# THE POWER OF BEING UNDERSTOOD

## POST-CLOSING AND TRANSACTIONAL DISPUTES

Mergers and acquisitions are almost always highly complex transactions, and increased complexity can cause heightened confusion, increased ambiguity and even significant disagreements between buyers and sellers—disagreements that can eventually lead to contentious and costly litigation. Post-closing or post-acquisition disputes come in a variety of formats, but all can have a lasting impact—they can delay or even derail what may otherwise appear as an obvious win-win transaction.

The complexity, ambiguity and uncertainty of post-closing calculations can create significant and negative economic impact (e.g., increased costs, strained relationships, judicial intervention) on the transacting parties. Ideally, disagreements can be resolved and a compromise reached. However, in many situations, disagreements over contract definitions (or lack thereof), calculation methodologies, data sources, timing and cut-off issues, or other items may be too significant to be worked out through across-the-table discussions, and ultimately end up leading to expensive and time consuming litigation.

### RSM's approach to post-closing and transactional disputes

Our highly skilled and experienced dispute advisory professionals focus on understanding our clients' needs first. Every transaction is unique, and understanding, evaluating and reviewing the parties and individuals involved, the mechanics of the deal agreement, and the areas of dispute are paramount to successfully resolving disagreements between buyers and sellers.

A typical first step in our approach in assisting buyers and sellers in evaluating post-acquisition disputes is evaluating the underlying causes of the disagreement. We then focus our analysis on the documents, data and other information sources that pertain to that specific issue.

**Post-acquisition disputes: Key areas of disagreement**

Disagreements related to post-closing items can occur for several reasons:

- Calculations required by the purchase agreements can be complex, and are sometimes unnecessary
- Deal documents may be vague, ambiguous or even silent with respect to key definitions and computation formulas
- There are often multiple (and sometimes contradicting) data sources that are relied upon to perform calculations
- Transactions may close on a date that is mid-period (e.g., mid-week, mid-month or mid-quarter) creating confusion regarding cut-off dates
- Information provided during due diligence or represented in deal documents may be incomplete or inaccurate, thereby necessitating significant adjustments

## Basics of accounting

Typical purchase agreement language dictates that the financial statements should be prepared in accordance with generally accepted accounting principles (GAAP), consistent with past practices or with the most-recent financial statements preparation. Points of contention can arise when:

- There is disagreement over whether or not GAAP has been followed
- The accounting treatment used by the seller in past practices is inconsistent with GAAP
- Components of GAAP are interpreted differently by the parties
- An error is discovered in the beginning financial statements that was unknown until after the agreement was executed
- There is disagreement about estimates and assumptions used to prepare the financial statements

## Common post-closing disputes

The following are three of the most common types of disputes that arise from transactions.

### 1. Working capital

Working capital disputes typically result from disagreement over language, or the interpretation of that language, in purchase and sale agreements. Buyers and sellers often challenge working capital calculations during the deal process, at the time of closing or even long after the transaction has closed.

Post-closing adjustments to working capital are commonly made under the guidance of GAAP; however, in many situations, adjustments are made in accordance with specific language or definitions established in purchase and sale agreements. Well-written purchase agreements often define specific terms and principles included in the contract and provide a detailed methodology for calculating any proposed adjustment. In some cases, the purchase agreement will include sample calculations for any expected or foreseen adjustments. However, vague terminology, undefined terms or the absence of these terms altogether can open the door for disagreements between buyers and sellers.

**Working capital: Key areas of disagreement**

Common issues in post-closing working capital disputes include:

- Changes to accounting methodologies and applications
- Accelerated revenue recognition and related accounts receivable
- Accounts payable and other short-term liability measurements
- Reserves and provisions that can be highly subjective
- Inventory valuation methodologies and the identification of inventory that may be obsolete or excessive
- Aging and collectability of accounts receivable
- Proper measurement and categorization of current assets (as assets or expenses) and current liabilities (as liabilities or deferred revenue)
- Discretionary bonus accruals
- Accounting for employee benefit liabilities and other actuarially determined amounts

### 2. Earn-outs

Earn-outs are consideration paid to the seller based on the post-closing performance of the business, most commonly related to meeting or exceeding defined financial and operational goals.

Earn-out arrangements can provide a mechanism for buyers and sellers to compromise on the acquisition price, and are commonly employed to incentivize the acquired company's management to remain with the purchasing entity after the acquisition. Additional compensation is not guaranteed, and is often tied to a designated performance metric such as earnings before interest, tax, depreciation and amortization (EBITDA), net income or cash flow from operations. In addition, a variety of other key performance indicators (KPIs), typically focused on operational efficiency and profitability, are often considered when calculating earn-out payments.

Similar to issues with other post-closing disputes, earn-out calculations can be susceptible to highly contested disagreements between buyers and sellers. Sellers often expect earn-out amounts to be relatively easy to achieve and earn, while buyers frequently hold a counter opinion.

### Earn-out disputes: Key areas of disagreement

Common causes of earn-out disputes include:

- Ambiguity of terms or contract language, most commonly related to the earn-out measurement and calculation methodology
- Problems assessing profitability measures, disagreements over accounting classifications and the timing or recognition of transactions, all of which can greatly influence financial reporting
- Difficulty of evaluating earn-out performance as contemplated by the purchase agreement—because the control of accounting information often rests with the buyer post-close, any changes to financial reporting policies (e.g., revenue recognition) business unit structures (e.g., combination of similar business units) or other similar areas, can make earn-out calculations a challenge
- Buyer and seller disagreement over the proper data sources required to evaluate earn-out performance
- Difficulty calculating the seller's profitability, as it may be influenced by factors other than the isolated transaction—for example, the purchased company's profitability may be affected by the buyer's access to additional capital for expansion of operations or to make additional acquisitions
- Difficulties surrounding how to account for macroeconomic factors (e.g., interest rate fluctuations or unexpected regulation), changes to the industry (e.g., heightened competition, increased costs for raw materials), and other factors that may affect profitability in a way that was unexpected by buyers and sellers

## 3. Representations and warranties

Almost every purchase agreement contains representations and warranties, which are factual statements about the past, present or future status of a target's operations, financials (such as assets and liabilities), business or other conditions.

Representations and warranties are vital for several reasons. They provide one party (usually the buyer) with disclosures of information that would otherwise only be known by the counterparty (usually the seller). This reduces asymmetries in knowledge that may be material to the transaction, and can shift certain risks associated with the transaction to the seller. This disclosure of information also allows the buyer to price the transaction more accurately and may even provide the seller with comfort that the buyer has the necessary funding and capital to pursue the deal.

Inaccuracies in representations and warranties made by either party may have serious ramifications in merger and acquisition transactions. Inaccuracies that are discovered may result in monetary compensation to the non-breaching party, and in some cases, could even lead to the termination or recission of the transaction. Therefore, the disclosing party has a strong incentive to ensure that its representations and warranties are accurate and factual. Disputes arising from representations and warranties have become more common and often lead to costly litigation.

### Representation and warranty disputes: Key areas of disagreement

Because representations and warranties relate not only to areas of finance and accounting concerns, but also to operational, structural and legal items, these disputes can target multiple items and issues, instead of a more narrow and focused area of disagreement. Common causes of representation and warranty disputes include:

- What the parties (both buyer and seller) knew (or in some cases, had knowledge of) prior to the transaction
- The identification and disclosure of material contracts and material customers that the buyer relied upon when negotiating the purchase price
- The buyer's reliance on financial statements and accounting information specifically identified in the deal documents
  - What financial statements are identified (e.g., financial statements, interim financial statements, projections and forecasts, etc.)?
  - What time period do the financial statements and accounting information cover (e.g., historical/year-end audited financial statements, trailing twelve months financial statements, forward looking projections, etc.)?
- Undisclosed or contingent liabilities that were known by the seller during due diligence or before the transaction was completed

## Neutral accounting services

Litigation consulting and accounting firms are often engaged to provide analysis relating to post-closing disputes because of relevant and direct experience in evaluating financial information and accounting records in both transaction and dispute settings. Over the past several years, due to an increase in the number of mergers and acquisitions, we have provided litigation consulting services to an increasing number of clients.

Most commonly, accounting firms are retained as a neutral third party to provide accounting expertise in working capital disputes. The provisions of a purchase and sale agreement normally require the buyer to provide a true-up calculation of net working capital at closing once the transaction has been completed. If the buyer's calculation is disputed, an accounting firm may be appointed as an independent expert to analyze the buyer's calculations and settle the dispute. Similarly, contracts may also require that a neutral accountant determine whether an earn-out was prepared in accordance with U.S. GAAP or other contractual terms.

Although an accounting firm will often be designated in advance of a purchase agreement, neutral accountants may also be selected by the buyer and seller in accordance with agreed-upon selection procedures. Either way, the neutral expert is typically not the same accounting firm used by the buyer or seller during the due diligence process or the firm that provides assurance services on an ongoing basis.

The neutral expert will independently assess the calculations in question and base his or her decision on the purchase agreement definitions and language dictating the calculation methodology.

## Strategies to avoid post-closing and post-acquisition disputes

Post-closing disputes often arise out of the complexity of transactions and calculations, ambiguity and confusion in the underlying deal agreements, changes in accounting treatment and financial reporting, and changes in operations. The following list includes some suggestions that could assist in reducing the occurrence, or at least lessening the impact, of post-closing disputes.

1. **Ensure terminology is well-defined:** Key terminology used in agreements may not be clearly defined (or defined at all) within the purchase agreement, potentially leading to disagreements over the intended meaning of certain key words and phrases. Be sure that key terminology has been clearly defined, and include examples or sample calculations in the purchase agreement to illustrate how the parties intend to make those calculations. In addition, double check that financial reporting periods and other cut-off deadlines are delineated in the agreements.

2. **Avoid vague terminology:** Even when key terminology used in agreements is well-defined, the word or phrase may still be open to debate and could be interpreted or calculated differently by both sides (i.e., there may be multiple ways to calculate certain items contained in the agreement). Make efforts to fully explain the definitions and key phrases included in the purchase agreement.

3. **Incorporate illustrative examples:** The inclusion of examples or descriptions of the calculation methodologies for commonly disputed post-closing issues can provide the parties with increased guidance when evaluating working capital adjustments, profitability calculations and other items of importance.

4. **Eliminate incomplete, inconsistent or bad data:** Companies may have poor bookkeeping practices, data may be incomplete or one party may argue that the other party intentionally misrepresented account balances, values or other items. The review and analysis of financial information (by both buyers and sellers) before the transaction has been completed can help reduce confusion and disagreement, as can a pre-arranged agreement as to which document or data source will be used in calculating adjustments post-close.

5. **When in doubt, put it in writing:** In situations where there is ambiguity, mild disagreement or potential confusion, it can be helpful to include more rather than less language in deal documents. Of course, adding language to an already lengthy deal agreement can seem superfluous, but the addition of explanatory language often triggers meaningful discussions between buyers and sellers that can help remove doubt and avoid potential disputes from occurring.

## The right team

RSM's litigation consulting and dispute advisory practice includes a large number of practitioners experienced in merger and acquisition transactions, and the often unavoidable disagreements that are triggered by purchase and sale agreements. We have experience assisting clients with a variety of post-closing issues and analyses, including working capital and earn-out disputes, representations and warranties claims and serving as neutral accountants.

RSM is the leading provider of audit, tax and consulting services focused on the middle market. With 9,000 professionals and associates in 90 offices nationwide and access to more than 41,000 people in 120 countries through our membership in RSM International, we can meet your needs wherever in the world you do business.

RSM professionals have significant experience providing litigation support services and leading high-stakes investigations for domestic and international clients. Based on our deep experience in merger and acquisition transactions and related litigation, we offer the consulting knowledge to help resolve post-acquisition disputes in an efficient and effective manner.

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