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ARBITRATION IN M&A TRANSACTIONS: LAWS OF NEW YORK AND DELAWARE Part III

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Parts I and II of this Article, published in the August 2016 and December 2016 issues of Dispute Resolution Journal, covered Pre-Contractual Considerations, Purchase Price Adjustments, Breach of Representation and Warranty, Earnouts, Tax Claims and Material Adverse Effects and Changes. This is the final piece of the article.

VIII. CLOSING CONDITIONS

When the closing of an acquisition does not occur simultaneously with the signing it means that a number of conditions have to be met for closing to occur. The agreement typically spells out those conditions and both the buyer and sellers have to fulfill their own conditions. Some are quite standard, others are heavily negotiated. Many agreements also provide that the parties have to exercise some level of efforts to ensure that the conditions are fulfilled. They range from reasonable commercial efforts to best efforts, with many variations in between. Disputes can arise as to whether a closing condition has been met or not or whether the party with the conditions has exercised the appropriate level of efforts. The resolution of the dispute depends on how specifically the particular condition is expressed in the agreement and how the closely the situation post-signing/pre-closing conforms to the condition stated – or whether the party charged to exercise its efforts is really doing so or is conversely

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dragging its feet to get out of a deal it is no longer happy with.. As such, these disputes tend to be very fact-specific.

The leading case in New York on the fulfillment of a condition precedent in the M&A context is a 2009 opinion by the Court of Appeals in *MHR Capital Partners LP et al. v Presstek, Inc.*[269] That opinion stated the perhaps obvious but nonetheless potent principle in M&A disputes that express conditions must be literally performed. The Court of Appeals did not accept arguments that the doctrine of substantial performance, which is a part of New York contract law applying to the completion of construction contracts among others, would apply to an express condition to close an acquisition agreement.

The dispute in that case arose out of an agreement that a buyer (Presstek) and its acquisition sub entered into with the owner of a distressed graphic arts and printing supplier called A.B. Dick Company. The target owed money to a private equity fund (MHR Capital Partners LP) and also had outstanding loans to a bank (Key Bank). The buyer and seller entered into a stock purchase agreement in 2004 and an ancillary escrow agreement. One of the conditions of the stock purchase agreement was that the private equity fund would waive its rights in exchange for payment of $10 million in cash and stock of the buyer. The stock purchase agreement was placed in escrow and not to be released until Key Bank also consented to the stock purchase transaction. A deadline was placed on Key Bank's consent (close of business on June 22, 2004). The consent was to come by signing a form that had certain terms – that the buyer would extinguish the target's debt to Key Bank by a combination of cash and its stock (rather than cash only) and that Key Bank was required not only to continue to fund the target but also to increase its "total aggregate lending commitment …. as necessary to ensure adequate funding" for the target through closing. The consent would also have required Key Bank to refrain from declaring a default on the outstanding indebtedness.

Key Bank did not sign the consent form by the deadline. Instead, on that date, Key Bank sent a one page letter by fax to the buyer in which Key Bank "consented" to the transaction but also did not agree with some of the terms of the consent form. In particular, it did not agree to continue to fund the target "as necessary" and also did not agree to refrain from declaring a default. The buyer terminated the

[269] 12 N,Y. 3dd 640, 912 N.E.2d 43, 884 N.Y.S.2d 211 (2009).

stock purchase agreement that same day.[270] The next month the buyer and seller entered into an asset purchase agreement that did not include payments to the private equity fund and required the target to file for bankruptcy. In bankruptcy, the seller applied for permission to sell the assets to buyer in an auction that would allow third parties to offer a higher price.

The lawsuit arose first through the private equity fund's objecting to the bankruptcy sale process. When the Bankruptcy Court did not agree to hold up the auction, the fund sued for damages in New York State court claiming that the buyer had improperly terminated the stock purchase agreement when Key Bank faxed its "consent" and extra conditions. One of its arguments was that Key Bank's fax was adequate approval and that any differences between the contractual consent form and the faxed letter were immaterial. In essence, the private equity fund argued that what Key Bank sent was good enough. The Court of Appeals did not agree. It found that Key Bank's "approval of the stock purchase transaction by the fixed date – through its execution of the consent form – was an express condition precedent."[271] Key Bank's fax was a "more limited acceptance" and did not fulfill "explicit requirement that Key Bank execute and agree to all the terms contained in the consent form, as required by the escrow agreement."[272]

Of course, New York law recognizes that a party to a contract cannot rely on the failure of another to perform a condition precedent when it has itself frustrated or prevented the occurrence of the condition.[273] That is a question of fact, though. The Court of Appeals did not find that any such facts were presented in the *MHR Capital Partners v. Presstek* case.

The opinion of the Court of Appeals in *MHR Capital Partners v. Presstek* has been cited numerous times since then by New York courts for the proposition that express conditions precedent must be fulfilled as drawn. One commentator has described this case "almost as gospel" on the state of the law on conditions precedent.[274]

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[270] 12 N.Y.3d 640, 643-44.

[271] 12 N.Y.3d at 646.

[272] *Id.*

[273] See *ADC Orange, Inc. v Coyote Acres, Inc.*, 7 N.Y.3d 484, 490 (2006) and the cases cited therein.

[274] Victor M. Metsch, *'Condition Precedent' Litigation Post MHR v. Presstek*, Smith, Gambrell & Russell, LLP (July 1, 2014), http://www.sgrlaw.com/print/?id=3571.

A Chancery Court opinion out of Delaware presents an interesting twist on the failure of a condition precedent analysis. In *The Williams Companies, Inc. v Energy Transfer Equity, L.P and LE GP, LLC*,[275] Vice-Chancellor Glasscock considered a condition precedent in a merger agreement that involved a law firm to one of the parties' providing at closing a legal opinion that the transaction should be treated as a tax-free exchange instead of a sale. The transaction involved a merger between The Williams Companies ("Williams), a publicly traded Delaware corporation based in Tulsa, Oklahoma operating midstream gathering and processing assets and interstate natural gas pipelines, and an entity created by Energy Transfer Equity, L.P. ("Energy Transfer"), a publicly traded Delaware limited partnership based in Dallas, Texas operating a network of natural gas and other types of pipelines. The parties signed their Agreement and Plan of Merger (the "Merger Agreement") on September 8, 2015. It was governed by Delaware law. The outside closing date was defined as June 28, 2016. The planned transaction was complicated, but it essentially had two prongs – one a "cash transaction" where Energy Transfer would transfer $6.05 billion to the entity it created, which would survive the merger, in exchange for 19% of the entity's stock, with the surviving entity then transferring the $6.05 billion to the former Williams shareholders and the second a "contribution transaction" where the surviving entity would transfer the Williams assets to Energy Transfer in exchange for newly issued units. Two key things about the cash transaction for purposes of the dispute that ensued was that the cash contribution by Energy Transfer to the new entity was in exchange for a fixed number of the new entity's shares (19%) and that the value of the new entity's shares were linked one-to-one to the publicly traded value of Energy Transfer's limited partnership units.

The Merger Agreement contained as a condition to the closing that Energy Transfer's law firm, Latham & Watkins, issue a written legal opinion that the contribution of the Williams assets to Energy Transfer and the issue of new units (the Contribution Transaction) "should qualify" as a tax-free exchange under the relevant provision of the Internal Revenue Code – Section 721(a).[276] In addition, Energy Transfer had represented in the Merger Agreement that it knew of no facts that would reasonably prevent the tax-free treatment of the

[275] 2016 Del. Ch. Lexis 92 (June 24, 2016).

[276] *Id*. at *17.

Contribution Transaction under Section 721(a). At the time the Merger Agreement was signed, Latham & Watkins considered the Section 721(a) opinion to be "fairly straightforward" and Williams' legal counsel was similarly unconcerned.[277] Apparently, since the Cash Transaction involved assets of equivalent value (cash and the shares of the new entity, tied one-to-one to the value of Energy Transfer's publicly traded units), the tax partners advising Energy Transfer were comfortable that Latham could issue a legal opinion that the transaction should be considered a tax-free exchange[278] – and apparently Williams' attorneys were comfortable having the opinion of a law firm to the other party to the Merger Agreement be a condition precedent to closing. It doesn't seem to have occurred to anyone involved in the transaction that the price of Energy Transfer's partnership units might change between signing and closing.

But change they did. Following the execution of the Merger Agreement in September 2015, energy prices – and thus the value of assets used in the transport of energy - declined further. Energy Transfer's publicly traded units dropped in price to between a third and a half of their value at signing. In order to raise the $6.05 billion it would have to transfer to the new entity and then to Williams, it would have to borrow heavily against its devalued assets. In short, the whole transaction became very financially unpalatable to Energy Transfer and it desired to exit the transaction.

In the meanwhile, in late March 2016, Energy Transfer's head of taxation, Brad Whitehurst, claims he noticed while reviewing a securities law filing regarding the merger that the Cash Transaction was for a fixed number of shares while his understanding had always been that it was for a floating number of shares. One cannot help but detect the sardonic tone of Vice-Chancellor Glasscock's description of this revelation.

> Despite the fact that he had reviewed drafts of transaction documents and other deal-related materials that said otherwise, and while no one else shared his view, Whitehurst testified that he originally understood the Cash Transaction to require [Energy Transfer] to exchange $6 billion in cash for a *floating* number of [new entity] shares.[279]

[277] *Id*. at *18, quoting from the trial transcript.

[278] *Id*. at *45.

[279] *Id*. at *19, citations omitted.

As a result of the change in value of Energy Transfer's partnership units, the shares of the new entity to be received at closing would only be worth $2 billion, thus leaving a difference of $4 billion, leading to a concern that the Cash and Contribution Transactions seen together would be considered by the IRS as disguised sale of Williams' assets triggering taxable gain. Mr. Whitehurst contacted the tax partner at Latham to ask him if there was any issue. According to Vice-Chancellor Glasscock's summary of the testimony, until the conversation with Brad Whitehurst, Latham was preparing to issue the tax opinion and that it had "previously never considered how any movement in [Energy Transfer's] unit price might affect Latham's ability to give the 721 opinion."[280] Other Latham tax partners become involved to study the issue and Latham soon began to indicate that it would probably be unable to issue the tax-free exchange opinion. Latham had "discovered for the first time" that the complex interactions between the Contribution and Cash Transactions could have significant tax implications under Section 721(a) of the Code.[281] On April 11, 2016, Latham informed Energy Transfer that it had conclusively determined it could not provide the tax opinion.

Energy Transfer involved a tax partner from another law firm who also said he could not issue the opinion, but for different reasons. The lawyers for Williams, Cravath Swaine & Moore, were informed. Although they were said to have strongly believed that the Contribution Transaction was a tax-free exchange and that they disagreed "fervently" with Latham's conclusion, they became involved in a process to try to find alternate structures for the transaction. To make a long story short, the parties could not agree on any alternative structure that would allow tax-free exchange treatment and Latham persisted in its refusal to issue the tax opinion.

Williams brought suit against Energy Transfer in the Delaware Chancery Court on May 13, 2016 asserting that Energy Transfer breached the Merger Agreement by failing to use commercially reasonable efforts to obtain the tax-free exchange opinion. It also claimed that Energy Transfer's representation was false that it knew of no facts that would reasonably prevent the tax-free treatment of the Contribution Transaction. It sought declarations to those effects and an injunction to prevent Energy Transfer from terminating or otherwise

[280] *Id*. at *21.

[281] *Id*.

avoiding its obligations under the Merger Agreement on the basis of its law firm's not issuing the tax-free exchange opinion or that the merger did not close by the outside date. Energy Transfer argued that its law firm's independent conclusion that it was unable to deliver the tax-free exchange opinion precluded specific performance of the Merger Agreement. It sought a declaration that Energy Transfer did not breach the Merger Agreement and that it could terminate the Merger Agreement without any liability.

Given the approaching June 28, 2016 outside date for closing, Vice-Chancellor Glasscock granted Williams' motion to expedite the proceeding and a two-day trial was held on June 20 and 21st. He issued his opinion immediately afterwards on June 24, 2016, finding that the failure of the condition precedent due to Latham's unwillingness to issue the tax opinion was indeed a reason that would allow Energy Transfer to avoid closing the transaction and terminate the Merger Agreement.

In his opinion, Vice-Chancellor Glasscock decided that it was more important to consider whether Latham had determined in good faith that it was unable to issue the tax-free exchange opinion than whether Energy Transfer exercised the appropriate level of efforts to obtain the opinion from Latham or to restructure the transaction is such a way that it could close. In conducting the analysis, he said he was looking at the situation with a "jaundiced eye" since it was only after the economics of the deal changed significantly and Energy Transfer was manifestly looking for a low-cost out from the deal that its own lawyer determined it could not issue the opinion.

It is really this aspect of the situation that is of interest to arbitration practitioners – the fact that the closing condition was to be satisfied based on the opinion of the lawyers to one of the parties to the transaction. This necessarily hinged the transaction on the subjective opinion of that law firm. Vice-Chancellor Glasscock picked up on this peculiarity. He highlighted that the parties could have contracted to a different level of certainty for the condition precedent opinion. They could, for instance, have picked an independent third party to make the determination. They could have opted for an objective standard – to be provided by a court or an arbitrator. Instead, they assigned responsibility to Energy Transfer's tax counsel, making its subjective good faith determination the condition precedent. This then made the dispute all about the good faith of that law firm, not any objective analysis. Vice-Chancellor Glasscock launched into that analysis and found that Latham could not in good faith issue the opinion, no matter how badly they may have misapprehended the issue when the Merger Agreement was signed and no matter how much not issuing the opinion supported their client's desire to get out of the deal.

Another aspect of the *Williams* decision of interest to the condition precedent analysis is its discussion of the typical requirement in M&A agreements that the parties exercise some level of efforts to consummate the transaction; in the case of this agreement "commercially reasonable" efforts. Williams argued that Equity Transfer did not exercise the right level of efforts to obtain the opinion from its law firm. This is a larger issue in M&A law – what all these differing efforts standards mean. On the facts of the *Williams* case, Vice-Chancellor Glasscock made relatively short shrift of it. Williams argued that Energy Transfer would have used any method "fair or foul" to avoid the transaction. Even if this were true, he found that Williams could not point to any commercially reasonable efforts that Energy Transfer Equity could have taken to force its law firm, acting in good faith, to issue the tax-free exchange opinion.[282] Williams had put forth alternate structuring proposals that Energy Transfer did not accept and which Latham did not think changed the tax analysis. As Vice-Chancellor Glasscock put it, Energy Transfer's "failure (if failure it was) to negotiate a change to the Merger Agreement to implement the [alternative] proposals had no material effect on the failure of the condition precedent, obtaining the 721 Opinion."[283]

In the end an important takeaway from the *Williams* opinion comes from the way Vice-Chancellor Glasscock characterizes Delaware law. He says, perhaps inventing a new word, that it is strongly "contractarian", meaning that Courts closely follow and enforce the terms of the parties' agreement.[284] He notes that a provision in favor of specific performance in case of breach, as the parties' contracted for in the Merger Agreement, must be respected. However, the Merger Agreement had a condition precedent to the closing of the transaction and that must be enforced as well. In this case, the condition precedent trumped the specific performance remedy. It is perhaps an unexceptional observation that if a merger or acquisition agreement has a condition precedent to closing it will be respected by

[282] *Id*. at *58.

[283] *Id*. at *59.

[284] *Id*. at *6.

the Delaware courts and the parties will not be forced to consummate the agreement, but on such basic tenets of contract law can billions of dollars of financial consequences turn in corporate transactions. The lesson for practitioners is that if you rely on the opinion of an advisor to one of the parties as a condition to close the transaction, you will have to have to overcome the high hurdle of proving bad faith if the opinion doesn't go your way, thus opening the possibility in drafting, as Vice-Chancellor Glasscock himself suggested, that a neutral evaluation procedure such as arbitration be employed.

Example of an Arbitral Award in a Closing Condition Dispute - *In the Matter of the Arbitration between KNZ, LLC and Katuga Enterprises, Inc., Wilson Nuesa, Myra Nuesa, Royland Tan, Ma. Consuela Tan, Ramon Rosales and Marilou Rosales and Imran Ali*[285] AAA Case No. 13 180 01557 06

This dispute arose from two stock purchase agreements. In one, the buyers entered into an agreement with Imran Ali, the seller, to purchase three unopened Dunkin' Donuts franchises in New York City. The second involved a purchase of one operating Dunkin' Donuts franchise, also in New York City. The total consideration for the four franchises was $2.7 million. The closing was conditioned upon the approval of the transactions by Dunkin' Donuts, the franchisor, which was necessary for transfer of the franchise rights from the seller to the buyers. It proved difficult to obtain the franchisor's consent, in part because prior approval had not been sought. As a result, the parties entered into a joint venture agreement which recited that the buyers were 49% owners of the franchises and the seller remained 51% owner. The 51% would transfer upon the franchisor's approval. More than $1.8 million of the purchase price was financed with a third party loan arranged through the joint venture and which each of the buyers and the seller personally guaranteed.

The new stores opened for business. Even though he was the only franchisee recognized by Dunkin' Donuts, the seller withdrew from the operation of the business. The buyers experienced difficulty in staffing and operating the stores. None of them were profitable.

[285] Decision of the Supreme Court, New York County to confirm reported at *In re Katuga Enterprises, Inc. v KNZ, LLC* 2007 WL 3070377 (2007), 2007 N.Y. Slip Op. 33323(U)(Trial Order).

None of the buyers ever qualified to be an authorized franchisee and neither the stock purchase agreements nor the joint venture agreement was ever disclosed to Dunkin' Donuts.

The seller initiated the arbitration seeking a declaration that the buyers were the "beneficial owners" of 100% of the stores and that they were therefore required to "assume all rights and responsibilities that naturally flow from such ownership". The buyers counterclaimed, demanding the return or either 51% or 100% of the purchase price.

A sole arbitrator heard the case. He issued a partial award, finding that it would be impossible to enforce the agreements to declare the buyers the owners of the stores without the consent of the franchisor. A further hearing was held on damages. Before the partial award, the seller, purporting to act as "managing member" of each of the franchises operating entities, actually entered into option agreements to sell the franchises back to Dunkin' Donuts. Dunkin' Donuts exercised those options for two of the stores at prices significantly lower than what the buyers paid per store.

Concerning the three franchises that had not yet opened, the arbitrator found that the buyers were entitled to a refund of $400,000 of the purchase price. The arbitrator justified this by his finding that the financial information provided by the seller contained misleading projections to induce the buyers to enter into the stock purchase agreement at a "grossly inflated aggregate purchase price". He found that the "most cursory examination of the projections reveal that they purported to represent an operating franchise, not the 'to be built' franchise stores" buyers were purchasing. When compared to the actual results in the first year of operation, "the projections relied on grossly overestimated sales and grossly underestimated operating expenses (exclusive of debt service related to the purchase price) for each of these three franchise stores." He did take into account the actual operating results and other factors such as the personal guarantees of the debt service to determine the amount of the refund. He ordered that the seller be responsible for 51% of the debt service and the buyers 49% going forward basis.

Concerning the operating store, there was no evidence of an inflated purchase price. The problem was that the franchisor had not and would not approve the transfer of ownership to the buyer. In "balancing the equities" the arbitrator stated that both parties to the agreement knew or should have known that the transfer of ownership would never be approved. He found that the transaction was "virtually impossible of performance at its inception" such that the original stock purchase agreement "must be declared null and void". As a result, the buyer was held to own no part of the operating store and the arbitrator ordered a full refund of the purchase price paid, less the net operating profit of the store from the time of the stock purchase agreement until the date of the award (about 18 months). He also found that the seller was liable for all repayment of the debt and that it must be extinguished from the proceeds of any future sale of the store. The seller was determined to have sole ownership and control of the store and enabled to sell the store to the franchisor or anyone else acceptable to the franchisor.

IX. FRAUD AND EXTRACONTRACTUAL RIGHTS

The bulk of the discussion above relates to claims based on breach of contract in the M&A context. Situations also arise where the buyer claims that the seller deliberately hid issues, such as intentionally misrepresenting the target's operations, or otherwise engaged in fraud in connection with the transaction.[286] In those situations, buyers sometimes make a common law fraud claim against the sellers, as doing so will typically enable the buyer to obtain damages from the sellers without being subject to any indemnification deductible/threshold or cap in the purchase agreement, as well as potentially enabling the buyer to obtain "rescission" of the transaction – literally an unwinding of the acquisition in which the purchase price is refunded by the sellers to the buyer and ownership of the target is transferred back to the sellers. As discussed below in the section on damages, if rescission of the contract is not practical due to the new situation, "rescissory damages" may be available instead.

A. Extra-Contractual Nature of Fraud Claims

Fraud claims are sometimes referred to as exercising "extra-contractual" rights because the buyer will be seeking to avoid the damage limitations in the purchase agreement.

One threshold issue in agreements that are governed by New York law is whether the alleged fraud is based on false representations and warranties of the sellers contained within the acquisition agreement.

[286] Discussion adapted from McDonald & Aaronson.

Some courts applying New York law have refused to allow buyer fraud claims based solely on breaches of the representations and warranties made by the sellers in the agreement on the rationale that, even if the breaches were intentional, they are actually breach of contract claims, rather than tort (fraud) claims. These cases are premised upon the freedom of contract among sophisticated parties to allocate risks and responsibilities among them. In one case, *Dyncorp v. GTE Corporation*,[287] the buyer claimed that the seller intentionally misrepresented the value of a major customer contract and hid serious problems with that contract from the buyer. The Southern District did not allow the fraud claim on the grounds that it really amounted to a breach of contract claim.

One issue that has come before the courts on a number of occasions is whether the integration clause of a contract (sometimes called the merger clause), that is to say the boilerplate section that the written contract is the entire agreement between the parties and supersedes any prior agreement, written or oral, precludes a claim for fraudulent inducement based on oral statements the seller has made about the business which allegedly induced the buyer to enter into the agreement on a fraudulent pretext. It is fairly well settled under New York law a general integration or merger clause does not preclude a claim for fraudulent inducement.[288] The question is whether the written contractual documents contained a specific disclaimer about the subject of the false statements.

B. Elements of Making Out Fraud Claims

Fraud claims are hard to make out under New York and Delaware law. They tend to be complex and fact dependent. There are five elements a buyer has to plead under New York law to make out a claim for fraud: (1) a representation of material fact; (2) falsity; (3) scienter (that is to say, knowledge that the statement was false); (4) reasonable reliance; and (5) injury.[289] Each of the elements must be proven by

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[287] 215 F. Supp.2d 308 (S.D.N.Y. 2002).

[288] *See, e.g., Manufacturers Hanover Trust Co. v. Yanakas,* 7 F.3d 310, 315 (2d Cir.1993); *Citibank, N.A. v. Plapinger,* 66 N.Y.2d 90, 495 N.Y.S.2d 309, 485 N.E.2d 974, 976 (1985); *Danann Realty Corp. v. Harris,* 5 N.Y.2d 317, 184 N.Y.S.2d 599, 157 N.E.2d 597, 598–99 (1959).

[289] *See Wells Fargo Bank Northwest, N.A. v. Taca Int'l Airlines, S.A.,* 247 F.Supp.2d 352, 363 (S.D.N.Y.2002) (citing *Manning v. Utilities Mut. Ins. Co., Inc.,* 254 F.3d 387, 400

clear and convincing evidence. It is axiomatic under New York law that fraud allegations need to be "pled with particularity." A general statement that the seller misled the buyer will not be sufficient to support a fraud claim. Courts generally require the buyer to particularly identify the time, place and contents of the false representation, and the identity of the person who made the false representation. The buyer can satisfy these requirements through contemporaneous e-mails and other written communications of the target and sellers concerning the subject matter of the representations, as well as through sworn testimony of the parties involved.[290]

1. Knowledge

The element of knowledge has generated a lot of case law. A buyer making a fraud claim must prove that the sellers *knowingly* made a false statement to the buyer about the issue that is the subject of the claim, on which the buyer justifiably relied. Under New York law, the representation must have been "knowingly" false. Delaware law allows fraud claims based on knowingly false representations, as well as those to which the defendant was "reckless" as to its truthfulness (i.e., had no basis for knowing whether or not it was true). This knowing falsehood usually occurs by the sellers either intentionally hiding the issue from the buyer or intentionally misrepresenting the issue to the buyer.

Some recent Delaware cases where the Chancery Court allowed fraud claims to proceed are illustrative. In *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLP*,[291] the buyer claimed that the seller misrepresented the termination of an important business relationship and that the pending termination of another important business relationship had been hidden by the target from the buyer. In *Anvil Holding Corp. v. Iron Acquisition Co., Inc.*,[292] the buyer claimed that the sellers intentionally withheld from the buyer impending adverse changes to the target's contract with its most important customer. In *ABRY Partners V, L.P. v. F&W Acquisition LLC*,[293] the sellers and the target allegedly took

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(2d Cir.2001)); *see also Computerized Radiological Servs. v. Syntex Corp.,* 786 F.2d 72, 76 (2d Cir.1986).

[290] McDonald & Aaronson, p, 16.

[291] C.A. No. 7906-VCG (Del. Ch. 2014).

[292] 2013 WL 2249655 (Del. Ch. 2013).

[293] 891 A.2d 1032 (Del. Ch. 2006).

intentional actions to distort the apparent financial condition of the target and provided misleading financial statements reflecting those actions to the buyer; the target also allegedly failed to disclose to the buyer an operational problem that led to an important customer's termination of its relationship with the target.

2. Reliance

The *ABRY Partners* case discussed is interesting in that it involved the interpretation of an "anti-reliance clause", which is typically found in acquisition agreements. An anti-reliance clause is one which makes indemnification the parties' sole remedy for misrepresentations in the agreement.[294] This is advantageous to the sellers in that its indemnification liability is usually subject to a cap. Of course, a claim of fraud seeks to go around or beyond the indemnification process and often involves an attempt to rescind the agreement, which is what the buyer in *ABRY Partners* sought, or to impose unlimited liability.

The Chancery Court, in a somewhat confusing decision, generally supported the enforceability of anti-reliance clauses, but discussed the public policy against "immunizing fraud" and held that parties may only insulate a seller from liability (or preclude rescission claims) for false statements of fact in an agreement that are not intentionally made. However, if a seller intentionally misrepresents a fact in a contract – that is, if a seller lies – Delaware's public policy would not permit the enforcement of a contractual provision limiting the buyer's remedy to a capped damages claim.[295] This case seems to stand then for the proposition that if the buyer can prove that the misrepresentation was intentional, the anti-reliance clause will not help the seller.

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[294] The particular clause provided: "[Buyers] acknowledge[] and agree[] that neither the [target] nor [the sellers] has made any representation or warranty, express or implied, as to the [target or its subsidiaries] or as to the accuracy or completeness of any information regarding the [target or its subsidiaries] furnished or made available to [the buyers], except as expressly set forth in this Agreement . . . and neither the [target] nor [the sellers] shall have or be subject to any liability to [the buyers] or any other Person resulting from . . . [the buyers'] use of, or reliance on, any such information or any information, documents or material made available to [the buyers] in any 'data rooms,' 'virtual data rooms,' management presentations or in any other form in expectation of, or in connection with, the transactions contemplated hereby."

[295] *See* "Walking the Tightrope: Limiting Fraud Claims Based on Extra-contractual Statements and Omissions" by Roxanne L. Houtman, Catherine A. Schmierer, ABA Business Law Today (Aug. 2013).

Under New York law, one of the best known cases in the M&A context on the question of whether the buyer reasonably relied on false representations made by the seller is the one discussed above in the material adverse changes and failure of condition sections involving the failed merger between Con Edison and Northeast Utilities (NU).[296]

The fraudulent inducement claim also revolved around the contract that NU's subsidiary, Select Energy, had entered into with Connecticut Light & Power (CL&P) to supply the electricity that CL&P had to distribute to customers. As discussed in the previous section, the contract was for a four-year term to cover half of CL&P's load at a fixed price. Select had to go out into competitive power markets to procure the electricity itself. If the market price in the future proved to be higher than the price agreed to with CL&P, Select would be obligated to purchase that electricity at the higher price and would lose money. If the price proved to be lower, Select would stand to make money. In order to avoid the risk of losing money, Select would have had to enter into forward contracts at prices that would assure it had electricity at a stable price. Select had certain risk management policies concerning the extent to which it had to cover in this way its exposure to CL&P, policies that were dated August 1999, some six weeks before the merger agreement between Con Edison and NU was signed.

According to Con Edison, the parties discussed Select's risk management policies and expected profit margins during meetings near the end of August 1999 and in a subsequent meeting on September 23, 1999, although the parties could not agree in the litigation on the extent to which they discussed risk management relating to Select. Con Edison claimed that during the course of the due diligence investigation it performed, NU represented that it had "covered" the CL&P contract, meaning that Select had purchased enough energy to meet its obligations over the four years of the contract. On November 2, 1999, after the merger agreement was signed on October 13, 1999, CL&P and Select entered into the four-year supply contract. Con Edison was expecting this. However, it turned out that Select had acquired sufficient electricity to cover its obligations only during the first two years of the contract. Select was thus "uncovered" for the second two years. Select maintained the open position believing it could acquire the necessary electricity to

[296] *Consolidated Edison, Inc. v Northeast Utilities*, 249 F.Supp.2d 387 (S.D.N.Y. 2003).

supply the last two years at a lower price because a large number of new power plants were set to open in New England, which would drive down prices.[297]

Con Edison claimed that at the September 23, 1999 meeting, NU's representative stated that Select had acquired power to cover all of its obligations under the four-year agreement such that profit margins were locked down for that business. NU's representative denied making that statement, claiming that the Con Edison representatives at the meeting understood very well that only the first two years were covered. The parties further disagreed about the extent to which Con Edison made due diligence inquiries about the risk management policies and the scope of NU's disclosure. As mentioned in the discussion above, Select adopted new risk management policies in May 2000 which were substantially different and about which Con Edison claims it did not find out until December 2000. Con Edison further claimed that under its own risk management policies, it would have had to pay $400 million to cover the open positions had the merger been consummated. It also alleged that during the due diligence process, NU was aware that these policies were under revision but did not disclose this fact to Con Edison. In March 2001 Con Edison demanded a reduction in the purchase price for this and other reasons discussed (mainly an adverse change in NU's earnings prospects and started a suit for a declaratory judgment that it was not required to close the merger. One of its arguments was that NU's oral statements concerning Select's risk management policies and the extent it had covered the obligations to CL&P were false and that NU's conduct had fraudulently induced Con Edison to enter into the merger agreement.

NU's defense to the fraudulent inducement claim was that Con Edison could not prove the element of reasonable reliance that is part of a fraud claim under New York law. NU supported this position with the language of the Confidentiality Agreement the parties had entered into concerning the due diligence materials (called the "Evaluation Material"), which had an express disclaimer of reliance on any representation made during due diligence in the following terms.

> *The Parties (i) acknowledge that neither Party nor any Representative of either Party makes any representation or*

[297] See recitation of facts at 249 F.Supp.2d 393.

> *warranty, either express or implied, as to the accuracy or completeness of any Evaluation Material*, and (ii) agree, to the fullest extent permitted by law, except as may be provided in a Definitive Agreement ... that neither Party nor any Representative of either Party shall have any liability to the other Party or any of the other Party's Representatives on any basis ... as a result of the Parties' participation in evaluating a possible Transaction, the review by either Party of the other Party or the use of the Evaluation Material by either Party or its Representatives in accordance with the provisions of this Agreement. *Each Party agrees that it is not entitled to rely on the accuracy or completeness of the Evaluation Material....*[298]

Further, the Confidentiality Agreement provided that only those representations and warranties made in a definitive agreement (the merger agreement) would have any legal effect. It was clear that there were no representations and warranties on the CL&P contract or Select's risk management policies in the actual merger agreement.

While Judge Koeltl agreed with Con Edison that the integration clause of the merger agreement did not bar a claim for fraudulent inducement, he sided with NU based on the strength of the disclaimer in the Confidentiality Agreement. He found that all of the oral statements Con Edison was relying on were made during the course of due diligence and Select's risk management policies were provided under the Confidentiality Agreement and that the Confidentiality Agreement unambiguously provided that neither party was entitled to rely on the accuracy or completeness of the "Evaluation Material" supplied during due diligence. Judge Koeltl further found that if the risk management policies of Select were significant enough, Con Edison could have made them the basis for a specific representation in the merger agreement. He also basically sided with NU in its claims that it did not withhold any information Con Edison asked for and that Con Edison had not demonstrated that its representatives had asked for the relevant information. In sum, he did not find that Con Edison had demonstrated the level of reliance sufficient to prevail on a claim of fraud and dismissed its claim as a matter of law.

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[298] Emphasis added by the Court, 249 F.Supp.2d at 400.

C. Potential Limitations on Liability in Successful Fraud Claims

In sum, a fraud claim is a much more difficult way for the buyer to be compensated for seller misrepresentations relating to an M&A transaction, as compared to making an indemnification claim, because it necessarily entails very detailed proof of the alleged fraud, which may not be easy to establish. However, in situations where it can be proved, it is quite possible that the limits of liability established in the agreement will not apply and the buyer might be able to recover more substantial damages.

Example of An Arbitral Award Involving a Fraud Claim -
In the Matter of the Arbitration between TA Associates, L.P. et al. And James Gandy, Hary Gandy and Trent Garmoe
JAMS NY Case No. 1425003574[299]

Gandi Innovations was a company founded by the respondents in this case in Ontario, Canada that from 2001 to 2007 built up a significant business selling large-scale color inkjet printing engines in North America. In September 2007, the claimant private equity funds entered into a membership interest purchase agreement with the founders under which the purchaser funds invested $75 million in exchange for a 39% equity interest in the company. Of the $75 million invested, $50 million was in the form of cash and $25 million was a subordinated loan. The fund investors asserted that it was central to their investment thesis that the founding shareholders not receive a substantial cash payment and that they stay involved in the business. Another stockholder named Peter Afeiche was to receive $40 million of the cash payment. The fund investors claimed that they learned in late 2008 or early 2009 that Mr. Afeiche had secretly transferred $38 million of the $40 million he received to the founding stockholders. The fund investors started arbitration under the JAMS rules claiming misrepresentation and fraud, among other things. They asserted that Mr. Afeiche transferred the $38 million as part of a fraudulent scheme to induce the fund's investment and to avoid taxes.

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[299] Award confirmed in *T.A. Associates, L.P., as successor to TA ASSOCIATES, INC., TA ASSOCIATES X, L.P., TA ATLANTIC AND PACIFIC V, L.P., TA STRATEGIC PARTNERS FUND II, L.P., T.A. STRATIC PARTNERS FUND II-A, L.P., TA INVESTORS II, L.P. and TA SUBORDINATED DEBT FUND II L.P. v James Gandy, Hary Gandy and Trent Garmoe*, 43 Misc.3d 1233(A), 993 N.Y.S.2d 646, 2014 N.Y. Misc. LEXIS 2597; 2014 NY Slip Op 50913(U) (N.Y. Cnt'y, June 9, 2014).

One of the remedies they sought was rescission of the contract or, in the alternative, rescissory damages.

The case was heard before a sole arbitrator who held hearings, made findings of fact and issued a partial award, but then died. He was replaced and the replacement arbitrator held additional hearings and delivered an interim award and then a final award on December 4, 2013. The membership interest purchase agreement was governed by Delaware law, so the award was based on Delaware legal principles.

The arbitrator noted that the parties disagreed on whether the founding sellers or their agent made representations that they would not receive a substantial portion of the proceeds of the transaction. She found as follows:

> With respect to this dispute, I fully credit the testimony of the [fund investor] witnesses that Respondents repeatedly represented that they would receive no "liquidity" in the transaction and that the only person receiving liquidity would be Mr. Afeiche. I reject as wholly incredible the testimony of Respondents [founding sellers] suggesting that [fund investor] knew that Respondents themselves would receive substantially all of the funds to be distributed to Mr. Afeiche. Rather, I find that Respondents made false representations to Claimants as part of a scheme to induce [fund investor] to invest in the Company and to obtain millions of dollars without paying taxes. To effectuate this scheme, Respondents caused their attorneys (who, I find had no knowledge of the scheme) to participate in the preparation of complex documentation of the transaction designed to create the impression that all cash proceeds would be distributed to Mr. Afeiche.

While finding that some of the fund investors' claims were really contractual claims and not fraud claims, that was not the case for the representations about the use of the proceeds. Had the fund investors known of the "blatant lies" and "complex scheme" put into place by the founding sellers, that would have called into question the entire value of the investment. The founding sellers argued that these fraud claims were barred by the entire agreement or "integration" clause of the purchase agreement. Citing a Delaware Chancery Court case, *Kronenberg v Katz,*[300] the arbitrator ruled that none of the fund

[300] 872 A.2d 568, 587-94 (Del. Ch. 2004).

investors claims were barred by the standard integration clause of the agreement.

The arbitrator found that all of the required elements of fraud were proven and that the fund investor claimants justifiably relied on the sellers' misrepresentations, as such they would not have entered into the purchase agreement had they known that the founding sellers had planned to receive substantially all of the proceeds. As to damages, the fund investor claimants were entitled to "rescissory damages." As a result, the founding sellers were held to be jointly and severally liable to the fund investors for the entire amount of their investment—$75 million—as well as interest at the New York prevailing rate – 9 per cent.

X. REMEDIES FOR BREACH

Under New York law, a sole arbitrator or a tribunal has broad discretion in crafting remedies if it finds that one party is in breach of an agreement. The First Department of the Appellate Division has put it this way: "Unless the arbitration agreement provides otherwise, an arbitrator is not bound by principles of substantive law or by rules of evidence but may do justice as he sees it, applying his own sense of law and equity to the facts as he finds them to be."[301] This is consistent with the prior jurisprudence of the Court of Appeals, which expressed in these terms the benefit of the flexibility of arbitration: "[T]he laudatory value of arbitration lies in the arbitrator's power to construct a remedy best suited to the situation without regard to the restrictions on traditional relief in a court of law."[302] That case involved a challenge to an arbitral award on the grounds that the damages were too speculative and did not follow the usual guidance of the courts. To that, the Court of Appeals responded: "Merely because the computation of damages may be so speculative as to be unsupportable if awarded by a court does not make the award infirm, for, as we have firmly stated, arbitrators are not bound by rules of substantive law or, indeed, rules of evidence."[303]

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[301] *Azrielant v. Azrielant,* 301 A.D.2d 269, 275 N.Y.S.2d 19 (1st Dept 2002), *lv denied* 99 N.Y.2d 509 [2003] [internal quotations and citations omitted]).

[302] *Bd. of Educ. of Cent. School Dist. No. 1 of Towns of Niagara, Wheatfield, Lewiston & Cambria v. Niagara-Wheatfield Teachers Assn.,* 46 N.Y.2d 553, 557 [1979]).

[303] *Id*.

The wide berth given to arbitrators by the New York courts goes somewhat beyond what the rules of arbitration of the main institutions provide with respect to remedies, which are more oriented to what is allowed by the terms of the contract, even if they also give the arbitrator discretion. The AAA's Commercial Arbitration Rules allow an arbitrator to grant "any remedy or relief that the arbitrator deems just and equitable and within the scope of the agreement of the parties, including, but not limited to, specific performance of a contract."[304] The Administered Arbitration Rules of the International Institute for Conflict Prevention and Resolution of Conflict ("CPR") are drafted in similar terms in that the "Tribunal may grant any remedy or relief … which is within the scope of the agreement of the parties and permissible under the law(s) or rules of law applicable to the dispute."[305] It also explicitly allows the tribunal to order specific performance of a contract.

The ICC Rules of Arbitration, which are meant to apply to many legal systems and substantive bodies of law, are even more oriented towards to the terms of the parties' agreement. Article 21(2) requires that the arbitral tribunal "take account of the provisions of the contract, if any, between the parties and of any relevant trade usages."[306] The ICC Rules tend to limit more the equitable powers of an arbitrator or tribunal insofar as they prohibit assuming the powers of an "amiable compositeur" or deciding "ex aequo et bono" unless the parties have agreed to give it such powers.[307] In other words, so-called "equitable" remedies of the types the New York courts would gladly seem to allow arbitrators to craft are not encouraged under the ICC Rules. The ICDR Rules on remedies speak in terms very similar to those of the ICC, including with respect to the tribunal not assuming the powers of "amiable compositeur" or ruling ex aequo et bono without the consent of the parties. This is not to say that in an ICC or ICDR arbitration, if the substantive law governing a contract is New York law and New York law, would allow under the circumstances for equitable remedies such as specific performance or rescission or reformation of a contract

[304] Rule 47(a) of the rules effective Oct. 1, 2013, available at https://www.adr.org/aaa/faces/rules/searchrules/.

[305] Rule 10.3, effective July 1, 2015, available at http://www.cpradr.org/RulesCaseServices/CPRRules.aspx.

[306] Available at http://www.iccwbo.org/products-and-services/arbitration-and-adr/ arbitration/icc-rules-of-arbitration/.

[307] Article 21(3).

when money damages are inadequate, the arbitrators hearing the case would be prevented from ordering those remedies.

Against this background, the following is a discussion of the main remedies which are, under New York law, most often applied in the M&A context.

A. Benefit of the Bargain

The general principle under New York law regarding damages for all types of breach of contract claims is that the party who has suffered from a breach by the other is entitled to the benefit of its bargain; that is to be placed in the position it would have occupied had the contract been fulfilled according to its terms.[308] That is normally accomplished by awarding money damages to make the injured party whole. This benefit-of-the-bargain principle is also the basic rule in breaches of acquisition and merger agreements. For breaches of a seller representation or warranty, the buyer generally will proceed to make an indemnification claim under the terms of the agreement.

In the M&A context, the benefit of the bargain is measured as the difference between the value of business as warranted by the seller and its true value at the time of the transaction.[309] The damages suffered by the buyer could be in the nature of an on-going impairment, such as when the business sold does not in fact have the level of sales of the key customers warranted, or a one-off impairment, such as when particular inventory is obsolete and has no value or does not exist. In the latter case, the damages will be the warranted value of the inventory. For the former case of ongoing impairment, the damages will be calculated as the difference between the equity value of the business as warranted and the actual equity value of the business post-closing.

If the purchase price for the acquired business was based on multiples valuation methodology (i.e. that the value was a certain multiple of the EBITDA of the business), then the same multiple will normally be applied to the impaired value. In this case the EBITDA value of the target will be calculated over a certain period of time (perhaps an average of the two or three years prior to closing) and

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[308] *Boyce v. Soundview Tech. Group, Inc.*, 464 F.3d 376, 384 (2d Cir. 2006).

[309] *See Bennett v. U.S. Trust Co. of N.Y.*, 770 F.2d 308, 316 (2d Cir. 1985)*; Clearview Concrete Prods. Corp. V. S. Charles Gherardi, Inc.*, 88 A.D.2d 461, 453 N.Y.S.2d 750, 756 (2d Dep't 1982). *Merrill Lynch* at 184-85.

then multiplied by the applicable multiple. That calculation yields the "enterprise value" from which the net value of outstanding debt must be subtracted to establish the equity value. The damages then are the difference between the equity value as warranted (i.e. with all customers/revenue, etc.) and the actual equity value without them.

B. Lost Synergies

Another damage theory that has been advanced by acquirers in some failed mergers and acquisitions is the "lost synergies" claim. The idea behind this is that a merger or an acquisition should result in synergies between the two previously separate businesses and savings as a result of eliminating overlapping expenses. Under conventional financial analysis methods, these synergies can be calculated, or at least estimated. It stands to reason then that if an agreed merger or acquisition fails as a result of the breach of the acquired party, the acquirer or the surviving party in a merger will be damaged by not being able to realize the synergies and savings anticipated.

One of the leading New York cases addressing a lost synergies claim is again the failed merger between Con Edison and Northeast Utilities ("NU") (discussed above). In the initial opinion issued in the suit brought by Con Edison for a declaratory judgment that it was not required to complete the merger, Judge Koeltl of the Southern District addressed Con Edison's damages claim for lost synergies.[310] Con Edison's claim for lost synergies was stated as follows:

> The damages suffered by Con Edison in the form of lost synergy savings equal the present value of Con Edison's approximately 82% share of (1) the expected $1,574,000,000 in synergy savings to be realized in the regulated businesses ... and (2) the expected $180,000,000 in synergy savings to be realized in the unregulated businesses....[311]

It appears that after the litigation was commenced, Con Edison's own expert prepared a report on the anticipated savings to be realized upon the merger which arrived at the figure of $707 million in net merger savings of which 82% of which would accrue to Con Edison, or about $597 million. [312] It should be noted that the concepts of lost

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[310] *Consolidated Edison, Inc. v. Northeast Utilities*, 249 F.Supp.2d 387 (S.D.N.Y. 2003).

[311] *Id*. at 420.

[312] *Id*.

synergies and lost savings are not the same. Savings are mostly the result of consolidating overlapping business lines and employment cost reductions, while synergies is a broader concept with a more forward looking aspect of being able to realize expansion of revenues.

NU's defense to the lost synergies claim was a bit odd in that it argued that with the size of the premium Con Edison was prepared to pay per share over the price before merger rumors began circulating ($26.50 over $18.56), which amounted to an aggregate premium of over $1 billion, Con Edison was in fact seriously overpaying for NU. Since the size of the supposed overpayment was more than the lost savings estimated by Con Edison's own expert, Con Edison was not at all damaged. As a result, NU argued that Con Edison's claim should be dismissed as a matter of law. Con Edison of course responded that it was not overpaying at all, that the valuation given was in the middle of the range it received from its financial advisors and that the price paid reflected the value Con Edison saw in the merged company.

Judge Koeltl did not accept NU's request to dismiss Con Edison's claim as a matter of law. After the case wound its way through an opinion by Judge Koeltl on the issue of whether NU's shareholders were entitled to damages for their lost premium, an appeal to the Second Circuit on that issue (discussed below) and several more opinions on remand, Con Edison and NU were preparing for a trial scheduled in 2008. At the beginning of that year, Judge Koeltl rebuffed another attempt by NU to dismiss the lost synergies claim, setting it for trial. After that the parties mediated a settlement to their dispute that involved NU making a payment to Con Edison to cover its legal and other expenses, so the lost synergies case claim was never resolved.

C. Lost Premium Damages/Shareholder Claims

On the flip side of the damages coin, NU argued that when Con Edison wrongfully backed out of the merger, its shareholders lost the premium that was part of the purchase price, and were damaged as a result. It sought the lost premium on behalf of its shareholders. Its claim was premised on an ultimate finding that Con Edison had breached the merger agreement by backing out of the merger, while Con Edison claimed that it was NU that breached the merger agreement by changing its risk management policies concerning its energy trading subsidiary, Select, and also that Con Edison was entitled not to consummate the merger due to a material adverse change in NU's financial prospects. A determination of whether one or the other parties was at fault was never made, as the case ultimately was settled. However, Judge Koeltl did determine that NU could sue on behalf of its shareholders based on his reading of the merger agreement as designating NU's shareholders as third party beneficiaries of the agreement.[313] This aspect of the case was submitted to the Second Circuit for consideration on interlocutory appeal, given its importance to the outcome. The Second Circuit read the contractual provisions differently, however.

The Second Circuit laid out the basic premise under New York law that a contractual promise can be enforced by a non-party (such as NU's shareholders) who is an intended third party beneficiary of that promise.[314] However, it also cited the emphasis placed by the New York Court of Appeals on whether the language of the contract clearly evidences an intent to permit enforcement by a third party when upholding that right.[315] So the Second Circuit delved more deeply into the question of whether Con Edison and NU intended to confer on NU's shareholders a right to enforce Con Edison's promise to complete the merger. A positive finding in this regard would mean a more than $1 billion premium for those shareholders and thus a huge liability for damages to Con Edison.

The merger agreement had a clause that excluded third party rights except in two specific situations, only one of which was relevant to the dispute. That one related to the time at which the merger was to be complete, called the "NU Effective Time." At the NU Effective time, each outstanding NU share was to be converted into the right to receive cash or stock in the post-merger company, which would have reflected the premium to be paid by Con Edison. According to the Second Circuit's reading of the agreement, that third party right would only arise on the completion of the merger, which never occurred. As a result, the Court found that this third party right never arose. At the District Court, NU had made much of the fact that the right never arose as a result of what it considered Con Edison's breach in backing out of the merger agreement. It had argued before Judge Koeltl below that there is a rule of law in New York that a party may not avoid performance of a contractual duty by preventing

313 *Id*. at 416-419.

314 Citing *Fourth Ocean Putnam Corp. v. Interstate Wrecking Co.*, 66 N.Y.2d 38, 43-44, 495 N.Y.S.2d 1, 485 N.E.2d 208 (1985).

315 *Id*., 66 N.Y.2d at 45.

the occurrence of a condition precedent, which is called the "prevention doctrine."[316] Judge Koeltl had relied heavily on this doctrine in ruling that NU's shareholders could sue Con Edison.[317] The Second Circuit did not agree with this approach because it was of the view that the language of the merger agreement did not evidence in a clear enough way the parties' intent to confer third party rights on the shareholders. They read the agreement as creating a third-party right, but only in a very specific circumstance—if and when the merger was completed. The Second Circuit was of the view that NU and an individual shareholder of NU who also sued were seeking to achieve through the prevention doctrine a right denied to them under the terms of the agreement.

> NU and [the individual shareholder] ask us to apply the prevention doctrine in a way that would transform a narrow right to secure payment if and when the NU Effective Time arises into a billion-dollar penalty for the failure to merge. We decline.[318]

The principle of party autonomy in the contract drafting process and the concern for upholding the parties' expectations played a large role in the Second Circuit's reasoning. Since NU would no longer exist as an independent entity if the merger were completed, the merger agreement put an obligation on Con Edison to create a fund out of which the merger consideration, including the premium, would be paid to the NU shareholders. The third party rights were fashioned to allow NU's shareholders to enforce their right to receive the merger consideration and premium in this particular situation. The Second Circuit was very concerned that if it were to find a third-party right for shareholders to seek damages for breach of the duty to merge before the NU Effective Time, that right would overwhelm the careful arrangements in the merger agreement. The Second Circuit found that that would unduly limit the signatories' own freedom of action to accept or risk the contractual consequences of non-performance.[319]

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[316] *See* e.g. *Kooleraire Serv. & Installation Corp. v Bd. of Educ.*, 28 N.Y.2d 101, 106, 320 N.Y.S.2d 46, 268 N.E.2d 782 (1971).

[317] *Consolidated Edison, Inc. v. Northeast Utilities*, 249 F.Supp.2d at 417, n.11.

[318] 426 F.2d at 529.

[319] 426 F.3d at 530.

While the Con Edison/Northeast Utilities case is a leading one in the area of whether shareholders have the right to enforce a merger or acquisition agreement, it should not be understood as a general statement of New York law that that right is generally not available to shareholders. In the end, the Second Circuit's decision turns heavily on the particular language of the agreement that limited third party rights to very specific situations. If an agreement does not have such specific language, it could well be that an acquirer or surviving party will be liable for shareholder claims.

A review of the Delaware cases on the issue of shareholder rights provides strong indications that Delaware courts would not reach the same result under Delaware law.[320] In the *Tyson* case discussed above and also below regarding specific performance as a remedy, the Court of Chancery, even though it was applying New York law, used the following terms in ordering specific performance of the merger agreement rather than awarding damages: ''Specific performance is the decisively preferable remedy for Tyson's breach, as it is the only method by which to adequately redress the harm threatened to IBP ***and its stockholders***'' (emphasis added).[321] According to the Chancery Court, specific performance was ''preferable to a vague and imprecise damages remedy that cannot adequately ***remedy the injury to IBP's stockholders***'' (emphasis added).[322] Clearly, at least in this somewhat offhand way, it shows that Chancellor Chandler in that case had some concern about how the shareholders were harmed, although this case was decided before the Second Circuit's opinion in Con Edison and it did not consider the impact of a no-third-party-beneficiaries clause. At a conference in 2008, then Vice-Chancellor Strine (later a Chancellor and then the Chief Justice of the Delaware Supreme Court) made remarks that also indicate his sympathy towards the rights of shareholders.

> I don't understand what the purpose of the Board of Directors negotiating a cash-out merger for its stockholders is if it is not . . . to obtain, as an instrument of the stockholders, the profits of the contract. . . . I really don't

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[320] Jaculin Aaron & Alan Goudiss, *The Challenges for Sellers in Obtaining Effective Remedies in M&A Transactions*, BNA Mergers & Acquisitions Law Report, 15 MALR 1277, 09/03/2012.

[321] *In re IBP, Inc. Shareholders Litig.*, 789 A.2d 14, 23 (Del. Ch. 2001).

[322] *Id.* at 84.

> have difficulty conceptualizing that the contract was negotiated for the benefit of the stockholders as it must be by the directors . . . that in order to . . . honor the expectations of the parties you have to recognize that was its purpose and to allow the board of directors as an instrument for the stockholders to collect.[323]

The apparent willingness of Delaware Courts to enforce the rights of public company shareholders to receive the benefit of a merger is reinforced from another decision by Chancellor Chandler from 2008 in a case called *Amirsaleh v. Board of Trade of the City of New York, Inc. and Intercontinental Exchange, Inc.*[324] Mahyer Amirsalah was a member of the New York Board of Trade, a physical commodities futures exchange located in New York City. His membership entitled him to lease his seats to third parties. The Board of Trade and Intercontinental Exchange entered into an agreement to merge (governed by Delaware law) where Intercontinental Exchange would be the surviving entity. Members of the Board of Trade had the choice of taking their consideration in the form of stock or cash, provided they made an election by a certain deadline. If they did not make the election by the deadline, the default was cash. Due to what was apparently a problem with the mail when Mr. Amirsalah's election form was sent to him, he did not meet the deadline but was able to turn in the form about two weeks late. By that time Intercontinental Exchange had stopped accepting election forms, even though it had accepted late election forms from a number of other members. By being cashed out, Mr. Amirsalah lost his seats on the exchange since he would no longer be a member and thus his ability to lease them out to others. He sued, claiming he had been treated unfairly.

One of the defenses raised by Intercontinental Exchange was that he did not have the right to sue under Delaware law because he was not a party to the merger agreement and the merger agreement had a clause that excluded third party rights. While Chancellor Chandler noted that Delaware Courts generally did not accept the notion that

[323] Leo Strine, Remarks at Securities Regulation Institute Seminar at the Northwestern University School of Law (Jan. 24, 2008), quoted in Ryan D. Thomas and Russell E. Stair, Revisiting Consolidated Edison – A Second Look at the Case That Has Many Questioning Traditional Assumptions Regarding the Availability of Shareholder Damages and Public Company Mergers, 64 BUS. LAW. 329, 342 n.70 (2008).

[324] *Amirsaleh v. Bd. of Trade of City of New York, Inc.*, 2008 WL 4182998 (Del. Ch. Sept. 11, 2008).

stockholders have enforceable rights as third-party beneficiaries of contracts entered into by corporations, mostly on the theory that a corporation is a legal entity that is distinct from its shareholders, this had mostly to due to a lack of evidence of the contracting parties' intent to confer a benefit under the contract to shareholders.[325] He emphasized that the key to third-party standing in contract law is the intent to benefit the third party. Citing previous decisions of other chancellors, he noted that for a third party to qualify as a beneficiary of a contract:

> (i) the contracting parties must have intended that the third party beneficiary benefit from the contract, (ii) the benefit must have been intended as a gift or in satisfaction of a pre-existing obligation to that person, and (iii) the intent to benefit the third party must be a material part of the parties' purpose in entering into the contract.[326]

Applying this test to the New York Board of Trade and Intercontinental Exchange merger agreement, he found that there really was no question that the members of the New York Board of Trade were intended beneficiaries of the merger agreement because the agreement "manifests an unambiguous intent to benefit the NYBOT Members." Analyzing the agreement, he pointed to the provision that "each Membership Interest issued and outstanding immediately prior to the Effective Time shall automatically be converted into and constitute the right to receive" either new Intercontinental Exchange shares or cash. The choice of the merger consideration was to be determined "at the election of the Member that is the holder of such Membership Interest." Upon election, shares or a check were issued directly to members. He cited the general Delaware law proposition that "[w]hen a promised performance is rendered directly to the beneficiary, 'it is presumed that the contract was for the beneficiary's benefit.'"[327] This analysis is really only another way of saying that if shareholders are going to get some payment for their shares in a merger, the merger agreement is for their benefit, which is an obvious point and not one the Second Circuit in *Con Edison* saw as dispositive. However, Chancellor

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[325] Citing *Orban v. Field*, C.A. No. 12820, 1993 WL 547187, at *9 (Del. Ch. Dec. 30 1993).

[326] *Madison Realty Partners 7, LLC v. Ag ISA, LLC*, C.A. No. 18094, 2001 WL 406268, at *5 (Del. Ch. Apr. 17, 2001), *quoted in Comrie v. Enterasys Networks, Inc.*, C.A. No. 19254, 2004 WL 293337, at *2 (Del. Ch. Feb. 17, 2004).

[327] *Comrie v. Enterasys Networks, Inc.*, 2004 WL 293337, at *3.

Chandler further cited a ruling the United States District Court for the District of Delaware that former shareholders of a corporation are intended third party beneficiaries where the merger agreement provided that the shareholders would receive compensation for their shares and the merger required shareholder approval.[328] Again, this is the case in nearly all mergers. Chancellor Chandler made short shrift of the New York Board of Trade and Intercontinental Exchange's argument that the merger agreement contained a general provision disclaiming the existence of any third party beneficiaries. He said that that disclaimer is "belied by the Agreement's specific grant of benefits" to New York Board of Trade Members. Chancellor Chandler did not grant the defendants' motion to dismiss Mr. Amirsaleh's claim, thus paving the way for him to make his arguments at trial that he was treated unfairly. Mr. Amirsaleh did ultimately prevail in his claim after a trial in the Chancery Court and an appeal to the Delaware Supreme Court. None of these proceedings called into question his right as a shareholder to the New York Board of Trade to make the claim.[329]

This Delaware case law therefore suggests very strongly that a court applying Delaware law would reach a different conclusion than the Second Circuit did in the *Con Edison* case. The uncertainty in the laws on shareholder rights to enforce the benefit of a breached merger agreement is a practice point for transactional lawyers in representing either of the parties to an agreement relating to the merger or acquisition of a public company. The lawyers representing the acquirer or the surviving party in agreement governed by New York law could well want to put forward a strongly worded disclaimer of third party beneficiary rights to avoid the type of penalty that Con Edison might have had to pay to Northeast Utilities. Conversely, the lawyers representing the target could well prefer Delaware law to govern so that the shareholders have a better chance of receiving the benefit of the transaction. Two practitioners have noted in an article on these cases that a carefully worded provision to this effect may still face resistance from a court on the grounds that it is not proper to allow a party (the

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[328] *Hadley v. Shaffer*, No. 99-144-JJF, 2003 WL 21960406, at *5 (D. Del. Aug. 12, 2003).

[329] Subsequent proceedings reported in *Amirsaleh v. Bd. of Trade of City of New York, Inc.*, 2009 WL 3756700 (Del. Ch. Nov. 9, 2009); *Amirsaleh v. Bd. of Trade of City of New York, Inc.*, 2010 WL 177681 (Del. Ch. Jan. 19, 2010); Delaware Supreme Court opinion reported at *Amirsaleh v. Bd. of Trade of City of New York, Inc.*, 2011WL 3585598 (Del. Aug. 16, 2011).

target) to recover, as contract damages, compensation for harm suffered by third parties (the target's shareholders).[330]

D. Specific Performance

Claims for specific performance arise frequently in the M&A context, often against the backdrop of a staggered signing and closing. They can go either way. The buyer may be claiming that one or more of the conditions to closing were not met, or there was a material adverse change in the target business in the pre-closing period and gives notice that it does not intend to close. In that case, the seller might seek to force the buyer to close. Conversely, a seller might get cold feet and want to back out of the deal, in which case the buyer might want to force it to complete the sale.

The common law legal principle that specific performance is only available if money damages are inadequate applies in the M&A context as well as others. More often than not, acquisition agreements include a clause authorizing specific performance as a remedy, reciting the parties' agreement that the subject of the contract is unique and that money damages would be inadequate. In this regard, the law in New York and Delaware differs somewhat in the M&A context. As discussed below, under New York law, contractual stipulations are generally not sufficient to establish the lack of an adequate remedy at law. Under Delaware law, however, a contractual stipulation that a breach of contract will result in irreparable harm for which there is no adequate remedy at law is typically sufficient unless the facts plainly do not support a finding of irreparable harm.[331]

One case highlighting the approach of the Delaware courts is *Kan. City S. v. Grupo TMM. S.A. de C.V.,* where the Chancery Court stated that:

> Although a contractual stipulation as to the irreparable nature of the harm that would result from a breach cannot limit this Court's discretion to decline to order injunctive relief, such a stipulation does allow the Court to make a finding of irreparable harm provided the agreement

[330] *See* Jaculin Aaron & Alan Goudiss, *The Challenges for Sellers in Obtaining Effective Remedies in M&A Transactions, op. cit.*

[331] *See SLC Beverages, Inc. v. Burnup & Sims, Inc.,* 1987 Del. Ch. LEXIS 472 (Del. Ch. August 20, 1987).

> containing the stipulation is otherwise enforceable. If the facts plainly do not warrant a finding of irreparable harm, this Court is not required to ignore those facts, especially since the parties cannot confer subject matter jurisdiction upon a court. But where there is no concern that the parties are attempting to improperly confer equitable jurisdiction upon this Court, a defendant cannot successfully argue that there is no irreparable harm. [332]

In *Gildor v. Optical Solutions, Inc.*, the court ruled that there was no need to examine whether elements for specific performance were satisfied because the agreement specifically stated that the parties can enforce their contractual rights by seeking specific performance. The court stated that "[a]lthough this court has not had the prior opportunity to determine whether a contractual provision granting an aggrieved party a contractual right of specific performance is enforceable, Delaware courts do not lightly trump the freedom to contract and, in the absence of some countervailing public policy interest, courts should respect the parties' bargain."[333]

New York courts take a quite different approach. As noted above, contractual stipulations are generally not sufficient to establish the lack of an adequate remedy at law and courts have found that parties cannot agree between themselves that certain legal standards, such as "irreparable harm" have been met. This principle was established by the Court of Appeals long ago (in 1907), which held that

> "[P]arties to an agreement cannot contract that courts will exercise their functions against or in favor of themselves. Whether or not a court will so exercise its powers is for the court itself to determine."[334]

The Delaware courts are not absolute, however, about enforcing parties' specific performance clauses. Even if the plaintiff establishes that monetary damages are an inadequate remedy, plaintiffs are never

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[332] 2003 Del. Ch. LEXIS 116, at *21-22 (Del. Ch. November 4, 2003).

[333] *Gildor v. Optical Solutions, Inc.,* 2006 Del. Ch. LEXIS 110; 2006 WL 4782348 at *37 (Del. Ch. June 5, 2006).

[334] *Dockstader v. Reed*, 121 A.D. 846, 848 (1907)*; See also Proyectos y Construcciones Procisa, S.A. de C.V. v. Continental Tire N. Am., Inc.,* Index No. 602540/2004, at 6-9 (N.Y. Sup. Aug. 25, 2004); *Agee v. Paramount Communs., Inc.,* 932 F. Supp. 85, 88 (S.D.N.Y. 1996).

absolutely entitled to specific performance and specific performance is granted at the discretion of the court.[335]

The leading case in the M&A context is again the *IBT v Tyson* case, discussed above regarding claims of material adverse change.[336] In that case, the Delaware Court of Chancery (applying New York law) did order the buyer to complete a merger when it wanted to back out due to a claimed material adverse change in the business where the merger consideration included stock of the buyer (Tyson Foods). The court found that "[S]pecific performance is the decisively preferable remedy for Tyson's breach, as it is the only method by which to adequate redress the harm threatened to IBP and its stockholders" and it was "preferable to a vague and imprecise damages remedy that cannot adequately remedy the injury to IBP's stockholders." This was a case where a court has enforced a specific performance clause against a buyer, forcing it to close the transaction. An important factor in the Chancery Court's analysis was that the consideration for Tyson's payment was stock. In the transaction, IBP's shareholders, the sellers, were given an opportunity to elect stock as merger compensation. The Delaware Court of Chancery held that the transaction contemplated was unique because it gave IBP shareholders the opportunity to benefit from the combination of Tyson Foods and IBP, and as such, money damages would be inadequate to compensate IBP and its shareholders.

The difficulty facing a target seeking specific performance by the buyer is establishing that monetary damages are inadequate, especially in the context of all cash transactions. Although other jurisdictions have granted specific performance for targets in all cash transactions,[337] the question is less settled in Delaware. In *Hexion Specialty Chems., Inc. v. Huntsman Corp.*,[338] the court only ordered the buyer of an all cash transaction to specifically perform all of its obligations except the closing. The court's dicta did, however, imply that the court would have been willing to grant specific performance of the closing itself had the agreement provided for it (the merger agreement provided that all

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335 *See West Willow Bay Court, LLC v. Robino-Bay Court Plaza, LLC,* 2007 BL 142615, at *35 (Del. Ch. Nov. 2, 2007).

336 *In re* IBP, Inc. Shareholders Litig., 789 A.2d 14 (Del. Ch 2001).

337 *See Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III) (Tenn. Ch. Ct. Dec. 27, 2007)*; *Kroblin Refrigerated Xpress, Inc. v. Pitterichi, 805 F.2d 96 (3d Cir. 1986).*

338 2008 WL 4457544 (Del. Ch. Sept. 29, 2008).

obligations, except the obligation to close, would be specifically enforceable).

The Delaware courts seem much better disposed to forcing sellers to complete a transaction, holding consistently that the opportunity to acquire a company or business is uniquely valuable and spurned buyers cannot be adequately compensated with monetary damages.[339]

Specific performance clauses may not be enforced by courts if ambiguity exists in the agreement. Specifically, caution should be used when drafting specific performance clauses in agreements that also contain liquidated damages provisions. *United Rentals, Inc. v. Ram Holdings, Inc.*,[340] involved a merger agreement pursuant to which RAM Holdings was to acquire all of the shares of United Rentals in exchange for cash. After RAM informed United Rentals that it did not wish to proceed with the transaction, United Rentals brought an action for specific performance in the Delaware Court of Chancery. The merger agreement contained two sections relating to remedies for breach, one which limited United Rental's remedy to a reverse breakup fee and the other allowing for specific performance. The court found the merger agreement to be ambiguous as to whether the parties agreed that specific performance was an intended remedy. Ultimately, the court refused to grant specific performance.

In sum, specific performance is a remedy available to both buyers and sellers when trying to force the closing of a transaction. In general, a court is more likely to enforce a specific performance clause in favor of a buyer and for sellers that have the option of receiving shares of the surviving corporation. However, specific performance is not an automatic right and is granted at the discretion of the courts.

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[339] *See Triple-A Baseball Club Associates v. Northeastern Baseball, Inc.,* 832 F.2d 214 (1st Cir. 1987), cert. denied, 485 U.S. 935 (1988); *Allegheny Energy, Inc. v. DQE, Inc.,* 171 F.3d 153 (3d Cir. 1999); *Medcom Holding Co. v. Baxter Travenol Labs., Inc.* 984 F.2d 223 (7th Cir. 1993); *True North Commc'ns, Inc. v. Publicis, S.A. et al.,* 711 A.2d 34 (Del. Ch. 1997) , *aff'd,* 1997 Del. LEXIS 472 (Del. Dec. 29, 1997).

[340] 937 A.2d 810 (Del. Ch. 2007).

Example of an Arbitral Award Granting Specific Performance in an M&A Dispute - *Offshore Exploration and Production, LLC, Claimant against Korea National Oil Corporation and Ecopetrol S.A.* ICDR Case No. 50 198 T 00825 11 Interim Award dated April 16, 2013[341]

The first award in the dispute described above concerning the post-closing tax indemnification claim is an example of an arbitral tribunal ordering specific performance under New York law. As noted, that dispute arose out of a sale by Offshore of the shares of a holding company that had many subsidiaries, including one in Peru. After closing the Peruvian tax authorities forced the Peruvian company to make a large payment ($75 million) to the government based on VAT taxes that supposedly were not paid in a five-year period prior to closing. The buyer sought reimbursement of the amounts paid, as the stock purchase agreement provided. The seller resisted, saying that would amount to an injunction without there being any proof of irreparable harm or of the buyer's likelihood of success on the merits.

The stock purchase agreement had a clause on specific performance, which allowed a party the right to seek specific performance of the agreement "without the necessity of proving the inadequacy of money damages as a remedy." The tribunal found that the buyer was entitled to an order requiring the seller to reimburse the Peruvian affiliate for the VAT taxes assessed and paid to the Peruvian government before the proceeding to contest the assessment was finished. According to the tribunal, "this determination is based solely on what the Tribunal views as the unambiguous language of the SPA regarding the payment of funds in advance of the dispute resolution procedure called for in the parties' agreement."

As to the seller's argument that ordering the payment would in essence amount to an injunction without the grounds being established:

> The tribunal is mindful that the case law compels an applicant for a mandatory preliminary injunction in a court of law to

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341 Decision of the Southern District in the action to confirm the award found at *Offshore Exploration & Prod. LLC v. Morgan Stanley Private Bank, N.A.*, 996 F.Supp. 2d 308, 2013 U.S. Dist. Lexis 16978 (S.D.N.Y. 2013); *Ecopetrol S.A v Offshore Exploration & Prod. LLC*, 46 F.Supp.3d 327 (S.D.N.Y. 2014); *Offshore Exploration & Production LLC v Morgan Stanley Private Bank, N.A., Ecopetrol S.A. and Korea National Oil Corporation*, 2015 WL 5568406 (2d Cir. 2015).

> carry a heavy burden. This, however, is arbitration. Arbitrators are not bound to the standards for interim relief set forth in the cases and may, in appropriate situations, even grant relief that would be unavailable in a court of law. *See, e.g. Sperry International Trade v. Government of Israel, 432 F.Supp. 901 (S.D.N.Y.), aff'd 689 F.2d 301 (2d Cir. 1982).* This is especially true in the instant case by reason of SPA Section 10.7(b) which grants the tribunal broad power to fashion appropriate relief, a power repeated in the International Dispute Resolution Procedures of the AAA under which this arbitration is being conducted. See, Articles 21(1) and 21(2).

Further, the tribunal read the specific performance clause of the agreement as expressly permitting the panel to grant the relief sought. It found that the "parties bargained for this provision and are entitled to its enforcement."

E. Rescission

The equitable remedy of rescission is one that comes up in the M&A context, especially when a party (usually the buyer) claims that it has been fraudulently induced into entering into the acquisition or merger agreement. Several examples of these types of claims are discussed in the section on Fraud and Extracontractual Rights above. Fraudulent inducement is one of the main grounds for justifying the remedy of rescission under New York law, the other three being a failure of consideration, the inability to perform the contract after it is made or a breach of the contract that substantially defeats the purpose of it.[342] If rescission is based on a breach of the contract, the breach must be "material and willful" or, if not willful, so substantial and fundamental as to strongly tend to defeat the object of the parties in making the contract.[343] Rescission is not a remedy that is available when money damages for a "normal" breach of contract are available.

A decision of the First Department from 2010 sets out the elements that must be established to prevail on a rescission claim based on fraudulent inducement: (1) knowing misrepresentation of a material

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[342] Marc A. Wites, NEW YORK LITIGATION Guide, Wites & Kapetan P.A. (2014), available at http://www.nylitguide.com/chapter-pages/rescission/.

[343] *Babylon Assocs. v County of Suffolk,* 101 A.D.2d 207, 215 (2d Dept. 1984).

fact, (2) intention to deceive, (3) reliance on the misrepresentation and (4) injury.[344]

Finally, the equitable remedy of rescission, which involves essentially pretending that the contract never existed, can only be effective when the status quo can be restored and there is "lacking complete and adequate remedy at law."[345]

In New York law, when actual rescission of the contract is not possible, a court may, in order to do justice, order "rescissory damages" instead. This principle goes back to a case from 1891 where the defendant defrauded the plaintiff's mother into selling her property and then resold the property to a good-faith purchaser before the plaintiff could bring suit against the defendant. The Court of Appeals held that, because rescission would unjustly involve taking the property from the good-faith purchaser, rescissory damages should be awarded: "[I]t is but just and equitable that [defendant] should restore to the plaintiff its equivalent in money, not as damages but as a substitute for the land itself."[346] This remedy continues to be recognized by modern courts in New York.[347]

Similarly, under Delaware law, in an action for rescission, if, due to a change in circumstances, rescission has been rendered impossible or impracticable, the court in its discretion can award rescissory damages instead.[348] The purpose of rescissory damages is to restore a plaintiff to the position occupied before the defendant's wrongful acts. An award of rescissory damages is an exception to the normal out-of-pocket measure. Such an award is considered exceptional, because rescissory damages are measured as of a point in time after the transaction, whereas compensatory damages are determined at the time of the transaction. As a consequence, rescissory damages may be significantly higher than the conventional out-of-pocket damages, because rescissory

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344 *GoSmile v Levine*, 81 A.D.3rd 77, 81-82 (1st Dep't 2010).

345 *Rudman v Cowles Communications*, 30 N.Y.2d 1, 13 (1972).

346 *Valentine v. Richardt*, 126 N.Y. 272, 277 (1891).

347 *See*, e.g., *Loengard v. Santa Fe Indus., Inc.*, 70 N.Y.2d 262, 266 n.* (1987); Ambac Assur. Corp. v. EMC Mortg. Corp., No. 08 Civ. 9464, 2009 WL 734073, at *2 (S.D.N.Y. Mar. 16, 2009) (rejecting argument that "New York [law] does not recognize rescissory damages").

348 *See* David L. Finger and Louis J. Finger, THE DELAWARE TRIAL HANDBOOK, § 22:3, available at http://www.delawgroup.com/delaware-trial-handbook-%C2%A7-223-rescissory-damages/, and cases cited therein.

damages could include post-transaction incremental value elements that would not be captured in an out-of-pocket recovery.[349]

Example of an Arbitral Award Granting Recissory Damages - *In the Matter of the Arbitration between T.A. Associates L.P. et al. and James Gandy, Harry Gandy and Trent Garmoe* JAMS NY Case No. 1425003574[350]

This arbitration award, summarized in the section on Fraud and Extra-contractual Remedies above, contained a finding by the arbitrator that the sellers had fraudulently induced the buyers into purchasing a 39 per cent equity interest in a company making industrial scale inkjet printers. The amount of the investment was $75 million and that award is an example of an arbitrator awarding rescissory damages, finding the sellers liable to the buyers for the entire $75 million amount of the purchase price, as well as interest at the New York prevailing rate—9 per cent.

XI. USE OF EMERGENCY ARBITRATION PROCEDURES

The major arbitral institutions whose rules are used in arbitrations involving New York and Delaware law all have procedures for emergency situations where a party to a dispute requires immediate consideration of a claim or some form of interim relief before the constitution of the arbitral tribunal or the appointment of a sole arbitrator. The AAA's Commercial Arbitration Rules require that a sole emergency arbitrator be nominated within one business day after receipt of an application, that the arbitrator nominated immediately disclose any potential conflict situation and that any challenge to the arbitrator also be made within one business day after the parties receive notice of the appointment.[351] The emergency arbitrator so appointed must then quickly schedule whatever hearings or conferences he or she deems necessary. The AAA Rules have guidelines as to the

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[349] *Id*.

[350] Award confirmed in *T.A. Associates, L.P., as successor to TA ASSOCIATES, INC., TA ASSOCIATES X, L.P., TA ATLANTIC AND PACIFIC V, L.P., TA STRATEGIC PARTNERS FUND II, L.P., T.A. STRATIC PARTNERS FUND II-A, L.P., TA INVESTORS II, L.P. and TA SUBORDINATED DEBT FUND II L.P. v James Gandy, Hary Gandy and Trent Garmoe*, 43 Misc.3d 1233(A), 993 N.Y.S.2d 646, 2014 N.Y. Misc. LEXIS 2597; 2014 NY Slip Op 50913(U) (N.Y. Ctn'y, June 9, 2014).

[351] Rule 38(c).

circumstances under which the emergency arbitrator can grant relief, namely that the party seeking the emergency relief has shown that "immediate and irreparable loss or damage shall result in the absence of emergency relief." If the arbitrator finds that the applying party is entitled to relief, he or she may enter an interim order or award.[352] The reasons must be stated.

The ICDR's procedures for initiating the process are identical. The ICDR Rules don't have the same restrictive language as the AAA's on the ground for relief and, as such, give the emergency arbitrator more leeway. Under Rule 6.4, the emergency arbitrator has the power to "order or award any interim or conservancy measures that the emergency arbitrator deems necessary, including injunctive relief and measures for the protection or conservation of property." Both the AAA and the ICDR Rules are explicit that any interim award or order of emergency relief may be conditioned on provision of "appropriate security" by the party seeking such relief.[353]

The ICC also adopted emergency arbitrator procedures in 2012. The relevant ICC Rule is Article 29 of the Commercial Rules, which makes reference to a separate Appendix V with more detailed procedures. A party that "needs urgent interim or conservatory measures that cannot await the constitution of an arbitral tribunal" is entitled to make an application.[354] The President of the ICC Court of Arbitration is supposed to appoint an emergency arbitrator within two calendar days of receipt of the application if the applicable conditions are met. Challenges to the emergency arbitrator are possible. They are supposed to be made within three days of the receipt of the file or, if later, relevant information.[355] There is no specific time given for a response to a challenge, only that the challenge is to be decided by the Court after the Secretariat has afforded an opportunity for the emergency arbitrator and the other party or parties to provide comments in writing "within a suitable period of time."[356]

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[352] Rule 38(e).

[353] ICDR Rule 6.6; AAA Rule 38(g).

[354] Rule 29(1).

[355] Appendix V, Art. 3(1).

[356] Appendix V, Art. 3(2).

In the meanwhile, the emergency arbitrator can get down to work. He or she is supposed to establish a procedural timetable for the emergency arbitrator proceedings within as short a time as possible, "normally within two days from the transmission of the file" to the emergency arbitrator.[357] He or she is then supposed to arrive at a decision within fifteen days after receipt of the file. The decision comes in the form of an "order" rather than an award. The ICC Rules seem to contemplate that the proceedings can go forward even while the ICC is considering any challenge made, in that one of the reasons why an order may cease to be binding is the acceptance of a challenge.[358] It also ceases to be binding once the full arbitral tribunal makes an award unless the tribunal ratifies the emergency order.

The ICC Rules are quite explicit as to the cost. It is $40,000 - $10,000 in administrative expenses and $30,000 for the arbitrator's fee—unless the President of the Court decides that a greater sum is appropriate.

CPR also has similar procedures for a party to request interim measures prior to the constitution of the tribunal. Under the CPR's Administered Arbitration Rules, a "special arbitrator" is appointed for that purpose.[359] A request for interim measures by a special arbitrator must be accompanied by a fee deposit established according to a published schedule. If the parties agree on the identity of the special arbitrator within one business day of the request, that person will be appointed. If not, which seems to be the more likely scenario, the CPR appoints from a list maintained for that purpose, if practicable, also within one business day of the request.[360] Challenges to the special mediator are possible, which are to be made within one business day after notice of the appointment. Unlike the other institutions, the CPR requires a decision on the challenge within one business day after its being made (if practicable).[361] Once appointed, the special arbitrator has to organize and conduct the proceedings "as expeditiously as possible." The special arbitrator's decision can be in the form of an order or an award.

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[357] Appendix V, Art. 5(1).

[358] Appendix V, Art. 6(6).

[359] Rule 14.

[360] Rule 14.5.

[361] Rule 14.6.

All of the institutions cited rules that specify that the emergency arbitrator's actions and orders are not inconsistent with the right of the parties to go to a court for emergency and interim relief.

A. Considerations Relating to the Use of Emergency Arbitrator Proceedings

Practitioners need to take into account certain considerations relating to the use of these emergency arbitration procedures. They do have certain limitations as compared to court proceedings. All of the rules require that the request be transmitted to the other party, which takes away the element of surprise that is sometimes needed and which is possible to preserve in an ex parte court proceeding. This would particularly be the case if the moving party is trying to seize bank accounts or prevent assets from being moved from the jurisdiction of the court. It may also not be fast enough, such as in a case when a party is seeking to draw under a letter of credit or a bank guarantee and the other party wishes to stop the draw. A stop-draw request under a letter of credit has to be made and ruled upon within the space of a day or two.

All of the rules of these institutions allow the emergency arbitrator can be challenged by either of the other parties. The time it takes for the institution to rule on the challenge can bog down the procedure, even if the ICC rules allow the proceeding to go forward while the challenge is being decided, while the CPR Rules seek to have a decision made within the space of one business day of the request being made.

The various emergency arbitrator rules only apply to the signatories to the agreement to arbitrate, thus making any order against a third party ineffective. National courts can make orders against third parties such as banks and other stakeholders.

A couple of other considerations might give counsel pause in using the emergency arbitrator rules. An emergency arbitrator can't impose sanctions for non-compliance, unlike a national court. Finally there are doubts in some jurisdictions outside the U.S. as to whether emergency arbitrator orders are enforceable as awards.

While these limitations are real, there are certainly potential advantages of Emergency Arbitrator Procedures. For one, they afford the possibility of interim relief in an international context when it may not be possible in a national court or the relevant national courts may be ineffective or biased. Further, the responding party has a fairly strong incentive to comply with the interim award. If it ignores it, this will reflect badly on its position in the ultimate arbitration.

Under emergency arbitrator procedures, there is a far greater chance of confidentiality being maintained under the arbitration rules. Nearly everything about court proceedings is public information, particularly in the United States.

Finally, emergency arbitrators may be more flexible in terms of relief to be granted, at least in the United States. There are U.S. cases to the effect that arbitrators are not bound to the standards of interim relief set forth in the cases and may, in appropriate circumstances, even grant relief that would be unavailable in a court of law.[362]

B. Case Law Examples of Emergency Arbitrator Awards Being Enforced

An emergency arbitrator award in a AAA proceeding that was enforced by the Southern District is the most prominent example of a quickly rendered emergency award providing an expedited outcome to a complex dispute.

This case involved an agreement originally reached in 2009 between Yahoo Inc. and Microsoft Corporation to merge the search capabilities of Microsoft and Yahoo internationally so as to better compete with Google.[363] Ads that pop up when internet searches are done on Microsoft's search engine Bing were provided by Microsoft's Bing Ad's system. Yahoo's system for providing search ads was called Panama.[364] The idea was that Yahoo would expand its search and search ad services from Panama to Bing Ads. The global market was divided into sixteen geographic markets. In fourteen of the sixteen geographic markets, the transition was successfully completed. The two that remained open were Taiwan and Hong Kong.

Microsoft and Yahoo originally agreed for the migration of the Taiwan and Hong Kong markets to be completed by 2011, but technical

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[362] *See Sperry Int'l Trade v. Government of Israel*, 432 F. Supp. 901 (SDNY), aff'd 689 F.2d 301 (2d Cir. 1982).

[363] *See* Kim Landsman, "Microsoft Case is Great Example of Emergency Arbitration", Law 360 New York (Dec. 13, 2013).

[364] Summary of facts derived from *Yahoo! Inc., v Microsoft Corporation*, 13 CV 7237 (Part I), Opinion & Order, Paterson, Robert P, S.D.N.Y. (Oct. 21, 2013).

problems led to delays (by mutual agreement). In February 2013, Microsoft and Yahoo agreed to a final plan to transition those markets by the end of October 2013.

By mid-September 2013, the parties agreed that the quality criteria had been met and the last phase of the transition was ready to begin. At that point, Microsoft's CEO Steve Ballmer announced that he was going to retire by August 2014. On September 20, 2013 Yahoo informed Microsoft that it would delay completion of its migration to Bing until early 2014. Yahoo gave as its reason "concerns about Microsoft's level of commitment to the Bing Ads platform" in light of Steve Ballmer's impeding retirement. Yahoo later made clear that it intended to "pause" migration efforts in Taiwan and Hong Kong until after Yahoo CEO Marissa Mayer was "able to discuss the partnership with Mr. Ballmer's successor."

On the same day that Yahoo informed Microsoft that it did not intend to proceed with the migration in Taiwan and Hong Kong, Microsoft told Yahoo that it considered Yahoo to be in breach of the original migration agreement. Six days later, Microsoft initiated the emergency arbitration procedure under the AAA rules that were in effect at the time.

It should be noted that the contract was entered into before the most current version of the AAA's Commercial Arbitration Rules entered into effect. The emergency arbitrator procedure is now fully a part of the rules, meaning that they will apply unless the parties opt out of them in the agreement to arbitrate. At the time of the Yahoo and Microsoft migration agreement, the AAA's rules made the emergency arbitrator procedure optional. However, the parties had provided for them to apply in their clause and agreed that the "arbitrator is authorized to compel and award injunctive or emergency relief." In a more general sense, the clause also allowed the emergency arbitrator or the fully-constituted tribunal to grant specific performance (in addition to any other remedies and including in connection with claims for interim, injunctive or emergency relief) "even if such relief could not be awarded or would otherwise not be available if the claim were to be adjudicated in a judicial proceeding."

After Microsoft invoked the emergency arbitrator procedure, the arbitrator was appointed and organized two days of hearings with ten witnesses within eleven days after the arbitration was commenced. He issued an injunction with six days after the hearing was over. He found for Microsoft—"that by imposing its pause and refusing to proceed with the scheduled Taiwan and Hong Kong migrations, Yahoo is in breach of the Agreement." The emergency arbitrator also concluded that, based on his evaluation of the evidence, it was critical that the second phase of the migration be completed because "advertiser orders and preferences change over time." He found that the "urgency of the transition establishes the emergency required by the Emergency Rules." He also found that Yahoo's breach of the agreement established irreparable harm to Microsoft.

He essentially ordered that the Taiwan and Hong Kong migrations be completed. The exact terms of the order were that Yahoo is:

> "restrained and enjoined from continuing any pause in transitioning and is 'commanded to use all efforts' to complete the Taiwan transition by Oct. 28, 2013 and the Hong Kong transition by Nov. 11, 2013."

The concern over advertiser order and preferences was in effect a finding of irreparable harm, which is one of the bases for granting specific performance in a larger sense. The emergency arbitrator was quite aware of this dynamic. While the interim relief was framed as an injunction, the arbitrator noted that "[a]n injunction can achieve the same goal as specific performance, namely to get the Taiwan and Hong Kong migrations completed."

Yahoo was of course not pleased with this outcome. It filed a motion right away to vacate the interim award in the Southern District. Yahoo argued that the arbitrator exceeded his authority by in essence awarding final relief even though the parties' agreement and the AAA rule only allowed interim relief. Yahoo also argued the more traditional grounds for vacating an arbitral award, that the decision was manifest error. The motion to vacate was heard in Part I of the Southern District, which is the judge assigned to hear emergency matters.

Within six days Judge Robert Patterson of the Southern District confirmed the award.[365] He rejected Yahoo's argument that the emergency arbitrator exceeded his authority. Yahoo had argued that the agreement only allowed the emergency arbitrator to enter an interim award prior to the constitution of a panel. Judge Paterson found, however, that the explicit language of the agreement allowed

[365] *Id.*

the relief granted by the emergency arbitrator, citing the language of the agreement quoted above concerning the arbitrator's broad powers. He found that during the arbitration the emergency arbitrator addressed Yahoo's argument that the preliminary injunction Microsoft was seeking was inappropriate because of its finality, but nevertheless found that injunctive relief was needed to restore the status quo, which was disrupted by Yahoo's unilateral pause. His conclusion was expressed in these terms: "Because restoration of the status quo may appropriately require one party to perform contractual obligations, the Arbitrator had a colorable basis for concluding that an injunction requiring Yahoo to continue to perform was necessary."

He also rejected the manifest disregard argument. The law in New York is that a party seeking vacatur based on an arbitrator's manifest disregard of the law bears the burden of proving that the arbitrator was fully aware of the existence of a clearly defined governing legal principle but refused to apply it, in effect ignoring it.[366] Judge Paterson found that Yahoo could not point to a clear rule of law that the emergency arbitrator ignored or refused to apply. Instances of where courts in New York overturn arbitral awards are exceedingly rare. In sum, Judge Paterson reaffirmed the strong policy in New York under the Federal Arbitration Act of affirming arbitral awards in terms expressed in prior cases: "If the parties agreed to submit an issue for arbitration, we will uphold a challenged award as long as the arbitrator offers a barely colorable justification for the outcome reached."[367]

Yahoo appealed Judge Paterson's decision to the Second Circuit. On January 2, 2014, the Second Circuit issued an order noting that the parties had agreed that the appeal would be withdrawn. It is unclear from the outcome whether the Emergency Arbitrator's award was followed, but it no doubt played a large role in the settlement reached. Most of the record in the Southern District and the Second Circuit was sealed and the full award was not made public. The only parts that are available to study are the excerpts in the Southern District's decision to confirm, thus preserving confidentiality for the parties. In fact, the identity of the emergency arbitrator was never known. The only clue we have from the record is that it was a man from the use of the pronoun "he" in reference to him.

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[366] *Duferco Int'l Steel Trading v. T. Klaveness Shipping A/S*, 333 F.2d 383, 389 (2.d Cir 2003).

[367] *ReliaStar Life Ins. Co. v EMC Nat. Life Co.*, 564 F.3d 81, 86 (2d Cir. 2009).

The ICC Emergency Procedures have only been cited in a U.S. court decision once so far. That was by the federal court in the Southern District of Texas in a case involving a complicated international joint venture arrangement.[368] The defendant invoked the ICC Emergency Arbitration Procedure and an emergency arbitrator was appointed. The Defendant sought an injunction from the emergency arbitrator requiring Plaintiff to withdraw its request for preliminary injunction pending before the federal court in Houston and other relief relating to the project they were involved in (ceasing tortious interference). The ICC Emergency Arbitrator found that Defendant had failed to demonstrate irreparable harm and denied its request for interim relief. The court did not pass in one way or another on the validity of the ICC procedure or the decision reached by the emergency arbitrator, although by not questioning it, the court implicitly respected the outcome.

Thus the cases available to us so far show that the fairly recently established emergency arbitrator rules of the various institutions are a viable option for a party seeking specific performance of a merger or acquisition if the arbitrator can be convinced that irreparable harm would occur if the transaction were not consummated. While the underlying agreement in the *Yahoo v Microsoft* case had unusually explicit and broad language authorizing the arbitrator to grant injunctive relief and specific performance, it was decided under the prior set of AAA rules. The current Commercial Arbitration Rules now make the emergency arbitrator procedures a part of every AAA clause, as to those of the other institutions. Given the deference given by New York State and federal courts to arbitral awards, an emergency arbitrator's award is likely to be upheld. Finally, as the *Yahoo v Microsoft* case shows, a great measure of confidentiality can be preserved in the process.

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[368] *Marsoft, Inc. v. United LNG, L.P., United LNG Holdings, LCC & Stephen P. Payne*, 2014 U.S. Dist. LEXIS 44631 (S.D. Tex. Mar. 3, 2014).