JONES DAY

AUGUST 2013

VIACOM INT'L, INC. V. WINSHALL: DELAWARE SUPREME COURT REINFORCES ACCOUNTING EXPERTS' AUTHORITY TO DECIDE PURCHASE PRICE DISPUTES, RESTRICTING COLLATERAL ATTACK BY DISGRUNTLED PARTIES

On July 16, the Delaware Supreme Court[1] published an opinion that confirms and clarifies the scope of an accounting expert's authority to resolve post-closing financial disputes that parties have agreed to submit for resolution under the terms of a definitive business acquisition agreement. This decision reaffirms alternative dispute resolution as the procedure of choice for quickly resolving complicated, technical financial issues that sometimes arise in the context of purchase price adjustments.

Post-closing purchase price adjustments are almost universally present in definitive agreements for the sale of a business.[2] These provisions—which include earn-out clauses, working capital adjustments, and debt/net debt true-ups—require an adjustment to the purchase price paid at closing, based on calculations relative to pre-closing targets, standards, or formulas. Such provisions set forth not only the methodology for determining the amount of the adjustment, but also a resolution process in the event the parties disagree on the amounts to be paid. These processes typically include (i) an exchange of the relevant financial calculations and access to work papers and supporting documentation, (ii) submission by the recipient party of objections to the calculation, (iii) a period of time within which the parties will attempt to resolve the dispute in good faith, and (iv) submission of the unresolved issues to a neutral accounting firm for ultimate resolution.[3]

Resolution dispute provisions sometimes refer to the financial arbitrator as an "expert and not as an arbitrator." Frequently, such provisions state that the resolution of the dispute by the independent accountant shall be "final, binding on and not appealable by the parties." These dispute resolution provisions otherwise take a variety of forms, including stating

© 2013 Jones Day. All rights reserved. Printed in the U.S.A.

the basis upon which a party may bring a claim to dispute the final determination (such as fraud or manifest error). Importantly, however, if the provision is intended as a binding agreement to arbitrate in contracts involving interstate commerce, the Federal Arbitration Act ("FAA") applies to resolution of the dispute. The FAA limits the bases upon which a party can avoid the arbitrator's decision through litigation. It was this approach that the plaintiff pursued in disputing the determination of the independent accountant in the *Viacom* case.

The *Viacom* dispute concerned an earn-out provision based on gross profit from the sales of the video game "Rock Band." As is typical, the parties' agreement set forth express procedures by which disputes over the earn-out would be identified and decided. As Chancellor Strine noted in his opinion, "the entire contractual resolution process was triggered by Viacom's final Earn-Out Statement and supporting documentation."[4] Viacom made no mention in its documents about inventory write-downs, but then, at hearing, Viacom argued that the earn-out at issue should be reduced to zero because of inventory write-downs. The accounting firm adjudicating the dispute (BDO) refused to consider the inventory write-down issue unless both parties agreed that the issue should be decided in the arbitration, citing the governing contract provision limiting the disputes to be resolved to those identified in the submissions that parties exchanged prior to the arbitration, and therefore ruled in favor of the seller.

In affirming the lower Court's rejection of Viacom's request to vacate the arbitrator's determination, the Delaware Supreme Court articulated the test by which the scope of an arbitrator's authority under "procedural arbitrability" would be determined. The *Viacom* Court recognized that, once the parties agree to submit the subject matter of a dispute to arbitration, "'procedural' questions that grow out of the dispute and bear on its final disposition should be left to the arbitrator."[5] In so doing, the Delaware Supreme Court stated as follows:

> [T]he only question that the court should decide is whether the subject matter in dispute falls within it. If the subject matter to be arbitrated is the calculation of an earn-out, or the amount of working capital, or the company's net worth at closing, all issues as to what financial or other information should be considered in performing the calculation are decided by the arbitrator. In resolving those issues, the arbitrator may well rely on the terms of the underlying agreement, and the arbitrator's interpretation of the contract is likely to affect the scope of the arbitration. Nonetheless, these decisions fall within the category of procedural arbitrability. They are not "gateway" issues about whether the particular dispute should be arbitrated at all. Rather, they are questions about how the subject of the arbitration should be decided.[6]

PRACTICE IMPLICATIONS

In light of this decision, practitioners should take note of the following:

- Clients should be aware that binding arbitration of post-closing purchase price adjustment disputes is standard deal practice and that it is important to expressly provide that such dispute resolution is to be binding and not appealable.

- If intended to be binding, practitioners should be careful about not including language that the Delaware Chancery Court referred to as creating an "eyebrow-knitting moment"[7]—such as referring to the independent accountants as "deemed to be acting as experts and not arbitrators."[8] Rather, provisions should expressly state that resolution of the dispute by the independent accountants will be final, binding, and conclusive, not appealable and not subject to further review, subject to applicable provisions of the FAA.

- If disputes arise (and they often do), clients and their counsel should specifically analyze the purchase price adjustment provisions of their agreement and what issues are presented by the dispute—separating disguised indemnity claims, assertions of fraud, misrepresentations, and other issues that are not properly within the scope of

such provisions from resolution of the financial accounting items in dispute.

- In preparing initial calculations and responsive objection statements, parties should include a thorough list of potential issues, arguments, and theories they intend to rely on to support their positions. Similarly, as they negotiate resolution of purchase price adjustment disputes, and prepare engagement letters of independent financial experts to assist with such resolution, parties should prepare, and if possible agree on, an accurate and complete written description of the accounting issues in dispute. If not so described, parties risk waiving the right to have such issues, arguments, and theories submitted for resolution as not properly presented or not within the scope and subject matter of the dispute resolution procedures.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Elizabeth C. Kitslaar
Chicago
+1.312.269.4114
ekitslaar@jonesday.com

James A. White
Chicago
+1.312.269.4161
jawhite@jonesday.com

ENDNOTES

1 *Viacom Int'l, Inc. v. Winshall* ("*Viacom II*"), No. 513, 2012, 2013 WL 3678786 (Del. July 16, 2013).

2 According to the ABA's 2011 Private Target M&A Deal Points Study, 82% of 2010 transactions include purchase price adjustments, of which 79% were based on working capital calculations and 20% were based on debt calculations. *2011 Private Target Mergers & Acquisitions Deal Points Study*, Am. Bar Ass'n—Bus. Law Section, 13 (Jan. 17, 2012), http://apps.americanbar.org/dch/committee.cfm?com=CL560003. During the same period, 38% of transactions included earn-out clauses. *Id.* at 20.

3 For an overview of issues arising in purchase price adjustment dispute resolution arbitration from the perspective of an accounting neutral, *see* Lawrence F. Ranallo, *Resolution of Purchase Price Disputes: Issues, Outcomes and Recommendations*, PricewaterhouseCoopers (2009), www.pwc.com/en_US/us/forensic-services/assets/purchase-price-disputes-resolution.pdf.

4 *Viacom Int'l, Inc. v. Winshall* ("*Viacom I*"), No. 7149-CS, 2012 WL 3249620, at *18 (Del. Ch. Aug. 9, 2012).

5 *Viacom II*, 2013 WL 3678786, at *4 (quoting *John Wiley and Sons, Inc. v. Livingston*, 376 U.S. 543, 557 (1964)).

6 *Id.* In *Viacom I*, Chancellor Strine rejected Viacom's argument that BDO's authority as arbitrator was confined to pure accounting issues, and did not extend to contract interpretation because BDO "did not go to law school," holding that such firm could interpret and apply the acquisition agreement as part of its mandate.

7 *Viacom I*, 2012 WL 3249620, at *3.

8 *Id.* at *2.

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at www.jonesday.com. The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the authors and do not necessarily reflect those of the Firm.