

# *Good Deals Gone Bad: Structuring Transactions to Reduce the Risk of Litigation*

## **Avoiding Post-Acquisition Disputes**

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# Today's Speakers



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*Purchase Price Adjustment  
Provisions and  
Strategies to Address  
Disputes*

# Why a Purchase Price Adjustment Provision?

- True-up of Enterprise Value
- Period of time between signing and closing can be long
  - Regulatory approvals may be required
  - Financing may need to be arranged
  - Specific contractual requirements may need to be achieved
- The business continues to operate. Both Buyer and Seller need assurance those operations will be conscientious
  - Prevent misappropriation or draining of assets from the business
- A second bite at the apple?

# Typical Purchase Price Adjustment Provision

- Example Calculation
  - “Working Capital shall be calculated as of the Closing Date in accordance with generally accepted accounting principles (‘GAAP’) consistently applied. If Working Capital is greater than \$[target], then the purchase price shall be increased by the amount of such excess. If Working Capital is less than \$[target], then the purchase price shall be decreased by the amount of such deficiency.”
  - Closing payments are based on pre-closing estimates, with one party preparing the actual calculation after the Closing Date to true-up the estimate

# Mechanics of the Purchase Price Adjustment Process

- Typical dispute process
  - Closing statement prepared by Buyer or Seller with a set time (e.g., 60 or 90 days after closing)
  - Dispute notice submitted by other party within set time (e.g., 30 days)
  - Period of time to attempt to resolve disputed items
  - Arbitration for remaining unresolved disputes
- Arbitrator should be limited by the positions the parties took in the closing statement and the objection notice
  - Example language:
    - “For each disputed item, the Neutral Arbitrator may not assign a value greater than the greatest value for such item or smaller than the smallest value for such item claimed in either the Closing Statement or Objection Notice.”

# GAAP vs. Consistency

- Most agreements refer to both GAAP and consistency
  - Historical practices may not be in accordance with GAAP
- Buyers may desire strict compliance with GAAP to correct historical errors. Example language:
  - “Working Capital shall be calculated in accordance with GAAP applied consistently with the company’s past practices, solely to the extent such practices are in accordance with GAAP.”
- Provide specific accounting methods in the agreement
- Sellers may prefer consistency with their past practices
  - “Working Capital shall be calculated in accordance with the company’s past practices. The parties agree no other practices shall be utilized and the intent of the Working Capital adjustment is to measure impact of economic events occurring between [signing or target date] and the Closing Date.”
- Interaction with the financial statement representation

# Purchase Agreement's Arbitration Requirements

- Selection of the arbitrator
  - The agreement may name a specific party to serve as arbitrator or may provide for the parties to agree on a mutually acceptable arbitrator. Sample language:
    - If the parties cannot resolve, “then any such remaining Disputed Items shall be submitted to the Chicago office of [Big 4 firm].”
    - Either party “may elect to have any such disagreement tendered to and resolved by a mutually agreeable internationally recognized independent certified public accounting firm.”
    - “The parties shall mutually engage an independent firm capable of serving as an accounting expert with relevant experience in resolving similar post-acquisition disputes.”



# Engaging an Arbitrator

- Scope
  - The arbitrator’s engagement letter should clearly identify the remaining unresolved disputes that the arbitrator has the authority to resolve
- Procedures
  - Threshold issues
  - Staggered vs. simultaneous submissions
  - Information requests
  - Hearings
- Deadlines
  - Purchase agreement deadlines may not be realistic for the parties or the arbitrator

# *Legal, Choice of Law and Venue Considerations*

# Basic Principles

- The purchase price adjustment mechanism and dispute provisions are matters of contract
  - Many issues can be avoided through carefully drafted provisions
- Depending on the jurisdiction, disputes before the Accountant may be considered arbitrations under the Federal Arbitration Act (although not always recognized as such by state courts)
- The FAA does not provide for federal subject matter jurisdiction
  - Exception for certain international disputes
  - Generally need diversity jurisdiction
- As a result, state courts frequently have jurisdiction if a party seeks court intervention

# In What Circumstances Should Court Intervention Be Considered?

Example: Buyer submits a closing balance sheet with adjustments equal to 40% of the purchase price based on position that agreement provides for “GAAP consistently applied” and Seller’s accounting was not GAAP

- Seller confronted with choice between arbitrating before an Accountant or seeking remedy in court
  - the Accountant may treat as a GAAP dispute
  - Argument is that this is a disguised claim for breach of the representation that the financial statements were GAAP
  - Claim should be subject to caps, baskets and another dispute mechanism (e.g., Delaware court is exclusive venue for all disputes under the agreement)

# In What Circumstances Should Court Intervention Be Considered? (cont.)

- Must consider upfront and before commencing Accountant arbitration
  - Case law support for heading off at outset
  - Difficult to get court to intervene mid-stream or overturn decision of arbitrator

## In What Circumstances Would Court Intervention Be Considered? (cont.)

- Parties can potentially avoid these concerns by clearly separating the closing adjustment from the financial statement representation. For example:
  - Limit purchase price adjustment to consistency without reference to GAAP
  - Provide representation that reference financial statements are GAAP

# Can the Court Direct the Accountant

- Short Answer: Depends on where you are.
- Common for provisions to contain language such as “the Accountant shall be deemed to be acting as an expert and not as an arbitrator”
  - New York State courts – credit this language and courts may “instruct the CPA firm ... with the proper interpretation of the agreement.” Terex Corporation (2012)
  - Second Circuit – subject to Federal Arbitration Act and is a question of federal common law, not New York law
    - Did the parties “submit certain disputes to a specified third party for binding resolution”?
    - If so, it is an arbitration. Bakoss (2012)

# Can the Court Direct the Accountant (cont.)

- Delaware law has been evolving
- Chancery Court decisions have directed Accountants on how to resolve purchase price disputes
  - “the Independent Accounting Firm shall adhere to the Court’s ruling that the intent of Section 3.3 of the APA is to maintain consistency in the application of accounting principles ...”  
General Dynamics (2011)
  - Determined that the “scope of the arbitration is limited to the objections raised in the Dispute Notice.” Aveta (2010)



# Can the Court Direct the Accountant (cont.)

- Delaware Supreme Court decision in Viacom International (2013) overturns these decisions
  - “If the subject matter to be arbitrated is the calculation of an earn-out, or the amount of working capital, or the company’s net worth at closing, all issues as to what financial or other information should be considered in performing the calculation are decided by the arbitrator.”
  - The “arbitrator may well rely on the terms of the underlying agreement, and the arbitrator’s interpretation of the contract is likely to affect the scope of the arbitration. Nonetheless, those decisions fall within the category of procedural arbitrability.”
- Viacom does not address the decisions of the Delaware courts pre-arbitration that a claim is not arbitrable.

# Consideration for the Transaction Lawyer

- If dispute is emerging, get advice early before opportunities to impact outcome are lost
  - Evaluate alternative of seeking court intervention at outset
  - Avoid waiver of procedural deficiencies
  - Input on selection of arbitrator
  - Negotiation of engagement letter
- This is litigation, not just an accounting dispute

# Presenter Profiles



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Brian focuses his practice on the intersection of litigation with accounting and finance issues. He is the co-leader of the firm's Professional Liability practice group. Brian brings his background as a Certified Public Accountant, including eight years with a national accounting firm, to bear on his legal work. Brian's combined legal and accounting experience enables him to serve clients in a variety of contexts. He has represented companies in disputes arising from purchases and sales of businesses, including purchase price (post-closing adjustment) disputes, and suits alleging breaches of representations and warranties. He also has represented companies in SEC and other regulatory investigations and contract and other disputes involving complex causation and damages issues. As part of his litigation practice, Brian has worked extensively with experts in the areas of auditing, accounting, causation and damages.

## Admissions

- New York – 2011
- Illinois – 1995
- US Ct. of Appeals for the 2<sup>nd</sup> (2013); 3<sup>rd</sup> (2001); and 7<sup>th</sup> (1996) Circuits
- US Dist. Ct. for the N. Dist. of Illinois – 1995
- US Dist. Ct. for the S. Dist. of New York – 2012

## Certifications

- CPA, Illinois



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Philip Brandes is a firmwide Corporate and Securities practice leader. He represents strategic and financial investors in mergers and acquisitions, leveraged buyouts, debt and equity securities offerings, bank financings and joint ventures, frequently with a cross-border dimension. He has particular experience advising private equity sponsors and pharmaceutical companies. The 2008 edition of *International Finance and Law Review's Guide to the World's Leading Financial Law Firms* recommended Philip as a leading US M&A lawyer, noting his "great responsiveness," "good manner" and "quality advice."

## Admissions

- New York – 1995

# *Questions?*

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