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RESOLVING DISPUTES IN A POST M&A ENVIRONMENT

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Holwell Shuster & Goldberg

Founded by former Southern District of New York Judge Richard Holwell and trial lawyers Michael Shuster, Daniel Goldberg, and Dorit Ungar Black, **Holwell Shuster & Goldberg** is a litigation boutique focused on the representation of clients in complex commercial, securities, antitrust, bankruptcy, and intellectual property litigation, as well as related civil, criminal, and regulatory matters.

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RESOLVING DISPUTES IN A POST M&A ENVIRONMENT



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CD: Could you provide a brief overview of recent high-profile post M&A dispute cases? What lessons have been learned from outcomes?

Ohlms: One case that attracted our attention which was recently resolved was the *Johnson & Johnson vs. Guidant Corporation* case out of the United States District Court for the Southern District of New York. At issue was whether Guidant violated an earlier merger agreement with Johnson & Johnson, allowing it to obtain a higher price from Boston Scientific. The case is a great reminder to try to think through all of the permutations that a provision may introduce into a transaction. While Guidant clearly believed that allowing the diligence to the third party was permitted given its necessary role in Guidant's transaction with Boston Scientific, the language at issue did not explicitly address such a scenario. No one is ever going to be able to draft an M&A agreement that contemplates and explicitly addresses every twist or turn a transaction may take, but if it was important enough to include a no solicitation provision, perhaps more effort should have been made to flush out the line between solicitation and responding to an unsolicited offer. The other lesson is how costly and time consuming this type of litigation can be. The cost is not made up solely of the legal fees or the settlement dollars paid, but also includes the value of the time spent

by company leaders addressing the litigation as opposed to advancing their business.

Holwell: Litigation is endemic to M&A transactions. Historically, shareholders have challenged over 90 percent of public company M&A deals. Most of these are settled before the transaction closes and are essentially a strategic tool for inducing, or defending against, a proposed sale, or perhaps, as a means of securing a healthy contingent fee for plaintiffs' counsel. By contrast, private company M&A litigation typically arises post-closing, when either the buyer's or seller's expectations are not met, so they resort to a court or arbitrator as a means of renegotiating pricing. Far from being resolved promptly, post-closing disputes can be costly and time consuming to both sides.

Kulkov: One particular recent dispute concerning a joint venture (JV) involved Rosnano entering a dispute over an additional agreement to a shareholder's agreement whereby Rosnano had a right to sell its stake to another JV participant in case the JV company did not reach a certain level of profitability. The court supported Rosnano's claim and obliged the respondent to buy the stake. Russian practitioners have noted that this decision is likely a sign of prospective changes in Russian court practice, particularly because the court showed willingness to employ foreign law mechanisms common in business practice, such as put option

or *astreinte*. Equally a high-profile dispute between Mikhail Cherney and Oleg Deripaska has recently been settled. The dispute arose over a 20 percent stake in UC Rusal, the world's biggest aluminium producer. The disputed stake was worth over \$1bn. Mr Cherney claimed to have been Deripaska's partner in Russia in the 1990s, and that he was owed a stake of Rusal. The case was pending in the English High Court, however, the parties eventually reached an out-of-court settlement. This case may illustrate that parties would not often use a formal dispute resolution mechanism provided for in their contract even if it is an extensively elaborate one, may not serve its purpose, or because any disagreement which appears to have been resolved can still potentially lead to court proceedings if one of the parties is unhappy with its outcome. This does not mean, however, that drawing up detailed and thought-through dispute resolution clauses in a contract can be skipped. Such provisions do not leave room for unreasonable claims and encourage parties to settle their disputes out of court. Moreover, if the parties fail to reach an agreement, a well-drafted dispute resolution clause provides a good faith party with more chances to win the case in court.

Bédard: To focus on my own experience of recent post acquisition disputes, representing both sellers and buyers, they have involved breaches of the financial statements representation regarding

assets that were alleged to be overvalued at the time of the acquisition in breach of the relevant accounting principles. The buyer proceeded to reduce the value of the assets leading to a claim for 'diminution in value of the assets'. Such disputes inevitably have given rise to intricate analysis of the relevant accounting rules according to which the value of these assets is determined. Lessons learned include that accounting firms that perform due diligence for buyers would be well advised to involve their litigation colleagues who specialise in post acquisition disputes. Last-minute changes to the governing law of the contract should also be avoided if they are not accompanied with a thorough review of the enforcement of the provisions of the contract pursuant to the new governing law. Every dispute also brings lessons for the drafting and the interpretation of key contract provisions such as the definition of losses, the threshold amount for the indemnification, de minimis claims and the representations and warranties.

Burgueño: Over the last couple of years, because of the general state of the world economy, most high profile disputes have had to do with buyer's or investor's refusal to close transactions. Most often, disputes arise when the buyer alleges a breach of representation and warranties on the side of the seller or other form of breach to avoid closing on the deal, rather than plainly invoking a MAC or other way-out clause. It bears noting, however,

that most post-M&A disputes are private in nature, as arbitration is the standard dispute mechanism agreed upon in M&A transactions, and even when the dispute is resolved through Mexican Courts, the docket is not public. The most high-profile M&A dispute is the one between restaurant chains operator Alsea, which was taken to court by Italcafe, the owner-seller of Italianni's chain of restaurants, after Alsea refused to close on the transaction. The details of the dispute are only known through the media, which is traditionally very inaccurate and normally used by each of the parties in dispute to try to influence public opinion. Alsea was ordered by the first instance judge to close on the deal, and while on appeal, Alsea and Italcafe settled the dispute and closed on the transaction after almost four years of litigation. A key lesson from the Alsea/Italcafé dispute, in addition, is that litigation before Mexican courts is not an adequate mechanism for resolving disputes of the complexity that often arises from M&A fallouts. The Alsea/Italcafé dispute took almost four years and several years of appeal and amparo proceedings were well ahead of them and in the end, the resolution by the judge was questioned by all parties.

CD: With shareholder activists frequently targeting companies involved in M&A, how would you characterise the

risks for board members on both the buy and sell side?

Kulkov: Shareholder activism in the M&A sphere has grown in recent years, and for board members to manage the activist threat, and decrease the company's vulnerability to shareholder activists' interference, it is important to ensure and implement

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*Luis Burgueño,
Von Wobeser & Sierra*

effective growth strategies, optimise capital allocation and enhance competitiveness. The best strategy on both the buy and sell side is to know one's company, its advantages and disadvantages, and the market it is operating in. Moreover, due to the complex nature of some ownership chains, it is essential for the shareholder to verify compliance of the business with the Russian law. For these reasons, warranty and disclosure issues take a

lot of time and are heavily negotiated. In Russia, shareholder activism is not well-developed, and does not have a great impact on M&A deals.

Burgueño: Shareholder activists are almost nonexistent in Mexico, but that does not mean that board members of the buyer and target may not be held liable under Mexican Law. Nevertheless, it bears noting that in general terms Mexican corporate law is protective of the board members of private and public companies, to the extent they act on good faith and with reasonable diligence. Mexican law does not allow for courts or arbitrators to second-guess the good faith decisions of directors.

Holwell: In the M&A arena, shareholder activists typically focus on undervalued public companies whose value, at least in the view of the activist, can be 'unlocked' by selling all or part of the company or by restructuring its operations. In recent years, hedge funds have fuelled a material increase in shareholder activism which has increased pressure on board members to justify the strategic decisions they and management have made. Frequently the issue is framed as whether the board should be focused on short term or long term value creation. A well advised board will be able to articulate a clear and sensible plan to increase shareholder value over

time. But poor operational performance coupled with poor stock performance may push directors who are conscious of their fiduciary duties, or perhaps

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pressured by recently elected dissident directors, to adopt the structural changes sought by the activist investor.

Ohlms: Shareholder activists greatly increase the amount of scrutiny that board members on both the buy and sell side face. We see this as a shift from a corporate governance model that greatly defers to the board to one that is shareholder-centric. The risks to the board members fall into two categories: those risks that are personal to them and the risks that their companies face. The personal risk is relatively easy to assess and guard against. Any director should ensure that their company has D&O insurance that meets certain quantitative and

qualitative benchmarks; however, this is particularly important for companies that are likely to attract activist investors. The board members also face a risk that their business judgment will be consciously or subconsciously redirected to focusing on short term goals that might be the focus of an activist investor instead of making decisions that are in the long term best interests of the company. For instance, developing a new product line could be criticised as diluting the company's brand strength or inviting unnecessary risk to a company with other well-established products. At the same time, that new product line may be the lifeblood of the company in five years when the activist investor has moved on to a new interest.

CD: What general advice can you offer to parties on managing and mitigating post M&A disputes?

Holwell: There are any number of ways to limit post-closing claims and to provide a rational procedure for resolving disputes that do arise. A fundamental imperative, however, is that both sides have to understand each other's goals, intentions and expectations. Post-closing surprises are not a good thing, even if the other side was asleep at the switch. The better informed each side is, the less likely there will be litigation later on.

Bédard: Post-acquisition disputes are often complex and it takes time for the seller to understand the strength and weaknesses of the buyer's claims. Significant resources have to be devoted to the analysis of the buyer's claims. The seller often finds itself in a situation where it acquires a detailed understanding of the buyer's claim rather late in the dispute resolution process, at a time when the parties may be too embroiled in the litigation or the arbitration to actively devote energies to a potential settlement. However, a buyer and a seller who are willing to exchange extensive information and perform a detailed analysis of the claims as soon as the indemnification notice is provided may be able to avoid litigation.

Burgueño: The first piece of advice is to retain counsel early when the dispute arises and have them involved from the very beginning. Quite often, the initial communications between the parties in dispute are critical, both in terms of the possibility of avoiding litigation and because initial communications can constitute evidence contrary to the client's interests in the event of litigation. The second general advice is to be certain that the team of advisers involves not only litigators but also M&A deal practitioners. A bad settlement will almost always be better than a good litigation, and the parties should be certain to engage lawyers who can advise them in alternative arrangements to avoid litigation until it really becomes unavoidable.



Kulkov: It is noteworthy that due to the specifics of Russian law and court practices which tend to show formalism and

in the form of escrow bank accounts, courts still mostly show an unwelcoming attitude towards these mechanisms. Careful drafting is one of the most important steps on the way to mitigating the risks of post M&A disputes. The key concern in drafting an agreement in an M&A deal is to strike a balance between the seller's and the buyer's interests. For instance, the seller

a lack of flexibility, as well as the fact that the Russian market is viewed as emerging, parties frequently choose English or US law to regulate M&A deals and opt for arbitration as a means of dispute resolution. Though crucial to M&A mechanisms in general, representations and warranties, escrow arrangements and indemnity are still quite alien concepts in the context of Russian law. Despite the recent trends introducing civil codes

is typically interested in selling the business 'as is', while the buyer would benefit from full disclosure. The seller should be encouraged to provide full disclosure of all the risks, because such disclosure, despite somewhat reducing the purchase price, minimises the risk of post M&A disputes. It should also be noted that earn out provisions should be used carefully, and only when necessary, because such provisions often provoke post-closing issues.

Ohlms: Use tools to quickly be able to quantify the risk and identify your best route forward.

Parties should also ensure that they focus early on communicating the history of negotiations to their counsel. At least initially, lawyers can be tempted to focus on the final written product and case law that governs how the agreed upon language will be interpreted. From a purely legal standpoint, that is a sound practice. But it can often result in the lawyer

associated with unmet forecasts, regulatory disputes, disputes surrounding warranty and indemnity provisions, and so on?

Burgueño: While there may be technical differences among the types of disputes, there are

being delayed or denied the opportunity to learn about what the parties were trying to document in their language and the respective motives that led to the need to craft the language at issue. Focusing solely on the end product is like a detective in a murder case focusing solely on the murder weapon. That's important, but the best detectives will focus at least an equal amount of energy on identifying the motive.

CD: To what extent might a different approach be required depending on the types of dispute – such as earn-out disputes, shareholder disputes, disputes

generally two kinds of disputes: disputes about money and disputes about people – for example, shareholders' disputes, governance disputes, and so on. Knowing which kind of issue underlies the dispute will be critical to assess what potential settlement may be reached, if any.

Ohlms: There continues to be an emphasis on using alternative dispute resolution for a wide variety of M&A disputes, such as shareholder disputes and disputes over warranty and indemnity provisions. While arbitrations do offer some benefits to clients over traditional litigation, I think there needs to be a

greater emphasis on defining the type of arbitration that will occur. What is the source of the arbitrator? It is a large ADR provider who will offer a distinguished panel of retired jurists who may or may not have experience in the type of language at issue? Or have the parties gone the extra step of trying to carefully define who will oversee the dispute resolution

can control the risk should be an important factor in determining the share of the risk that that party can reasonably assume. For example, if there is an antitrust/competition risk, the acquirer may be in a position to ameliorate the risk through selective divestiture. Accordingly, it would be reasonable to place responsibility for controlling the risk, subject to

process and how that process is defined? These are very deal-specific issues – there is no one size that fits all. However, they need to be given more attention at the time the parties are crafting the M&A agreement. It can be difficult to incentivise a concentrated focus on a forum selection or ADR provision because no one in a transaction at the time of closing wants to believe that a dispute is lurking.

Holwell: Different types of potential disputes require different solutions. All potential problems can be viewed as an allocation of risk that an event will or will not occur. The extent to which a party

clear limitations, on the acquirer.

Kulkov: The general advice for mitigating dispute risks is to include more specific and detailed provisions in the purchase agreement. The approach may slightly differ depending on the types of deal and dispute it may entail. There are a number of common grounds for post M&A disputes, unmet earn out provisions, breach of representations and warranties, for example, and the contract should address them as the case may be. Typically in an asset deal, it is normal for a party to provide a price adjustment mechanism in case of breach of representations and warranties. For

instance, in order to settle the dispute in earnest contractual relationships, it is usually forwarded to the independent auditor. This mechanism is still undeveloped in Russia and requires a foreign ruling statement in the arbitration agreement.

concerns. Based on this information, it is not hard to forecast the different types of dispute that may arise. If, for instance, the most important disputes that may arise revolve around the payment of the price or the



CD: What guidance can litigators give to commercial lawyers on drafting dispute resolution clauses in sale and purchase agreements, and in drafting better M&A provisions in general?

Burgueño: When drafting dispute resolution clauses, it is highly advisable to first look at the different potential scenarios of disputes. Although it may appear to be a guessing game, it is a fact that from the negotiation stage it is relatively easy to learn and understand each parties' interests and

enforcement of guarantees, it would always be advisable to subject the agreement to litigation before the courts. However, if there are some complex clauses that could be subject to interpretation, in principle it would be more advisable to submit the dispute to arbitration.

Ohlms: Having an experienced M&A attorney review dispute resolution clauses and certain key provisions during the drafting process helps a client fully understand the need to balance risk management with efficient dealmaking and drafting. While impossible to draft an agreement that explicitly addresses every contingency, no one could argue they are putting their best foot forward in a transaction without having consulted counsel who focus on addressing the disputes that arise from these types of transaction. Having the client meet with the litigator will help the client understand what risks are present, what a fair analysis of those risks is and how to best insulate against the risks. Involving the litigator also helps the deal team understand where they might wish to focus some additional efforts in their drafting. And finally, being involved in the process helps litigators better understand the dynamics of the transaction and the client's risk appetite in case a dispute does arise down the road. The pace of transactions will deter involving yet another lawyer, but spending a few more hours during the pre-closing timeframe can save years of distraction on post-closing litigation.

Holwell: Poor drafting of a dispute resolution clause is as inexcusable as it is frequent. Specificity is required. What arbitral organisation's rules are

to apply? How many arbitrators? How are they selected? What substantive law is to be used? A jurisdiction's choice of law rules, consent to personal jurisdiction and service of process and provisions for enforcement should all be agreed upon. Note that some non-Western countries limit the power of their

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corporations to enter into arbitration agreements. And to prevent an arbitration from turning into the equivalent of endless court proceedings, parties should consider setting time limits on how long the arbitrators can take to issue a final award.

Kulkov: Certain factors leading to transaction disputes can often be mitigated with careful planning and attention to detail prior to the signing of the purchase agreement. The language of the purchase agreement must be specific. For example, detailed

provisions regarding the relevant accounting guidance and earn-out calculations may assist in mitigating an earn-out dispute. Dispute resolution clauses should be drafted with similar care and attention as substantive deal provisions. From a seller's perspective, it is generally advisable to seek the express exclusion of claims for rescission of the agreement to the extent permissible under laws applicable to acquisition agreements. In terms of dispute resolution methods, the choice of legal venue is as important as the choice of the law governing the purchase agreement. It is necessary to take into account that in some cases parties do not have the right to choose the venue under Russian law, in disputes concerning immovable property and the transfer of title to shares in a company, for example.

Bédard: Commercial lawyers already know this, of course, but the importance of the definition of 'losses' that are subject to indemnification cannot be overstated. Of importance may also be the issue of the potential increase in the value of some assets to counter an indemnification claim for diminution in value of other assets. The effect of excluding materiality thresholds for purposes of the existence and establishment of a breach of representation should also be considered.

CD: In your estimation, what are the specific dangers posed by the use of boilerplate clauses? Is the constancy of such clauses an overriding concern? Should parties strive to include bespoke provisions specific to the circumstances of their transaction?

Bédard: A perception of danger arises when words that have become common appear to lose

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*Maxim Kulkov,
Kulkov, Kolotilov and Partners*

their legal impact and the concern is that judges and arbitrators do not give them as much attention as they should or that they do not enforce them as strictly as the parties might expect. It is not a great concern that boilerplate clauses may be losing their effectiveness.

Kulkov: Boilerplate provisions may increase the risk of post-closing disputes if incorporated automatically without considering the specifics of the deal. Including a boilerplate provision on the choice of governing law or dispute resolution method, may lead to undesirable results. Indeed a minor dispute might end up being referred to the LCIA in accordance with the dispute resolution clause, which entails unreasonably high legal expenses. Boilerplate provisions on the entirety of the contract should not be included if the parties conclude or intend to conclude addendums or additional agreements. One also has to be careful with no resale or no lease boilerplate clause, because the intention of the buyer may be the opposite. Overall, it is highly advisable that parties include elaborate provisions specific to the circumstances of their transaction. Although boilerplate clauses are helpful, they should be used in such a way as to accommodate the particular situation in order to achieve a balanced and successful M&A agreement.

Burgueño: This is a fundamental issue that we are seeing more and more often as the cause for disputes in post-M&A transactions. It is very common that M&A transactions use boilerplate clauses from other deals and even for deals subject to different laws. US law practitioners do it very

often: they include certain clauses in contracts that are subject to Mexican law which, when analysed under Mexican Law, have different meanings and legal consequences, or no legal consequence at all. A contract, particularly in civil law jurisdictions as Mexico, is not an independent, standalone entity, but is complemented and modified so that the rules govern the enforceability and interpretation of contracts. Bringing common law or any other law

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boilerplate clauses into a deal governed by Mexican law without the proper advice from qualified Mexican counsel is, to say the least, not smart and potentially negligent.

Holwell: Some consider original drafting to be a mortal sin. An overstatement, to be sure, but too much freelancing in drafting acquisition agreements is a dangerous thing. All firms have ‘best practice’

drafts for a reason – they clearly express the intent of the parties at least with regard to core provisions that are found in every deal. But unlike bond indentures, carefully tailored provisions are unavoidable in an M&A transaction. And it is always striking how, in retrospect, a provision is found by the court to be totally ambiguous.

Ohlms: This is the age-old battle of boilerplate versus bespoke provisions. Besides efficiency in drafting, boilerplate provisions can offer some increased transparency of how they will be interpreted by a court. Meanwhile, by their very nature, bespoke provisions increase the time spent drafting and inject uncertainty in how a court will interpret a provision that has never been seen in the wild before. Lawyers will always have their go-to language for certain provisions. But it is important to identify with the client what provisions should include at least more tailoring than others and how that adjusts the risk profile of the transaction.

CD: How do you see M&A dispute management and mitigation methods developing over the coming months? Is more realistic forecasting, along with comprehensive due diligence procedures, a key part of reducing conflict?

Holwell: Due diligence by both buyer and seller is the sine qua non of a well negotiated M&A deal. The

seller has to ensure that all the material information gets into the buyer's hands and that the information is consistent with a reasonably broad reading of the representations and warranties to which it agrees. The buyer has to review the information without rose-coloured glasses. Realistic forecasting is to be hoped for, but woe to the buyer who relies solely on the seller's forecasts. Where both sides do their homework, and assuming they are represented by able counsel, the risk of post closing litigation is materially reduced.

Ohlms: The volume and pace of transactions is increasing. In the tech space especially, earn-outs are frequently being used again to bridge differences in valuations between buyers and sellers. Many of those deals will not escape the gravitational pull of earn-out litigation. We are seeing more energy being spent by both clients and lawyers on identifying the risks that either come from the nature of the client's business or the nature of the contemplated transaction. When present together, those efforts result in a powerful tool to identify, categorise and quantify risk. Once that is accomplished, the team can decide where to focus its attention and efforts. More than ever we are seeing clients discuss their diligence procedures which they believe are best in class. While we have no doubt that they have developed sophisticated diligence protocol and procedures, the fact is they are having to process more information during diligence than ever

before. It's not entirely different from the effect of e-discovery on litigation. One cannot dispute that e-discovery gave clients the opportunity to identify their opponents' most sensitive and potentially damaging communications. The challenge is to sort through terabytes of data and identify those key documents. Similarly, sophisticated diligence procedures can go a long way in helping a buyer forecast the future of the entity or assets in the transaction, assuming that they have the ability to sort through large volumes of data to get to the key documents that will lead to accurate forecasts, commensurate expectations for the entity or assets post-closing, and thus minimise post-closing disputes.

Bédard: Due diligence may be part of reducing conflict but it has inherent limitations in uncovering potential breaches of representations and warranties.

Burgueño: Unfortunately, we do not anticipate any material improvement in this regard. Comprehensiveness of due diligence is inversely proportional to the buyer's urge to close the deal as well as the available resources. Of course, smart buyers will always prefer to pursue comprehensive due diligence by qualified counsel and will carefully ponder every aspect of the deal, in particular forecasting assumptions. There is no better way to prevent future disputes. But quite often potential

buyers or investors are willing to let the urge to close the deal interfere with adequate diligence. Since it is generally anticipated that there will be a surge in M&A activity in Mexico in the coming years, many buyers will inevitably succumb to this temptation. Alternative fee arrangements, which many clients now pursue, particularly during due diligence, may also work against buyers' interests in this regard. When buyers' counsel has agreed to a fixed or cap fee, it will be naturally incentivised to maintain profitability by limiting the time and resources invested in due diligence. The only obstacle to this will be counsel's ethics and professionalism. But high quality, professional and ethical M&A counsel is not a commodity and only rarely cheap.

Kulkov: In Russia, the sphere of M&A dispute management and mitigation is underdeveloped since parties prefer choosing foreign law to govern their contracts. In the future, there may be developments in Russian legislation and court practice towards the recognition of foreign law mechanisms used in M&A transactions. However, we do not expect any groundbreaking developments in M&A over the coming months. One of the latest trends worldwide is the growing popularity of insurance against representations and warranties claims. Additionally, recently sellers are trying to include indemnities within the many limitations on liability that apply to the warranties. Realistic forecasting is definitely a key part of reducing risks of post M&A conflicts

along with due diligence and careful drafting, since a lot of post M&A disputes concern unmet forecasts or breach of representations and warranties. Moreover,

Russian lawyers usually draw a so-called compliance risk map during negotiations. 