Avoiding Costly Post-Acquisition Disputes Over Portfolio Companies

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Because of the typical three- to five-year holding period of private equity firms' ownership in portfolio companies, PE firms are typically highly experienced in the acquisition and disposition of companies and the nuances of dealmaking.

In the current environment, where access to capital is abundant due to historically low interest rates, there continues to be significant competition among private equity firms for high-performing portfolio companies. As the demand and competition for suitable portfolio assets has increased, valuations and purchase prices have followed course, leading to transactions executed at purchase price multiples that would appear expensive compared to recently observed transaction multiples.

As a result of high valuations and related purchase prices, PE firms expect portfolio returns to be correspondingly significant. But given the current economy's uncertain and uneven nature, portfolio companies sometimes simply do not meet the heightened expectations and forecasts sought by private equity management. As a result, firms explore even more closely how and why an acquisition has not produced the expected cash flow and profitability. And in many situations, the underperformance of a portfolio company acquisition can trigger a review of deal agreements to determine if all contract terms have been fulfilled and if financial recovery is warranted.

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 between the buyer and seller. However, in many situations, disagreements over contract definitions (or lack of them), calculation methodologies, data sources, timing and cutoff 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 disputes or even litigation.

And because every transaction is unique, 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 analyzing post-acquisition disputes is evaluating the underlying causes of the disagreement. From a financial and accounting perspective, disagreements related to post-closing items can occur for several reasons, including:

- Calculations required by the purchase agreements can be complex, confusing, and complicated
- Deal documents may be vague, ambiguous, or even silent with respect to key definitions and computation formulas
- Multiple and sometimes contradicting data sources are often relied upon to perform calculations
- Transactions may close on a date that is midperiod (*e.g.,* midweek, midmonth, or midquarter), creating confusion regarding cutoff dates
- Information provided during due diligence or represented in deal documents may be incomplete or inaccurate, necessitating significant adjustments

Common Areas of Dispute

While transactional disputes can arise for a variety of reasons, the most common causes of disagreements from an accounting and financial perspective relate to the areas of working capital, earn-outs, and representations and warranties.

Working Capital. Working capital disputes typically result from disagreements over language or the interpretation of language in purchase and sale agreements. Buyers and sellers often challenge working capital calculations and adjustments made 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 generally accepted accounting principles (GAAP) consistent with past practices or with the most recent balance sheet preparation. Points of contention regarding this language can arise over one or more of the following:

- There is disagreement over whether GAAP has been followed
- The accounting treatment used

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by the seller in past practices is inconsistent with GAAP

- The parties interpret components of GAAP differently
- An error in the beginning balance sheet is discovered after the agreement is executed
- There is disagreement about estimates and assumptions used to prepare the balance sheet

Further, 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 includes 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 (**Figure 1**).

Earn-outs. Earn-outs are consideration paid to the seller based on post-closing performance of the business and are 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 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 (**Figure 2**). Sellers often expect earn-out goals and amounts to be relatively easy to achieve and earn, while buyers frequently hold a counter opinion.

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 reassure the seller that the buyer has the necessary funding and capital to pursue the deal.

FIGURE 1: WORKING CAPITAL: KEY AREAS OF DISAGREEMENT

Common issues in post-closing working capital disputes include:

- Recent 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 methodology and 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

FIGURE 2: EARN-OUTS: KEY AREAS OF DISAGREEMENT

Common causes of 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 classifications, or the timing and recognition of transactions, which can greatly influence financial reporting.
- Control of accounting information often rests with the buyer post-close, and financial reporting policies (*e.g.*, revenue recognition) and business unit structures (*e.g.*, combination of similar business units), etc., may make it difficult or impossible to evaluate earn-out performance as contemplated by the purchase agreement.
- Buyers and sellers may disagree over the proper data sources required to evaluate earn-out performance.
- Profitability may be influenced by factors other than the isolated transaction between the buyer and seller. 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.
- Macroeconomic factors (*e.g.*, interest rates or unexpected regulation), changes to the industry (*e.g.*, heightened competition, increased costs for raw materials), and other factors may affect profitability in a way that was unanticipated by buyers and sellers.

FIGURE 3: REPRESENTATIONS & WARRANTIES: 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, disputes can specify multiple concerns of deal participants, instead of a more narrow and focused area of disagreement.

Common causes of 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.*, fiscal year-end audited financial statements, trailing 12-month financial statements, forward-looking projections, etc.)?
- Undisclosed and/or contingent liabilities that were known by the seller during due diligence or before the transaction was completed

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 nonbreaching party and, in some cases, could even lead to the termination of the transaction. Therefore, the disclosing party has a strong incentive to ensure that its representations and warranties are indeed factual. Disputes arising from representations and warranties have become more common and often lead to costly litigation (**Figure 3**).

Avoiding 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 could assist private equity firms in reducing the occurrence, or at least lessening the impact, of post-closing disputes:

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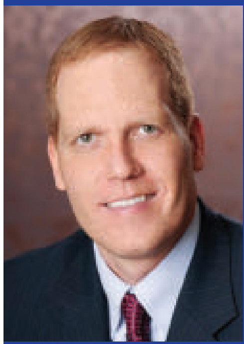
1 Ensure terminology is well-defined. Key terminology used in agreements may not be clearly defined (or defined at all) within the purchase agreement, potentially leading to disagreements over the intended meaning of certain key words and phrases. Be sure that key terminology has been clearly defined and include example 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 cutoff deadlines are delineated in the agreements.

2 Avoid vague terminology. Even when key terminology used in agreements is well-defined, a word or phrase may still be open to debate and could be interpreted or calculated differently by each side (*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.



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

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 a transaction has closed can help reduce confusion and disagreement, as can a prearranged 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 a buyer and seller that can help remove doubt and prevent potential disputes from occurring. J