IN THE SUPREME COURT OF THE STATE OF DELAWARE

VIACOM INTERNATIONAL INC., Plaintiff and Counter-Defendant Below, Appellant, v. WALTER A. WINSHALL, in his capacity as the Stockholders Representative, Defendant and Counter-Plaintiff Below, Appellee.	No. 513, 2012 On appeal from the Court of Chancery of the State of Delaware C.A. No. 7149-CS Redacted Public Version Filed November 16, 2012

APPELLANT'S OPENING BRIEF

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November 1, 2012

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I. Nature of the Proceedings

This case arises out of the acquisition of Harmonix Music Systems, Inc. ("Harmonix") by Appellant Viacom International Inc. ("Viacom") pursuant to an "Agreement and Plan of Merger" dated September 20, 2006 (the "Merger Agreement"). The parties dispute the amount, if any, Viacom owes to the selling stockholders of Harmonix in post-merger earn-out payments based on Harmonix's financial performance in the years 2007 and 2008 (the "Earn-Outs").[1]

Viacom calculated the Earn-Outs pursuant to the formula in the Merger Agreement. The representative of the selling stockholders, Appellee Walter A. Winshall, then commenced this resolution accounting dispute by contesting certain aspects of Viacom's calculation—most significantly, Viacom's treatment of the cost of unsold inventory. In calculating Harmonix's gross profit for 2007 and 2008, Viacom deducted the cost of manufacturing all the goods in those years, both sold and unsold. Winshall disputed Viacom's methodology and argued instead that, applying the accounting principle of "matching" costs to revenues, only the cost of goods *actually sold* should be considered in calculating Harmonix's gross profit.

Although there were other disagreements, the dispute raised by Winshall regarding the cost of unsold inventory was the most significant one. It represented the difference between Earn-Outs of zero under Viacom's method and Earn-Outs in the hundreds of millions of dollars under Winshall's method.

Pursuant to the Merger Agreement, the parties submitted their disagreements to a neutral accounting firm (the "Resolution Accountants"). In that proceeding, Winshall pursued his challenge to Viacom's deduction of the cost of manufacturing the unsold inventory, advocating that the Resolution Accountants should adopt his matching approach. In response, Viacom (1) defended its deduction of the cost of manufacturing the unsold goods as being required by the terms of the Merger Agreement; and (2) in case the Resolution Accountants decided to adopt Winshall's matching approach, presented evidence of the cost of writing down the diminished value of the unsold inventory under that approach (the "Inventory Write-Down").

When the market value of inventory declines below its cost, that loss in value must be recorded as a cost offsetting revenues earned in the

[1] Although the parties disagreed over the Earn-Outs for both 2007 and 2008, only the payment for 2008 remains in issue.

period during which the inventory's value declined, and thus a reduction in profit. Viacom submitted evidence that the cost of writing down the value of the inventory left unsold in 2008 was $54 million—a cost that would have to be included in the recalculation of the Earn-Out for 2008 under Winshall's own accounting method.

The Resolution Accountants issued a determination on December 19, 2011 and recalculated the Earn-Outs for both 2007 and 2008 (the "Determination"). They recalculated the Earn-Out for 2007 to be $234,130,148 and the Earn-Out for 2008 to be $298,813,095. They did so by, *inter alia*, applying the matching approach advocated by Winshall and finding that the Earn-Out calculation should not reflect the full cost of unsold inventory.

They refused, however, even to consider Viacom's evidence that, under Winshall's accounting method, the calculation of the Earn-Out for 2008 must reflect the Inventory Write-Down. The Resolution Accountants acknowledged Viacom's evidence, but concluded they did not have the authority to hear that evidence because Winshall—at the very last minute—disputed the arbitrability of the Inventory Write-Down and would not agree to allow the Resolution Accountants to consider it. The Resolution Accountants thus declined to consider the Inventory Write-Down. They also declined to decide whether or not the Inventory Write-Down was arbitrable, stating that they would defer to the court.

Viacom therefore filed this action in the Court of Chancery to vacate the Determination on the ground that the Inventory Write-Down was arbitrable and that the Resolution Accountants' refusal to consider it denied Viacom a fair hearing. Viacom argued that Winshall himself had put the unsold inventory issue into dispute, and that Viacom was denied the opportunity to respond to Winshall's central position (matching) on the central issue (the unsold inventory)—a position that the Resolution Accountants embraced while at the same time refusing to hear Viacom's evidence on the subject. Accordingly, Viacom argued that the Determination should be vacated under the Federal Arbitration Act ("FAA" or the "Act"), which provides that a court may vacate an award where the arbitrators are guilty of misconduct "in refusing to hear evidence pertinent and material to the controversy." 9 U.S.C. § 10(a)(3).

The Court of Chancery denied Viacom's motion to vacate, and granted Winshall's motion for summary judgment on his counterclaim for confirmation of the Determination. The Court of Chancery held that although the Resolution Accountants did in fact refuse to consider the evidence of the Inventory Write-Down, that refusal was justified because

(1) the Resolution Accountants had made a decision that the issue was not arbitrable; (2) that decision was a matter of "procedural" arbitrability and, thus, entitled to judicial deference; and (3) that decision was a correct interpretation of the Earn-Out and dispute resolution provisions of the Merger Agreement.

In so holding, the Court committed three reversible errors of law: it misconstrued the Resolution Accountants' decision, misapplied Delaware law, and misread the Merger Agreement. Each one of the court's findings is subject to *de novo* review.

First, the Court of Chancery erroneously found that the Resolution Accountants themselves had decided that the Inventory Write-Down was not arbitrable. They did not. In fact, the Resolution Accountants expressly declined to decide arbitrability and left that decision to the court. The Court of Chancery therefore erred by deferring to a determination of non-arbitrability that was never in fact made. Rather than deferring to a non-existent ruling, the Court of Chancery should itself have found the Inventory Write-Down to be arbitrable under the Merger Agreement and sent the issue back to the Resolution Accountants.

Second, the Court of Chancery contravened Delaware law by holding that the purported (but non-existent) determination of non-arbitrability was a matter of "procedural" arbitrability within the primary authority of the Resolution Accountants and, therefore, entitled to judicial deference. Numerous decisions hold that whether or not an issue has been properly submitted to a neutral accountant under an arbitration agreement is a legal question of contract interpretation and, thus, a matter of substantive arbitrability for independent judicial review. The Court of Chancery itself "confess[ed]" that it could not distinguish the "cases from this court that support [Viacom's] arguments"—including Viacom's argument that the Resolution Accountants did not have the primary authority to decide the arbitrability of the Inventory Write-Down. Rather than departing from settled Delaware law, the Court of Chancery should have adhered to precedent, found the Inventory Write-Down to be arbitrable, and sent the issue back to the Resolution Accountants.

Third, the Court of Chancery misinterpreted the Merger Agreement in finding that the Inventory Write-Down was not arbitrable. It erroneously concluded that the Inventory Write-Down was not arbitrable on the basis that Viacom had not included that cost in its Earn-Out Statement for 2008. Under the Merger Agreement, however, the Earn-Out Statement does not define the full scope of the dispute. The scope of the dispute is defined by the document commencing the dispute resolution process: the "Summary of Issues" prepared by the sellers' representative to notify Viacom of his disagreements with Viacom's Earn-Out calculations. It was the Summary of Issues that raised the cost of unsold inventory as an issue. And it was the Summary of Issues that asserted Winshall's matching approach to resolve that dispute.

The Court of Chancery, however, disregarded the Summary of Issues and ignored Viacom's argument that it was Winshall who put the Inventory Write-Down in issue. In effect, the Court held that the Resolution Accounting process was like a baseball arbitration. Viacom, it seems, was stuck with the Earn-Out calculation it made at the outset, regardless of the disputes Winshall subsequently raised *and* regardless of what accounting method Winshall urged the Resolution Accountants to use in resolving those disputes. Even though the unsold inventory was the largest issue Winshall submitted to the Resolution Accountants and even though the Resolution Accountants themselves did not decide other issues in this all-or-nothing manner, the court held that Viacom had no right to submit evidence of how Winshall's proposed accounting method should be applied to the Inventory Write-Down.

Viacom respectfully requests that this Court reverse the Court of Chancery's decision and afford Viacom the fundamentally fair hearing before the Resolution Accountants to which it is entitled under the Federal Arbitration Act.

II. Summary of Argument

A. The Resolution Accountants refused to hear highly relevant evidence resulting in a $191 million overstatement of the Earn-Out for 2008. It is undisputed that the Resolution Accountants did not consider the Inventory Write-Down evidence Viacom submitted in response to the unsold inventory issue raised by Winshall and in response to the accounting method advanced by Winshall for resolving that dispute. The refusal by the Resolution Accountants to hear such "pertinent and material evidence" deprived Viacom of a fair hearing and, accordingly, the Court of Chancery erred in failing to vacate the Determination under Section 10(a)(3) of the Federal Arbitration Act.

B. The Court of Chancery committed reversible legal error by denying Viacom's motion to vacate, and instead granting Winshall's motion for summary judgment, on the basis of deference to a purported finding by the Resolution Accountants that the Inventory Write-Down was not arbitrable.

1. The Resolution Accountants did *not* determine whether the Inventory Write-Down was an arbitrable issue. Instead, the Resolution Accountants declined to make that determination in deference to the court. The Court of Chancery therefore erred by deferring to a purported determination of non-arbitrability that did not exist.

2. Even if the Resolution Accountants had determined that the Inventory Write-Down was not arbitrable, that determination would be a matter of substantive arbitrability and, thus, not due any judicial deference. The Court of Chancery erred by giving the purported finding of non-arbitrability deference.

C. The Court of Chancery committed reversible legal error by denying Viacom's motion to vacate, and instead granting Winshall's motion for summary judgment, based on its own determination that the Inventory Write-Down was not arbitrable. Once Winshall put into dispute the cost of the unsold inventory, and then advocated an accounting methodology different from the one Viacom had used, Viacom was entitled not only to defend its own approach, but to present evidence regarding the proper application of Winshall's alternative approach. Winshall himself did not object to the arbitrability of the Inventory Write-Down until after the parties' evidentiary submissions were complete. And there is no provision in the Merger Agreement under which Viacom agreed to sit defenseless and remain silent when confronted with alternative accounting methods for recalculating the Earn-Outs.

III. Statement of Facts

Viacom is a global entertainment company whose portfolio of television, motion picture, and digital media brands includes MTV Networks (now Viacom Media Networks), BET Networks, and Paramount Pictures. Ex. A, at 3. Harmonix is a developer of music-oriented video games. *Id*.

In 2005 and 2006, Harmonix's revenues were $5.5 million and $17.9 million, respectively. A159. Viacom acquired Harmonix from its selling stockholders pursuant to a merger agreement dated September 20, 2006. A1.

At that time, Harmonix was receiving royalties from sales of its *Guitar Hero* game by a third-party licensee and was in the midst of developing *Rock Band*, which was not scheduled to be released until November 2007. A158, 163. Harmonix followed *Rock Band* with a sequel, *Rock Band 2*, released in the fall of 2008. A163.

A. The Earn-Out Calculation

The purchase price for Harmonix was $175 million, which Viacom paid in cash at closing. A11. The Merger Agreement also provided for the possibility of "Contingent Consideration" in the form of Earn-Outs for the years 2007 and 2008.

Under the Merger Agreement, Viacom calculates whether any Earn-Outs are due and delivers that calculation to the Stockholders' Representative in an "Earn-Out Statement" for each of the years 2007 and 2008. A16-17. The Earn-Outs, if any, are to be calculated by Viacom pursuant to the formula in Section 2.4 of the Merger Agreement. The Earn-Out is the amount by which "Gross Profit" exceeds stipulated profit thresholds ($32 million for 2007 and $45 million for 2008) multiplied by 3.5. A9-10.

The components of this calculation are each defined in the Merger Agreement. "Gross Profit" is defined as "the sum of Product Gross Profit for all of the products of" Harmonix. A11. "Product Gross Profit" is defined as "the positive or negative difference, between (i) Net Revenue attributable to such product and (ii) the sum of all Direct Variable Costs attributable to such product." A11-12. In other words, Product Gross Profit equals "Net Revenue" from the company's products minus "Direct Variable Costs" for manufacturing and distributing them.

B. The Dispute Resolution Process

Section 2.4 of the Merger Agreement also provides a dispute resolution process in the event the Stockholders' Representative decides to dispute Viacom's calculation of the Earn-Outs. That process has three steps: (1) the Stockholders' Representative delivers a list of disagreements to Viacom; (2) the parties negotiate their disagreements in good faith; and (3) absent successful negotiations, the parties submit their remaining disagreements to the Resolution Accountants

Thus, the dispute process begins with the Stockholders' Representative submitting to Viacom a list of its disagreements called the "Summary of Issues." A16. "If the Stockholders' Representative disagrees with the calculation of the . . . Earn-Out Payment Amount, it must deliver to [Viacom] . . . a written description of each such disagreement." *Id.* This document serves in effect as the initial pleading, providing notice to Viacom of the issues in dispute and establishing the disagreements that may be submitted to a neutral accountant for resolution.

To the extent the parties are unable to resolve the dispute on their own, Section 2.3(b) of the Merger Agreement provides that they may submit their disagreements to the Resolution Accountants, identified as a "nationally recognized firm of independent certified public accountants mutually acceptable" to the parties. A15. The scope of the Resolution Accountants' engagement is strictly limited to "the resolution of the Earn-Out Disagreements, and the recalculation of the 2007 Earn-Out Payment Amount or 2008 Earn-Out Payment Amount, as the case may be, in light of such resolution . . . ." A17-18. The "Earn-Out Disagreements" are those disputes raised by the Summary of Issues. A17-18. The Merger Agreement is explicit that the Resolution Accountants "shall be deemed to be acting as experts and not as arbitrators." A18.

C. The Dispute Over the Cost of Unsold Inventory

Viacom delivered its Final Earn-Out Statements for 2007 and 2008 on January 4, 2010 and March 9, 2010, respectively. A98, 120. In accordance with the Merger Agreement, the Earn-Out Statements contained no arguments or advocacy, but merely calculations based on various sources of revenue and components of cost. With respect to the cost of the products manufactured but not sold as of year-end—*i.e.*, the unsold inventory—Viacom's calculation of "Gross Profit" deducted the full variable cost of manufacturing all of those units. *Id.*[2]

Winshall commenced the dispute process by delivering a Summary of Issues with respect to the 2007 Earn-Out on January 22, 2010 and by delivering a Summary of Issues with respect to the 2008 Earn-Out on March 26, 2010. The single largest issue put in dispute by the Summary of Issues was how to treat the cost of the unsold inventory in calculating "Gross Profit." As one of the enumerated "Earn-Out Disagreements," Winshall claimed that Viacom should not have deducted the cost of unsold products and was permitted to deduct only "the costs of making the products *that were sold*" in a given year. A108 (emphasis added).

In summarizing the dispute, Winshall asserted that "the cost of inventory cannot be deducted when calculating Product Gross Profit." A112. To resolve that dispute, Winshall argued that "in order to be deductible . . . , the Direct Variable Costs must relate to the same products that generated the Net Revenue." A112. This accounting methodology, that costs must be "matched" with revenues during a period, was the centerpiece of Winshall's challenge throughout the dispute resolution process. For 2008, it represented the difference between Earn-Outs of zero and Earn-Outs of hundreds of millions of dollars. A135.

D. The Resolution Accounting Proceeding

The parties availed themselves of the dispute resolution process set forth in the Merger Agreement and agreed that BDO USA LLP would serve as the Resolution Accountants. On December 8, 2010, the Resolution Accountants, Viacom and the Stockholders' Representative executed an engagement letter setting forth the schedule and procedures that would govern the Resolution Accounting proceeding ("Engagement Letter"). A137. The parties agreed that they would present their respective positions regarding the issues in dispute through written evidentiary

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2 Viacom had previously (in September 2008) made an "on account" payment of $149.8 million to the selling stockholders based on a *preliminary* calculation of the 2007 Earn-Out Payment. A89. Viacom had not deducted the cost of unsold inventory in that calculation, but made clear that it was not obligated to provide any earn-out calculation at that time and was offering to make an initial payment only subject to a final calculation and an agreement with the sellers. *Id.* The sellers acknowledged that Viacom's conditional payment was "without prejudice to [Viacom's] rights under the Merger Agreement." A96.

submissions (both an opening and reply submission), and a one-day hearing before the Resolution Accountants. A140.

The Engagement Letter included an itemized list of the issues to be resolved—including the dispute over the cost of the unsold inventory—entitled the "Stockholders' Representative's List of Items in Dispute to Be Resolved by the Resolution Accountants." A147-50. Like the Summary of Issues, it identified the "cost of inventory held at the end of 2007 [and 2008]" as the principal issue in dispute for resolution. A147, 149.

E. The Parties' Evidentiary Submissions

The parties submitted to the Resolution Accountants a total of more than 250 pages of argument and 250 pages of evidentiary exhibits. They submitted simultaneous opening submissions and simultaneous reply submissions. The parties debated the issue of the Inventory Write-Down *on the merits*. And nowhere in his submissions did Winshall once argue that the Inventory Write-Down was outside the scope of the proceeding or otherwise non-arbitrable.

Winshall's opening submission expounded at length on his theory for resolving the unsold inventory dispute. As in his Summary of Issues, Winshall invoked the "matching principle." Winshall argued that the contractual definition of Product Gross Profit "applies the fundamental principle of matching: expenses are matched to the sales generating revenues during a particular period." A259-60. Under this theory, Winshall argued, the cost of manufacturing goods still in inventory at the end of the year should not be deducted in calculating Gross Profit.

Viacom's opening submission anticipated Winshall's matching argument—having seen it raised in the Summary of Issues—and took the position that the contractual definitions of the Earn-Out formula did not provide for matching. Therefore, Viacom argued, it was correct to deduct the variable costs for manufacturing both the goods that sold and the goods that did not sell. A 172-82.

Viacom also took issue with Winshall's position that "it is unfair to include the cost of unsold units in the Earn-Out because Viacom might have been able to sell those units after the Earn-Out period and keep all the revenue." A181. Viacom explained that given the economic downturn in 2008, "[t]he reality" of the marketplace was that the unsold goods in inventory "either (1) only sold at sharply reduced prices, or (2) never sold at all." A181-82. In other words, like the stale bread in a bakery at the end of the day, the unsold goods had lost their marketable value and could only be sold for less than their cost or had become obsolete.

Thus, in the event the Resolution Accountants decided to accept Winshall's accounting approach, Viacom argued that the Earn-Out for 2008 would still be the same (*i.e.*, zero) because of the need to write down the diminished value of the unsold inventory:

> Whether the Earn-Out is determined by including the full variable cost of the unsold inventory as the Agreement provides, *or by deducting the cost of writing-down the inventory to its net realizable value*, the Earn-Out for 2008 would still be zero.

A182 (emphasis added). Viacom's reply submission further explained that, under the "matching principle" of accounting, a reduction in the value of unsold inventory to the "lower of cost or market" (LCM) is a cost that must be recorded as a reduction of revenue and profit.[3] Viacom set forth in detail the basis for the Inventory Write-Down calculation and why, under an approach that required matching costs to revenues, any costs associated with the Inventory Write-Down would need to be deducted in recalculating the Earn-Out for 2008. A201-05.

Winshall's reply submission, meanwhile, characterized the Inventory Write-Down as Viacom's "back-up position" and devoted two pages to a *substantive* attack on that position. A436-37. Winshall argued the merits of the issue, and contended that on the facts and the evidence no write-down should be deducted in recalculating the Earn-Out for 2008. Winshall did *not* argue that the Resolution Accountants should refuse to consider Viacom's evidence or that it was non-arbitrable.

That was not an oversight by Winshall. In the same reply submission, Winshall argued that *other* cost deductions proposed by Viacom *were* non-arbitrable. Those "new deductions," Winshall protested, could not be considered by the Resolution Accountants because "[t]he Merger Agreement . . . does not give Viacom the right to amend its Earn-Out Statement." A423-24. Winshall did not include the Inventory Write-Down as one of the objectionable "new deductions." And he did not

[3] "Under LCM, if the market value of a company's inventory is lower than its cost, the company reduces the amount recorded for inventory to its market value." Jay S. Rich et al., *Cornerstones of Financial Accounting* 305-06 (2010).

contend that it was beyond the scope of the Resolution Accountants' authority to consider and decide the Inventory Write-Down issue.

F. The Resolution Accountants *Sua Sponte* Raise the Arbitrability Issue

On September 20, 2011, *after* the parties had completed their written submissions, the Resolution Accountants wrote a letter to the parties, asking whether the parties agreed that certain "significant areas of dispute" could be resolved by the Resolution Accountants. A551. Despite the fact that the parties already had submitted and argued the merits of the Inventory Write-Down, the letter suggested that the Resolution Accountants were uncertain whether the parties had agreed that the issue could be resolved by the Resolution Accountants. Thus, they asked whether "the Parties mutually agreed upon whether the Resolution Accountants may resolve" the issue of the "2008 Inventory Write-Down." A501.

Having been given an unwarranted opportunity to object to the arbitrability of the Inventory Write-Down, Winshall asserted for the first time that the issue was not properly submitted for resolution. A523-24. Viacom pointed out that the Inventory Write-Down was responsive to the unsold inventory dispute raised by the Summary of Issues and relevant as a direct response to Winshall's "matching" argument. Viacom wrote that Winshall "cannot object to the proper recalculation of the write-down of inventory, as he is the one who has advanced this approach . . . ." A513.

G. The Resolution Accountants' Determination

On December 19, 2011, the Resolution Accountants issued their Determination, calculating the total due to Winshall in Earn-Out payments and costs at $383,469,166. A533.[4] They noted that the largest disagreement between the parties was how to treat the cost of the unsold products at year-end. A559. On that question, they sided with Winshall, finding that "the calculation [of Gross Profit] should deduct the costs of manufacturing *only* those units that were sold during the period." A584 (emphasis in original). The Resolution Accountants held that "the matching of revenues and expenses within a period is a well-established, basic business concept which has been codified as part of GAAP." A586.

[4] This figure was net of the $149.8 million already paid by Viacom. *See* note 2, *supra*.

But having adopted Winshall's approach, the Resolution Accountants refused to consider the evidence Viacom had submitted regarding the proper application of that approach for 2008—*i.e.*, the Inventory Write-Down. Viacom's evidence demonstrated that, because the market value of the unsold inventory had declined below its cost, the accounting rules that Winshall himself invoked required that the $54 million loss in value of the unsold goods be treated as a cost for 2008. A346.

The Resolution Accountants did not disagree, but declined to consider the issue. Without reducing Gross Profit for 2008 based on the cost of writing-down the impaired value of the unsold inventory, the Resolution Accountants re-calculated the 2008 Earn-Out Payment to be $298,813,095. A557-58. That resulted in a $191 million overstatement of the Earn-Out for 2008.[5]

As the reason for their incomplete application of Winshall's matching approach, the Resolution Accountants cited the parties' after-the-fact disagreement about whether the Inventory Write-Down was "properly before the Resolution Accountants for determination." A697. The Resolution Accountants stated that they would not resolve this arbitrability dispute in the absence of agreement or a court order. Thus, the Resolution Accountants stated they "are prepared" to determine whether the Inventory Write-Down is arbitrable and/or to resolve the Inventory Write-Down issue. A706. In short, they made no decision with respect to the Inventory Write-Down:

> Finally, the Resolution Accountants ***are prepared to make a determination*** whether [the Inventory Write-Down] may be asserted under the terms of the Merger Agreement if either: (1) the Parties subsequently agree to permit the Resolution Accountants to do so, or (2) it is adjudicated by a court that the Resolution Accountants should do so. In addition, the Resolution Accountants ***are prepared to resolve*** [the Inventory Write-Down] if: (1) the Parties subsequently agree to permit the Resolution Accountants to do so, or (2) it is adjudicated by a court that [the Inventory Write-Down] may be asserted

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[5] The Resolution Accountants re-calculated the 2008 Earn-Out Payment based on a Gross Profit of $130,375,170. If the Inventory Write-Down ($54,637,300) is deducted, the Gross Profit would be $75,737,870 and the 2008 Earn-Out Payment would be $107,582,5545 ($75,737,870 - $45,000,000 X 3.5). The overstatement = $191,284,550 ($298,813,095 - $107,582,545).

under the Merger Agreement and should be resolved by the Resolution Accountants.

A706 (emphasis added).

H. The Court of Chancery Proceedings and Decision Below

On December 27, 2011, Viacom filed suit in the Court of Chancery seeking to vacate the Determination. Viacom asserted that the Resolution Accountants should have considered the Inventory Write-Down, as that issue was clearly arbitrable in response to Winshall's matching theory, and noted that the Resolution Accountants had not even decided the arbitrability question. A985, 992, 994. Viacom argued that the Resolution Accountants' refusal to hear the evidence of the Inventory Write-Down was grounds for vacating the award under Section 10(a)(3) of the Federal Arbitration Act. Viacom thus sought an order vacating the Determination and remanding to the Resolution Accountants for consideration of the Inventory Write-Down.

On August 9, 2012, the Court of Chancery denied Viacom's motion for summary judgment and granted Winshall's cross-motion for summary judgment on his counterclaim to confirm the Determination. The Court of Chancery first concluded that the Resolution Accountants had found the Inventory Write-Down issue to be non-arbitrable, Ex. A, at 33, 40, and that the question was one of "procedural" arbitrability within the primary authority of the Resolution Accountants, *id.*, at 29. Although the court "confess[ed] in so finding that Viacom has cited to cases from this court that support its arguments," the court declined to follow that precedent. Ex. A, at 34.

The Court of Chancery then held that, in its interpretation of the Merger Agreement, the Inventory Write-Down was not an arbitrable issue. Ex. A, at 41-43. The court never addressed, however, Viacom's argument that the Inventory Write-Down was arbitrable because it was put into dispute by Winshall himself when he disagreed with Viacom's approach to the cost of unsold inventory and urged an alternative approach (*i.e.*, "matching"). The Court of Chancery simply did not consider whether, under Winshall's accounting method, the Inventory Write-Down was an arbitrable issue.

IV. Argument

A. The Resolution Accountants' Refusal to Hear "Pertinent and Material Evidence" Is Grounds for Vacating the Determination Under the Federal Arbitration Act.

1. Question Presented

Did the Resolution Accountants refuse to hear evidence that was "pertinent and material" and, thereby, establish the grounds for vacating the Determination under Section 10(a)(3) of the Federal Arbitration Act? This question was preserved for appeal. A928-40.

2. Standard of Review

This Court reviews a grant of summary judgment confirming an arbitration award "*de novo*, both as to the facts and the law." *M3 Healthcare Solutions* v. *Family Practice Assocs., P.A.*, 996 A.2d 1279, 1282 (Del. 2010).

3. Merits

It is undisputed that despite adopting and applying Winshall's matching method for recalculating the Earn-Out for 2008, the Resolution Accountants refused to hear evidence submitted by Viacom regarding the proper application of that accounting method. It is also undisputed that unless that refusal to hear evidence was somehow justified, it would be grounds for vacating the Determination under Section 10(a)(3) of the FAA. A court may vacate an arbitral award for refusing to hear "evidence pertinent and material to the controversy." 9 U.S.C. § 10(a)(3).

Winshall did not dispute that writing down the diminished value of unsold goods could be appropriate under his matching method of accounting. Nor did the Court of Chancery hold that, if it were arbitrable, the Inventory Write-Down would not be "pertinent and material" under Section 10(a)(3) of the FAA.

Section 10(a)(3) of the FAA is designed to ensure the fundamental fairness of alternative dispute resolution proceedings and provide relief in cases of severe prejudice to one of the parties. Thus, it is "axiomatic" that a court "may vacate an award if a party to an arbitration proceeding has not been given . . . opportunity to present arguments and evidence on the merits of the dispute." *Teamsters Local 312* v. *Matlack, Inc.*, 118 F.3d 985, 995-96 (3d Cir. 1997) (relying on FAA standards for guidance in resolving labor arbitration dispute).[6] The "misconduct" required under this part of Section 10(a) is *not* "bad faith, but 'misbehavior though without taint of corruption or fraud, [if] . . . born of indiscretion.'" *Newark Stereotypers' Union No. 18* v. *Newark Morning Ledger Co.*, 397 F.2d 594, 599 (3d Cir. 1968) (quoting *Stefano Berizzi Co.* v. *Krausz*, 146 N.E. 436, 437 (N.Y. 1925) (Cardozo, J.)) (internal quotations omitted).

Courts have held that "misconduct" under Section 10(a)(3) can be the refusal to hear pertinent and material evidence when such a refusal results in a hearing that is fundamentally unfair. *See, e.g., Tempo Shain Corp.* v. *Bertek, Inc.*, 120 F.3d 16, 19-22 (2d Cir. 1997) (award vacated because the panel made its decision without hearing a witness with key testimony "pertinent and material to the controversy"); *Hoteles Condado Beach, La Concha and Convention Ctr.* v. *Union De Tronquistas, Local 901*, 763 F.2d 34, 36, 39-40 (5th Cir. 1985) (affirming vacatur of award because arbitrator refused to consider evidence presented in trial transcript from related criminal proceeding and thus failed "to consider evidence central to the dispute before him"). Where, as in this case, "the

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6 *See also Gulf Coast Indus. Workers Union* v. *Exxon Co., USA*, 70 F.3d 847, 850 (5th Cir. 1995) (affirming vacatur because arbitrator refused to consider evidence of drug test indicating that employee's cigarette contained marijuana, which was central to a dispute about whether Exxon had just cause to terminate employee for drug possession); *Hoteles Condado Beach, La Concha and Convention Ctr.* v. *Union De Tronquistas*, 763 F.2d 34, 39-40 (1st Cir. 1985) (affirming vacatur where arbitrator failed to accord any weight to evidence that was central to parties' dispute); *Teamsters, Chauffeurs, Warehousemen and Helpers, Local Union No. 506* v. *E.D. Clapp*, 551 F. Supp. 570, 578 (N.D.N.Y. 1982) (vacating arbitration award because one party "was not given an opportunity to complete its presentation of proof regarding the . . . merits of the grievances then under consideration"); *Fairchild Corp.* v. *Alcoa, Inc.*, 510 F. Supp. 2d 280, 287 (S.D.N.Y. 2007) (vacatur appropriate where "an arbitrator, to the prejudice of one of the parties, rejects consideration of relevant evidence essential to the adjudication of a fundamental issue in dispute, and the party would otherwise be deprived of sufficient opportunity to present proof of a claim or defense," but upholding award); *Konkar Mar. Enters., S.A.* v. *Compagnie Belge D'Affretement*, 668 F. Supp. 267, 271 (S.D.N.Y. 1987) (stating that "[w]here a party to an arbitration does not receive a full and fair hearing on the merits, a district court will not hesitate to vacate the award," but upholding award because party received adequate notice).

arbitrator's refusal to hear proffered testimony so affects the rights of a party that it may be said that he was deprived of a fair hearing," the court may vacate the award. *Century Indem. Co.* v. *Certain Underwriters at Lloyd's, London*, 584 F.3d 513, 557 (3d Cir. 2009) (internal quotations omitted).[7]

Provided that the Inventory Write-Down evidence related to an arbitrable issue, the authorities make clear that the Resolution Accountants' failure to consider it is grounds for vacating the Determination. The nearly $200 million impact of the Inventory Write-Down shows that Viacom's evidence is not merely "pertinent and material," but of paramount significance to the accurate calculation of the 2008 Earn-Out under Winshall's method of accounting. The Resolution Accountants adopted Winshall's accounting method and then unfairly applied it only part way, admittedly refusing to consider the evidence presented by Viacom relating to the correct and complete application of that very method. The Determination should have been vacated.

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[7] State arbitration statutes that parallel the FAA also have also been applied to set aside awards where, as here, an "arbitrator" failed properly to consider the evidence in connection with a material issue, or failed to address an issue in dispute. *See*, *e.g.*, *Grynberg* v. *BP Exploration Operating Co. Ltd.*, 938 N.Y.S.2d 439, 440 (N.Y. App. Div. 2012) (applying New York Arbitration Law; vacating arbitration award for failure to consider material issue in dispute). Most such statutes, like the New York Arbitration Law, upon which Congress based the FAA, *Hall Street Assocs., L.L.C.* v. *Mattel, Inc.*, 552 U.S. 576, 589 n.7 (2008), include a vacatur provision similar to section 10(a) of the FAA. *See*, *e.g.*, N.Y. C.P.L.R. § 7511(b)(1).

B. The Court of Chancery Erred by Deferring to the Resolution Accountants.

1. Questions Presented

Did the Court of Chancery err by deferring to a finding of non-arbitrability that the Resolution Accountants never actually made? And, even if the Resolution Accountants had made such a decision, did the Court of Chancery err in finding that such a decision would have been a matter of "procedural" arbitrability entitled to judicial deference? These questions were preserved for appeal. A940-43; 985-93.

2. Standard of Review

This Court reviews a grant of summary judgment confirming an arbitration award "*de novo*, both as to the facts and the law." *M3 Healthcare Solutions,* 996 A.2d at 1282. This Court also reviews *de novo* the Court of Chancery's determination that the arbitrability of the Inventory Write-Down was a question of "procedural" arbitrability within the primary authority of the Resolution Accountants. *See SBC Interactive, Inc.* v. *Corporate Media Partners*, 714 A.2d 758, 760 (Del. 1998) ("We are . . . free to make our own determination of whether, as a matter of law, SBC's claims were properly relegated to arbitration.").

3. Merits

The Court of Chancery declined to vacate the Determination based on the Resolution Accountants' refusal to hear evidence because the court believed that (1) the Resolution Accountants themselves had decided that the Inventory Write-Down was non-arbitrable, and (2) that decision was entitled to deference as a matter of "procedural" arbitrability. Each of those conclusions is legally erroneous.

(a) The Resolution Accountants Did *Not* Resolve the Parties' Disagreement Over the Arbitrability of the Inventory Write-Down.

The Court of Chancery's stated deference to the Resolution Accountants rests on the court's finding that the Resolution Accountants had themselves "decided that the Inventory Write-Down was outside the scope" of the arbitrable issues. Ex. A, at 40; *see also* Ex. A, at 33. But this is directly at odds with the statements of the Resolution Accountants, who declared that they "are prepared" to decide whether the Inventory Write-Down is arbitrable, but had not done so.

The arbitrability dispute arose in response to the Resolution Accountants' letter to the parties, sent after the evidentiary submissions were complete, asking whether the parties "mutually agreed upon whether the Resolution Accountants may resolve," *inter alia*, the Inventory Write-Down dispute. A501. By this point, Winshall already had raised the unsold inventory issue in his Summary of Issues and had responded *on the merits* to Viacom's Inventory Write-Down argument. Moreover, Winshall had never raised any objection to the arbitrability of the Inventory Write-Down. Nonetheless, the Resolution Accountants *sua sponte* raised the question of arbitrability and Winshall took advantage of the moment to veto consideration of the Inventory Write-Down.

Faced with this 13th hour lack of agreement, the Resolution Accountants stated that they did not have the authority, absent consent or court order, to address the Inventory Write-Down—either the arbitrability of that issue or the merits of that issue. As the Resolution Accountants repeated several times, their "determination ***at this time*** is limited to only those Earn-Out Disagreements . . . which the Parties agreed . . . are properly before the Resolution Accountants." A705 (emphasis added). The phrase "at this time" referred to the fact that the Resolution Accountants had not made a decision that the Inventory Write-Down was beyond the scope of the proceeding and, therefore, it might come back to them for determination. Indeed, they expressly anticipated that they might yet reach the merits of the Inventory Write-Down. They even suggested that additional discovery regarding the write-down might be warranted. A705.[8]

The Resolution Accountants made clear that they had not decided the issue of arbitrability. They stated that they *would* decide the arbitrability of the Inventory Write-Down, but only if asked by the parties or ordered by the court. Likewise, they stated that they *would* decide the merits of the Inventory Write-Down, but only if asked by the parties or ordered by the court. In their words, the Resolution Accountants are "***prepared*** to make a determination whether [the Inventory Write-Down]

[8] The Resolution Accountants identified a *potential basis* for non-arbitrability, noting that the Inventory Write-Down was not included in the 2008 Earn-Out Statement and "there is no mechanism evident to the Resolution Accountants for Viacom to submit additional or alternative reductions to Gross Profit" after that statement. A703. But the Resolution Accountants did not *decide* that Viacom was precluded from raising the Inventory Write-Down on that basis, but rather left it to the court to make a determination. A706.

may be asserted under the terms of the Merger Agreement." A706 (emphasis added). And they are "***<u>prepared</u>***" to resolve" the issue on the merits. *Id*. (emphasis added).

The Court of Chancery therefore erred by deferring to a determination of non-arbitrability by the Resolution Accountants that did not exist.

(b) No Deference Is Due to the Resolution Accountants on the Arbitrability Issue.

Even if the Resolution Accountants had ruled on arbitrability, that ruling would not be entitled to deference. Unlike arbitral rulings on the merits, which the FAA compels courts to honor except in limited circumstances, rulings on arbitrability are not entitled to deference where the parties did not "clearly agree" to arbitrate arbitrability. *DMS Properties-First, Inc.* v. *P.W. Scott Assocs., Inc.*, 748 A.2d 389, 391 (Del. 2000). It is well established that "if the parties did not clearly agree to submit the question of arbitrability to arbitration, then a reviewing court *must decide arbitrability independently and without deference*." *Id*. (emphasis added) (citing *First Options of Chicago Inc.* v. *Kaplan*, 514 U.S. 938, 943-45 (1995) ("Courts should not assume that the parties agreed to arbitrate arbitrability unless there is clea[r] and unmistakabl[e] evidence that they did so.") (internal quotations omitted)); *see also James & Jackson, LLC* v. *Willie Gary, LLC*, 906 A.2d 76, 79 (Del. 2006).

(i) The Parties Did Not Agree to Give the Resolution Accountants the Authority to Determine their Own Power.

There is nothing in the Merger Agreement (or anywhere else) indicating that the parties intended the Resolution Accountants to resolve disputes over which issues were arbitrable, much less a "clear and unmistakable" intent to that effect. To the contrary, the Merger Agreement carefully circumscribes the Resolution Accountants' authority, limiting it to "the resolution of the Earn-Out Disagreements, and the recalculation of the [Earn-Outs] in light of such resolution." A17-18. The Engagement Letter similarly provides that "the Parties specifically do not submit to the Resolution Accountants . . . [a]ny other issue not specified in the 2007 Summary of Issues or the 2008 Summary of Issues." A138. Reflecting the Resolution Accountants' limited decision-making authority, they are deemed by the Merger Agreement "to be acting as experts and not as arbitrators." A18.

Delaware courts repeatedly have held in similar circumstances that the court—not a neutral accounting expert—must resolve arbitrability disputes that arise in post-merger accounting proceedings. *See Nash* v. *Dayton Superior Corp.* 728 A.2d 59, 63 (Del. Ch. 1998); *HDS Investment Holding Inc.* v. *Home Depot, Inc.*, 2008 WL 4606262, at *4 (Del. Ch. Oct. 17, 2008); *Avnet, Inc.* v. *H.I.G. Source, Inc.*, 2010 WL 3787581, at *1, *3 (Del. Ch. Sept. 29, 2010).

Nash involved a post-acquisition price adjustment and accounting dispute resolution process much like the one here. Dayton Superior acquired Symons pursuant to an agreement of sale that established a four-step process for determining the consideration paid to Symons' stockholders. The stockholders received consideration at closing, subject to post-closing adjustments based on a "Closing Balance Sheet." 728 A.2d at 60. Within 60 days of closing, Dayton (the buyer) was to prepare the "Closing Balance Sheet." The selling stockholders then had 45 days to deliver a "Notice of Disagreement" setting forth their disagreements with the Closing Balance Sheet. *Id*. Any disagreements that remained following a period of negotiation could be submitted to "an independent national accounting firm" for "review and resolution." *Id*.

After the negotiations failed, the selling stockholders filed a lawsuit complaining that Dayton had "attempted, improperly, to interject certain 'New Items' " during the negotiation phase that " 'had not been raised or even indicated in either the Closing Balance Sheet or the Notice of Disagreement.' " *Id.* at 61. The selling stockholders took the same position as Winshall does here: that new issues allegedly raised *after* the buyer's initial calculation (like Viacom's Earn-Out Statement), and *after* the sellers' statement of disagreements (like Winshall's Summary of Issues), could not be considered by the accounting firm.

On that basis, the selling stockholders moved to enjoin Dayton from submitting the "New Items" to the accountants for resolution. *Id*. They argued—just as Winshall does with respect to Viacom's Earn-Out Statement and the Inventory Write-Down—that Dayton's "'attempt to revise the Closing Balance Sheet with the New Items during Step Three is impermissible under the procedures established' by the Agreement." *Id*. Like Winshall, the selling stockholders in *Nash* sought "'to limit the arbitration to only those items properly submitted pursuant to the terms of the Agreement . . . .'" *Id*.

The court found, as the parties themselves recognized, that "because the arbitration provisions of the Agreement are limited in scope, arbitrability is for the Court to decide." *Id*. at 63. The court concluded that the "scope of issues to be submitted to the accounting firm" is a matter of "substantive arbitrability" for the court, not the accountants. *Id.* at 61, 63 (relying on and quoting from *SBC Interactive, Inc.*, 714 A.2d at 761).

The court reached the same result in *HDS Investment Holding Inc.* v. *Home Depot, Inc*., 2008 WL 4606262 (Del. Ch. Oct. 17, 2008). It too involved a four-step price adjustment and dispute resolution process: the buyer's delivery of a "Closing Statement" with a purchase price adjustment calculation, followed by the sellers' "Notice of Disagreement" and, failing successful negotiations, submission to a "neutral auditor." *Id*. at *2-*3. As in this case and *Nash*, the seller complained that *after* the contractually-mandated deadline, the buyer submitted an improper and untimely "Revised Closing Statement" with a "revised" purchase price adjustment calculation. *Id*. at *3. As in this case and *Nash*, the question 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 issue of arbitrability was one of contract interpretation, and because the parties had not agreed to give the neutral auditor authority to decide such legal issues, the court held that the issue was for the court to resolve independently. "Whether the Revised Closing Statement can be considered by the neutral auditor is a contractual issue that should be decided by the Court." *Id*. In reasoning equally applicable here, the court found:

> the arbitration provision in the Agreement is narrow and thus the Court should only send to arbitration those issues that the parties expressly agreed to arbitrate. The neutral arbitrator is charged with resolving disputes regarding the calculation of the Applicable Amount that remain after the Resolution Period.

Id. (footnote omitted).

The auditor's limited mandate, just like the Resolution Accountants' here, was decisive: "[n]othing 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." *Id.* Likewise, nothing in Section 2.4(c) of the Merger Agreement empowered the Resolution Accountants here to decide that Viacom's purportedly "additional" or "alternative" Earn-Out deduction could not be considered by them—a decision, we submit, the Resolution Accountants did not in fact make, recognizing the strict limits of their authority.

Again, in *Avnet, Inc.* v. *H.I.G. Source, Inc.*, the court held that whether an "untimely" submission should be considered by the accountants in a purchase price adjustment process is a matter of "substantive arbitrability" to be decided by the court. 2010 WL 3787581, at *1, *3 (Del. Ch. Sept. 29, 2010). Again, the narrow scope of the dispute resolution clause and the limited authority of the accountants were dispositive: where the parties "agreed to submit only a limited range of issues to the arbitrator"—the accounting firm Grant Thornton—"it seems unlikely that parties agreed to submit a broad range of legal issues to the accountant-arbitrator." *Id.* at *9.[9]

These authorities correctly hold that, where parties establish a neutral accounting proceeding limited to resolving particular accounting issues, (1) the accountants are not empowered to decide questions of substantive arbitrability, as their powers derive exclusively from the terms of the parties' agreement; and (2) courts should not defer to the accountants on such questions of arbitrability.

As a matter of arbitration policy, parties must have confidence that arbitrators will decide neither too much nor too little, and that independent judicial review will provide a meaningful assurance against either outcome. As the United States Supreme Court found in *First Options*, "given the principle that a party can be forced to arbitrate only those issues it specifically has agreed to submit to arbitration, one can understand why courts might hesitate to interpret silence or ambiguity on the 'who should decide arbitrability' point as giving the arbitrators that power, for doing so might too often force unwilling parties to arbitrate a matter they reasonably would have thought a judge, not an arbitrator, would decide." 514 U.S. at 945.

[9] *See also Aveta Inc.* v. *Bengoa,* 2008 WL 5255818, at *2 (Del. Ch. Dec. 11, 2008) (explaining that a question of "whether the dispute is one that, on its face, falls within the arbitration clause of the contract [is] properly for the court to decide where the contract does not clearly and unmistakably reflect the parties' agreement to submit [that] question[] to arbitration" (internal quotations omitted)).

(ii) The Court of Chancery Should Not Have Deferred to the Resolution Accountants on a Question of their Power.

The Court of Chancery failed to follow the above authorities, even though it "confess[ed]" it could not distinguish them. Ex. A, at 34. Instead, the court deferred to a purported (and non-existent) finding of non-arbitrability by the Resolution Accountants. *Id*. at 36-37 ("[M]y role is not to pass independent judgment on the Determination . . . ."). The court based its departure from precedent on inapposite "procedural" arbitrability cases and unjustified "efficiency" concerns.

The Court of Chancery acknowledged the general rule that questions of arbitrability are for the court to decide, but it relied on an exception for "procedural" issues adopted by the United States Supreme Court in *Howsam* v. *Dean Witter Reynolds, Inc.*, 537 U.S. 79 (2002). In that case, the parties had agreed to arbitrate before the National Association of Securities Dealers ("NASD"). The NASD maintained a code of arbitration procedure, which the parties agreed to follow, containing a six-year statute of limitations. *Id*. at 82. The Court concluded that it was best for the NASD to apply the NASD's own rule, and that the case did not raise the kind of "question of arbitrability" that is reserved for independent decision by the courts.

Howsam did not alter the rule that "[t]he question whether the parties have submitted a particular dispute to arbitration, *i.e.*, the question of arbitrability, is an issue for judicial determination unless the parties clearly and unmistakably provide otherwise." 537 U.S. at 83 (internal quotations omitted). Rather, it held that the NASD time limit was outside "the scope of this . . . interpretive rule," *id*., for two reasons. First, application of the NASD rule was the type of issue that the "parties would likely expect that an [NASD] arbitrator would decide." *Id*. at 84.[10] Second, "the NASD arbitrators, comparatively more expert about the meaning of their own rule, are comparatively better able to interpret and to apply it." *Id*. at 85. Thus, "the strong pro-court presumption as to the parties' likely intent does not apply." *Id*. at 86.

[10] The Court also cited "prerequisites such as time limits, notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate" as examples of the "kinds of general circumstance where parties would likely expect that an arbitrator would decide the gateway matter." *Id*. at 84-85; *see also James & Jackson, LLC*, 906 A.2d at 79.

Neither of these reasons for deferring to the NASD on the application of NASD rules is applicable here. Nor, as the courts in *HDS* and *Avnet* recognized, are they applicable to questions generally about the authority of a neutral auditor to decide the scope of issues subject to arbitration, where arbitrability turns on the interpretation of a contract. *E.g.*, *Avnet*, 2010 WL 3787581, at *7.

Unlike in *Howsam*, the parties here did not agree broadly to arbitrate all disputes in a forum with its own set of procedural rules. To the contrary, the Merger Agreement provides a very narrow role for the Resolution Accountants. They are to serve as "experts and not as arbitrators," and to resolve only the parties' disagreements about the Earn-Outs. A18. The rules of the proceeding, meanwhile, are established in the Merger Agreement, not by a set of procedures—like the NASD procedural code—external to the parties' agreement. *See Howsam*, 537 U.S. at 86 (describing rule at issue as a "*forum-specific* procedural gateway matter[].") (emphasis added).

Moreover, unlike the NASD in *Howsam*, the Resolution Accountants here are not "comparatively more expert" than a court in interpreting the Merger Agreement to determine whether an issue is properly subject to arbitration. In fact, the opposite is true: as the Merger Agreement itself reflects, the institutional competence of the Resolution Accountants is as experts in examining accounting issues, not as arbitrators of legal issues.

Thus, there is every reason to believe that the parties did *not* intend the Resolution Accountants to resolve contractual interpretation questions about the scope of the proceeding. Because of these fundamental differences between the "procedural" issue that arose in *Howsam* and the scope of issues in a resolution accounting process, the Delaware courts in *Nash*, *HDS*, and *Avnet* were correct to apply the general rule of no deference. It is for the court, not the accountant, to decide the "contractual issue" of whether the arbitration clause encompasses actions taken that, allegedly, "do not closely conform with the process agreed upon by the parties for the preparation of the Closing Balance Sheet and resolving disputes about it." *Avnet*, 2010 WL 3787581 at *7.[11]

[11] The Court of Chancery cited two Delaware cases as purportedly supporting its approach, and which it said it could not reconcile with *Nash*, *HDS*, and *Avnet*. Ex. A, at 34 n.108. But the cases are not inconsistent. In neither case did the court defer to the arbitrator on the question of the scope of authority to consider the merits of a particular dispute. In *Me-*

The Court of Chancery cited the "efficiency purpose behind arbitration" as a reason for disregarding these precedents. Ex. A, at 32. The court viewed its approach as necessary to avoid "a drag on the economy" and "burden[ing] the courts and other litigants with cases where judges would act as schoolmarms over arbitrating parties' procedural squabbles." *Id*. at 33. This concern is unwarranted by experience and unsupported by the case law.

Since *Nash* was decided 15 years ago, there has been no flood of purchase price adjustment proceedings inundating the courts with arbitrability disputes. Nor is there any indication that participants in such alternative dispute mechanisms have been "running back and forth between the courts and the arbitrator." Ex A., at 33. Quite the contrary, there have been only a handful of instances in which the Delaware courts have been called on to determine the scope of resolution accounting proceedings. And in each case, the court resolved the matter as a question of "substantive" arbitrability.

The Court of Chancery's "efficiency" views incorrectly assume that interpreting a merger agreement to determine the scope of issues to be arbitrated in an accounting proceeding is a mere "procedural squabble." That dismissive label, however, makes light of the substantive and significant legal question: whether a party can be forced to arbitrate an issue—in this case, arbitrability itself—it did not clearly agree to arbitrate. *See DMS Properties-First, Inc.*, 748 A.2d at 391-92. To be sure, courts cannot monitor every aspect of an arbitration, and there are wide zones in which courts properly defer to neutral accountants. However, where those accountants venture beyond the boundaries of the parties' express and limited consent, and decide matters the parties never agreed could be decided outside of court, Delaware courts properly recognize that they retain primary authority to make such decisions.

Given that the parties here did not convey plenary authority to the Resolution Accountants, the parties did not agree "to submit a broad

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hiel v. *Solo Cup Co.*, 2005 WL 1252348 (Del. Ch. May 13, 2008), the issue was whether the arbitrator could compel discovery—a plainly procedural question. *Id.* at *6. And in *Aveta* v. *Bengoa*, 2008 WL 5255818 (Del. Ch. Dec. 11, 2008), the court itself resolved the arbitrability issue, holding that a dispute regarding the adequacy of documentation provided under the merger agreement was "facially within the ambit of the . . . arbitration clauses." *Id.* at *3. The procedural issue that was then referred to the arbitrator was, like in *Mehiel*, essentially a discovery dispute.

range of legal issues to the accountant-arbitrator." *Avnet, Inc.*, 2010 WL 3787581, at *9. It was then-Vice Chancellor Strine who *rejected* "applying a strong policy gloss in favor of referring arbitrability questions to arbitration" when deciding whether a court or arbitrator should decide questions of arbitrability. *Willie Gary LLC* v. *James & Jackson LLC*, 2006 WL 75309, at *8 (Del. Ch. Jan. 10, 2006). "As I understand our law, I should not apply such a policy gloss but should interpret the LLC Agreement as written." *Id*. So too here.

In electing to disregard all the precedents on point, the Court of Chancery stated that it was duty bound to follow the FAA. Ex. A, at 35. But the FAA is not at odds with the cases that the Court of Chancery "confess[ed]" support Viacom's position. The FAA's central purpose is to encourage parties to avail themselves of arbitration—a goal that would be undermined by deference to arbitrators on the critical issue of the scope of their power.

C. The Inventory Write-Down Is Arbitrable Under the Merger Agreement.

1. Question Presented

Did the Court of Chancery err by holding that the Inventory Write-Down was not subject to arbitration under the Merger Agreement? This issue was preserved for appeal. A934-40; 994-1006.

2. Standard of Review

This Court reviews a grant of summary judgment confirming an arbitration award "*de novo*, both as to the facts and the law." *M3 Healthcare Solutions,* 996 A.2d at 1282. "Questions of contract interpretation are subject to *de novo* review." *Genencor Int'l, Inc.* v. *Novo Nordisk A/S*, 766 A.2d 8, 13 (Del. 2000). In particular, "a question of substantive arbitrability is decided by the Court of Chancery as a matter of contract law and reviewed by this Court *de novo*." *DMS Properties-First, Inc.*, 748 A.2d at 391.

Whether the Inventory Write-Down issue is arbitrable is a question of contract interpretation, as the Court of Chancery recognized. Ex. A, at 41 (considering whether Resolution Accountants' purported arbitrability decision was "a correct reading of the terms of the Merger Agreement"). State law contract principles govern the interpretation of arbitration provisions under the Federal Arbitration Act. *First Options*, 514 U.S. at 944. In Delaware, the scope of an arbitration agreement is an issue of the parties' intent. *SBC Interactive, Inc.*, 714 A.2d at 761.

3. Merits

Proceeding from the mistaken premise that the Resolution Accountants had already decided that the Inventory Write-Down was non-arbitrable, the Court of Chancery summarily concluded that the Resolution Accountants were "correct." Ex. A, at 41. It found that the Inventory Write-Down was not within the scope of the proceeding because it was not included in Viacom's Earn-Out Statement for 2008. Ex. A, at 41-42.

The court's deferential review was so unexacting that it never even addressed, let alone rejected, Viacom's main argument for vacating the Determination: that the Inventory Write-Down was put at issue for resolution by Winshall's Summary of Issues. It was the Summary of Issues that triggered the parties' dispute by disagreeing with Viacom's treatment of the unsold inventory *and* advocating that the accounting concept of matching be applied to resolve that disagreement. Under that accounting principle, which the Resolution Accountants ultimately adopted, writing down the inventory to reflect its diminished value is one of the costs that should be "matched" to revenues.

The Court of Chancery disregarded all of that and, instead, held that because the Inventory Write-Down was not included in Viacom's beginning Earn-Out calculation, Viacom had no right to submit evidence about the proper application of the accounting method that Winshall raised for resolving the biggest issue in the proceeding. That is contrary to and unsupported by the terms of the Merger Agreement and, as such, constitutes reversible legal error.

(a) Winshall's "Matching" Theory Put the Inventory Write-Down into Play.

The Resolution Accountants were charged with the "resolution of the Earn-Out Disagreements" and "the recalculation of the . . . Earn-Out Payment Amount." A17. The "Earn-Out Disagreements" are defined in the Merger Agreement as those issues ***set forth in the Summary of Issues*** provided by Winshall in response to Viacom's calculation. A16-17. The arbitrability of the Inventory Write-Down, therefore, turns not on the Earn-Out Statement, but on whether it was raised as part of the Earn-Out Disagreements in the Summary of Issues.

The cost of unsold inventory clearly was put in dispute by Winshall's Summary of Issues. In it, Winshall declared: "the cost of inventory cannot be deducted when calculating Product Gross Profit." A112. In the "Description of Disagreements" contained in the Summary of Issues, Winshall succinctly described the parties' dispute: the calculation of Gross Profit "should not include the year-end inventory." A111. And the Summary of Issues went on to describe the matching approach that should be used to resolve that dispute: "in order to be deductible . . ., the Direct Variable Costs must relate to the same products that generated the Net Revenue." A112.

The Engagement Letter with the Resolution Accountants also included an itemized list of the "Earn-Out Disagreements" being submitted for resolution. It was entitled: the "Stockholders' Representative's List of Items in Dispute to Be Resolved by Resolution Accountant." A147. And it too included the unsold inventory issue: whether the "cost of inventory held at the end of 2007 [and 2008] is properly deducted from Product Gross Profit." A147, 149.

Where the Summary of Issues and Engagement Letter were concise in identifying the unsold inventory dispute, Winshall's written submissions to the Resolution Accountants were prolix, dedicating roughly 40 pages of argument to his single point that "the fundamental accounting principle of matching" should be used to resolve that dispute. A258-74; 424-37. In the Table of Contents of Winshall's Opening Submission, under "THE EARN-OUT DISAGREEMENTS," Winshall's very first argument was: "When calculating Gross Profit, Viacom may deduct only the cost of goods sold, *not the cost of goods unsold*." A244 (emphasis added).

In arguing his side of the unsold inventory disagreement, Winshall asked the Resolution Accountants to resolve the dispute by applying the accounting principle of matching: costs are matched to the sales generating revenues. A260. He specifically directed the Resolution Accountants to "basic concepts of accounting" as the way to determine how to treat the cost of unsold inventory: "Although the [Merger] Agreement does not require application of GAAP, at the same time it does not repudiate the basic concepts of accounting," including "the matching principle." A428. The Resolution Accountants agreed with Winshall, and resolved the unsold inventory dispute based on "the matching of revenues and expenses," which they described as "a well-established, basic business concept which has been codified as part of GAAP." A586.

By raising the unsold inventory issue and successfully urging the Resolution Accountants to apply these GAAP-related accounting principles, Winshall brought the Inventory Write-Down squarely within the scope of the dispute. Viacom disagreed with that GAAP-like approach, but argued that if the Resolution Accountants adopted it, it would require that the cost of writing down the value of the year-end 2008 inventory be deducted as a Direct Variable Cost. A181.

There is no dispute on this appeal that, if the market value of the unsold inventory fell below its cost to produce, then the cost of writing down the inventory to the lower of cost or market (LCM) would have to be recognized as a cost under the same "basic concepts of accounting" advocated by Winshall and used by the Resolution Accountants. In seeking to achieve the "objective of a proper matching of costs and revenues," a "loss of utility shall be reflected as a charge against the revenues of the period in which it occurs." Accounting Standards Codification ("ASC") 330-10-35-2. Given the build-up of inventory at year-end 2008, and the company's inability to sell that product at a price that would recover its cost (if at all), the decline in value of the inventory must be "recognized as a loss of *the current period*." ASC 330-10-35-1 (emphasis added). The relevant accounting rule states:

> [I]n accounting for inventories, *a loss shall be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes*. The measurement of such losses shall be accomplished by applying the rule of pricing inventories at the lower of cost or market.

ASC 330-10-35-2 (emphasis added). In other words, costs stemming from a value impairment are to be included in the costs that are "matched" against revenues for a given period.[12]

(b) The Court of Chancery Ignored Viacom's Argument.

The Court of Chancery misread the Merger Agreement as precluding Viacom from making this argument in response to Winshall's proposed accounting approach because no write-down was reflected in Viacom's Earn-Out Statement. The court held that "there could be no Earn-Out Disagreements that were not teed up by the Earn-Out Statement." Ex. A, at 41. Thus, the court reasoned, Viacom was "the master of framing the dispute," a fact that rendered non-arbitrable any evidence that was not specifically set forth in the Earn-Out Statement. *Id*. at 42.

Under the Merger Agreement, the Earn-Out Statement is not the equivalent of a civil complaint, alleging the parties' dispute and setting forth the "plaintiff's" arguments and evidence. Indeed, at the time of the Earn-Out Statement, there is no dispute—just a calculation. A11-12. Thus, the full scope and content of the dispute are established not by the Earn-Out Statement, but by the Summary of Issues delivered by the Stockholders' Representative. The Summary of Issues is the opening pleading, setting forth the Stockholders' Representative's disagreements with Viacom's calculation. Section 2.4(c) of the Merger Agreement states that the "unresolved items in such Summary of Issues" are what frame the "Earn-Out Disagreements"; and, in turn, the "scope of the Resolution Accountants engagement . . . shall be limited to the resolution of the Earn-Out Disagreements." A17-18.

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[12] Information that becomes available *after* the end of the period that relates to the value of inventory during the period must be considered in determining the impairment and any write-down in value for that period. *See* ASC 885-10-25-1 ("An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet including the estimates inherent in the process of preparing financial statements.").

In other words, it is the Summary of Issues that pleads what is wrong with Viacom's calculation and alleges what the right calculation should be. It is true that the Earn-Out Statement sets the stage for the dispute, in the sense that the Earn-Out Disagreements must relate to Viacom's calculation. If Viacom had not included the cost of unsold inventory in its Earn-Out calculation, then presumably there would be no dispute about the cost of unsold inventory. But the nature of that dispute, the competing accounting approaches of the parties, and the alternative methodologies for resolving that dispute are established by the Summary of Issues.

That there is no provision in the Merger Agreement for a supplemental Earn-Out Statement is a strawman: it presupposes that Viacom needed to "amend" its Earn-Out Statement in order to be able to respond to Winshall's disagreement about unsold inventory or to submit evidence about the proper application of Winshall's proposed accounting methodology.

But the parties never agreed that Viacom would be confined to defending the Earn-Out Statement and barred from trying to correct Winshall's accounting approach or arithmetic. Nothing in the terms of the Merger Agreement prohibited Viacom from submitting evidence and argument in response to Winshall's positions and calculations, even if not reflected in the Earn-Out Statement. It defies reason, fairness, and the basic rules of contract interpretation to infer (as the court did) that the absence of provision for amending the Earn-Out Statement means that Viacom could not respond to arguments, accounting methods, and math that it did not see until *after* it delivered the Earn-Out Statement.

There likewise are no provisions in the Merger Agreement that prohibited Viacom from submitting data so that the Resolution Accountants could fulfill *their* mandate and make the proper "recalculation of the 2007 Earn-Out Payment Amount or 2008 Earn-Out Payment Amount." A17. To the contrary, the parties agreed to two rounds of evidentiary and argumentative submissions, which ultimately totaled more than 500 pages. The Resolution Accountants' Engagement Letter states that the Earn-Out Disagreements shall be resolved on the basis of the Merger Agreement as well as "the Parties' initial and reply submissions . . . and the argument made during the hearing." A140.

The Court of Chancery's opinion nowhere addresses the central question of whether the Inventory Write-Down is arbitrable because Winshall put it into play. Instead, the court detoured into an inappropriate review of the *merits* of the Inventory Write-Down as an accounting matter. The court discussed at length the appropriate timing of the write-down under GAAP, and questioned whether Viacom's calculation was reliable. Ex. A, 9-10. Thus, the Court of Chancery turned FAA review upside down—examining the factual merits of the Inventory Write-Down (which is the province of the accounting experts) while deferring to the Resolution Accountants on the issue of arbitrability (which is the province of the court).[13]

(c) The Court's Interpretation Is Inconsistent with the Understanding of the Parties and the Resolution Accountants.

Interpreting the Merger Agreement as the court did—to preclude Viacom from presenting evidence *responsive* to Winshall's challenge—does not reflect the parties' intent. The Resolution Accounting proceeding became something of an all-or-nothing baseball arbitration: once Viacom calculated the Earn-Outs based on a deduction of 100% of the cost of unsold inventory, Viacom was forbidden from saying a word about the proper application of matching, and the Resolution Accountants were compelled to choose between Viacom's 100% deduction and Winshall's zero deduction—even if "matching" required a very different result.

By that way of thinking, if Viacom had excluded a category of revenue from its Earn-Out Statement, and Winshall then submitted a Summary of Issues disagreeing and arguing that Viacom should have included another $100 million of revenue, Viacom would not have been able to submit evidence that the correct calculation of such revenue was only $10 million, nor to submit evidence of the deductible costs associated with generating that revenue (since those deductions were not on Viacom's Earn-Out Statement). That would result in a multi-hundred million dollar overstatement of the Earn-Out, just as it did here.

The court's interpretation of the Merger Agreement also is contradicted by Winshall's own position during the proceedings. Not once

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13 The court also believed that the accounting documents Viacom delivered with the Earn-Out Statements did not reflect a write-down in inventory. Ex. A, at 42. The court was just wrong. One of the financial statements provided in conjunction with the Earn-Out Statement for 2008 showed a $13.8 million write-down for obsolete inventory. A1011. Moreover, the back-up documentation for the full $54 million write-down had already been provided *in advance* of the Earn-Out Statement. A1010.

in his submissions did Winshall argue that the Resolution Accountants did not have the authority to consider the Inventory Write-Down. Quite the opposite: Winshall engaged on the merits—and only the merits. A436-37. Winshall did object to certain *other* cost deductions proposed by Viacom that he called "Viacom's new deductions." A423-24. He claimed that Viacom raised those "new deductions" for the first time in its submissions and that the Merger Agreement "does not give Viacom the right to amend its Earn-Out Statement to add new deductions." *Id*. However, the Inventory Write-Down was *not* identified by Winshall as one of those objectionable "new" deductions.

The Resolution Accountants themselves did not feel constrained to make an all-or-nothing choice between the numbers presented by Viacom in its Earn-Out Statements and by Winshall in his Summary of Issues. When, in their view, the evidence submitted later in the process warranted a recalculation of the Earn-Outs that differed from the parties' opening positions, the Resolution Accountants heard and applied that evidence.

For example, in the Earn-Out Statements, Viacom deducted 100% of the fees charged for letters of credit. A207-08. In the Summary of Issues, Winshall asserted that no such fees were deductible. A116-17; 130-31. The Resolution Accountants chose a middle path, one not found in either the Earn-Out Statements or Summary of Issues. A664. The Resolution Accountants made a pro-rata deduction based on arguments and data subsequently presented during the evidentiary submission process.[14]

Thus, even though the Resolution Accountants agreed in principle with Viacom's accounting approach to the letter of credit fees, they recalculated the Earn-Out based on evidence and arguments presented in the submissions regarding the proper application of that accounting principle. Likewise, having agreed in principle with Winshall's accounting approach to the cost of unsold inventory, they should have heard Viacom's evidence regarding the proper application of that principle.

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[14] The Resolution Accountants made a similar determination with respect to another cost deducted by Viacom, [redacted] A659-60. Viacom deducted the full amount attributable to 2008; the Stockholders' Representative disagreed and argued the deduction should be zero. The Resolution Accountants agreed it was a deductible cost but, based on the data and arguments in the evidentiary submissions, concluded that only the portion [redacted] associated with product that sold in 2008 should be deducted. A660.

That is the meaning and intent behind the parties' agreement that the Resolution Accountants "shall be deemed to be acting as experts and not as arbitrators." A18. As Winshall himself argued below: "Questions about GAAP (generally accepted accounted [sic] principles) are appropriately answered by accountants." A959. As experts, not arbitrators, the Resolution Accountants were charged and bound to do just that—and not refuse to hear accounting evidence directly relevant to the issue in dispute and directly responsive to Winshall's position. *Cf. Omni Tech Corp.* v. *MPC Solutions Sales, LLC*, 432 F.3d 797, 800-801 (7th Cir. 2005) (concluding that a "proposal to confine the accountant to selecting one of the parties' numbers is untenable. The parties agreed that the independent accountant would reach a decision *as an expert does*, not as the umpire in a final-offer arbitration does.") (emphasis in original).

V. Conclusion

For the foregoing reasons, the judgment of the Court of Chancery should be reversed, the Determination of the Resolution Accountants should be vacated, and the Court should direct the Resolution Accountants to resolve the Inventory Write-Down with regard to the 2008 Earn-Out.

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Dated: November 1, 2012