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ARTICLES

Chancery Arbitrations after Year One: Annotated New Form

By Greg Varallo, Rich Rollo, and John Mark Zeberkiewicz – August 16, 2012

On January 5, 2010, the Delaware Court of Chancery adopted a set of rules providing for arbitration in the court, giving life to a recently adopted statute permitting Delaware’s Chancery judges to act as private arbitrators. *See* 10 Del. Code § 349 (adopted Apr. 2, 2009); Del. Ch. Ct. Rules 96–98 (adopted Jan. 5, 2010). *See also* Gregory P. Williams, Gregory V. Varallo, Jillian Remming & A. Jacob Werrett, “Arbitration in the Delaware Court of Chancery,” *Insights*, July 2011, at 1. Practitioners in the court now have the benefit of having worked through some of the initial “growing pains” associated with this new forum. With at least five arbitrations having moved through the court’s arbitration docket since the first such proceeding was filed in March 2011, we are privileged to have been involved in each one, serving as lead counsel in most. Having tried or argued most of these early matters, we have attempted to refine our firm’s form arbitration provision to reflect our direct experiences. While the specifics of any arbitration in Chancery are confidential, [the updated form](#) [PDF] with annotations reflects our experiences and flags issues that may arise in any arbitration proceeding and that, accordingly, parties should consider addressing when negotiating the specific terms of any agreement to arbitrate in Chancery.

Although the form is designed to be included in a merger agreement or other significant transaction agreement between sophisticated commercial parties, its principal terms may be modified and included in a stand-alone agreement that commercial parties enter into after a dispute has arisen over a preexisting agreement or other instrument.

The statute allowing such arbitrations provides for appointment of a chancellor or vice chancellor of the court as arbitrator where (1) the parties consent to arbitration, (2) at least one of the parties is a business entity, (3) one of the parties is either formed in Delaware or maintains its principal place of business there, (4) neither party is a consumer, and (5) the amount in controversy is no less than \$1 million. *See* 10 Del. Code §§ 349, 347(a) & (b). The arbitrations are confidential, *id.*; Del. Ch. Ct. R. 97(a)(4) & 98(b), and the rules of the court contemplate disposition of such matters within 90 days of filing. *See* Del. Ch. Ct. R. 97(e). Appeals from the arbitration are subject to waiver or, if not waived, go directly to the Delaware Supreme Court. *See* 10 Del. Code § 349(c). Most importantly, the parties have an almost unlimited ability to “customize” the process by agreeing in advance (or at the time the dispute is presented) to provisions they deem appropriate to streamline and make more efficient the resolution of the dispute. Thus, rather than *litigate* disputes over earn-out clauses, escrow arrangements, or alleged breaches of representations and warranties, or even whether a “material adverse event” has occurred, parties may, by mutual consent, have those and countless other matters resolved through a confidential, prompt, and potentially non-appealable alternative dispute resolution mechanism. Unlike the typical alternative dispute resolution forum, however, this one is hosted by a sitting judge, appointed specially as arbitrator—someone who makes his or her living making tough decisions, not attempting to compromise or “split the baby,” and who, as a

member of one of the world's leading courts for business disputes, has substantial expertise in complex corporate and commercial matters. In short, the new arbitration forum offers all of the benefits of litigation in the Court of Chancery, with the added benefit of privacy, an ultra-quick resolution schedule, and the potential to make the resolution final, binding, and non-appealable.

Of course, nothing is ever perfect. Both sides to an agreement have to consent to this alternative dispute resolution mechanism to trigger it. In addition, at least one public interest group, the Delaware Coalition for Open Government, Inc., has brought a constitutional challenge to the process. The group initially filed a complaint in the U.S. District Court for the District of Delaware, *Delaware Coalition for Open Government, Inc. v. The Hon. Leo E. Strine, et al.*, C.A. No.1:11-cv-01015-MAM(D. Del. Jan. 20, 2012), but the judges on that court recused themselves, following which the case was transferred to the U.S. District Court for the Eastern District of Pennsylvania. See Peg Brickley, "Secrecy Puts Judges on Defense in Delaware," *Wall St. J.*, Feb. 21, 2012, at B1.

As the name of this group would suggest, the complaint alleges that the confidentiality provisions of the arbitration statute, as enacted by the rules, "constitute an unlawful deprivation of the public's right of access to trials." See Complaint ¶ 20, *Delaware Coal. for Open Gov't, Inc.*, C.A. No. 1:11-cv-01015-MAM. The group is accordingly seeking a declaration that the arbitration statute and the rules are unconstitutional, a permanent injunction against the named defendants (the sitting chancellor and vice chancellors and the State of Delaware) from conducting any nonpublic proceedings under the statute and the rules, and an order unsealing all documents filed pursuant to the statute and the rules. *Id.* ¶¶ a, b & c.

Although the case is still pending in federal court, if the statute and the rules were found to be unconstitutional, one potential outcome would be that Delaware maintain a Chancery arbitration regime, albeit one that does not permit the proceedings to remain confidential. Given this possibility, parties may consider including in their arbitration provisions a limited "severability" clause that would provide for the confidentiality mandates to be severed from the provision, with the otherwise valid terms being enforced, or direct that the provisions of any successor statute or rules be applied mutatis mutandis to the maximum extent possible. If the court were no longer conducting arbitration proceedings, the provision would specify that the parties will arbitrate the covered disputes in Wilmington, Delaware, before a former member of the court selected in good faith by mutual agreement of the parties or, if no such member of the court is available, by another qualified arbitrator selected in good faith by the parties. Nevertheless, until and unless the federal courts put a halt to the regime or to any part of it, this new arbitration forum is "open for business."

As the lead author noted in a previous article introducing the new procedure and the court's rules, several companies incorporated first-generation arbitration provisions into public merger agreements and other documents. See Williams et al., *supra*, at 3–4 (discussing the Teradata Corp. arbitration provision for escrow claims in a public transaction and Global Defense Technology & Systems Inc.'s provision submitting all disputes arising under a public merger agreement to Chancery arbitration). The merger agreement between Skyworks Solutions, Inc.,

and Advanced Analogic Technologies, Inc., also included a provision requiring disputes between the parties under the agreement to be submitted to arbitration in the Court of Chancery. *See* Skyworks Solutions, Inc., Registration Statement (Form S-4), at A-57–A-59, § 9.11 (June 16, 2011).

These provisions were crafted before arbitrations were actually held in the court and therefore do not reflect actual experience with the new procedure. Although these provisions are helpful in starting precedents, experience with the procedure suggests that they should no longer be relied upon as “state of the art.” Instead, the “second generation” form, which includes provisions arising out of our direct experience with the procedure, should now be used as the starting point for parties considering the possibility of submitting potential disputes to Chancery arbitration.

As noted above, contractual parties have significant flexibility in negotiating the terms under which disputes may be arbitrated through the Chancery arbitration process. To this end, our form provides a solid framework for an agreement to arbitrate in the Court of Chancery and sets forth, in bracketed language, several provisions that the parties may, but need not, include. The commentary in the footnotes explains why parties may find it worthwhile to include such language in a particular setting. The commentary also attempts to explicate many of the material terms of the form provision and the basis for those terms. Like any form, this is one that will continue to evolve over time. Moreover, the parties may wish to further modify or supplement this form, depending on the type of parties involved in the transaction (e.g., private or public; large-, mid- or small-cap), their relation to one another (e.g., arm’s-length contractual parties negotiating a one-time transaction or a company and one of its equity holders or lenders), the nature of the potential disputes likely to arise between the parties, and any other factors that may be relevant in the context of a particular transaction or arrangement. Accordingly, we would recommend that you consult with your litigators and Delaware counsel before using it, especially if the need arises in the distant future.

Conclusion

After a full year of hands-on experience with binding private arbitration in the Court of Chancery, a second-generation dispute resolution form has evolved. Consider using this form as a starting place for agreements opting for this important new alternative dispute resolution forum.

Keywords: litigation, commercial, business, Delaware, Court of Chancery, arbitration

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Using Employees Retained after an Acquisition in Litigation

By Mark R. Jacobs – August 16, 2012

When private equity firms acquire a new business, many of those firms hire former employees of the acquired business to stay in key positions after the transaction closes. Retained employees have valuable institutional knowledge crucial to achieving the business's goals as the business moves forward as a private-equity-backed venture. Those retained employees may also have substantial knowledge that is material to any post-closing disputes that may arise between the buyer and the seller of the business. For instance, the buyer may hire the business's controller and later discover that the financial information provided to the lawyer by the seller during due diligence was inaccurate, thereby breaching the seller's representations and warranties regarding the accuracy of its financial statements. Or the buyer may retain the business's head of sales and subsequently determine that the seller breached its representations and warranties concerning its projected orders from its top customers.

In situations such as these, the retained employees can provide crucial insight into the seller's operations that is relevant to litigation over the seller's conduct in connection with the acquisition, such as identifying the seller's key players and describing the seller's business methods that gave rise to the buyer's claims. In fact, the employees retained by the buyer may have participated in the activity that is the subject of the buyer's allegations. Although the retained employees may be valuable resources in litigation, their prior relationship with the adverse party and their personal involvement in any potential misconduct raise important issues to be considered in preparing a buyer's litigation strategy.

Understand the Employee's Relationship to the Buyer

Many decisions about the use of retained employees in litigation will be heavily influenced by the employees' business and legal relationship with the buyer. A buyer is often an entity created by the private equity firm solely for the purpose of acquiring the seller's business. The private equity firm controls the purchasing entity, and principals from that firm decide which of the seller's employees to retain. Employees that have the type of knowledge that is most helpful in litigation typically hold management or upper-level positions in the business and are perceived by the private equity firm as critical for success beyond the eventual resolution of the dispute. Those retained employees often have employment contracts that define their employment arrangement with the buyer, including their duties, authority, and protections against termination. In addition, many private equity firms offer retained employees the opportunity to obtain ownership interests in the business after the acquisition as a retention incentive and to align the employees' interests with those of the private equity firm. Some private equity firms even require that retained employees participate in the ownership of the business.

If retained employees will play an integral role in litigation against their former employer, it is important to determine their relationship to the buyer early in the matter. All contracts governing their relationship with the buyer should be reviewed, including any operating agreement, shareholder agreement, or other corporate governing documents that may control the employees'

rights as equity owners in the business. As explained below, the employees' participation in the ownership of the buyer's business and continued employment by the buyer may become a focus of the seller's response to the buyer's claims. The employees' contractual rights and protections, as well as their importance to the buyer's business operations, may restrict the options for dealing with the seller's tactics.

Determine Any Duties That the Employee Has to the Seller

Retained employees are often hesitant to discuss information they learned while working for the seller. Not only are they concerned that their involvement with the seller's conduct will affect their relationship with the buyer, but they may also worry that they have continuing duties to the seller to maintain information as confidential. These concerns are usually easily addressed, but understanding any possible lingering duties to the seller will help the employee become comfortable with discussing material information.

The employment of critical employees by a buyer is usually negotiated as part of the acquisition transaction with the seller. In fact, the employment contracts for those employees are often exhibits to the purchase agreement. Therefore, the seller agrees that the retained employee will be employed by the buyer and cannot object that the mere employment violates any duties to the seller. If the continued employment of retained employees is not part of the negotiations with the seller, any potential noncompetition restrictions should be reviewed. Even if the seller agrees that the buyer may hire former employees of the seller, the employees may still be concerned about contractual restrictions on disclosure of confidential information that may otherwise survive the end of their employment with the seller.

Retained employees may have signed confidentiality agreements with the seller or be bound by confidentiality restrictions in policies instituted by the seller. The benefit of those agreements and policies typically inure to the business that the buyer purchases. As part of the acquisition transaction, those benefits are often expressly assigned to the buyer. Further, the buyer normally acquires all of the information, intellectual property, and goodwill that the seller used in running the acquired business. Consequently, the retained employees' knowledge concerning the business should belong to the buyer, not the seller. In some instances, an employee may have signed a confidentiality agreement with an entity other than the seller, such as the parent company of the seller, increasing the complication of evaluating the employee's duties in the context of litigation.

Although the scope of any confidentiality restrictions rarely, if ever, prevents a retained employee from disclosing information about the seller after an acquisition, concerns about an employee's duties to the seller might further be alleviated through provisions in the purchase agreement between the buyer and seller. For instance, when a buyer intends to hire a seller's employees, the purchase agreement might include an express waiver or acknowledgment that any of the employees' obligations to the seller (or its parents and affiliates), including any confidentiality obligations, are terminated as of the date of the acquisition.

Anticipate the Seller's Attacks on the Retained Employee

In litigation, a seller will try to undermine the value that its former employees provide to the

buyer's case. A seller will probably focus on the buyer's continued employment of the retained employee to demonstrate that the buyer's accusations are baseless or, at least, overstated. If a buyer asserts that the seller's actions were improper, the seller will question why the buyer continues to employ the people who were actively involved in that alleged misconduct. This argument is particularly potent if a buyer claims that it was defrauded by the seller, yet continues to employ those who committed the fraud.

The seller may take an even more aggressive approach and file third-party claims against a retained employee based on the employee's involvement in the conduct underlying the buyer's allegations. For instance, the seller may assert claims for breach of fiduciary duty or breach of the employee's duty of loyalty stemming from the prior employment with the seller. The seller may allege that the employee's independent actions caused the breaches asserted by the buyer or that the employee failed to make the seller aware of information that should have been disclosed to the buyer. If the buyer asserts a claim for fraud, the seller may seek to join the employee as a party personally liable for any fraud committed by that employee. When a seller puts a retained employee at risk, that employee will often turn to the buyer for guidance and protection. The buyer should anticipate how to deal with the seller's attacks on the employee.

Minimizing the importance of the retained employee may mitigate the seller's ability to raise the employee's connection to the buyer as an issue in litigation. One way to distance the employee from the buyer is to fire the employee. The buyer may be hesitant to fire the employee for business reasons, and termination may be difficult or impossible as a result of the employee's contracts with the buyer. By terminating the employee, the buyer will also lose access to the employee's knowledge, compounding the difficulty of pursuing claims against the seller. However, firing the retained employee can be an effective option that eliminates many other challenges that potentially affect the litigation.

The buyer may also reduce the employee's profile in any dispute by relying on evidence and testimony from other sources and witnesses. The buyer could retain an expert to provide testimony concerning the seller's business practices and their effects on the transaction. After an acquisition, private equity firms often bring into a business new members of management who have no connection with the seller. Those employees are usually experienced in the relevant industry and can provide sophisticated testimony concerning pertinent issues.

If the seller asserts claims against the retained employee, the employee will often have to hire separate counsel. The employee may ask the buyer to indemnify the employee for the cost of defense and for any liability related to the seller's claims. The buyer may already have indemnification obligations to the employee under any employment contract negotiated in connection with the acquisition. If those provisions are drafted broadly enough, the buyer may be responsible to the employee for the seller's claims. Even if there are no existing obligations, the buyer may feel compelled to indemnify the retained employee for business and strategic reasons. The buyer should be made aware of the possibility of these extra costs as early as possible, and any indemnification agreement negotiated after litigation begins should be carefully crafted to specifically define the buyer's obligations.

Conclusion

Retained employees might be the most valuable source of information in litigation against the seller of a business, but their involvement presents many challenges that are not found in other circumstances. Meeting those challenges requires a thorough understanding of the underlying acquisition transaction beyond the discrete legal issues that trigger the dispute between the buyer and seller. Early communication with the buyer about its expectation and review of all relevant transaction documents are critical to foreseeing and effectively addressing those unique problems.

Keywords: litigation, commercial, business, acquisitions, employees, private equity firms

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Private Equity Valuations: Standards and Recent Developments

By Brett D. Jaffe and Oliver S. Haker – August 16, 2012

It has been widely reported that in late 2011, several leading private equity funds received informal inquiry letters from the Division of Enforcement of the Securities and Exchange Commission (SEC). G. Zuckerman, “SEC Launches Inquiry Aimed at Private Equity,” *Wall St. J.*, Feb. 11, 2012; P. Lattman, “Private Equity Industry Attracts S.E.C. Scrutiny,” *N.Y. Times*, Feb. 12, 2012. Although these informal inquiry letters were broad in their scope (as is often the case in such inquiries), the SEC staff is understood to have requested production of documents concerning the valuation of private equity fund assets, the manner in which those valuations are reported, and details of agreements between the private equity fund and third-party valuation service providers. Such requests suggest a concern among regulators about the manner in which the funds that comprise the \$1.2 trillion private equity industry value their investments and present performance data to current and prospective investors. In light of the SEC’s focus on private equity valuation, as well as a number of private civil litigations directed to the issue, it is worth considering the standards governing the valuation of private equity assets and recent developments in the law on those valuations.

Valuation of any portfolio asset—private equity or otherwise—begins with the concept of fair value. Statement of Financial Accounting Standards (SFAS) 157 (now known as Accounting Standards Codification (ASC) 820) defined and established a framework for measuring fair value under United States Generally Accepted Accounting Principles, or GAAP. “Fair value” is defined as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” SFAS 157, ¶ 5 (also known as ASC 820 in the updated Financial Accounting Standards Board codification). In the context of highly liquid, publicly traded securities (such as equities trading on a national securities exchange), fair value is relatively easy to calculate: It is typically the current trading price of the security, multiplied by the size of the portfolio position. However, in the context of private equity investments, calculation of fair value is far more complex. Without a liquid market to determine a prevailing market valuation, private equity fund managers must exercise discretion in determining a valuation methodology that will properly reflect the fair value of their investment. Such methodologies include reliance on valuation implied by the company’s most recent financing round, analysis of comparable companies, discounted cash flow analysis, and valuation predicated on the company’s net asset value. The private equity fund manager’s job is further complicated by the fact that no one of these methodologies may be sufficient to calculate a portfolio position’s fair value. As has frequently been recognized, the “more illiquid the investment, the greater the need exists to use multiple valuation techniques to arrive at fair value.” Rothstein Kass, *Fair Value Measurements and Disclosures: Best Practices for Implementation and Compliance for the Alternative Investment Industry—2010 Update*.

Critically, however, courts have recognized that the private equity fund manager's proper and reasonable exercise of discretion in determining fair value may protect the fund and its managers from private claims challenging the valuation of private equity assets. In a notable July 2011 decision, the United States District Court for the Southern District of New York addressed this issue in the context of the wide-ranging litigation related to the collapse of Lehman Brothers. *In re Lehman Bros. Secs. & ERISA Lit.*, 799 F. Supp. 2d 258, 311 (S.D.N.Y. 2011). In *Lehman Brothers*, pension funds and other investors claimed that Lehman's offering materials for various Lehman debt and equity securities contained material misstatements and omissions. Specifically, the plaintiffs alleged that Lehman's offering materials were false and misleading because they represented that Lehman's "private equity investments are measured at fair value" and that the offering materials expressly noted that Lehman had adopted SFAS 157 for determining "fair value." The plaintiffs alleged Lehman's valuation model made unreasonable assumptions and failed to consider certain market information in determining the fair value of Lehman's investment. Among other things, Lehman allegedly assumed a rental growth rate 1.9 to 3.5 percent higher than that projected by third parties and real estate investment trust (REIT) net operating income growth rates that were higher than the historical average. Lehman also allegedly failed to consider capitalization rates of other publicly traded REITs and used models that assumed real estate collateral would appreciate even as real estate prices were declining. Accordingly, the plaintiffs alleged, the valuation of the assets generated by Lehman's model did not truly reflect their "fair value," rendering Lehman's offering materials false and misleading. *Id.* at 311–12.

The court granted Lehman's motion to dismiss these claims, recognizing that

allegations that Lehman's valuation models were based on assumptions or inputs different than those used by third parties . . . or those plaintiffs would have used, is not sufficient to state a claim that Lehman's valuation methods did not comply with SFAS's fair value requirements or that the valuation statements based on those models otherwise were misleading.

Id. at 312.

The court emphasized that SFAS 157 expressly contemplated that different models, based on different assumptions, could be used to determine fair value; therefore, Lehman's "decision to use certain inputs and assumptions rather than others [was] consistent with SFAS 157." *Id.* Moreover, the court recognized the central roles that discretion and judgment play in the valuation of private equity investments, holding that "Lehman's determination that certain models, assumptions, and inputs were likely to provide accurate estimations of fair value was a matter of judgment." *Id.* The court noted that the values assigned by Lehman were "not statements of objective fact but instead reflect Lehman's judgment or opinion" and would thus be actionable only if the plaintiffs had alleged that Lehman did not truly believe those valuations at the time they were issued. *Id.* at 313.

While the *Lehman Brothers* court protected good-faith efforts to provide fair valuations of private equity assets, fund managers who make unreasonable assumptions in the face of clear

contrary indications of fair value still risk significant exposure to regulators and private litigants. In one notable example, in October 2011, Oppenheimer Holdings Inc. received requests from the SEC and the Attorney General of Massachusetts for information concerning the valuation of a portfolio holding in one of its private equity funds. D. McLaughlin & C. Stein, “U.S. Attorney Probing Oppenheimer Holdings on Fund Valuation,” *Bloomberg News* (Mar. 13, 2012). Subsequently, in February 2012, the U.S. Attorney’s Office for the District of Massachusetts notified Oppenheimer that it is investigating the same matter.

Oppenheimer Holdings Inc.’s 2011 10-K disclosed that it has been responding to information requests from the SEC and the Attorney General of Massachusetts since October 2011 related to “an alleged overvaluation in the fall of 2009 of a single portfolio holding in the Oppenheimer Global Resource Private Equity Fund L.P.,” as well as certain marketing practices associated with the fund during that same period. It further disclosed that the notice received from the U.S. Attorney’s Office for Massachusetts in February 2012 disclosed that the office intended to seek information from Oppenheimer regarding the same matters.

According to press reports, these regulatory investigations concern valuations employed by Oppenheimer’s Global Reserve Private Equity Fund I (OGR Fund). The OGR Fund invested in Cartesian Investors A LP, itself a closed-end fund holding a single asset: an investment in a publicly traded Romanian entity named S.C. Fondul Propriestatea SA. G. Zuckerman, “Private-Equity Fund in Valuation Inquiry,” *Wall St. J.*, Feb. 24, 2012. In documents shared with investors at the end of the second quarter of 2009, Oppenheimer valued its Cartesian investment assuming a value of 33 cents per share for S.C. Fondul. *Id.* However, on that same date, S.C. Fondul was publicly trading at just 7 cents per share on the Romanian stock exchange, and Cartesian Capital itself placed a value of only about 20 cents per share on S.C. Fondul. *Id.* In a move that drew scrutiny from regulators, Oppenheimer valued the investment at \$9.3 million—approximately \$7.3 million more than the public trading price for the underlying security itself. *Id.*

As is frequently the case, private litigants have filed suit on the heels of these regulatory inquiries. In March 2012, a securities class action suit was brought against various Oppenheimer entities and individuals, including the OGR Fund, in connection with the fund’s valuation of Cartesian Capital and the underlying S.C. Fondul asset. *See Brockton Ret. Bd. v. Oppenheimer Global Res. Private Equity Fund I, L.P., Oppenheimer Asset Mgmt., Inc., Oppenheimer Alt. Inv. Mgmt., LLC, Oppenheimer & Co. Inc., Brian Williamson & Patrick Kane*, Case No. 1:12-cv-10552-RWZ (D. Mass. Mar. 26, 2012). The complaint asserts that the OGR Fund’s private placement memorandum contained materially misleading statements concerning the purported value of the fund’s holdings, the profitability and performance of the fund, and the policies and procedures used by the fund in conducting due diligence into the performance and valuation of its assets.

Tracking the regulatory inquiries, the complaint alleges the OGR Fund achieved its stated internal rate of return of 38.3 percent only by improperly valuing its investment in S.C. Fondul at 33 cents per share, a sharp departure from the 7 cents per share price then prevailing on the

Romanian stock exchange. The plaintiffs point to the text of SFAS 157, which notes that, in most contexts, “quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.” Oppenheimer’s valuation of the fund asset at a multiple of that trading price is, according to the complaint, an improper application of SFAS 157’s fair value standard. Unlike the plaintiffs in *Lehman Brothers*, the *Oppenheimer* plaintiffs appear able to identify a generally accepted and accurate market methodology (public stock price) by which their assets could have been valued but for Oppenheimer’s alleged refusal to utilize it.

It is not yet clear how the SEC’s broad-based inquiry into private equity valuations will affect fund managers’ current valuation practices. One possible consequence of the current SEC investigation of the industry may be to require greater disclosure by the funds of the methodologies, assumptions, and models used to value their holdings. Although this increased transparency would be welcomed by investors (many of which are pension funds and other entities with reporting requirements of their own), it could also generate increased private litigation directed to private equity funds and fund managers. As investors become equipped with more information concerning various valuation methodologies, they can better detect if and when a fund deviates from its stated valuation methodologies and assumptions, as alleged in *Oppenheimer*. But, for the fund manager, increased regulatory scrutiny and the threat of private litigation will almost certainly force a reconsideration of valuation methodologies and assumptions. Managers may well be wise to invest the time and resources necessary to examine these issues now, before forced to do so by regulators or in the context of potentially devastating private securities litigation.

Keywords: litigation, commercial, business, private equity valuations, securities, regulations

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Fiduciary Duties in the Alternative Entity Context

By Srinivas M. Raju and Jillian G. Remming – August 16, 2012

Delaware limited partnerships (LPs) and limited liability companies (LLCs), sometimes referred to collectively as alternative entities, are not the same as corporations, although there are many similarities. Just as in corporations, fiduciary duties apply by default to those who manage Delaware LPs and LLCs. Both the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act (DRULPA), however, reflect a strong policy favoring broad freedom of contract in connection with almost all aspects of the formation, operation, and termination of Delaware LPs and LLCs, including relationships among the partners or members. Consistent with the policy favoring freedom of contract, a limited partnership agreement or a limited liability company agreement can modify and even eliminate such fiduciary duties, subject to the implied contractual covenant of good faith and fair dealing. To the extent that these fiduciary duties are modified by contract, Delaware courts will enforce the terms of the limited partnership agreement or limited liability company agreement. This can lead to results that are far different from cases decided in the corporate context.

DRULPA and the LLC Act Permit the Modification of Fiduciary Duties

DRULPA section 17-1101(d), in pertinent part, provides as follows:

To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner . . . the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

The LLC Act contains virtually identical language at section 18-1101(c). The decisions of the Delaware courts, in applying this language, demonstrate that only when the terms of the LP or LLC agreement clearly, expressly, and unambiguously conflict with the applications of traditional fiduciary principles will the default fiduciary duties be deemed to have been effectively modified. Furthermore, these decisions recognize that the implied contractual covenant cannot be eliminated.

The Implied Contractual Covenant of Good Faith and Fair Dealing

The implied contractual covenant of good faith and fair dealing is a common-law concept that antedated its usage in DRULPA and the LLC Act. By not defining the term in DRULPA or the LLC Act, the Delaware legislature is assumed to have adopted the common-law concept. *Gerber v. Enter. Prods. Holdings, LLC*, 2012 WL 34442, at *13 n.58 (Del. Ch. Jan. 6, 2012). Delaware courts have described the implied covenant as a gap filler. *Id.* at *12; *Nemec v. Shrader*, 991 A.2d 1120, 1127 (Del. 2010). Although the existing contract terms control, if the parties have not contracted for a particular circumstance, a court may use the implied covenant to determine “what the parties likely would have done if they had considered the issue involved.” *Cincinnati SMSA Ltd. P’ship v. Cincinnati Bell Cellular Sys. Co.*, 708 A.2d 989, 992 (Del. 1998) (citation

omitted). The implied covenant thereby serves as a method of protecting the reasonable expectations of the parties. *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 443 (Del. 1996). However, the implied covenant cannot be used to override express provisions of a contract. *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872, 888 (Del. Ch. 2009).

Default Fiduciary Duties Are Owed by Those Who Manage

Whereas Delaware corporations are managed by boards of directors, Delaware LPs and LLCs can be managed by individual partners or members or they can be managed by corporations, LPs, or LLCs, which in turn can have boards of directors (or managers) that manage the underlying LP or LLC. Thus, although it is easy to discern who owes fiduciary duties in the corporate context (the members of the board of directors) and to whom (the corporation and its stockholders), it was not always clear in the alternative entity context. In *In re USACafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991), the court recognized that institutions necessarily act through people, and it held that the directors of a corporate general partner of a Delaware LP owed fiduciary duties to the partnership and its limited partners. Thus, in Delaware, it has been the rule for over two decades that directors of a corporate general partner owe fiduciary duties to the underlying LP or LLC and its limited partners or members.

The courts have tethered this fiduciary duty concept to those who exercise control over the partnership's property, even if not directors. See *Brinckerhoff v. Enbridge Energy Co.*, 2011 WL 4599654, at *7 (Del. Ch. Sept. 30, 2011) (“[T]his Court has been careful to tether duties to control.”); *Wallace ex rel. Cencom Cable Income Partners II, Inc. v. Wood*, 752 A.2d 1175, 1178 (Del. Ch. 1999) (“Officers, affiliates and parents of a general partner, may owe fiduciary duties to limited partners if those entities control the partnership's property.”).

Modifying Fiduciary Duties in the Context of Conflicts of Interest

The modification of fiduciary duties in the alternative entity context can lead to far different results than in the corporate context particularly with respect to conflict of interest transactions. For example, in *Brickell Partners v. Wise*, 794 A.2d 1 (Del. Ch. 2001), the plaintiff, who was a unit holder in a limited partnership, challenged an acquisition transaction between the LP and an affiliate of the corporate general partner, alleging that it was unfair to the unit holders and that the directors of the corporate general partner who approved the transaction had conflicts of interest. The defendants argued that the limited partnership agreement modified the traditional default fiduciary duties that would otherwise apply to the acquisition in the absence of such modification. The LP agreement provided that conflicts of interest could be resolved if the general partner sought “Special Approval” of the course of action. With such “Special Approval,” the course of action in respect of the conflict of interest would be “permitted and deemed approved by all Partners” and would “not constitute a breach [of the LP agreement] . . . or of any duty stated or implied by law or equity” because such course of action was “conclusively deemed fair and reasonable” to the partnership under the LP agreement.

The court agreed with the defendants that this plain and unambiguous language displaced traditional fiduciary duty principles. The court noted that under the LP agreement, “Special Approval” meant “approval by a majority of the members of the Conflicts and Audit Committee

of the Partnership.” Since such special approval was obtained for the transaction, the defendants’ conduct was insulated from challenge and the complaint dismissed. If unmodified, the fiduciary duty of loyalty would have required that the defendants demonstrate that the acquisition was entirely fair.

A later case clarified that “Special Approval,” standing alone, does not necessarily insulate a transaction from challenge. *See Brinckerhoff v. Tex. E. Prods. Pipeline Co.*, 986 A.2d 370, 390 (Del. Ch. 2010) (noting that special approval does not automatically mean judgment for the defendants). Rather, such approval must have been given in compliance with the implied covenant. Furthermore, a distinguishing feature in *Brickell* was that the Conflicts and Audit Committee had the right under the partnership agreement to make the special approval determination in its “sole discretion.”

All Fiduciary Duties Are Subject to Modification

Brickell shows how the common-law fiduciary duty of loyalty could be modified by a limited partnership agreement. In *Lonergan v. EPE Holdings LLC*, 5 A.3d 1008 (Del. Ch. 2010), the court found that an LP agreement eliminated all fiduciary duties, including the duty of disclosure. (We note that *Lonergan* was decided in the context of a motion to expedite the proceedings on the plaintiff’s application for a preliminary injunction. Thus, the applicable standard was whether the plaintiff had pled a colorable claim and demonstrated a sufficient possibility of irreparable harm.)

In the corporate setting, the duty to disclose is a fiduciary duty derived “from the duties of care and loyalty.” *Pfeffer v. Redstone*, 965 A.2d 676, 684 (Del. 2009). The duty to disclose all material information reasonably available arises when seeking stockholder action; a related duty to not speak falsely arises whenever directors choose to communicate with stockholders. *Lonergan*, 5 A.3d at 1023. A general partner owes fiduciary duties, if not modified by contract, that include a duty of disclosure, as do directors of a corporation. *Sussex Life Care Assocs. v. Strickler*, 1988 WL 156833, at *4 (Del. Ch. June 13, 1989).

In *Lonergan*, the plaintiff, a unit holder of Enterprise GP Holdings, L.P., challenged a merger between that LP and another LP controlled by it. The court found that two provisions of the LP agreement, when read together, eliminated all fiduciary duties. The court concluded that the only duties owed by the general partner to the LP were (1) contractual standards set forth in the LP agreement and (2) the implied covenant. Given that the LP agreement had eliminated all fiduciary duties, there could be no duty to disclose other than any contractual disclosure standards set forth in the LP agreement. In that regard, the LP agreement required only that the limited partners be given notice of the meeting at which the vote on the merger was to be held and a copy of a summary of the merger agreement enclosed with the notice. The defendants complied with these minimal notice requirements. The court noted that it could not infer any common-law obligation to disclose all material information—which is what would have been required in the corporate context—from the implied covenant. Thus, the *Lonergan* decision is significant in at least two respects: (1) it shows that the implied covenant will not be used to

override the clear language of an LP agreement, and (2) it shows that LP agreements can eliminate all fiduciary duties, including the duty of disclosure.

The Implied Covenant Can Fill Gaps in the Agreement

Another interesting case that analyzes the interplay between modification of default fiduciary duties and the implied covenant is *Gerber v. Enterprise Products Holdings, LLC*, 2012 WL 34442 (Del. Ch. Jan. 6, 2012). In *Gerber*, the plaintiff, a unit holder of Enterprise GP Holdings, L.P., challenged the sale of a subsidiary of that LP to an affiliate and a subsequent merger of the partnership into the same affiliate one year later. Both transactions were put to a committee of independent directors of the general partner, which, in turn, hired a financial advisor to render an opinion as to whether the transactions were fair from a financial point of view to the partnership and its unit holders. Following the financial advisor's determination that the transactions were fair from a financial point of view, the committee approved the transactions. Subsequently, the general partner also approved the transactions.

The limited partnership agreement contained a provision modifying fiduciary duties similar to the one in *Brickell*, and the court similarly enforced the provision. Thus, because a committee of independent directors of the general partner approved the transactions, the transactions had received "Special Approval" under the partnership agreement. The court dismissed the plaintiff's breach of fiduciary duty claims, because the defendants met the standard as modified by the limited partnership agreement. In addition to confirming that partnerships could modify fiduciary duties by contract, the court in *Gerber* made three other important holdings.

First, the court held that the implied covenant applies only to parties to an agreement. Accordingly, the corporate general partner was the only defendant that could have breached the implied covenant, because it was the only defendant that was a signatory to the limited partnership agreement. Thus, *Gerber* confirms that even though directors of a corporate general partner may owe fiduciary duties to the LP and its partners, such directors cannot be liable for breaching the implied covenant if they are not themselves parties to the partnership agreement.

Second, the court enforced a provision in the partnership agreement providing that a conclusive presumption of good faith attaches to the general partner when relying on an expert opinion. Because the general partner relied on fairness opinions from the financial advisor to the committee, the conclusive presumption applied. In *Brinckerhoff v. Enbridge Energy Co.*, 2011 WL 4599654 (Del. Ch. Sept. 30, 2011), the limited partnership agreement had a provision similar to the one in *Gerber*, providing that a conclusive presumption of good faith attached to the general partner when relying on an expert opinion. The court noted that under the express terms of the partnership agreement, this presumption applied only to the general partner, not the director defendants. Nevertheless, the court noted that "[i]t may nevertheless be the case that if a limited partnership agreement expressly permits a corporate general partner to take certain action, that the board of that general partner cannot be found to have acted in bad faith for causing the general partner to take the expressly permitted action." *Id.* at *9. Thus, to what extent the conclusive presumption extends to directors of the general partner remains to be seen.

By contrast, in the corporate context, a director has a fiduciary duty to act in good faith (a subset of the duty of loyalty) and may be found to have violated this duty if he or she “intentionally acts with a purpose other than that of advancing the best interests of the corporation,” “acts with the intent to violate applicable positive law,” or “intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his [or her] duties.” *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006). In *Gerber*, the standard set forth in the partnership agreement supplanted the common-law fiduciary duty to act in good faith such that no further inquiry was required if the standard in the agreement had been met.

Third, given that the general partner conclusively acted in good faith pursuant to the partnership agreement by relying on an expert opinion, the court held that the general partner could not have breached the implied covenant. Because the express terms of the limited partnership agreement already fully addressed good-faith concepts, the implied covenant could not be used to fill in any non-existent gaps.

At first glance, this holding would appear to contradict the express preservation of the implied covenant in DRULPA and the LLC Act. Anticipating this apparent contradiction, the court noted that this was not a situation in which it was enforcing a provision that said the implied covenant is not part of the agreement, as such a provision would clearly be unenforceable under DRULPA and the LLC Act. *See Gerber*, 2012 WL 34442, at *13 n.58. Rather, this was simply a contract that had no gaps, as there was a provision providing a conclusive presumption that the general partner acted in good faith by relying on an expert opinion.

LLC Act Can Limit Standing for Creditors to Bring Derivative Claims

In the corporate context, creditors may have standing to bring derivative claims on behalf of an insolvent corporation against the directors of the corporation for breach of fiduciary duties. Until relatively recently, a few Delaware decisions had implied, and many commentators and practitioners had assumed, that creditors of an insolvent LLC or LP may sue derivatively. However, in *CML V, LLC v. Bax*, 6 A.3d 238 (Del. Ch. 2010), *aff'd*, 28 A.3d 1037 (Del. 2011) the court ruled that section 18-1002 of the LLC Act limits standing to bring a derivative claim to holders of LLC interests and their assignees and does not grant standing to creditors to assert derivative claims. Given that section 17-1001 of DRULPA has similar language, it is assumed that the same result would apply in the LP context. In reaching its conclusion, the court further explained that “[b]ecause the conceptual underpinnings of the corporation law and Delaware’s [alternative entity] law are different, courts should be wary of uncritically importing requirements from the [corporation law] into the [alternative entity] context.” *Bax*, 6 A.3d at 249–50 (citation omitted).

Conclusion

Although the same default fiduciary duties apply to Delaware LPs and LLCs as apply to Delaware corporations, there are fundamental differences that can lead to vastly different results. DRULPA and the LLC Act are based on contractual freedom, which includes the freedom to modify or even eliminate default fiduciary duties. Delaware courts will enforce contractual modification of fiduciary duties in LP and LLC agreements. Indeed, as the cases discussed in this

article demonstrate, all fiduciary duties may be contractually modified such that compliance with the contractual standard set forth in the relevant LP or LLC agreement is sufficient and no further compliance with default fiduciary duties is required. We expect that as the Delaware courts encounter more disputes involving Delaware LPs and LLCs, we will continue to see decisions enforcing contractual modification of fiduciary duties. Also, we expect that such decisions will continue to recognize the applicability of the implied covenant, which cannot be eliminated.

Keywords: litigation, commercial, business, fiduciary duties, alternative entity, Delaware, limited partnerships, limited liability companies, Delaware Revised Uniform Limited Partnership Act

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Forum Alternatives for Purchase Price Adjustment Disputes

By Jeffrey S. Torosian and Kimberly M. DeShano – August 16, 2012

Purchase and sale agreements for operating businesses, as well as merger agreements, commonly include procedures for adjusting the purchase price based on changes in the working capital of the target business from the time the contract is executed to the closing date. Even when this procedure is detailed, conflicting means of resolving the disputes over the purchase price adjustment can arise. This is particularly true when the purchase price dispute centers on issues that involve Generally Accepted Accounting Principles (GAAP) and that also implicate the agreement's indemnification provisions for GAAP-related representations. As a result, the parties' agreement may contain competing provisions for how to resolve these disputes and in what forum. Whether drafting or litigating these provisions, attorneys need to be aware of how courts may resolve these conflicts.

A Typical Purchase Price Adjustment Provision

Although each acquisition agreement is unique, many contain common elements for a post-closing purchase price adjustment process. In this process, the parties establish some type of reference figure for working capital—either a target figure is agreed upon in the acquisition agreement or a balance sheet is prepared during the due diligence period, usually by the seller (the reference balance sheet). Then a balance sheet is prepared as of the closing date, typically by the purchaser (the final balance sheet). The two balance sheets are compared and—assuming there is no dispute—the purchase price is adjusted up or down based on the difference, according to the terms of the parties' agreement. The agreement will typically require that both the reference balance sheet and the final balance sheet be prepared in accordance with GAAP or consistently with the seller's historical accounting practices, or both.

The parties will frequently disagree on the final balance sheet and must then follow the procedures set forth in their agreement to resolve this dispute. Typically, these procedures will require the party receiving the final balance sheet to object to the calculation and the opposing party to then respond to each objection. If those disputes cannot be resolved, the agreement will often provide for the submission of the remaining disputes to an agreed-upon accountant (an accountant arbitrator), who will then issue a final and binding determination of the final balance sheet and the resulting adjustment to the purchase price.

This process can be relatively straightforward, but often the agreements will also contain a separate dispute resolution procedure for indemnification claims relating to the breach of a representation or warranty. These dispute resolution procedures may require indemnification claims to be heard by a specific court or by a legal arbitration association separate from the accountant arbitrator.

Conflicts arise when disputes can be characterized as purchase price adjustments or indemnification claims or both. For instance, common in these agreements is the seller's representation that the company's financials were prepared in accordance with GAAP. Suing on

that claim under an indemnification provision, rather than claiming a change in the working capital (for the difference between a non-GAAP-compliant reference balance sheet versus a GAAP-compliant final balance sheet) under the purchase price adjustment provision, may have significant ramifications. That is because the indemnification provision usually has a minimum damages floor and a maximum damages cap limiting the buyer's possible recovery. Accordingly, buyers may try to characterize the indemnification dispute as a working capital dispute to avoid limitations to their recovery of damages.

Few courts have wrestled with the issue of whether a dispute constitutes a purchase price adjustment dispute or an indemnification claim, and the ones that have dealt with it have approached the issue differently. However, all of the courts have placed a special focus on the language of the acquisition agreement as a whole.

The Courts' Tools of Interpretation

Courts routinely state that they favor arbitration as a matter of statute and public policy. Although courts interpret arbitration provisions like any other contract provision, that is, according to the parties' intent, they construe the parties' intentions regarding arbitrability generously. Nonetheless, courts generally give effect to every provision in an agreement in a way that reconciles them in the context of the agreement as a whole. This concept is especially critical where questions over GAAP compliance are raised with respect to preparation of the reference balance sheet or the final balance sheet, because compliance with GAAP may have implications under the indemnification provision as well.

Disputes Deemed to Be Outside the Purchase Price Adjustment Process

At first blush, it would appear that any disputes over the preparation of the reference or final balance sheet will always be subject to dispute resolution under the purchase price adjustment provision. Typically, the parties agreed to submit such disputes to the accountant arbitrator because it is expected to be a private, quick way to resolve any disagreement over the parties' calculations. But when issues arise over how the balance sheets are prepared, specifically whether they are GAAP-compliant or consistent with the company's past accounting practices, some courts have found that determination to be beyond the scope of a purchase price adjustment arbitration process and subject to the agreement's separate indemnification provisions.

For instance, in *OSI Systems, Inc. v. Instrumentarium Corp.*, the seller of a medical services business prepared a final balance sheet that, upon being compared with the reference balance sheet, would have lowered the purchase price by \$7 million. 892 A.2d 1086, 1088 (Del. Ch. 2006). The acquisition agreement permitted the buyer to prepare its own version of the final balance sheet, which resulted in a purchase price reduction of \$24 million, over half of the entire purchase price. The buyer claimed that the seller did not apply GAAP in preparing either the reference balance sheet or its version of the final balance sheet. Although the agreement provided for disputes regarding the final balance sheet to be submitted to an independent accounting firm for final resolution, the seller refused, claiming that the alleged failure to comply with GAAP constituted instead a breach of the GAAP representation, which would make the claim subject to separate legal arbitration and limited to 25 percent of the purchase price. The

Delaware Chancery Court agreed, concerned that the buyer was trying to make an end run around the damages limitation cap for indemnification claims by “funneling” them into the purchase price adjustment process. As a result, the court found that the dispute was subject to legal arbitration under the indemnification provision and not subject to the purchase price adjustment process. Specifically, the court found that the purchase price adjustment process required the accountant arbitrator to apply the accounting principles used in the reference balance sheet to the final balance sheet, meaning that the buyer could not ask the accountant arbitrator to apply inconsistent principles even if those inconsistent principles were GAAP-compliant.

Similarly, in *In re Westmoreland*, the purchaser objected to the seller’s final balance sheet, claiming a purchase price adjustment of over \$74 million (50 percent of the purchase price) because it did not comply with GAAP. 100 N.Y.2d 352, 356 (N.Y. Ct. App. 2003). The parties’ acquisition agreement also contained a separate representation that the financial statements complied with GAAP and an indemnification provision with a damages cap of \$1.75 million. The seller refused to submit to arbitration, as required for purchase price adjustment disputes, and insisted that the issue be litigated as a breach of representation under the indemnification provision. The New York Court of Appeals agreed that any question regarding GAAP compliance should be litigated as a breach of representation. It noted that the purchaser had the opportunity during due diligence to review the accounting methodologies used by the seller and could not now use an independent accountant in a streamlined alternative dispute resolution proceeding to object to “the transaction’s underlying accounting fundamentals.”

Other courts that have refused to allow the purchase price adjustment process to apply to issues of GAAP compliance have focused on the placement of the seller’s GAAP representation in the acquisition agreement’s separate representation and warranties provision. *See E*Trade Fin. Corp. v. Deutsche Bank AG*, No. 09-3029-Civ., 2010 WL 1196814, at *1 (2d Cir. 2010) (noting that indemnification provision provided for sole and exclusive remedy for breaches of representation); *Holt Co. of Ohio v. Ohio Mach. Co.*, No. 05AP-1280, 2007 WL 1674023, at * 11 (Ohio Ct. App. 10th Dist. June 12, 2007) (focusing on placement of GAAP representation as separate from purchase price adjustment provision).

Disputes Kept Within the Purchase Price Adjustment Process

Courts that have found the opposite—that disputes over GAAP compliance of the reference and final balance sheets should be resolved under the purchase price adjustment provision—have also focused on the interpretation of the acquisition agreement as a whole. For example, in *Advanstar Communications, Inc. v. Beckley-Cardy, Inc.*, the court noted that the provision requiring the final balance sheet to comply with GAAP was found within the same provision that required any purchase price adjustment disputes to be arbitrated by an independent auditor. 1994 WL 176981, at *2 (S.D.N.Y. May 6, 1994). This placement made it clear to the court that the parties “intended to have an independent auditor determine whether or not the party departed from . . . past accounting policies and procedures.”

In two other cases, courts found that the language of the acquisition agreement was even more explicit. In *Matria Healthcare, Inc. v. Coral SR, LLC*, the agreement included both a purchase price adjustment process that required submission to an accountant arbitrator and a separate arbitration provision for other claims (including claims for breaches of representations and warranties). No. 2531-10, 2007 WL 763303, at *2 (Del. Ch. Mar. 1, 2007). Any recovery for representation claims were limited to the parties' \$20 million escrow fund and specifically excluded any matters that could pertain to the purchase price adjustment. The Delaware Chancery Court found that this exclusion required that the parties' dispute over the accounting treatment of a settlement with the seller's customer be resolved by the accountant arbitrator pursuant to the purchase price adjustment provision, even if it could also be considered a breach of representation.

The indemnification provision in *Violin Entertainment Acquisition Co. v. Virgin Enterprise Holdings, Inc.*, similarly excluded issues related to the final balance sheet. 871 N.Y.S.2d 613, 613 (N.Y. App. Div. 2009). The New York appellate court in that case held that this language required the purchaser's claim that the final balance sheet was not GAAP compliant to be submitted to the accountant arbitrator, rather than have it resolved as an indemnification claim.

In yet another case, a federal district court noted that the seller had repeatedly indicated to the buyer during the purchase price adjustment process that it believed the dispute should be submitted to the accountant arbitrator. *Gestetner Holdings, PLC v. Nashua Corp.*, 784 F. Supp. 78, 83 (S.D.N.Y. 1992). That conduct, combined with the court's finding that "where claims may be understood to raise an arbitral issue, arbitration must be compelled, even if the claims can be characterized another way," required resolution of the issue by the accountant arbitrator.

Conclusion

In short, courts are initially inclined to order arbitration or other alternative dispute resolution of purchase price adjustments where the parties clearly agreed to it in their contract. But courts will look to the overall intent of the acquisition agreement as well as to the parties' post-closing conduct to assess the scope of that process. Courts may be concerned when it appears that the parties clearly intended a limited and narrow purchase price adjustment process but then raise broader issues. Courts are likewise suspicious of attempts to obtain significant discounts through this process when caps are provided elsewhere in the agreement. Finally, courts may be reluctant to permit major adjustments to be imposed by a limited non-judicial arbitrator. Transactional attorneys would be wise to consult with litigation counsel both when negotiating purchase price adjustment provisions and when engaged in the initial exchange of dispute notices to ensure that disputes are resolved through the intended process and forum.

Keywords: litigation, commercial, business, forum alternatives, purchase price adjustment

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NEWS & DEVELOPMENTS

First Circuit Applies PSLRA's Heightened Pleading Standards

Stressing the importance of pleading particular facts to support an allegation of scienter, the First Circuit affirmed the Rule 12(b)(6) dismissal of a securities-fraud class action against Textron Inc. and several senior officers in [Automotive Industries Pension Trust Fund v. Textron Inc.](#) [PDF], 682 F.3d 34 (1st Cir. June 7, 2012). The class-action complaint targeted public statements made by Textron, before and in the early days of the financial crisis, about the strength and depth of the order backlog at its Cessna Aircraft subsidiary, which Textron represented would help carry it through difficult economic times. In early 2009, Textron reported substantial cuts to Cessna production levels, decreased orders, and numerous cancellations and delivery deferrals in the fourth quarter of 2008. The company's share price declined, and this action was commenced, the plaintiff alleging that Textron had, over the course of 18 months, fraudulently misstated the strength of the Cessna backlog.

Keywords: litigation, commercial, business, Private Securities Litigation Reform Act, First Circuit, class actions

—Paula Bagger, partner, *Cooke Clancy & Gruenthal LLP*, Boston, Massachusetts

Federal Circuit Flips on Willful Infringement Determination

In [Bard Peripheral Vascular, Inc. v. W.L. Gore & Assocs., Inc.](#) [PDF], 682 F.3d 1003 (Fed. Cir. June 14, 2012), the Federal Circuit vacated a portion of its earlier decision in the case and established a new and different approach to the determination of willful patent infringement. In its earlier decision, 670 F.3d 1171, the court articulated that the ultimate determination of willful patent infringement, as set out in *In re Seagate Technology, LLC*, 497 F.3d 1360 (Fed. Cir. 2007), is a matter of fact. However, on reconsideration, the Federal Circuit has now announced that at least the threshold objective prong of the *Seagate* willfulness standard is a question of law based on underlying mixed questions of law and fact subject to de novo review.

Keywords: litigation, commercial, business, Federal Circuit, willful infringement, intellectual property

—Andrew Crain, partner, *Thomas, Kayden, Horstemeyer & Risley, LLP*

Christensen Brothers Win Appeal Against USA Network

In [Forest Park Pictures v. Universal Television Network, Inc.](#) [PDF], 683 F.3d 424, No. 11-2011-cv (2d Cir. June 26, 2012), the Second Circuit held that a state-law claim for breach of a

contract that included the promise to pay for the use of copyrighted work is not preempted by the Copyright Act.

Keywords: litigation, commercial, business, Second Circuit, Copyright Act, breach of contract

—*Christopher F. Girard, Robinson & Cole, LLP, Hartford, Connecticut*

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