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*Report by the
Committee on International Commercial Disputes*

**Purchase Price Adjustment Clauses And Expert Determinations:
Legal Issues, Practical Problems And Suggested Improvements**

June 2013

Table of Contents

	<u>Page</u>
Introduction.....	1
I. The Basic Mechanics Of A Purchase Price Adjustment Clause.....	8
II. The Legal Characterization Of Purchase Price Adjustment Clauses: Arbitration Or Expert Determination?	9
A. Expert Determinations And Arbitration Are Two Well-Recognized And Distinct Methods Of Non-Judicial Dispute Resolution	10
B. Article 76 Of The New York Civil Practice Law And Rules Was Specifically Enacted To Provide For Judicial Enforcement Of Expert Determinations As Separate And Distinct From Arbitration.....	16
C. The Standard Of Review Applied To Expert Determinations	20
III. Court Decisions Determining Whether A Proceeding Is An Arbitration Or An Expert Determination.....	23
A. Cases Finding The Agreement Is For An Expert Determination, Not An Arbitration.....	25
B. The Failure To Recognize The Existence Of Expert Determinations Can Lead Courts To Stretch The Definition Of Arbitration Virtually Beyond Recognition	27
C. The Lack Of Awareness Of The Law Of Expert Determination Has Led Some Courts To Create A Special Form Of Limited Arbitration.	31
IV. Court Decisions Addressing Whether Purchase Price Adjustment Clauses Are Expert Determinations Or Arbitrations.....	38
A. New York Courts Regularly Enforce Purchase Price Adjustment Clauses Under New York CPLR § 7601	38
B. The Designation Of An Accounting Firm As The Decision Maker Has Led Some Courts To Transform Even What The Court Labels As An Arbitration Into A Proceeding That Closely Resembles An Expert Determination	41
C. Failure To Recognize The Existence Of Expert Determination As An Alternative To Arbitration Can Lead to Results Which Are Contrary To The Intent Of The Parties.....	46
D. Recommendations Of The Committee.....	52
V. Two Procedural Problems Currently Found In Purchase Price Adjustment Clauses	54

Table of Contents

	<u>Page</u>
A. Disputes Regarding The Right Of Access To “Books and Records” In Purchase Price Adjustment Clauses	54
B. Recommendations Of The Committee As To The Access To Books And Records Problem.....	59
C. The Presence Of A General Arbitration Clause In A Contract With A Purchase Price Adjustment Clause Raises Issues That The Parties Should Address	60
Conclusion	62
Appendix A.....	64
Appendix B.....	66
Appendix C.....	70

Purchase Price Adjustment Clauses And Expert Determinations: Legal Issues, Practical Problems And Suggested Improvements

Report by the Committee on International Commercial Disputes
of the Association of the Bar of the City of New York*

Introduction

Purchase agreements governing the sale of private companies in both cross-border and domestic transactions often include a provision allowing for a post-closing adjustment of the purchase price, commonly referred to as the “Purchase Price Adjustment Clause.” Parties include such clauses because there can be a substantial period of time between the signing of the purchase agreement and the closing of the transaction.¹ During this time, the value of the company may change. The purpose of a purchase price adjustment provision is to provide for an adjustment in the purchase price (up or down) to reflect changes in the value of the company.²

It is standard practice for a Purchase Price Adjustment Clause to contain its own dispute resolution mechanism. The parties usually agree that any dispute concerning the values reported in the financial schedules used by the parties to determine the amount of any price adjustment are to be submitted to an independent accounting firm for a final and binding determination.³ It is this non-judicial dispute resolution mechanism that is the focus of this report.

* The Committee on International Commercial Disputes of the New York City Bar Association wishes to recognize and specially thank Steven H. Reisberg, chair of the subcommittee that prepared this report, for his tremendous contribution to every aspect of the analysis and drafting that went into this report. The Committee also notes that the Honorable John G. Koeltl, a member of the Committee during the period that this report was being drafted, took no part in the drafting or approval of this report.

¹ See generally Leigh Walton & Kevin Krebs, *Purchase Price Adjustments, Earnouts and Other Purchase Price Provisions*, American Bar Association, Section of Business Law, Spring Meeting (2005). There can be a number of reasons for this delay, including time needed for closing conditions to be satisfied, Hart-Scott-Rodino requirements, time needed to obtain regulatory and shareholder approvals or third-party consents.

² Purchase Price Adjustment Clauses most often are based on changes to the company’s net working capital during the pre-closing period, but other financial metrics can be used. See *id.* at 9.

³ In addition to purchase price adjustments calculated at the time of closing, an acquisition agreement can also provide for a portion of the purchase price to be paid in the future dependent on the post-closing financial performance of the company. These clauses are generally referred to as “Earn-Out Clauses.” Like Purchase Price Adjustment Clauses, it is common for Earn-Out Clauses to provide for any dispute to be referred to an independent accounting firm for a final and binding determination. The analysis set forth in this report equally applies to Earn-Out Clauses, and some of the cases cited concern such clauses. See, e.g., *Fit Tech, Inc. v. Bally Total Fitness Holding Corp.*, 374 F.3d 1 (1st Cir. 2004) (post-closing earn-out payment); *Costello v. Patterson Dental Supply, Inc.*, No. 5:06-CV-213, 2007 WL 1041128 (W.D. Mich. Apr. 5, 2007) (post-closing adjustment and earn-out payment); *Viacom Int’l, Inc. v. Winshall*, Civil Action No. 7149-CS, 2012 WL 3249620 (Del. Ch. Aug. 9, 2012) (earn-out payment); *E.S. Originals Inc. v. Totes Isotoner Corp.*, 734 F. Supp. 2d 523 (S.D.N.Y. 2010) (same).

This report takes a close look at this dispute resolution mechanism from a legal and practical point of view, rather than an accounting or financial perspective. The analysis is motivated by the substantial increase in the number of court cases concerning Purchase Price Adjustment Clauses and the fact that many parties, and particularly foreign parties, may not be familiar with the legal issues relating to these clauses. We have used these cases as a lens to identify significant issues in the operation and enforcement of Purchase Price Adjustment Clauses.

Executive Summary

There is significant confusion as to just what a purchase price adjustment proceeding is from a legal point of view. Often, it is assumed that a Purchase Price Adjustment Clause is the same as an arbitration agreement. Under this formulation, the independent accounting firm is the “arbitrator” and the legal rules governing the proceeding are the same as for any arbitration. A review of the case law shows that the assumption that a Purchase Price Adjustment Clause is an arbitration agreement and the proceeding is one governed by the law of arbitration is often made without any detailed analysis. We suggest that a review of the cases reveals that many practitioners assume that a Purchase Price Adjustment Clause must be an arbitration agreement because, if it is not an arbitration agreement, then it is not clear what else it could be.

The law of many countries has long recognized the existence of two very different non-judicial dispute resolution proceedings, each of which leads to a binding result: namely, “arbitration” and “expert determination.”⁴ While each country has its own rules regarding expert determination, what is most important is that “[m]ost jurisdictions concur that arbitration laws do not apply to expert determination proceedings.”⁵

Arbitration, of course, is well known in the United States. However, for reasons that will be explained, that is not the case for the term “expert determination.” In the United States, the term historically used to distinguish what other countries call expert determination from arbitration is “appraisal” or “appraisement.”⁶ The use of the term “appraisal” is

⁴ See JOHN KENDALL, CLIVE FREEDMAN, & JAMES FARRELL, *EXPERT DETERMINATION 2* (4th ed. 2008) (hereinafter “Kendall”) (“Both expert determination and arbitration are private systems of dispute resolution leading to a binding result.”); NIGEL BLACKABY & CONSTANTINE PARTASIDES WITH ALAN REDFERN & MARTIN HUNTER, *REDFERN & HUNTER ON INTERNATIONAL ARBITRATION* § 1.142 (5th ed. 2009) (“there are methods of alternative dispute resolution which produce a binding decision” in addition to arbitration and of “these, probably the best known is that of expert determination.”).

⁵ Klaus Sachs, *The Interaction Between Expert Determination and Arbitration*, in *ARBITRATION OF MERGER AND ACQUISITION DISPUTES*, ASA SPECIAL SERIES NO. 24 235, 239-40 (Gabrielle Kaufmann-Kolher & Alexandra Johnson eds. 2005) (hereinafter “Sachs”). Similarly, the current draft of the Restatement Third of the U.S. Law of International Arbitration excludes expert determinations from its definition of arbitration. See *RESTATEMENT (THIRD) OF U.S. LAW OF INT’L COMM. ARB.* § 1-1 (Tentative Draft No. 2, 2012) (“expert determinations ordinarily fall outside the statutory and treaty regimes addressing arbitration, and accordingly lie outside the scope of the Restatement.”).

⁶ See *In re Penn. Cent. Corp.*, 56 N.Y.2d 120, 126-27 (1982) (“Historically the courts have recognized a basic distinction between appraisal and arbitration.”); 21 RICHARD A. LORD, *WILLISTON ON CONTRACTS* § 57:8 (4th ed. 2012) (“The procedure most often confused with arbitration is appraisal.”).

unfortunate, and most likely simply a holdover from older English case law that did “not generally use the word ‘expert’ to describe the decision-maker” and in which the procedure was “called a ‘valuation’ or an ‘appraisal.’”⁷ Today, however, use of the term expert determination is well-established under English law.⁸

This report will use the term “expert determination” because that term is much more descriptive of the actual process. Indeed, one of the reasons why courts and counsel alike have had difficulty in recognizing that a Purchase Price Adjustment Proceeding is not an arbitration may, at least in part, be one of legal vocabulary.⁹

It has recently been said that courts in the United States “have only seldom been called upon to make the distinction between expert determination and arbitration,” and that a “coherent test to distinguish between expert determination and arbitration has not emerged” under U.S. law.¹⁰ In fact, this same commentator has stated that a “line of jurisprudence at both the federal and state levels has, in fact, assimilated most forms of ADR into ‘arbitration’ for the purpose of being able to enforce the parties’ ADR agreements or the resulting decisions under the Federal Arbitration Act.”¹¹ We suggest that this characterization is not correct but is understandable because the law of expert determination in the United States is found in the common law of appraisal, and this has both hidden and hampered the recognition and development of the law of expert determination.

A purpose of this report is to set forth the jurisprudence governing expert determinations in the United States. A related objective is to propose a coherent test to distinguish expert determination and arbitration and to explain the essential differences between these two alternative forms of private, contractual dispute resolution.¹²

⁷ Kendall, *supra* n.4, at 4.

⁸ *Id.* at 3.

⁹ In the United States, the term appraisal has come to have a more limited connotation, often applied in the context of a unilateral determination of the value, such as a bank’s use of an appraiser to obtain the value of real property in connection with issuing a mortgage or an insurance company’s use of an appraiser to assess the value of a loss. As a result, the term no longer seems either natural or appropriate to apply to an alternative to arbitration as another form of dispute resolution.

¹⁰ Martin Valasek & Frédéric Wilson, *Distinguishing Expert Determination from Arbitration: The Canadian Approach in a Comparative Perspective*, 29 ARB. INT’L 63, 78-79 (2013) (hereinafter “Valasek & Wilson”).

¹¹ *Id.* at 78.

¹² Courts in the U.S. as well as other countries, struggle with how to define and distinguish expert determination from arbitration. *See, e.g.*, Kendall, *supra* n.4, at 274 (“This question” – how to distinguish arbitration from expert determination – “has occupied the courts more than any other issue raised by the whole subject of expert determination. Some of the problems have arisen from lawyers being simply confused.”).

As will be shown, the law of New York is particularly well developed with regard to expert determination. The New York Legislature has long recognized the importance of protecting and enforcing the difference between arbitration and expert determination. New York has enacted specific legislation designed to ensure that the parties' election to have a dispute resolved by expert determination, as opposed to arbitration, is fully recognized and enforced. This legislation is supplemented by extensive case law regarding expert determinations. As a result, New York state courts have easily recognized that purchase price adjustment proceedings are most often intended by the parties to be a form of expert determination and they enforce these provisions in a manner that is in accord with the intent of the parties.¹³

However, many state and federal courts struggle with how to distinguish arbitration from expert determination. One approach used by some courts simply defines arbitration as any agreement to have a dispute submitted to a third party for a binding decision. Other courts seek to determine how closely the chosen procedure resembles "classic" arbitration.¹⁴ But neither of these is satisfactory. One results in the collapse of the distinction between expert determination and arbitration, as both result in a binding determination. The other relies on counting procedural characteristics, which is unreliable because arbitrations and expert determinations can utilize many of the same procedures.

We suggest that a close analysis of the case law reveals that the fundamental difference between an expert determination and arbitration can be found in the type and scope of authority that is being delegated by the parties to the decision maker.¹⁵ In the case of a typical expert determination, the authority granted to the expert is limited to deciding a specific factual dispute concerning a matter within the special expertise of the decision maker, usually concerning an issue of valuation. The decision maker's authority is limited to its mandate to use its specialized knowledge to resolve a specified issue of fact. The parties agree that the expert's determination of the disputed factual issue will be final and binding on them. The parties are not, however, normally granting the expert the authority to make binding decisions on issues of law or legal claims, such as legal liability.

If the proceeding is an arbitration, this means that the parties have intended to delegate to the decision maker authority to decide all legal and factual issues necessary to resolve the matter. The grant of authority to an arbitrator, but not to an expert, is analogous to the powers of a judge in a judicial proceeding. The parties expect the arbitrator to rule on legal claims, legal causes of action and to award a legal remedy, such as damages or injunctive relief. The parties, by agreeing to arbitration, are selecting a form of dispute resolution that by its very definition is understood as granting the decision maker the authority to make binding decisions of both law and fact. Accordingly, and as will be shown by examination of the case law, we propose that the best way for a court to distinguish between expert determinations and arbitrations is to look at the type and scope of authority the parties grant to the decision maker.

¹³ See Section IV.A.

¹⁴ See, generally, *Advanced Bodycare Solutions, LLC v. Thione Int'l, Inc.*, 524 F.3d 1235, 1239 (11th Cir. 2008); *Fit Tech, Inc. v. Bally Total Fitness Holding Corp.*, 375 F.3d 1, 3 (1st Cir. 2004).

¹⁵ See Sections III and IV.C.

In deciding whether to choose either arbitration or expert determination, practitioners should be aware of the significant differences between these two alternative forms of private contractual dispute resolution. The laws governing expert determination and arbitration are materially different in several important ways, involving matters of both substance and procedure.¹⁶ A purpose of this report is to describe and explain those differences. Neither is “better” than the other. Parties can decide upon the method of dispute resolution best suited to what they want to accomplish based on the specific facts and circumstances of the transaction.

First, and most generally, while arbitration can be viewed as a complete alternative to court litigation, that is not the case for expert determination. An arbitration ordinarily encompasses the resolution of the entire legal controversy between the parties, while an expert determination is limited to the resolution of specific disputed issues of fact, most often concerning some form of valuation.

Second, there are very significant differences in procedure. An arbitration includes the due process protections of an adversarial proceeding. Arbitrators are expected to hold a hearing or otherwise provide the parties with a fair opportunity to present their evidence. Most importantly, an arbitrator is required to decide the matter only on the evidence submitted by the parties. An arbitrator may not engage in any independent investigation, hear evidence outside the presence of the parties, or participate in any *ex parte* communications.

In an expert determination, these strict due process requirements do not automatically apply.¹⁷ Experts are allowed to be more inquisitorial than judges and are not required to decide the dispute only on evidence submitted to them by the parties. Experts are expected to act on the basis of their own special knowledge and expertise. The expert, subject to any limitations imposed by the parties in the contract, has inquisitorial powers and can exercise that discretion to gather information from any source that in the expert’s judgment is required to resolve the matter, including by independent investigation and *ex parte* communications. As a result, not all the evidence an expert considers must be presented in the presence of the parties. These more informal procedures also allow for an expert determination to be structured so as to provide a much faster resolution of a specific factual issue than if the same issue were to be resolved by arbitration.

Third, there are substantial differences in the standard of review.¹⁸ Review of an arbitration award is governed by the Federal Arbitration Act (the “FAA”). The grounds to set aside an arbitration award are limited. *See* 9 U.S.C. § 10. Courts will not review an arbitration award on the grounds that the arbitrator may have made an error of law or mistake of fact.

¹⁶ *See, e.g.,* Kendall, *supra* n.4, at 2 (Because “[b]oth expert determinations and arbitration are private systems of dispute resolution leading to a binding result[,] [t]hey are often confused with each other. While the systems have many similarities, there are important differences. This has created a great deal of difficulty”); *Notes: Arbitration or Appraisal?*, 8 SYRACUSE L. REV. 205, 205 (1956-57) (The distinction between them is important, “since the law has developed and attached fundamentally different rules of substance and procedure” between them).

¹⁷ *See* Section II.

¹⁸ *See* Section II.C.

Furthermore, the parties cannot by contract change the standard of review set forth in the FAA.¹⁹ By contrast, this is not the case for expert determinations. Expert determinations are governed by State law, not the FAA. The standard under New York law, as well as the law of many other states, is that such determinations will be binding on the parties in the absence of “fraud, bad faith or palpable mistake.” Moreover, parties can contractually set the standard of review to be applied in reviewing the expert's determination, such as that the expert’s determination shall be final and binding on all parties, except in the case of manifest error.²⁰

Fourth, an arbitration award, after being confirmed by a court, results in the entry of a court judgment. An arbitration award is enforceable within the United States under the FAA and internationally under the U.N. Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the “New York Convention”). Expert determinations are governed solely by state law and do not have the benefit of being enforceable internationally under the New York Convention.²¹ Also, in many cases an expert determination will only resolve an issue of fact, and issues of liability remain to be determined in a plenary action.²²

We then take a close look at how the courts have handled these issues in the context of purchase price adjustment disputes.

New York state courts have regularly confirmed determinations made by independent accounting firms in purchase price adjustment disputes under the statutory authority of New York CPLR § 7601, while at the same time recognizing and explaining why such proceedings are not arbitrations and not governed by arbitration law. *See, e.g., Westmoreland Coal Co. v. Entech, Inc.*, 100 N.Y.2d 352 (2003) (petition pursuant to CPLR § 7601 to compel party to submit purchase price adjustment dispute to the designated independent accounting firm).²³ There are a number of federal cases and state cases, however, where parties and the courts have treated Purchase Price Adjustment Clauses as providing for arbitration because they do not know what other legal framework might apply.²⁴ As a result, the Purchase Price

¹⁹ *See Hall Street Assocs., L.L.C. v. Mattel, Inc.*, 552 U.S. 576, 588-92 (2008).

²⁰ *See* Section II.C.

²¹ *See* WILLIAM W. PARK, *ARBITRATION OF INTERNATIONAL BUSINESS DISPUTES* 767-68 (2d ed. 2012) (an “arbitrator’s award generally will benefit from the network of enforcement provisions created by multinational treaties,” but “an expert’s opinion can only be enforced abroad in a new action under the relevant foreign law”). In *Frydman v. Cosmair, Inc.*, No. 94-3772 (LAP), 1995 WL 404841, at *5 (S.D.N.Y. July 6, 1995), for example, the court held that an agreement by the parties to have the price of the shares being sold determined pursuant to Article 1592 of the French Civil Code was “not an arbitration agreement.” *Id.* at *5. As a result, the court remanded the action to state court because a price appraisal falls outside the New York Convention or Section 9 of the FAA.

²² State law, such as the law of New York, however, recognizes that in some cases the issue resolved by the expert does resolve the entire dispute between the parties, as there are not issues of law that are in dispute to be resolved, and in these cases the expert’s determination can be directly reviewed and confirmed by a court and entered as a judgment. *See* Section II.B.

²³ *See* Section IV.A.

²⁴ *See* text accompanying notes 89 to 95, *infra*.

Adjustment Clause has been sometimes viewed as an arbitration agreement because that is the only manner in which the court or the parties believed that such a clause could be enforced and determinations by the accounting firms given effect.

We will also discuss how applying the law of arbitration to what, more properly should be viewed as an expert determination can lead to results that are inconsistent with the intent of the parties. The parties' intent as to the scope and depth of authority of the decision maker as between an arbitration and an expert determination are fundamentally different. As a result, application of general principles of arbitration law can lead to providing the decision maker with authority that is broader than that intended.²⁵ Some courts, in order to avoid this result, have created a special form of limited arbitration, that in many respects resembles an expert determination, where the arbitrator's authority is strictly limited to deciding only issues of fact.²⁶ A correct and better result can be reached by recognizing and applying the law of expert determination to these cases.

We suggest that Purchase Price Adjustment Clauses are more properly characterized as a form of expert determination, not arbitration. While the parties can certainly provide otherwise and expressly state that any such disputes shall be resolved by arbitration, that does not seem to be the typical intent. In fact, a number of Purchase Price Adjustment Clauses expressly state that the independent accounting firm shall "act as experts, and not as arbitrators."²⁷

The designation of an accounting firm as the decision maker, together with a mandate restricted to resolving specific factual issues concerning the post-closing financial schedules, further supports this view. What the parties generally intend is for the accounting firm to have the limited authority of an expert in an expert determination, not the broad authority of an arbitrator. The procedures commonly followed also support this conclusion. Purchase price adjustment proceedings do not follow the adversarial model of arbitration, where the decision maker is required to decide legal claims based only on the factual information presented at an adversarial hearing. Instead, the accounting firm is expected to use its own special knowledge and expertise. It is also common for the accounting firm to conduct its own investigation to some degree, such as by sending the parties requests for information. It is also standard practice for the accountants assigned to resolve the dispute to consult, outside the presence of the parties, with other professionals within the firm who may have particular expertise relevant to issues in dispute.²⁸

²⁵ See Section IV.C. Indeed, the lack of recognition of the law of expert determination has led some courts to stretch the definition of arbitration beyond any reasonable understanding of the term. See Section III.B.

²⁶ See Sections III.C and IV.B.

²⁷ See Section IV. This same formulation is often present in decisions from the U.K. See, e.g., *Hillsbridge Invs. Ltd. v. Moresfield Ltd.*, [2000] 2 B.C.L.C. 241, 2000 WL 664552 ("The Independent Accountants shall act as experts and not as arbitrators.").

²⁸ The ability to call upon these "internal experts" is typically disclosed in the engagement letter between the parties and the accounting firm.

We recommend that practitioners, when drafting Purchase Price Adjustment Clauses, expressly state whether the parties intend expert determination rather than arbitration. If the parties agree, the clause should state that the accounting firm is to “act as an expert and not as an arbitrator” in resolving the dispute.²⁹ At present, most Purchase Price Adjustment Clauses do not expressly address whether the proceeding is intended to be an expert determination. It is suggested that one reason for this is the failure of U.S. law to recognize the evolution of the law of appraisal into the law of expert determination, as has been done under English law. As result, many practitioners do not know of this alternative form of binding dispute resolution and of the appropriate vocabulary to distinguish it from arbitration.

Finally, we discuss two practical procedural problems that arise in the operation of the purchase price adjustment process. The first, which has been the source of substantial litigation, concerns the provision commonly found in Purchase Price Adjustment Clauses granting a party the right to have access to the books, records and personnel of the party that has prepared the post-closing financial statements upon which the proposed purchase price adjustment is to be based. Access to this financial information is often necessary in order for the other party to be able to understand the post-closing statements and prepare any objections. At present, the only recourse by a party is to file a lawsuit in court. The result is substantial expense and delay.

This report sets forth specific recommendations as to how Purchase Price Adjustment Clauses can be modified in order to allow a party to seek the early intervention of the independent accounting firm in order to resolve such disputes, instead of the courts. The accounting firm’s expertise makes it particularly qualified to determine if the requested financial information is needed and to evaluate if it has been provided. The accounting firm also is a superior forum for deciding if a party has been prejudiced by the failure to have been provided timely access to such information and whether it should be allowed an opportunity to amend its notice of objection or other affected documents.

The report also addresses the procedural issues that arise where the acquisition agreement contains both a Purchase Price Adjustment Clause and a general arbitration clause. One issue concerns the application of each clause to specific claims. Another important procedural issue is the relative hierarchy between these two clauses and the courts. In other words, are these two dispute resolution proceedings separate and independent of the other? To illustrate, if a party wants to enforce (or seek to challenge and set aside) the accounting firm’s determination, can it do so by applying directly to the courts or must it initiate a proceeding under the contract’s general arbitration clause? Because there is little case law addressing this issue, it is recommended that the parties in their contract make clear the role, if any, that the arbitrators are intended to play with respect to any purchase price adjustment determination.

I. The Basic Mechanics Of A Purchase Price Adjustment Clause

The basic mechanics of a Purchase Price Adjustment Clause for our purposes can be summarized as a set of procedures that allows the purchase price to be adjusted (up or down)

²⁹ See Section IV.D and Appendix B.

based on a comparison of a specific financial metric at two points in time: (i) at around the time the Purchase Agreement was signed; and (ii) calculated as of the closing date.³⁰ For example, a common type of purchase price adjustment is one in which the purchase price is adjusted based on changes to the company's working capital. In this case, a preliminary or estimated working capital statement (the "Estimated Working Capital Statement") is prepared based on the financial information available at the time of the negotiation of the purchase price and the signing of the PSA. This value is sometimes referred to as the "Reference Financial Statement." At a point in time shortly after the closing a second working capital statement (the "Final Working Capital Statement") is prepared, using the same accounting procedures, but based on the financial condition of the company as of the closing date. Any difference in value of the working capital becomes the purchase price adjustment.

To illustrate, a Purchase Price Adjustment Clause based on changes in working capital could operate as follows. The seller would provide the buyer with a schedule showing the amount of working capital (the "Initial Working Capital"), calculated based on the financial statement of the company at or around the date of the signing of the Purchase Agreement. There will then be a period of time, sometimes a substantial period of time, during which the company remains in the control of the sellers prior to the closing. At the closing, control will pass to the buyer. The Purchase Price Adjustment Clause then requires that, within 30 to 60 days after the closing, the buyer is to prepare a new version of the same schedule showing the amount of working capital (the "Closing Working Capital"), prepared based on the financial condition of the company as of the Closing Date. In our example, the Initial Working Capital will be compared to the Final Working Capital, and the purchase price will be adjusted to take into account any increase or decrease in the amount of working capital.

The focus in this report is that every Purchase Price Adjustment Clause also contains its own dispute resolution mechanism. The Purchase Price Adjustment Clause will normally provide that after the buyer delivers its calculation of the Closing Working Capital to the seller after the closing of the transaction, the seller will have a period of time (*e.g.*, 30 days) to provide written notice to the buyer of any objections that the seller has to the buyer's calculation of the Closing Working Capital. There is then a period of time for negotiation between the parties to see if they can resolve the objections. If agreement cannot be reached, then the clause provides that any unresolved objections shall be submitted to an independent accounting firm for a final and binding decision on the remaining objections.

II. The Legal Characterization Of Purchase Price Adjustment Clauses: Arbitration Or Expert Determination?

Any legal analysis of a Purchase Price Adjustment Clause must begin with the threshold question concerning its correct legal characterization. At present, there is significant confusion as to just "what" a Purchase Price adjustment proceeding is from a legal point of view. Often it is simply assumed that the Purchase Price Adjustment Clause must be an arbitration clause. But this assumption is often made without any detailed analysis and is sometimes

³⁰ A sample Purchase Price Adjustment Clause, which has been materially edited for purposes of this article, is set forth in Appendix A. We have presented this example for purposes of illustration. There can be many variations on this simple model.

reached because it is not clear what else such a clause could be and still be enforceable. Is a purchase price adjustment proceeding before an independent accounting firm an arbitration? And if it is not an arbitration, then what is it?

A. Expert Determinations And Arbitration Are Two Well-Recognized And Distinct Methods Of Non-Judicial Dispute Resolution

The law of many countries has long recognized the existence of two distinct contractual dispute resolution alternatives to court litigation, namely: (i) arbitration and (ii) expert determination.³¹ Expert determination is recognized under the laws of countries such as England, Canada, Australia, and New Zealand,³² and under different names under the laws of Belgium, Germany, Hong Kong, Italy, France, and The Netherlands, among others.³³ While each country has its own rules regarding expert determinations, what is important is that “[m]ost jurisdictions concur that arbitration laws do not apply to expert determination proceedings.”³⁴ This is the same position taken in the current draft of the Restatement Third of the U.S. Law of International Arbitration, which distinguishes and excludes expert determinations from its definition of arbitration.³⁵

In England, for example, expert determinations, as distinct from arbitration, have “been a feature of English commercial and legal practice for at least 250 years.”³⁶ English law recognizes that an “expert determination is a very different alternative form of dispute resolution” and as to which “the Arbitration Act 1996” does not apply.³⁷ Expert determinations

³¹ See Kendall, *supra* n.4, at 2 (“Both expert determination and arbitration are private systems of dispute resolution leading to a binding result.”); NIGEL BLACKABY & CONSTANTINE PARTASIDES WITH ALAN REDFERN & MARTIN, REDFERN AND HUNTER ON INTERNATIONAL ARBITRATION § 1.142 (5th ed. 2009) (“there are methods of alternative dispute resolution which produce a binding decision” in addition to arbitration and of “these, probably the best known is that of expert determination.”).

³² See Valasek & Wilson, *supra* n.10, at 78-79.

³³ See Sachs, *supra* n.5, at 240; Kendall, *supra* n.4, at 309 (Analogous systems to expert determination “are being used around the world for important commercial applications.”) (includes brief survey of cases from Africa, the Americas, Asia and Europe).

³⁴ Sachs, *supra* n.5, at 239 & n.10; TREVOR COOK & ALEJANDRO I. GARCIA, INTERNATIONAL INTELLECTUAL PROPERTY ARBITRATION 3 (2010) (“Although [expert determinations] produces determinations that are, like arbitration awards, binding it is recognized by most jurisdictions as something that differs from arbitration, although in practice the distinction between the two sometimes can be hard to draw and the basis for drawing it may differ as between jurisdictions.”).

³⁵ RESTATEMENT (THIRD) OF U.S. LAW OF INT’L COMM. ARB. § 1-1 (Tentative Draft No. 2, 2012) (“The Restatement also distinguishes arbitration from ‘expert determination’ as that method is commonly practiced. . . . Such expert determination ordinarily fall outside the statutory and treaty regimes addressing arbitration, and accordingly lie outside the scope of the Restatement.”).

³⁶ Kendall, *supra* n.4, at 6.

³⁷ See *Barclays Bank plc v. Nylon Capital LLP*, [2011] EWCA (Civ) 826, No. A3/2010/1413 [23], [2012] Bus. L.R. 542 (Eng.); see generally Kendall, *supra* n.4, at 211-27.

are more informal, in that there is “no procedural code for expert determination, in contrast to arbitration.”³⁸ Also, because expert determination clauses generally presuppose that the parties intended only specific disputes to be resolved by the expert, there is “no presumption in favor of giving a wide and generous interpretation to the jurisdiction” being conferred to the expert, as there would be under an arbitration clause.³⁹ An expert has been held not to have final authority to determine its own jurisdiction, that being an issue of contract interpretation that is “ultimately for the court to determine.”⁴⁰ Similarly, unlike arbitration, there is no general principle regarding the extent to which the expert can decide the meaning of terms in a contract.⁴¹ Under English law, purchase price adjustment disputes are classified as a form of expert determination, not arbitration.⁴²

In the United States, the term historically used to distinguish an expert determination from an arbitration is “appraisal” or “appraisement.” *See, e.g., In re Penn Cent. Corp.*, 56 N.Y.2d 120, 126-27 (1982) (“Historically, the courts have recognized a basic distinction between appraisal and arbitration.”); *Portland Gen. Elec. Co. v. U.S. Bank Trust N.A.*, 218 F.3d 1085, 1089 (9th Cir. 2000) (“Arbitration and appraisal are distinct methods of dispute resolution”); *Questrom v. Federated Dep’t Stores, Inc.*, 41 F. Supp. 2d 294, 300-01 (S.D.N.Y. 1999) (“Such procedures-which commonly are referred to as appraisals or, especially in older sources, appraisements” are distinct from arbitrations). The use of the term “appraisal” is simply a holdover from older English case law which called the procedure “a ‘valuation’ or an ‘appraisement.’”⁴³ Today, as noted above, use of the term expert determination is well established under English law.⁴⁴ This report will use the term expert determination because such term is much more descriptive of what the process actually has become. Indeed, it is suggested that courts and practitioners adopt the term expert determination, in place of appraisal, as has been done under English law.

³⁸ *Barclays Bank plc*, [2011] EWCA (Civ) 826 [37].

³⁹ *Id.* [28].

⁴⁰ *Id.* [21]; Kendall, *supra* n.4, at 164, 170.

⁴¹ *See* Kendall, *supra* n.4, at 171-75; *see, e.g., Barclays Bank plc*, [2011] EWCA (Civ) 826 [70] (“it must be questionable whether the parties would have intended an accountant, surveyor or other professional with no legal qualification to determine a point of law”) (Lord Neuberger of Abbotsbury); *Homespace Ltd. v. Sita South East Ltd.*, [2007] EWHC 629 (Ch), No. HC-06-CO-1139 [56] (Eng.) (“[i]n my opinion the parties cannot be taken as having intended to refer [the interpretation of these contract terms] to Mr. Hill, who is not a lawyer.”).

⁴² Kendall, *supra* n.4, at 42-44.

⁴³ Kendall, *supra* n.4, at 4.

⁴⁴ *Id.* at 3.

There are clear and important distinctions between arbitration and appraisal under U.S. law.⁴⁵ There is a very substantial body of law in this area but which, as noted above, has most often been labeled appraisal.

The Supreme Court's decision in *City of Omaha v. Omaha Water Co.*, 218 U.S. 180 (1910), remains an often cited case as to the fundamental differences between appraisal and arbitration. *City of Omaha* was an action for specific performance of an option to purchase a waterworks plant. *Id.* at 191. The plant had been constructed pursuant to legislative authority which provided that the "city of Omaha shall have the right at any time after the expiration of twenty years to purchase said waterworks at an appraised valuation." The purchase price, in the absence of agreement by the parties, was to be determined by a panel "of three engineers, one to be selected by the city council, one by the waterworks company and these two to select the third." *Id.* Based on this description, many today would assume that this is an agreement to have the price determined by arbitration, and that the proceeding would be governed by arbitration law. Such an assumption would be incorrect.

In this case, a majority of the panel of engineers fixed the value of the system at \$6,263,000. The City refused to accept this valuation and filed suit seeking to set aside the valuation on the ground of misconduct by the appraisers. The primary argument by the City was that "the appraisers heard evidence in the absence of the city" and "that this was such misconduct as to vitiate the valuation." *Id.* at 193-94. While the "great bulk of the evidence was heard and submitted in the presence of counsel," the panel had also "called upon the company for their books" and "had these books gone over by an expert auditor of their own selection." *Id.* at 197. The City took issue with the fact that "[w]hat information was derived from the[se] books [was] not shown." *Id.*

The Court stated that if this was an "arbitration," then the independent review of the company's books by an auditor who reported only to the panel would indeed be "such misconduct as would vitiate the award." *Id.* at 198. But the Court determined that the proceeding called for in the contract was an appraisal, not an arbitration. The Court went on to explain that this difference was dispositive:

[I]n an appraisal, such as that here involved, the strict rules relating to arbitration and award do not apply, and the appraisers were not rigidly required to confine themselves either to matters within their own knowledge or those submitted to them formally in the presence of the parties; [and could] if they saw fit . . . inform

⁴⁵ See, e.g., *Budget Rent-A-Car of Wash.-Or., Inc. v. Todd Inv. Co.*, 603 P.2d 1199, 1201 (Or. Ct. App. 1979) ("At common law, agreements for arbitration and those for appraisal were distinct entities subject to differing treatment."); *Collision v. Deisem*, 265 A.2d 57, 59 (Del. Ch. 1970) ("But this case does not involve arbitration and it is worth pointing out that such a proceeding differs fundamentally from appraisal."); *Comins v. Sharkansky*, 644 N.E.2d 646, 648 (Mass. Ct. App. 1995) ("There is a clearly recognized distinction between the arbitration of a controversy and a contract one term of which calls for the ascertainment by designated persons of values, quantities, losses or similar facts.") (internal quotation and citation omitted); *Notes: Arbitration or Appraisal?*, 8 SYRACUSE L. REV. 205, 205 (1956-57) (The distinction between them is important, "since the law has developed and attached fundamentally different rules of substance and procedure" to them.).

themselves from any other source, as experts who were at last to act upon their own judgment.

Id. Further distinguishing this proceeding from an arbitration, the Court noted that the panel was “made up of such engineers selected because they [are] experts,” and thus it was expected that “these engineers were to examine and estimate the value and acquaint themselves with the condition and extent of the property in question in their own way and not according to the procedure required in a judicial proceeding.” *Id.* at 196.

Appraisals, which we suggest are much more appropriately referred to as “expert determinations,” can easily be found in a wide range of commercial agreements in the United States.⁴⁶ These include agreements that provide for a third party to make a final and binding decision determining, for example, (i) the rental payment required upon exercise of an option to renew a lease or upon the periodic adjustment of rent under a long-term lease,⁴⁷ (ii) the purchase price to be paid upon exercise of an option to purchase land or personal property,⁴⁸ or under an option to purchase shares in a private company,⁴⁹ (iii) the purchase price for the sale of a business,⁵⁰ (iv) the amount due to an executive as special compensation under an employment agreement,⁵¹ (v) the amount of loss under an insurance policy,⁵² and (vi) the value, quality or quantity of goods or commodities being sold.⁵³

⁴⁶ See, e.g., John R. Casolaro, *A Primer on Appraisal to Resolve Valuation Disputes-Part I*, 65 N.Y. ST. B.J. 10, 10 (1993) (hereinafter “Casolaro”) (“Appraisal can be used to determine renewal rent under commercial leases, purchase price under an option, rent escalation for electricity under commercial leases, and for many other purposes.”); Andrew L. Pickens, *Appraisal: An Old but Effective Form of ADR for Contract Liabilities*, 60 TEX. B.J. 18, 23 (1997) (“Appraisal continues to be an effective means of resolving differences as to the amount or extent of liability on a contract,” where “the issue of liability itself is not in dispute.”).

⁴⁷ See, e.g., *Marceron v. Chevy Chaser Services, Inc.*, 258 F.2d 155 (D.C. Cir. 1958) (adjustment of rent by appraisal upon renewal under lease); *Rice v. Ritz Assocs., Inc.*, 450 N.Y.S.2d 7 (1st Dep’t 1982) *aff’d*, 58 N.Y.2d 923 (1983) (rent adjustment under lease); *Georg Jensen, Inc. v. 130 Prince Assocs., LLC*, 890 N.Y.S.2d 369 (Table), No. 102554/09, 2009 WL 2022228 (N.Y. Sup. Ct. June 4, 2009) (rent upon exercise of renewal option).

⁴⁸ See, e.g., *Tonkery v. Martina*, 78 N.Y.2d 893 (1991) (purchase price upon exercise of three year option to purchase real property to be fixed by three appraisers); *Portland Gen. Elec. Co.*, 218 F.3d at 1087 (option to purchase two turbine units at fair market value end of lease term to be determined by a “qualified equipment appraiser”).

⁴⁹ See, e.g., *Trio Asbestos Removal Corp. v. Marinelli*, 37 A.D.3d 475 (2d Dep’t 2007) (stockholders agreement providing that valuation of shares to be sold be determined by the company’s accounting firm); *AFC-Low Income Hous. Credit Partners v. POZ Village Dev., Inc.*, No. B237721, 2012 WL 3792549 (Cal. Ct. App. Aug. 31, 2012) (right under partnership agreement to buy-out remaining general partners at “fair market value”); *Comins v. Sharkansky*, 644 N.E.2d 646 (Mass App. Ct. 1995) (value of shares).

⁵⁰ See, e.g., *Skinner v. Davidson, Inc.*, 351 P.2d 872 (Colo. 1960) (sale of an automobile dealership); *Budget Rent-A-Car*, 603 P.2d at 1199 (sale of car rental agency).

⁵¹ See, e.g., *Questrom*, 41 F. Supp. 2d at 300-01 (CEO’s incentive compensation under employment agreement fixed as a percentage of increase in the company’s value from 1990 to 1995 as determined by an independent investment banking firm).

Because expert determinations and arbitrations are both private contractual forms of alternative dispute resolution intended to lead to a result that is final and binding on the parties, the two proceedings have been described as “close cousins.”⁵⁴ Courts and commentators, however, have often struggled to articulate and apply the distinction between them.⁵⁵ But, as *City of Omaha* illustrates, there are important differences between these proceedings and such differences can be dispositive.⁵⁶

We suggest that a close analysis of the case law reveals that the best way to determine if a contractual provision for a binding determination by a third party is intended to be an arbitration or an expert determination is by looking at the type and scope of authority granted by the parties to the decision maker. In the case of a typical expert determination, the authority granted to the expert is limited to deciding a specific factual dispute, normally concerning a matter within the special expertise of the decision maker.⁵⁷ As will be shown, in an expert determination, the scope of authority granted to the decision maker is limited and closely tied to the expert’s specific type of expertise. As a consequence, the parties agree that the expert’s determination of the disputed factual issue will be final and binding on them.⁵⁸ The parties,

⁵² See, e.g., LEE R. RUSS & THOMAS F. SEGALLA, 15 COUCH ON INS. § 209:8 (3d ed. 2012) (“In the insurance context, appraisal is often sought to fix the amount of loss, or replacement cost of real property. The determination of the amount of loss sustained by the insured is, of course, to be distinguished from the insured right, if any, to recover on the policy.”); *Florida Ins. Guar. Ass’n v. Devon Neighborhood Ass’n*, 67 So.3d 187 (Fla. 2011) (appraisal provisions in insurance policy).

⁵³ See, e.g., *Cities Serv. Co. v. Derby & Co.*, 654 F. Supp. 492, 494 (S.D.N.Y. 1982) (quantity and quality of crude oil delivered by tanker determined by an independent inspector); see generally Kendall, *supra* n.4, at 48-70.

⁵⁴ Casolaro, *supra* n.46, at 10 (Appraisal “has always been a close cousin to arbitration.”).

⁵⁵ Kendall, *supra* n.4, at 2 (Because “[b]oth expert determinations and arbitration are private systems of dispute resolution leading to a binding result[,] [t]hey are often confused with each other. While the systems have many similarities, there are important differences. This has created a great deal of difficulty . . .”).

⁵⁶ WILLIAM W. PARK, ARBITRATION OF INTERNATIONAL BUSINESS DISPUTES 767 (2d ed. 2012) (“Notwithstanding Shakespeare’s suggestion that what we call something does not matter, it makes a significant difference whether a contractually designated decision-maker is characterized as an arbitrator, or in the alternative an expert . . .”).

⁵⁷ *Budget Rent-A-Car*, 603 P.2d at 1201 (“Appraisal agreements, then, are typically limited to . . . ascertainment of quality or quantity of items, the ascertainment of loss or damage to property, or the ascertainment of the value of property.”); *Sands v. Union Pac. R.R. Co.*, 148 F. Supp. 422, 424-25 (D. Or. 1956) (“Oregon law divides agreements to arbitrate future disputes into two types: the general arbitration agreement, in which the parties agree to submit to arbitration all disputed questions including the ultimate question of liability; and the limited arbitration agreement (sometimes referred to as an appraisal agreement), in which the parties agree to arbitrate disputes over specific facts, but not the ultimate question of liability.”); *Skinner v. Davidson, Inc.*, 351 P.2d 872, 877 (Colo. 1960) (“they were selected to appraise the value of the goods, not to interpret the written contract”).

⁵⁸ See WILLISTON ON CONTRACTS § 57:8 (“An appraisal may also be used in lieu of judicial proceedings to establish only the amount of loss, and not liability for the loss. Appraisements to determine facts other than liability, such as damages, have been enforced.”); COUCH ON INS. § 209:8 (“In the insurance context,

however, normally have not granted the expert the authority to make binding decisions on general issues of law or legal disputes, such as legal liability.⁵⁹

If the proceeding is an arbitration, this means that the parties have intended to delegate to the decision maker authority to decide all legal and factual issues necessary to resolve the matter. It is for this reason that it is commonly said that an “agreement for arbitration ordinarily encompasses the disposition of the entire controversy between the parties.”⁶⁰ The grant of authority to an arbitrator, but not to an expert, is analogous to that of a judge in a judicial proceeding.⁶¹ By agreeing to arbitration, the parties are selecting a form of dispute resolution that is understood as granting the decision maker the authority to make binding decisions of both law and fact.

The distinction between expert determination and arbitration as being grounded on the type of authority delegated to the decision maker has long been reflected in the case law, as seen in *In re Delmar Box Co.*, 309 N.Y. 60, 63-64 (1955):

A number of basic distinctions have long prevailed between [appraisal and arbitration.] An agreement for arbitration ordinarily encompasses the disposition of the entire controversy between the

appraisal is often sought to fix the amount of loss, or replacement cost of real property. The determination of the amount of loss sustained by the insured is, of course, to be distinguished from the insured’s right, if any, to recover on the policy.”); *Evanston Ins. Co. v. Cogswell Props., LLC*, 683 F.3d 684, 693-94 (6th Cir. 2012) (Appraisal under insurance policy is not arbitration because the legal issue of liability under the insurance policy remains, and so the appraisal “does not provide for a final and binding remedy by a neutral third party.”).

⁵⁹ See WILLISTON ON CONTRACTS § 57:8 (“the final test should be whether or not the parties intended the ‘arbitrators’ to determine ultimate liability or merely facts incident thereto”). This refers to the standard, typical form of expert determination. While in the typical case an expert’s authority is limited to issues of fact, it is possible for the parties to grant the expert specific authority with regard to some legal issue, for example, issues of contract interpretation that fall within the scope of the expert’s expertise. The degree of authority, if any, to an expert to decide issues of law, and whether such decisions are subject to *de novo* court review, is completely fact-specific. See Section II.C.

⁶⁰ *In re Delmar Box Co.*, 309 N.Y. 60, 63 (1955); accord *Taylor v. Farm Bureau Mutual Ins. Co.*, 759 N.W.2d 2 (Table), No. 07-1580, at *4 (Iowa Ct. App. 2008) (“While both proceedings are designed to effect speedy and efficient resolutions in lieu of judicial proceedings, arbitration will generally decide an entire controversy.”); *Minot Town & Country v. Fireman’s Fund Ins. Co.*, 587 N.W.2d 189, 190 (N.D. 1998) (“Generally, arbitration is a quasi-judicial proceeding that ordinarily will decide the entire controversy.”).

⁶¹ Arbitration is when “the parties have substituted for the court a private tribunal with power to render a final judgment on the issues submitted.” Appraisers may act without a hearing “and inform themselves from any source, as experts who [are] . . . to act upon their own judgment.” *Comins*, 644 N.E.2d 646, 648 (Mass. Ct. App. 1995) (alteration in original) (internal quotation and citation omitted) (fair market value of stock to be determined by certified public accountant); *Kirkwood v. Cal. State Auto. Ass’n Inter-Ins. Bureau*, 122 Cal. Rptr. 3d 480, 486 (Cal. Ct. App. 2011) (“Thus, subject to the confines of the arbitration agreement, a private contractual arbitrator normally will have the power to decide any question of contract interpretation, historical fact or general law necessary, in the arbitrator’s understanding of the case, to reach a decision.) (internal quotation and citation omitted).

parties, upon which judgment may be entered after judicial confirmation of the arbitration award . . . while the agreement for appraisal extends merely to the resolution of specific issues of actual cash value and the amount of loss, all other issues being reserved for determination in a plenary action.

Id. at 63 (citations omitted).

The Supreme Court addressed this distinction in *Hamilton v. Liverpool, London & Globe Ins. Co.*, 136 U.S. 242 (1890), in the context of an insurance policy. The insurance contract provided that “any difference arising between [the parties] as to the amount of loss or damage of the property insured shall be submitted, at the request in writing of either party, to the appraisal of competent and impartial persons, to be chosen as therein provided, whose award shall be conclusive as to the amount of such loss or damage only, and shall not determine the question of the liability of the company.” *Id.* at 254. The “appraisal” by contract was “distinctly made a condition precedent to the payment of any loss” as well as to “to the maintenance of any action” (*i.e.*, any lawsuit on the policy). *Id.* at 255.

The Court held that such provisions were fully enforceable under the law of contracts and did not interfere with the court’s authority to rule on the question of liability. As the Court explained, this dispute resolution mechanism was “not ousting the jurisdiction of the courts, but leaving the general question of liability to be judicially determined, and simply providing a reasonable method of estimating and ascertaining the amount of the loss, is unquestionably valid, according to the uniform current of authority in England and in this country.” *Id.* Indeed, what made this provision enforceable was precisely the limitation that the authority of the appraiser was only to determine “the amount of loss.” The parties did not grant the appraiser authority to rule on any issue of law, “leaving the general question of liability to be judicially determined.” *Id.* If the appraiser had also been granted the authority to decide on issues of law necessary to resolve the entire dispute, the law at the time would have found it invalid as it would have sought to oust the court of jurisdiction.⁶²

B. Article 76 Of The New York Civil Practice Law And Rules Was Specifically Enacted To Provide For Judicial Enforcement Of Expert Determinations As Separate And Distinct From Arbitration

The New York Legislature has a long history of seeking to provide statutory authority for the enforcement of expert determinations. A report to the New York Legislature, submitted in support of legislation that led to the enactment of what is today Article 76 of the CPLR, recited the long and broad use of expert determinations, as follows:

Many business agreements contain provisions for determination by a designated third party . . . of valuation, appraisal of loss,

⁶² See *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 510-11 & n.4 (1974) (“English courts traditionally considered irrevocable arbitration agreements as “ousting” the courts of jurisdiction, and refused to enforce such agreements for this reason. This view was adopted by American courts as part of the common law up to the time of the adoption of the Arbitration Act.”).

verification of performance, ascertainment of quantity or quality, fixing of boundary lines, or other specific questions relevant to the transaction. Agreements of this kind were recognized as valid at an early date.⁶³

Indeed, one of the reasons for the enactment of Article 76 was that courts had previously held that such agreements could not be specifically enforced under the statute governing arbitration, because they were not arbitrations. *See In re Delmar Box Co.*, 309 N.Y. at 63-64, 66.⁶⁴ Section 7601 therefore confers broad power on the New York courts to enforce such agreements independent of the law of arbitration. CPLR § 7601 provides, in part:

§ 7601. Special proceeding to enforce agreement that issue or controversy be determined by a person named or to be selected

[1] A special proceeding may be commenced to specifically enforce an agreement that a question of valuation, appraisal or other issue or controversy be determined by a person named or to be selected. [2] The court may enforce such an agreement as if it were an arbitration agreement, in which case the proceeding shall be conducted as if brought under article seventy-five of this chapter. (Bracketed numbers added).

The Court of Appeals explained this grant of power in great detail in *In re Penn Central Corp.*, 56 N.Y.2d 120 (1982). The dispute in *Penn Central* arose following a transaction whereby Consolidated Rail Corporation (“Conrail”) acquired from Penn Central Corp. (“Penn Central”) the surface rights, but not the air rights, to a railroad yard on the West Side of Manhattan. In 1980, the parties agreed to sell the entire property to the Triborough Bridge and Tunnel Authority for approximately \$17 million, but could not agree on the allocation of the proceeds between them. *Id.* at 123-24. As a result, the selling parties agreed to put the proceeds in escrow and to appoint a panel of “three qualified and disinterested appraisers” to determine the proper allocation of the purchase price. *Id.* at 124. The agreement provided “that each side would select an appraiser” and “that the third appraiser would be chosen by the first two.” A “decision by two-thirds of the panel would control.” *Id.* The appraisers issued a report concluding that “a fair and reasonable allocation of the purchase price” was 65% for Penn Central and 35% for Conrail. Conrail, however, refused to consent to the release of the escrowed funds in accord with this allocation. *Id.* at 125.

Penn Central commenced a court proceeding to “have the award confirmed” pursuant to CPLR § 7601 (expert determination) and CPLR § 7510 (the arbitration statute). *Id.*

⁶³ See LAW REVISION COMM’N, RECOMMENDATION TO THE LEGISLATURE RELATING TO ENFORCEMENT OF AGREEMENTS FOR APPRAISAL OR VALUATION AND TO ARBITRATION OF CERTAIN NON-JUSTICIABLE ISSUES, N.Y. Legis. Doc 65(C), at 385 (1957).

⁶⁴ See SENATE FIN. COMM. AND ASSEMBLY WAYS & MEANS COMM., FOURTH PRELIMINARY REPORT OF THE ADVISORY COMMITTEE ON PRACTICE AND PROCEDURE TO THE GOVERNOR AND LEGISLATURE, N.Y. Legis. Doc. 20, at 62 (1960).

The trial court dismissed the action, concluding that because “this *was not* an arbitration but an ‘appraisal only’ . . . the court[] lack[ed] the power to enter judgment upon an appraisal.” *Id.* at 127 (emphasis added).

The Appellate Division reversed, finding that the proceeding before the panel of appraisers *was* an arbitration. As the court explained, “except for the use of the word ‘appraisal,’ this constituted an arbitration agreement.” *Id.* The Appellate Division therefore concluded that it did have the authority to enforce the determination made by the appraisers. (As will be seen, it is often the case that courts will hold that a contract calls for an arbitration because they believe they must do so in order to have the authority to enforce the agreement.)

The Court of Appeals disagreed with both the trial court and the appellate court. The Court of Appeals began its discussion by noting that “[h]istorically the courts have recognized a basic distinction between appraisal and arbitration.” *Id.* at 126. The court explained that:

Although both [appraisal and arbitration] contemplate a nonjudicial and informal resolution of a dispute by a third party, the prevailing practice in appraisal is more informal and “entirely different [from the] procedure governing arbitration” (*Matter of Delmar Box Co.*, 309 N.Y. 60, 70). Unless the parties have waived their rights, arbitrators are required to take an oath, hold hearings on notice to the parties, decide the matter only on the evidence submitted at the hearing and, if more than one arbitrator has been selected, all must attend the hearing. This is not the accepted procedure in appraisals and appraisers are not required to observe these formalities.

Id. at 126-27 (citations omitted).⁶⁵ The Court of Appeals further explained that the “distinction is important” because “an award made in an appraisal proceeding, conducted in the informal manner accepted in such proceedings, should not be subject to challenge for failure to observe the formalities suited only to arbitrators.” *In re Penn Cent. Corp.*, 56 N.Y.2d at 128.⁶⁶

The Court of Appeals first found that the proceeding by the panel was not an arbitration. Therefore, the panel’s decision could not be confirmed as an arbitration award. *In re Penn Cent. Corp.*, 56 N.Y.2d at 128-29. The Court of Appeals then turned to CPLR § 7601.

⁶⁵ See also Casolaro, *supra* n.46, at 10 (Appraisers “do not hold hearings where witnesses are sworn and examination and cross-examination takes place as in court. Appraisers have no power to subpoena witnesses. Appraisers are permitted to proceed with *ex parte* investigations if each party is afforded an opportunity to present its views.”).

⁶⁶ This difference can be vividly illustrated by comparison of Judge Cardozo’s opinion in *Stefano Berizzi Co., Inc. v. Bela Krausz*, 239 N.Y. 315 (1925), with that of the Supreme Court in *City of Omaha v. Omaha Water Co.*, 218 U.S. 180 (1910). In *Stefano Berizzi*, the award was vacated because the arbitrator made an independent investigation as to the quality of the goods. In *City of Omaha*, the award by the appraisers was upheld, even though the panel had relied, in part, on an independent investigation by an expert auditor of its own selection. 218 U.S. at 197.

The Court of Appeals explained that the New York Legislature’s desire in enacting Section 7601 was “to preserve the appraisal format distinct from arbitration.” *Id.* at 129. Section 7601 states that “[a] special proceeding may be commenced to specifically enforce an agreement that a question of valuation, appraisal or other issue or controversy be determined by a person named or to be selected.” As explained by the Court of Appeals, the statute was designed to keep such determinations separate from the law of arbitration.

The Court of Appeals also explicitly rejected the argument that a court can only enforce a decision by a panel of appraisers by converting it into an arbitration. *Id.* Instead, the Court of Appeals held that the legislative history shows “the drafters expressed a need to preserve the appraisal form distinct from arbitration.” *Id.* Legislative reports confirm this point such as in the following about appraisals and arbitration: “the procedures are really different and . . . the greater formality in arbitration ought not to be made compulsory for appraisal and evaluation proceedings.” *Id.* (quoting NY Legis Doc, 1960, No. 20, pp. 61, 64).

As a result, the Court of Appeals held that CPLR § 7601 provides the courts with the power to specifically enforce such agreements – by being able “to choose from a wider range of remedies.” *Id.* “It was contemplated that under this statute, a court would have the option” to:

- (1) order specific performance of the appraisal agreement, a remedy not available in common law;
- (2) direct the parties to proceed to arbitration, the only sanction authorized by the prior statute but now considered a “last resort”; or
- (3) exercise its equitable discretion by adopting some other form of relief appropriate to the particular case, including remedies not specifically identified in the statute.

Id. (internal quotation and citations omitted). Indeed, the option of enforcing such an agreement by ordering that it be converted into an arbitration, and thereby requiring that it proceed in accordance with law governing arbitration, is now considered “a last resort.” *Id.*⁶⁷

The Court of Appeals further held that Section 7601 provides New York courts with the authority to confirm the decision made by the expert and enter it as a court judgment. *Id.* at 130. The Court of Appeals explained that “where valuation represents only part of a dispute or serves as a condition precedent to the exercise of other contractual rights,” there is no

⁶⁷ This is critically important because it makes clear that the first and second sentences of CPLR § 7601 must be read as independent of each other. The first sentence of Section 7601 reads: “A special proceeding may be commenced to specifically enforce an agreement . . . that a question of valuation, appraisal or other issue or controversy be determined by a person named or to be selected.” This sentence itself grants to the court the power to exercise its equitable discretion, including specific performance. The second sentence of Section 7601 reads: “The court may enforce such an agreement as if it were an arbitration agreement, in which case the proceeding shall be conducted as if brought under article seventy-five.” The second sentence preserves what under the prior statute was the only remedy, but which under the new statute is now considered “a last resort.” CPLR § 7601.

need to independently confirm the valuation determination. *Id.* In such cases, there will necessarily be a judicial proceeding in which the factual determination made by the expert or appraiser will form a part.

However, the court went on to recognize that there is a special class of cases where “the valuation determination resolves the entire dispute between the parties, as is generally expected only in arbitrations.” *Id.* at 127. The court held that in cases where “the only dispute between the parties concerns a question of valuation, which they have agreed to submit to a panel of appraisers for a nonjudicial and expeditious determination, there is no reason why the award should not be confirmed in a special proceeding and the matter finally resolved as the parties obviously intended when they made the agreement.” *Id.* at 130. In such cases, where “the appraisal award actually does resolve the parties’ dispute in its entirety,” the court can confirm the appraisal award and enter it as a court judgment. *Id.* at 128. This is exactly what was done in the *Penn Central* case.

In short, under New York law, CPLR § 7601 provides the courts with broad statutory authority to enforce expert determination clauses including, in appropriate cases, judicial confirmation and entry of judgment.⁶⁸

C. The Standard Of Review Applied To Expert Determinations

Another reason it is important for the courts to correctly differentiate between expert determination decisions and arbitration awards is because the two proceedings are subject to very different standards of review. While there are substantial similarities, there are also important differences.

The standard for court review of an expert determination under New York law, as well as the law of many other states,⁶⁹ is that such determinations will be binding on the parties in the absence of “fraud, bad faith or palpable mistake.” *Lear Siegler Aerospace Prods. Holding Corp. v. Smith Indus., Inc.*, No. 88 Civ. 1528 (JMC), 1990 WL 422417, at *5 (S.D.N.Y. Mar. 16, 1990). Courts have articulated this standard for a number of different types of expert determinations. *See, e.g., Ardsley Constr. Co v. Port Auth. of N.Y. & N.J.*, 54 N.Y.2d 876, 877 (1981) (“decision of the engineer is conclusive and final . . . unless it was infected by fraud, bad

⁶⁸ While New York law may be the most well developed in this area, the vast majority of other states similarly enforce expert determinations on their own terms, as a matter of the law of contracts, distinct from arbitration and arbitration law. *See, e.g., Portland Gen. Elec. Co.*, 218 F.3d at 1089 (Oregon law); *Omni Tech Corp v. MPC Solutions Sales, LLC*, 432 F.3d 797 (7th Cir. 2005) (Wisconsin law); *Questrom*, 41 F. Supp. 2d at 302-03 (Ohio law); *Miller v. USAA Cas. Ins. Co.*, 44 P.3d 663, 680 (Utah 2002) (Utah law).

⁶⁹ *See Evanston Ins. Co. v. Cogswell Props., LLC*, 683 F.3d 684, 696 (6th Cir. 2012) (Michigan law) (Judicial review “is limited to instances of bad faith, fraud, misconduct, or manifest mistake”); *Stuckman v. Westfield Ins. Co.*, 968 N.E.2d 1012, 1018 (Ohio Ct. App. 2011) (“Generally, a court should not interfere with an appraisal award absent fraud, mistake or misfeasance.”); *Portland Gen. Elec. Co.*, 218 F.3d at 1090 (“If the appraisal was rendered in accord with the contract, it is final and binding upon the parties, absent a showing of fraud, bad faith or a failure to exercise honest judgment.”) (internal quotation and citation omitted); *Sanitary Farm Dairies, Inc. v. Gammel*, 195 F.2d 106, 106 (8th Cir. 1952) (Minnesota law) (except where it is capable of impeachment “for fraud, or such mistake as would imply bad faith, or a failure to exercise honest judgment.”).

faith or palpable error”); *Liberty Fabrics, Inc. v. Corporate Props. Assocs.*, 5, 636 N.Y.S.2d 781, 781 (1st Dep’t 1996) (an “appraisal determination should be upheld in the absence of fraud, bias or bad faith”); *Painin v. Spier*, No. 601230/2005, 2006 WL 5187003, at 3 (N.Y. Sup. Ct. Mar. 7, 2006) (“appraisal should be upheld in the absence of bias, bad faith or fraud”). This standard has been held to encompass cases where “the third party failed to follow the standards or procedures prescribed in the contract.” *Lear Siegler*, 1990 WL 422417, at *5 (purchase price adjustment case).

The standard to set aside an expert determination is a difficult one to meet, maintaining the general policy that judicial review of such determinations is limited and substantial deference is to be afforded to such decisions. See *Grey v. Fed. Deposit Ins. Corp.*, No. 88 Civ. 7452 (THK), 2002 WL 959564, at *5 (S.D.N.Y. May 8, 2002) (the policy is “to interfere as little as possible”).⁷⁰ Similarly, unless the agreement provides otherwise, appraisers are granted broad authority as to the procedures used in formulating their decision. *Grosz v. Serge Sabarsky, Inc.*, 806 N.Y.S.2d 498 (1st Dep’t 2005).⁷¹

However, the standard of “fraud, bad faith or palpable mistake” allows courts greater discretion in reviewing the merits of an expert determination, when compared to arbitration awards. See *European-Am. Banking Corp. v. Chock Full O’Nuts Corp.*, 442 N.Y.S.2d 715, 718 (1st Dep’t 1981) (acknowledging “this greater degree of judicial control”); see *Evanston Ins. Co. v. Cogswell Props., LLC*, 683 F.3d 684, 695 (6th Cir. 2012) (the “attempt to recast the appraisal provision as an arbitration provision is understandable because the FAA might have afforded a more deferential standard of review to the decision.”); *Morris, Nichols, Arshat & Tunnell v. R-H Int’l, Ltd.*, 1987 WL 33980 (Del. Ch. Dec. 29, 1987) (Berger, V.C.) (“this court is not limited in its review of an appraisal as it would be in the case of arbitration”).

The “fraud, bad faith or palpable mistake” standard allows an expert determination to be invalidated if a court finds that the expert lacks a “reasonable basis . . . for [his] determination.” *Tufano Contracting Corp. v. Port of N.Y. Auth.*, 238 N.Y.S.2d 607, 608-09 (2d Dep’t 1963), *aff’d*, 13 N.Y.2d 848 (1963); *Savin Bros. v. State of N.Y.*, 405 N.Y.S.2d 516, 519 (4th Dep’t 1978) (“if there appears no reasonable basis for the engineer’s action, if it is patently erroneous, then the courts have found the equivalent of bad faith”); *Georg Jensen*, 890 N.Y.S.2d at 369 (finding that the “appraisal itself is so severely flawed that it evidences bias”; appraiser could not even “articulate the methodology he employed in arriving at his appraisal”).

⁷⁰ See *Stuckman v. Westfield Ins. Co.*, 968 N.E.2d 1012, 1018 (Ohio Ct. App. 2011) (“A court’s review of an appraisal is extremely limited.”) (internal quotation and citation omitted); *Smith v. Shelby Ins. Grp.*, Nos. 96-T-5547, 96-T-5566, 1997 WL 799512, at *4 (Ohio Ct. App. Dec. 26, 1997) (A “court will indulge in every reasonable presumption to sustain” an appraisal.)

⁷¹ See *Vitale v. Friedman*, 666 N.Y.S.2d 403, 403 (1st Dep’t 1997) (appraisers “have broad discretion as to their methods and sources of information,” absent contractual restrictions); *Georg Jensen, Inc. v. 130 Prince Assocs., LLC*, 890 N.Y.S.2d 369 (Table), No. 102554/09, 2009 WL 2022228, at *5 (N.Y. Sup. Ct. June 4, 2009) (“In the absence of specific methods or procedures to be utilized, appraisers are given wide latitude in arriving at their determinations.”); see also *AFC-Low Income Hous. Credit Partners v. POZ Village Dev., Inc.*, No. B237721, 2012 WL 3792549, at *3-4 (Cal. Ct. App. Aug. 31, 2012) (“The appraiser’s scope of authority is set by the agreement.” Because “the agreement does not specify what methodology should be used,” it is “up to the appraisers to determine the methodology [to] be utilized.”).

Courts have also set aside an appraisal on the grounds of bad faith or gross error when it can be shown that the independent expert failed to follow customary practice or procedure, or where there is proof that the method used was unreliable. *See, e.g., Cities Serv. Co. v. Derby & Co.*, 654 F. Supp. 492, 500-01 (S.D.N.Y. 1982).

Courts, as is also the case with arbitrations, will take a very close look at whether an expert has followed any specific instructions set forth in the contract. In *Cities Service Co. v. Derby & Co.*, 654 F. Supp. 492 (S.D.N.Y. 1987), the contract specified that the quantity of crude oil delivered was to be determined by an independent inspector. The contract further stated that the independent inspector shall make the determinations as to quantity and quality “in accordance with” the “Petroleum Measurement Tables of the American Society for Testing and Materials” in conjunction with “API Standard 2540,” and “such other standards as the parties hereto may hereafter agree.” *Id.* at 494. The court held that “where a contract sets forth the standards or procedures to be followed by an independent third party to whom the determination of quantity, quality or value is entrusted, the failure of such independent third party to follow the standards of procedures prescribed in the contract will invalidate any certification or determination so made even if the contract makes such certification or determination conclusive and binding.” *Id.* at 501. On the basis of these principles, the court set aside the independent inspector’s determinations for failure to comply with the standards and procedures required by the agreement. Where “the independent inspector does not exercise his powers according to the rules set forth in the contract, ‘his decision is binding on no one.’” *Id.* at 502 (citation omitted).

Expert determinations, however, unlike arbitrations, can generally be reviewed for errors of law. A defining characteristic of an expert determination is that the parties generally have not delegated to the expert the authority to decide issues of law. This means that legal determinations are subject to plenary review. As the Second Circuit explained in *Amerex Group, Inc. v. Lexington Insurance Co.*, 678 F.3d 193 (2d Cir. 2012), which concerned an appraisal under an insurance contract:

Amerex next contends that the district court should not have upheld the appraisal award because the Panel improperly decided questions of law. Amerex correctly identifies the limit to an appraisal panel’s authority under New York law. A basic proposition of insurance law provides that “the scope of coverage provided by an insurance policy is a purely legal issue that cannot be determined by an appraisal, which is limited to factual disputes over the amount of loss for which the insurer is liable.”

Id. at 204 (citations omitted).⁷² *Accord Jefferson Ins. Co. of N.Y. v. Superior Court of Alameda County*, 475 P.2d 880, 883 (Cal. 1970) (“It is certainly not their function to resolve question of coverage and interpret provisions of the policy.”) (internal quotation and citation omitted). “Just as an arbitrator may exceed his authority by granting relief which is beyond the scope of the arbitration agreement, so too an appraiser can exceed his authority by making an award which is

⁷² The appraisal was upheld because Amerex “failed to identify any specific legal issue of contract interpretation” that the panel decided. *Id.* at 206.

not within the limits of the submission to him. The issue turns on the agreement of the parties. Moreover, it is for the court, not the appraiser, to decide the scope of the submission where that question is in dispute.” *AIU Ins. Co. v. Lexes*, 815 A.2d 312, 314 (Del. 2003).

A good illustration of this principle can be found in *Adkins Ltd. P’ship v. O St. Mgmt., LLC*, 56 A.3d 1159 (D.C. 2012), which concerned an appraiser’s valuation of a buy-out right of a partner’s interest in a real estate development company. The Operating Agreement provided that the price to be paid was to be determined by a process in which each party appointed an appraiser to determine the fair market value of the Membership Interest being sold, and in the event the two values differed by more than \$50,000, then the two appraisers would together appoint a third. The Operating Agreement did not specify whether to appraise the properties based on either fee simple interest or their value as encumbered by the existing long-term leases on one of the properties. The trial court ruled on this issue as a matter of contract interpretation, and instructed that the appraisal should be made according to the court’s interpretation. *Adkins* argued on appeal that it was improper for the trial court to have issued any instructions to the appraisers.

The District of Columbia Court of Appeals affirmed, holding that issues of law, such as a contract interpretation, were for the court to determine: “when an appraiser must interpret the meaning of a legal document – a contract between parties – before he may perform his appraisal, that interpretation is subject to judicial review.” *Id.* at 1167. Unlike “the actual appraisal of value, which is accorded deference, an appraiser’s interpretation of his instruction as set forth in a contract is ‘clothed with no presumption of correctness.’” *Id.* (citation omitted). The court went on to clarify that because “[t]he interest that the parties intended the appraiser to value is a question of contract interpretation going to the scope of the appraiser’s authority; it is a question of law that the trial court – and this court on appeal – reviews *de novo*.” *Id.* Accordingly, it held that because “the trial court was interpreting the contract to determine the scope of the appraiser’s authority” it “was not usurping the role of the appraiser.”

III. Court Decisions Determining Whether A Proceeding Is An Arbitration Or An Expert Determination

Courts have used various formulations when seeking to decide if a given proceeding qualifies as an arbitration under either the FAA or other state law arbitration statute. Many courts seek to make this determination by looking at how closely the chosen procedure resembles “classic” arbitration.⁷³ This approach may work well for cases at extreme ends of the “arbitration – expert determination” spectrum. But a test that relies on counting procedural characteristics runs into the problem that arbitrations and expert determinations can utilize many of the same procedures. Not all arbitrations are required to hold an evidentiary hearing where witnesses testify and are cross-examined. To like effect, not all expert determinations are required to allow the decision maker to conduct *ex parte* investigations. An approach based on comparing “secondary characteristics” is not reliable.

⁷³ See generally *Advanced Bodycare Solutions, LLC v. Thione Int’l, Inc.*, 524 F.3d 1235, 1239 (11th Cir. 2008).

What emerges from an analysis of the cases is that the better approach is to focus on what the parties reasonably intended as the type and scope of the authority of the decision maker, which can be done by using well-established rules of contract interpretation.⁷⁴ The focus should be on the authority granted by the parties to the decision maker. Where the parties have selected an expert to decide factual issues within the scope of that decision maker's expertise, the parties have chosen expert determination as the dispute resolution mechanism, not arbitration. In fact, as will be shown, what is remarkable is the critical role that the designation of an expert continues to play even where a court has otherwise assumed or concluded that the proceeding is an arbitration. In many of these cases, the courts have rightly continued to focus on the reasonable intent of the parties with the result that the courts have been led to create a very special type of limited arbitration.⁷⁵ This unique form of limited arbitration very closely resembles an expert determination in many respects.⁷⁶

A very good place to start is Judge Easterbrook's decision in *Omni Tech Corp. v. MPC Solutions Sales, LLC*, 432 F.3d 797 (7th Cir. 2005). The contract in question provided that any disagreements concerning the post-closing net working capital statement would be referred to a designated accounting firm that "shall, acting as experts and not as arbitrators, determine . . . whether and to what extent, if any, the Final Net Working Capital required adjustment." *Id.* at 798 (emphasis added). The contract further stated that "[t]he determination of the Independent Accountant shall be final, conclusive and binding" upon the parties. *Id.* Omni Tech refused to comply, instead filing suit seeking to have the district court resolve the disputes concerning any post-closing purchase price adjustment.

The district court denied defendant's motion to dismiss or stay the lawsuit. The district court explained that the provision could not be an arbitration agreement because the parties had agreed, as clearly stated in the contract, that the accountants were acting "as experts and not as arbitrators." This left the court with a major problem. Because the contractual provision was not an arbitration agreement, the FAA's grant to the district court of authority to stay a lawsuit in favor of an arbitration did not apply. As a result, the district court was at a loss

⁷⁴ We refer to such contract interpretation principles such as that a "court in interpreting disputed contract language asks what reasonable persons in the position of the parties would ordinarily have intended by using the words in question in the circumstances." *FIT Tech*, 374 F.3d at 8. Similarly, that a written contract "will be read as a whole" and "if possible it will be so interpreted as to give effect to its general purpose." See *Westmoreland Coal Co. v. Entech, Inc.*, 100 N.Y.2d 352, 358 (2003); see generally Restatement (Second) of Contracts § 202 (1981).

⁷⁵ See Section IV.B.

⁷⁶ It is suggested that if the U.S. law of appraisal had evolved to be called the law of expert determination, as in England, the name expert determination and its jurisprudence would be much better known. The courts in many of these cases would then have been able to recognize that the proceeding intended by the parties was more likely an expert determination, not an arbitration, and therefore would not have been forced to attempt to create a special class of limited arbitration.

– it did not believe it had any authority to stay the lawsuit and require the parties to submit the dispute to the accounting firm.⁷⁷

The Seventh Circuit reversed. As Judge Easterbrook explained, that the proceeding may not be an arbitration does not mean that the parties’ contractual agreement as to another “form of alternative dispute resolution” can be ignored.

The district court assumed that it may ignore any form of alternative dispute resolution other than “arbitration.” Why would that be so? Many contracts have venue or forum-selection clauses. These do not call for “arbitration” but are routinely enforced, even when they send the dispute for resolution outside the court’s jurisdiction.

Omni Tech Corp., 432 F.3d at 799. Judge Easterbrook noted that under the contract “PricewaterhouseCoopers will act as an expert and not as an arbitrator [This] means that it will resolve the dispute as accountants do – by examining the corporate books and applying normal accounting principles plus any special definition the parties have adopted – rather than by entertaining arguments from lawyers and listening to testimony.” *Id.*

But this did not mean that the “section of the contract committing resolution to an independent private party is hortatory.” *Id.* To the contrary, this provision “must be honored,” noting that supporting authority for this interpretation was found in several “Wisconsin decisions enforcing clauses that look very much like this one (and for good measure call the procedure ‘arbitration’).” *Id.* at 798. Most importantly, Judge Easterbrook explained that “[n]ames are unimportant, however; what matters is that Wisconsin respects the parties’ ability to make agreements of this kind.” *Id.* Therefore, he found it “unnecessary” to decide if this proceeding “should be called an agreement to arbitrate.” *Id.* at 800. What was important to the Seventh Circuit was that the parties’ agreement was enforceable, independent of arbitration law, as a matter of contract law.

A. Cases Finding The Agreement Is For An Expert Determination, Not An Arbitration

Many courts in a wide variety of contexts have found that the dispute resolution method selected by parties is, as a matter of law, an expert determination, not an arbitration.

In *Portland General Electric Co. v. U.S. Bank Trust N.A.*, 218 F.3d 1085 (9th Cir. 2000), for example, the court addressed a provision in an equipment lease which provided for an independent appraiser to determine the fair market value of two turbine generators that the lessee had an option to purchase. The Ninth Circuit noted that “[a]rbitration and appraisal are distinct

⁷⁷ This same problem is found in *Bor Corp. v. ADT Auto. Inc.*, No. 96 Civ. 1019 (JFK), 1996 WL 689364 (S.D.N.Y. Nov. 27, 1996). The district court held that because the provision that E&Y was to make a conclusive and binding determination regarding any purchase price adjustment was not an arbitration agreement, that it could not compel arbitration and therefore any adjustment to the purchase price would need to be decided by the court.

methods of dispute resolution and it cannot be assumed that because the FAA governs the former it necessarily must apply to the latter.” *Id.* at 1089. The court explained that “Oregon courts have distinguished appraisals from arbitrations and have expressly held that appraisal are not governed by Oregon’s arbitration statute.” *Id.* at 1090. The “fundamental difference[] between these two forms of dispute resolution” was that “arbitration agreements permit arbitrators to resolve pending disputes between the parties *and* to determine ultimate liability.” *Id.* (emphasis added). Appraisal agreements, on the other hand, are typically limited to “the ascertainment of quality or quantity or items, the ascertainment of loss or damage to property of the ascertainment of the value of property.” *Id.* Such agreements are fully enforceable under Oregon law as a matter of the law of contracts. *Id.* The court held that the district court erred when it reviewed and confirmed the appraisal under the standards set forth in the FAA, and remanded for reconsideration “under the applicable Oregon contract law.” *Id.* at 1091.

In *Evanston Insurance Co. v. Cogswell Properties, LLC*, 683 F.3d 684 (6th Cir. 2012), the insurance policy provided that in the event the parties disagreed as to the amount of loss, “each party will select a competent and impartial appraiser,” and the “two appointed appraisers will select an umpire.” A “decision agreed to by any two will be binding.” *Id.* at 686. The Sixth Circuit stated that it first needed to set forth the test for determining whether this provision was an arbitration agreement under the FAA. It held that “[u]nder federal law, whether the appraisal provision in this case is ‘arbitration’ under the FAA depends upon how closely it resembles classic arbitration.” *Id.* at 693. The court emphasized that what makes a proceeding an arbitration is that the parties have empowered a third party to render a decision which will result in a *complete* settlement of the dispute – “a final and binding remedy.” *Id.* at 693-94 (emphasis added).⁷⁸

The court then held that under this definition, the “provision [in question] does not constitute arbitration for the purposes of the FAA.” *Evanston Ins. Co. v. Cogswell Props., LLC*, 683 F.3d 684, 696 (6th Cir. 2012). In reaching its conclusion, the court explained that the appraisal was limited to “the determination of the amount of loss and the value of the Building.” *Id.* It did not address issues of liability, reserving the question of whether the insurance company was liable for the loss. In other words, the proceeding would result in a determination that was final and binding as to only one element of the claim, namely the value of the loss. The contract did not give the decision makers authority to rule on legal liability. As a result, the Sixth Circuit concluded that the appraisal provision was not an arbitration agreement under the FAA because it did “not provide for a final and binding remedy by a neutral third party.” *Id.* at 694-95. The court noted that its conclusion was consistent with Michigan state law and the holding of numerous other state courts in recognizing that appraisal in a property insurance policy is not controlled by the FAA “because appraisal differs significantly from arbitration.” *Id.* at 695.

The Fifth Circuit similarly held in *Hartford Lloyd’s Ins. Co. v. Teachworth*, 898 F.2d 1058 (5th Cir. 1990). Under the insurance policy, each party was to select an appraiser, and if the first two appraisers failed to agree as to the value and loss of any item, then they would

⁷⁸ See also *Salt Lake Tribune Pub. Co. v. Mgmt. Planning, Inc.*, 390 F.3d 684 (10th Cir. 2004) (in a case concerning an exercise price under an option to purchase a newspaper, the court held that the proceeding was not an arbitration).

“submit their differences only” to a disinterested third appraiser. *Id.* at 1059. The Fifth Circuit noted that while appraisal and arbitration are both procedures “to submit a dispute to a third party,” there “are significant differences between them.” *Id.* at 1061. One significant difference concerns the type of the authority given to the decision maker. “An arbitration agreement may encompass the entire controversy between the parties or it may be tailored to particular legal or factual disputes. In contrast, an appraisal determines only the amount of loss, without resolving issues such as whether the insured is liable under the policy.” *Id.* at 1061-62. The Sixth Circuit held that “by reviewing the appraisal award under the FAA, the district court applied the wrong standard in assessing the validity of the award.” *Id.* at 1063.

The critical distinguishing characteristic that can be inferred from the cases is that in an arbitration the decision maker is expected to be a substitute judge, with authority to rule on any issues of law and fact necessary to come to a complete, final and binding result. Judges are expected to decide cases based on the evidence presented to them by the parties. To the extent they bring any special expertise to the decision making process it is limited to their expertise in the law. In an expert determination, on the other hand, experts are expected to use their own knowledge and expertise to resolve an issue of disputed fact. The expert is expected to contribute to the mix of information.

As a result, in an arbitration, parties intend for the arbitrators to issue a decision which completely resolves the dispute, including the issue of legal liability. In an expert determination, however, the decision maker’s authority is generally limited to determining questions of fact within such person’s area of special expertise, and the expert is neither expected nor authorized to make final and binding rulings on issues of law. As a result, unless there are no issues of law remaining to be decided, an expert determination cannot determine the ultimate liability of a party.⁷⁹

B. The Failure To Recognize The Existence Of Expert Determinations Can Lead Courts To Stretch The Definition Of Arbitration Virtually Beyond Recognition

The failure to recognize expert determinations as an independent form of alternative dispute resolution, separate and distinct from arbitration, can lead courts to stretch the definition of arbitration beyond any reasonable understanding of that term.

In *Bakoss v. Certain Underwriters at Lloyds of London Issuing Certificate No. 0510135*, 707 F.3d 140 (2d Cir. 2013), the Second Circuit addressed a dispute under a Certificate of Insurance (the “Certificate”) that provided for payments to Bakoss (a medical doctor) in the event he became “Permanently Totally Disabled.” The Certificate provided that each party had the right to have Bakoss examined by a physician of their choice. In the event of disagreement between each party’s physician as to whether the insured was Permanently Totally Disabled, the Certificate stated that the two physicians would jointly “name a third Physician to make a

⁷⁹ As discussed, under New York law, where there are no issues of law remaining to be decided, the courts have the authority to convert the expert determination into a judgment. See *In re Penn. Cent. Corp.*, 56 N.Y.2d at 130.

decision on the matter which shall be final and binding.” *Id.* at 142 (internal quotation and citation omitted).

The insurer (“Lloyds”) removed the action to federal district court, claiming that the third-physician clause was an arbitration agreement, thus providing for federal subject-matter jurisdiction pursuant to 28 U.S.C. 1331 and Chapter 2 of the FAA. *See* 9 U.S.C. §§ 201-08. The characterization of the “third-physician clause” as an arbitration agreement was critical as it was necessary for subject matter jurisdiction in the federal courts. If the third-physician clause was not an arbitration agreement, then the matter would have to be remanded to state court.

The Second Circuit first held that the district court correctly applied federal common law to determine whether the third-party physician clause was an “arbitration agreement” under the FAA. *Bakoss*, 707 F.3d at 143. One can speculate that the Second Circuit saw this case as an opportunity to address what it considered to be the more interesting issue of whether the definition of “arbitration” under the FAA is a matter of federal or state law. In fact, discussion of this issue occupies most of the opinion.

The Second Circuit stated that the district court was correct in relying on *McDonnell Douglass Finance Corp. v. Pennsylvania Power & Light Co.*, 858 F.2d 825 (2d Cir. 1988), for the broad proposition that an arbitration agreement will be found to exist where “the language clearly manifests an intention by the parties to submit certain disputes to a specified third party for binding resolution.” *Id.* at 830. The Second Circuit also agreed with the district court’s reliance on *AMF Inc. v. Brunswick Corp.*, 621 F. Supp. 456 (E.D.N.Y. 1985), that under the FAA “[a]n adversary proceeding, submission of evidence, witnesses and cross-examination are not essential elements of arbitration.” *AMF Inc.*, 621 F. Supp. at 460. The court also looked to *AMF* for its holding that “[i]f the parties have agreed to submit a dispute for decision by a third party, they have agreed to arbitration.” *Id.*

As to the merits, the court affirmed the district court’s grant of summary judgment to Lloyds on the grounds of failure to give timely notice under the Certificate, which required notice within twenty days or as soon after as was reasonably possible. *Bakoss v. Certain Underwriters at Lloyds of London Issuing Certificate No. 0510135*, No. 10-CV-1455(DLI)(LB), 2011 WL 4529668, at *1 (E.D.N.Y. Sept. 27, 2011). The district court found that the notice had not been provided for at least nine months, that there was no valid excuse for the delay, and that such delay was unreasonable as a matter of law.

In order to reach that issue, however, it was necessary for the court to find that the dispute resolution procedure set forth in the Certificate was an arbitration. The procedure the Second Circuit held was an arbitration did not allow for the presentation by the parties of written or testimonial evidence at a hearing before the decision makers, provided no opportunity to cross-examine or submit rebuttal evidence, and no opportunity for the submission of legal memoranda or attorney argument. Moreover, the scope of the authority of the arbitrators was strictly limited to determining a single, factual issue – whether the patient was Permanently Totally Disabled. In other words, what the Second Circuit found qualified as an arbitration was a procedure in which two physicians each conducted separate *ex parte* examinations of the patient, and if they did not agree that the person was Permanently Totally Disabled they selected a third physician to conduct his or her own independent examination. The determination by the third

physician was final and binding, but only as to this factual issue. This, we contend, is clearly an expert determination, and to call it an arbitration is to stretch the definition of arbitration far beyond its understood usage.

Notably, the Second Circuit's decision in *Bakoss* was not the result of plaintiff's failure to assert that the proceeding was not an arbitration. To the contrary, the plaintiff specifically argued that under "New York law, this provision is not considered an arbitration agreement." Br. for Pl.-Counter-Def. Appellant at 17-18, *Bakoss v. Certain Underwriters at Lloyds of London Issuing Certificate No. 0510135*, No. 11-4371-cv (2d Cir. Feb. 9, 2012). Plaintiff argued that in applying New York law the court "should be guided by *Penn Central Corp. v. Consolidated Rail Corp.*, 56 N.Y.2d 120 (1982), which distinguishes between arbitration . . . and more limited forms of dispute resolution which resolve one issue, 'leaving all other issues for resolution at a plenary trial. The latter is a Proceeding to Enforce Agreement For Determination of Issue,' governed by CPLR § 7601 and is not an 'arbitration'" *Id.* (internal quotation and citation omitted). The Second Circuit did not address this argument, however. The plaintiff did not use the term "expert determination" and perhaps the failure to use such terminology to advance its argument furthered the court in its decision that the proceeding was an arbitration, not expert determination. It is perhaps the lack of the correct legal vocabulary to make the argument that contributed to the failure to recognize the proceeding as an expert determination.

The Supreme Court of Oregon did not have this problem when it reached the opposite conclusion in *Shepard & Morse Lumber Co. v. Collins*, 256 P.2d 500 (Or. 1953), which involved virtually identical facts. The contract at issue provided that the employer would make certain compensation payments to the employee during the time the employee was "totally disabled." The agreement stated that if either party was dissatisfied with the decision of the attending physician, "then the employer and the employee shall each select one duly licensed physician and surgeon to serve as arbitrators, and if these two are unable to agree, then said arbitrators shall select a third duly licensed physician and surgeon and the decision of two or more of the arbitrators shall be final and binding." *Id.* at 501. In this case, despite the parties' use of the term "arbitrator," the court readily held that the procedure was an appraisal (more properly, an expert determination), not an arbitration.

The Oregon court began by noting that the "common-law rules respecting the distinctions between arbitration and appraisal had previously received the sanction of this court." *Id.* at 504. The court also stated that it "cannot be disputed that if the agreement is one for an appraisal rather than arbitration, as those terms have been heretofore understood, the [Oregon arbitration] statute does not apply." *Id.* at 502.

Despite the agreement's reference to the physicians as "arbitrators," it was clear to the court that the contract called for an appraisal, not an arbitration. The court explained,

Under the agreement three physicians and surgeons were to determine the extent of defendant's disability. Obviously, it seems to us, the parties did not intend that three physicians and surgeons should conduct hearings and listen to testimony on a question of this kind, but rather that they would base their determination upon

their examination of the defendant, his medical history, and such other investigation as they would ordinarily make in similar cases, and on their expert professional knowledge. In other words, they would be charged with the duties of appraisers rather than arbitrators.

Id. at 507. In 1953, the term “appraisal” under the common law worked well as the label to differentiate this special form of dispute resolution from arbitration. Today, the more appropriate term that should be used is expert determination.

The decision in *AMF Inc. v. Brunswick Corp.*, 621 F. Supp. 456 (E.D.N.Y. 1985), cited approvingly by the Second Circuit in *Bakoss*, is another example of the term arbitration being too broadly applied. A settlement agreement between two competitors, AMF Inc. (“AMF”) and Brunswick Corp. (“Brunswick”) provided that any future dispute between them regarding advertising claims alleging “competitive superiority” based “on data, studies or tests,” would be first submitted to the National Advertising Division (“NAD”) of the Better Business Bureau for the rendition of an advisory opinion. “Such opinion shall not be binding upon the parties, but shall be advisory only.” *Id.* at 458 (emphasis added). Moreover, the procedure used by the NAD did not employ an adversary process, and, in fact, certain evidence was submitted “*in camera* and *ex parte*.” *Id.* at 461. AMF filed an action seeking to compel Brunswick to comply “with their agreement to obtain a non-binding advisory opinion” from the NAD. Brunswick claimed that the alleged advertisement did not fall within the scope of the settlement agreement. *Id.* at 457-58.

The district court first addressed the issue of whether this provision in the settlement was an arbitration agreement and found that it was. The court stated that “[i]f the parties have agreed to submit a dispute for a decision by a third party, they have agreed to arbitration. The arbitrator’s decision need not be binding in the same sense that a judicial decision” is. *Id.* at 460.

The court continued, stating that “[n]o magic words such as ‘arbitrate’ or ‘binding arbitration’ or ‘final dispute resolution’ are needed to obtain the benefits of the [FAA].” *Id.* at 460. So too, the absence of an “adversary proceeding, submission of evidence, witnesses and cross-examination are not essential elements of arbitration.” *Id.* Nor need the decision of the third party be final or binding. In short, according to this decision, a proceeding which allows for *ex parte* communications and *in camera* submission of evidence resulting in the issuance of a non-binding advisory opinion is an “arbitration.”⁸⁰

The district court, it should be noted, itself later explained that it could have come to the same result pursuant to the law of contracts. The court stated that “whether or not the agreement be deemed one to arbitrate, it is an enforceable contract to utilize a confidential

⁸⁰ The Ninth Circuit in *Wolsey, Ltd. v. Foodmaker, Inc.*, 144 F.3d 1205 (9th Cir. 1998), reached a similar resulting holding that a provision requiring “non-binding arbitration” as a condition precedent to commencing court litigation was an “arbitration” under the FAA. In contrast, in *Advanced Bodycare Solutions, LLC v. Thione International, Inc.*, 524 F.3d 1235 (11th Cir. 2008), the Eleventh Circuit held that a contract providing for mediation is not an arbitration under the FAA.

advisory process in a matter of serious concern to the parties. The agreement may be enforced in equity.” *AMF, Inc.*, 621 F. Supp. at 461.

These cases help illustrate that courts do not need to classify all contractual dispute resolution provisions as arbitrations in order to make such provisions enforceable.

C. The Lack Of Awareness Of The Law Of Expert Determination Has Led Some Courts To Create A Special Form Of Limited Arbitration.

Courts that have viewed contractual provisions as arbitration agreements, which, under our analysis, are better considered expert determinations, have often faced a problem. The problem concerns the intent of the parties. It is fundamental that “[a]rbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit.” *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83 (2002) (internal quotation and citation omitted). This requires that “[w]hether enforcing an agreement to arbitrate or construing an arbitration clause, courts and arbitrators must give effect to the contractual rights and expectations of the parties.” *See Stolt-Nielsen S.A. v. AnimalFeeds Int’l Corp.*, 559 U.S. 662, 130 S. Ct. 1758, 1773-74 (2010) (internal quotation and citation omitted).⁸¹ This can create a problem because the parties’ intent as to the scope and depth of authority of the decision maker as between an arbitration and an expert determination are fundamentally different. As a result, rules and presumptions created for arbitration may lead to the wrong answer if applied to an expert determination.

As will be seen, this conflict has led some courts, in order to give effect to the intent and reasonable expectations of the parties, to essentially transform an arbitration into a form of expert determination. Even where the court has concluded that the agreement is an arbitration agreement, the parties’ designation of an expert as the decision maker can have a very substantial and transformative effect on how the court interprets the type and scope of authority of the “arbitrator.” In order to comply with the fundamental premise that arbitration is a creature of contract that the intentions of the parties control, some courts have been led to create a very special species of arbitration where the arbitrator’s authority is strictly limited to deciding only issues of fact.

This phenomenon is illustrated in *McDonnell Douglass Finance Corp. v. Pennsylvania Power & Light Co.*, 858 F.2d 825 (2d Cir. 1988). This case is often cited as support for a very broad definition of arbitration, whereby arbitration is defined as including any contractual provision “that manifests an intention by the parties to submit certain disputes to a specified third party for binding resolution.” *Id.* at 830. Such a definition, however, is clearly too broad as it applies equally to arbitration as well as expert determinations, thereby collapsing one into the other.

⁸¹ *See Mastobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 57 (1995) (The “FAA’s proarbitration policy does not operate without regard to the wishes of the contracting parties.”); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985) (as “with any other contract, the parties’ intentions control”).

But an examination of what the Second Circuit actually *held* in *McDonnell Douglass* shows that the court's focus on the parties' intent resulted in an "arbitration" of a very special and limited kind. The court characterized the proceeding as an arbitration. But the court then held that in this case the authority of the decision maker was strictly limited to deciding factual issues within the scope of the decision maker's special area of expertise – essentially transforming the contractual dispute resolution mechanism into an expert determination.

The case concerned Preferred Stock Purchase Agreements (the "Agreements"), which governed the sale by Pennsylvania Power & Light Company ("PP & L" or the "Company") of its preferred stock. The Agreements set forth certain conditions under which PP & L would be required to make indemnity payments to the shareholders, which could be triggered by changes in the tax laws. The Agreements further provided that in such events, PP & L had the option to redeem the shares. The relevant provision stated that "if the Company shall have made a good faith determination that there is substantial risk that it would be required to make any indemnity payments pursuant to this paragraph 4N . . . then the Company, at its option, may redeem all the Shares then outstanding at the redemption price of \$100 per share plus dividends accrued to the date of redemption." *Id.* at 827.

The agreement, in this same paragraph, also provided for an alternative dispute resolution mechanism in the event of certain disagreements. Paragraph 4N provided that:

If the Company should disagree with any Owner's computation of the amount of the required indemnity payment or refund thereof as provided below or if any Owner should disagree with such good faith determination of the Company that there is substantial risk, then the Company and the Owner shall appoint an independent tax counsel to resolve the dispute

Id. (emphasis added).

Subsequently, the Tax Reform Act of 1986 reduced the amount of the Dividends Received Reduction. As a result of that development, PP & L sent notice that it was exercising its right to redeem the shares, because the change in the tax regulations would require the Company to make indemnity payments to the owners of the shares. Many owners responded by sending letters to PP & L attempting to waive their right to any indemnity payments, apparently because the yield on the preferred shares was so favorable they did not want the shares redeemed.

The plaintiffs, owners of the preferred shares, filed lawsuits seeking declaratory relief that PP & L's call for redemption of the shares was "wrongful" or in "bad faith," because the plaintiffs' waivers of their right to indemnification had the effect of negating PP & L's option to redeem the shares. The plaintiffs further alleged that "PP & L had failed to make a good faith determination that a substantial risk of indemnification existed, as required under Paragraph 4N" in order to trigger the option to redeem. *Id.* at 829. In response, PP & L filed a motion to stay the lawsuit and compel "arbitration" of the dispute to the independent tax counsel.

The Second Circuit first addressed whether the language calling for the appointment of an independent tax counsel to resolve certain disputes was an enforceable arbitration clause. The court held that it was because “the language clearly manifests an intention by the parties to submit certain disputes to a specified third party for binding resolution.” *Id.* at 830. This is the broad proposition for which the case is most often cited.

The court then proceeded to address the “scope of the clause.” The Second Circuit recited the general rule that “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.” *Id.* at 831 (quoting *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983)). But then, the Second Circuit quite correctly refused to apply this general rule about arbitration agreements to the case before it.

As the Second Circuit explained, the strong federal presumption in favor of arbitration cannot override the intention of the parties as set forth in the agreement:

However, it is equally clear that “federal policy alone cannot be enough to extend the application of an arbitration clause far beyond its intended scope.” . . . [W]hile keeping in mind the federal policy favoring arbitration, we must carefully consider whether the parties to these Agreement intended that disputes as to the utility’s good faith in seeking redemption under Paragraph 4N would be submitted for binding arbitration to an independent tax counsel.

Id. at 831-32. The Second Circuit explained that when construing a narrow arbitration clause, “we must be careful to carry out the specific and limited intent of the parties. Although we must be mindful of the federal presumption in favor of arbitration, we cannot allow that presumption to have the strong effect here that it would have if we were construing a broad arbitration clause.” *Id.* at 832.

In the case at hand, the Second Circuit concluded that the parties did not intend the arbitration clause to reach the issue in dispute, namely the dispute as “to the utility’s good faith.” In interpreting the clause in this matter, the court relied very heavily on the fact that “the parties agreed to refer their disputes to a tax counsel rather than to an arbitrator of more general expertise.” *Id.*

First, we find it significant that the parties agreed to refer their disputes to tax counsel rather than to an arbitrator of more general expertise. The specific and limited intent indicated by that choice is evident throughout the rest of the clause.

Id. The decision “to refer their disputes to tax counsel rather than to an arbitrator of general expertise” was pivotal to the court’s analysis and its conclusion.

The Second Circuit acknowledged that the clause on its face provided that “if any Owner should disagree with such good faith determination of the Company that there is substantial risk” it would be required to make any indemnity payment, that such dispute about the Company’s good faith determination was to be submitted to the independent tax counsel.

But the parties designation of a tax expert as the decision maker was a controlling factor relied upon by the court in seeking to understand what the parties reasonably intended.

The clause takes effect if the utility “should disagree with any [shareholder’s] computation of the amount of the required indemnity payment . . . or if any [shareholder] should disagree with [the] good faith determination of the [utility] that there is substantial risk [of indemnification].” *Although the latter half of that clause could be read literally to encompass all PP & L’s good faith determination*, the overall context of the passage indicates that it applies only to those aspects of the utility’s determination that rest on PP & L’s interpretation of tax law in determining the scope of its potential liability to shareholders.

Id. (alterations in original) (emphasis added). The Supreme Court’s directive that “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration,” *Moses H. Cone Mem’l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24-25 (1983), if applied here, would be an impediment to giving effect to the intent of the parties.

The precise issue to be decided was whether the plaintiff’s submission of written waivers of their right to indemnification had rendered PP & L’s contractual right to redeem ineffective. *See McDonnell Douglass*, 858 F.2d at 834 (whether the “shareholders’ attempted waivers had effectively negated any power of redemption that the utility might have had under Paragraph 4N” of the Agreement). This was a legal question that involved both contract interpretation and the legal effect to be given to the waivers.

The Second Circuit had to decide whether these legal issues were ones the parties intended to be decided by the arbitrator. The court held that these contractual interpretation and legal issues were outside the scope of the authority of the “tax counsel arbitrator.”

[T]he effect of the clause should be limited to tax law questions and to the computation of the amount of any indemnity payments that the utility might owe its shareholder as a result of changes in the tax laws. Had the parties intended to submit all issues regarding the utility’s good faith to an arbitrator, we do not believe they would have chosen a tax counsel.

Id. at 833. The Second Circuit concluded that in order to give effect to the intent and reasonable expectations of the parties the arbitrator’s authority was limited to specific factual matters within the scope of such expert’s specialized knowledge.

California and the District of Columbia are two jurisdictions that have amended their state arbitration statutes so as to include contractual provisions for appraisals and expert determinations. As a result, expert determinations are arbitrations as a matter of state statutory law. What is both significant and somewhat surprising, however, is that courts in both jurisdictions have properly continued to give primacy to the contractual reasonable expectation

of the parties. As a result, the arbitrator's scope of authority has been interpreted in certain cases as being limited to resolving only specified factual issues.

In 1977, the District of Columbia Arbitration Act ("DCAA") was amended, in part, so that by "virtue of arbitration agreements made enforceable by this act, the parties can choose arbitrators who are familiar with the practices and customs of a trade, or the current prices, merchantable quality, and the like. Thus the bill affords an opportunity for parties to seek expert decisions in short periods of time." *See Wash. Auto. Co. v. 1828 L St. Assocs.*, 906 A.2d 869, 876 (D.C. 2006). Whereas New York enacted Article 76 to provide independent statutory authority for expert determinations, the District of Columbia amended its arbitration act to include them and thereby provide a statutory basis for their enforcement. The result is what the court in *Washington Automotive Co.* called "a very particularized type of arbitration." *Id.* at 877.

Adkins Limited Partnership v. O Street Management, LLC, 56 A.3d 1159 (D.C. 2012), illustrates this point. This case concerned enforcement of a buy-out provision under a limited partnership agreement. The only issue left to resolve between the parties was the price that O Street Management, LLC ("OSM") would pay Adkins in the buy-out. The agreement stated that the buy-out price was to be determined by means of an appraisal. *Id.* at 1163.

In *Adkins*, the parties disagreed regarding a contract interpretation issue. In response, the trial court ruled that the contract provision required that the property be valued as encumbered by the existing lease, and so instructed the "arbitrator." While acknowledging that the proceeding was subject to the DCAA, the court nevertheless stated that "an appraiser's role is more limited than the role of an arbitrator." *Id.* at 1166.

Ordinarily, a trial court's role in reviewing an appraisal is limited, as is its role in reviewing arbitration award. When the parties have agreed only for the appraisal of a specific thing and the contract does not provide for an appraiser to settle a particular dispute, however, an appraiser's role is more limited than the role of an arbitrator, *i.e.*, the appraiser's task is "merely [that] of fixing value."

Id. (alteration in original) (citation omitted).

As a result, the court went on to explain that while the "actual appraisal of value" is accorded deference, "an appraiser's interpretation of his instruction as set forth in the contract is 'clothed with no presumption of correctness'" and is subject to *de novo* judicial review. The court explained:

Of course, an appraiser "may use any reasonable method of appraisal it deems appropriate, unless the [contract] specifies otherwise," and we "will not question" the value fixed by the appraiser that the parties have chosen "in the absence of fraud or mistake."

However, when an appraiser must interpret the meaning of a legal document – a contract between parties – before he may perform his appraisal, that interpretation is subject to judicial review.

Id. at 1167 (alteration in original) (citations omitted). *Accord Marceon v. Chevy Chase Servs., Inc.*, 258 F.2d 155, 158 (D.C. Cir. 1958) (“In effect arbitrators are private judges whose powers are defined by contract and to a degree by custom. Appraisers, by definition perform a narrower function, that merely of fixing value.”).

The same is found in court decisions under the California arbitration statute, which has a statutory definition of arbitration that expressly includes appraisals.⁸² Nevertheless, California courts have held that contracts calling for an appraisal are to be interpreted very differently because the appraiser’s powers “are far more limited.” *See Doan v. State Farm Gen. Ins. Co.*, 125 Cal. Rptr. 3d 793, 801 (Cal. Ct. App. 2011) (“Despite the fact that an appraisal is a special form of limited arbitration, there are significant differences between the powers of an arbitrator and those of an appraiser.”) (internal quotation and citation omitted); *Jefferson Ins. Co. of N.Y. v. Superior Court of Alameda County*, 475 P.2d 880, 883 (Cal. 1970) (“The function of appraisers is to determine the amount of damage resulting to various items submitted for their consideration. It is certainly not their function to resolve questions of coverage and interpret provisions of the policy.”) (internal quotation and citation omitted).⁸³

Failure to recognize that expert determinations are an independent form of alternative dispute resolution, materially different from arbitration, can lead a court to granting the decision maker broader authority than that reasonably intended by the parties.

In *SRG Global, Inc. v. Robert Family Holdings, Inc.*, Civil Action No. 5314-VCP, 2010 WL 4880654 (Del. Ch. Nov. 30, 2010), the court addressed whether an Environmental Expert had the authority to rule on the parties’ conflicting interpretations of the contract. During the negotiations, it was found that there was groundwater and soil contamination at one location and potential contamination at several other locations. The Share Purchase Agreement contained two provisions for indemnification with respect to environmental liabilities. Under both provisions, the buyer was to provide the seller with an Environmental Cost Notice which would describe the nature of the Environmental Liabilities, the proposed course of action and the estimated cost of remediation. The seller had twenty days to provide written objections. If the parties were not able to resolve their differences, “the parties shall submit all unresolved issues to a qualified senior environmental specialist at ERM (the ‘Environmental Expert’).” The resolution by the Environmental Expert “shall be final and binding on the parties.” *Id.* at *2.

⁸² *See* Cal. Civ. Proc. Code § 1280(a) (“As used in this title ‘Agreement’ includes but is not limited to agreements providing for valuations, appraisals and similar proceedings and agreements between employers and employees or between their respective representatives.”).

⁸³ This same distinction is found in cases under the Florida arbitration statute. *See, e.g., Allstate Ins. Co. v. Suarez*, 786 So.2d 645, 646 (Fla. Dist. Ct. App. 2001) (“Although appraisal clauses are treated as arbitration clauses for most purposes, the two processes are not identical.”).

The court first addressed what it called “SRG’s half-hearted” contention “that the dispute resolution procedure before the Expert does not constitute an arbitration.” *Id.* at *5. The court rejected this contention, noting that SRG itself “undermined this argument in their earlier filings by classifying the dispute resolution process here as arbitration.” *Id.* The court further noted that “SRG has conceded that it does not make a ‘material difference’ whether the resolution process is found to be an arbitration.” *Id.* The court added that the “fact that the decision maker is referred to an ‘expert,’ rather than an ‘arbitrator’ is not dispositive.” *Id.*⁸⁴ Accordingly, the court considered the parties as having agreed to resolve the dispute by arbitration with the Environmental Expert serving as the arbitrator.

One key issue was whether the Environmental Expert when determining the costs of the cleanup could take into account the availability of any insurance coverage. *Id.* at *4. The court found that the contract was ambiguous on this point, noting that “RFH has shown that under one reasonable interpretation” the expert could take potential insurance coverage into account, while SRG had offered a reasonable, contrary interpretation. Indeed, one party asserted that the contract contained “a scrivener’s error” relevant to the resolution of this issue. *Id.* at *9.

The court stated that because this was an arbitration, “Delaware courts focus on whether the questions presented involve ‘procedural’ versus ‘substantive’ arbitrability” in determining whether an issue should be decided by an arbitrator as opposed to a court. *Id.* at *5. The court explained:

the adequacy of notice would present a procedural question, because whether a condition precedent to arbitration had been met, is a procedural issue. Thus, issues such as “time limits, notices, laches and estoppel” have been found to be procedural. Likewise, allegations of waiver, delay, and similar defenses to arbitrability also have been held to be procedural.

Id. at *6. While procedural issues are for the arbitrator to decide, “substantive arbitrability” questions deal with “whether the arbitration clause is valid or enforceable” and “whether the parties decided in the contract to submit a particular dispute to arbitration.” *Id.* at *6, *7 n.66 (internal quotation and citation omitted). Further, the Supreme Court’s finding that “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration” and this includes where “the problem at hand is the construction of the contract language itself” should also be taken into account. *Moses H. Cone*, 460 U.S. at 24-25.

The court held that under this approach it was the Environmental Expert, not the court, that should decide the contract interpretation issue, presumably including the claim of scrivener’s error. *SRG Global, Inc.*, 2010 WL 4880654, at *10 (“Courts long have held that such issues are procedural and should be decided by the arbitrator.”). While such a ruling makes

⁸⁴ The court distinguished cases such as *Omni Tech* because “the agreement at issue [in that case] stated that the decision maker would ‘act as an *expert and not as an arbitrator.*’” *Id.* at *10 (citation omitted) (emphasis added). The court emphasized that the agreement at issue “contains no comparable language, and if SRG and RFH intended the Expert to be so limited, they easily could have said so in the agreements.” *Id.*

perfect sense in the case of an arbitrator, it is hard to believe that the parties intended or expected the Environmental Expert to hear and decide issues of contract interpretation or issues such as waiver, laches, estoppel, and similar legal defenses.

The court does not address how the Environmental Expert was supposed to decide these issues. A fair resolution of these issues could involve depositions, document requests, an evidentiary hearing where witnesses testify and are subject to cross-examination, as well as legal briefing and argument by counsel. That the parties intended the Environmental Expert to preside over such proceedings seems highly unlikely. Moreover, as these matters were held to be for the arbitrator to decide, the Environmental Expert's rulings on these legal issues was not subject to judicial review.

In summary, we suggest that because the court classified the proceeding as an arbitration it was a small step to conclude that the Environmental Expert had the authority under well-established arbitration law precedent to resolve legal issues of contract construction and interpretation. We suggest that the court arrived at the wrong result because of its earlier error in not treating this as an expert determination.

IV. Court Decisions Addressing Whether Purchase Price Adjustment Clauses Are Expert Determinations Or Arbitrations

We believe that purchase price adjustment proceedings are best viewed as a form of expert determination, not arbitration. While the parties can certainly provide otherwise, that does not seem to be the usual intent. That the proceeding is intended to be governed by the law of expert determination, not arbitration, is best reflected when the Purchase Price Adjustment Clause expressly states that the independent accounting firm shall “act as experts, and not as arbitrators.”⁸⁵

A. New York Courts Regularly Enforce Purchase Price Adjustment Clauses Under New York CPLR § 7601

The New York state courts have regularly confirmed determinations made by independent accounting firms in purchase price adjustment disputes as expert determinations under the statutory authority of CPLR § 7601, and not as arbitrations governed by arbitration law. *See, e.g., Westmoreland Coal Co. v. Entech, Inc.*, 100 N.Y.S.2d 352 (2003) (petition pursuant to CPLR § 7601 to compel party to submit purchase price adjustment dispute to the designated independent accounting firm).

⁸⁵ The language “acting as experts, and not as arbitrators” can be found in contracts underlying a number of reported cases. *See, e.g. Omni Tech Corp. v. MPC Solutions Sales, LLC*, 432 F.3d 797, 798 (7th Cir. 2005) (“to [an accounting firm that] shall, acting as experts and not as arbitrators”) (alteration in original); *Luxtotta Grp., S.p.A. v. Bausch & Lomb Inc.*, 160 F. Supp. 2d 552, 554 (S.D.N.Y. 2001) (CPA Firm “shall, acting as experts in accounting and not as arbitrators,”); *Doosan Infracore Co. v. Ingersoll-Rand Co.*, No 652170/2010, slip op. at 4 (N.Y. Sup. Ct. Mar. 15, 2011) (“to act as experts in accounting and not as arbitrators”); *Terex Corp. v. Bucyrus Int’l, Inc.*, No. 651889/2010, slip op. at 9 (N.Y. Sup. Ct. June 7, 2011) (“acting as experts in accounting and not as arbitrators”).

In *Pavonix, Inc. v. SumTotal Systems, Inc.*, No. 101651/2011, 2011 WL 2167878 (N.Y. Sup. Ct. May 25, 2011), the purchase price adjustment clause in the Asset Purchase Agreement required the buyer to provide a Closing Statement, setting forth the companies' actual Net Working Capital as of the closing date. In the event of a dispute between the parties as to the Closing Statement, "the 'disputed matter shall be submitted to and determined by an independent team of auditors of KPMG LLP.'" *Id.* at 3. KPMG's determination was to be "final, binding and conclusive."

The court held that the agreement to submit these disputes to KPMG was not an arbitration agreement. First, the court noted that "the word 'arbitration' does not appear in the Agreement." *Id.* However, the court also noted that whether the term arbitration is used was not dispositive.

Second, and key to its decision, the court focused on the nature of *what* KPMG was expected to review and *how* KPMG was expected by the parties to make its determination. The court explained:

The Agreement requires that the "disputed matter shall be submitted to and determined by an independent team of auditors of KPMG LLP." According to Black's Law Dictionary, an audit is "a formal examination of an individual's or organization's accounting records, financial situation, or compliance with some other set of standards." Black's Law Dictionary (3d pocket ed. 2006). This is not a call for arbitration – a quasi-judicial proceeding relying on testimony and argument.

Id. at 3-4 (citation omitted). The court also relied upon *In re Penn Central Corp.* and CPLR § 7601 in discussing the difference between an appraisal and an arbitration. The court noted that CPLR § 7601 was intended to provide the court with power to enforce an appraisal agreement, "on its own terms without resort to Article 75" (which governs arbitrations). *Id.* at 4.

The court concluded that "it would be unfair and/or inconsistent with the intent of the parties to overlay Article 75 [the arbitration statute] onto Section 2.5(e) [the clause designating KPMG] of the Agreement." *Id.* The court noted that after the filing of the action by the buyer, the Seller had subsequently submitted the required Dispute Notice setting forth its objections to the Closing Statement. It further found that both parties had now agreed that the issues raised were to be resolved by KPMG. Accordingly, the court dismissed the petition as moot, and the parties were encouraged "to proceed expeditiously" to have the issues resolved by KPMG.

Similarly, in *Luxottica Group, S.p.A. v. Bausch & Lomb Inc.*, 160 F. Supp. 2d 552 (S.D.N.Y. 2001), the contract provided that a CPA Firm "shall, acting as experts in accounting and not as arbitrators, determine" on the basis of the Accounting Principles any objections to the closing net operating statement. The parties were unable to resolve eight objections to the proposed purchase price adjustment, totaling \$81 million. The seller argued that the objections were claims for breach of the Agreement's contractual warranties and, therefore, were not subject to the purchase price adjustment procedures. The buyer moved for an order compelling

Bausch & Lomb Inc. (“B&L”) to submit the disputes to the independent accountants for determination.

The court noted that while “parties dedicate the bulk of their submissions to wrangling over whether section 2.5 is an arbitration clause,” it was not necessary to decide this issue because “[e]ven if it is not an arbitration clause, it is enforceable under N.Y. CPLR § 7601.” The court explained that CPLR § 7601 provides for the enforceability of an agreement “that a question of valuation, appraisal or other issue or controversy be determined by a person named or to be selected.” *Id.* at 556. The language of Section 7601 is not limited only to appraisals – it covers all “agreements” to have a third party resolve a matter. B&L also argued that the agreement never referred to the Expert Accountant Procedure as a “valuation” or “appraisal.” The court rejected this argument, stating that similar types of agreements have been regularly enforced under CPLR § 7601.

Doosan Infracore Co. v. Ingersoll-Rand Co., No. 652170/2010 (N.Y. Sup. Ct. Mar. 15, 2011) is another example illustrating enforcement under CPLR § 7601. *Doosan* concerned an Asset Purchase Agreement (“ASP”) whereby Ingersoll-Rand Co. (“Ingersoll”) sold certain businesses to Doosan entities for an initial purchase price of \$4.9 billion. The ASPA contained a provision allowing for a post-closing adjustment if there was a change in the net asset value of the business at the time of the closing. Under the ASPA, if the parties could not resolve any dispute with regard to any change in net asset value, the matter would be submitted to a mutually acceptable accounting firm (the “CPA Firm”). The CPA Firm would, acting as “experts in accounting and not as arbitrators,” make a conclusive and binding decision. The CPA Firm rendered a decision determining that there was a payment due from buyers to the sellers in the amount, as adjusted, of \$31 million.

The buyers opposed the petition to confirm the CPA Firm’s determination on two separate grounds. First, the buyers contended that the CPA Firm had acted outside its authority by resolving an issue regarding the distribution of certain pension assets “as a matter of law” based on its *interpretation* of the ASPA. *See Doosan*, slip op. at 4. The court rejected this argument finding that “in allocating pension assets, the CPA Firm did not interpret the ASPA.” *Id.* Instead, “the CPA Firm applied the appropriate accounting rules to determine the dispute.” *Id.* The court held that the firm’s finding reflected “application of accounting principles well within the ken of accounting professionals.” *Id.* at 5.

Second, the buyers opposed confirmation of the CPA Firm’s determination because there was an additional dispute between the parties under the ASPA, which was not submitted to the CPA Firm, and therefore remained subject to a judicial resolution by the court. This remaining dispute related to a covenant that the seller would not make any change in the compensation, severance or termination benefits payable to any employees prior to the closing. The buyer alleged that the seller had breached this covenant by entering into a new bonus plan. Whether the new bonus plan was a breach of the covenant was not submitted to the CPA Firm because the parties agreed it was not an “accounting related” dispute.

The court held that the presence of this independent judicial claim did not prevent confirmation of the CPA Firm’s determination. The court noted that under New York law, “there is no need to confirm an award in the typical case where calculation represents only part

of a dispute or serves as condition precedent to the exercise of other contractual rights which may also be in dispute.” *Id.* at 4 (quoting *In re Penn Cent. Corp.*, 56 N.Y.2d at 130). “However, when the issues are separate and confirmation of an appraisal award will not result in additional litigation and delay, the award should be confirmed.” *Id.* Such was the case here, and thus the court confirmed the CPA Firm’s determination.

B. The Designation Of An Accounting Firm As The Decision Maker Has Led Some Courts To Transform Even What The Court Labels As An Arbitration Into A Proceeding That Closely Resembles An Expert Determination

As previously discussed, where parties have designated an expert as the decision maker some courts have created a species of arbitration which in many respects resembles an expert determination. Some courts, in order to give effect to the reasonable expectation of the parties, have created a form of arbitration where the arbitrator’s authority is strictly limited to deciding only issues of fact. This can also be seen in cases involving Purchase Price Adjustment Clauses.

This phenomenon is found in *Fit Tech, Inc. v. Bally Total Fitness Holding Corp.*, 375 F.3d 1 (1st Cir. 2004), a case concerning a post-closing earn-out payment. The principal plaintiffs, David Laird and Scott Baker, had sold eight fitness centers (doing business under names such as Fit Tech), to Bally Total Fitness Holding Corp. (“Bally”). Under the asset purchase agreement, the purchase price could be increased during the two years following the closing depending on the post-closing earnings of the fitness centers. The final calculation of the supplemental amount was to be based on an “Earn-Out Schedule” provided by the buyer. The contract provided that in the event the buyer and seller could not resolve any objections to any of the items on the Earn-Out Schedule, “then the items in dispute will be referred to the Accountants [Price Waterhouse] for final determination” binding on the parties. *Id.* at 3.

As a preliminary matter, the First Circuit had to determine whether the proceeding before the accountants was an arbitration under the FAA, because this controlled whether the court had appellate jurisdiction. The court concluded that “whether what ha[d] been agreed to amounts to ‘arbitration’ under” the FAA was a matter of federal law, not state law. *Id.* at 5. It then addressed the “more interesting question” of whether this was indeed an arbitration. *Id.* at 7.

The court held that the test to be used is one that examines “how closely the specified procedure resembles classic arbitration.” *Id.* It does not appear, however, that the court ever considered whether the proceeding should more properly be characterized as an expert determination, as there is no discussion of this alternative. In deciding that the proceeding was an arbitration, the court noted certain procedural elements:

the purchase agreement makes the Price Waterhouse remedy “final” . . . and other common incidents of arbitration of a contractual dispute are present: an independent adjudicator, substantive standards (the contractual terms of the pay-out), and an opportunity for each side to present its case.

Id. The court acknowledged that the Purchase Price Adjustment Clause departed “from a common feature of many arbitrations” because “the purchase agreement refers to Price Waterhouse for its resolution [of] only the accounting issues.” *Id.* But the court noted that “arbitration agreements sometimes do cover only a part of an overall dispute,” and selecting “an expert to handle arbitration is by no means uncommon.” *Id.* Accordingly, the court concluded that the provision at issue was an arbitration agreement.

The court then addressed the critically important question of the scope of the issues that were to be referred to Price Waterhouse. Plaintiffs had asserted two general classes of claims against Bally. The first category, which the court called the “accounting violations,” alleged that the Earn-Out Schedule contained errors because Bally had improperly calculated earnings contrary to the applicable accounting principles. The second category, described as the “operating violations,” consisted of claims that Bally had wrongfully taken actions in breach of the contract that were designed to reduce earnings for the specific fitness centers sold, such as using its computer system to direct phone inquiries away from the former Laird-Baker centers and toward its pre-existing facilities. *Id.* at 4. This operational misconduct could, “just like ordinary accounting errors, alter the figures” on the financial schedules and reduce the pay-out. *Id.* at 8. So, Bally argued, both categories of claims were included under the contract language “any disagreement” and should therefore be submitted to the accountants.

The First Circuit’s approach to resolving the issue was to focus on the intent of the parties. A “court in interpreting disputed contract language asks what a reasonable person in the position of the parties would ordinarily have intended by using the words in question in the circumstances.” *Id.* One of the key facts used by the court to interpret the parties’ intent was that the designated decision maker was an accounting firm. The court accordingly interpreted the “any disagreement” contract language as referring only “to disagreements about *accounting* issues arising in the calculations that underpin the schedules.” *Id.* As a result, the court held that Price Waterhouse had jurisdiction to hear the alleged “accounting violations,” but not the so-called “operating violations.”

With respect to the operating claims, the court concluded that the parties could not have intended that these type of claims were to be resolved by an accounting firm. The court explained:

[I]t makes no sense to assume that accountants would be entrusted with evaluating disputes about the operation of the business in question. Yes, operational misconduct may well affect the level of earning and therefore the schedules, but the misconduct itself would not be a breach of proper accounting standards. Nor would one expect accountants to have special competence in deciding whether business misconduct unrelated to accounting conventions [were] a breach of contract or any implied duty of fair dealing.

Id. at 8. Whether “Bally had manipulated the phone system to divert calls” involves “not an accounting question but contract interpretation and judgments about reasonable business practices.” *Id.* These type of issues were not intended by the parties to be within the scope of the authority granted to the accounting firm.

In short, the court held that the accounting firm as the decision maker would be acting as an expert and resolve factual issues by applying its expertise in accounting standards. When the intent of the parties is specifically considered – “what reasonable persons in the position of the parties would ordinarily have intended by using the words in question in the circumstances” – the result looks very much like an expert determination. The arbitrator-accountant’s authority is limited to “accounting issues.” Equally important, the accounting firm’s authority did not extend to issues of contract interpretation, resolving legal claims such as breach of contract or the breach of any implied obligation of fair dealing, or to making “judgments about reasonable business practices.” *Id.*⁸⁶

A similar result can be found in *Bratt Enterprises, Inc. v. Noble International, Ltd.*, 338 F.3d 609 (6th Cir. 2003). The asset purchase agreement provided that the buyer (“Noble”) would purchase a steel processing business, including most, but not all, of its liabilities. In particular, the agreement provided that the seller (“Bratt”) would retain all accounts payable in excess of \$1.2 million, “effectively capping Noble’s liability for the accounts payable.” *Id.* at 611. The Closing Balance Sheet produced after the closing showed accounts payable in the amount of \$1.8 million – higher than the \$1.2 million limitation in the contract. Bratt argued, however, that it was not liable for the difference, contending that the \$1.2 million limitation of liability for accounts payable was the result of “a common or mutual mistake.” *Id.* at 613. The agreement provided that disagreements “with any of the amounts included in the Closing Balance Sheet” would be submitted to an independent accounting firm. *Id.* Accordingly, Noble filed a motion to compel arbitration of its claim for payment of \$600,000.

The district court granted the motion to compel. The Sixth Circuit reversed. The majority held that the “plain language” of the contract “demonstrates that the parties agreed to submit disagreements regarding ‘any of the *amounts* included in the Closing Balance Sheet’ to arbitration,” not “any and all disputes.” *Id.* at 613 (emphasis added). A “party cannot be required to submit to arbitration any dispute that the party has not agreed to so submit.” *Id.* at 612. Accordingly, the court held that any disagreement as to the amount of the accounts payable was for the accounting firm to decide, but the breach of contract claim concerning the “validity of the \$1.2 million limitation provision” could not be submitted to the accounting firm because it was not within the scope of the arbitration agreement. *Id.* at 613.

What is further particularly instructive about this case comes from a review of the dissent, in which Judge Clay asserted that the “majority’s approach to resolving the dispute is in contravention of the principles and jurisprudence pertaining to matters of arbitrations.” *Id.* at 614. He wrote that the “majority ignores this well steeped body of federal policy and law in

⁸⁶ To like effect, in *Costello v. Patterson Dental Supply, Inc.*, No. 5:06-CV-213, 2007 WL 1041128 (W.D. Mich. Apr. 5, 2007), the court held that the Purchase Price Adjustment Clause was an arbitration agreement, but then found that virtually all the claims being asserted were not to be submitted to the Independent Account because they were “clearly legal or equitable claims.” *Id.* at *6. The court held that “the short time frame for the decision (30 days); the lack of testimony under oath; and the complete lack of expertise of the Independent Accountants in law” all evidenced that the parties intended that the type of disputes to be submitted were limited to those that fell within the special expertise of an accounting firm. *Id.*

concluding that the parties' dispute regarding the validity of the \$1.2 million limitation did not fall within the ambit of the arbitration provision." *Id.* In particular, he argued that:

[T]he majority fails to heed the Supreme Court's directive that 'any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, *whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.*'"

Id. (quoting *Moses H. Cone*, 460 U.S. at 24-25) (emphasis added).

The decision to characterize a Purchase Price Adjustment Clause as an arbitration necessarily invokes a series of well-established arbitration rules and presumptions. As seen by the dissent, these general principles of arbitration law can easily lead to a judge treating an expert just like any other arbitrator. The problem is this will result in the expert being given much broader and deeper authority than was reasonably intended by the parties.⁸⁷

In order to avoid a result inconsistent with the reasonable intent of the parties, the courts therefore should find a methodology distinct from simply applying traditional arbitration rules and principles. *HDS Investment Holding Inc. v. Home Depot, Inc.*, Civil Action No. 3968-CC, 2008 WL 4606262 (Del. Ch. Oct. 17, 2008), for example, concerned a Purchase and Sale Agreement whereby HDS Holdings purchased HDS Supply from Home Depot for \$8.5 billion. The Purchase Price Adjustment Clause expressly stated that the accounting firm "shall act as an arbitrator." *Id.* at *5. The purchase price adjustment was to be based on any changes in the amount of working capital. As part of this process, HDS Holdings was to prepare a Closing Statement no later than 90 days after the closing. Home Depot then had a period of time to provide notice of any disagreements, followed by a period of negotiation. If "at the conclusion of the Negotiation Period, there are any amounts remaining in dispute then all amounts remaining in dispute may at any time thereafter be submitted to Ernst & Young [the Neutral Auditor]." *Id.*

One issue before the court was whether the Neutral Auditor had the authority to rule on HDS Holding's request that it be allowed to *change* its Closing Statement. *Id.* at *2. This issue arose because after HDS Holdings had timely sent the Closing Statement, Home Depot responded with a request for additional supporting documents. Thereafter, when HDS Holdings provided Home Depot with the requested information, it also included a Revised Closing Statement substantially *increasing* its claim. Home Depot objected to the Revised Closing Statement on the grounds that it was submitted more than 90 days after the closing. *Id.* at *3.

The issue was "whether the Court or the neutral auditor should decide whether the neutral auditor can consider the Revised Closing Statement." *Id.* at *8. Because the proceeding

⁸⁷ The same can happen as the result of the application of arbitration rules that allocate jurisdiction between the court and the arbitrator by using concepts of "substantive" and "procedural" arbitrability. See *SRG Global, Inc.*, 2010 WL 4880654, discussed in Section III.B and the Delaware cases discussed in Section IV.C.

was assumed to be an arbitration, the court should have resolved this issue by deciding if the timeliness of the Revised Closing Statement was an issue of “substantive” versus “procedural” arbitrability. *See SRG Global, Inc.*, 2010 WL 4880654, at *5-6 (“Delaware courts focus on whether the questions presented involve ‘procedural’ versus ‘substantive’ arbitrability” in determining whether an issue should be decided by an arbitrator as opposed to a court.).

Indeed, the Supreme Court has held that “‘procedural’ questions which grow out of the dispute and bear on its final disposition are presumptively *not* for the judge, but for the arbitrator to decide.” *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 84 (2002) (internal quotation and citation omitted). Under this long line of authority, questions of compliance with “time limits” are presumptively to be decided by the arbitrator. *Id.* at 85. Moreover, the Supreme Court has further held that in light of the strong federal policy in favor of arbitration, “any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.” *Moses H. Cone*, 460 U.S. at 24-25. In short, under arbitration law, this is an easy case – whether the untimely Revised Closing Statement can be considered by the accounting firm is a procedural issue to be decided by the arbitrator.

Surprisingly, this was not the ruling by the court. Instead, the court focused on the intent of the parties “as evidenced by the written words and their context in the Agreement.” *HDS Inv. Holding Inc.*, 2008 WL 4606262, at *7 n.26. In particular, the court inferred much from the fact that the parties had specified “Ernst & Young, an accounting firm,” as the decision maker. *See id.* at *5 (“The specification of Ernst & Young, an accounting firm, as the first choice as neutral auditor is further evidence that the parties did not intend the arbitration provision to encompass legal disputes arising under other clauses of the Agreement.”). The court also relied on the language of the arbitration provision and its location in § 2.5 of the Agreement. *Id.*

In holding that whether HDS could submit a Revised Closing Statement was an issue for the court, the court explained the dispute was a “contractual issue.” The court stated:

Whether the Revised Closing Statement can be considered by the neutral auditor is a contractual issue that should be decided by the Court. . . . Nothing in the arbitration provision indicates that the parties agreed that the neutral auditor would determine contractual issues regarding whether a revised or delayed Closing Statement could be considered by the neutral auditor. I will not expand the arbitration agreement beyond the express intent of the parties.

Id. at *8.

In short, in order to give effect to the intent of the parties, the court created an arbitration where the arbitrator did not have authority to decide issues of contract interpretation – even those arising under the Purchase Price Adjustment Clause itself. Further, the court neither discussed nor applied the well-established distinction between procedural and substantive arbitration, because doing so would lead to a result likely inconsistent with the intent of the parties.

C. Failure To Recognize The Existence Of Expert Determination As An Alternative To Arbitration Can Lead to Results Which Are Contrary To The Intent Of The Parties

At present, the case law shows substantial confusion regarding the proper legal characterization of Purchase Price Adjustment Clauses. Close review of the cases reveals that courts and parties often have simply assumed, without any detailed analysis, that these provisions are arbitration agreements governed by arbitration law.⁸⁸ Indeed, in some cases it can be inferred that the participants have reached this conclusion because they do not know what else such proceedings might be.

This confusion is illustrated by the recent decision in *Viacom International, Inc. v. Winshall*, Civil Action No. 7149-CS, 2012 WL 3249620 (Del. Ch. Aug. 9, 2012). The case concerned post-closing Earn-Out payments due to the selling stockholders under a Merger Agreement. The amount of any payment was contingent on the company's financial performance. The company was to prepare and deliver to the selling Stockholders Representative an Earn-Out Statement for the year after the closing. The Stockholders Representative had 20 days to give notice of any disagreement. In the event the parties could not resolve their disagreements, then either party could submit any unresolved disagreement to the Resolution Accountants. The Merger Agreement stated that the Resolution Accountants "shall be deemed to be acting as experts and not as arbitrators," and its decision will be final and binding. *Id.* at *2.

The statement that the accountants "shall be deemed to be acting as experts and not as arbitrators," but whose decision would nonetheless be final and binding on the parties, caused considerable confusion. The court candidly stated that it found reading this statement to be an "eyebrow-knitting moment." *Id.* at *3.

But not content with having deemed the Resolution Accountants as experts and not arbitrators and thus causing one eyebrow-knitting moment, the drafters forged on to state in a later section that . . . no party shall have the right to bring any claim disputing such final determination, *in the absence of fraud or manifest error.*

Id. (emphasis added).

Indeed, counsel for the parties appeared to have been equally confused. As the court explained, with what can be inferred to have been with a clear sense of relief, the party that had initiated the action now "concedes in its briefs that 'for purposes of the pending motions . . . the Resolution Accountant's Determination may be reviewed under [FAA] standards.'" *Id.* at *10 (alteration in original). Counsel's concession altered the course of the action because by so doing, "Viacom has thus abandoned for purposes of these cross-motions its first three causes of

⁸⁸ See, e.g., *Talegen Holdings, Inc. v. Fremont Gen. Corp.*, No. 98 Civ. 0366(DC), 1998 WL 513066, at *3 (S.D.N.Y. Aug. 19, 1998) (the parties agreed "that § 2.3(c) is a narrow arbitration clause"); *Gestetner Holdings, PLC v. Nashua Corp.*, 784 F. Supp. 78, 80 (S.D.N.Y. 1992) ("The parties agree that the Petition is governed by the Federal Arbitration Act . . .").

action . . . because these causes of action are all premised on the inapplicability of the FAA.” *Id.*

As a result, in order to place the dispute on familiar ground, the court and the parties agreed to treat the proceeding before the accountants as an arbitration. As the court observed, “this case turns on whether, under the FAA, there is a basis to vacate or deny enforcement of the Resolution Accountant’s Determination as to the 2008 Earn-Out.” *Id.* In other words, the court and the parties acted in direct contradiction to the clearly stated intent of the parties that the designated accounting firm “shall be deemed to be acting as experts and not as arbitrators.” *Id.*

The decision to treat the proceeding as an arbitration, in direct contradiction to the clearly stated intent, had at least three material effects. First, it materially changed the standard of review to be applied to the Resolution Accountant’s Determination. The Merger Agreement stated that the Resolution Accountant’s Determination “shall be final and binding on all parties,” except in the case of “fraud or manifest error.” *Id.* at *3 (emphasis added). Review on the basis of manifest error is recognized under the law of contracts with respect to appraisals and expert determinations.⁸⁹ It is not, however, a statutory basis for the review of an arbitration award under the FAA. Had the court and parties recognized that this was an expert determination, the court could have given effect to the parties’ stated intent that the accountants’ determination be subject to increased judicial review.⁹⁰

Instead, the standard of review contractually agreed to by the parties was ignored. The court explained, “[g]iven the parties’ agreement to apply the FAA, I apply it, and do not apply the Merger Agreement’s standard of review.” *Viacom*, 2012 WL 3249620, at *11. The court then continued, *in dicta*, to incorrectly state that the contractual standard of review for “manifest error” is “most sensibly understood as a corollary to ‘evident material mistake’” under Section 11(a) of the FAA. *Id.* at *11 n.80. This is clearly wrong. Section 11(a) is very narrow and limited, and only allows for modification, not vacatur, in cases where there has been “an evident miscalculation of figures or an evident material mistake in the description of any person, thing or property referred to in the award.” 9 U.S.C. § 11(a). Moreover, by categorizing the proceeding as an arbitration, the court deprived the parties of the ability by contract to specify a

⁸⁹ The general state law standard for review allows an expert determination to be set aside in the case of “fraud, bad faith or palpable mistake.” See Section II.C. As Kendall has stated: “Expert clauses often provide that the decision is to be final and binding ‘in the absence of manifest error.’” Kendall, *supra* n.4, at 228 (citation omitted). A “manifest error has been referred to as a ‘plain and obvious error.’” *Id.* at 229 (citation omitted); see also *Tufano Contracting Corp. v. Port of N.Y. Auth.*, 238 N.Y.S.2d 607, 609 (2d Dep’t 1963) *aff’d*, 13 N.Y.2d 848 (1963) (expert determination invalidated where a court finds that the expert lacks “a reasonable basis . . . for [his] determination.”).

⁹⁰ The standard of “fraud, bad faith or palpable mistake” allows courts greater discretion in reviewing the merits of an expert determination when compared to arbitration awards. See *European-Am. Banking Corp. v. Chock Full O’Nuts Corp.*, 442 N.Y.S.2d 715, 718 (1st Dep’t 1981) (acknowledging “this greater degree of judicial control”); *Evanston Ins. Co. v. Cogswell Props., LLC*, 683 F.3d 684, 696 (6th Cir. 2012) (the “attempt to recast the appraisal as an arbitration provision is understandable because the FAA might have afforded a more deferential standard of review to the decision.”); *Morris, Nichols, Arshnt & Tunnell v. R-H Int’l, Ltd.*, 1987 WL 33980, at *4 (Del. Ch. Dec. 29, 1987) (Berger, V.C.) (“this court is not limited in its review of an appraisal as it would be in the case of an arbitration”).

standard of review. *See Hall St. Assocs., LLC v. Mattel, Inc.*, 552 U.S. 576, 588-92 (2008) (parties cannot by contract change standard of review under the FAA).

Second, the arbitration label resulted in the court wrongly treating the accountants as having the authority to rule on issues of law, including interpretation of the contract, free from judicial review. As the court stated, the “FAA does not prescribe a ‘general review for an arbitrator’s legal errors.’” *See Viacom*, 2012 WL 3249620, at *11(citation omitted).

A court’s role in reviewing the outcome of the arbitration proceedings is not to correct factual or legal errors made by the arbitrator. Likewise, courts do not inquire into whether arbitrators read a contract they are interpreting correctly. . . . In other words, to vacate the award the court must find something beyond and different from a mere error in the law or failure on the part of the arbitrators to understand or apply the law.

Id. (internal quotations and citations omitted). This, of course, is not the law as to expert determinations. In an expert determination, the decision maker’s authority is generally limited to certain questions of fact, usually those that concern a valuation. Unless the parties expressly provide otherwise, experts, such as accountants, are not authorized to make final decisions on issues of law, and any contractual interpretations are subject to *de novo* review.⁹¹

Third, in the *Viacom* case, each party had included in their submission to the accountants “arguments that were arguably not presented in accordance with the contractual requirements for determining the Earn-Outs.” *Viacom*, 2012 WL 3249620, at *14. The accountants had decided which of these arguments had been asserted in compliance with the contractual requirements, and refused to consider those it concluded were not. *Id.* *Viacom* sought to challenge these rulings. The court stated that whether these issues were for the court or the accountants would be decided by distinguishing between “substantive arbitrability” and “procedural arbitrability.” *Id.* at *12. As the court explained, “procedural” issues are presumptively for the arbitrator, which include “whether the parties have complied with the terms of the arbitration provision” and issues such as “time limits, notice, laches, estoppel . . . as well as allegations of waiver, delay, or a like defense to arbitrability.” *Id.*

The court held that the determination of which question had been properly preserved under the procedures set forth in the contract was an issue of procedural arbitrability

⁹¹ *See* Section II.C. Whether an expert has based its determination on a legal interpretation of a contract or the practical application of its own expertise is very fact-specific. In *Doosan*, for example, one party contended that the accounting firm decision was subject to review “as a matter of law” because it had based its determination in part on an interpretation of the contract. The court rejected this argument finding that “in allocating pension assets, the CPA Firm did not interpret the ASPA.” Instead, “the CPA Firm applied the appropriate accounting rules to determine the dispute.” The court held that the firm’s findings reflect “application of accounting principles well within the ken of accounting professionals.” *Doosan Infracore Co. v. Ingersoll-Rand Co.*, No 652170/2010, slip op. at 4-5 (N.Y. Sup. Ct. Mar. 15, 2011).

for the accountants to determine, and not subject to any court review. *Id.* at *14.⁹² But the court then went on to state that “I confess in so finding that Viacom has cited to cases from this court that support its arguments.” *Viacom*, 2012 WL 3249620, at *15. As to these cases, “[c]andor requires me to acknowledge that I cannot reconcile them all.” *Id.*

A consequence of the fundamental differences between arbitration and expert determination is that certain arbitration law rules should never be applied to purchase price adjustment disputes. This is because doing so can result in the expert being granted broader and deeper authority than that reasonably expected by the parties. More specifically, one general arbitration rule that should not be applied to Purchase Price Adjustment Clauses is that “any doubts concerning the scope of arbitral issues should be resolved in favor of arbitration,” including where the issue “is the construction of the contract language itself.” *Moses H. Cone*, 460 U.S. at 24-25. Another that should not be used is the distinction between substantive and procedural arbitrability for the purpose of determining which issues are for the court or the expert. *See Howsam*, 537 U.S. at 84-85 (issues of “procedural arbitrability,” such as “time limits, notice, laches, estoppel and other conditions precedent to an obligation to arbitrate” as well as “allegation[s] of waiver, delay or a like defense to arbitrability” are presumptively for the arbitrator) (alteration in original) (internal quotation and citation omitted).

Where the court applies arbitration law to what is, in fact, an expert determination such application can lead to results inconsistent with the intent of the parties. The problem can be completely avoided if the courts recognize that the contractual dispute resolution method selected is an expert determination, not an arbitration. But where this has not happened, the case law shows courts struggling with trying to find a way not to apply these arbitration rules and presumptions to cases where the court sees that application of such rules leads to the wrong result.

A good illustration of this problem is *Avnet, Inc. v. H.I.G. Source, Inc.*, Civil Action No. 5266-VCP, 2010 WL 3787581 (Del. Ch. Sept. 29, 2010). Avnet, Inc. (“Avnet”) had acquired Source Acquisition Corp. (“Source” or the “Company”) from H.I.G. Source, Inc. (“HIG”) for \$63 million, subject to adjustment. The Agreement provided that Avnet within 60 days after the closing would prepare and deliver a Closing Balance Sheet showing its calculations. HIG had 30 days within which to file a Notice of Disagreement. If the parties were unable to resolve their differences, Grant Thornton LLP, an accounting firm, would “resolve all remaining disputed items.” *Id.* at *2.

Avnet failed to provide a Closing Balance Sheet within the required 60 days. In fact, Avnet failed to do so for more than a year, after which time it sent a Closing Balance Sheet claiming that it was owed \$1.8 million. HIG objected to the Closing Balance Sheet as untimely and without force or effect. Avnet filed a Complaint seeking to compel HIG to participate in what it characterized as an arbitration before the accounting firm to resolve the purchase price

⁹² In contrast, the court in *HDS Inv. Holding, Inc. v. Home Depot, Inc.*, Civil Action No. 3968-CC, 2008 WL 4606262 (Del. Ch. Oct. 17, 2008), held that because the issue of the timeliness of the Revising Closing Statement required contract interpretation it was an issue for the court, not the arbitrator.

adjustment dispute.⁹³ HIG, in its answer and counterclaims, asserted that Avnet's arbitration claim was barred because of its failure to prepare the Closing Balance Sheet within the 60 days required by the Agreement, as well as by reason of laches, estoppel, waiver and the failure of a condition precedent. *Id.* at *5.

Because the participants assumed that the Purchase Price Adjustment Clause was an arbitration agreement, the court approached the matter by analyzing whether the issues in dispute were issues of "procedural arbitrability" or "substantive arbitrability." The court stated that in order to determine if "the issues raised in the underlying dispute with HIG Source are to be decided by the arbitrator, in this case Grant Thornton," the court had to "first decide whether the question presented involves issues of 'procedural arbitrability' or 'substantive arbitrability.'" *Id.* at *4.

As the district court noted, the Supreme Court has long "characterized as procedural issues . . . whether prerequisites such as time limits, notice, laches, estoppel and other conditions precedent to an obligation to arbitrate have been met, as well as allegations of waiver, delay or like defenses to arbitrability." *Id.* (internal quotations and citations omitted). This list of "procedural issues" includes the exact issues in dispute before the court. Accordingly, under well-established principles of arbitration law, the dispute concerning the timeliness of the Closing Statement as well as the defenses of laches, estoppel, waiver and the failure of a condition precedent are all matters to be resolved by the arbitrator, Grant Thornton.

The court now had a difficult problem. The application of these well established rules of arbitration law led to all issues being submitted to the accounting firm. The accounting firm, for example, would decide if Avnet could submit its Closing Balance Sheet more than a year late, as well as rule on the legal defenses of laches, waiver and estoppel – a result that the court recognized made no sense. As previously noted, it is difficult to see how an accounting firm would go about deciding such issues. Moreover, that the parties intended this to be within the authority of the accounting firm seems highly unlikely.

In order to avoid reaching the wrong result, the district court needed to find a way to transform what were clearly "procedural" issues into ones of "substantive" arbitrability. If it could, then these matters would be left for the court to decide. The court sought to accomplish this transformation by noting that the parties had offered different, reasonable interpretations of the Agreement. The Agreement, therefore, was "ambiguous" as to whether the parties intended these types of issues to be presented to the accountant-arbitrator. From there, the court simply held that "[r]esolution of that ambiguity involves a question of substantive arbitrability" that must be decided by the court. *Id.* at *6.⁹⁴ In essence, the court's reasoning is based on the silent

⁹³ The parties and the court appear to have acted on the common assumption that the proceeding was an arbitration, but there is no discussion or analysis of this issue.

⁹⁴ In *SRG Global*, the parties had offered different reasonable interpretations of whether the environmental expert-arbitrator could consider the availability of insurance in estimating the cost of remediation. Vice Chancellor Parsons, who also decided *Avnet*, held that the contract interpretation issue was for the environmental expert-arbitrator to resolve. See *SRG Global, Inc. v Robert Family Holdings, Inc.*, Civil Action No. 5314-VCP, 2010 WL 4880654, at *11 (Del. Ch. Nov. 30, 2010).

premise that the definition of “procedural arbitrability” simply does not apply where the decision maker is an expert assigned to resolve a factual issue.

The court was on much more solid ground when it found, in the alternative, that even if the Agreement was not ambiguous, it would still hold that the court, and not the accounting firm, should decide these issues. Here, the court applied the law of contract interpretation to look directly at the reasonable intent of the parties. As the court explained:

[I]t seems unlikely that the parties agreed to submit a broad range of legal issues to the accountant–arbitrator. Rather, the accountant-arbitrator was only empowered to decide those disputes clearly within the ambit of the arbitration clause. [Here,] limited to those issues related to the Closing Balance sheet

Avnet, Inc., 2010 WL 3787581, at *9.

The *Avnet* case illustrates two points. First, the parties’ designation of an accounting firm as the decision maker was fundamental to the court’s determination that the parties intended the accountant-arbitrator’s authority to be limited to deciding factual issues concerning accounting, and not legal issues. Second, application of well-established principles of arbitration law to Purchase Price Adjustment Clauses can lead to results that are contrary to the intent of the parties.

This same struggle to reach the correct result can be found in *Nash v. Dayton Superior Corp.*, 728 A.2d 59 (Del. Ch. 1998), which concerned whether a party could add new issues late in the process. The Purchase Price Adjustment Clause provided for the standard exchange of a Closing Balance Sheet followed by a Notice of Disagreement. In the event the parties failed to reach complete agreement, then “any and all matters which remain in dispute and which were properly included in the Notice of Disagreement” were to be resolved by an independent accounting firm. *Id.* at 60. During the negotiation period, the seller attempted to raise new issues. The question was whether under the Purchase Price Adjustment Clause a party could revise its Closing Balance Sheet after service of the Notice of Disagreement, arguably in response to such objections.

Because the participants assumed that the Purchase Price Adjustment Clause was an arbitration agreement, the paradigm the court used was to determine if the issue was one of “substantive arbitrability.” *Id.* at 63. The court stated the question was “whether the dispute is one that, on its face, falls within the arbitration clause,” noting that “[a]ny doubt as to arbitrability is to be resolved in favor of arbitration.” *Id.* (internal quotation and citation omitted). As this was a matter of compliance with contractual time limits, it was also clear that under arbitration law this was an issue of procedural arbitrability that presumptively was for the arbitrator-accountants.

The court in holding that the issue was for the court, not the arbitrator, simply chose not to apply the rule it had recited that doubts should be resolved in favor of arbitration. The court also failed to address the long line of authority that procedural issues were presumptively for the arbitrator. Instead, it argued that there was “at least potentially, a factual

question as to whether the parties intended the arbitration process to permit Dayton Superior [the seller] to revise the Closing Balance Sheet in response to objections raised by the Notice of Disagreement.” *Id.* at 63-64. It therefore denied the motion to compel, because “in the present posture of the matter, I am unable to conclude that the New Items claim is clearly arbitrable.” *Id.* at 64 (emphasis added).

In short, we suggest these cases illustrate that one of the reasons Purchase Price Adjustment Clauses should not be treated as arbitration agreements is because certain well established arbitration rules and presumptions do not work with respect to such clauses. These rules were generated with respect to proceedings where the parties intended that the decision maker (arbitrator) would have the authority to resolve all issues of law and fact necessary to resolve the legal causes of action being submitted for resolution on the merits. When applied to Purchase Price Adjustment Clauses, however, application of these arbitration law presumptions can easily lead to results that are in conflict with the intent of the parties.

D. Recommendations Of The Committee

At present, parties most often do not use either the terms arbitration or expert determination when drafting Purchase Price Adjustment Clauses. In some cases, the parties do expressly provide that the accounting firm “shall act as expert, and not as arbitrator.”⁹⁵ In some other cases, the parties use the term arbitrator or arbitration. This Committee suggests, however, that even where parties use the terms arbitrator or arbitration in the context of a Purchase Price Adjustment Clause, it is not their intent that the proceeding be a typical arbitration. In fact, and to the contrary, where the parties designate an expert accounting firm with a limited mandate to resolve factual disputes by the application of accounting principles, what they likely intend is what under the law is more properly called an expert determination.

We believe that a reason most parties currently do not make this clear is in substantial part because they have not had available to them the knowledge and “legal vocabulary” to do so. The failure of U.S. law to mark the evolution of the law of appraisal into the law of expert determination, as it has under English law, has deprived many practitioners of the knowledge of this alternative form of binding dispute resolution and also of the vocabulary to give it its proper name.⁹⁶ The lack of the proper vocabulary has led many courts and practitioners into believing that Purchase Price Adjustment Clauses must be arbitrations, by default.

That Purchase Price Adjustment Clauses should be recognized as expert determinations, and not arbitrations, is supported by the type and scope of the authority the parties intend the decision maker to have with the goal of expert determination. The parties have designated an accounting firm as the decision maker, and seek to have such accounting firm resolve issues concerning the correctness of certain values in the post-closing financial

⁹⁵ See Section IV.

⁹⁶ The power to name allows us to make important distinctions. As a result, we live in a world where there are both horses and zebra, rather than one with “striped horses.” This distinction is important for anyone who has tried to saddle and ride a “striped horse.”

schedules. And the accounting firm is expected to make its decision by applying its expertise in accounting principles. What the parties intend is for the decision maker to have the limited authority of an expert, not the broad authority of an arbitrator.

The procedures commonly followed further supports this conclusion. Purchase price adjustment disputes do not follow the adversarial model of arbitration, where the decision maker is required to decide the claims based only on the factual information presented at an open hearing or its equivalent. To the contrary, it is standard for the Purchase Price Adjustment Clause to allow the accounting firm to conduct its own investigation to some degree, such as by sending information requests to the parties in order to obtain the factual information it believes it needs. The accountants assigned to resolve the dispute may also consult with other professionals in the firm who have special expertise.⁹⁷ Consultations with these “internal experts” is routine and done outside the presence of the parties. Indeed, it is expected that the engagement partner will supervise a team of individuals that will perform research, obtain information, prepare calculations and perform such other tasks and analysis as needed. In short, contrary to the procedures governing an arbitration, the decision maker is expected to have access to a substantial body of information, including access to internal experts, outside of any hearing and without the participation of the parties.

Recognition of Purchase Price Adjustment Clauses as governed by the law of expert determination also allows the parties greater discretion in designating the standard of review. While we do not have any statistical data, it is known that some Purchase Price Adjustment Clauses provide that the decision by the accounting firm will be final and binding, absent “fraud or manifest error.” This standard also appears in agreements governed by English law.⁹⁸ The common law standards for review of expert determination are also different from those governing arbitrations. In addition, parties do not have the ability to alter the standards of review set forth in the FAA applicable to arbitration awards.⁹⁹

What is most important is that the parties’ intent and expectations control. In light of the current confusion under the court decisions, this Committee recommends that if the parties intend the Purchase Price Adjustment Clause to be an arbitration agreement, they should make this intent clear when drafting the clause. The parties should use the terms “arbitrator” and “arbitration.”¹⁰⁰ It is also suggested that the agreement provide for the arbitrator to issue its determination in the form of an “award,” naming the prevailing party and the full amount of any

⁹⁷ The typical engagement letter usually expressly provides something along the lines that “J. Smith, the engagement partner, may consult from time to time with other partners, managers or staff of the accounting firm in connection with this engagement and may direct other partners, managers or employees to perform research, prepare calculations or perform such other work as he/she deems necessary and appropriate in the circumstances.”

⁹⁸ See Kendall, *supra* n.4, at 228-29.

⁹⁹ See *Hall Street*, 552 U.S. at 588-92.

¹⁰⁰ A potential issue that may arise where the parties designate an accounting firm as the “arbitrator” relates to “who” the arbitrator will be that will preside at any hearing and issue the award. This can be addressed by the parties in the engagement letter with the accounting firm.

price adjustment to be paid, together with any pre-award interest.¹⁰¹ The parties should also make clear that the proceeding is intended to be an arbitration governed by the FAA, and that judgment on the award can be entered in any court of competent jurisdiction.

Where, however, the parties intend that the Purchase Price Adjustment Clause be governed by the law of expert determination, then the parties should make clear that this is their intent.¹⁰² The parties should include the language that the accounting firm is to make its determination “acting as an expert and not as an arbitrator.” The parties should recite that the Purchase Price Adjustment Clause is not an arbitration agreement, but is to be governed by the law of expert determination and appraisal. Finally, parties may also wish to consider including contractual provisions expressly stating that the accounting firm’s authority is limited to resolving disputed issues of fact by the application of accounting principles, and that the accounting firm shall not have the final authority to make any binding decisions as to issues of law.

V. Two Procedural Problems Currently Found In Purchase Price Adjustment Clauses

A review of the case law shows that certain types of problems repeatedly arise under Purchase Price Adjustment Clauses, two of which we address here. The issues are present regardless whether the Purchase Price Adjustment Clause is classified as an arbitration or an expert determination.

A. Disputes Regarding The Right Of Access To “Books and Records” In Purchase Price Adjustment Clauses

A provision commonly found in Purchase Price Adjustment Clauses is the right of one party to have access to the books, records and personnel of the party that has prepared the post-closing financial statements. Access to this financial information is often necessary in order for a party to be able to fully understand the post-closing statements and prepare its required objections.

A Purchase Price Adjustment Clause may contain, for example, a provision along the following lines:

Buyer shall provide the Seller with reasonable access to all relevant books, records, working papers and those employees who participated or provided information in connection with the Buyer’s preparation of the Closing Financial Statements and

¹⁰¹ Many purchase price adjustment clauses currently provide that the accounting firm is only to resolve any “remaining disputes.” This problem was present in *Thule AB v. Advanced Accessory Holding Corp.*, No. 09 Civ. 91(PKC), 2009 WL 928307 (S.D.N.Y. Apr. 2, 2009). The result was that the court confirmed the determination by the accounting firm, but as to other “adjustments agreed to by the defendants independent of the Reviewing Accounts award,” held that such amount “will now be due and owing” and “[i]f not paid, Thule may pursue all remedies available to it.” *Id.* at *4-5.

¹⁰² The Committee has set forth in Appendix B a modified Purchase Price Adjustment Clause that contains specific language the parties may consider adding in order to make this intent clear.

Closing Working Capital calculation if requested by Seller in connection with its preparation of its notice of objection.

Timely access also is important because the time period for a party to provide notice of any objections is very limited. The contract also may require that a party set forth its objections with a certain level of reasonable detail. Failure to include a specific issue in the objection notice typically results in waiver of the issue. A failure to comply with any “reasonable detail” requirement makes the notice of objection vulnerable to the argument that an issue has been adequately noticed and should be stricken.

At present, a party’s only remedy is to commence a lawsuit seeking the assistance of the courts to compel compliance.¹⁰³ As the cases discussed below illustrate, this results in substantial delay and expense, which interferes with the fair and efficient functioning of the process.

A good example of how disputes under a “reasonable access” clause can significantly disrupt and delay the purchase price adjustment process is found in *Terex Corp. v. Bucyrus Int’l, Inc.*, No. 651889/2010 (N.Y. Sup. Ct. June 7, 2011). In that case, Terex Corporation (“Terex”) sold certain assets (the “Businesses”) to Bucyrus International, Inc. (“Bucyrus”). Because the transaction involved the sale only of certain of Terex’s assets, the seller (Terex) retained substantial financial information concerning the sold businesses. This information was needed by the buyer in order to prepare the post-closing statements.

The purchase price adjustment clause contained a “reasonable access” provision, providing that Terex shall “provid[e] Buyer and its accountants access to the books and records of the Business in its possession and to any other information in its possession necessary to prepare the [closing statement].”¹⁰⁴ Terex was also required to provide “Buyer and its accountants access to any relevant books and records of the Business not in the possession of the Buyer” to assist the buyer in evaluating any of Terex’s objections to the closing statement. *Terex Corp.*, slip op. at 16. When Bucyrus refused to comply with Terex’s requests for access to such books, records and personnel, Terex was forced to file a lawsuit.

The Complaint in *Terex* was filed on October 29, 2010. The ruling on the motion was issued more than seven months later on June 7, 2011. The cost and delay is obvious. The court held on the merits that Bucyrus was required to provide access to its books and records, explaining that Terex could not “effectively protect its interests” without such access. *Id.* at 14. Despite this already substantial delay, however, the court proceeding continued. In its ruling, the court provided a timetable for the production of the information, the filing of objections, meet and confer dates, and retained jurisdiction to rule on any unresolved objections. All such rulings, of course, were also subject to appeal.

¹⁰³ The presence of a general arbitration clause raises the additional issue of the proper forum for seeking such relief. *See* Section IV.C.

¹⁰⁴ *See* Bucyrus International, Inc.’s Mem. of Law in Opp’n to Pl.’s Mot. for Summ. Judg. at 16, *Terex Corp. v. Bucyrus Int’l, Inc.*, No. 651889/2010 (N.Y. Sup. Ct. Jan. 31, 2011) (first alteration in original).

Similarly, in *Mehiel v. Solo Cup Co.*, No. Civ. A. 851-N, 2005 WL 1252348 (Del. Ch. May 13, 2005), the agreement between the parties provided that the selling Stockholders' Representative "shall have full access to all relevant books and records and employees of the Company to the extent required to complete its review of the Closing Working Capital Statement." *Id.* at *4. In this case, the company had retained and relied on the work of KPMG in the preparation of the Closing Working Capital Statement. The Stockholders Representative demanded access to the records and personnel of KPMG, but the buyer refused. The result was litigation, with the proceedings before the Neutral Auditor delayed for eight months.¹⁰⁵

Each of the above cases resulted in substantial delay, cost and interference with the efficient functioning of the Purchase Price Adjustment Clause.

The adequacy of a notice of objection was at issue in *Caribbean [sic] Fertilizer Group Ltd. v. Protein Genetics, Inc.*, No. 604490/00, 2001 BL 628 (N.Y. Sup. Ct. July 9, 2001). There, the buyer initially ignored the seller's request for certain financial information needed to prepare any objections. As a result, the seller was required to serve its objections to the post-closing statement (the "Objection Notice") based on what it contended was incomplete and inadequate information.

In this case, it was the buyer ("Caribbean") that commenced a lawsuit, seeking a ruling that the seller's Objection Notice should be stricken as fatally defective for failure to comply with contractual requirement that the Objection Notice describe any proposed adjustments in "reasonable detail." *Id.* at *2. The court denied the motion for summary judgment. The court held that that the seller's Objection Notice was sufficient in light of the fact that seller "lacked the information necessary to prepare its objections, that it requested that information from Caribbean, and that Caribbean promised to provide but failed to do so." *Id.* at *3. As the court explained, Caribbean "cannot demand strict compliance with the objection deadline if its own conduct made a timely response impossible." *Id.*

While the court denied the motion that the Objection Notice be stricken, the court did not address what, if anything, the accounting firm could do if the seller, after being provided with full access to the required financial information, sought to amend its Objection Notice by adding new claims. We will address this issue shortly.

Courts in these disputes also have had to address the issue of "who" – the court or the accounting firm – is to decide whether a party has breached its obligation to provide the required access to financial information. In *Terex*, *Mehiel* and *Caribbean* discussed above, the parties were apparently content to have the court address these issues. In both of the cases

¹⁰⁵ On the merits, the court denied the relief requested. The court found that the words of the contract authorized access only to the books, records and employees of the "Company," and therefore the buyer had "no obligation . . . to provide [the seller] with access to [the outside consultant's] books, records, or employees, or to books, records, or employees of any entity other than SFH." *Id.* at *5. "If [the seller] wanted a contractual right to access a broader range of material, then he should have contracted for it." *Id.* Thus, the seller had to prepare its dispute notice without the opportunity to analyze the work and calculations of the outside consultant upon which the closing statement was to some measure actually based.

below, however, the courts relied on principles of arbitration law in holding that the accounting firm, not the court, was the proper forum for deciding (i) if a party had breached its obligation to provide access to required information or (ii) whether the objection notice satisfied the contractual requirement that the basis of the objection be set forth in “reasonable detail.”¹⁰⁶ As will be shown, however, these cases raise more issues than they answer.

The court in *E.S. Originals Inc. v. Totes Isotoner Corp.*, 734 F. Supp. 2d 523 (S.D.N.Y. 2010), resolved the “who is to decide” issue by ruling that the accounting firm, not the court, was to resolve these contractual issues. The case concerned a dispute over post-closing earn-out payments. The buyer was required to deliver a “Net Sales Statement” to the seller that was to serve as a basis upon which the post-closing earn-out payments were to be calculated. Seller had the right to access “all of the books, records, and other information necessary to calculate any earn-out payments.” *Id.* at 525. In the event of disagreement, the “item[s] remaining in dispute” were to be resolved by the “Independent Accounting Firm.” *Id.* at 531 (alteration in original).

The seller (“ESO”) filed a court action for breach of contract seeking damages for its failure to receive post-closing earn-out payments. The buyer (“Totes”) moved to dismiss the complaint, arguing that ESO has failed to dispute the Net Sales Statement with the reasonable detail required by the contract. In the alternative, Totes argued that the action should be stayed or dismissed pending arbitration before the accounting firm. The seller responded that any lack of reasonable detail should be excused, because “it was *prevented* from providing more detail in its Dispute Notice because of [Totes’s] failure to live up to its contractual obligations.” *Id.* at 528 (alteration in original).

The contract language required that the notice of objection set forth “each disputed item” and specify the amount and basis for such dispute in “reasonable detail.” *Id.* at 531. As all parties assumed that this was an arbitration clause, the court resolved the issues using arbitration law. The court noted that the “preference for arbitration is so strong that, ‘under the FAA, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.’” *Id.* at 529 (citation omitted). The court held that ESO’s objections to the post-closing statement “as well as disputes concerning the financial documents and records ESO believes are necessary for resolving these discrepancies” were matters to “be resolved by the accounting firm arbitrator called for by the Agreement.” *Id.* at 531.

The court in *Aveta Inc. v. Bengoa*, C.A. No. 3598-VCL, 2008 WL 5255818 (Del. Ch. Dec. 11, 2008), arrived at the same result. The Selling Stockholder claimed that providing the required access to the books, records and personnel was a condition precedent to having the

¹⁰⁶ A similar situation arose in *Pavonix, Inc. v. SumTotal Sys., Inc.*, No. 101651/2011, 2011 WL 2167878 (N.Y. Sup. Ct. May 25, 2011), where the seller asserted that the post-closing statement provided by the Buyer was “devoid of critical details and explanations of [the buyer’s] calculations, leaving [the seller] unable to understand whether [the buyer’s] calculations comport[ed] with the [purchase agreement’s] requirements.” *Id.* at 2. The seller argued that because of the buyer’s lack of cooperation, it was forced to provide only a “preliminary Dispute Notice.” In this case, the parties settled this issue by agreeing that these issues were to be decided by the designated accounting firm, so the action was dismissed as moot.

purchase price adjustment dispute go forward before the Reviewing Accountant.¹⁰⁷ The court noted that in deciding the “who” question, there was “a presumption in favor of arbitration.” *Id.* at *2. The court found that the dispute concerning the “adequacy of the documents provided” was a question of “procedural arbitrability,” and therefore was “a matter for the arbitrator [E&Y] to determine.” *Id.* at *3.

The cases expose a serious and fundamental problem. One line of cases requires that the party commence a court litigation in order to obtain access to the needed financial information, with the consequent substantial cost and delay. The other finds that the accounting firm is to decide compliance with the contractually required access to books, records and personnel or adequacy of the notice of objection. But what these later cases do not address is that under Purchase Price Adjustment Clauses as currently drafted it is not possible for the aggrieved party to obtain the assistance of the accounting firm at this early stage of the process.

As currently structured, the independent accounting firm is retained only at the very end of the process. The procedures first provide for the post-closing financial statements to be prepared. Next, the other party is given a limited period of time to prepare its objections. The parties then negotiate. It is only if the parties cannot reach agreement that an accounting firm is retained and its role is limited to resolving the remaining disputed items.

The result is that there is no engagement letter with any accounting firm at the early stage of the process. There is no practical ability for a party to seek the intervention of an accounting firm early on in order to obtain the information it needs to prepare its objection notice. Currently, there is no one, except the court, that a party can turn to in order to seek an order requiring the other party to provide the contractually required access to books, records, and personnel.¹⁰⁸

This problem is made more acute by the very short time limits imposed on a party to prepare its notice of objections. Such objection notices are typically required to be prepared within 30 to 45 days. Setting aside, for the moment, that there is no retained accounting firm, it is not clear what power the accounting firm would have to address this dispute. For example, does the accounting firm have the authority to change, extend or toll the time periods specified in the contract for the preparation of the objection notice? Indeed, could the accounting firm issue a temporary stay of such time periods in order to have time to hear and resolve the dispute? Alternatively, would the parties have to seek an injunction staying or extending the time to file the objection notice from the courts?

Similar problems arise if the aggrieved party seeks to introduce this issue at the end of the process in connection with the proceedings before the accounting firm. The issue then becomes whether the accounting firm, in connection with its resolution of the disputed items, can hear a claim by a party asserting that the other breached the contract by failing to fully provide

¹⁰⁷ The characterization of the proceeding before the Reviewing Accountants as an arbitration does not appear to have been at issue, but rather accepted by parties and the court.

¹⁰⁸ In the event that the agreement contains a general arbitration clause, there is the additional issue as to whether the arbitral tribunal would be the proper forum for resolution of this dispute.

access to required financial information. If the accounting firm can hear such claim, then what, if anything, can it order as a remedy?¹⁰⁹ Can the accounting firm, for example, grant the aggrieved party the right to prepare an amended notice of objection in which it adds new issues and seeks a higher price adjustment? Also, what is the standard the accounting firm should use in deciding such matters?

As present, there are no clear answers to these questions. As a result, the parties may well find themselves back in court fighting over each of these issues.

B. Recommendations Of The Committee As To The Access To Books And Records Problem

It is the Committee's recommendation that parties consider modifying their Purchase Price Adjustment Clauses so that a party will have the ability to seek the early intervention of the designated accounting firm to resolve disputes about compliance with the obligation to provide access to any required books, records and personnel. Whether a party has provided the required access is a factual dispute. The accounting firm's expertise makes it a superior forum for resolving these factual disputes, which requires an evaluation of the adequacy of the financial information provided.

In order to accomplish this, the Purchase Price Adjustment Clause must be modified in order to provide a party with access to the accounting firm early in the process. The scope of authority of the accounting firm also must be addressed. The parties should also make clear that the accounting firm has the authority to stay and extend any affected dates. If a party can show that it has been prejudiced by the failure to have had complete access to such information, then the accounting firm should have the authority to allow the party an opportunity to amend its notice of objection or other affected documents.

The following is suggested language that can be adapted for use in a Purchase Price Adjustment Clause to accomplish these changes.

1.0 A party claiming that [the buyer] has failed to comply with its obligations under [Section x.y] to provide access to financial information may initiate the appointment of the Independent Accounting Firm [identified in the contract] by making a written request directly to the Accounting Firm.

1.1. The Accounting Firm shall have the authority:

¹⁰⁹ In *Melun Industries, Inc. v. Strange*, 898 F. Supp. 990 (S.D.N.Y. 1990), the court held that the accounting firm had authority to allow a party to file an untimely, amended Post-Closing Statement where the buyer argued that its delay should be excused because it was caused by the seller's "failure to provide necessary financial data." *Id.* at 992. This case, however, arguably was decided on very unique facts. The contract at issue did not provide for a set number of days within which the post-closing statement needed to be prepared. Instead, the time to prepare the statement only began to run after the seller had provided all of the relevant documents. The court found that there "was a factual dispute" about when the Post-Closing Statement was due, and held that whether the amended post-closing statement was timely was an issue to be decided by the accounting firm.

(i) to determine if a party has complied with its obligations to provide access to the financial information required pursuant to [Section x.y] and to order that a party comply with any such obligations;

(ii) to extend any deadlines set forth herein, including the immediate temporary suspension of such deadlines during the time period necessary for it to resolve such dispute;

(iii) to allow a party the right to amend any prior [Notice of Objection] where it finds that such party had been prejudiced by the failure to have been provided access to such financial information.

The parties may also wish to consider the issue of who is to decide any challenge to the adequacy of an objection notice. As noted, some Purchase Price Adjustment Clauses provide that the objection notice set forth the amount and basis for each objection with reasonable detail. It is suggested that this is fundamentally a factual question within the expertise of the accounting firm. If the accounting firm is to be given the authority to decide such issue, it should be made clear that the accounting firm has discretion as to the appropriate remedy.

C. The Presence Of A General Arbitration Clause In A Contract With A Purchase Price Adjustment Clause Raises Issues That The Parties Should Address

A contract containing a general arbitration clause and a Purchase Price Adjustment Clause raises a number of issues as to how one dispute resolution proceeding relates to the other.

A first issue is one of allocation. Does a particular dispute fall within the jurisdiction of the accounting firm under the Purchase Price Adjustment Clause or the arbitrator under the general arbitration clause. This same issue arises in contracts without an arbitration clause, where the question is one concerning the respective jurisdiction of the court and the accounting firm. While there are always hard cases on specific facts, most courts have had little difficulty in finding that claims asserting a breach of other provisions of the contract are outside the scope of the jurisdiction of the accounting firm. *See, e.g., XL Capital, Ltd. v. Kronenberg*, No. 04 Civ. 5496(JSR), 2004 WL 2101952 (S.D.N.Y. Sept. 20, 2004), *aff'd*, 145 F. App'x 384 (2d Cir. 2005). There is also a conflict with respect to cases where the same facts give rise to a claim that can be asserted under a Purchase Price Adjustment Clause or as a claim for indemnification, particularly where the claim for indemnification is for breach of a contractual representation as to the financial statements of the company.¹¹⁰

¹¹⁰ The conflict can be illustrated by comparing *Westmoreland Coal Co. v. Entech, Inc.*, 100 N.Y.2d 352 (2003), with *Terex Corp. v. Bucyrus Int'l, Inc.*, No. 651889/2010 (N.Y. Sup Ct. June 6, 2011), a case which distinguished and therefore did not apply *Westmoreland*.

A second issue relates to the relative hierarchy between these two dispute resolution proceedings and their relationship to the courts: are these two dispute resolution proceedings independent of the other. To illustrate, if there is a dispute between the parties as to the contractual obligation under a Purchase Price Adjustment Clause to provide access to the financial information used to prepare the post-closing financial schedules, can the aggrieved party apply to a court or is it required to file a demand for arbitration? The same problem arises at the end of the process. What is the proper forum, the court or the arbitral tribunal, for a party seeking to either enforce or set aside a determination by the accounting firm. In short, can the arbitrators review the accounting firm's determination as to any purchase price adjustment?

We do not suggest that there is a right answer to this issue, but only that it is one of which the parties should be aware and address. There is too little case law on this issue to make any general statements. We note that some courts that have addressed this issue have held that a general arbitration clause does not apply to the expert determination provision. Under this view, a party would apply directly to the courts to enforce, or to seek to set aside, the decision of the accounting firm. *See, e.g., Katz v. Feinberg*, 167 F. Supp. 2d 556 (S.D.N.Y. 2001), *aff'd*, 290 F.3d 95 (2d Cir. 2002) (accountant's decision is not subject to arbitral review); *Cendant Corp. v. Forbes*, 70 F. Supp. 2d 339, 342-43 (S.D.N.Y. 1999) ("it is logical to conclude that by entering into the appraisal agreement, they intended to remove the question from the range of arbitrable matters and to be bound by the appraiser's findings"); *Wash. Auto. Co. v. 1828 L St. Assocs.*, 906 A.2d 869, 880 (D.C. 2006) (appraisal under lease cannot be subjected to challenge by invoking the general arbitration provision). Under this view, the two dispute resolution provisions are viewed as independent of the other.

It is also possible to view the arbitration provision as having a superior position relative to the Purchase Price Adjustment Clause. Under this view, it can be argued that the parties have decided that any disputes under the contract are to be decided by arbitration, not court litigation. This argument can be particularly strong in the context of cross-border transactions, where arbitration is selected in part because neither party wants to consent to having disputes resolved in the national courts of the other.

Under this view, a party would need to commence an arbitration in order to obtain confirmation or to seek to challenge and set aside a determination by the accounting firm.¹¹¹ The arbitral tribunal would play the same role as a court in connection with the enforcement of any purchase price adjustment. The resulting arbitration award would then itself be subject to confirmation, challenge or enforcement. One of the advantages of this approach is that the purchase price adjustment would be reflected in an award that would be enforceable under the New York Convention.

Blue Tee Corp. v. Koehring Co., 999 F.2d 633 (2d Cir. 1993), helps to illustrate the issue. The case concerned a purchase price adjustment dispute that was before the accounting firm Arthur Andersen. During the proceeding before the accounting firm, the seller submitted evidence that the parties had agreed on a last-minute change to the method by which

¹¹¹ According to Kendall, unless specifically carved out, under English law any challenge to the decision of an expert should be resolved by arbitration, not the court. *See Kendall, supra* n.4, at 210.

the inventory would be valued. *See id.* at 635. The accounting firm “expressly disclaimed competence to determine whether, as [seller] argued, the parties had amended the Agreement at the last minute, thereby materially affecting the valuation of inventory.” *Id.* It did, however, determine that under a literal interpretation of the Agreement, assuming it had not been amended, the buyer had overpaid by \$878,000. *Id.*

The seller then demanded arbitration under the general arbitration clause of the agreement. In its arbitration demand, it requested that the arbitral tribunal find in favor of its claim that the parties had agreed on a change in the method by which inventory was valued, and that as a result it was entitled to a purchase price adjustment in its favor. “After eight days of hearings, including testimony from six witnesses and extensive oral and written presentations by the parties,” the AAA panel agreed and ruled in favor of the seller finding that the method for valuing inventory had been changed by the parties. *Id.* at 636. The Second Circuit affirmed confirmation of the arbitral award.

Here, there was a legal claim asserted by the seller that the Agreement had been amended. The accounting firm, quite correctly, “expressly disclaimed competence” to decide this legal claim. As a result, in *Blue Tee*, the legal claim was held to be matter for the arbitral tribunal to decide. Why should the answer be any different where the issue is confirmation or a challenge to the accounting firm’s determination? On the other hand, the parties may well want to avoid the substantial expense and delay that would result if the parties had to commence an arbitration in order to enforce payment of a purchase price adjustment.

Parties, when drafting their agreements, would be well advised to expressly address this issue. This can be done, depending on what the parties decide, by having the general arbitration clause include a carve-out specifically excluding from its scope a review of any determinations by the accounting firm pursuant to the purchase price adjustment provision. If, however, the parties intend for the arbitrators to have such jurisdiction, then this should be expressly stated.¹¹²

Conclusion

Purchase Price Adjustment Clauses are an important feature found in most domestic and cross-border contracts for the sale of private companies. At present, there is significant confusion in the U.S. as to whether a purchase price adjustment clause is an arbitration clause. We believe that many U.S. practitioners assume that a Purchase Price Adjustment Clause does provide for arbitration because, if it does not, then is not clear what else it could provide for.

We have shown that the law of the United States, consistent with the law of many other countries, has long recognized the existence of two very different contractual dispute resolution proceedings, namely, “arbitration” and “expert determination.” While the term “arbitration” is well known in the United States, that is not the case for the term “expert determination.” This is because the term historically used in the United States for these proceedings is “appraisal” or “appraisement.” We have suggested that use of the term

¹¹² Appendix C sets forth suggested language to be added to a general arbitration clause to address this issue.

“appraisal” is an unfortunate holdover from older English case law. The failure of U.S. law to mark the evolution of the law of appraisal into the law of expert determination, as it did under English law, has deprived many practitioners of the knowledge of this alternative form of binding dispute resolution, as well as the ability to recognize it and the vocabulary to give it its proper name. As a result, many courts and practitioners have wrongly assumed that Purchase Price Adjustment Clauses must be arbitrations, by default.

A purpose of this report has been to set forth the jurisprudence governing expert determinations in the United States. Practitioners in deciding whether to choose arbitration or expert determination should be aware of the significant differences between these two forms of alternative dispute resolution. The law of New York is particularly well developed with regard to expert determinations. The New York Legislature has long recognized the importance of protecting and enforcing the difference between arbitration and expert determination, including the enactment of specific legislation designed to make sure that the parties’ election to have a dispute resolved by expert determination, as opposed to by arbitration, is fully recognized and enforced.

A particular focus of this report has been to take a close look at the case law arising out of purchase price adjustment disputes. As a result of this analysis, we suggest that Purchase Price Adjustment Clauses are usually best viewed as a form of expert determination, not arbitration. We have also examined some of the issues that have been the subject of significant court litigation relating to such clauses. As a result of this analysis, we have made suggestions as to how parties can draft these clauses so as to better express their intent and avoid, or at least minimize, related litigation. We have suggested how Purchase Price Adjustment Clauses should best be analyzed and interpreted by the courts. In particular, we have pointed out the critical importance that the designation of an accounting firm as the decision maker plays in understanding the reasonable intent and expectation of the parties as to the scope and depth of the authority granted to the accounting firm. A goal of this report has been to promote better understanding of the law of expert determination, and recognition that purchase price adjustment proceedings are most often intended by the parties to be a form of expert determination. As a result, the clauses should be interpreted and enforced under the law of expert determination, not the law of arbitration, in order to best accord with the intent of the parties.

Appendix A

Basic Purchase Price Adjustment Clause¹¹³

1.0 THE PURCHASE PRICE

The Purchase Price will be [\$100 million], plus or minus the Adjustment Amount. The “Adjustment Amount” (which may be a positive or negative number) will be equal to the amount determined by subtracting the Closing Working Capital from the Initial Working Capital.

“Working Capital” as of a given date shall mean the amount calculated by subtracting the current liabilities of Seller included in the Assumed Liabilities as of that date from the current assets of Seller included in the Assets as of that date. The Working Capital of Seller as of the date of the Reference Balance Sheet (the “Initial Working Capital”) was [_____] dollars.

2.0 THE PURCHASE PRICE ADJUSTMENT PROCEDURE

2.1 Buyer shall prepare financial statements (“Closing Financial Statements”) of the Company as of the Closing Date on the same basis and applying the same accounting principles, policies and practices that were used in preparing the Reference Balance Sheet, including the principles, policies and practices set forth on Exhibit __. Buyer shall then determine the Working Capital as of the Closing Date (the “Closing Working Capital”) based upon the Closing Financial Statements and using the same methodology as was used to calculate the Initial Working Capital. Buyer shall deliver the Closing Financial Statements and its determination of the Closing Working Capital to Seller within sixty (60) days following the Closing Date.

2.2 If within thirty (30) days following delivery of the Closing Financial Statements and the Closing Working Capital calculation, Seller has not given Buyer written notice of any objection as to the Closing Working Capital calculation (which notice shall state the basis of Seller’s objection in reasonable detail) (the “Objection Notice”), then the Closing Working Capital calculated by Buyer shall be binding and conclusive on the parties and be used in computing the Adjustment Amount.

2.3 If Seller duly gives Buyer an Objection Notice, and if Seller and Buyer fail to resolve the issues outstanding with respect to the Closing Financial Statements and the calculation of the Closing Working Capital within thirty (30) days of Buyer’s receipt of Seller’s Objection Notice, then Seller and Buyer shall submit the issues remaining in dispute to [name], independent public accountants (the “Independent Accounting Firm”) for resolution. The determination by the Independent Accountants of the issues remaining in dispute, shall be final, binding and conclusive on the parties.

¹¹³ This is a simplified example provided for illustration purposes only.

2.4 Buyer shall provide the Seller with reasonable access to all relevant books, records, working papers and those employees who participated or provided information in connection with the Buyer's preparation of the Closing Financial Statements and Closing Working Capital calculation if requested by Seller in connection with its preparation of its Objection Notice.

2.5 If issues are submitted to the Independent Accountants for resolution, Seller and Buyer shall furnish or cause to be furnished to the Independent Accountants such work papers and other documents and information relating to the disputed issues as the Independent Accountants may request and are available to that party or its agents.

Appendix B

Purchase Price Adjustment Clause -- Expert Determination ¹¹⁴

1.0 THE PURCHASE PRICE

The Purchase Price will be [\$100 million], plus or minus the Adjustment Amount. The “Adjustment Amount” (which may be a positive or negative number) will be equal to the amount determined by subtracting the Closing Working Capital from the Initial Working Capital.

“Working Capital” as of a given date shall mean the amount calculated by subtracting the current liabilities of Seller included in the Assumed Liabilities as of that date from the current assets of Seller included in the Assets as of that date. The Working Capital of Seller as of the date of the Reference Balance Sheet (the “Initial Working Capital”) was [_____] dollars.

2.0 THE PURCHASE PRICE ADJUSTMENT PROCEDURE

2.1 Buyer shall prepare financial statements (“Closing Financial Statements”) of the Company as of the Closing Date on the same basis and applying the same accounting principles, policies and practices that were used in preparing the Reference Balance Sheet, including the principles, policies and practices set forth on Exhibit __. Buyer shall then determine the Working Capital as of the Closing Date (the “Closing Working Capital”) based upon the Closing Financial Statements and using the same methodology as was used to calculate the Initial Working Capital. Buyer shall deliver the Closing Financial Statements and its determination of the Closing Working Capital to Seller within sixty (60) days following the Closing Date.

2.2 If within thirty (30) days following delivery of the Closing Financial Statements and the Closing Working Capital calculation, Seller has not given Buyer written notice of any objection as to the Closing Working Capital calculation (which notice shall state the basis of Seller’s objection in reasonable detail) (the “Objection Notice”), then the Closing Working Capital calculated by Buyer shall be binding and conclusive on the parties and be used in computing the Adjustment Amount.

2.3 If Seller duly gives Buyer an Objection Notice, and if Seller and Buyer fail to resolve the issues outstanding with respect to the Closing Financial Statements and the calculation of the Closing Working Capital within thirty (30) days of Buyer’s receipt of Seller’s Objection Notice, then Seller and Buyer shall submit the issues remaining in dispute to [name], independent public accountants (the “Independent Accounting Firm”) for resolution.

¹¹⁴ The Purchase Price Adjustment Clause set forth in Appendix B has been modified in order to include provisions the parties may consider adding where the intent is for an expert determination.

[Expert Determination Clause]

[i] The Independent Accounting Firm shall act as an expert, not as an arbitrator, in resolving the dispute. The proceeding before the Independent Accounting Firm shall be an expert determination under the law governing expert determination and appraisal proceedings.¹¹⁵

[Standard of Review Clause]¹¹⁶

[i] The determination by the Independent Accountants shall be final and binding on the parties.

or

The determination by the Independent Accountants shall be final and binding on the parties, except in the case of manifest error.

or

The determination by the Independent Accountants as to any issue of fact shall be final and binding on the parties, except in the case of manifest error. The determination shall be subject to de novo review for any error of law.

[Enforcement Clause]

[i] The Independent Account Firm shall set forth in its determination the resolution of each of the unresolved issues from the Objection Notice and a calculation showing the final amount owed as the Adjustment Amount of the Purchase Price, together with interest calculated from the date of the Closing.¹¹⁷

[ii] (If the agreement is governed by New York law, then the following is suggested.) The determination by the Independent Accounting Firm shall be governed by Article 76 of the Civil Practice Laws and Rules of the State of New York.¹¹⁸

¹¹⁵ See text accompanying footnotes 84,95-97.

¹¹⁶ See text accompanying footnotes 68-71.

¹¹⁷ See text accompanying footnotes 88-91,101. The parties may wish to specify the interest rate, as well as the post-judgment interest rate. In the United States, a contractual interest rate does not apply to a court judgment, which generally is governed by statute. The parties may contract for a post-judgment interest rate but must do so by expressly referencing the post-judgment period. *See, e.g., Westinghouse Credit Corp v. D'Urso*, 371 F. 3d 96, 101 (2d Cir. 2004).

¹¹⁸ See text accompanying footnotes 62-67, 84.

[Potential Conflict With Any General Arbitration Clause]¹¹⁹

[i] Any determination by the Independent Account Firm may be enforced and entered as a judgment by any court of competent jurisdiction. Any dispute arising under this [Purchase Price Adjustment Clause] is not subject to arbitration under Section X.y of this Agreement.

or

Any dispute arising under this [Purchase Price Adjustment Clause], including enforcement of the determination by the Independent Accounting Firm, must be submitted to arbitration under Section X.y of this Agreement.

2.4 Buyer shall provide the Seller with reasonable access to all relevant books, records, working papers and those employees who participated or provided information in connection with the Buyer's preparation of the Closing Financial Statements and Closing Working Capital calculation if requested by Seller in connection with its preparation of its Objection Notice.

2.5 If issues are submitted to the Independent Accountants for resolution, Seller and Buyer shall furnish or cause to be furnished to the Independent Accountants such work papers and other documents and information relating to the disputed issues as the Independent Accountants may request and are available to that party or its agents.

[Jurisdiction To Resolve Disputes Concerning Access To Information]¹²⁰

3.0 A party claiming that the [Buyer] has failed to comply with its obligations under [Section 2.4] to provide access to financial information may initiate the appointment of the Independent Accounting Firm by making a written request directly to the Accounting Firm.

3.1. The Accounting Firm shall have the authority:

(i) to determine if a party has complied with its obligations to provide access to the financial information required pursuant to [Section 2.4] and to order that a party comply with any such obligations;

(ii) to extend any deadlines set forth herein, including the immediate temporary suspension of such deadlines during the time period necessary for to resolve the disputed issue;

¹¹⁹ See text accompanying footnotes 110-112.

¹²⁰ See text accompanying footnotes 102-109.

(iii) to allow a party the right to amend any prior [Notice of Objection] where it finds that such party had been prejudiced by the failure to have been provided access to such financial information.

3.2 Any deadline set forth herein shall be temporarily suspended upon the making of a written request to the Accounting Firm asserting a failure to comply with [Section 2.4].

Appendix C

Language To Be Added To A General Arbitration Clause To Address The Potential Conflict With A Purchase Price Adjustment Clause

1. Purchase Price Adjustment Process To Be Excluded From The Scope Of The General Arbitrating Clause

Example 1: All disputes arising out of or in connection with this Agreement, *with the exception of any and all issues arising under the Purchase Price Adjustment process set forth in Section ____, above*, shall be finally settled under the Rules of the [name of arbitral institution] by [one or more] arbitrators appointed in accordance with said Rules....

Example 2: All disputes arising out of or in connection with this Agreement, *with the exception of the recognition and enforcement of any adjustment to the Purchase Price determined pursuant to Section ____, above*, shall be finally settled under the Rules of the [name of arbitral institution] by [one or more] arbitrators appointed in accordance with said Rules....

2. Purchase Price Adjustment Process To Be Within The Scope Of The General Arbitration Clause

Example 1: All disputes arising out of or in connection with this Agreement, including *any and all issues arising under or concerning the Purchase Price Adjustment process set forth in Section ____, above*, shall be finally settled under the Rules of the [name of arbitral institution] by [one or more] arbitrators appointed in accordance with said Rules....

Example 2: All disputes arising out of or in connection with this Agreement, *including the recognition and enforcement of any adjustment to the Purchase Price determined pursuant to Section ____, above*, shall be finally settled under the Rules of the [name of arbitral institution] by [one or more] arbitrators appointed in accordance with said Rules...

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† Chair of the Subcommittee that drafted the Report on Purchase Price Adjustment Clauses

* Members of the Subcommittee on Purchase Price Adjustment Clauses

^{xx} *The Honorable John G. Koeltl took no part in the preparation of this report*