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Perspective

The COVID-19 Case for ADR Provisions in M&A Agreements

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The COVID-19 pandemic has wreaked havoc on economies and upended economic metrics. It's led to some M&A deals dying, others being delayed and many sitting in limbo as parties struggle to close: Deals were agreed on pre-COVID terms based on financials that are, more often than not, simply no longer remotely applicable. With the court system backlogged and parties needing to address transaction matters in a timely fashion, alternative dispute mechanisms such as arbitration and mediation are increasingly becoming attractive options for deal makers. Going forward, deal parties and their lawyers should seek to untangle themselves from the courts and, as a matter of course, include both mediation and arbitration provisions in their transaction agreements.

This past year, a number of M&A deals have been in the headlines with one party seeking to enforce a sale on the basis of the pre-COVID agreed terms and the other party arguing that closing conditions haven't been met due to the pandemic. Parties can look to a number of provisions to argue against enforcement: Some will turn to the material adverse effect clause, possibly arguing that the industry in which the target operates has been disproportionately impacted by the pandemic; others may look to a seller's inability to satisfy the typical pre-closing ordinary course of business covenant. Some deal parties, such as LVMH and Tiffany, took it upon themselves to revisit purchase price and ultimately closed with an—albeit nominal—purchase price adjustment. L Brands and Sycamore took the opposite approach for the sale of Victoria Secret, agreeing to terminate their transaction agreement. No termination fee was paid. In most cases, deal parties initially turned to the courts to settle their dispute but COVID-19 didn't spare courts. They find themselves faced with significant backlogs, with reduced capacity amidst a growing number of cases, as both small and big players look to revisit pre-COVID arrangements. Transaction parties are now faced with a difficult choice: wait for an indeterminate period of time for courts to catch up to the caseload, and thus take on all the risks and costs accompanying such delays, or turn to an alternative dispute resolution mechanism. Some may have the wherewithal to be patient but for many businesses survival and resolution of dispute go hand in hand. For those constituents, arbitration and mediation are invaluable lifelines.

Although arbitration provisions are not uncommon in cross border deals involving several jurisdictions and governing law options, they are less common in domestic M&A deals. That being said, the time seems ripe to revisit this approach and consider arbitration for all deals. Arbitration traditionally offers a faster and more economical and confidential adjudication option. For complex matters, it provides parties with the additional benefit of being able to select arbitrators with relevant technical or financial expertise. Also, although the more limited discovery potential in arbitration can be viewed as an impediment by some, it is indicative of a streamlined process that is appealing to many deal players. One potential drawback though arises in cases involving multiple parties given the limitations on joinder when third parties haven't agreed to arbitration. All in all, however, arbitration has historically had its appeal, an appeal that has grown exponentially as arbitration organizations have quickly

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moved to virtual hearings and grown their offerings to counter court delays and address the rising needs for adjudication. M&A parties can benefit from such processes and would be well served to agree to move their disputes to arbitration proceedings, even in the absence of an arbitration provision in a transaction agreement inked pre-COVID. Going forward, transaction parties must recognize that the impact of the pandemic will continue to lead to court delays for the foreseeable future. This crisis should also motivate parties to foresee the potential for similar unforeseen crises and consider including arbitration provisions in all agreements going forward.

As appealing as arbitration may be as an alternative to the courts, it remains an adjudication process that is bound by the applicable law and the underlying contract that is the very subject of the dispute. The purchase price reduction agreed to by LVMH and Tiffany would not have been possible had they opted for courts or arbitration. In agreeing to renegotiate their deal terms, the parties most likely took into account the impact of the pandemic on normal course of business and, more generally, the new economic reality that arose between signing and closing. This review and revision of deal terms is a luxury that parties simply don't enjoy in any adjudicative process. This is a key advantage of commercial mediation, an alternative dispute mechanism that empowers parties, with the help of an independent third party, to revisit deal terms should they both so desire. They can take into account the previously unforeseen events that materialized and their consequences on all constituents. In mediation, deal parties can work with their mutually selected mediator and leverage the mediator's experience and expertise to craft a settlement that generally was simply not contemplated by the underlying contract. In the COVID-19 era, mediation stands out as an optimal option for many deal parties. Consider a seller that would otherwise look to enforce a sale on previously agreed financials but who recognizes that, if they were to push to enforce such sale, the buyer would become insolvent, a lose-lose situation for all. It's difficult to know with certainty what led L Brands and Sycamore to agree to terminate their deal. That being said, with no termination fee being paid, one can assume that the parties believed either that the buyer could successfully claim that one or more closing condition was not met or that they would both be worse off if they were to wait for adjudication on the basis of the pre-COVID deal struck.

The current pandemic should motivate deal parties to include both arbitration and mediation provisions in their agreements going forward.

In the current economic climate, mediation is an ideal option for many M&A parties. First and foremost, parties can parallel process and thus avoid delays by proceeding with mediation while they await movement on the adjudication process. Second, mediation allows parties to "save" deals in a confidential process that allows them to explore deal terms and structures beyond their agreement with a knowledgeable, independent professional possessing the expertise parties value. Consider for example parties that are eager to complete a sale and acquisition but disagree on deal value. Through mediation, they could agree to an earnout that would allow them, for example, to close on the basis of a lower purchase price that can be adjusted upward post-closing should certain pre agreed financial metrics materialize. In the current environment, the benefits of mediation can be viewed through the game theory lens of the prisoner's dilemma: The optimal solution for both parties occurs when they cooperate and collaborate to find a mutually viable solution beyond the inked agreement. Don't cooperate, and risk substantial losses for both.

The current pandemic should motivate deal parties to include both arbitration and mediation provisions in their agreements going forward. For those who haven't done so and are "in limbo," nothing prevents them from amending their current agreements to turn to arbitration and mediation. That being said, parties would be better served by including these ADR clauses at the outset going forward. This is particularly true for mediation: By including a mediation clause in a transaction agreement, parties eliminate the risk of either of them feeling that its perceived negotiation posture could be viewed adversely if it were to be the one suggesting mediation in the absence of a pre-agreed clause. It also allows parties to avoid stalling tactics and gives them the opportunity to outline timeframes and deadlines and deter bad behavior from either side.

We all hope that we're nearing the end of this COVID-19 era, but its consequences will be felt for years. M&A parties should learn from the "shock" to the system and revisit agreements going forward with a view to taking control of their dispute resolution mechanisms. For so long as courts retain jurisdiction, parties' hands will be tied and they will remain at the mercy of a system whose shortcomings have been amplified by the pandemic.