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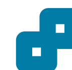

Post-completion M&A Disputes: Two Paths to Resolution

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In summary

This article discusses the relationship between expert determination and arbitration, the different processes and timelines involved for each dispute resolution mechanism, and the different outcomes produced. The article also highlights considerations bearing on the choice between the two mechanisms.

Discussion points

- Expert determination – the benefits and pitfalls
- Arbitration or litigation over sellers' accounting warranty breaches
- Liability
- The 'true and fair' and 'materiality' accounting concepts
- Warranty and indemnity (W&I) insurance products
- Damages

Referenced in this article

- *Great Dunmow Estates Ltd v Crest Nicholson Operations Ltd and others* [2019] EWCA Civ 1683
- *Baron Park Robinson v Harman (1848)*
- Article 9:502 of the Principles of European Contract Law

Introduction

M&A disputes have surged recently. In 2021, the M&A market reached record volumes, and in some sectors valuations were unprecedentedly high. At the same time inflation returned, aggressively, and the market responded to a spate of disruptions – including the end of the low interest rate environment, external shocks to supply chains, the energy crisis, a banking crisis, fear of a recession, and the war in Ukraine.

The M&A landscape is currently plagued by wider geopolitical uncertainty, not least the strained relations between the US and China. The legacy of the covid-19 pandemic continues to be felt.

Meanwhile a significant proportion of dealmaking has involved areas of the market that are either prone to volatility or largely novel. Deals involving fintech companies and businesses exposed to the wild fluctuations of energy or cryptocurrency prices have proved especially contentious, not least because of the complex regulatory and fiduciary obligations they involve.

Further complications arise from the increasing emphasis on ESG. As companies wrestle with environmental, social and governance matters – and as they respond to political and regulatory changes in this sphere, as well as to stakeholders' ever-multiplying perceptions of risk – the already vexed question of what constitutes deal value is taking on an extra dimension.

The result is a disputatious M&A culture. In many cases, acquisition targets have fallen short of the expected returns that were priced into bids, especially in those industries most affected by high energy prices or disruptions to supply chains.

Disappointment breeds disputes. Such disputes can be litigated, arbitrated or resolved using other mechanisms, including expert determination. Estimates suggest that the majority of share purchase agreements (SPAs), perhaps as many as 75 per cent, include arbitration clauses. Alongside these, most SPAs with price adjustment mechanisms include expert determination clauses – under the terms of which an expert, who is appointed by both sides, resolves disagreements over the accounting basis of individual purchase price adjustments.

Many expert determinations conclude without arbitration being necessary. But, if the disagreement concerns legal matters or other matters outside of the expert determination, one of the parties (more often the buyer) may consider whether to start an arbitration subsequent to and in addition to an expert determination, or concurrently, or indeed may choose to skip the expert determination process entirely and move straight to arbitration.

This article discusses the relationship between the two dispute resolution mechanisms. While expert determination and arbitration may relate to the same accounting matters, the two follow different processes and timelines, and they

produce different outcomes: an accounting determination usually results in a dollar-for-dollar price adjustment, whereas a warranty breach may justify the award of compensatory damages, which should put the claimant in the position it would have been in but for the wrongful act. These are fundamental differences. The discussion below explores them further and highlights considerations bearing on the choice between the two mechanisms.

Expert determination

After a business is sold, disagreements can arise between parties over the value of cash, debt or working capital that existed at the date at which the sale was completed (ie, the completion date), or over the amounts due under deferred consideration arrangements such as earn-out provisions. These disagreements are typically of an accounting nature, rooted in the interpretation of certain accounting or financial provisions in the SPA.

With this in mind, the SPA commonly provides for the use of an expert or independent accountant to determine such disagreements. The use of independent expert determination is not limited to SPAs and may be a mechanism for resolving disputes in other forms of contractual agreements. For example, some partnership agreements provide for an independent accountant to determine partners' disagreements about the valuation of their interest or distributions when the partnership is dissolved.

We have recently observed the increasing popularity of expert determinations as an alternative form of resolving disputes, especially those arising from specific technical questions, even where the SPA does not explicitly provide for this mechanism. This is due to the benefits that an independent expert can introduce in resolving a post-M&A dispute.

We will discuss in detail some of the benefits, as well as some of the potential pitfalls, of using an expert determination.

As noted above, commercial disputes that arise following the completion of the sale of a business often result from disagreements over how to interpret a set of accounting or financial provisions in the SPA. Determination of such disputes by an independent and experienced accounting expert can be an informed and efficient process, altogether smoother and less strenuous than the processes of arbitration or litigation.

The efficiencies gained through the use of an expert typically result in a quicker and less costly resolution than arbitration or litigation. The SPAs often set out a timetable for an expert determination process. While the expert is not bound by such timetable, they may invite the parties to agree on a reasonable timetable while confirming the expert's instructions.

In many jurisdictions, there is no procedural code governing expert determination (in which respect it thus differs strikingly from arbitration). This offers flexibility in setting out a framework that is suited to the dispute. While the expert ultimately defines this framework and the procedures to be followed, the parties are often given the opportunity to provide comments on the proposed procedures. This makes the process feel more inclusive and less prickly.

An expert determination, absent fraud or manifest error, is typically final and binding upon the parties. This affords the parties quicker closure regarding their disagreement and consequently a prompt opportunity to move past it.

While using expert determination can lead to the benefits described above, it begets several potential challenges.

As noted, the key benefit of an expert determination is an informed and efficient decision that is final and binding on parties. However, the crystallisation of this benefit depends on the appointed expert's technical skills and experience of running such processes.

The process of selecting an expert or agreeing on the expert's terms of engagement can be subject to disagreement or delays. This is particularly likely if one of the parties refuses to engage in constructive discussion concerning the expert's appointment, or the scope or terms of the expert's engagement. After all, the reason the parties are engaging an expert is because they were unable to resolve their disagreements in good faith. It follows that any matter requiring them to reach agreement will be fraught with differences of opinion.

SPAs sometimes foresee such deadlocks and make provisions for averting them, for instance by naming an expert or firm of expert accountants. However, this may not always prove effective, as the named experts could be stymied by conflicts of interest or commercial factors. SPAs also often include a provision that requires the parties, should they fail to agree on the identity of the expert within a time frame agreed in the SPA, to ask an independent professional institute (eg, the Institute of Chartered Accountants in England and Wales) to identify a suitable expert. While these provisions may help with identifying an expert, the scope or terms of engaging the identified expert could still be disputed by the parties.

Unless specifically stipulated in the SPA, the expert's jurisdiction in a determination process can be challenged by the parties if, for example, the expert's determination involves interpretation or determination of legal constructions within the SPA. This can give rise to a point of contention or deadlock between the parties, especially if they are unable to agree on a way forward. This is illustrated by *Great Dunmow Estates Ltd v Crest Nicholson Operations Ltd and others* [2019] EWCA Civ 1683, a case in which the Court of Appeal confirmed that an expert did not have jurisdiction to interpret certain contractual provisions.

Adjustments made by an expert as part of a post-M&A dispute determination are often limited to a dollar-for-dollar remedy. As such, expert determination may not be the most effective mechanism for seeking relief when the impact of the disputed items is considered to have a continuous (rather than a one-off) impact on the value of the acquired business or when compensatory damages are sought.

In conclusion, expert determination can be an effective and cost-efficient route to resolve post-M&A disputes, especially when the nature of the disputed items is narrow, one-off and technical in scope. But the expert's qualification and experience of navigating such a determination process are critical in realising these benefits.

Arbitration or litigation over sellers' accounting warranty breaches

Liability

In every transaction the SPA contains representations and warranties from each party to the other. The principal purpose of these is the allocation of risk between the buyer and the seller, to force disclosure and to serve as a condition of closing the deal. The types of warranties that we are concerned with here and that can interact with completion accounts disputes are primarily sellers' warranties of the financial statements.

Typical accounting warranties require that:

- the warranted accounts present a true and fair view of the asset, liabilities, financial position, and financial performance of the target; and
- the warranted accounts have been properly prepared in accordance with company law and applicable accounting standards.

The warranted accounts tend to be the most recent audited financial statements existing prior to completion. If the acquisition relates to a group of entities, then the warranted accounts will typically, but not always, be the consolidated financial statements produced for the group. If, for whatever reason, the group consolidated financial statements are not covered by the warranty, it is important to identify the financial statements that are covered and establish whether they are impacted by the issues giving rise to the potential claim.

Where the warranty covers the group consolidated financial statements, it is important to demonstrate the breach at that level. This is of particular significance when considering the 'true and fair' position. A matter which at the level of an individual entity may give rise to concerns about financial statements not being true and fair may not have the same implications when considered in the context of the group consolidated financial statement.

To establish breach, it will be necessary to demonstrate that the warranted accounts did not present a 'true and fair' view, and/or have not been properly prepared in accordance with company law and applicable accounting standards. Given the construct of financial statements and the interpretation and application of accounting standards, it will not satisfy a claim for breach simply to establish that the sellers adopted different, perhaps more aggressive, accounting practices to those that the buyer would have adopted. Aggressive accounting practices tend to result in improved reporting results in the financial performance and financial position of an entity. They fall within the boundaries of GAAP – in substance, even if not necessarily in spirit.

The accounting notion of 'true and fair' represents the financial statements as being accurate, free from bias, and reflecting the substance of transactions over form.[1] It is not a guarantee of absolute accuracy. Rather, it is considered within the context of tolerable thresholds.

This introduces us to the accounting concept of 'materiality'.[2] In essence, is the nature or extent of the error or omission such that it would influence the users of the financial statements? This requires an objective qualitative assessment as well as a quantitative one.

Financial statements are not free from errors or omissions. Indeed, when performing an audit, auditors will often compile a schedule of unadjusted errors. When such errors, individually and cumulatively, do not exceed a pre-determined tolerable threshold, the auditors are willing to give an opinion that the financial statements are 'true and fair', without the need to make any correcting adjustments.

If the buyer has identified issues giving rise to errors which the auditors have previously flagged as not requiring adjustment, does this undermine the assertion that the statements are 'true and fair'? Similarly, if the errors identified by the buyer can be offset by other errors, previously identified as not requiring adjustment by the auditors, does this compromise their truth and fairness?

To establish the position, it is important to take note of previous communications with the auditors. These communications may reveal that the auditors reviewed the accounting treatment giving rise to the alleged breach, and contemporaneous information may have been provided that allowed the auditors to be satisfied with the accounting treatment, as reported in the warranted accounts. Alternatively, the auditors may have disagreed with the accounting treatment, but it was not considered to impact the truth and fairness of the warranted accounts.

1 https://www.frc.org.uk/accountants/accounting-and-reporting-policy/true-and-fair-concept.
2 https://www.icaew.com/technical/audit-and-assurance/audit/risk-assessment-internal-control-and-response/materiality-in-the-audit-of-financial-statements.

Where the alleged breach relates to financial performance reported in the warranted accounts, and the nature of the error or omission is such that it represents a timing issue (as is so often the case with revenue recognition), one should consider not just the derecognition of revenues and profits from the warranted accounts, but also the potential need to recognise revenues and profits that were erroneously included in the prior period's financial statements.

The net impact on the financial performance reported in the warranted accounts will depend upon the revenue and profit profile of the business. If revenues were increasing year on year, the positive financial performance of the business may have been overstated, but the degree of the overstatement may not be as first envisaged.

A relatively recent development in the realm of M&A disputes is the introduction of warranty and indemnity (W&I) insurance products. These have added another layer of complexity to dispute resolution. Policies typically exclude certain risks, such as corruption and the underfunding of pensions. Contrary to what buyers may imagine, insurance is not the same as a guarantee, and purchasing it does not absolve them of the need to carry out appropriate due diligence.

The buyer will also need to be mindful of the time limits imposed under the policy in respect of notification of the claim. Generally, the warranty claim period starts from the date of completion, and covers a period of 24 to 36 months. The error or issue giving rise to a W&I claim being contemplated may only come to the attention of the buyer when the next set of financial statements are being prepared. This may be some way into the warranty claim period, and it will be important to act quickly.

A claim must be fully supported and sufficiently robust to withstand scrutiny by the insurers. The investigation therefore needs to be thorough, but at the same time proportionate. Consideration should be given to seeking legal advice as well as expert accounting and quantum advice at an early stage.

Establishing breach is not always straightforward. At the risk of stating the obvious, for there to be a successful claim it is necessary to establish a breach of the warranties set out in the final policy. Wording changes may have occurred between drafts and final policy documents. The impact of such changes can be crucial to the interpretation and application of warranty, and valuable time, effort and resources can be squandered in pursuing a line of investigation that may not in itself support a claim for breach.

The W&I policy may stipulate that the right to pursue an action against the seller is waived. In such circumstances, a claim under the W&I policy will be the only recourse, unless it can be established that there was fraud on the part of the seller.

A claim for alleged fraud against the seller will invariably lead to increased investigation costs. It will be necessary to establish not only what was known at the time, but usually also dishonest intent. The burden of proof will remain the same as for any civil action, but due to the removal of agreed liability caps and the stigma attached to allegations of fraud, the seller would be inclined to mount a more robust challenge to such a claim. Where there is a claim against the seller in relation to alleged fraud, the insurers may seek to pursue a subrogated recovery claim, as a waiver of subrogation rights would not apply in instances of alleged fraud.

Damages

The award of damages is the principal remedy granted by courts and tribunals for breach of contract.[3] The general principle is that contract damages should put the aggrieved party as close as possible into the position in which it would have been if the contract had been duly performed. Such damages cover the loss that the aggrieved party has suffered and the gain of which it has been deprived.[4] The basic compensatory calculation is a factual comparison between what actually happened (the breach position) and what would have happened but for the breach (the non-breach position).[5]

In general, when considering a claim for breach of contract, the actual position is often straightforward to establish as it is readily observable. What can be more difficult to determine is often the counterfactual position – that is, what would have happened had the contract not been breached. In cases of a seller's accounting warranty breach, on the other hand, it is the actual position that can be more difficult to establish – for example, what the target company is actually worth, given a breach. This is because the parties have usually valued the no-breach (as warranted) position, thinking that was the reality.

A related question that can arise in these cases is whether the price paid in a transaction corresponds to the value as warranted. This question is especially relevant in periods of exceptionally high valuations – such as the recent peak in the M&A market, which has given rise to a wave of post-deal disputes – and amid the complexities of the latest generation of M&A disputes.

The buyer may seek to pursue a claim against the seller. Such a claim may well be restricted to a monetary value that falls significantly short of the cap that may be claimed under a W&I insurance policy. In the interest of closure and convenience, the seller may be inclined to accept certain allegations of breach,

3 Adam Kramer, *The Law of Contract Damages*, 496 (2nd ed., Hart Publishing, 2017), 249, 4. For example, it was set out by *Baron Park Robinson v Harman* in 1848 and cited many times. See Kramer, at 13 with further citations.
4 For example, see article 9:502 of the Principles of European Contract Law.
5 Adam Kramer, *The Law of Contract Damages*, 496 (2nd ed., Hart Publishing, 2017), 249.

with a little less rigour and challenge than would be applied by insurers facing a somewhat larger claim. Acceptance of a claim by a seller will therefore be of interest to the insurers, but does not in itself present a 'slam dunk' case to the insurers for them to accept.

In considering whether to make a claim for damages alleging breach of warranties, the buyer will need to keep in mind the excess that it will need to cover in the event of the claim being successful. Invariably, the excess represents the minimum level of loss that would need to be established before pursuing a claim. An early assessment of loss or likely loss will therefore need to undertaken.

Conclusion

Expert determination and arbitration or litigation can, and often do, relate to the same accounting matters in the target's financial statements. However, when faced with the question of whether to start an arbitration subsequent to and in addition to an expert determination, or concurrently, or indeed skip the expert determination process entirely and move straight to arbitration, the parties should carefully consider the differences between these dispute resolution mechanisms. These relate to the timeline involved, process, cost and outcome.

Expert determinations typically resolve narrow accounting questions that are required to be concluded in order to calculate the final purchase price. An expert determination is, or should be, limited to the areas of disagreement between the parties. The expert, usually an accountant, determines a dollar-for-dollar price adjustment.

A warranty breach, on the other hand, may give rise to compensatory damages. Pursuing a case for breach yields an altogether different perspective, and arbitration or litigation often produce markedly different outcomes from expert determination. The general principle is that damages should put the claimant in the position it would have been in but for the breach. This is frequently a question of value delivered versus value promised, not a dollar-for-dollar accounting correction. Assessing damages often involves revisiting the valuation of the target company.

Warranty breach claims tend to be broader in scope than expert determinations – and they also frequently come alongside fraud claims, which can mean that contractual limitations on damages do not apply. The process can open up substantially broader areas of dispute than expert determinations.

W&I insurance policies introduce extra scope for making breach of warranty claims. However, there is an additional level of complexity which needs to be considered when pursuing such claims. It is important to act in a timely manner,

and seek appropriate legal, accounting and quantum advice to determine the most appropriate approach.

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John Hudson has over 22 years of experience in fraud investigations, financial investigations, forensic accounting, litigation and dispute advisory work. His expertise in forensic accounting and regulatory investigations covers a wide range of industries including financial services, oil and gas, telecommunications, retail, sports, shipping, engineering and not-for-profit operations. He has served clients and conducted investigations in Africa, Continental Europe, the Middle East, and the UK.

John has managed teams performing a review of accounting records in support of W&I claims and assessing the extent to which the alleged misstatements gave rise to breaches under the warranties. He has provided expert advice and assistance in assessing allegations of accounting irregularities and evaluating the impact of alleged misstatements on warranted accounts.

He has significant experience of conducting investigations on behalf of UK and foreign regulators, and has assisted clients undertaking technical accounting reviews and performing restatements of financial statements.

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Kami's expertise extends to the preparation of advisory as well as expert determination or witness reports, in the context of post-M&A disputes including those arising from price adjustments (eg, completion accounts), deferred considerations (eg, earn-outs), and breach of contract and warranty claims.

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Heiko focuses on expert work in commercial disputes. His expertise includes matters related to M&A, joint ventures, breach of warranty and insolvency. He has worked on matters in ICC, DIS, LCIA, ICSID, Swiss Rules, SIAC arbitration forums, ad hoc arbitrations and the courts. He has worked on some of the most complex corporate disputes in Europe, with values of up to several billion euros. Heiko is experienced in giving oral expert testimony. He has worked across a broad range of industries, including aerospace and defence, automotive, chemicals, manufacturing, casting, construction, energy, financial services, infrastructure, retail, services, technology and telecommunications.

Heiko was recognised among the world's foremost expert witnesses in the 10th edition of Global Arbitration Review's *GAR 100*. He is listed in *Who's Who Legal* among the most recognised expert witnesses in international arbitration and leading litigation and quantum consultants.

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