LAWYERS WEEKLY

June 27, 2011
THE DOLAN COMPANY

Lawyer Scores Big With Baseball Arbitration

Providence lawyer Robert M. Duffy recently prevailed in a high-stakes M&A dispute that was resolved through a relatively uncommon method of arbitration.

In baseball arbitration, there is no middle ground. Both sides simply present their positions and propose a monetary award. The arbitrator must pick one of the numbers and has no other discretion in deciding the case.

Duffy represented a seller involved in a post-acquisition M&A dispute with the buyer. The deal went down shortly before the market crashed in 2008, and the buyer came back and argued that it had paid too much for the seller's company, a manufacturing and distribution outfit in Connecticut.

The buyer, who negotiated a baseball arbitration provision into the contract, claimed, among other things, that it should recover $3.4 million from the sale because there was a breach of the representations and warranties in its contract with the seller.

But the arbitrator sided with Duffy's client, awarding the buyer only $500,000.

Duffy, a partner at Duffy & Sweeney, spoke with Lawyers Weekly's Phillip Bantz last week about the case.

Q. *What's the benefit of baseball arbitration over more traditional arbitration?*
A. It forces both sides to candidly asses their case and the relative merits of it. And hopefully they can come to a similar conclusion so the case doesn't go all the way to an arbitrator.

Q. *How do the sides come up with their proposed monetary awards?*
A. What you do in a build-up method for baseball arbitration is you take each claim and determine what the likelihood of recovery would be if you lost, and multiply it by the likelihood that you will lose. Basically, you determine the merits of the claim. You get to a number and now you have to decide what the claimant's number is likely to be. Then you've got a gap. The arbitrator is going to look at the gap between the numbers and usually go with the number that is closest to the number they've come up with.

Q. *So when does the other side disclose its number?*
A. Both sides exchange numbers simultaneously before arbitration and before you get your evidence in. And the numbers cannot be changed.

Q. *Were you surprised by the buyer's proposal?*
A. I thought they were going to come in at $3.5 to $4 million, and they came in at $3.4 million. The components of how they arrived at the number were different than I expected them to be, so I was surprised at how they came to the number, but I was on the number. I was fairly certain that they were in that range. And they had a cap of $4.2 million, which was negotiated in the indemnities in the contract.

Q. *Your proposed award was significantly lower.*
A. We put out $500,000. … It's not unusual to have a big difference in the numbers when you go to arbitration, because if you were to get to a closer number you probably would have already resolved the case. In this case, the arbitrator found that our number was the more appropriate number and awarded the $500,000.

"This case brings into play some relatively new theories of recovery that were being put forth by the buyer as to why they were entitled to as much money as they were claiming. I call it a post-Lehman approach."

— Robert M. Duffy, Providence

Q. *What was the buyer's argument?*
A. This case brings into play some relatively new theories of recovery that were being put forth by the buyer as to why they were entitled to as much money as they were claiming. I call it a post-Lehman approach. Since the financial meltdown, buyers have been coming back to sellers seeking to recover various amounts on the purchase price because the market has changed and the company's not worth as much as they paid.

Q. *How did the buyer come up with $3.4 million?*
A. In this case they said the inventory, the financial statements, were $230,000 less than the seller said it was. We said we know, and there's a net working capital adjustment section in the contract for that. The adjustment section is intended to adjust differences between the financial condition of the company at the closing date and what was bargained for in the financial statements. But the buyer comes out and argues for multiple damages.

Q. *How could they ask for multiple damages?*
A. A buyer would argue that they paid five times the earnings for a company. For example, a company might have $2 million in earnings and get $10 million from the market, so the buyer would say the multiple would be five. And they would argue that if they paid five times the earnings for a company and the financial statements on the earnings are $200,000 too high, that's a million dollars that they should get back from the purchase price.

Q. *Is this argument becoming more popular among buyers?*
A. Yes. We've seen a significant increase in these types of arguments from buyers since 2008. They're closely scrutinizing these deals and coming back to sellers, saying that you owe us more than a one-time adjustment because we relied on this number and you owe us a multiple of that adjustment. It's much more popular now.

Q. *Has this had any impact on M&A contracts?*
A. What we're seeing now is the buyers' counsel is starting to include express language in purchase agreements that allow for multiple recovery. They're trying to weave it into the agreements.

Q. *Did the language in the purchase agreement in this case address multiple recovery?*
A. No. It said that any net working capital adjustment to the purchasing price would be dollar for dollar. It think this case points out that, under traditional purchase agreements, if you want to get damages if there is a contractual breach of the representations and warranties on financial statements, you have to clearly spell it out in the contract that the parties anticipate a multiple of that difference will be awarded.

Q. *What accounts for discrepancies in a company's financial statements?*
A. A company is changing every day. You're shipping products, getting raw materials, accounts are accruing. If you don't have a perpetual accounting system, you have to adjust your inventory at various times, usually monthly. I don't think a company really knows precisely what its financial statement is until a physical inventory is done, which is typically done by the buyer at closing. RILW