CHAPTER 1

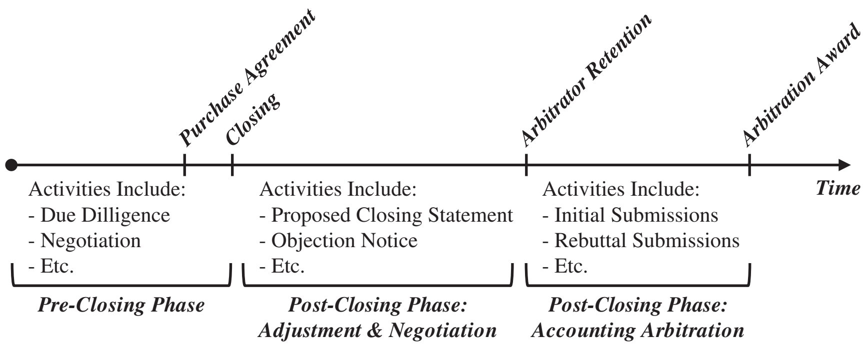
Introduction to M&A Disputes

The purchase and sale of a business is typically an extensive process involving the identification of potential counterparties, due diligence, negotiation of a price and the purchase agreement, and finally the closing of the transaction. The closing represents the culmination of months of hard work often involving the assistance of a variety of advisors, including investment bankers, transaction counsel, and accountants.

The closing, however, does not necessarily mean that the transaction is fully completed and the purchase price is set. Many contracts governing the acquisition of a company or a business contain one or more mechanisms that allow for post-closing adjustments to the purchase price based on a predetermined metric such as net working capital; earnings before interest, taxes, depreciation, and amortization (EBITDA); or some other metric. Such mechanisms and any resulting proposed purchase price adjustments may be resolved amicably between the parties. On the other hand, the adjustment process may lead to post-closing disputes between the parties regarding the appropriate amount of the purchase price adjustment.

THE TRANSACTION LIFECYCLE

Purchase price adjustments are generally implemented after the closing of the transaction. The underlying mechanisms, however, are agreed upon prior to the closing. Moreover, the actual post-closing adjustments may well find their genesis in pre-closing events. Shown here is a sample representation of the lifecycle of a typical merger and acquisition transaction.



Sample Transaction Lifecycle with NWC Adjustment

M&A transactions can take a variety of forms and can follow varying timelines. Notwithstanding, the transaction lifecycle can generally be broken down into two major time periods—pre-closing and post-closing—with a variety of activities occurring in each period. For example, if the seller initiates the sales process, it may perform a variety of activities early on in the process to identify potential buyers and to get the company ready for sale. Once the field of potential buyers has narrowed, the parties can engage in further information exchanges, the buyer can perform its due diligence, and the parties can negotiate the purchase agreement.

The purchase agreement can incorporate both a negotiated purchase price amount (e.g., $1 billion) as well as a variety of adjustments that need to be made to arrive at the amount that is to ultimately be paid by the buyer. By means of example, the purchase price may be set on a debt free/cash free basis, that is, the agreed upon purchase price of $1 billion assumes the company has no debt and no cash. To arrive at the amount ultimately owed by the buyer, the company's debt and cash at closing have to be, respectively, deducted from and added to the negotiated purchase price amount (of $1 billion).

Transactions routinely provide for purchase price adjustments to be implemented post-closing. For example, many purchase agreements contain a net working capital adjustment mechanism in order to have the final purchase price—i.e., after any post-closing adjustments—reflect the actual amount of net working capital that was transferred with the business as of the closing date. Such adjustments are made post-closing because, among other things, it is typically not possible to correctly quantify the net working capital on the closing date itself because of the time necessary to perform a typical "closing of the books."

In such situations, the purchase agreement can provide for a preliminary closing statement based on which the preliminary purchase price is calculated and paid at closing. Subsequent to closing, the buyer is commonly contractually required to submit a proposed closing statement with updated net working capital amounts and any resulting purchase price adjustment. The seller may disagree with the buyer's calculations and send a—contractually provided for—objection notice. In the case of disagreement regarding any proposed adjustments, the purchase agreement commonly provides for negotiations between the parties, which are typically aided by the exchange of information between them.

In the event the parties cannot resolve the implementation of the purchase price adjustment between them, the purchase agreement may provide for the disputed items to be submitted to an accounting arbitrator for resolution. The dispute phase will typically at least involve the parties tendering initial and rebuttal submissions (with supporting documentation) to the accounting arbitrator for consideration and resolution of the dispute.

The focus of this book is on disputes arising after the closing of an M&A transaction and their resolution through accounting arbitration. Of course, the parties' pre-closing activities can have an impact on the post-closing purchase price adjustment process. For example, the level of sell-side and buy-side due diligence performed prior to closing can result in the preemptive identification and resolution of potential problem areas and, generally, increase the parties' knowledge of the accounting of the company being sold/acquired. Moreover, the negotiation of the purchase agreement and the precise language of its provisions can have a significant impact on the implementation of any purchase price adjustment mechanisms and the ultimate purchase price paid and received.

CATEGORIES OF PURCHASE PRICE ADJUSTMENT PROVISIONS

Contractual post-closing purchase price adjustment mechanisms are found in purchase agreements that are structured as stock purchases as well as in those that are structured as asset purchases. Post-closing purchase price adjustments can range from immaterial in the context of the transaction to large amounts that significantly impact the economics for the buyer and seller. There are three broad categories of potential contractual post-closing adjustments to the purchase price:

1. Adjustments to the purchase price based on the financial position or performance of the target company as of or through the closing date
2. Adjustments to the purchase price based on the financial performance of the target company subsequent to the closing date
3. Adjustments to the purchase price based on the allocation of financial responsibility through representations, warranties, and indemnifications in the purchase agreement

Each of those categories of post-closing adjustments can lead to disputes between the parties to the transaction. In addition to contractual purchase price adjustment disputes, there are also disputes related to the transaction and/or the purchase price that are based directly on the legal framework governing the transaction as opposed to the underlying contract. An example of a possible legal challenge that can lead to an adjustment to a share purchase price is a Delaware appraisal action. Another example of a legal challenge related to alleged under- or overpayment can be an action based on allegations of transaction fraud. Parties can also end up in dispute regarding a transaction that was never consummated based on, for example, allegations that one of the parties wrongfully failed to close. As this book focuses on accounting arbitrations, which generally find their basis in being preemptively agreed upon as a form of alternative dispute resolution, non-contractual purchase price adjustment disputes are outside the scope of this book (although we discuss transaction fraud briefly in Chapter 22).

As it relates to contractual purchase price adjustments, agreements governing larger transactions generally contain at least a choice of law and forum selection clause. Many agreements, however, go much further and contain arbitration and/or expert determination clauses complete with prescribed procedures and an agreed-upon timeline for dispute resolution. The agreed-upon choices for alternative dispute resolution and the associated procedures can differ dependent on the nature of the potential dispute. In other words, one purchase agreement can contain multiple avenues for dispute resolution. For example, an agreement can simultaneously contain (i) an overall clause that prescribes New York law as the governing law and the federal court for the Southern District of New York as the venue of choice, (ii) an arbitration clause that arranges for an American Arbitration Association appointed arbitrator to decide any indemnification-related disputes, and (iii) a clause that provides for an independent accountant to resolve any post-closing net working capital disputes.

In general, the perceived benefits of alternative dispute resolution include the relative efficiency of the process, as it is often both faster and cheaper than traditional litigation, as well as the ability to tailor procedures and discovery. The limitations on discovery tend to be especially attractive to foreign transaction parties, for which the U.S. discovery process is often significantly more extensive than the obligations that are imposed by their home jurisdictions. In addition, especially in the event of a would-be venue that is smaller and less used to foreign litigants, some foreign parties may fear that they would be at a disadvantage due to local biases. Of course, alternative dispute resolution also has downsides, including a commonly perceived tendency of arbitrators to arrive at split or compromise decisions as well as significant limitations on the ability to appeal an arbitration ruling. In the case of purchase price adjustment clauses, the efficiency benefits of alternative dispute resolution can be further increased by having, what are essentially, accounting disputes analyzed and decided by accountants.

The first category of purchase price adjustment disputes—adjustments based on the target company's financial position or performance as of or through the closing date—is as close as it gets to contract-based pure accounting disputes. The underlying adjustment mechanisms include those based on the amounts of net working capital, debt (or net debt), and/or cash and cash equivalents that are transferred with the company at closing. The adjustment mechanisms can also incorporate performance measures such as EBITDA, earnings before interest and taxes (EBIT), or a variety of custom measures that cover a defined period prior to closing. For example, the contractual purchase price adjustment formula can incorporate the company's Adjusted EBITDA for the 12 months leading up to closing into the calculation of the ultimate purchase price. Not surprisingly, purchase agreements routinely arrange for purchase price disputes related to category 1 adjustment mechanisms to be brought before an independent accountant. Coates (2012)—in his analysis of a sample of M&A agreements for the period from 2007 through 2008—found that "83% of contracts containing price-adjustment clauses also contained clauses mandating arbitration of disputes arising out of those price-adjustment clauses."[1]

Importantly, disputes related to category 1 adjustment mechanisms center on the quantification of an adjustment, if any. Generally, there is not the two-step of actionable wrongful conduct and damages that is common in general civil litigation. Indeed, the need for some form of adjustment is generally not indicative of wrongful behavior. The existence of a dispute does not belie this; the parties may simply disagree on the appropriate accounting and need assistance in quantifying (part of) the adjustment.

Category 2 adjustments—adjustments based on post-closing performance—are commonly referred to as earn-out provisions and allow the seller of a company to retain some interest in the upside of the company's financial performance while protecting the buyer against paying upfront for expected performance that may never materialize. In a sense, disputes in the second category are often not about adjusting an estimated purchase price, but about quantifying what should be the ultimate purchase price based on post-closing performance. Those disputes can encompass accounting issues and/or various legal and non-accounting factual allegations about wrongful conduct. The accounting issues are frequently resolved by accounting arbitrators. The non-accounting aspects of such disputes are typically brought before attorney arbitrators or judges, but can still involve accountants to provide consulting services and/or educate the trier of fact on the relevant accounting issues as a retained expert.

Disputes in the third category—adjustments based on representations, warranties, and indemnifications—are typically legal in nature. Moreover, although the related payments may be considered adjustments to the purchase price from an accounting perspective, the purchase agreements typically treat those items as payments between the parties and not explicitly as purchase price adjustments, unless for accounting or tax purposes. In our experience, it is highly uncommon for disputes in the third category to be brought before an independent accountant.

Notwithstanding, the findings of the independent accountant in relation to a dispute in the first category can indirectly impact the outcome of disputes in the second and third categories. By means of example, the accounting arbitrator can rule on the amount that should be included on the balance sheet as of the closing date for a partially performed contract, which would fall under the first category. That starting balance and the associated accounting can then have an impact on the amount of revenue that should be recognized in the year subsequent to closing. As a result, the accountant's ruling related to balance sheet work-in-progress accounting can impact the amount of the earn-out owed to the seller for performance subsequent to closing. Similarly, by means of another example, the independent accountant could rule on the appropriate amount to be included on the balance sheet as a tax accrual. If the purchase agreement also contains a clause that arranges for indemnification of prior period taxes in excess of the applicable tax accrual, the ruling of the independent accountant in the context of a category 1 adjustment could very well impact a purchase price adjustment in relation to category 3.

As this book relates to accounting arbitrations as opposed to civil litigation, it focuses primarily on the conception, negotiation, and adjudication of the first category of post-closing purchase price adjustments. The most prevalent adjustment mechanism in this category is for the amount of net working capital that exists on the target company's balance sheet as of the closing date. Post-closing net working capital adjustments also form the bulk of post-closing disputes that are brought before an accounting arbitrator.

Given their prevalence in practice as well as the analogous applicability of many of the identified issues to other adjustment mechanisms, the majority of this book will focus on net working capital–based adjustment mechanisms and disputes. Notwithstanding, we mention other purchase price adjustment mechanisms and disputes throughout this book where appropriate. We also specifically discuss certain other adjustment mechanisms, including EBITDA-based adjustments and earn-outs in Chapter 22.

ACCOUNTING ARBITRATIONS VERSUS EXPERT DETERMINATIONS

Post-closing purchase price adjustment disputes before an independent accountant can take the formal form of an accounting arbitration or of an expert determination. There are a variety of legal consequences that may be associated with the selection of one over the other regarding, for example, the accountant's legal powers and the enforceability of the conclusion.

The parties may (or may not) preemptively select one formal approach over the other in the purchase agreement. The dispute resolution process before the independent accountant and the issues at play, however, are typically the same whether the parties opt for expert determination or arbitration.

Since for purposes of this book the terms are essentially interchangeable, we will refer to both *arbitrations* and *expert determinations* as accounting arbitrations or arbitrations throughout this book. Similarly, we will refer to the independent accountant as the accounting arbitrator or arbitrator whether he or she was retained to issue an arbitration award or to render an expert determination. The same is not uncommon in various articles and other publications on the topic of M&A disputes.

OVERVIEW OF THE BOOK

In this book, we will cover the various aspects of the accounting arbitration process as well as selected common arguments and issues. We will use the net working capital adjustment mechanism as the basis for most of our discussion.

First, we provide an overview of the dispute phase to briefly introduce the post-closing dispute resolution process

(Chapter 2) as well as an overview of post-closing net working capital adjustments (Chapter 3). Those two chapters will provide the reader with foundational information to place the subsequent chapters in context.

We then address some of the core concepts and issues at the foundation of many post-closing purchase price adjustments and disputes, including the nature of GAAP (Chapter 4), the concept of *past practices in accordance with GAAP* (Chapter 5), and several other important and commonly recurring items (Chapters 6–9).

After this, we discuss the post-closing purchase price dispute process in more detail. We start off with opportunities for mitigation that are available to the parties prior to the dispute being brought before the accounting arbitrator (Chapter 10). We then discuss the entire dispute process from retention of the accounting arbitrator through the award (Chapters 11–14).

After discussing the process, we discuss common sources of adjustments, including some specific financial statement accounts (Chapters 15–19). We include technical accounting guidance as well as advice on the documentation and presentation of arguments to the accounting arbitrator.

Finally, we cover other relevant topics, including a discussion of purchase agreements and their relevant provisions (Chapter 20), the interaction of net working capital adjustments and indemnification provisions (Chapter 21), other adjustment mechanisms (Chapter 22), and selected international considerations (Chapter 23).

Overall, this book is meant to provide in-depth professional guidance for practitioners. It cannot, however, exhaustively cover each possible variation. There are few absolute truths in a field for which the framework is predominantly set by contractual arrangements between sellers and buyers in combination with accounting guidance. In order to keep the book readable, we have attempted to avoid inserting "typically" or "generally" into every statement even when exceptions can exist. We urge the reader to carefully evaluate the facts, circumstances, and legal context of the individual cases with which he or she comes into contact. As we cover the various topics, we have attempted to illustrate important concepts with examples. Those examples are simplified to illustrate specific concepts, are fictitious, and are not meant to capture the full nuance of real-world matters.

NOTE

1. *See* John C. Coates IV, "Managing Disputes through Contract: Evidence from M&A," *Harvard Business Law Review*, Vol. 2, 2012, p. 333.