

**THE MODEL ACQUISITION DOCUMENTATION PROJECT AND
ALTERNATIVE DISPUTE RESOLUTION –
ARBITRATION OF MERGERS AND ACQUISITIONS**

Presented by

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BIOGRAPHY

George M. Taylor, III is a partner in the Birmingham law firm of Burr & Forman LLP, where he practices in the area of merger and acquisition law. He serves as a member of the firm's Management Committee and as chairman of the firm's Technology Committee. Mr. Taylor received his B.A. degree, summa cum laude, from the University of the South, Sewanee, Tennessee, and his J.D. degree from Vanderbilt University where he was a member of the Order of the Coif. He is a member of the Birmingham, American, and International Bar Associations, and the Alabama State Bar. Mr. Taylor is a past member of the Alabama State Board of Bar Examiners and former editor of the *Vanderbilt Journal of Transnational Law*. Mr. Taylor is a fifteen-year veteran of the Committee on Negotiated Acquisitions of the American Bar Association. As part of his work with that committee, Mr. Taylor participated in the drafting of the ABA Model Stock Purchase Agreement with Commentary, and he is now a member of the editorial group completing the drafting of the ABA Model Asset Purchase Agreement, expected to be published later this year.

MODEL ACQUISITION DOCUMENTATION PROJECT AND THE USE OF ALTERNATIVE DISPUTE RESOLUTION

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I. INTRODUCTION AND BACKGROUND OF THE MODEL ACQUISITION DOCUMENTATION PROJECTS

The ABA Model Stock Purchase Agreement, which has now been in print for over five years, was drafted and published as the first major project of the Business Law Section's Committee on Negotiated Acquisitions. The Committee was formed approximately fifteen years ago by the Section in an effort to address a gap in the Section's structure which had left no place for the discussion of ordinary acquisitions not brought in the context of hostile acquisitions of publicly traded companies.

The first major project of the Negotiated Acquisitions Committee was the drafting of a model stock purchase agreement that could serve as a purchaser's first draft in a non-hostile purchase. As time progressed, the committee grew in size, and by the time the ABA Model Stock Purchase Agreement with Commentary was published, that document represented the work of over 120 practitioners throughout the United States and in a number of foreign countries. The Committee now numbers over 500, and the work of the Committee has broadened to include an extensive array of seminar offerings as well as additional model acquisition documents. The next document to be published will be the ABA Model Asset Purchase Agreement with Commentary, parts of which are excerpted below. Other subcommittees of the Negotiated Acquisitions Committee are at work on joint venture agreements, international acquisition documents, and related ancillary documents.

Within the numerous debates engaged in by the members of the Committee during the drafting process was whether the model agreement should reflect the present state of the art or a vision of what should be developing as the ideal acquisition agreement. The latter thought was to "push the envelope" by including provisions which, though not presently accepted by acquisition lawyers as a matter of course, nevertheless represented a welcome development in the practice or

one that deserved serious attention. This approach would be similar to that used by the drafters of the RESTATEMENT OF THE LAW (2D), who frequently went beyond the current state of the law (and the scope of the first series of RESTATEMENT OF THE LAW) in outlining legal principles. The committee took the conservative course with the result that the Model Stock Purchase Agreement as it stands is not an effort to move beyond the current state of practice but is primarily a reflection of acquisition customs at the time of its drafting.

The discussion of whether to move beyond accepted acquisition practices was nowhere more apparent than in the discussions of the use of alternative dispute resolution. The debate among the members was scholarly and civil and reflected both disparate practices in different regions of the country and particular experiences that each of the members had had in arbitration matters. Even though the decision was made to exclude ADR provisions from the text of the Model Stock Purchase Agreement, the commentary to the Model Stock Purchase Agreement included a brief discussion of ADR. This discussion, though somewhat dated, is included in this volume for your review. At the time of drafting of the yet-to-be-published Model Asset Purchase Agreement, arbitration had found wider-spread usage, and accordingly the commentary on the Model Asset Purchase Agreement not only discusses the use of ADR but furnishes model language for consideration. This Section is included below as well. Also enclosed in this volume are excerpts from the purchase price adjustment section of the Model Stock Purchase Agreement, which provisions, in arbitration-like style, confer on third-party accountants the right to determine the most important point of controversy in any acquisition document, the purchase price.

II. ARBITRATION AND MEDIATION IN THE MODEL STOCK PURCHASE AGREEMENT

Having decided against the use of ADR in the Model Stock Purchase Agreement, the drafters could easily have ignored the subject altogether. The group followed a better approach, which was to add discussion about ADR in the commentary section. That language was included in a somewhat arbitrarily-selected location in the miscellaneous section of the Agreement. Discussion of ADR is found following Section 11.5, which deals with Jurisdiction and Service of Process:

11.5 JURISDICTION; SERVICE OF PROCESS

Any action or proceeding seeking to enforce any provision of, or based on any right arising out of, this Agreement may be brought against any of the parties in the courts of the State of _____, County of _____, or, if it has or can acquire jurisdiction in the United States District Court for the _____ District of _____, and each of the parties consents to the jurisdiction of such courts (and of the appropriate appellate courts) in any such action or proceeding and waives any objection to venue laid therein. Process in any action or proceeding referred to in the preceding sentence may be served on any party anywhere in the world.

COMMENT

This provision is designed to ensure that jurisdiction can be obtained for any litigation arising from the acquisition. The Model Stock Purchase Agreement recognizes that a federal district court might not have jurisdiction over a claim related to the acquisition, but provides that each party consents to federal court jurisdiction if such jurisdiction can be acquired. The Model Stock Purchase Agreement also waives objections to venue, which gives certainty to the forum of any litigation. If the acquisition agreement includes an arbitration provision, the jurisdiction and service of process provisions should be made consistent with an arbitration provision.

The last sentence of Section 11.5 establishes that service of process may be obtained on any party anywhere in the world and establishes a basis for acquiring in personam jurisdiction.

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The Model Stock Purchase Agreement does not contain an alternative dispute resolution ("ADR") provision (other than that related to the purchase price adjustment formula in Section 2.5) and contemplates litigation as the principal means of dispute resolution. Existing practice with respect to ADR provisions is varied and changing. A Buyer's reasonable first draft may contemplate that litigation is the appropriate dispute resolution mechanism because the Buyer is more likely than the Sellers to assert claims under the acquisition agreement. The prospect of litigation may give the Buyer greater leverage in resolving such claims than would the prospect of mandatory ADR. However, in choosing between litigation and ADR, the Buyer should consider factors such as the cost, the time until resolution, the scope of discovery, its ongoing relationship with the Sellers, confidentiality of the dispute, and the need for expertise in resolving the dispute.

The Buyer may prefer the broad scope of discovery available in litigation. Although discovery is available under some kinds of ADR procedures, it is generally more limited. Because many of the facts necessary for favorable resolution of the Buyer's claims may be in the Sellers' possession (especially if a dispute centers on representations and warranties containing knowledge qualifications), these facts may not be available without discovery. Recourse to court sanctions for failing to respond properly to discovery requests may be important to the Buyer.

Many attorneys and clients feel that ADR has the effect of leveling the playing field by giving more certainty and speed to the outcome. If the Buyer is the wealthier party, it may prefer litigation.

Nonetheless, the Buyer may prefer ADR in certain circumstances. If the Buyer and the Sellers have a continuing business relationship, they may desire to avoid or minimize adversarial proceedings by using ADR. ADR also makes it easier

to preserve the confidentiality of a controversy. If the parties believe that special expertise is necessary to resolve the dispute, an ADR process can provide an expert panel.

ADR in the context of business transactions can take a variety of forms. Although arbitration is perhaps the most well known, other forms of ADR include mediation, conciliation, summary or "mini" trials, and structured negotiation. ADR may be binding on the parties or may be merely an agreement to attempt to resolve an issue in good faith prior to litigation. For a general discussion of the types of ADR and the issues involved, see *Alternate Dispute Resolution* (Coopers & Meyerson eds., 1991). For guidance on drafting ADR provisions, see American Arbitration Association, *Drafting Dispute Resolution Clauses: A Practical Guide* (1993).

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One should note that while the exclusion of arbitration from this Agreement was in part motivated by the consensus of the Committee as to current practice, it was also heavily influenced by the feeling that the particular issues faced by a Buyer would best be served by litigation. This is a difficult call, and no practitioner ever knows definitively whether arbitration is in the best interests of the Buyer until the clause is actually invoked.

III. ARBITRATION AND MEDIATION IN THE MODEL ASSET PURCHASE AGREEMENT

By the time the Negotiated Acquisitions Committee completed its work on the Model Stock Purchase Agreement and started work on the Model Asset Purchase Agreement, arbitration had become more widely recognized in acquisition transactions. The Committee revisited its earlier decision to exclude ADR from the Model Agreement but reached the same conclusion. However, with this document the Committee felt that the widespread use of arbitration deserved a more detailed treatment than had been found in the Model Stock Purchase Agreement. The result is a more elaborate treatment of ADR at the conclusion of the Section dealing with Jurisdiction and Venue:

13.4 JURISDICTION; SERVICE OF PROCESS

Any Proceeding arising out of or relating to this Agreement or any Contemplated Transaction may be brought in the courts of the State of _____, County of _____, or, if it has or can acquire jurisdiction, in the United States District Court for the _____ District of _____, and each of the parties irrevocably submits to the exclusive jurisdiction of each such court in any such Proceeding, waives any objection it may now or hereafter have to venue or to convenience of forum, agrees that all claims in respect of the Proceeding shall be heard and determined only in any such court, and

agrees not to bring any Proceeding arising out of or relating to this Agreement or any Contemplated Transaction in any other court. The parties agree that either or both of them may file a copy of this paragraph with any court as written evidence of the knowing, voluntary and bargained agreement between the parties irrevocably to waive any objections to venue or to convenience of forum. Process in any Proceeding referred to in the preceding first sentence of this Section may be served on any party anywhere in the world.

COMMENT

In this Section the parties select an exclusive forum for actions arising out of or relating to the Model Agreement and submit to jurisdiction in that forum. The forum selected by the buyer usually will be its principal place of business, which may not be acceptable to the seller. Often the seller will attempt to change the designation to a more convenient forum or simply to confer jurisdiction in the forum selected by the buyer without making it the exclusive forum. For an analysis of whether a forum selection clause is permissive or exclusive, see *Action Corp. v. Toshiba America Consumer Prods., Inc.*, 975 F. Supp. 170 (D.P.R. 1997).

Clauses by which the parties consent to jurisdiction are usually given effect so long as they have been freely negotiated among sophisticated parties. Exclusive forum-selection clauses are generally upheld by the courts if they have been freely bargained for, are not contrary to an important public policy of the forum and are generally reasonable. See generally Casad, *Jurisdiction and Forum Selection* § 4.17 (1988, 1998 Supp.). Accordingly, a court in a forum other than the one selected may, in certain circumstances, elect to assert jurisdiction, notwithstanding the parties' designation of another forum. In these situations, the courts will determine whether the provision in the agreement violates public policy of that state and therefore enforcement of the forum selection clause would be unreasonable.

Some state statutes attempt to validate the parties' selection of a forum. For example, a California statute provides that actions against foreign corporations and nonresident persons can be maintained in California where the action or proceeding arises out of or relates to an agreement for which a choice of California law has been made by the parties, and the contract relates to a transaction involving not less than \$1 million and contains a provision whereby the corporation or nonresident agrees to submit to the jurisdiction of the California courts. CAL. CIV. PROC. CODE § 410.40. See also DEL. CODE TIT. 6, § 2708(b) and N.Y. GEN. OBLIG. LAW § 5-1402.

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The Model Agreement does not contain an alternate dispute resolution ("ADR") provision (other than that related to the purchase price adjustment

procedure in Section 2.9) and contemplates litigation as the principal means of dispute resolution. Because of the growing use of ADR in acquisition documentation, the practitioner should at least might wish to consider the advisability of various ADR clauses in the initial draft. ADR comes in many forms and variants, the most common of which is mandatory arbitration. Other forms of ADR are discussed later in this Comment.

For many years there was considerable debate in the various jurisdictions as to the enforceability of mandatory arbitration clauses. Those discussions have been resolved by a number of recent U.S. Supreme Court decisions that leave little doubt as to the enforceability of arbitration clauses in commercial documents. In *Southland Corp. v. Keating*, 465 U.S. 1 (1984), the Supreme Court held that Section 2 of the Federal Arbitration Act preempted a provision of the California Franchise Investment Law which California courts had interpreted as necessitating judicial consideration rather than arbitration. In *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 513 U.S. 265 (1995), the Supreme Court held that the Federal Arbitration Act applies to the full extent of the Commerce Clause of the U. S. Constitution, and supersedes efforts by some state courts to limit the effect of arbitration clauses within their jurisdictions. In *Allied-Bruce*, the Court held that arbitration may include all forms of damages, including punitive damages claims. See also *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995). In *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995), the U.S. Supreme Court addressed the issue of who decides whether a dispute is arbitrable, the arbitrator or the court, and held that where the clause itself confers this power on the arbitrator the clause should be respected and the courts should give the arbitrator great flexibility in making such determinations.

Notwithstanding the evolution of the law to enforce such clauses, there is much debate among practitioners as to the advisability of including mandatory binding arbitration clauses in acquisition documents. Factors which support exclusion of a mandatory binding arbitration clause include the following: (i) litigation is the appropriate dispute resolution mechanism because the buyer is more likely than the seller to assert claims under the acquisition agreement; (ii) the prospect of litigation may give the buyer greater leverage with respect to resolving such claims than would the prospect of mandatory arbitration; (iii) arbitration may promote an unfavorable settlement; (iv) arbitration brings an increased risk of compromised compensatory damage awards; (v) arbitration lowers the likelihood of receiving high punitive damages; (vi) certain provisional remedies (such as injunctive relief) may not be available in arbitration; (vii) the arbitration decision may not be subject to meaningful judicial review; (viii) rules of discovery and evidence (unavailable in some arbitration proceedings) may favor the buyer's position; (ix) the ease with which claims may be asserted in arbitration increases the likelihood that claims will be asserted; and (x) because many of the facts necessary for favorable resolution of the buyer's claims may be in the seller's possession (especially if a dispute centers on representations and warranties containing knowledge

qualifications), these facts may not be available to the buyer without full discovery. Factors which would encourage inclusion of a mandatory binding arbitration clause in a buyer's initial draft include the following: (i) arbitration may promote a reasonable settlement; (ii) arbitration may reduce costs; (iii) arbitration creates the possibility of keeping the dispute confidential; (iv) arbitrators may be more sophisticated in business affairs than judges or juries and reach a more appropriate result; (v) arbitration may be speedier than litigation; (vi) arbitration eliminates any "home court" advantage to a seller litigating in its own jurisdiction; (vii) arbitration is a less confrontational environment and may better maintain the business relations of the buyer and the seller; (viii) arbitration furnishes an opportunity to have special experts selected by the parties rule on technical issues; and (ix) arbitration decreases the risk of punitive damages.

Any analysis of this issue must begin with a determination of whether the buyer is more likely to sue or be sued, with the second step of the process being a selection of the environment which would most favor the buyer under those circumstances. The practice remains for a reasonable buyer's first draft to exclude any mandatory arbitration clause, but a number of factors, particularly concern over appearing before a judge and jury in a seller's jurisdiction, are resulting in increasing use of these clauses.

The American Arbitration Association issues general rules for commercial arbitration and specific rules for other types of arbitration including construction, patent, real estate valuation, securities, employment, title insurance, and franchises. The New York Stock Exchange and the National Association of Security Dealers also have specific rules of arbitration. Often the use of such arbitration procedures is part of the ordinary course of business, especially in the securities industry.

A complete ADR provision for mandatory binding arbitration generally addresses the following topics: consent by the parties to arbitration, the disputes which will be covered (generally all matters arising out of the transaction), the rules under which the arbitration will be governed, the substantive law to be applied, the location of the arbitration, the mechanism for selecting arbitrators (including their number and qualification), the person (arbitrator or court) who is to determine whether a dispute is subject to arbitration, any agreed limitation upon damages that can be awarded (although limitations on the remedies to be awarded have been looked upon with disfavor by the courts), and any requirements that the arbitrator recognize rules of evidence or other procedural rules or issue a written opinion. Some ADR provisions leave the qualifications and the number of the arbitrators to be determined once the need for arbitration is evident; others specify as much as possible in advance. Some ADR provisions also specify discovery procedures and procedures concerning exchange of information by the parties. The discovery provisions may require that discovery proceed in accordance with the Federal Rules of Civil Procedure. A comprehensive provision generally includes enforceability language and procedures for appeal of the award, although provisions for appeal may

undercut the entire rationale for ADR. See generally AMERICAN ARBITRATION ASSOCIATION, DRAFTING DISPUTE RESOLUTION CLAUSES: A PRACTICAL GUIDE (1993).

Drafters of ADR provisions should check for case law and statutes governing arbitration in the jurisdiction selected as the site of the arbitration to avoid unintended outcomes. For example, in California, an agreement to arbitrate claims relating to a contract creates authority to arbitrate "tort claims," and an agreement to arbitrate "any controversy" creates authority to award punitive damages. See *Tate v. Saratoga Savings & Loan Ass'n*, 216 Cal. App. 3d 843 (1989).

An example of a mandatory binding arbitration clause that might be appropriate to a buyer's first draft follows:

Any controversy or claim arising out of or relating to this Agreement or any related agreement shall be settled by arbitration in accordance with the following provisions:

A. Disputes Covered. The agreement of the parties to arbitrate covers all disputes of every kind relating to or arising out of this Agreement, any related agreement or any of the Contemplated Transactions. Disputes include actions for breach of contract with respect to this Agreement or the related agreement, as well as any claim based on tort or any other causes of action relating to the Contemplated Transactions such as claims based on an allegation of fraud or misrepresentation and claims based on a federal or state statute. In addition, the arbitrators selected according to procedures set forth below shall determine the arbitrability of any matter brought to them, and their decision shall be final and binding on the parties.

B. Forum. The forum for the arbitration shall be _____, _____.

C. Law. The governing law for the arbitration shall be the law of the State of _____, without reference to its conflicts of laws provisions.

D. Selection. There shall be three arbitrators, unless the parties are able to agree on a single arbitrator. In the absence of such agreement within ten days after the initiation of an arbitration proceeding, Seller shall select one arbitrator and Buyer shall select one arbitrator, and those two arbitrators shall then select within ten days a third arbitrator. If those two arbitrators are unable to select a third arbitrator within such ten day period, a third arbitrator shall be appointed by the commercial panel of the American Arbitration

Association. The decision in writing of at least two of the three arbitrators shall be final and binding upon the parties.

E. Administration. The arbitration shall be administered by the American Arbitration Association.

F. Rules. The rules of arbitration shall be the Commercial Arbitration Rules of the American Arbitration Association, as modified by any other instructions that the parties may agree upon at the time, except that each party shall have the right to conduct discovery in any manner and to the extent authorized by the Federal Rules of Civil Procedure as interpreted by the federal courts. In the event of any conflict between those Rules and the provisions of this Section, the provisions of this Section shall prevail.

G. Substantive Law. The arbitrators shall be bound by and shall strictly enforce the terms of this Agreement and may not limit, expand or otherwise modify its terms. The arbitrators shall make a good faith effort to apply substantive applicable law, but an arbitration decision shall not be subject to review because of errors of law. The arbitrators shall be bound to honor claims of privilege or work product doctrine recognized at law, but the arbitrators shall have the discretion to determine whether any such claim of privilege or work product doctrine applies.

H. Decision. The arbitrators' decision shall provide a reasoned basis for the resolution of each dispute and for any award. The arbitrators shall not have power to award damages in connection with any dispute in excess of actual compensatory damages and shall not multiply actual damages or award consequential or punitive damages or award any other damages that are excluded under the provisions of Article 11 of this Agreement.

I. Expenses. Each party shall bear its own fees and expenses with respect to the arbitration and any proceeding related thereto and the parties shall share equally the fees and expenses of the American Arbitration Association and the arbitrators.

J. Remedies; Award. The arbitrators shall have power and authority to award any remedy or judgment that could be awarded by a court of law in [designate jurisdiction]. The award rendered by arbitration shall be final and binding upon the parties, and judgment upon the award may be entered in any court of competent jurisdiction in the United States.

If each party selects one arbitrator, it might be appropriate to make clear in the arbitration clause whether those party-appointed arbitrators are to be neutral or are, in effect, advocate-arbitrators. Some arbitration clauses require the selection of three neutral arbitrators, all of whom are appointed in accordance with the rules of the arbitration authority.

An alternative to mandatory binding arbitration is mediation. A mediation clause may simply require negotiation (with or without a good faith standard) prior to litigation. Mediation is often an optional pre-arbitration procedure offered by the arbitration authority to the parties involved in an arbitration. The following is an example of a mediation provision:

Any controversy or claim arising out of or relating to this Agreement or any related agreement or any of the Contemplated Transactions will be settled in the following manner: (a) senior executives representing each of Seller and Buyer will meet to discuss and attempt to resolve any such controversy or claim; (b) if such controversy or claim is not resolved as contemplated by clause (a), Seller and Buyer will, by mutual consent, select an independent third party to mediate such controversy or claim, provided that such mediation will not be binding upon any of the parties; and (c) if such controversy or claim is not resolved as contemplated by clauses (a) or (b), the parties will have such rights and remedies as are available under this Agreement or, if and to the extent not provided for in this Agreement, are otherwise available.

Among other alternative dispute resolution mechanisms is the private judge. The use of a private judge represents a combination of litigation and arbitration techniques and addresses the need for expedited trials between private parties. California statutes and other state laws specifically sanction this procedure, whereby the parties agree to appoint a "referee" to decide the dispute. Once appointed, the referee assumes all the power of a trial judge except contempt power. For example, testimony is made under oath but is often neither recorded nor reported. If the parties so desire, rules of evidence, procedures, or pleading may be modified. The referee provides the supervising court with a written report. This report stands as an appealable judgment.

In international transactions, mandatory binding arbitration often is preferred. Many attorneys and clients believe that the presence of an arbitration provision in an international contract gives some assurance that the contract will be performed in accordance with its terms because parties may be more reluctant to arbitrate than to litigate in a foreign national forum where one party would have a local advantage. In deciding to arbitrate a controversy in a country outside the United States, drafters of ADR provisions should verify that the arbitration result will not be disregarded by the courts of the country in which a decision may be enforced. Drafters of ADR

provisions in the international context should be aware that resolutions of controversies by institutional arbitration (such as the International Chamber of Commerce or the London Court of Arbitration) are somewhat more readily honored by national courts outside the United States for enforcement purposes than are decisions of private party arbitrators operating outside the formal institutions. The Federal Arbitration Act recognizes the enforceability of international arbitration.

A commonly used international arbitration institution is the International Chamber of Commerce (the "ICC"), headquartered in Paris. The ICC provides for built-in review of all arbitration awards issued under its authority through its Court of Arbitration, a built-in review procedure. Drafters of ADR provisions who want to use the ICC Rules of Arbitration may want to be sure that they have the most recent version of the Rules. In general, the ICC Rules of Arbitration provide somewhat more latitude to the arbitrators to determine whether to allow expert testimony and the amount of fact-finding to be conducted. Generally, an arbitration award under the ICC is rendered within six months after the close of hearings. A standard ICC arbitration clause is as follows:

All disputes arising in connection with this Agreement or any of the Contemplated Transactions will be finally settled under the rules of conciliation and arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with these rules.

The rules often used within institutional arbitration are the rules of the United Nations Commission on International Trade Law ("UNCITRAL"). Among others, the American Arbitration Association and the ICC also provide for the use of UNCITRAL rules. Although the UNCITRAL rules reflect an effort to develop a standard international practice for arbitration, such rules may depart from United States practice in important respects. For example, all costs of arbitration under the UNCITRAL rules are paid by the unsuccessful party unless the arbitrators specifically determine that apportionment is necessary.

As with all ADR provisions, the substantive and governing procedural law (including application of conflicts of law) must be considered. The ADR provision may indicate whether custom or usage or subjective standards of what is just and equitable are to be considered by the arbitration panel in interpreting a contract. A key variable in choosing the forum for arbitration will be the location of the person against whom an award may be enforced and the enforceability of an arbitration award made in a local jurisdiction as opposed to a foreign jurisdiction. The currency for the award in an international dispute could be specified in the ADR provisions.

For a detailed discussion of international arbitration, see Letterman, LETTERMAN'S LAW OF PRIVATE INTERNATIONAL BUSINESS § 11.11 (1990 & Supp. 1991). For additional guidance on alternative dispute resolution, see the CORPORATE

COUNSELORS' DESK BOOK (Block & Epstein eds. 4th ed. 1992, Supp. 1998). For a general discussion of the types of ADR and the issues involved, see A DRAFTER'S GUIDE TO ALTERNATE DISPUTE RESOLUTION (Cooper & Meyerson eds., 1991).

IV. "STEALTH" ARBITRATION IN MODEL ACQUISITION DOCUMENTS – THE PURCHASE PRICE ADJUSTMENT MECHANISM

Both the Model Stock Purchase Agreement and the Model Asset Purchase Agreement include purchase price adjustment mechanisms. These are included because purchase price adjustments are common in many types of acquisition transactions and the drafters desired to provide a guide to practitioners attempting to produce effective adjustment clauses. In both documents these clauses are premised on placing the final decision as to accounting matters in the hands of a qualified certified public accountant or other professional. In the case of the Model Stock Purchase Agreement, the adjustment is based on a final determination of stockholders' equity. In the case of the Model Asset Purchase Agreement, the adjustment is based on working capital. These clauses demonstrate the need for professional finders of fact in certain aspects of acquisition disputes and by implication support the case for using ADR in other areas of acquisition disputes as well. The following is the purchase price adjustment clause from the Model Asset Purchase Agreement:

2.9 ADJUSTMENT PROCEDURE

(a) "Working Capital" as of a given date shall mean the amount calculated by subtracting the current liabilities of Seller included in the Assumed Liabilities as of that date from the current assets of Seller included in the Assets as of that date. The Working Capital of Seller as of the date of the Balance Sheet (the "Initial Working Capital") was _____ Dollars (\$ _____).

(b) Buyer shall prepare financial statements ("Closing Financial Statements") of Seller as of the Effective Time and for the period from the date of the Balance Sheet through the Effective Time on the same basis and applying the same accounting principles, policies and practices that were used in preparing the Balance Sheet, including the principles, policies and practices set forth on Exhibit 2.9. Buyer shall then determine the Working Capital as of the Effective Time minus accruals in accordance with GAAP in respect of liabilities to be incurred by Buyer after the Effective Time (the "Closing Working Capital") based on the Closing Financial Statements and using the same methodology as was used to calculate the Initial Working Capital. Buyer shall deliver the Closing Financial Statements and its determination of the Closing Working Capital to Seller within sixty (60) days following the Closing Date.

(c) If within thirty (30) days following delivery of the Closing Financial Statements and the Closing Working Capital calculation, Seller has not given Buyer written notice of its objection to the Closing Working Capital calculation (which

notice must state the basis of Seller's objection), then the Closing Working Capital calculated by Buyer shall be binding and conclusive on the parties and be used in computing the Adjustment Amount.

(d) If Seller duly gives Buyer such notice of objection, and if Seller and Buyer fail to resolve the issues outstanding with respect to the Closing Financial Statements and the calculation of the Closing Working Capital within thirty (30) days of Buyer's receipt of Seller's objection notice, Seller and Buyer shall submit the issues remaining in dispute to _____, independent public accountants (the "Independent Accountants") for resolution applying the principles, policies and practices referred to in Section 2.9(b). If issues are submitted to the Independent Accountants for resolution, (i) Seller and Buyer shall furnish or cause to be furnished to the Independent Accountants such work papers and other documents and information relating to the disputed issues as the Independent Accountants may request and are available to that party or its agents and shall be afforded the opportunity to present to the Independent Accountants any material relating to the disputed issues and to discuss the issues with the Independent Accountants; (ii) the determination by the Independent Accountants, as set forth in a notice to be delivered to both Seller and Buyer within sixty (60) days of the submission to the Independent Accountants of the issues remaining in dispute, shall be final, binding and conclusive on the parties and shall be used in the calculation of the Closing Working Capital; and (iii) Seller and Buyer will each bear fifty percent (50%) of the fees and costs of the Independent Accountants for such determination.

COMMENT

The specific terms of the business deal must be considered when developing a purchase price adjustment mechanism. For example, in the event that the transaction contemplates an accounts receivable repurchase obligation requiring the Seller to repurchase all or a portion of its accounts receivable not collected prior to a certain date, the purchase price adjustment procedure must take such repurchases into account when determining the adjustment amount. The Model Agreement provides that the Buyer will prepare the Closing Financial Statements and calculate the Working Capital as of the Effective Time. In order to account for the effects of the underlying transaction, Working Capital is limited to the difference between the current liabilities of the Seller included in the Assumed Liabilities and the current assets of the Seller included in the Assets.

To minimize the potential for disputes with respect to the determination of the adjustment amount, the acquisition agreement specifies the manner in which the adjustment amount is calculated and the procedures to be utilized in determining the adjustment yardstick as of a given date. The Model Agreement addresses this objective by stating that the Closing Financial Statements shall be prepared on the same basis and applying the same accounting principles, policies and practices that

were used in preparing the Balance Sheet, including the principles, policies and practices listed on Exhibit 2.9. Therefore, the buyer's due diligence ordinarily will focus not only on the items reflected on the Balance Sheet, but also on the accounting principles, policies and practices used to produce it, as it may be difficult for the Buyer to dispute these matters after Closing. For cost, timing and other reasons, the parties may elect to prepare less comprehensive financial statements for the limited purpose of determining the adjustment amount. Determination of the adjustment amount will depend upon the type of financial statements which have been prepared and special accounting procedures may need to be employed in calculating the adjustment components. Where the parties engage the accountant to issue a report of findings based upon the application of agreed-upon procedures to specified elements, accounts or items of a financial statement, such agreed-upon procedures should follow applicable statements on accounting standards and be clearly set forth in the acquisition agreement. See *Statement on Auditing Standards No. 75*, "Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement," and *Statement on Standards for Attestation Engagements No. 4*, "Agreed-Upon Procedures Engagements." Unless consistent accounting principles, policies and practices are applied, the purchase price adjustment will not be insulated from the effects of changes in accounting principles, policies and practices. Since purchase price adjustment mechanisms rely heavily on the application of accounting principles and methods to particular fact situations, the input of the parties' accountants is central to the crafting of a mechanism which is responsive to the facts and workable and reflects the expectations and intentions of the parties in establishing the ultimate purchase price.

Provisions establishing dispute resolution procedures follow the provisions for the initial determination and objection. If the parties are unable to resolve amicably any disputes with respect to the Closing Financial Statements and the Closing Working Capital, Section 2.9(d) provides for dispute resolution by independent accountants previously agreed to by the parties. If the acquisition agreement does not specify who will serve as the independent accountants, the parties should establish the procedure for selection. Even if the independent accountants are named, it may be wise to provide replacement procedures in case a post-closing conflict arises with respect to the selection of the independent accountants (e.g., through merger of the independent accountants with accountants for the Buyer or the Seller).

The procedure to be followed and the scope of authority given for resolution of disputes concerning the post-closing adjustments vary in acquisition agreements. Section 2.9 provides that the Buyer will determine the Working Capital based on the Closing Financial Statements using the same methodology as was used to calculate the Initial Working Capital. The Closing Financial Statements and the Buyer's determination of the Closing Working Capital are then delivered to the Seller and, if the Seller has not objected within the requisite time period to the Closing Working Capital calculation (stating the basis of the objection), the calculation is "binding and

conclusive on the parties." If the Seller objects and the issues outstanding are not resolved, the "issues remaining in dispute" are to be submitted to the accountants for resolution "applying the principles, policies and practices referred to in Section 2.9(b)." The determination by the accountants of the issues remaining in dispute is "final, binding and conclusive on the parties" and is to be used in the calculation of the Closing Working Capital.

The procedure set forth in Section 2.9 does not provide for the accountants to act as arbitrators, and there is no separate arbitration provision governing disputes under the Model Agreement. See the Comment to Section 13.4. However, Section 2.9 provides that the determination by the accountants is to be "final, binding and conclusive" on the parties. To what extent will this determination be binding on the parties, arbitrable or confirmable by a court? This is largely a question of state law, except that the Federal Arbitration Act will preempt any state law that conflicts or stands as an obstacle to the purpose of the Act to favor arbitration. The issue is often addressed in the context of a motion to compel arbitration by one of the parties to the acquisition agreement. The court in *Talegen Holdings, Inc. v. Fremont General Corp.*, 1998 U.S. Dist. LEXIS 12805, *8 (S.D.N.Y. 1998), dealt with such a motion as follows:

In resolving a motion to compel arbitration under the Federal Arbitration Act . . . , a court must: (1) determine whether the parties agreed to arbitrate; (2) ascertain the scope of that agreement to see if the claims raised in the lawsuit fall within the terms of the agreement; (3) if federal statutory claims are asserted, decide whether Congress has deemed those claims to be nonarbitrable; and (4) if some, but not all claims are to be arbitrated, determine whether to stay the balance of the proceedings pending arbitration.

It then stated that "[c]ourts have consistently found that purchase price adjustment dispute resolution provisions such as the one at issue here constitute enforceable arbitration agreements." *Id.* at *10. The clauses providing for dispute resolution mechanisms need not expressly provide for arbitration in order for a court to determine that the parties have agreed to arbitration.

If a court determines that the parties agreed to arbitration, the extent to which arbitration will be compelled under the Federal Arbitration Act depends on whether the provision is broadly or narrowly drawn. A broad clause creates a presumption of arbitrability, whereas a narrow clause allows a court to consider "whether the claims fall reasonably within the scope of that clause." *Id.* at *9. Even with a narrow provision, "[b]ecause the [Federal Arbitration Act] embodies Congress's strong preference for arbitration, 'any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.'" *Id.*; see also *Wayrol Plc v. Ameritech Corp.*, 1999 U.S. Dist. LEXIS 6141 (S.D.N.Y. 1999); *Advanstar Communications, Inc. v. Beckley-Cardy, Inc.*, 1994 WL 176981 at *3 (S.D.N.Y. 1994) (while a narrow

clause must be construed in favor of arbitration, courts may not disregard boundaries set by the agreement).

The question of what comes within the arbitrable issues is a matter of law for a court. If the dispute arises over the accounting methods used in calculating the closing working capital or net worth, a court might compel arbitration as to those issues. See *Advanstar*, 1194 WL 176981 (clauses allowing arbitration of disagreements about balance sheet calculations "include disputes over the accounting methods used"). A court can disregard whether the claims might be characterized in another way. See *Talegen* at *17. On the other hand, some courts require that the provision include on its face the issue in dispute. In *Gestetner Holdings, Plc v. Nashua Corp.*, 784 F. Supp. 78 (S.D.N.Y. 1992), the court held that an objection to the closing net book value includes an objection about whether the closing balance sheet failed to comply with generally accepted accounting principles; however, the court did not rule on whether the initial balance sheet, for which the defendant argued that indemnification was the exclusive remedy, could also be considered an arbitrable dispute. See also *Gelco Corp. v. Baker Inds., Inc.*, 779 F.2d 26 (8th Cir. 1985) (clause covering disputes concerning adjustments to closing financial statements did not encompass state court claims for breach of contract); *Twin City Monorail, Inc. v. Robbins & Myers, Inc.*, 728 F.2d 1069 (8th Cir. 1984) (clause extended only to disputed inventory items and not to all disputes arising out of the contract); *Basix Corp. v. Cubic Corp.*, 1996 WL 517667 (S.D.N.Y. 1996) (clause applied only to well-defined class of disagreements over the closing balance sheet); *Stena Line (U.K.) Ltd. v. Sea Containers Ltd.*, 758 F. Supp. 934 (S.D.N.Y. 1991) (only limited issues concerning impact of beginning balance sheet on later balance sheet are arbitrable); *Medcom Holdings Co. v. Baxter Travenol Lab., Inc.*, 1988 U.S. Dist. LEXIS 11441 (N.D. Ill. 1988) (clause limited to accounts or items on balance sheet does not encompass objections to valuation of property or accounting principles by which property is valued).

The scope of the accountants' authority in Section 2.9(d) is expressly limited to those issues remaining in dispute and does not extend more broadly to the Closing Financial Statements or to the calculation of the Initial Working Capital or the Closing Working Capital. The above authority suggests that if there is a dispute over whether the financial statements from which the Initial Working Capital or the Closing Working Capital are calculated have been prepared in accordance with generally accepted accounting principles or reflect the consistent application of those principles, the Buyer may not be able to resolve the matter under the procedure established in Section 2.9(c) and (d). However, it might be able to make a claim for indemnification based on a breach of the financial statement representations and warranties in Section 3.4. If any of the items in the financial statements from which Initial Working Capital is computed are in error, the inaccuracy could affect the Adjustment Amount payable under Section 2.8. Again, the Buyer's recourse might be limited to a claim for indemnification. If the error is to the disadvantage of the Seller, it may not be able to restate the financial statements or cause the Initial

Working Capital to be adjusted and therefore would have no recourse for its own error. See *Melun Indus., Inc. v. Strange*, 898 F. Supp. 990 (S.D.N.Y. 1990); *Melun Indus., Inc. v. Strange*, 898 F. Supp. 995 (S.D.N.Y. 1992).

In view of this authority, the buyer may wish to weigh the advantages and disadvantages of initially providing for a broad or narrow scope of issues to be considered by the accountants. By narrowing the issues, it will focus the accountants on the disputed accounting items and prevent them from opening up other matters concerning the preparation of the financial statements from which the working capital calculation is derived. However, reconsideration of some of the broader accounting issues might result in a different overall resolution for the parties. The buyer might also consider whether to provide that the accountants are to act as arbitrators, thereby addressing the question of arbitrability, at least as to the issues required to be submitted to the accountants. This may, however, have procedural or other implications under the Federal Arbitration Act or state law.

The phrase "issues remaining in dispute" in the second sentence of Section 2.9(d) limits the inquiry of the independent accountants to the specific unresolved items. The parties might consider parameters on the submission of issues in dispute to the independent accountants. For example, they could agree that if the amount in dispute is less than a specified amount, they will split the difference and avoid the costs of the accountants' fees and the time and effort involved in resolving the dispute. The parties may also want to structure an arrangement for the payment of amounts not in dispute.

Purchase price adjustment mechanisms do not work in isolation and the seller may want to include in these provisions a statement to the effect that any liabilities included in the calculation of the adjustment amount will not give the buyer any right to indemnification. The rationale for such a clause is that the buyer is protected from damages associated with such claims by the purchase price adjustment.

V. COMMENTS ON THE FUTURE

As we go through our modest comments on arbitration and mediation in acquisition documents, we invite your attention to the future of acquisition practice. In the international arena, arbitration is now the accepted standard and is indeed an integral part of many transnational agreements. As regards domestic transactions, arbitration is still not widely accepted. The future use of ADR in acquisition documents depends on a number of factors. These include the ability of practitioners to produce arbitration clauses that confer significant benefits on the parties without depriving them of the benefit of the bargain. Such clauses must necessarily address concern over erratic arbitration decisions, ease of enforcement, appellate rights, determinations of the scope of arbitration, and speed in resolving conflicts. Also at work are the interests of our clients. Sophisticated business people are now adopting policies for implementation by their legal departments which require the use of arbitration clauses. Other clients are raising questions of

counsel who fail to include such clauses or who fail at least to advise them on the pros and cons of such clauses. Critics can argue that there are dangers in placing an acquisition dispute either in the hands of the courts or of arbitrators, and examples abound of unsatisfactory results in both forums. The challenge facing the acquisition practitioner is to guide the client in making an informed decision as to the inclusion of various forms of ADR in acquisition documents, and when such decision is made, to draft the document in such a way as to bring the best of ADR to bear in resolving any dispute.

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