*Litigation Support Services Insights*

# Avoidance and Resolution of Post-Acquisition Disputes

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## Introduction

In today's volatile economic environment, the price a buyer is willing to pay for a business is often a moving target right up to the transaction closing date. Many acquisition agreements contain provisions that create a post-closing adjustment to the deal purchase price. This post-closing adjustment is based on the change in a financial or accounting measurement (often net assets or working capital) between (1) the signing of the contract and (2) the date of closing.

When the transaction parties still cannot agree on the appropriate price for the business at the closing date, they often turn to an earnout or contingent payment arrangement. An earnout, which is essentially a form of post-closing adjustment, is a contractual provision giving the seller the potential of additional future compensation. This potential additional compensation is based on the business achieving certain financial goals.

Disputes often arise as to the meaning and application of the accounting terms incorporated into these contractual provisions. Through a careful choice of contract wording, the parties can minimize these often unexpected and expensive surprises. Financial advisors can assist in this process by (1) assessing the target/seller company and (2) assisting legal counsel in drafting clear and concise post-closing adjustment provisions. These contract provisions should avoid the vagaries that often arise in the application of accounting principles.

If a dispute does occur, the deal financial advisor can assist legal counsel in arbitration or litigation by:

1. identifying the disputed issues,
2. preparing a formal position paper regarding the disputed items,
3. planning a response to the other party's position,
4. analyzing and identifying the essence of the matters in dispute, and
5. providing a critique of the opposing expert's deposition or trial testimony.[1]

In many cases, the complex nature of these disputes is recognized by legal counsel, and a provision is included in the contract that calls for resolution of these disputes through a post-closing accounting arbitration.

## Purchase Price Adjustments

Most business acquisitions have a period between (1) the signing of the agreement—the time when the parties become legally obligated to effect the transaction—and (2) the transaction closing, when the acquisition actually occurs. This is true whether the transaction is a stock purchase, an asset purchase, or a merger.

There are a number of explanations for the delay between signing and closing. In a public company transaction, stockholder approval by the seller's shareholders (or by the buyer's shareholders) is usually required. Other time consuming tasks include (1) antitrust filings, (2) gaining regulatory approvals, (3) securing financing, and (4) conducting due diligence. This time lag between signing and closing lends an amount of uncertainty to the final purchase price.

This risk is alleviated by adjusting the purchase price based upon a change in a specified valuation benchmark. The valuation benchmark often refers to a balance sheet measurement such as net "working capital" or "net assets." The adjustment is calculated as the difference in the valuation benchmark amount between (1) the date of the financial statements used to negotiate the purchase price (often an interim financial statement) and (2) the closing date financial statements.

Such purchase price adjustments are favored by many attorneys because they also allow for the consideration of the following factors:

1. The lengthy period between the execution of an acquisition contract and the closing date. Tasks such as modifying debt covenants, obtaining regulatory approvals, and finalizing specific contract provisions may require several months to complete.
2. An unwillingness on the part of a buyer to bear the risk of the target company's financial deterioration should the seller fail to manage the target company properly up to the closing date.
3. An element of protection for the buyer against misrepresentations by the seller related to the target company's financial position. Frequently, closing date financial statements, which generally serve as the basis for purchase price adjustments, are subjected to an independent audit. A purchase price adjustment may serve as an automatic and timely means of recovering for certain types of misrepresentations that can be uncovered by an audit.

4. A desire by the seller to benefit from the ongoing efforts to effectively manage the target company's operations for the period between the contract date and the closing date.[2]

### Understand the Limitations of Generally Accepted Accounting Principles

Disputes often arise when the buyer objects to the preparation of the closing balance sheet upon which the purchase price is ultimately determined. Most transaction agreements specify that the closing balance sheet be prepared "in accordance with generally accepted accounting principles (GAAP) prepared on a consistent basis. . . ." In doing so, the transaction agreement drafters often believe that the application of GAAP will render a consistent result that will be uniform among accountants. In reality, this is not the case.

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The term "generally accepted accounting principles" is used to broadly describe the body of principles that governs the accounting for financial transactions underlying the preparation of a set of financial statements. Generally accepted accounting principles are derived from a variety of sources, including promulgations of (1) the Financial Accounting Standards Board and its predecessor, the Accounting Principles Board, and (2) the American Institute of Certified Public Accountants. Other sources of GAAP include the general body of accounting literature, consisting of textbooks, articles, papers, and so forth.

GAAP are not intended to be a fixed set of rules. They are more akin to guidelines or, more precisely, a group of objectives and conventions that have evolved over time to govern how financial statements are prepared and presented. Often a number of different standards will address a single accounting issue or, in some cases, the standards may conflict.

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In such a situation, accountants look to the Statement of Accounting Standard (SAS) Number 69 which establishes a hierarchy to follow in determining what is GAAP. SAS 69 establishes various levels of GAAP, ranking each source of data in order of importance.

As one can see, simply requiring that the closing balance sheet or stockholders' equity statement be prepared in accordance with GAAP does not guarantee that all parties will arrive at the same figure. With this in mind, attorneys should spend more time with the deal financial advisors when drafting the purchase price adjustment provision.

When practical, counsel should work with the financial advisor to identify the sensitive accounts that will appear in the closing date balance sheet or capital statement.

For example, a professional services firm may have issues with the collectibility of accounts receivable and the accrual of executive compensation. A construction company may have issues with revenue recognition and the valuation of accounts receivable and work in process. Subsidiaries or multi-division companies may have issues with the allocation of revenue or the elimination of inter-company profits.

Working closely with the transaction financial advisor will help the attorney recognize the potential areas of dispute and carefully craft provisions that will protect his or her client from potential misstatements of the sensitive accounts and, in return, avoid costly litigation.

Counsel should also recognize that, unlike the audited closing-date financial statements, the interim financial statements relied on during the contract negotiation and due diligence period may not have been prepared in accordance with GAAP. As a result, subsequent comparison to the GAAP basis closing date financial statements may lead to unwelcome surprises.

Most companies do not subject their interim financial statements to audit. In fact, most companies do not make the necessary adjustments to bring the financial statements into compliance with GAAP until the end of the year. As a result, many of the accounts that require the application of accounting judgment (e.g., accounts receivable and inventory reserves) or independent measurement (e.g., depreciation, inventory, and accruals) may be misstated.

Attorneys may work with the deal financial advisor (1) to identify these areas and (2) to anticipate the adjustments that will be required when the seller issues the closing date financial statements.

### Consider Materiality

Notwithstanding differences in the interpretation of GAAP, audited closing date financial information may actually contain a number of departures from GAAP. It is quite possible that the independent auditors have discovered these inaccuracies but have elected not to adjust the account. This could be because the adjustment would have been immaterial to the financial statement taken as a whole.

Counsel should keep in mind that an audit is only designed to obtain reasonable assurance that the financial statements are free of material misstatement. FASB Statement of Financial Accounting Concepts No. 2, Qualitative Characteristics of Accounting Information, states in part: "The essence of the materiality concept is clear. The omission or misstatement of an item in a financial report is material if, in the light of the sur-

rounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."

FASB has elected not to prescribe materiality thresholds because "no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment."

As a result, certain sensitive accounts may contain GAAP departures that are significant to the purchaser but remain immaterial to the independent auditor. Accounts where there may be immaterial GAAP departures include: [3]

1. Vacation pay accruals.
2. Operating leases. Many leases are accounted for as operating leases, although they are capital leases under the SFAS No. 13 tests. The valuation effect is difficult to predict because a capital lease creates both an asset and a liability.
3. Accruals for services. Many companies account for services on a cash basis or on an invoice received basis—rather than on a full accrual basis.
4. Reserves for excess and obsolete inventory and for doubtful accounts. Many companies "true up" these reserves annually, especially if the impact is expected to be small.
5. Inventory shrinkage. Many companies slightly over-provide for inventory shrinkage so as not to be "surprised" by the results of the annual physical inventory.

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When these misstatements affect accounts such as inventory, accounts receivable or accounts payable, they also have a direct effect on earnings. And, these misstatements may ultimately affect the buyer's opinion as to acquisition value. This is particularly true when the buyer has calculated value by applying a pricing multiple to the target company earnings or cash flow. If practical, counsel should work with the deal financial advisor to identify the accounts in the seller's financial statements that require more precise measurement than a typical financial statement audit can provide. Counsel can work with the financial advisor to draft a provision that will require seller to provide a more precise measurement of the sensitive accounts in the closing date financial statement.

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The concept of materiality can also be used by the seller to limit the consequences of a situation as described above. Many sellers choose to include a materiality qualification to limit the scope of their representations. Sellers understand that the buyer will be in control of the books and records of the company from the closing date forward. Therefore, the seller will try to avoid a situation where (1) the buyer takes a microscope to the books and records of their newly acquired entity and (2) discovers a number of small adjustments from the closing date financial statement. When the cumulative earnings effect is run through the deal valuation pricing multiples, even small adjustments can lead to large damage claims—or even allegations of fraud. Seller's counsel may work with the financial advisor (1) to determine an appropriate level of materiality and (2) to draft a mechanism to protect the seller accordingly.

### Consider Defining Damage Parameters in the Contract

When an indemnifiable breach is alleged that affects the reported earnings or projections of the seller, one of the biggest obstacles to settlement (which would exist even if the parties were able to agree as to fault), is "valuing" the breach.[4] As discussed above, much of the difficulty comes from the fact that many deals are valued at a multiple of target company earnings. Therefore, the buyer will often seek damages that are a corresponding multiple of the earnings misstatement. The seller will argue (1) that this multiple-based damages analysis does not reflect economic reality and (2) that the true amount of damages is significantly less.

Attorneys may consider negotiating a provision to (1) obviate this result and (2) to get both sides on the same damage wavelength. Limiting the creativity allowed in the damage calculation enhances the chances of settling a post-closing dispute in advance of litigation—by taking away the temptation to gamble on a large verdict.

## Earnout Provisions

The uncertainty of today's economic climate creates many performance challenges for companies. Therefore, it is not surprising that buyers in merger and acquisition deals are reluctant to pay high prices without some assurance of the target's performance. Sellers, in turn, often wish to participate in future earnings as a way to make the deal more attractive to them. To help meet the needs of both buyers and sellers, the deal principals and their financial advisors are increasingly turning to earnouts.[5]

An earnout is a method for triggering changes in the purchase price based on future performance of the target compa-

ny. An earnout is useful in helping buyers and sellers to reach a consensus regarding the purchase price. This is because the earnout may satisfy (1) the seller's demand for anticipated future value of the company and (2) the buyer's desire to avoid overpaying for potential value.

Earnout provisions, like purchase price adjustment provisions, often rely on accounting measurements. These accounting measurements either serve (1) as the trigger for a fixed earnout payment or (2) as a benchmark by which to calculate a variable earnout payment. All of the precautions described above related to accounting terminology should be considered in drafting the earnout provision, in addition to a few other precautions discussed below.

In particular, it is important for the seller's counsel to understand (1) the business being sold, (2) how earnings are calculated, (3) what past accounting practices were used, and (4) possible business risks associated with the business.

### Set Reasonable Earnout Goals

The terms of an earnout can be as varied and complex as the parties desire. However, to avoid costly litigation, the percentage of earnout as compared to total purchase price should be kept at a reasonable level. A seller who takes a large earnout but relinquishes oversight and control of the company is more likely to suspect foul play. At the same time, the buyer has more temptation to become creative in reporting earnings.

Also, the term of the earnout payments should be limited. The term of an earnout will typically range between one and three years. Longer term earnout provisions are cumbersome, uncertain, and are of less value in the later years (due to the time value of money). Buyers are usually successful in arguing that longer earnouts are improper because they reflect (1) the post-closing management of the buyer rather than (2) the pre-closing value of the business.[6]

### Clearly Define the Earnout Goals[7]

The key to avoiding a dispute over the earnout provision is a clear and reliable definition of earnings, understood by both the deal financial advisors and the deal lawyers. The first issue that the parties will address will be the earning figure to be used, whether it is (1) after-tax earnings, (2) EBIT (earnings before interest and tax), (3) EBITDA (earnings before interest, tax, depreciation, and amortization), or (4) some other financial measure.

The seller will usually want to state the earnout provision earnings figure in "above the line" or gross revenue terms. The buyer will want the earnout provision earnings figure to be as close to bottom line net profits as possible.

Problems for the seller in accepting a bottom line figure arise from the panoply of expenses and adjustments included in the calculation of profits. Major issues include:

1. the treatment of depreciation expense and any increase in depreciation expense due to the stepped-up basis of the acquired assets, which the seller will want to cap or exclude to avoid the expense of depreciation arising from post-closing investment to achieve long-term earnings, and
2. amortization of acquired goodwill and expenses related to the transaction, which the seller will want to exclude from earnings.

Other issues that should be addressed in the definition of the earnout income measure include:

1. allocation of overhead,
2. whether or not interest charges on capital are deducted from earnings,
3. changes in accounting policies,
4. changes in insurance coverage and costs,
5. the level of product claims and allowances,
6. employee terminations and severance costs, and
7. potential loss of sales due to the buyer's competitive products.

Finally, significant issues may arise related to: (1) bad debt reserves, (2) contingent liability reserves, (3) inventory write-downs, and (4) capitalization versus expensing of post-closing expenditures. Earnout provisions that do not adequately resolve these issues before closing will cause unwanted surprises after closing.

In light of the above, counsel for both sides should consider the advantages of stating the earnout goals in terms of percentages of gross revenue rather than in terms of net income. This is because the expense amounts are easier to manipulate.

This type of percent of revenue earnout goal could avoid a number of disagreements by negating:

1. the "creativity" that often comes with the application of GAAP.
2. the temptation to manipulate the spending patterns or allocation practices of the buyer.

In the end, a percent of revenue earnout goal may save both sides the time and money that would have been spent in litigation or arbitration.

### Define the Oversight Function

To ensure that the earnout goals are meaningful, the contract provision should always obligate the buyer to operate the business during the earnout period in a manner that will not detrimentally affect the earnout payments. For example, the seller

will want a provision that prohibits the buyer from (1) discontinuing a product or line of business or (2) withdrawing from a geographical section of the market.

In addition, the seller may want to require the buyer to account for the purchased entity as a separate division in order to avoid complex or unnecessary inter-company allocations.

As an alternative, if the buyer decides (1) to make major changes in the subject business or (2) to integrate the acquired operations into its other businesses, then the seller should insist on immediate payment of all or part of the earnout. This is because the independent identity of the acquired business or its earnings will be affected.

It is also important to state in the deal contract exactly who will be (1) reviewing the books and (2) verifying the business's performance. From a seller's perspective, it would be easier to monitor the operations of the business if the seller maintains an employment or consulting relationship with the buyer. By doing so, the seller can make sure the buyer is taking all steps necessary to reach the earnout goals, is not making unrecorded sales for cash, is not keeping two sets of books, and so on.

From the buyer's perspective, an earnout is a good solution to uncertainty about the business's future. This is because the earnout payments can often be internally financed. The buyer will want to place a cap on the total earnout payments to limit the risks. Particularly if the seller remains active with the business, the buyer will want to be sure the seller isn't making sales (1) that will never be collected or (2) that will depress the company's profit margin.

## The Accounting Arbitration[8]

The parties to a purchase agreement often look for a cost-effective method for resolving any dispute that may arise. An accounting arbitration is an excellent alternative to litigation when it comes to settling purchase price adjustment and earnout disputes. Financial advisors play a number of roles in these proceedings including arbitrator, expert, and consultant. The following is a brief discussion of the financial advisor's various roles in a typical accounting arbitration.

First, financial advisors representing both sides may play an important role in identifying (1) the issues and (2) the related strengths and weaknesses of the positions taken by the parties. At the onset, financial advisors are often asked to help focus the issues that will be covered by the arbitration.

For example, financial advisors will often find that (1) a disputed item is simply due to a reclassification that does not affect the purchase price adjustment or (2) that the amount is too insignificant to warrant the expense of requiring an arbitrator's ruling.

Throughout the arbitration, the financial advisor may assist counsel in preparing formal position papers with respect to the disputed items. These position papers set forth the parties' understandings of the relevant facts and provide support for their position. The financial advisor can:

1. help counsel understand the form and substance of the accounting issues,
2. help counsel understand what documents or other forms of evidence can be used to support the understanding, and
3. identify the related accounting position, including the relevant accounting literature.

The financial advisor may also assist counsel in developing a response to the opposition's position paper

The final determination of the arbitrator is generally communicated to the parties in a written report. The financial advisor may assist counsel by (1) reviewing the arbitrator's ruling and (2) verifying that it is not based on incomplete or misunderstood facts.

There are many advantages to resolving purchase price or earnout disputes through an accounting arbitration. First, the accounting arbitration process generally leads to a quicker and more cost-effective resolution of the dispute—as compared to formal litigation. It is also an advantage to both parties to leave the ultimate resolution of the issues in the hands of a financial advisor arbitrator who understands the relevant accounting and valuation issues in dispute. The likelihood of a financial advisor arbitrator reaching a fair resolution is often greater than leaving the resolution to a judge or jury. This is because a judge or jury may lack a fundamental understanding of GAAP, the acquisition process, and the related valuation issues.

Notes:

1. David Schector, "Avoiding or Resolving Purchase-Price Disputes," *The CPA Journal Online*, March 1993.
2. Ibid.
3. Luther E. Birdzell, "Preventing Expensive Surprises with Post-Closing Adjustments," *The CPA Journal Online*, July 1993.
4. James C. Freund, "A Dozen Tips on How to Resolve Post-Closing M&A Disputes Outside the Courthouse" *The M&A Lawyer*, November 2003.
5. Philip Kruse and Stephen Goldberg, "Buyers, Sellers Increasingly Use Earnouts to Cope with Purchase Price Anxiety," *CapitalEyes – Fleet Capital*, December 2002.
6. See Mark J. Gunderson and Francis X. Gorman, "Making an Earnout Work: A Seller's Perspective," *The Metropolitan Corporate Counsel*, October 2001.
7. Ibid.
8. See Schector, "Avoiding or Resolving Purchase-Price Disputes."

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