legal basis for liability and the adequate legal remedy being sought.

In this sense, the quintessential question regarding the proper adaptation of M&A contracts to the Brazilian legal context is how exactly to perceive a breach of a representation or warranty. One possible path is to address this type of breach not as a breach of contract, but as a false information being provided and attach thereto all the consequences that arise from a false statement. Alternatively, another possible path is to look at these types of breaches as insurance, such that when a representation does not match reality, the opposing party is entitled to trigger the insurance (i.e., the warranty) and to seek compensation or indemnification for the corresponding loss. These available paths further raise the issues of whether the breach attracts liability under a contract or tort theory of recovery. While typically the path of contractual liability will be the clearest, a sufficiently egregious misrepresentation could affect the very formation of the contract.

The bases for liability are a clear example of the difficulty in importing these concepts into Brazilian law without a proper technical or taxonomical equivalency test. Because different legal classifications will result in different legal remedies, a comprehensive analysis of the factual context in which the obligations are inserted is essential to proper analysis of these agreements under Brazilian law.

Duty to Inform and Duty to Self-Inform: Due Diligence Provisions and Sandbagging Clauses

Also focused on a proper equivalency of M&A contracts with the Brazilian legal system, Rodrigo Octávio Broglia Mendes discussed contracting parties' duties to inform their counterparties and to self-inform, particularly with regards to *due diligence* provisions and *sandbagging* clauses. Mr. Broglia also noted the context in which M&A contracts fit and the Anglo-Saxon origin of these types of agreements, an environment in which the principle of *caveat emptor* works as an instruction for the buyer to take every precaution possible, which does not translate directly to Brazilian law on account of the broader notions of good faith that permeate contract interpretation in Brazil.

Rodrigo began his analysis by looking at M&A contracts from an economic perspective and focused on the cashflow of the business operation that is being acquired. On this basis, the entire

design of the contract is predicated on protecting cashflow and the parties' reasonable expectations in relation thereto. In this context, representations and warranties provide for the exchange of information that will give some guarantee regarding cashflow and will result in some compensation or indemnification in the event that any circumstances that will adversely affect that cashflow materialize.

Mr. Broglia then discussed pro-sandbagging and anti-sandbagging clauses and their approach under Brazilian law. In M&A, the term "sandbagging" refers to whether a buyer's knowledge that a particular representation or warranty is not entirely true should limit that buyer's ability to recover for its falsity or incompleteness. A pro-sandbagging clause does not limit the practice, while an anti-sandbagging clause does. Said differently, a pro-sandbagging clause renders knowledge irrelevant for recovery, while an anti-sandbagging clause limits recovery to that which was not known at the time of contracting. While this type of clause may seem strange to the uninitiated, Mr. Broglia noted that the majority of M&A agreements in the United States contain pro-sandbagging provisions because they encourage the parties to transact their rights and to exclude any liability as they may wish.

Under Brazilian law, Rodrigo explains, the relevance of a buyer's knowledge to trigger contractual remedies is whether there is a breach of good faith or an abuse of rights. As a result, these types of clauses cannot be viewed in a vacuum: their validity or invalidity will be predicated on the factual context of the dispute, how the parties behaved, and whether either party assumed the risk of loss or abused a right. In any case, whether the parties agree to a pro-sandbagging clause (rendering prior knowledge irrelevant) or an anti-sandbagging clause (encouraging disclosure of known liabilities), Rodrigo emphasizes that the worse possible scenario is silence, which will leave a decisionmaker in the position of having to decide what the parties intended with regards to their contractual risks.

Disputes Regarding Price Adjustment and Earn-Out Mechanisms

Jennifer Permesly discussed purchase price disputes and earn-out mechanisms and provided an update on the experience from New York regarding dispute resolution processes involving accounting firms versus the traditional arbitration practice. As Ms. Permesly noted, purchase price adjustment clauses play a key role in corporate disputes and are designed to ensure that the buyer will get that which they bargained for. In this sense, price adjustment clauses are predicated on the provision of a reference balance sheet at the beginning of a deal (which will serve as a target for the transaction) and a closing balance sheet (against which price adjustments will be made).

As Jennifer noted, some of these disputes pertain exclusively to mathematical and accounting issues while other disputes involve truly legal issues that require a determination fully comporting with due process. In her experience, where the disputes involve solely accounting issues, it is sensible to appoint accountants as decisionmakers without having to proceed down the path of a full arbitration. This, Jennifer explains, is common practice in New York, where Article 76 of the Civil Practice Law and Rules specifically provides for expert determination as a mechanism for the resolution of disputes of this nature (for further details please see New York City Bar's report titled "Purchase Price Adjustment Clauses And Expert Determinations" dated June 2013). Ms. Permesly further notes that a threshold question is whether the dispute is an "accounting-type" dispute (for which an accountant might be best suited to resolve) or a "legal-type" dispute (for which a lawyer

and experienced arbitrator may be best positioned to resolve).

Another relevant consideration, particularly in a cross-border scenario, is that an expert decisionmaker that does not qualify as an arbitrator will not render a decision that is enforceable under the New York Convention, but the flip side is that this decision will also not be subject to review in accordance with the standards of the New York Convention. As such, while enforcement outside of the United States may be harder to achieve (by virtue of an expert determination not qualifying as a "convention award"), where the potential enforcement is focused on the United States (or its equivalent under Brazilian law), this may be a viable alternative to traditional arbitration that may reduce or narrow the scope of potential disputes that will be referred to arbitration.

Conclusions

As the panel discussions made clear, to incorporate wholesale practices and procedures originated in Anglo-Saxon law without the proper technical and taxonomical equivalency under Brazilian law is a recipe for disaster. Conversely, to ignore that M&A transactions following the American model have become the global practice is a short path for Brazil to find itself in economic isolation. Somewhere between these two extremes lies a generation of Brazilian transactional and dispute practitioners fully committed to finding efficient dispute resolution mechanisms fully consistent with Brazilian law and *à mode brésilienne*. The key, as is usually the case in legal affairs, is to perform a technically sound review of the applicable legal concepts and in line with the economic objectives that they seek to regulate.

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