Arbitration of Purchase Price Adjustment Disputes in M&A Transaction

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TABLE OF CONTENT

LIST OF ABBREVIATIONS .............................................................................................................................................. 4
INTRODUCTION .................................................................................................................................................................. 6

PART I - ARBITRATION AND MERGERS AND ACQUISITIONS .............................................................. 8
  1. Characteristics of M&A and Arbitration .................................................................................................................. 8
  2. Advantages of Arbitration in M&A Transaction ..................................................................................................... 11
     2.1 Avoidance of Publicity ........................................................................................................................................... 11
     2.2 Choice of Arbitrators with Good Expertise in Industry ...................................................................................... 14
     2.3 Flexibility in Choice of Language of the Proceedings and Communications .................................................. 15
     2.4 Resolution of Dispute in an Amicable and Timely Manner ............................................................................. 15

II - FREQUENTLY DISPUTED ISSUES THAT TRIGGER PURCHASE PRICE
ADJUSTMENT DISPUTES .................................................................................................................................................. 18
  1. Pre-Closing and Post-Closing Disputes .................................................................................................................... 18
  2. The Purchase Price Adjustment ............................................................................................................................... 20
  3. Frequently Disputes Issues Affecting Adjustment of the Purchase Price ............................................................ 23
     3.1 Accounting Specifications ...................................................................................................................................... 24
        3.1.1 Usage of GAAP-Methods and Practices ........................................................................................................... 24
        3.1.2 Precedence of GAAP over Consistency ........................................................................................................... 25
        3.1.3 Ambiguity Regarding Interim and Year-End Reporting of Financial Statements ................................................... 26
        3.1.4 Errors or Irregularities Discovered After Closing ........................................................................................ 27
        3.1.5 Materiality of the Purchase Price .................................................................................................................... 28
  4. Failure to Disclose the Material Information ........................................................................................................... 29
     4.1 Representations and Warranties .......................................................................................................................... 29
4.2  Purchase price adjustment or Indemnification? ......................................................... 31

4.3  Material Adverse Effect/Change.................................................................................. 33

4.4  Adjustment Based on Earn-Out Clauses .................................................................... 34

PROCEDURAL IMPLICATIONS OF THE PURCHASE PRICE ADJUSTMENT

DISPUTES .................................................................................................................................. 36

   1. The Important Role of Experts ...................................................................................... 36

   2. Difference between Expert Arbitrator and Legal Arbitration ..................................... 37

   3. Problems that Arise in Relation with Expert Determination and Arbitration ............ 39

   3. Ensuring Party Equality in Multi-Party and Multi-Contract Arbitration .................... 45

BIBLIOGRAPHY .......................................................................................................................... 51
LIST OF ABBREVIATIONS

AAA American Arbitration Association
ABA American Bar Association
ADR Alternative Dispute Resolution
ACC Association of Corporate Council
Co. Corporation
CF Cash Flow
CIETAC China International Economic and Trade Arbitration Commission
Corp. Corporation
DIS Die Deutsche Institution für Schiedsgerichtsbarkeit e.V. (German Institution of Arbitration)
EBITDA Earnings before Interest, Taxes, Depreciation and Amortization
ed. Edition
ed. / eds. Editor / Editors
etc. Et cetra (and other things)
E&Y Ernst & Young
GAAP Generally Accepted Accounting Principles
FIFO First In, First Out
IAMA The Institute of Arbitrators & Mediators Australia
IBPA Inter-Pacific Bar Association
ICC International Chamber of Commerce
Id. Ibidem [in the same source]
i.e. Id est (that is)
Inc. Incorporation
JCAA Japan Commercial Arbitration Association
LCIA London Court of International Arbitration
LIFO Last In, First Out
LOI Letter of Intent
M&A Mergers and Acquisitions
MAC Material Adverse Change
INTRODUCTION

“Nowadays arbitration agreement in international and national M&A transactions is rather the rule then the exception.”¹

Last decades demonstrated increase not only in national mergers but in cross-borders as well. Increased market power, reduction of market entry barriers, faster entry into the market and diversification, all these factors facilitated the increase of cross border acquisitions.² However, past years have shown significant downturn in the economy and difficult market conditions. Economic downturn has brought severe challenges to newly acquired businesses, resulting into post-deal disputes that commonly addressed “unmet business expectations.”³ Buyers, frustrated with the aftermath of their acquisitions, look for ways to renegotiate a better transaction by means of dispute resolution mechanisms. These are well illustrated in the purchase price adjustment disputes becoming common trend in M&A transactions.⁴

The objective of this paper is to address the increasing role of arbitration in disputes arising out of M&A transactions, particularly, disputes related to the adjustment of the purchase price. Due to economic climate, significant proportion of disputes made effect on the new arbitration matters of post-acquisition disputes. These disputes are especially complex by nature as they incorporate economic, financial and legal matters altogether.⁵ In addition, the purchase price adjustment provisions frequently interplay with other provisions of the merger agreement, which result to complex legal and accounting matters. The question is how effective is the recourse to arbitration to settle the purchase price adjustment disputes and what kind of procedural and substantive particularities may entail in the event of the disagreement between the parties. On one hand, the paper describes and analyses the typical disputes that occur in business transactions, resulting into post-closing adjustment of the purchase price, and on the other hand

it examines the procedural particularities of such proceedings in the light of arbitration proceedings.

The paper consists of three parts. The first part addresses two distinct legal fields and provides general description of their characteristics and operation. It examines the compelling reasons for choosing arbitration over litigation and the benefits of arbitration from M&A perspective. Part two summarizes the stages of potential disputes that may occur through the transaction. The focus is made on the disagreements which are likely to trigger the disputes related to the adjustment of the purchase price, such disagreements are mainly on accounting specifications, provisions of representations and warranties, indemnification, material adverse change and earn out clauses. These provisions have equal economic effect and result into modification of the purchase price when special circumstances are met.

Consequently, these issues are often argued, given the obligations under each provision result into different legal and economic effect for the parties. The third part, contemplates the particularities typical for purchase price adjustment disputes in arbitration proceedings. To refer the purchase price adjustment disputes to experts before arbitration is cost effective and time efficient. However, if one of the parties disregards the first stage of expert determination and directs recourse to arbitration, it may become subject of conflict. In addition M&A transactions often involve multi-party and multi-contract situations, which affect the constitution of the arbitration tribunal. These particularities can be avoided by careful drafting of the dispute resolution provisions.
PART I - ARBITRATION AND MERGERS AND ACQUISITIONS

1. Characteristics of M&A and Arbitration

An acquisition process comprises "of several phases, often beginning with the seller preparing a sales document with the objective of highlighting the characteristics of the business that make it an attractive acquisition prospect. It typically explains the nature of the business, history of the company, organizational structure, potential synergies and opportunities for future growth." After bidding by interested buyers, the parties start negotiations and submit a letter of intent to the target company. The negotiations are subsequently followed by due diligence phase. The purpose of due diligence is to inspect necessary information regarding the legal, business and financial affairs of the target company.

Confirmatory due diligence report leads to the conclusion of the purchase agreement (the Agreement). The Agreement comprises from provisional purchase price and procedures of post-closing adjustment mechanisms. In the end, the closing of the deal takes place. It is important to distinguish between the signing and closing phases, since signing only refers to physical signing of the contract, while the closing is the official handing over of the purchased object. During the closing, the balance sheet and other financial documents of the target company are used to adjust the purchase price with the presupposed true value of the company.

The purpose of M&A deal is the creation of extra value that is attained through successful acquisition of the target company. Whether extra value is obtained, however, is not always the

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8 Wölfe, Andreas; Wilske, Stephan; Wilson, Kathryn (The Comparative Law Yearbook of International Business): Cross border Mergers and Acquisitions Demystified (2012, p.35)
case. One of the reasons for failure of the merger is overpayment of the purchase price. “The company is in a constant flow and its value changes constantly.” That is the main reason why it is difficult to determine the purchase price that would remain valid from the signing until the end of the transaction. The changed value of the purchase price must be adjusted at the time of closing. Commonly, evaluation of the target company is a complicated matter.

The value of the company is dynamic and changes through M&A process, sometimes by a large amount. The valuation is especially complicated as the buyer has to rely on information provided by the seller in the light of information asymmetry. In conclusion, valuation of the business is challenging because the buyer cannot ensure that it is paying the fair market value for the target company. Eventually, M&A deal is a long and complicated process, especially, when it comes to cross border deals with a multi-jurisdictional framework, “the greater the number of jurisdictions involved, the greater the number of potential pitfalls.”

In contrast, Parties agree on arbitration to resolve their disputes outside of the judicial system. Generally, arbitrators are the non-governmental decision makers, who are consensually selected by the parties, and the award rendered by the arbitral tribunal binds them. Parties are entitled to choose the procedures they want to follow, thus, arbitration gives the parties substantial autonomy and control over the process. In addition, parties are free to determine the location

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12 Wölfl, Andreas; Wilske, Stephan; Wilson, Kathryn (The Comparative Law Yearbook of International Business): Cross border Mergers and Acquisitions Demystified (2012, p.26)
15 Wölfl, Andreas; Wilske, Stephan; Wilson, Kathryn (The Comparative Law Yearbook of International Business): Cross border Mergers and Acquisitions Demystified (2012, p.26)
16 Wölfl, Andreas; Wilske, Stephan; Wilson, Kathryn (The Comparative Law Yearbook of International Business): Cross border Mergers and Acquisitions Demystified (2012, p.26)
17 Wölfl, Andreas; Wilske, Stephan; Wilson, Kathryn (The Comparative Law Yearbook of International Business): Cross border Mergers and Acquisitions Demystified (2012, p.26)
18 Wölfl, Andreas; Wilske, Stephan; Wilson, Kathryn (The Comparative Law Yearbook of International Business): Cross border Mergers and Acquisitions Demystified (2012, p.26)
of arbitral procedure and the language of the proceedings. Characteristics of arbitration are
common in both international and national context.

Parties are free to choose institutional or *ad hoc* arbitration proceedings. Institutional arbitrations
are conducted in accordance with the rules of arbitration institutions. “In contrast, *ad hoc*
arbitrations are conducted without the benefit of appointing an administrative authority or
adhering to generally preexisting arbitration rules and are subject only to the parties of the
arbitration agreement and applicable national arbitration legislation.”

In international disputes, parties resort to international arbitration, to avoid jurisdiction of the
opposing party’s home court system. By referring the dispute to arbitration, parties do believe to
receive fair hearings and avoid becoming subject to a “home court advantage.” The
attractiveness of international arbitration has largely advanced, by reasons of, easy enforcement
of the awards under United Nations Convention on Recognition and Enforcement of Foreign
convention Provides to prevailing parties enhanced opportunity of enforcement of the award in
almost each country around the world. As of today the number of signatories of New York
Convention reaches 146 states, giving effect to potential enforcement in all the member
countries. The grounds for setting the award aside are narrow, mostly based on procedural
defects. Notably, the merits of the award cannot be challenged in the court. This makes an
international arbitration an established method of determining international disputes.

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2. Advantages of Arbitration in M&A Transaction

Nowadays, disputes arising out of M&A transactions are increasingly referred to arbitration.\textsuperscript{32} The success of international arbitration derives from the advantages it provides to the parties of the dispute. “Parties value arbitration over litigation for a variety of reasons, including \textit{inter alia}, greater party autonomy, greater efficiency in terms of both, money and time, greater predictability as to applicable law, the forum in which the dispute will be heard and jurisdictional issues and greater ability to enforce the resulting decision in foreign countries.” \textsuperscript{33}

The primary reasons for choosing international arbitration in cross border disputes are the neutrality of the forum and the enforceability of the award “by virtue of New York Convention.”\textsuperscript{34} The neutrality of the forum is essential for the parties due to existing perception of inherent predisposition of national courts that are believed to benefit the home party and put the foreign party at a disadvantage.\textsuperscript{35} Under New York Convention, each member state accepts the obligation to enforce the arbitral award in their jurisdiction without further examination of the merits.\textsuperscript{36} In addition to the general advantages, arbitration offers advantages which are especially beneficial from M&A perspective.

2.1 Avoidance of Publicity

In M&A transactions parties strive to keep their dispute confidential to avoid unnecessary publicity.\textsuperscript{37} Many companies prefer to keep dispute resolution procedures confidential, as they are not willing to disclose information regarding their business operations or do not want to make public the negative outcome of the disagreement.\textsuperscript{38} This attitude of companies is comprehensible, as the disputes leaves negative impression over the image of the companies. Especially, in the light of the allegations, which are frequently made regarding bad faith, misrepresentation,

\textsuperscript{34} Moses, Margaret L.: \textit{The principles and Practice of International Commercial Arbitration} (2008, p.3).
\textsuperscript{35} Wölfle, Andreas; Wilske, Stephan; Wilson, Kathryn (The Comparative Law Yearbook of International Business): \textit{Cross border Mergers and Acquisitions Demystified} (2012, p.26).
\textsuperscript{36} Wölfle, Andreas; Wilske, Stephan; Wilson, Kathryn (The Comparative Law Yearbook of International Business): \textit{Cross border Mergers and Acquisitions Demystified} (2012, p.26).
\textsuperscript{37} Ehle, Bernd; Scherer, Mathias (IBPA Journal No 47): \textit{Arbitration of International M&A disputes} (2007, p. 23).
\textsuperscript{38} Moses, Margaret L.: \textit{The principles and Practice of International Commercial Arbitration} (2008, p.4).
incompetence, or lack of finances. Overall it can significantly and unjustly damage the business reputation of the company.\textsuperscript{39}

As shown by 2010 International Arbitration Survey, confidentiality is important for the users of arbitration, but it is not an essential element for the decision to arbitrate.\textsuperscript{40} However, this is not a case for disputes in mergers and acquisitions, given the information involved in the transactions is generally sensitive and parties strictly avoid revealing corporate information. Likewise, the survey on Dispute Resolution in International M&A Deals, studied by American Bar Association in 2010, confirmed confidentiality to be the most compelling reason for the parties to arbitrate M&A disputes. The other overriding reasons identified are language of the proceedings and expertise of arbitrators.\textsuperscript{41} See the chart table below.

\begin{center}
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\end{center}

Graph: Knnull, Wiliam H.; Brown, Mayer: \textit{ABA Section of Business Law Survey on Dispute Resolution in International M&A Deals General Report} (p.8)

\textsuperscript{39} Redfern, Alan, Hunter, Martin, with Blackaby, Nickel, Parsadises, Constantine, \textit{Law and Practice of International Commercial Arbitration} (2004, p. 27).
\textsuperscript{41} Knnull, Wiliam H.; Brown, Mayer (http://apps.americanbar.org/buslaw/bht/content/2010/10/0001d.pdf): \textit{ABA Section of Business Law Survey on Dispute Resolution in International M&A Deals General Report} (last visited 19\textsuperscript{th} July 2012, p.4, p.8)
Generally speaking, “international arbitrations are more confidential than judicial proceedings as it relates to submissions, evidentiary hearings, and final awards. This protects business and commercial confidence and can facilitate settlement by reducing opportunities and incentives for public posturing.” Even it is generally accepted, that arbitrators have the ethical duty to keep confidentiality, the experts, witnesses and third parties are not bound with that duty, unless, the agreement specifically states so. Therefore, in M&A transactions parties should keep in mind, “neither the arbitral proceedings nor the award are _per se_ confidential unless the contract, the arbitration rules, or the applicable arbitration law provides for confidentiality.” The parties may agree to keep the resolution of dispute confidential in accordance with _ad hoc_ confidentiality rules, yet, the latter cannot override the legal disclosure obligations in financial statements or legal rights.

In case of institutional arbitration, rules of institutions provide for confidentiality. Nowadays all leading arbitral institutions such as the International Chamber of Commerce (ICC), United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules, World Intellectual Property Organization (WIPO), London Court of International Arbitration (LCIA), American Arbitration Association (AAA), China International Economic and Trade Arbitration Commission (CIETAC), Japan Commercial Arbitration Association (JCAA), Maritime Arbitration Societies, all respect parties privacy, by providing closed hearings and non-publication of the award without the consent of the parties. In addition, the ICC allows publication of “sanitized” awards only, which means that the awards are redacted in a way that the identity of the parties is not disclosed. Therefore, taking into account the character of the M&A transactions, where the companies are largely dependent on their business reputation, confidentiality and privacy of the hearings are highly valued.

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2.2 Choice of Arbitrators with Good Expertise in Industry

Since, dealing with M&A disputes involves handling complicated valuation and accounting issues, the persons who deal with M&A disagreements must have a sound knowledge of business industry and preferably be financially literate. This is especially true for purchase price adjustment disputes, where legal and accounting questions are closely interlinked. In contrast, in the courts, judges are randomly selected for hearing a particular case, regardless of past experience in the underlying industry. Under common circumstances, the judges are not specialized in complex commercial matters and especially in a certain type of transactions, such as M&A or Joint Ventures deals. As a result, aforesaid consideration may affect the quality of the dispute resolution process significantly.

Parties desire to have the dispute resolved by the arbitrator who has considerable expertise in the industry is achieved through parties autonomy in the selection of arbitrators. International arbitration agreements can influence the characteristic and expertise of an arbitrator, by specifically requiring for designation of a person with particular credentials and qualifications, in the arbitration agreement. For instance by requesting qualifications such as to legal, accounting or engineering experience or degrees.

To conclude, arbitration gives parties freedom to select an arbitrator with certain qualification that is well coordinated with the nature of the dispute. The arbitrators, who have the necessary competences and skills to hear the dispute, are more likely resolve the matter in an effective and efficient manner. During the election process of arbitrators, parties are able to take into

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54 Id.
consideration “arbitrators’ competences, expertise, language proficiency and availability.” Parties have an opportunity to choose an arbitrator, whom they trust, consider as impartial and highly competent to resolve their dispute.

2.3 Flexibility in Choice of Language of the Proceedings and Communications

This advantage is especially important in for international transactions. Cross border M&A transactions involve voluminous documentation and challenging language. The flexibility of choosing the language in international arbitration helps to avoid excessive translations and consequently saves the time and money. A claimant, who decides to submit the dispute before the state court in the absence of choice of jurisdiction for the specific court, usually is obliged to submit the case in the court of defendant in its place of business, or residence. The claimant will not be able to present his case by lawyers of its nationality, but has to hire foreign lawyers. The probability that the language is different is high, thus translation of all documents and evidences is required, which is associated with high costs, delays of proceedings and creates opportunities for misunderstandings. In addition, the court may not be familiar with international transactions of that type. All above mentioned makes recourse to state courts unattractive.

2.4 Resolution of Dispute in an Amicable and Timely Manner

Amicable way of dispute resolution is particularly prominent from M&A perspective, as “in the case of merger, the parties have common perspective and a strong motivation to compromise.”

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In view of that, arbitration is known to provide amicable, more business-like dispute resolution mechanism, which fosters the possibility to settle and preserve the future business relationship. Likewise, in M&A transactions, in the event of dispute the parties generally remain associated and communicate in terms of business relationships. A survey conducted by PricewaterhouseCoopers in 2008, found that a significant majority of corporations prefer to use international arbitration to resolve their cross-border disputes, and 27% of the participating corporations settled disputes in order to preserve business relationships.

Amicable dispute resolution mechanism is especially appealing in the purchase price adjustment disputes, where parties are oriented to keep the deal work. In the case of Daimler Chrysler and Bombardier, parties had settled the purchase price adjustment dispute before the International Chamber of Commerce (ICC) in 2004. Bombardier initiated arbitration and requested reduction of the purchase price as it had discovered undisclosed costs after the purchase of railcar maker “Adtranz”. The parties successfully ended the arbitration with settlement and reduction of the purchase price.

In M&A transactions, time is of significant importance, as the longer time between the signing and closing there is a higher probability that the value of the company will changes. “Disputes on closing are particularly critical in terms of time, because every delay on the conclusion of an agreement implies an imperilment of the company and company transfer.” Resolution of dispute through arbitration proceedings does not per se lead to faster decisions than litigation. However, parties have control over the proceedings and they can influence the duration of the proceedings by limiting the possibilities of an appeal, or agreeing to expedited procedures. For instance, under Swiss Rules of International Arbitration in point of expedited arbitration, the time limits for the constitution of an arbitral tribunal may be shortened, the number of briefs is limited and the tribunal should render the award not later than 6 months after the transmission of

61 PricewaterhouseCoopers, Queen Mary University of London, School of International Arbitration (http://www.arbitrationonline.org/docs/IAsudy_2006.pdf): International arbitration: Corporate attitudes and practices 2006 (last visited 19 July 2012, p. 2)
the file.\textsuperscript{64} The similar expedited rules on arbitration are advocated by a majority of other arbitration intuitions as well.

As to how suitable is, the expedited arbitration for M&A disputes is a different question and largely depends on the stage of M&A transaction where the dispute occurs. For instance, disputes that arise during the pre-closing period, such as disputes related to the letter of intent, confidentiality and exclusivity agreements and due diligence, “are relatively simple, and the underlying facts are also comparatively clear.” \textsuperscript{65} Therefore, expedited arbitration can be suitable for those types of disputes. In contrast, post-closing disputes such as purchase price adjustment, warranties and guarantees are difficult to clarify due to the complexity of valuation and legal questions. “Therefore, its suitability for fast-track arbitration cannot be determined in general but is best determined for every single case separately.”\textsuperscript{66}

The advantages provided by arbitration are without question. Arbitration provides faster, less costly, party controlled dispute resolution mechanism that differentiates arbitration from litigation in state courts.\textsuperscript{67} International arbitration offers advantages especially expedient for M&A transactions. Besides of neutrality of the form and easy enforceability of arbitral awards, parties in arbitration are able to keep the dispute discreet from the public and competitors and thus, safeguard the reputation of the corporation. Moreover, the parties are free to appoint an arbitrator who is knowledgeable in accounting and valuation issues, they can agree on the language and communications of the proceedings, thus save on translation expenses. In the end, parties can have the dispute resolved in an amicable manner by means of settlement. That is noteworthy, especially in purchase price adjustment disputes, where both sides are keen to reach a common goal. Arbitration proceedings encourage settlement and maintenance of future business relationships. All mentioned make arbitration a suitable dispute resolution mechanism for M&A transactions.


\textsuperscript{67} Moses, Margaret L.: \textit{The principles and Practice of International Commercial Arbitration} (2008, p.3).
II - FREQUENTLY DISPUTED ISSUES THAT TRIGGER PURCHASE PRICE ADJUSTMENT DISPUTES

1. Pre-Closing and Post-Closing Disputes

“Potential disputes in M&A transactions can be varied and numerous, and are often just as complex as the deals themselves.”68 Two main stages at which disputes may and do occur can be divided as the negotiation stage – pre-closing disputes and disputes arising from merger agreements the post-closing stage.69 Disputes that arise during Pre-closing transactions relate to the breaches of the letter of intent, as well as to the breach of confidentiality or exclusive rights agreement. Frequently, one of the parties asserts that the other party broke the negotiations in bad faith and caused damage. The claimant requests compensation for damages or payment of the penalty agreed upon in cases of such breach.70

In pre-closing disputes, once parties agree on essential terms of the transaction they sign Memorandum of Understanding (hereinafter MOU) or Letter of Intent (hereinafter LOI), where the structure of deal is envisaged71. “Such 'pre-contracts' are often identified expressly as non-binding, but may create a quasi-legal relationship which imposes certain obligations upon the parties, namely the duty to negotiate and act in good faith. Noncompliance with such duty may give rise to a dispute.”72 For the case of infringement of such binding rules fixed amounts provided as a penalty may apply, the dispute may rise over the amount of penalty and a statutory reduction by the judge. Without agreed penalty in the contract, it may be difficult for the plaintiff to quantify the damages.73

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70 Broichmann, Alice (International Arbitration Law Review, Issue 4): Disputes in the Fast Lane: Fast Track Arbitration in Mergers and Acquisition Disputes (p. 149)
71 Ehle, Bernd; Scherer, Mathias (IBPA Journal No 47): Arbitration of International M&A disputes (2007, p. 24)
72 Ehle, Bernd; Scherer, Mathias (IBPA Journal No 47): Arbitration of International M&A disputes (2007, p. 23-28)
Nevertheless, majority of the disputes occur after the closing, the so known post-closing disputes.\textsuperscript{74} This is typically and primarily, the claims between the buyer and the seller arising out of contractual warranties or guarantees, frequently, due to alleged violation of pre-contractual information duties. To preserve confidentiality is contractually agreed regarding both the fact of the negotiations and the information that is being exchanged, during the due diligence and especially when the potential buyer is a competitor. On this stage dispute may arise between the buyers and sellers to violations of the of the confidentiality and exclusivity agreements, the party may also argue that the other abandoned the negotiations in bad faith and thus caused damage.\textsuperscript{75} Finally it is worth noting that even in cases where the prospective buyer violated a confidentiality agreement, it is usually difficult for the seller to prove damages.\textsuperscript{76} These cases are very different from one another. Nevertheless, they share common observation which shall be discussed below.

In conclusion, a dispute may occur between signing and closing of the transactions as well. As demonstrated in the case, submitted before DIS on the acquisition of a German target company by an American group of companies, the dispute arose between the phase of signing of the contract and closing. Parties agreed that the American buyer after the conclusion of an "irrevocable and unconditional" financial commitment should submit evidence of the financing of the purchase price to a bank by a certain date. Otherwise, a penalty €10 million was threatened. Applicant stipulated the arbitration as consideration for the inclusion of exclusive interviews with the buyer. The dispute here was, whether the purchaser submitted evidence of funding which corresponded to the contractual requirements by the deadline. “Unconditional and irrevocable” financing commitment was not satisfied. Penalty payment as a result was awarded.\textsuperscript{78}

The disputes in M&A deals may occur at different stages of transaction. For the purposes of this paper we shall focus on post-closing disputes only, given those are more likely to affect the

\textsuperscript{74} Sachs, Klaus (Schieds VZ Heft 3): Schiedsgerichtsverfahren über Unternehmenskaufverträge unter besonderer Berücksichtigung kartellrechtlicher Aspekte (2004, p.125).
\textsuperscript{76} Tscäni, Rudolf; Frey, Harold: Streiterledigung in M&A-Transaktionen, original reads as follows, Schliesslich gilt es zu erwählen, dass auch in Fällen, in denen der Kaufinteressent eine Vertraulichkeitsabrede verletzt, es für den Verkäufer meist schwierig ist, einen Schaden nachzuweisen. “ (2010, p.54)
\textsuperscript{77} Sachs, Klaus (Schieds VZ Heft 3): Schiedsgerichtsverfahren über Unternehmenskaufverträge unter besonderer Berücksichtigung kartellrechtlicher Aspekte (2004, p.125).
\textsuperscript{78} Sachs, Klaus (Schieds VZ Heft 3): Schiedsgerichtsverfahren über Unternehmenskaufverträge unter besonderer Berücksichtigung kartellrechtlicher Aspekte (2004, p.125).
adjustment of the purchase price and review the particularities it entails. Nevertheless, before consideration of different aspects of the disputes that emerge in relation with adjustment of purchase price of the target company, we shall review the objectives of the purchase price adjustment itself.

2. The Purchase Price Adjustment

Price is the most important in any transaction. Buyer and seller, both, invest a lot of time and effort in calculating the value of the business. Controversially, “they may come up with very different prices due to both, the difficulty in predicting the future success of the business and the difference in information held by buyer and seller.” On one hand, a buyer wants to avoid overpayment for business and ensure that the business is free from future unexpected liabilities a seller, on the other hand, wants to receive a high price and limited exposure to future liabilities. In these circumstances parties often agree on provisional fundamental price, which is subject to adjustment in the future based on the terms agreed in advance, contractually.

The purpose of the post-closing purchase price adjustment mechanism (the “Purchase Price Adjustment”) is to include positive or negative changes between the pre-closing financial statements and financial documents of the closing date of the agreement (the “Closing”). Additionally, it provides a way of insurance to keep the seller motivated in management of the business, between signing and closing, in alliance with the long term interest of the buyer rather than the short-term interest of the seller. In the event of the seller’s mismanagement of the company resulting to decrease in value of the business, the purchase price shall be adjusted accordingly. Thus buyer has chance to mitigate the loss for the decreased value. Similarly, the

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80 Id.


seller receives the higher purchase price, if the company’s value increases during the agreed period.

Common reason why Purchase Price Adjustment clause is included in the purchase agreement (the “Agreement) is that M&A deals need a considerable time for completion.\(^{84}\) Between execution of the Agreement and Closing exists a time lag, which is generally due to either: competition issues, tax consideration, obtaining approval from the relevant authorities, or from third parties, from the board of directors, and for performance of confirmatory due diligence.\(^{85}\) The longer the time period between the signing and closing there is the higher possibility that the value of the target company will change.\(^{86}\) During this period, changes in the balance sheet or cash flows may raise necessity of modification of previously agreed purchase price, sometimes by a large amount.\(^{87}\)

The mechanism for adjustment of the final purchase price is stated in SPA and is calculated based on various calculation methods. Such as: “the book values of net worth, working capital, Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA)—based on the acquired entity’s results of operations.”\(^{88}\) For instance, adjustment based on the net asset, is calculated by, total book value of the assets of the company minus the total book value of its liabilities. This mechanism provides protection from the downturn in the business before closing, and gives the seller some benefit if it manages the business well during the transition.\(^{89}\) Usually it is the seller, who prepares the pre-closing financial documents and buyer calculates the final closing statements of net assets and working capital is generally performed by the buyer.\(^{90}\)

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As already mentioned, the uniform closing price adjustment mechanism does not exist; generally, parties first determine pre-closing working capital balance (the “Reference Balance”) and consequently, compare it to the Working Capital Balance of the closing date (the “Final Balance”). The difference between those two amounts is used for adjustment of the final purchase price. The typical process of closing adjustment is summarized by the court of Chancery’s decision in OSI Systems v. Instrumentarium Corp. (2006):

“To arrive at a final purchase price, the provision begins by stating a nominal purchase price of $57,384 million, which then is adjusted primarily through the so called “Closing Adjustment”… The “Closing Adjustment Formula” is driven by a comparison of the Spacelabs’s (target Company) Modified Working Capital as of June 30, 2003 and a Final Modified Working Capital Statement as of the Closing Date, March 19, 2004.”

Generally, it is provided in the agreement how to resolve the disagreements regarding the purchase price adjustment. For instance, purchase price agreement may provide that buyer will submit the final statement to the seller in the time of 60 days; seller will have a time to review the statement and give notice if it finds any part of the statement unreasonable. The parties work in good faith to resolve the disagreements for a specific period of time; if the efforts are unsuccessful full parties submit the dispute before third parties.

One issue that may arise regarding the preparation of the final statement is the buyer’s failure to deliver the final statement by the time provided in the contract. As adjustment of purchase price provides increase or decrease of the final purchase price the buyer would not be motivated to deliver the final statements, only in case, when the purchase price has increased. Frequently the agreement does not cover this issue. To avoid complications agreement should provide, in an expressly manner, that “the seller has right to prepare the final statement if the buyer fails to

92 Id.
timely do so.” 96 For the preparation of the final statement seller would need the access to financial documents of the target company which, generally after the closing is in the possession of the buyer. Therefore, the agreement also should refer to the sufficient access to targets financial information.97

As the Purchase Price Adjustment dispute consists from accounting and legal questions it provides the bases for conflicts during different phases of M&A transaction and “are often considered to be the most frequent source of post-closing disputes between parties to private company acquisitions.”98

3. Frequently Disputes Issues Affecting Adjustment of the Purchase Price

The Purchase Price Adjustment clauses directly influence the adjustment of purchase price, and raise accounting and legal questions. However, there are other tools that can result to modification of purchase price in M&A transactions, and those among others, are representation and warranties clauses, indemnification clauses, and Material Adverse Change (MAC) clauses.99 When any of them is breached the purchase price adjustment may become the matter of dispute between the parties. In this chapter we shall consider the issues that frequently trigger adjustment of the purchase price since those issues are closely interlinked to one another. However, it is worth noting that no purchase price adjustment dispute is the same.100 This purpose of this paper is to consider utmost persistent problems that often appear in purchase price adjustment claims.

3.1 Accounting Specifications

Most of the disputes regarding the adjustment of the purchase price arise due to parties’ failure to clearly define balance sheet items, namely, what will be measured and how it will be measured. In addition, imprecise language of the agreement as to measurement metrics, dispute resolution clauses and interrelation between purchase price adjustment and indemnification, all complicate the picture of the dispute. Every price adjustment dispute is different; the list of the accounting specifications enumerated below is non-exhaustive, but most frequently met in this type of disputes.

3.1.1 Usage of GAAP-Methods and Practices

Accounting specifications often arise in relation with Generally Accepted Accounting Principles (thereinafter “GAAP”). Parties often indicate that the balance sheet will conform to GAAP, mistakenly believing it to be one number and no dispute may arise regarding it. However, GAAP constitutes from wide range of acceptable accounting practices. Disputes mostly entail as to which method is more appropriate for valuation, the one used by the buyer or the one used by the seller. Two situations may result to such disputes: First, when buyer proposes adjustment method other from the one used by the seller, second, when seller applies one accounting method during negotiations and execution of the purchase price and as to closing switches to a different method which is more beneficial from his perspective.

Even though both of these methods may be acceptable under GAAP, the result by the adjustment of purchase price may significantly differ. For avoiding uncertainty, parties should

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specify in the Agreement which out of many GAAP acceptable methods and approaches shall be
applied during the adjustment process. In addition, dispute may arise as to which accounting
principles should apply in multi-jurisdictional, cross border transactions, for instance, UK GAAP
or French GAAP, and which of them shall prevail in light of the sellers past accounting
practices.

As mentioned before (or above), GAAP provides many methods and principles which may lead
to disputes during the adjustment of the purchase price. As an example, we can refer to the case
of Twin City Monorail v. Robbins & Myers, where parties agreed to use GAAP for evaluation of
the inventory. Since GAAP entails several different methods the buyer insisted on the method of
valuation, last in first out - LIFO and the seller demanded, first in first out – FIFO. The
application of those methods made the difference of $700,000, which became a matter of big
controversy between the parties. Therefore, the Agreement should precisely state the method the
parties shall use during the calculation of the final purchase price. It can be as easy as: “inventory
will be valued at the lower of cost or market, using the LIFO method of valuation.”

3.1.2 Precedence of GAAP over Consistency

Dispute may arise as to precedence of GAAP over consistency. In these occasions, the courts
or arbitrators examine parties’ agreement to find what the parties’ intentions were. When the
agreement is rather unclear, the arbitrator shall decide the problem independently. Generally
speaking, in case of conflict, GAAP triumphs over consistency, unless, the purchase agreement
provides variations regarding the preparation of the financial statement. For instance, the

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107 Twin City Monorail, Inc. v. Robbins & Myers, Inc., 728 F.2d 1069 (8th Cir. 1984)
application of GAAP shall prevail, notwithstanding the consistent usage of non-GAAP method in previous transactions.\textsuperscript{114} However, when an agreement provides specifically for consistency, consistency shall prevail.\textsuperscript{115} Finally, disputable may become the definition of the term “consistency,” since it may be applied in different contexts.\textsuperscript{116}

Another issue is consistency in preparation of reference balance and final balance. The court in \textit{OSI systems} stated that the balances that were needed to determine the Working Capital at Closing were to be:\textsuperscript{117}

“Prepared in accordance with the Transaction Accounting Principles applied consistently with their application in connection with the preparation of the Reference Statement of Working Capital …”\textsuperscript{118}

Therefore, parties are required to apply the same accounting principles consistently, during the preparation of reference statement and final balance even when the buyer argues that those principles do not comply with the contractual standards or GAAP. The claim in connection with the application of accounting principles shall be challenged under the breach of representation claim.\textsuperscript{119}

3.1.3 Ambiguity Regarding Interim and Year-End Reporting of Financial Statements

Uncertainty may arise on how to interpret the time periods during the preparation of the closing date balance sheet. For example, when the financial statements in negotiations were last years audited financial statements and the closing occurs in interim date, the question arises as to how

to prepare the balance sheet in that case. It can be on the contrary as well, when financial statements were made in interim month end, the closing takes place at the year end. The parties have to agree which time period should be used to achieve consistency. Those practical uncertainties cause accounting specifications in price adjustment disputes.

### 3.1.4 Errors or Irregularities Discovered After Closing

Sometimes the source of dispute may become information that is revealed after the closing date. How these disputes shall be treated largely depends on the error and its discovery. Generally, parties do not address these issues in the agreement as they do not expect occurrence of errors in the balance sheet. If the error is corrected by the seller for its own benefit, the “buyer may argue that the seller should not benefit from its own errors”

When the buyer discovers the error that is not mentioned in the balance sheet, it generally shall receive the purchase price adjustment. In conclusion, the circumstances causing the error the time of occurrence of the dispute, time of discovery, when the seller made corrections, shall all contribute to the determination of the effect on the adjustment of the purchase price. It is necessary for the seller to indicate in the Agreement the time limit objection; otherwise, seller will constantly fear to receive claims from buyer, even after closing considerable time has passed

Nevertheless, it can also happen that the intervening events and business developments affect the classification of an asset or liability under the applicable accounting principles. The case of *Mehil v. Solo Cup Company* (2007) reflects one of these situations. Parties agreed on post-closing adjustment based on changes to working Capital. Agreement called for arbitration of disputes

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related to the adjustment of the purchase price. The dispute arose regarding the facility located in St. Thomas Maryland with a value of $5.6 million. Seller treated the facility as an asset and included in the working capital; however, buyer contested that the facility should have been treated as a long term asset and hence, excluded from the working capital. The arbitrator determined the dispute in approving buyers’ position and decreased the value of the purchase price for $5.6 million. The seller challenged the ruling in the court, however, the court did not address the merits of the case and concluded that since the dispute was resolved by arbitrator seller could not litigate the case in the court.

### 3.1.5 Materiality of the Purchase Price

M&A agreements frequently contain materiality threshold clauses specifying a threshold that should be met in order the price adjustment to be made. Once the difference is higher than the contractually provided threshold, buyer will either receive the full adjustment of the price or only the difference by which the adjusted amount exceeds the threshold (a basket). Interpretation and application of concept of materiality to financial statements may result into a dispute. If the agreement does not address the materiality, parties may argue whether materiality shall be applied or not.

Buyer usually shall argue that the purchase price adjustment should be awarded, notwithstanding the materiality, unless the agreement specifically provides for basket or threshold clauses. The seller may argue that since the financial statements are prepared in accordance with the GAAP standards, and GAAP contains the materiality concept, it does apply to the price adjustment. On the other hand, seller may argue that material for a going concern business is not the same as the materiality of balance sheet of closing the transaction. Hence, M&A agreement should address the materiality standards that shall be applied to the adjustment of the purchase price.\(^\text{127}\)

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4. Failure to Disclose the Material Information

The target companies are frequently sued for not accurately, completely or timely disclosing material information about the transaction. Failure to disclose the material information is frequently cause of the adjustment of the purchase price. The Adjustment of Purchase Price disputes often interplay with representations and warranties, indemnification, and material adverse change claims and thus parties often disagree over the character of the dispute. The certain situations shall be discussed below.

4.1 Representations and Warranties

Representations and warranties cover the factual situation of the target company for the time of closing. Seller warrants the factual and legal conditions of the Target Company, in relation to existing liabilities. Buyer acquires company based on assumptions that the company is free from disputes with employees, suppliers and customers, is not polluting the environment etc. These assumptions are warranties, incorporated in the acquisition agreement.

The Seller’s representation of information incompletely or inadequately, may result to claim of breach of warranties against the seller. On the other hand, buyer’s failure to examine the representations properly may end with unexpected surprises. Representations and warranties are closely connected with the purchase price of the target company, as they reflect the “target’s guaranteed qualities.” If any of the warranted qualities turns out not to conform to the warranties provided by the seller, for instance when the balance sheet contains certain assets which do not exist, the purchaser shall request the adjustment of the purchase price.

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respectively. The qualities identified in representations and warranties in most cases are subject to due diligence.

For instance, M&A agreements frequently include a representation that the financial statements of the company are accurate, complete and prepared in compliance with the agreed accounting principles (e.g. US GAAP), that all the material contracts concluded by the target company, were made available to the buyer and that there are no other undisclosed contracts or material adverse change that has occurred after the previous year. Parties address the consequences of breaches of representations and warranties and methods of dispute resolution in the acquisition agreement.

Disputes related to representations and warranties often rise from ambiguously, vaguely or incompletely drafted clauses. The character of the dispute, whether it falls under warranty or purchase price adjustment provisions is often subject of big disagreement between the parties. Even when the parties argue over the calculation of post-closing adjustment financial statements, dispute may not be treated as purchase price adjustment dispute, but, as a breach of warranties. This happens when the disagreement between the parties exists in relation to non-compliance with agreed and warranted accounting principles. The following has significant legal and financial consequences for the parties. *Westmoreland Coal Co. v. Entech the New York (2003)* provides one of the examples regarding the situation considered.

In the case of *Westmoreland Coal Co. v. Entech the New York (2003)*, Westmoreland Coal Company acquired capital stock of Entech’s coal mining subsidiaries. Entech had warranted in the acquisition agreement that the financial statements were prepared in accordance with Generally Accepted Accounting Principles (GAAP). After closing, Westmoreland objected to Entech’s calculation of the net assets as the calculation method did not comply with GAAP, and

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consequently, requested downward adjustment of the purchase price for $74 million, nearly for the half price.

As the dispute arose, seller refused to submit it before ADR and insisted on litigation. Buyer filed a petition in the court to compel the seller to arbitration, its petition was satisfied. Consequently seller appealed. The State Court of Appeals had to rule on the appropriate forum for dispute resolution of closing financial statements. The court had to decide whether the buyer’s objections to accounting method and valuation of assets of the seller, constituted a purchase price adjustment dispute, which, according to the stock purchase agreement was to be resolved under ADR, or whether the seller breached representations and warranties, covered by indemnification provision, calling for litigation. New York Court of Appeals reversed the judgment of the state court and found that objections to valuation were a breach of representation and warranties and hence litigation was the right forum for resolving the dispute.

4.2 Purchase price adjustment or Indemnification?

Indemnity is a promise of compensation for occurrence of a certain event to an indemnified person, without being obligated to decrease the value of the business by the amount caused by the breach. The purpose of indemnities is to recover post-closing economic damages, caused by the breach of representation and warranties or covenants. Indemnity claims come into play, when warranty claim would not provide adequate compensation. Indemnities may cover specific identified risks such as litigation, environmental matters, and tax liabilities.  

Unless the SPA is specific, a question may arise whether a certain issue is subject to purchase price adjustment or indemnification. The consequences of the decision may have a diverse outcome for each party. In the case of Brim Holding Co., Inc. v. Province Healthcare Co (2008) a “dispute arose as to whether the defendant breached its indemnification obligations under the terms of a stock purchase agreement.”

144 Franceschi, Jean-Marc; Lagier, Quentin (Hogan & Hartson MNP, April 14 2010): *Indemnification provisions in M&A deals.*


to certain litigation. “Brim paid $500,000 to settle the litigation, and then made a demand upon Province for indemnification. Province rejected the demand on the ground that Brim had already recovered the payment through a working capital adjustment.

The defendant contended that the plaintiff had "already received reimbursement for that payment through the post-closing working capital adjustment and the plaintiff, therefore," was not entitled to reimbursement under the indemnification provisions.” 144 “The court focused on the indemnification language which clearly and unambiguously required the seller to indemnify the buyer for litigation and ruled in favor of the buyer.” 145 The Delaware Chancery Court arrived at a similar result with respect to employee liabilities in HDS Investment Holding Inc. 146

However, the judgment of the court in Brim Holding Co., Inc. v. Province Healthcare Co (2008) resulted to unintended double recovery against the seller. To avoid analogous double recovery, when parties agree on indemnity with regard to certain losses, any reserve related to such losses should be excluded from the Working Capital and should not be taken into consideration during the determination of the Closing Adjustment. 147

Similarly, in the case of Virgin Entertainment Holding Inc (2008), 148 the New York Court of Appeals found the claim of buyer, Violin Entertainment, to be not purchase price adjustment, but indemnification claim, and rejected the state courts order which compelled parties to arbitration. Violin Entertainment Inc. acquired Virgin Entertainment. Violin claimed that it overpaid the purchase price, as the accounts at closing were prepared in violation of GAAP. In SPA, Virgin Holdings provided Violin with reference financial statements which Virgin Holdings represented and warranted reflected the company's finances at the time in accordance with GAAP.

Violin claimed that the Company's financial statements as of the closing date were wrong and therefore it had a purchase price adjustment claim. However, the court referred to Westmoreland

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Coal Co. v. Entech case, and held that the purchaser's objections to the closing date certificate were indemnification claims, not purchase price adjustment claims, as the purchaser was not complaining about the changes that occurred between the signing of the deal and the closing. Rather, accounting principles and methods that was “specifically represented and warranted” ... Accordingly, court denied Violin’s petition to compel arbitration.

As the cases demonstrated, the courts often confronted with the question whether the claim is characterized as a purchase price adjustment claim or as an indemnity claim for breach of representation and warranty. Therefore, the seller should ensure that the purchase price adjustment claims do not cover the claims which would otherwise be subject to indemnification. Thus, parties need a decent clarification on what shall be measured and how.149

4.3 Material Adverse Effect/Change

Material adverse change (MAC) or material adverse effect (MAE) are conditions used in Merger and Acquisition agreements for allocating risks between the parties during the signing and closing of the contract.150 MAC clauses give a party right of recession from contract if certain negative changes occur until the closing of the transaction.151 What consists of material change is defined in Black’s Law Dictionary “as meaning “of such a nature that knowledge of the item would affect a person’s decision-making process,” material can also mean, less precisely, “significant” or “important enough to merit attention.”152 In the event of MAC occurrence buyer is allowed to terminate the agreement without paying any penalty.153

The primary purpose of a MAC clause is to protect a party against a significant economic change of a deal. The absence of a MAC can be a pre-condition to the buyer’s obligation of transaction

153 Eltvedt, Edouard; Franceschi, Jean-Marc (Hogan & Hartson MNP, March 10 2010): The MAC clause in French M&A deals (2010).
completion.\textsuperscript{154} Usually financial investors acquire targets through debt financing, accordingly, it is essential for acquirers to be in a position to cancel the transaction when the debt financing in the circumstances becomes unavailable. Then on occurrence of a MAC can be a representation provided by the seller as well, which is subject to indemnification if the representation turns out to be incorrect.\textsuperscript{155} “When representing an appropriate field of change, it would consist of the business, results of operations, assets, liabilities, or financial condition of the target, but the exact formulation depends on the kind of transaction involved.”\textsuperscript{156}

The legal effect of MAC generally results to rescission of a party from the contract, which is largely undesirable consequence in M&A deal.\textsuperscript{157} Thereby, parties first try to renegotiate the purchase price before recession. It is common to renegotiate the purchase price in the event of MAC,\textsuperscript{158} party may as well terminate the agreement as MAC allows termination without penalty. In conclusion, Purchase Price Adjustment clauses, as well as, indemnity claims, representations and warranties claims, Material Adverse Change (MAC) clauses, all have the same effect. When the value of the company changes all lead to modification of the purchase price, thus, to Purchase Price Adjustment.\textsuperscript{159} Accordingly, the clauses should be drafted carefully and be well coordinated, to avoid contradiction or overlap between the clauses, since as demonstrated above depending how the claim is classifies may have a drastically different outcome for the parties.

4.4 Adjustment Based on Earn-Out Clauses

When the buyer and seller have distinct opinions on the future performance of the company, an earn-out adjustment may assist them to reach an agreement. The buyer may pay a lower price than the seller would prefer, but subsequently receive a high earn-out if the value of the business

\textsuperscript{154} Eltvedt, Edouard; Franceschi, Jean-Marc (Hogan & Hartson MNP, March 10 2010): The MAC clause in French M&A deals (2010.)
\textsuperscript{155} Eltvedt, Edouard; Franceschi, Jean-Marc (Hogan & Hartson MNP, March 10 2010): The MAC clause in French M&A deals (2010.)
Earn out clause may be advantageous for both, buyer and seller. Buyer can adjust the price based on future earnings and the seller who was acting in good faith and did not overrate its company may benefit from the positive adjustment. These earn-out arrangements, even if carefully structured, cannot anticipate some of the unique issues that may arise. The key point is these are highly subjective criteria. In earn out clauses the most frequently disputed issue is the calculation of EBITDA related to accounting classification of the transaction and the timing when the transaction should occur. Likewise, in the case of *Comet Systems, Inc. Shareholders’ Agent v. MIVA, Inc.*, (2008) the dispute arose regarding the interpretation of a provision for calculation of EBITDA, of the merger agreement.

The Comet Systems (thereinafter Comet) was acquired by MIVA Inc. (thereinafter MIVA) the acquisition agreement provided for earn out adjustment of the purchase price. Dispute arose specifically over the bonus of $800,000 which was paid to employs of Comet. The questions were whether the bonus constituted “cost per user” or operation expenses. Notwithstanding, Comet’s argument that it had treated bonuses in the past as operating expenses, the court determined that since the payment was "one time and non-recurring" it presented a onetime expense that should not be taken into consideration in calculating an earn out. Therefore, the calculation of EBITDA may trigger one of its kind disputes of an accounting nature, which could be hardly anticipated in forward by the parties. However, parties should identify the main provisions of EBITDA in forward to avoid at least implications over fundamental matters.

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PROCEDURAL IMPLICATIONS OF THE PURCHASE PRICE ADJUSTMENT DISPUTES

As mentioned in the previous part of the paper careful drafting of the components of the purchase price adjustment calculations has a significant importance for the parties, however, it is equally and even more importantly, required to draft the dispute resolution clause, careful and clear manner, as the parties largely depend on the dispute resolution mechanisms in achieving what they expected from the deal.

1. The Important Role of Experts

In case of M&A transactions, it is common to submit the dispute to experts before the arbitration.\(^\text{164}\) M&A agreements regularly include multi step dispute resolution clauses by means of which neutral expert will determine dispute relating to matters such as post-closing balance sheet adjustments and arbitrators will resolve further disputes: “in short, it provides an attractive combination of binding and non-binding ADR mechanisms.”\(^\text{165}\) In the event of two stages of dispute resolution, arbitration takes place only when the efforts taken in the prior stage were ineffective.\(^\text{166}\)

In M&A transactions, the final purchase price is determined using the financial figures as of the closing date.\(^\text{167}\) Disputes regarding the closing accounts have a technical character, since they primarily focus on application of accounting standards.\(^\text{168}\) For instance, disputes regarding the valuation of shares are commonly referred to audit companies rather than arbitrators.\(^\text{169}\) At the expert determination stage, if the parties cannot agree on valuation or adjustment, parties


\(^{169}\) ASA Bulletin 2/2005 p. 249
maintain an independent third party, an accountant to conclude on specific accounting questions. Experts are retained to determine a matter of fact, valuation or law.”

“Expert determination is very suitable for settling such matters, particularly because any state or arbitral court would also normally call an expert to clarify such economic issues.”

It is logical, to submit the purchase price adjustment disputes to expert determination, as it provides a quick and inexpensive way to solve valuation of technical matters. The purpose of involving third parties in dispute, is first, to benefit from their expert knowledge, for example in chartered accounting, technical, environmental, or construction matters, and second, to have a neutral third party who has the confidence of both parties to act as a form of out-of-court dispute resolution.

The major task of the experts is to determine price adjustment disputes in a straightforward and the non-bureaucratic way.

When referring to expert determination we should bear in mind that expert determination does not mean the “appointment of an expert by the arbitral tribunal for the purposes of arbitral proceedings, since the findings of the tribunal appointed expert can be freely assessed by the tribunal.” Whereas, an expert’s decision is not binding but advisory, the process is “Expert Evaluation.” An expert, whose report has a binding effect, is an expert arbitrator. The latter often causes confusion regarding the scopes of competences between the experts and arbitrators.

2. Difference between Expert Arbitrator and Legal Arbitration

178 ASA Bulletin 2/2005, p.258
To differentiate expert determination from arbitration is important matter for the following purposes: first, only the awards rendered by the arbitrators are being enforceable, and second, the remedies against expert determination, even when the experts are equipped with binding power, are wider than for the awards rendered by the arbitrators.\textsuperscript{179} The binding power of the expert determination depends on the terms of the parties’ agreement.\textsuperscript{180}

An expert, unlike arbitrators, neither tries to achieve resolution of the dispute, nor does he render an award that is enforceable.\textsuperscript{181} “However, the expert determination does bind the arbitral tribunal dealing in the same case in the sense, that the latter will not have the right to revisit the factual outcome settled on by the expert.”\textsuperscript{182} Another difference between the two is that there is no requirement "for the expert to be a natural person. The expert can be a company, such as a large accounting firm. Whether a company, or natural person, the expert must be as impartial and independent as an arbitrator. In addition, the procedure followed by the expert must comply with the basic requirements of due process and the right to be heard.”\textsuperscript{183}

Furthermore, since “the expert is neither an arbitrator nor a judge. The expert will not have the necessary legal tools at hand to properly conduct a proceeding and make the parties observe the rules. In particular, the expert cannot force a reluctant party to comply with expert's and the other party's requests relating to, for instance, the submission of comments, attendance at the hearing, the production of documents or the granting of access to data and persons.”\textsuperscript{184} Therefore, expert is not in a position to overcome a misconduct of the parties.\textsuperscript{185} In contrast to arbitration, the agreement to refer a dispute to an expert generally occurs after the dispute is arisen. However, it may as well be inserted as "a clause in a commercial contract, which provides that, in the event of a dispute, the parties agree to refer the dispute to an expert.”\textsuperscript{186}

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\item[179] ASA Bulletin 2/2005 p. 249
\item[180] ASA Bulletin 2/2005 p. 249
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In conclusion, since parties are free to determine the process of expert determination and arbitration, the process may bear similarities. The similarities constitute in parties autonomy to create the process, as both are processes that depend on the contract. The parties are free to specify speed, formality and complexity of the proceedings. This sometimes makes difficult to distinguish the borderline between the two. However, even when the determination of an expert is binding “it does not have res judicata effect and it cannot be enforced.” 

In case of disagreement between the parties over the binding power of an expert, the subsequent legal proceedings of the arbitral tribunal will decide whether the expert determination is binding over the parties or not.

3. Problems that Arise in Relation with Expert Determination and Arbitration

Besides of providing effective resolution to valuation disputes expert determination may as well become source of procedural implications. Generally, the problem arises in relations with the following ambiguities: First the expert determination clause may not always be specific and easy to understand; sometimes it is difficult to conclude whether a clause provides for arbitration or an expert determination. The nature of the clause is not determined solely based on the names provided in the agreement but according to the parties’ intention, scope of competences and procedures.

Second, when M&A agreement includes dispute resolution clauses of expert determination and arbitration, it is difficult to find the borders between the scopes of application of each clause. Namely, if the valuation of the purchase price was determined by an expert and is binding over arbitration, the expert determination might have based the determinations on other matters, such

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189 Age Old Builders Pty Ltd v Swintons Pty Ltd [2003] VSC 307 21 August 2003. In the award made in December 2002, the Victorian Civil & Administrative Tribunal (VCAT) ruled that an agreement, which included the Institute of Arbitrators and Mediators Australia (IAMA) rules of expert determination, was as a matter of fact, an arbitration agreement and was void by reason of the provisions of the Domestic Building Contracts Act 1995. The court of Appeal reversed the judgment stating that the cause provides for expert determination, not arbitration.

as, contract interpretation. Arbitral tribunal may find the latter to be under its competences and consider itself free to determine it,\textsuperscript{191} thus, voiding the determination of expert.

The following was the case in FAX (France) v. SL (Netherlands) (1999), which involved acquisition of shares with guaranteed value, arbitration proceedings were to be followed after “audit arbitration”. Purchaser submitted the dispute to ICC arbitration and requested to find the seller in breach of the guarantee clause by providing wrong accounts. Additionally, purchaser requested to order the seller to pay damages. The arbitral tribunal first had to rule on its own competence in view of “price adjustment procedure” performed by “audit arbitration” and arbitration clause included in the share purchase agreement. After interpretation of provisions, arbitral tribunal found itself competent and rejected to be bound by the audit arbitration.\textsuperscript{192}

Third, the procedure of expert determination must comply with the requirements of fair proceedings, but expert is not in a position to make the parties adhere to the legal rules, for instance, attendance on hearings or production of documents, therefore, it is difficult to ensure that experts comply with procedural requirements.\textsuperscript{193}

Fourth, problematic issue is expert determination of legal issues, as well. Even though, it is desirable to limit the duties of experts to technical questions, such as application of accounting standards in adjusting final accounts, experts are still often confronted with legal issues. For instance, definition of net assets, cash and working capital may become necessary for adjusting the purchase price.\textsuperscript{194} That is why, the common difficulty in purchase price adjustment arbitration, is one of the parties’ disregard of expert determination and commencement of arbitration, before experts are even commissioned. Party in that case may argue that it needs clarification of legal questions, such as contract interpretation, prior to expert valuation, as the expert need to rely on certain legal terms to conduct valuations. In that case, the arbitral tribunal


\textsuperscript{192} Ehle, Bernd D. (The Comparative Law Yearbook of International Business Vol. 27): Arbitration as Dispute Resolution Mechanism in Mergers and Acquisitions (2005, p. 300) FAX (France) v. SL (Netherlands), Partial Award, ICC Case No. 8630, ASA Bulletin 1999, pp. 338-354


is constituted to decide the disagreement. Arbitrators can also appoint experts who shall carry out the valuation.  

When one of the parties disregards the first step of expert determination, the following consequences largely depends on the agreement of the parties and the nature of the expert’s powers. If the step is a precondition to arbitration and is clear and determinative procedure, then it would appear that the tribunal would have no jurisdiction to decide the matter until the procedure is followed. If, however, it did so, then any award it made would be open to challenge. 

Peculiarly, acquisition agreements often include arbitration and expert determination provisions as two separate dispute resolution clauses in one agreement. The disputes regarding the adjustment of the purchase price are submitted to experts, while all other disputes are subject to arbitration. Thus purchase price adjustment dispute is separated from general dispute resolution clause. As the case law shows, when there is two separate dispute resolution clause the issue of arbitrability is decided by the courts and not by the arbitral tribunal, as it would be in case of single arbitration clause under the general circumstances. The question in case of two ADR clauses, is not whether there should be arbitration at all but which out of two arbitration forums is the proper one. Thus, presumption of arbitrability does not apply. In addition, the courts in Untied States follow that when an agreement includes "one specific, a valuation provision and one general, a broad arbitration clause, the specific provision will govern the claims that fall under it." The inclusion of valuation provision to address purchase price adjustment disputes is considered as parties’ intent to remove the valuation determinations, from general arbitration clause. Thus, valuation disputes cannot be submitted to general arbitration directly.

The case of *Columbus v. InterComme* (2006), demonstrates the procedural difficulties that may arise when parties agree multi-stage dispute resolution clauses, and addresses issues of arbitrability of

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199 See Blue Tee Corp. v. Kochring Co., 999 F.2d 633 (2d Cir.1993); see also Whirlpool Corp. v. Philips Elec., N.V. (In re Whirlpool Corp.), 848 F.Supp. 474, 479 (S.D.N.Y.1994)

the two competing arbitrations. According to the facts of the case, parties agreed to arbitrate any dispute over the adjustment of the purchase price for Columbus' acquisition of the shares of Trinidad and Tobago Trans-Cable Company Limited (TTT), before independent accounting firm of PricewaterhouseCoopers (PWC) and other disputes before the American Arbitration Association (AAA). “A dispute arose over how to calculate TTT's EBITDA - a metric for operating cash flow which is one of the components of the CF Adjustment. The issue was whether TTT's investment income - which is not, generally considered part of a company's operating income - should be included in the EBITDA calculation.”

The court held that it was the court who decides whether the parties agreed to arbitrate and not the arbitrator. The court referred to the case of Katz and XL, and stated that the presence of both specific and general arbitration provisions creates an ambiguity and the interaction of these two clauses, requires that a court determine the arbitrability issues, not the AAA. Besides of Intercoms, argument that the claim did not only related to the purchase price adjustment but included representation and warranty claim which was subject to arbitration before AAA, the court did not agree and concluded that InterComm cannot “simply ignore what is a condition precedent to arbitration,” Therefore, the court decided parties should have arbitrated before PWC.

Importantly, determination of jurisdiction between two different forums for dispute resolution has not only a procedural meaning for the parties, but it significantly affects the outcome of the AAA arbitration. The dispute in this case was whether parties should have arbitrated before PWC, opposed to AAA. In addition, respondent argued that arbitration could not commence since the precedent to the arbitration was not satisfied - "i.e., the issuance by Ernst and Young (E&Y) of the Closing Audit Report." The court held that it was the court who decides whether the parties agreed to arbitrate and not the arbitrator. The court referred to the case of Katz and XL, and stated that the presence of

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201 Columbus v. InterComm., 2006 WL 2307830, (S.D.N.Y. June 12, 2006.)
202 Columbus v. InterComm., 2006 WL 2307830, (S.D.N.Y. June 12, 2006.)
both specific and general arbitration provisions creates an ambiguity and the interaction of these two clauses, requires that a court determine the arbitrability issues, not the AAA. Besides of Intercoms, argument that the claim did not only related to the purchase price adjustment but included representation and warranty claim which was subject to arbitration before AAA, as well, the court did not agree to InterComms arguments and concluded that InterComm cannot “simply ignore what is a condition precedent to arbitration.” Therefore, the court decided parties should have arbitrated before PWC.

Importantly, determination of jurisdiction between expert determination and arbitration has not only a procedural meaning for the parties, but it significantly affects the outcome of the adjustment of the purchase price. This explains the reasons of frequent disagreements between the parties over submission of dispute before the appropriate forum and is remarkably well demonstrated in the case of OSI Systems, Inc. v. Instrumentarium Corp (2006).

In the case of OSI Systems, Inc v. Instrumentarium Corp, the dispute arose regarding the method by which OSI came to its conclusion in the calculation of closing purchase price. A plaintiff, OSI purchased a medical products and services business, from Finish company, Instrumentarium Corporation. The purchase price agreement contained the nominal price of $57.384 million, and the mechanism for adjustment of the purchase price. As of the closing date, OSI calculated Modified Working Capital Statement, which was $30 million lower than calculated by the Instrumentarium in the previous year.

Therefore, according to OSI, it was entitled to a downward Closing Adjustment of approximately $25.347 million - 54% of the nominal price. As the respondent argued the difference in the Working Capital calculations was not resulted from changes in Working Capital by reasons of business operations, but from a fundamental alteration in accounting principles. On the other hand, OSI argued that it did not rely on the same accounting principles as the seller, Instrumentarium, because the seller did not comply with U.S GAAP in its calculation.

The Agreement provided that the purchase price adjustment disputes would be resolved before “Closing Adjustment Arbitration” by the accounting firm, and the obligation of breach of representation and warranties before legal arbitration. As the seller argued, inaccuracy of financial

205 Columbus v. InterComm., 2006 WL 2307830, (S.D.N.Y. June 12, 2006)
statements was subject to legal arbitration and constituted a violation of representation and warranties. This argument had a significant financial worth for the seller, since the breach of representation had an indemnity cap of 25% of the purchase price. The indemnity cap would enable the seller to adjustment of the purchase price only by 25% instead of 54% as it was demanded by the buyer.

The court had to determine which, legal or accounting arbitration, should decide the dispute. The court ruled in favor of the seller by sending parties to legal arbitration. Where the parties had first to determine whether the accounting principles used in the Reference Statement complied with US GAAP, and then to proceed with Closing Adjustment Arbitration by the accounting firm. However, sending parties to legal arbitration would amount for the buyer adjustment of the purchase price only by 25% and not by 54%.

As we have seen the multi-step dispute resolution clauses which aim at a resolution of dispute in a speedy and inexpensive way, may regrow into lengthy and complicated procedural disputes. As a solution to the above mentioned problems, if parties disagree with expert’s valuation of the final accounts it is better providing for mandatory arbitration. Furthermore, parties should make a clear distinction between the arbitration and expert determination, and additionally, specify in the clause that the expert will not act as an arbitrator. The jurisdiction of an expert’s scope of the area should be defined to avoid the numerous conflicts of competences between the experts and arbitrators. The appointment of expert should be addressed in the clause, more specifically, arbitrators should be given the possibility to appoint experts when the latter is unavailable or parties cannot agree on appointment of expert.

In conclusion, the combination of expert determination and arbitration can be an effective and speedy method for dispute resolution in M&A transactions and typically applies to purchase price adjustment claims. However, it may also become the source of new disputes when parties
disagree whether they have reached the next step,\textsuperscript{210} or condition precedent to arbitration has occurred or not. This may cause lengthy disagreements and delays of proceedings, making dispute resolution process extremely complex and expensive. Thus, parties should pay sufficient attention to the formulation of dispute resolution clauses, especially in the context of scope of competences. Furthermore, parties shall draft the dispute resolution clauses in a narrow and straightforward way to leave as less room as possible for the manipulations and different interpretations regarding the dispute resolution procedure of adjustment of the purchase price.

3. Ensuring Party Equality in Multi-Party and Multi-Contract Arbitration

The other important issue concerning arbitration of M&A Transactions is complex business transactions involving new company structures with multi-party arbitration.\textsuperscript{211} Merger and Acquisition transactions are not only involving participation of several parties in arbitration (multi-party proceedings) but economically connected contracts to arbitration (multi-contract arbitration) as well.\textsuperscript{212} For instance, a violation of the purchase agreement may cause cancelation of the supply contracts and vice versa.\textsuperscript{213} In disputes surrounding these transactions problem arises with constitution of arbitral tribunal in context of equal participation of the parties.\textsuperscript{214} Those implications are frequently occurring in M&A arbitration, and purchase price adjustment disputes are no exception to it.

Multi-party and multi-contract arbitration often raises difficult procedural questions. In particular, constitution of the arbitral tribunal in alliance with parties’ intentions and respect to the principle of fair and equal treatment of each party in the process of selection of the arbitral tribunal.\textsuperscript{215} The proper constitution of the arbitral tribunal is not necessary only from the perspective of procedural administration of the case, but from the execution of the final

\textsuperscript{210} Ehle, Bernd D. (The Comparative Law Yearbook of International Business Vol. 27): Arbitration as Dispute Resolution Mechanism in Mergers and Acquisitions (2005, p. 301)


\textsuperscript{214} Ehle, Bernd D. (The Comparative Law Yearbook of International Business Vol. 27): Arbitration as Dispute Resolution Mechanism in Mergers and Acquisitions (2005, p. 287)

outcome, as well. The award rendered by the improperly designated arbitral tribunal bears the risk of being annulled at the place of arbitral situs or held unenforceable at the place where enforcement of the award is sought.

The case of Dutco (1992) was a landmark decision which fundamentally changed the institutional approach to setting up arbitral tribunals in multiparty proceedings. The case of Dutco is different from other cases involving multi-party arbitration in the terms that multiple respondents were not affiliated companies, but companies with distinct interests and claims. When there are multiple respondents who have identical interests regarding the outcome of the arbitral proceedings, it is more likely that respondents shall agree on the appointment of the same arbitrator, as there is no legitimate reason not to do so. Accordingly, the case studies have demonstrated that when there are unaffiliated respondents with distinct claims, as it was in the case of Dutco, respect to principle of equality requires arbitrators to be elected under the modern rules of arbitration, for instance, in accordance with article 10 of the ICC Arbitration Rules, in the event of no special agreement between the parties. However in cases when, respondents are closely affiliated or have inseparable interests, they are often treated as a one party during the designation of the arbitral tribunal.

Following the Dutco case, the ICC added a new provision to article 10 of the ICC Arbitration Rules that entitles the ICC Court of Arbitration to designate the arbitral tribunal in cases of multi-party arbitration, where parties disagree on designation of an arbitrator. As of today, the rules of the most arbitration institutions, the London Court of International Arbitration (LCIA), the Arbitration Institute of the Stockholm of Chamber of Commerce, the Singapore

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219 Koch, C (28 ASA Bulletin 2/2010 (June)): Judicial Activism and the Limits of International Arbitration in Multiparty Disputes.
224 LCIA Arbitration Rules, effective 1 January 1998, Article 8 (Three or More Parties).
225 Rules of the Arbitration Institute of the Stockholm Chamber of Commerce, effective 1 April 1999, Article 16 (3) (Number of Arbitrators and Manner of their Appointment).
International Arbitration Centre (SIAC),\textsuperscript{226} the China International Economic and Trade Arbitration Commission (CIETAC),\textsuperscript{227} and the Swiss Rules of International Arbitration are well aware of the problems that may arise from the improper designation of the arbitral tribunal in multi-party situations and provide for adequate solutions to solve this practical problem, consistent with the principle of equal treatment of the parties.\textsuperscript{228}

In order to avoid misunderstandings, it is in parties’ interests to consider the problem of multi-party arbitrations when drafting arbitration agreements in M&A transactions. Especially, in the event of the ad hoc arbitration, parties should address the selection process of the arbitrators.\textsuperscript{229} It can be sufficient, to insert the model clauses of arbitral institutions regarding multi-party arbitration in the acquisition agreement. The equality of the parties is an element of international public policy.\textsuperscript{230} Therefore, the breach of this principle can result to non-recognition of an arbitral award.\textsuperscript{231} In the light of careful drafting of the selection process of arbitrators, parties shall make sure that the award shall not be set aside or declared unenforceable due to the unequal treatment of the parties or improper constitution of the arbitral tribunal.

\begin{footnotesize}
\begin{itemize}
  \item[\textsuperscript{226}] Arbitration Rules of the Singapore International Arbitration Centre SIAC Rules 4th Edition, 1 July 2010, Rule 9: Multi-party Appointment of Arbitrator(s)
  \item[\textsuperscript{227}] China International Economic and Trade Arbitration Commission CIETAC Arbitration Rules
  \item[\textsuperscript{228}] Ehle, Bernd; Scherer, Mathias (IBPA Journal No 47): \textit{Arbitration of International M\&A disputes} (2007, p. 2)
  \item[\textsuperscript{229}] Böckstiegel, Karl-Heinz; Kröll, Stefan; Nacimiento, Patricia (Transnational Dispute Management, \textit{Vol. 6, Issue 1, March 2009}): \textit{Germany as a Place for International and Domestic Arbitrations – General Overview} (2009, p. 60, para 160).
  \item[\textsuperscript{230}] Böckstiegel, Karl-Heinz; Kröll, Stefan; Nacimiento, Patricia (Transnational Dispute Management, \textit{Vol. 6, Issue 1, March 2009}): \textit{Germany as a Place for International and Domestic Arbitrations – General Overview} (2009, p. 60, para 160; Art. V (2)(b))
  \item[\textsuperscript{231}] Böckstiegel, Karl-Heinz; Kröll, Stefan; Nacimiento, Patricia (Transnational Dispute Management, \textit{Vol. 6, Issue 1, March 2009}): \textit{Germany as a Place for International and Domestic Arbitrations – General Overview} (2009, p. 60, para 160).
\end{itemize}
\end{footnotesize}
The purchase price adjustment mechanism is an effective tool to allocate the risk between the buyer and the seller during the signing and closing of the deal, specifically when parties considerably disagree over the value of the business. The parties are entitled to decrease or increase the initial purchase price in accordance with the changed value of the target company. Thus, the purchase price adjustment encourages the seller to manage the target company in an alliance with long term interest of the buyer, rather than the short term interest of the seller.

Most of the purchase price adjustment mechanisms require the adjustments to be prepared consistently in accordance with GAAP. The Arbitrators rely on these principles during the calculation of adjustments. However, the GAAP consists of extensive variation of the practices which are acceptable but could significantly change the result of the adjustment of the purchase price. Furthermore, if the financial statements, which are used for adjustment, are not prepared in accordance with GAAP, the whole process may be compromised, not mentioning the disagreements that could follow between the parties.

Furthermore, the adjustment of the purchase price disputes are frequently triggered in relation with indemnity claims, representations and warranties claims, Material Adverse Change (MAC) clauses. All mentioned have economic effect similar to adjustment of the purchase price. In the event of change in value of the company, all result to modification of the purchase price, thus, to purchase price adjustment. These provisions often interplay between one another giving an effect to controversies between the parties. Therefore, the clauses should be drafted carefully and be well coordinated to avoid contradiction or overlap between the clauses. From the purchase price adjustment point of view and depending on which of the mentioned provisions was breached, it delivers significantly different outcome for the parties.

Thus, arbitration is an effective mechanism for resolving the purchase price adjustment disputes, as opposed to the court litigation, both in the domestic and in the international context. To have an alternative of selecting an arbitrator who is familiar with M&A transactions and is well suited for these particular purchase price adjustment disputes, is of immense importance for the parties. In addition, arbitration provides certain advantages: such as confidentiality, flexibility, and outlook for amicable settlement. Characteristically, in the purchase price adjustment disputes,
crucial role is performed by the experts. Parties or the arbitration tribunal appoint an expert to conclude on specific valuation issues.

Often the subject of controversy becomes whether the dispute should be submitted before an expert or an arbitrator. Depending on the language of the contract, the dispute is determined either by an arbitrator or in the case when specific and general dispute resolution clauses are present, by the state court. Notwithstanding certain procedural particularities and pitfalls, arbitration remains to be an effective method for dispute resolution in all stages of merger and acquisitions, including the adjustment of the purchase price. The keys to successful arbitration in the purchase price adjustment disputes is the careful drafting of the arbitration agreement, which clearly distinguishes between the experts and arbitrators’ competences and the choice of the right experts.

In conclusion, dispute resolution mechanisms in connection with price adjustments as well as adjustment procedure, require careful thought and consideration. Distinctly defining the framework and competences for the arbitrator to render the decision and cautiously selecting the arbitrator are keys to achieving a fair and predictable resolution. However, open end of the adjustment mechanism and conflicting interests, intervention of legal and financial principles, inconsistencies between applied procedures, nonexistence of well-defined accounting concepts, different practices of reporting and accounting methods, especially between parties with diverse cultural background, has resulted and shall result into the frequent source of post-closing disputes between the parties of the transaction. Even careful contract drafting will not eliminate all of the complex issues that characterize to these transactions.
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