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Private Equity Alert

Would You Like To Arbitrate That Purchase Agreement Dispute?

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As parties to a transaction negotiate the terms of their agreement, one of the key considerations (judged in hindsight, after a dispute has arisen) is to determine what governing law[1] and forum[2] will apply to a dispute. A forum selection clause may provide for a particular court in a specified jurisdiction, such as the federal courts located in the city and county of a particular state, or for an alternate dispute resolution process, such as arbitration. As there are both benefits and drawbacks to any forum selection, the parties should carefully consider the forum they choose. This article briefly addresses the pros and cons of arbitration, situations where litigation may be preferable and drafting considerations for an agreement to arbitrate, in each case, from the viewpoint of US counterparties arbitrating domestically and applying US law.

The Pros and Cons of Arbitration

So, in negotiating a purchase agreement, when might arbitration be in your interest and what should you consider if you select arbitration?

Confidentiality

Contrary to the public litigation process, in arbitration parties can enter into a confidentiality agreement regarding the proceedings. This makes arbitration an attractive choice where disputes could potentially be embarrassing to a party or where that party wants to avoid setting a public precedent. Conversely, litigation may be in a party's interest, and provide substantial leverage, where it suspects that its opponent desires confidentiality.

Selection of Arbitrator

One of the most important benefits of arbitration is the ability to select the arbitrator(s). Parties can specify in their agreement the required qualifications of an arbitrator in an effort to ensure the arbitrator has the sufficient background and expertise to understand the issues that may be presented in the dispute. For example, the parties might specify that the arbitrator be a practicing attorney with at least ten years of experience, a retired judge, an accountant, a person having experience in the industry in question or other qualifications important to the parties. The experience of arbitrators can vary widely, so parties that do not specify in their agreements the required qualifications of an arbitrator (including that each arbitrator should be neutral) may end up dissatisfied with the expertise of the arbitrator(s) selected.

Parties to an agreement can also select the number of arbitrators to be appointed to a dispute. Typically, parties either designate a single neutral arbitrator or a neutral panel of three. While a single arbitrator

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could provide greater speed and efficiency, a panel of three arbitrators may be less likely to deliver an erroneous or aberrational award. Where the parties desire a panel of three arbitrators, they can choose to have all three appointed through the arbitral organization's selection process, or as another option, to have each party select an arbitrator and the two thus selected select the third arbitrator (who typically then serves as the chair of the panel).

Flexibility

Instead of the mandatory rules of civil procedure, arbitral organizations provide a set of default rules that can typically be altered by the parties and their arbitrator(s). In deciding to arbitrate, parties are able to pick a particular arbitral organization (*e.g.*, the American Arbitration Association (AAA), ICC or JAMS), which they believe best serves their needs. The arbitral organization, whose rules and procedures will govern the procedural aspect of their dispute, may also be selected based on the location where the parties have proper venue.

In addition to providing the basic framework that will govern the dispute, absent a contrary provision in the parties' agreement, the arbitral organization will establish the procedure for selecting the arbitrator(s). The parties, together with the arbitrator(s), will then have the opportunity to participate in a preliminary conference to establish the discovery and other procedural matters that will govern the dispute, designing a process that makes sense for the size of the dispute and the goals of the parties. For example, parties wishing to maximize efficiency may agree at the outset to little or no discovery, limited or no depositions, limited use of experts, and the like.

All of this flexibility, however, can lead to uncertainty. In a high-stakes dispute where strategy will play a key role in resolution, this uncertainty, combined with a lack of an ability to appeal, may be undesirable.

Finality of Award

Before agreeing to arbitration, parties should consider that there will be only a very limited right to appeal the award. "[B]y agreeing to arbitrate, a party 'trades the procedures and opportunity for review of the courtroom for the simplicity, informality, and expedition of arbitration.'"[3] In fact, the Federal Arbitration Act allows a district court to vacate an arbitration only in the case of fraud, corruption, arbitrator misconduct or where the arbitrator(s) exceeded their powers.[4] The arbitration statutes of states such as Delaware, New York and Texas provide similarly narrow grounds for vacating an arbitration award.[5] This finality of the award, however, can be a benefit to parties where there is a need for final and quick resolution of the dispute, such as where the parties have an on-going relationship and need to be able to put the dispute behind them (assuming both parties are likely to honor the award agreement).

Speed of Resolution

Depending on the type of dispute that is filed and the courts' backlog in the applicable jurisdiction, arbitration may provide for a faster resolution than traditional litigation. Further, the parties' limited ability to appeal an arbitration award expedites the process of arriving at a final resolution, which may result in a quicker resolution than that provided by traditional litigation. It should be noted, however, that once the parties obtain an arbitration award, it still has to be enforced in another forum and that is a process which can result in delays equal to those occurring in a traditional appeal.

Post-Closing Purchase Price Adjustments

Regardless of the forum selected for the agreement overall, purchase price adjustments are an example of a discrete issue that lends itself to arbitration. A common practice in today's purchase agreements is to provide that in the event the parties are unable to agree on a post-closing adjustment to the purchase price, the dispute will be resolved by an "independent accountant." Increasingly, however, the "big four" accounting firms are declining to participate in these types of disputes due to the "independence" issues they raise. Instead of providing for an independent accounting firm and being forced to seek an alternative at the time the dispute actually arises, the parties may provide for the dispute to be settled by arbitration and specify the qualities they want in the arbitration panel (*e.g.*, a panel of arbitrators consisting of at least one lawyer and two accountants, in each case, with experience in the applicable industry).

International Disputes

While not the primary focus of this article, there are often strong benefits to selecting arbitration for cross-border disputes. Perhaps most importantly, the UN's Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention") adopted in 1958 enables the cross-border enforcement of international arbitration awards among the over 140 signatory countries. The New York Convention limits the grounds for refusal to enforce an arbitration agreement or award, resulting in the enforcement of arbitration awards abroad even where the judgment of a national court may be difficult, if not impossible, to enforce.[6]

Additionally, the flexibility of arbitration allows the parties to select arbitrator qualifications and governing procedures designed to prevent a party from being unfairly disadvantaged by the customs, local law and language barriers that may be presented in one party's home forum versus another – *i.e.*, eliminating the home court advantage. For example, the parties may specify that the arbitrator(s) should or should not be a national of a particular country, the location and language of the arbitration and the law that will govern the arbitration.

When Litigation is Preferable

Practitioners will generally agree that litigation is preferable where the governing law and contract terms are well developed and settled. For example, litigation may be preferable in the case of commercial debt documents or in high-stakes disputes where an arbitrator error or an aberrational award could jeopardize the company's ability to operate its business, and the lack of a right to appeal and the uncertainty around the rules and procedures of arbitration present too much risk. Additionally, while various arbitral organizations are adopting procedures to address the need for emergency relief, many practitioners believe that the court system is preferable where a party will need an emergency ruling, such as injunctive relief.

There are also certain tactical reasons to consider litigation. For example, where you have a favorable "home court" forum, your opponent wants to avoid a public trial or you intend to rely on novel legal theories, litigation may be the preferable option. Litigation may also be preferable where you are looking to delay resolution of the dispute, as the party seeking delay will be able to take advantage of the slower nature of the traditional litigation process and preserve its ability to appeal the award (causing yet further delay).

Drafting Considerations for your Agreement to Arbitrate

Once the parties have settled on arbitration, there are a number of

issues that should be addressed in the arbitration agreement. The parties should consider which arbitral organization will best administer a dispute (*e.g.*, AAA, JAMS, ICC, etc.) based upon their particular circumstances and specify such organization in its agreement. The size of the arbitration panel, the manner of selecting the arbitrators (*i.e.*, three neutrals vs. "I pick, you pick"), the qualification requirements for each arbitrator, the location and language of the arbitration and the governing substantive law should also be specified. Rather than relying on the preliminary hearing, parties may also agree to any limitations on discovery and briefing, establish deadlines and specify the format of the final hearing. Before agreeing to such matters, however, the parties should consider that once specified in their agreement the arbitrator(s) will have little freedom to modify the process in the event it doesn't best serve the parties' dispute. A thorough arbitration clause will also address confidentiality, the timing and form of the arbitration award and the allocation of arbitration costs. The parties should also address any carve-outs to arbitration (*e.g.*, injunctive relief) and consent to the entry of a judgment in respect of the arbitration award.

Conclusion

Arbitration can be an effective means of dispute resolution, and may sometimes be preferable to litigation, but parties to a potential dispute should consider its benefits and limitations before agreeing to resolve their dispute through arbitration. In choosing arbitration, particular care should be paid to the arbitral organization selected and the provisions included in the agreement to arbitrate. There are numerous options in arbitration, so taking the time to craft an agreement that is carefully tailored to the parties' particular circumstances will ensure a more efficient and constructive arbitration process should it become a reality.

1 Parties to a contract are generally free to select the law governing their contract, unless the chosen state's law has no substantial relationship to the parties or the transaction or the application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue. *Restatement (Second) of Conflict of Laws* § 187 (1971). Choosing a governing law, however, is a determination that is best made on a case-by-case basis, and that decision is not addressed here.

2 An agreement among parties to a transaction selecting the forum where their dispute will be adjudicated will generally be given effect, except in limited circumstances such as where the provision is unfair, unreasonable, invalidated by statute or where no court of that state would be competent to hear the suit. *Restatement (Second) of Conflict of Laws* § 80 (1971).

3 *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 29-33 (1991) (quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985)).

4 Federal Arbitration Act, 9 U.S.C. § 10(a).

5 *See* Del. Code Ann. tit. 10, § 5714; N.Y. C.P.L.R. 711; and Tex. Civ. Prac. & Rem. Code Ann. § 171.088.

6 Edna Sussman, *Why Arbitrate? The Benefits and Savings*, 81-Oct. N.Y. St. B.J. 20, 21 (2009).

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