

Resolving M&A Price Disputes: Experts or Arbitrators?

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Merger agreements typically include post-closing purchase price adjustment provisions. A net working capital, or NWC, adjustment, for example, increases or decreases the purchase price post-closing based on a comparison of the final NWC amount delivered at closing to either a target or estimated NWC amount. If parties cannot agree on the proper purchase price adjustment, merger agreements often provide for a dispute resolution process before a third-party accountant or other financial professional. Often, a threshold question in these disputes is whether the agreement's dispute resolution process is an expert determination or an arbitration — and the answer can have a meaningful impact.

Unlike arbitrators, experts typically do not have the authority to interpret an agreement's language or address legal arguments. Instead, experts are limited to deciding a specific factual question (e.g., what is the proper value of a particular asset?). In addition, the Federal Arbitration Act only applies to arbitrations — not expert determinations — and, therefore, parties cannot compel an expert determination or enforce an expert's decision under the FAA. Finally, the standard of review is more onerous for an arbitration award than an expert determination, and that distinction can affect the parties' ability to overturn the decision maker's ruling.

Expert Determination or Arbitration?

Many states recognize a meaningful difference between expert determinations and arbitrations. In July 2018, in *Penton Business Media Holdings v. Informa PLC*,¹ the Delaware Court of Chancery reaffirmed this distinction under Delaware law, noting accord with 24 other states and a split among federal appellate courts.²

In *Penton*, the court considered a merger agreement that required the parties to submit disputes about the proper allocation of post-closing tax benefits to an independent accounting firm. The seller wanted to provide the accounting firm with term sheets and other extrinsic evidence to support its position on the tax benefit allocation and argued that the accounting firm could determine for itself what evidence it could consider in reaching a decision. Conversely, the buyer claimed that the accounting firm could not decide what information it could consider. The buyer argued that the accounting firm was an expert — not an arbitrator — and therefore had no authority to interpret the agreement.

The parties' agreement explicitly stated that the accountant shall act as an "expert, not an arbitrator."³ The *Penton* court recognized, however, that nomenclature is not necessarily dispositive. Even

when an agreement includes the “expert not arbitrator” language, the court envisaged a situation where the dispute resolution process could still be an arbitration.⁴ The court cited with approval New York’s “well-developed body of expert-determination jurisprudence,” which “places heavy weight upon the scope of the [dispute resolution] provision and the procedure that the parties agree to follow” when deciding the question of expert determination versus arbitration.⁵

When an agreement provides for a complete resolution of the parties’ dispute, the process is typically considered an arbitration. Conversely, in an expert determination (often referred to as an “appraisal” in New York), the decision maker’s authority is limited to deciding a specific factual dispute within the decision maker’s area of expertise.⁶ Similarly, an arbitration often follows certain procedural formalities, such as hearings, discovery and witness testimony. On the other hand, an expert determination is more informal and allows the decision maker to investigate beyond the parties’ submissions and to draw on his or her own subject matter expertise.⁷

In *Penton*, the court held that the parties’ dispute resolution process was, in fact, an expert determination — not an arbitration. The court found that the agreement’s “expert not arbitrator” language was evidence of the parties’ intent and that there was no conflict with the agreement’s provisions defining the dispute resolution process. The agreement limited the accounting firm to resolving disputes about the information contained on the tax form and further limited the information that the accountant could consider in reaching a decision.⁸

Federal common law arguably requires less to find an agreement to arbitrate. In *McDonnell Douglas Finance Corp. v. Pennsylvania Power & Light Co.*, the Second Circuit held that an agreement’s dispute resolution mechanism constituted an arbitration clause because its “language clearly manifests an intention by the parties to submit certain disputes to a specified third party for binding resolution.”⁹ Other federal courts similarly have held that “an adversary proceeding, submission of evidence, witnesses and cross-examination are not essential elements of arbitration [I]f the parties have agreed to submit a dispute for a decision by a third party, they have agreed to arbitration.”¹⁰ Accordingly, it is important to understand what law will govern any dispute. Indeed, the *Penton* court noted that 22 states have eliminated the distinction between expert determinations and arbitrations.¹¹

Does the Decision Maker Have the Authority to Interpret the Contract?

In *Penton*, the parties’ agreement was silent regarding the accounting firm’s authority to interpret the agreement or decide legal issues. But in finding that the dispute resolution process was an expert determination, the court held that the accounting firm did not have this authority. The court instead found that because the agreement “structures a tailored procedure that assigns only narrow questions to the expert . . . [a]ll other issues go to this court, which is the plenary adjudicator under the forum selection clause.”¹² Conversely, if the court had determined that the dispute resolution process was an arbitration, it likely would have ruled that the accounting firm had authority because an arbitrator has authority to interpret the contract absent specific agreement language to the contrary.

The *Penton* court proceeded to interpret the parties’ agreement and held, based on the agreement’s “plain language,” that the accounting firm could not consider term sheets or any other extrinsic evidence in reaching its decision. Specifically, the agreement stated that the accounting firm “shall not import or take into account usage, custom or other extrinsic factors” and prohibited “*ex parte* conferences, oral examinations, testimony, deposition,

discovery or other forms of evidence gathering or hearings.”¹³ The court found that this language limited the accounting firm to considering the contract’s language and the relevant tax and accounting principles.¹⁴

Can You Compel a Party to Submit the Dispute for Resolution?

Congress enacted the FAA in 1925, establishing a strong public policy that favors arbitration as a method for resolving disputes. The FAA provides a right of action to compel arbitration and to enforce an arbitration award;¹⁵ however, it only governs arbitrations — not expert determinations. Accordingly, in jurisdictions that recognize a distinction between expert determinations and arbitrations, a party cannot compel an expert determination or enforce an expert’s decision under the FAA.

The FAA’s inapplicability makes it more difficult to compel expert determinations and to enforce the expert’s decision. Generally, a party must file a breach of contract action seeking a declaratory order that instructs the parties to complete the dispute resolution process. These actions invariably include issues beyond whether the parties intended to submit their dispute for expert determination. Parties resisting the expert determination process often claim breach of contract as well as other legal defenses and seek discovery to support those defenses. This can result in a more protracted and costly litigation before the parties ever reach the agreement’s contemplated dispute resolution process.

New York has passed legislation, CPLR § 7601, that specifically allows parties to file petitions to compel expert determination proceedings and to enforce expert decisions. Importantly, however, CPLR § 7601 explicitly reserves the courts’ right to determine legal defenses and arguments regarding contract interpretation, providing that “[w]here there is a defense which would require dismissal of an action for breach of the agreement, the proceeding shall be dismissed.”

What Is the Standard of Review?

Arbitration awards are subject to a more onerous review standard than expert determinations. The FAA provides four bases for vacating an arbitration award:

1. Where the award was procured by corruption, fraud or undue means
2. Where there was evident partiality or corruption in the arbitrators, or either of them
3. Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party were prejudiced
4. Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final and definite award on the subject matter submitted was not made.¹⁶

Many jurisdictions will also vacate an arbitration award upon a finding of “manifest disregard of the law.”¹⁷ The Second Circuit has “cautioned that manifest disregard clearly means more than error or misunderstanding with respect to the law.”¹⁸ Simple mistakes are insufficient to vacate an arbitration award. “[A] court must find both that (1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether, and (2) the law

ignored by the arbitrators was well defined, explicit, and clearly applicable to the case.”¹⁹

To the contrary, courts have reviewed expert determinations for “fraud, bad faith, or palpable mistake.”²⁰ While this is still a deferential standard, it is significantly less onerous than the review standard for arbitration awards. Courts may overturn an expert determination if the expert lacked a reasonable basis for the decision, failed to follow the dispute resolution agreement’s specific instructions, or incorrectly decided legal issues.²¹ Accordingly, there is a more meaningful opportunity to overturn an expert determination, whereas arbitration awards are vacated “only in those exceedingly rare instances where some egregious impropriety on the part of the arbitrator is apparent.”²²

Conclusion

So what does this all mean? Parties structuring dispute resolution clauses should be both deliberate and explicit. The drafting process is an opportunity to tailor a dispute resolution process that best accomplishes the parties’ objectives. The more specific the agreement’s provisions are, the less opportunity there will be for dispute. Too often, parties use boilerplate language without understanding the potential impact it will have if there is a dispute. Understand your goals, what type of dispute resolution process best achieves those goals, and how different jurisdictions will interpret various agreement provisions. Doing so may help you avoid litigation about the nature of your dispute resolution process.

Endnotes

¹ No. 2017-0847-JTL, 2018 Del. Ch. LEXIS 223 (Del. Ch. July 9, 2018).

² *Id.* at *20-21 (citations omitted). The Fifth and Ninth Circuits look to state law to determine if a dispute resolution process is an arbitration, while the First, Second, Sixth and Tenth Circuits apply federal common law. Daniel Burkhardt, Note, *Agree to Disagree: The Circuit Split on the Definition of “Arbitration,”* 92 U. Det. Mercy L. Rev. 57 (2015).

³ See, e.g., *Penton Bus. Media Holdings*, 2018 Del. Ch. LEXIS 223, at *32-34.

⁴ *Id.* at *34-35.

⁵ *Id.* (quoting *In re Delmar Box Co.*, 309 N.Y. 60, 127 N.E.2d 808, 811 (N.Y. 1955)).

⁶ *Id.* at *36 (citing *Delmar Box*, 127 N.E.2d at 811); see also N.Y.C. Bar Comm. on Int’l Commercial Arbitration, *Purchase Price Adjustment Clauses and Expert Determinations: Legal Issues, Practical Problems and Suggested Improvements* (2013), at 4.

⁷ *Penton Bus. Media Holdings*, 2018 Del. Ch. LEXIS 223, at *36-37, n.110 (citing *Delmar Box*, 127 N.E.2d at 811).

⁸ *Id.* at *37-38, *7-9.

⁹ 858 F.2d 825, 830 (2d Cir. 1988).

¹⁰ *Bakoss v. Certain Underwriters at Lloyds of London Issuing Certificate No. 0510135*, 707 F.3d 140, 143 (2d Cir. 2013) (quoting *AMF Inc. v. Brunswick Corp.*, 621 F. Supp. 456, 460 (E.D.N.Y. 1985)).

¹¹ *Penton Bus. Media Holdings*, 2018 Del. Ch. LEXIS 223, at *20 (citing Lina M. Colón Santiago, *Insurance Appraisal & Arbitration*, 8 No. 1 U. Puerto Rico Bu. L.J. 65, 74 (2016)).

¹² *Id.* at *41.

¹³ *Id.* at *42.

¹⁴ *Id.* at *45.

¹⁵ See 9 U.S.C. §§ 4, 9.

¹⁶ 9 U.S.C. § 10(a).

¹⁷ See, e.g., *Halligan v. Piper Jaffray Inc.*, 148 F.3d 197, 202 (2d Cir. 1998).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ See N.Y.C. Bar Comm. on Int'l Commercial Arbitration, *Purchase Price Adjustment Clauses and Expert Determinations: Legal Issues, Practical Problems and Suggested Improvements* (2013), at 20, n.69.

²¹ *Id.* at 21-22 (citing cases).

²² *T.Co Metals LLC v. Dempsey Pipe & Supply Inc.*, 592 F.3d 329, 340 (2d Cir. 2010).

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