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Post-closing disputes: Key issues and ways to avoid them

Business acquisitions and dispositions are often highly complex transactions which can possess an increased potential for disagreements—disagreements that can eventually lead to contentious and costly litigation. Various types of disputes can arise from the purchase or sale of a business, and these post-closing or post-acquisition disputes can delay or even derail what may otherwise appear as obvious "win-win" transactions.

If nothing else, post-closing disputes can be frustrating and potentially very costly. Typically, the parties involved in a deal have spent considerable time, effort and resources identifying and negotiating the transaction and bringing the deal toward a close. The parties have also likely allotted significant efforts to post-closing planning and strategies: for sellers, what to do next with returned capital; and for buyers, how to maximize profitability through operational synergies.

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

- Calculations required by the purchase agreements can be complex, sometimes unnecessarily
- There are often multiple (and sometimes contradicting) data sources that are relied upon to perform calculations
- Transactions may close on a date that is midperiod (i.e., midweek, month, or quarter) creating confusion regarding cut-off dates and periods
- Deal documents may be vague, ambiguous or even silent with respect to key definitions and computation formulas
- Situations where one party believes the other party provided incomplete or misleading information during the due diligence process or in closing documents thereby necessitating significant adjustments

The complexity, ambiguity and uncertainty of post-closing calculations can create significant and negative economic impact (e.g., increased costs, strained relationships, judicial intervention, etc.) on the parties. Ideally, disagreements can be resolved and a compromise reached. However, in other 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.

Working capital disputes

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 and adjustments made during the deal process, including during negotiations, at the time of closing or even long after the transaction has closed.

Post-closing adjustments are commonly made under the guidance of generally accepted accounting principles (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, lack of definitions, vague terms or the absence of these terms altogether can open the door for disagreements between buyers and sellers. Common issues in post-closing working capital disputes can include:

- Recent changes to accounting methodologies and applications
- 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

Typical purchase agreement language dictates that the balance sheet should be prepared in accordance with GAAP, consistent with past practices or with the most-recent balance sheet preparation. Points of contention can arise when:

- There is disagreement of whether or not GAAP has been followed
- GAAP appears to have been followed, but not consistently
- Components of GAAP are interpreted differently by the parties
- An error is discovered in the beginning balance sheet that is unknown until after the agreement is executed
- There is disagreement about estimates the seller has used

Real-world insights: Working capital adjustments

RSM was engaged to analyze documents and records related to several items in question in preparation for arbitration.

Overview
The buyer claimed that the seller made material misrepresentations of assets, liabilities and the value of the company. The asset purchase agreement indicated that inventory consisted of a usable quality and quantity with respect to finished goods salability.

Dispute issue
Disagreement arose over the representations of quality and quantity made by the seller. The buyer asserted that a large portion of the inventory was either slow-moving or entirely obsolete.

Earn-out disputes

Over the past several years, many distressed companies, still ailing due to the lingering effects of the economic slowdown, looked to be acquired. Simultaneously, potential buyers are increasingly approaching profitable companies due to the abundance of available capital. As such, merger and acquisition activity, especially within the middle market, remains strong and active.

Earn-outs are consideration paid to the seller based on post-closing performance of the business, or more specifically, the business achieving certain levels of financial performance, or meeting or exceeding defined financial goals. These payments are commonly employed to bridge disagreement between the buyer and seller with regard to price. This additional compensation is often tied to a designated performance metric such as operating income, 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.

Buyers and sellers usually craft customized earn-out language and provisions for each transaction as relevant KPIs and other earn-out metrics are generally specific to the parties' industries. Earn-outs are often expressed as a percentage of or a multiple in excess of a target amount. For example, an earn-out may be tied to profitability in excess of an operating metric such as EBITDA (e.g., 3.5 times the amount for which EBITDA exceeds $10 million). Payments for meeting the required conditions can be issued in relatively short time periods (several months) after the transaction has closed, but are generally paid in installments over a longer time period ranging from two to five years.

Similar to issues with other post-closing disputes, earn-out calculations can be susceptible to disagreements relating to ambiguity of terms or contract language, potential manipulation by one party or the other, simple disagreement over proper data sources, or calculation methodology. Because sellers often expect earn-out amounts to be relatively easy to achieve and earn, these can be highly contested issues.

Real-world insights: Tying an earn-out to net sales

RSM was engaged to analyze items at issue and review the work of an accounting advisor hired by the buyer in preparation for arbitration.

Overview
A seller attempted to eliminate or minimize potential for disagreement by tying an earn-out to a consolidated sales amount defined as "total revenue." Unfortunately, this arrangement became complicated quickly as the buyer and seller disagreed over a variety of issues:

- The definitions of "new" versus "existing" products and the inclusion (or exclusion) of those items in total revenue
- The treatment of the "same product category" when products historically produced by the seller were consolidated into the buyer's general product category
- New products created through the seller's intellectual property versus the buyer's independent research and development

Dispute issue
The seller disputed the way in which the earn-out was calculated by the buyer due to poorly defined revenue metrics and potential inclusion of revenue from certain products and product categories.

Earn-out disputes can quickly become complicated by various factors and measurement methodologies. Disagreements frequently involve problems assessing profitability measures, disagreements over classifications, or the timing and recognition of transactions, which can greatly influence financial reporting. In addition, as the control of accounting and financial reporting often rests with the buyer post-close, sellers often contend that the buyers have an incentive to report financial results in a fashion to reduce—or even eliminate—earn-out payments.

For example, earn-outs based on an increase of net sales can be difficult to calculate because the business processes employed before and after a deal may be fundamentally different. A buyer often implements new strategies that boost sales immediately following a purchase, such as expanding

into new territories, developing innovative product lines or selling its products through existing retail outlets instead of wholesale distributors. Disputes arise when these new revenue streams are separated or not separated from gross sales to arrive at a net sales figure upon which an earn-out is calculated and later distributed.

In other instances, profitability (which can also dictate earn-out payments) 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.

A well-written earn-out provision would likely be multilayered, be specific to each transaction and contemplate the possibility and effects of events that could occur, even if they are not likely to occur. However, the language which defines sales and other key variables can be vague at times, ambiguous or missing altogether from purchase agreements.

Real-world insights: Earn-out dependent on additional acquisitions

RSM was engaged to review and analyze documents and information related to an earn-out dispute in preparation for trial.

Overview
A seller was required to reach certain EBITDA milestones to obtain additional consideration for the sale of his company. These milestones were predicated on the buyer providing additional capital to the business for additional acquisitions. The following issues arose:

- The seller claimed that the buyer did not make additional capital available that was necessary for the business to make acquisitions and reach established EBITDA targets. The buyer claimed that funds were available for acquisitions.
- The seller asserted that the buyer did not approve certain transactions that the seller believed would improve financial results. The buyer countered that the suggested transactions were not approved due to poor quality of the target companies.
- The seller maintained that the buyer did not provide external marketing resources as promised to boost revenue and earnings. The buyer explained that the seller had full access to personnel within the company to assist in marketing efforts.

Dispute issue
The seller maintained that the buyer did not provide the agreed upon capital and support which would allow the organization to reach its established EBITDA target.

Ways to potentially avoid working capital and earn-out disputes

Working capital and earn-out disputes often arise out of the complexity of transactions and calculations, as well as data issues. The following list includes some suggestions that may help avoid some of these issues that can be contentious, costly and diminish the benefits of a deal.

- 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 cut-off deadlines are delineated in the agreements.
- 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.
- 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 items of importance.
- 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 closed 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.

Utilizing some of these suggestions could assist in reducing the occurrence, or at least lessening the impact, of post-closing working capital and earn-out disputes.

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