JONES DAY | One Firm Worldwide℠

WHITE PAPER

August 2017

Delaware Supreme Court Reverses Chancellor's *Chicago Bridge* Ruling

Authority of Independent Auditor to Resolve Purchase Price Adjustment Disputes Limited in Scope under Purchase Agreement

In a much-anticipated decision, on June 27, 2017, the Supreme Court of Delaware reversed the Chancery Court's ruling in *Chicago Bridge v. Westinghouse*.[1] The Delaware Supreme Court determined that an independent auditor appointed to resolve purchase price adjustment disputes did not have a "wide-ranging brief to adjudicate all disputes" under the Purchase Agreement but, rather, "one confined to a discrete set of narrow disputes." Specifically, the Court held that the Independent Auditor could not hear the seller's arguments that the purchase price should be reduced because historical financial statements and accounting practices were not compliant with generally accepted accounting principles. The decision represents an important statement on the limits of authority of Independent Auditors acting "as an expert, not an arbitrator."

BACKGROUND

Chicago Bridge sold Westinghouse its Stone and Webster ("Stone") subsidiary. Prior to the sale, Stone and Westinghouse had contracted to build two nuclear power plants. The Purchase Agreement contained a fairly standard post-closing purchase price adjustment provision setting the final price through a comparison of closing net working capital to a negotiated target of $1.174 billion (the "True-Up," as the Court called it). As is typical, disputes about the final, post-adjustment purchase price were to be submitted to an Independent Auditor. The net working capital was to be calculated in accordance with generally accepted accounting principles ("GAAP") applied on a consistent basis throughout the periods indicated.

As the Court emphasized, the deal had some noteworthy and unusual features. The purchase price (pre-adjustment) was set at zero. Moreover, the contract included a "Liability Bar" under which the buyer agreed that its remedy for breach of representations and warranties was to refuse to close; none of the seller representations and warranties survived closing. In addition, the buyer, Westinghouse, agreed to indemnify Chicago Bridge for all future liabilities related to Stone. Lastly, disputes over the post-closing adjustment were to be submitted to an Independent Auditor who was to act "as an expert, and not as an arbitrator" and issue a decision, in the form of a "brief written statement," within 30 days and relying solely on the parties' written submissions.

Post-closing, the parties exchanged vastly differing final price calculations. Under Chicago Bridge's sell-side calculation, the buyer would pay it $428 million, the difference between the estimated net working capital and the target. The buyer, contending that the target's financials were not GAAP-compliant, claimed that Chicago Bridge owed the buyer $2.15 billion. Chicago Bridge filed an action in Delaware Chancery Court asking for a declaration that the buyer's claims sought an improper enlargement of the jurisdiction of the accountant/expert.

Before the Chancery Court, the buyer successfully argued that it could properly raise GAAP-compliance of seller's financials in the post-closing accountant proceeding because the closing price adjustment was supposed to be calculated in accordance with GAAP as consistently applied by the target. While the seller argued that the buyer's claim represented an improper endrun to the contract's provision that all representations and warranties expired at closing, Chancellor Laster concluded that there was a carve-out in the non-survival provision for matters raised in the post-closing, purchase price adjustment procedure.[2]

DELAWARE SUPREME COURT OPINION

In a decision that repeatedly invoked the need to read contract provisions in the light of the structure and substance of the overall contract, the Supreme Court of Delaware reversed and held that the buyer's GAAP compliance claims were not within the purview of the Independent Auditor. "When viewed in the proper context, the True-Up is an important, but narrow, subordinate, and cabined remedy available to address any developments affecting Stone's working capital that occurred in the period between signing and closing."[3]

The Court concluded that "the essence of the deal" was that "Chicago Bridge would deliver Stone to Westinghouse for zero dollars in up-front consideration and, in return would be *released from any further liabilities connected with the projects*."[4] The Court narrowly construed the proper scope and function of the post-closing price adjustment procedure ("True-Up"). The Court noted that, generally speaking, "purchase price adjustments in merger agreements account for changes in a target's business between signing and closing."[5] Since the agreement provided that financial statements

given to Westinghouse before closing would be in accordance with GAAP "consistently applied," the True-Up would protect Westinghouse "to the extent Chicago Bridge or Stone tried to suddenly shift course in how it chose to treat Stone from an accounting perspective."[6] The Court pointed to the contract's limits on the time and manner in which the accountant/expert could make its decisions (a process that the Court referred to as "this blinkered rapid manner") to support its narrow reading of the issues that could be raised in the True-Up procedure.[7]

Based on its analysis of the Purchase Agreement as a whole, the Court concluded that the buyer's effort to raise GAAP compliance in the True-Up proceeding was an improper attempt to circumvent the contract's "Liability Bar": "Put bluntly, Westinghouse alleges that it gave up nothing in the Liability Bar because, through the True-Up, it could seek monetary payments by alleging that Chicago Bridge's historical accounting treatment wasn't GAAP compliant."[8] The Court gave short shrift to the argument that that the contract carved out issues raised in the post-closing proceeding from the Liability Bar. Instead, the Court concluded that Section 10.3's provision that the Liability Bar "shall not … operate to interfere with or impede the operation of the provisions" "simply makes clear that the True-Up has teeth for addressing changes in Stone's business." Thus, the Court concluded Section 10.3 clarified that, despite the full releases provided in the Liability Bar, the seller could owe the buyer money post-closing only as a function of changes in the business between the target's measurement date (i.e., signing) and closing.

ANALYSIS

The Delaware Supreme Court's *Chicago Bridge* decision can be read as addressing the unusual particulars of a deal structured around the seller transferring the target company with no representations or associated indemnity that survived closing—a walkaway deal with a Liability Bar. On the other hand, the decision makes general statements about common purchase agreement features, such as post-closing price adjustment procedures before accountant/experts, that could have broader implications for structuring deals and litigating post-closing disputes.

Going forward, buyers seeking to raise GAAP-compliance issues in post-closing price adjustments are likely to argue that *Chicago Bridge* represents the Delaware Supreme Court's analysis of a specific, unusual deal and should be applied accordingly. For example, the Court noted that Westinghouse had sought, in negotiations with Chicago Bridge, indemnities from the latter for breaches of the key representations, including the core financial representations, which Chicago Bridge refused.[9] Similarly, the opinion stresses that provisions like the Liability Bar are very unusual.[10] Finally, the Court seemed particularly unimpressed with the price-adjustment claims advanced by the buyer. For example, the Court noted that a $900 million adjustment was based on the idea that Stone (a wholly owned subsidiary of the buyer post-closing) would not be able to fully recover on its contract claims against its parent, the buyer. In addition, some $400 million of the buyer's proposed adjustment related to a purchase accounting valuation adjustment from the 2013 acquisition of Stone by Chicago Bridge. The Court noted that this non-cash liability "had no relevance" from the buyer's perspective.[11]

Sellers seeking to avoid challenges to the target's application of GAAP in post-closing price adjustments, on the other hand, will argue that *Chicago Bridge* represents a broader rejection of GAAP challenges in post-closing price adjustment procedures. For example, the opinion, after noting that post-closing accountant true-up disputes before Independent Auditors have become increasingly important, goes on to state that "they also have spawned extensive litigation raising the point that, like here, purchasers are abusing these processes to circumvent the *contractual limits* on their rights and revisit the intent and economics of the underlying deal."[12] The Court then noted that "This appeal presents the Court with its first opportunity to address the increasingly important issue of when an Independent Auditor is empowered to engage in a *de novo* GAAP review as part of the net working capital process—even if doing so swallows other bargained-for promises in the agreement that eliminate a buyer's rights."

Similarly, the opinion cautions that an attempt to engage Independent Auditors in "*de novo* GAAP review" may be treated with some suspicion.[13] The Court noted the highly expedited and focused nature of Independent Auditor proceedings and further explained that contract language requiring the Independent Auditor function "solely as an expert and not as an arbitrator" must be given meaning.[14] In the same vein, the Court examined the fairly common contract language requiring that the Independent Auditor decide "any and all matters that

remain in dispute" between the parties regarding post-closing price adjustment and stressed that it cannot be read in isolation and literally. "This any and all language cannot and should not be read to make the net working capital true-up process so broad as to swallow up the rest of the contract."[15]

IMPLICATIONS FOR DEALS

Purchase Price Adjustment Remedies Must Be Read in Light of the Provisions (Including Liability Caps and Limits) Contained in Overlapping Indemnification Provisions

The Delaware Supreme Court's decision raises questions of whether and when an independent auditor appointed as an "expert and not arbitrator" under purchase price adjustment provisions will have authority to consider any claim that could also be brought as a breach of representation or indemnity claim—specifically that the seller's historical financial statements and practices (which also carried through to the closing balance sheet) did not comply with GAAP. Unlike the Chicago Bridge agreement, most purchase agreements acknowledge such overlap and incorporate protective clauses to provide certainty to the process as well as to prevent double counting.

First, indemnification provisions normally bar a buyer from claiming indemnity for amounts taken into account in the price adjustment process.[16] Since statistically most purchase price adjustments do not exceed 2 percent of deal value, [17] and indemnity caps are normally five to six times this amount (10-12 percent of deal value), price adjustments will rarely economically override or enlarge indemnification rights.

Secondly (and as belt and suspenders), some purchase agreements bar a buyer from making a claim based on an element of the price adjustment methodology after the price adjustment process is complete.[18] Accordingly, when counseling clients in post-closing price adjustment disputes, it is important to evaluate thoughtfully which objections are more indemnity-based than accounting-based—separating disguised indemnity claims, assertions of fraud, misrepresentations, and other issues that are not properly within the scope of such provisions from resolution of the financial accounting items in dispute—and whether an indemnity or fraud claim could yield a higher recovery. This analysis is particularly important where the numbers appear to have been materially misstated or falsified, are factually inaccurate or unsupported by the general ledger, or affect the integrity of the income statement (which may give rise to greater multiple of earnings-based damages).

Purchase Agreements Should Explicitly Address Whether Working Capital Calculations Based upon a Measurement Against a "Target" Calculation Must Be Based on Changes in Facts and Circumstances Between Signing and Closing

The Delaware Supreme Court's decision strongly suggests that under "GAAP, consistently applied" language, an Independent Auditor appointed as an "expert not as an arbitrator" should not decide whether Closing Net Working Capital should be recalculated based solely on any failure to follow GAAP or a misapplication of GAAP. Language in the case suggests that post-closing accounting procedures are limited to an "apples-to-apples" comparison intended to capture only changes over time to working capital between the measurement date and Closing.

While this is consistent with the view that "quick and dirty" accountant-led determinations make them less suitable for complex, high-value cases involving contract interpretation or complicated application of accounting principles, it is equally troublesome that such determinations must now be asserted in the Delaware Chancery Court. Because these disputes typically involve mixed questions of breaches of representations, application of accounting principles, changes to the business between signing and closing, and more detailed issues of fact, some consideration should be given to enabling either party to elect a full-scale legal or panel (as contrasted with individual accountant-led) arbitration for matters of this type, especially if the dollar value of the claims exceed historic norms of 2 percent of deal value. Such arbitration could consider both purchase price adjustments and indemnity claims arising from the same financial statement calculations.

A Challenge to Pre-Target Date Accounting Entries as Not Prepared in Accordance with the Relevant Accounting Principles (including GAAP) Should Be Based on Specific Contract Language

While the Delaware Supreme Court goes to great length to argue (citing the Kling & Nugent Treatise on Negotiated Acquisitions of Companies, Subsidiaries and Divisions) that adjustments to the purchase price should generally arise solely from changes in the target business between signing and closing, our experience suggests that clients' intentions

are often to the contrary, especially where financial statements have not been audited, the target business is a "carve-out," or the business being sold otherwise has lacked discipline or scrutiny in respect of its prior accounting practices.

Since the *Chicago Bridge* decision appears to restrict a party from arguing as part of a True-Up process that any pre-target date accounting entries fail a GAAP standard, any buyer that wishes to preserve a right to argue a violation of GAAP as part of a purchase price adjustment should consider specific language to that effect.[19] Moreover, as more private deals are structured in a "public company style" (i.e., no or very limited survival of representations and warranties), it will be important for careful drafters to consider how GAAP compliance should be addressed in the working capital adjustment provisions. In the weeks following the Delaware Supreme Court's decision, we have already observed *Chicago Bridge* clauses in post-closing adjustment provisions that explicitly prohibit GAAP challenges to the working capital calculations.[20]

Presigning Due Diligence, Contract Drafting, and Expert Accounting Input Should Include a Focus on the Net Working Capital and Net Debt Calculations

Our January 2017 Commentary highlights best practices for avoiding post-closing adjustment disputes. These include:

- Highlighting and assessing treatment prior to *signing* of potential areas of dispute in the accounting determination;
- Removing the "acting as an expert and not as an arbitrator" qualification on the role of the accounting expert if the parties intend to broaden the scope of the accountant's mandate or, alternatively, including express limitations on post-closing accounting arbitration and the arbitrator's authority, such as restricting the accounting expert's determinations to the application of accounting principles, as defined in the agreement, and limiting determinations of contract interpretation or law;
- Listing the specific components of the accounting formula and not referring simply to "net working capital," "current assets," "current liabilities," or similar broad categories, and including a sample calculation;
- Clarifying which principles—GAAP, "modified"-GAAP, or seller's non-GAAP/sample statement principles—take precedence in the event of a conflict;
- Using caution with language contained in the indemnity's exclusive remedy provisions that exclude purchase price adjustment provisions from liability caps and indemnity limits; and
- Considering contract standards that state limits on a buyer's right to assert its own sometimes novel adjustments (e.g., purchase accounting adjustments) or a full-blown *Chicago Bridge* clause.

The Parties' Prior Course of Dealings Should Inform How Any Financial Adjustments Should Operate

As described above, the Stone sale was the culmination of years of claims asserted by Westinghouse and Chicago Bridge that arose from an extensive, preexisting collaboration and complicated commercial relationship (the construction of nuclear power plants by the seller's subsidiaries in a partnership with the buyer). The Liability Bar evidenced a strong intent of the parties to rid the seller of any liabilities associated with the cost of completing these projects or the risk of collecting funds from other consortium members associated with plant construction. Since these contract liabilities also manifested themselves through the alleged, required adjustments to the closing working capital, the court rightfully rejected these adjustments as barred by the purchase contract's Liability Bar. Parties agreeing to a future payment based on a financial calculation that includes, or overlaps with, amounts subject to a separate release of claims or a separate contract between the parties in a different capacity need to be thoughtful as to how the separate features of the multiple agreements interrelate. Lack of attention to detail and ambiguous contract language may risk creating a back-door remedy that the parties intended to foreclose and associated unintended consequences.

IMPLICATIONS FOR POST-CLOSING DISPUTES

Depending on the contract wording in question, *Chicago Bridge* could provide ammunition for sellers seeking to limit the scope of issues that can be addressed in a price adjustment dispute. In addition to substantive arguments that can be raised with buyers, the case provides a procedural roadmap for mounting a preemptive court challenge to limit the scope of matters to be decided by an Independent Auditor. While as a general matter, arbitrators have the authority to rule on the scope of their own jurisdiction, the opinion suggests that Independent Auditors "acting as an expert, not an auditor" lack this broad authority, and therefore a dispute over what claims

can be asserted in a true-up proceeding must be addressed by a court.[21]

Parties seeking judicial review of the scope of Independent Auditor proceedings should be mindful that differing standards may apply to before-the-fact challenges and to challenges to final determinations or awards by Independent Auditors. As is typical, the Purchase Agreement in *Chicago Bridge* provided that the determination of the Independent Auditor would be conclusive, binding, and nonappealable and would not be subject to challenge for any reason other than manifest error or fraud.[22] Generally, judicial review under this standard is exceedingly narrow—even narrower than review under the Federal Arbitration Act.[23] Thus, there may be risks to waiting to pose a judicial challenge to an Independent Auditor's authority to decide GAAP issues until after that auditor's determination has been made.

LAWYER CONTACTS

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

Michael P. Conway
Chicago
+1.312.269.4145
mconway@jonesday.com

Bryan E. Davis
Atlanta
+1.404.581.8631
bedavis@jonesday.com

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

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

ENDNOTES

1 *Chicago Bridge & Iron Company N.V., v. Westinghouse Electric Company LLC, et al.*, C.A. No. 12585 2017 (Del. Jun. 27, 2017) ("Chicago Bridge"). Chancellor Laster's opinion below was the subject of a January 2017 Jones Day *Commentary*, "Accounting True-Up vs. Valuation Dispute" ("January *Commentary*").

2 Section 10.3 stated, in pertinent part, that the waiver of liability "shall not … operate to interfere with or impede the operation of the provisions" addressing the True-Up.

3 *Id.* at 6.

4 *Id*. at 30 (emphasis added).

5 *Id*. at 31.

6 *Id*. at 36.

7 *Id*. at 8, 38.

8 *Id*. at 28

9 *Id*. at 12.

10 *Id*. at 14-15, citing an ABA study that concluded that virtually all private deals in the period studied provided for some post-closing survival of representations and warranties.

11 *Id*. at 19.

12 *Id.* at 7 (emphasis added).

13 The Court also noted that prior to signing the purchase agreement, the buyer knew about the accounting practices it alleged should give rise to the adjustments, since they were included in the financial statements on which the buyer relied when negotiating the deal.

14 *Id.* at 42.

15 *Id.* at 39.

16 *See*, e.g., the following provision: "Seller shall not have any liability for Losses under subclause (i) of Section 9.1(a) [indemnity for breaches of reps] (x) to the extent any matter forming the basis for such Losses was given effect in the calculation of Cash, Current Assets, Current Liabilities or Net Working Capital as of the Closing, or (y) to the extent any reserve, provision or allowance (in the form of an accrued liability or an offset to an asset or similar item) was included in the calculation of the Cash, Current Assets, Current Liabilities or Net Working Capital as of the Closing."

17 Eighty-eight percent of post-closing purchase price adjustments were less than 2 percent of the transaction value, while 10 percent ranged between 3 and 10 percent. Two percent of adjustments fall in the 10–40 percent range. Source: 2015 SRS Acquiom Claims Study.

18 *See*, e.g., the following: "After the determination of the Final Closing Statement pursuant to this Section _____, neither Party shall have the right to make any claim based on the preparation of the Final Closing Statement or the calculation of the Cash, Current Assets, Current Liabilities or Net Working Capital as of the Closing (even if subsequent events or subsequently discovered facts would have affected the preparation of the Final Closing Statement or the calculation of the Cash, Current Assets, Current Liabilities or Net Working Capital had such subsequent events or subsequently discovered facts been known at the time of the Closing)."

19 *See*, e.g., the following: "The parties acknowledge that the intent of this Section _____ is not to solely measure changes in Net Working Capital between signing and Closing. Neither the preparation nor acceptance of the Sample Statement or the Closing Statement nor the provisions of Section ____ [representations and warranties as to financial statements' compliance with GAAP] or any right of indemnity in respect thereof, shall restrict, prohibit or otherwise affect the buyer's ability to propose adjustments to, or recalculate, the Closing Net Working Capital on the basis that any of the accounting accruals, book entries, calculations or other attributes of the Closing Net Working Capital (a) did not comply with [the Accounting Principles] [GAAP], or (b) were or are based on calculations that were also included in the Closing Statement, the [Audited] [Interim] Financial Statements or the Target Net Working Capital Calculation."

20 *See*, e.g., Stock Purchase Agreement dated July 17, 2017, providing for the sale (without rights of indemnity for breaches on company representations) of Pik Holdings, Inc. to Church & Dwight Co., Inc. (available on EDGAR) ("For the avoidance of doubt, the calculations to be made pursuant to this Section 2.3(b) and the purchase price adjustment to be made pursuant to Section 2.3(b) are not intended to be used to adjust for errors or omissions that may be found with respect to the Company Financial Statements or any inconsistencies between the Company Financial Statements or the Accounting Principles, on the one hand, and GAAP, on the other, for which Parent's rights under the RWI [representation and warranty insurance] Policy shall be the sole and exclusive remedy." Note that rep and warranty insurance policies frequently exclude from damages any loss recoverable pursuant to purchase price adjustment provisions.

21 *Chicago Bridge* at 38-39, n.83.

22 Purchase Agreement, Ex. A. to Verified Complaint, at 5.

23 *See* Justice Strine's opinion in *Viacom Int'l v. Winshall,* 2012 WL 3249620 at 11, *aff'd,* 72 A.3d 78 (2013).