ALL RISE: ACCOUNTANTS AS ARBITRATORS IN M&A DEALS

Drafting Tips to Protect Clients from Unintended Surprises

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Experts estimate that in 2019 alone, the value of global merger and acquisition ("M&A") deals amounted to a staggering $3.7 trillion. It is common for M&A transaction documents to include alternative dispute resolution provisions between and among the parties of the transaction whereby parties agree how disputes or controversies will be resolved. These provisions also often include a mandatory mediation process, which can be binding or non-binding, followed by an arbitration provision or an agreed upon litigation provision that typically includes a venue and choice of law designation ("ADR Provisions").

Practitioners and business owners should be aware that most M&A transaction documents also include significant provisions providing for the resolution of financial disputes by way of an agreed upon submission to forensic accountants. For those not well versed in the specifics and nuances of M&A transactions, these "financial" alternative dispute resolution provisions can – if not drafted properly and negotiated fairly – create unintended consequences and ramifications for the parties.

Typically, buyers and sellers of companies spend considerable time and resources valuing a target company for the purpose of determining a purchase price. In addition, parties spend time reviewing related factors, such as earnings multiples, book values, inventory and cash levels, working capital, growth projections and earn-out values. While the negotiation of the purchase price to be paid at closing is often the most critical economic/business factor to be agreed upon by the parties to a transaction, an often overlooked aspect of M&A transactions includes the impact and relationship of post-closing adjustments to an agreed-upon purchase price and the effect that such adjustments may have on the overall amount paid by a buyer and ultimately received by a seller(s). Sophisticated practitioners and parties to an M&A transaction must spend as much time and energy on the post-closing adjustments as the pre-closing negotiation of a purchase price in order to avoid unwarranted surprises.

Except for strictly asset-based deals, because closings are typically completed on an agreed upon date based on estimated financial projections of the seller, the typical definitive agreement

in connection with an M&A transaction will often include several areas that will trigger the potential for an adjustment to a purchase price after the actual closing, including the following: adjustments regarding the amount of required working capital (which is typically defined as current assets minus current liabilities); adjustments with respect to earnings before interest, taxes, depreciation and amortization ("EBITDA"); adjustments to net book value (which is defined as total assets minus total liabilities); adjustments with respect to indemnification obligations; adjustments with respect to deviations from representations and warranties made at the time of closing by the seller(s); and adjustments related to the calculation of earn-out provisions.

Once a closing date has been established, the legal transfer of ownership will take place as of a closing date based upon estimated financial projections developed by the seller in conjunction with its internal financial team and outside public accountants. Most purchase and sale agreements will provide for a post-closing adjustment period, which provides the opportunity for the purchaser to review actual financial records with respect to working capital (including cash, inventory levels and accounts receivable), net book value and earn-out provisions, and to adjust or reconcile the projections to actual figures, which are typically calculated within 60 to 120 days after the closing. To the extent that the projected numbers are more favorable than the actual, typically the sellers will owe the buyers money back and, conversely, to the extent the actual closing figures are more favorable than the projected numbers, the purchaser will owe the seller an additional payment.

Earn-out provisions can be used in the M&A arena to bridge the gap between respective opinions as to the value of the company. If a seller believes that the value is higher than what a purchaser is willing to pay, one way to bridge that value gap is to allow for an additional payment(s) of purchase price consideration to the seller(s) post-closing if certain financial revenue targets in terms of revenue and profitability are met by the seller(s). These types of arrangements can be helpful in bridging value discrepancy, but they are also fraught with the potential for disagreements and, at a minimum, a mismatch between the expectation of the seller(s) (who no longer owns the company but is dependent on its financial health for the additional payment) and the purchaser, who will have a vested interest and the right to run the company as it deems appropriate even if it means undermining the potential that the seller(s) may meet the financial projections to obtain its earn-out.

Standard adjustments to the purchase price will account for changes in the company's financial condition after the purchase agreement is signed, especially if there is a long delay between the time of signing and the time of closing in order for the parties to obtain third-party regulatory consent. In such a case, post-closing purchase price mechanisms allow a protocol to modify the purchase price to account for changes in the seller's financial condition. As a result, the potential for an adjustment serves to focus the seller's attention on continuing to run the selling company as efficiently and profitably as possible so as to maximize the purchase price and minimize the potential for a negative post-closing purchase price adjustment.

Similarly, post-closing purchase price adjustments provide a purchaser the ability to ensure the financial condition and integrity of the company at the time of closing despite closing on estimated financial figures. Purchasers are negotiating and paying for a company based upon a certain financial condition of the company. In the same way, the seller will be looking for a degree of certainty in terms of receiving the agreed-upon purchase price and net closing proceeds.

Given that most M&A transactions are in fact closed on estimated financial figures, even where the parties are operating with the utmost good faith, there is a significant potential for disagreements to arise with respect to the calculation and applicability of post-closing adjustments. Considering the value of most M&A deals both singularly and in the aggregate, these types of disputes can involve multiple millions of dollars.

While ADR Provisions are fairly standard within M&A transaction documents, practitioners and parties to these transactions need to be aware that financial disputes are often governed by separate detailed provisions within the transaction documents and are handled outside the typical ADR Provisions. Standard practice is to provide that disputes regarding financial issues are to be handled by a "neutral" third party accountant. For lawyers who are used to standard litigation or traditional ADR Provisions, the use of a specific ADR Provision with respect to financial provisions can seem unusual and/or cause surprise. It is common to delegate the analysis of these financial post-closing adjustment issues to accountants who have a degree of familiarity in general with the issues and a background in forensic accounting and analytical financial analysis. For lawyers who are used to arguing over specific legal issues, these types of financial disputes often turn more on accounting issues, such as record keeping, past practice and custom of the seller(s), interpretation of generally accepted accounting principles or "GAAP," and the specific language of the financial provisions and covenants of the definitive agreement, than on legal issues.

For that reason, practitioners and parties to M&A transactions should take great care when entering into an M&A transaction to ensure that financial books and records, especially on behalf of a seller, are as complete as possible and that the language of the financial terms and conditions and the post-closing financial adjustments provision in particular are reviewed closely by the seller's internal financial team and outside regular accountants. Failure to include a detailed review of such provisions and to provide for frequent communication during the negotiation between and among the investment bankers, counsel and the internal and external accounting teams can be a trap for those who are not used to ADR Provisions substantially handled by outside accountants. Past practice and custom of the seller is an extremely important component and consideration. Great care should be given when drafting the definitive agreement to ensure that the appropriate standards of review and compliance are implemented. Similarly, the standard for any deviation that could give rise to a dispute with respect to post-closing financial adjustments and the process to select the neutral financial arbitrator should also be drafted with care. The parties should also specify the time period for submitting disputed issues and the nature and extent of the authorized submissions and presentation to the arbitrator.

Ultimately, while the use of financial ADR, just as with more traditional ADR Provisions for purely legal issues, can be a cost-effective and efficient way to resolve disputes, care must be given and close attention to detail must be paid when drafting the definitive agreement so as to ensure that the parties to the M&A agreement have their expectations reasonably met, and that surprises and financial issues are minimized and avoided.

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