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Details Matter: Mitigating M&A Post-Closing Purchase Price Disputes

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Introduction

A post-closing purchase price dispute is never a pleasant experience. I would venture a guess that no one reading this would willingly be involved in a dispute at all, much less spend significant time and money trying to win an argument regarding the intended meaning of purchase agreement provisions the parties drafted and presumably agreed to months ago. While clearly not intended or desired by transaction parties, post-closing disputes very frequently involve such issues. There is hope, however! Let's discuss how including, revising or expanding some specific provisions in the purchase agreement can mitigate the severity of such post-closing disputes or potentially prevent them from happening at all. Let's also discuss how, if a dispute does occur, some specific provisions can assist in focusing the dispute resolution process on the substantive issues rather than on unintended ambiguities in the purchase agreement.

ALL Aspects of the Purchase Agreement Are Important

For every M&A deal there is an underlying purchase or merger agreement, some aspects of which are more heavily negotiated than others depending on the perceived level of importance by the parties and their advisors. Other provisions of the purchase agreement are often skimmed over because such provisions are perceived to be of less importance or have a perceived remote possibility of coming into play. Regardless of the perceived level of importance of certain provisions, keep in mind that the entire document (including all exhibits, appendices and side letters) memorializes the parties' agreement governing the related transaction, and once executed it is final and binding and typically can only be changed with the mutual consent of all parties to the transaction.

This may all be very obvious to the readers of this publication and there is not much that many transaction parties would consider interesting about a purchase agreement or a merger agreement – outside of the purchase price, the assets being acquired, and the closing date. In fact, the term "boilerplate" may come to mind regarding much of the agreement. The reality, however, is that every M&A deal has its own unique characteristics that should be captured in the provisions of the relevant agreement. When you add the complexities inherent in many cross-border transactions, the potential for needed customization of the purchase agreement can increase significantly. Without appropriately clarifying the provisions impacted by this customization, the result can be unintended ambiguities, inapplicable provisions, or even omissions that can play a significant role in creating or magnifying post-closing purchase price adjustments and disputes.

Post-Closing Provisions of the Purchase Agreement

What is sometimes overlooked (or considered less important) in drafting purchase agreements is the significant importance of clarity in the implementation of certain provisions, especially those governing or impacting post-closing issues that can arise such as post-closing purchase price adjustments, representation and warranty claims, leakage, and potential disputes related to such issues. But who really wants to deal with ***these*** items? The transaction parties would rather experience all of the typical excitement surrounding a transaction and to get there are focused on arriving at an agreeable purchase price, the right EBITDA multiple, the due diligence results, the prospect of adding a new product line, and/or the prospect of completing the sale to focus on core operations. After all, the post-closing issues discussed here may not actually happen, right?

A rather cliché phrase I like to invoke in response to this attitude is "it is not a problem, until it ***is*** a problem". A failure to sufficiently attend to such items, especially for complicated or heavily negotiated transactions, can create a myriad of post-closing issues, some of which find their genesis in unnecessary and avoidable ambiguities or omissions in the agreement. To be clear, these issues, if they arise, can be very expensive to deal with and may cost one or both parties significant time and money to resolve. Paying attention to just a few post-closing related provisions in the purchase agreement can prevent, or at a minimum mitigate, post-closing disputes. The time invested in addressing these items pre-close can save transaction parties a significant amount of time and money post-close. After all, if a post-closing dispute never arises, what have the parties lost except a little time dealing with those provisions pre-close, compared to the potentially significant cost of a large purchase price adjustment or dealing with a wide-ranging dispute post-close?

Notwithstanding the implied importance, there are cost – benefit considerations, as well as time constraints, related to negotiating and refining purchase agreement provisions. So where exactly should the parties focus their time and efforts? Outside of the perceived more critical provisions, the transacting parties should allocate some time to the post-closing provisions of the purchase agreement that could be open to interpretation several months down the road. Such provisions are those related to post-closing purchase price adjustments, earn-outs, representations and warranties and similar items, as well as any related dispute resolution provisions. Clarity in implementation provisions (e.g., post-closing purchase price adjustment methodology and calculation) is important in the execution of such activities and is even more important should such items result in a dispute. Hoping that an implementation issue or a dispute will not arise is not a basis for accepting less than adequate clarification in such purchase agreement provisions.

There are numerous provisions to a purchase agreement that touch on post-closing activities and this article cannot possibly cover every such provision. The focus here will be on some of the purchase agreement provisions that, in practice, if appropriately addressed can help prevent or mitigate post-closing disputes.

Types of Disputes Being Addressed

Post-closing disputes have been mentioned, but not the types of disputes being addressed. Most of the provisions discussed herein are related to net working capital or closing accounts mechanisms, and the related dispute resolution provisions, common in US-based purchase agreements. Before you assume this topic not applicable to your company, because the UK and Europe have moved towards the use of locked box transactions in an attempt to avoid purchase price adjustment calculations and disputes, be aware that cross-border transactions involving US-based counterparties still commonly include net working capital based purchase price adjustments and related provisions. In addition, transactions involving companies in some developing countries still utilize such mechanisms, so they are still relevant globally.

Post-closing purchase price adjustment disputes are most often resolved through an arbitration or expert determination process, but it is not the typical commercial arbitration process involving a tribunal of attorneys. Such dispute resolution proceedings are commonly referred to as expert determination. Purchase price disputes are most often resolved by a single accounting arbitrator (also referred to as the accounting expert; neutral accountant; or similar terms), selected and agreed to by the parties in accordance with the terms of the specific purchase agreement. I commonly use the term "accounting arbitrator". Sometimes an individual or a firm is specifically named in the purchase agreement. In other agreements a general reference to a nationally recognized accounting firm is all that is included. Regardless of the selection method (which is very important, but is an entire discussion on its own), the use of an accounting arbitrator, versus attorneys, is logical because the vast majority of such disputes are based on disagreements between the parties regarding the accounting for various balance sheet items that are a part of net working capital (e.g., inventory, accounts receivable, contingent liabilities, and similar items).

To avoid confusion, it should be clarified that the terms "arbitration" and "arbitrator" are used somewhat loosely in this opaque practice area and should not be confused with the more formal commercial arbitration process. For example, there are no specifically required rules or procedures to follow in a purchase price dispute resolution process, other than what may be provided for in the relevant purchase agreement, and professional standards for CPAs, CAs or other relevant certifications held by the accounting arbitrator. Also, legal precedent and other legal arguments, such as intent, are often not persuasive in a purchase price dispute arbitration because the arguments are not being made to an attorney or a judge. An accountant, not an attorney, will be rendering the determination, and importantly, that determination is typically non-appealable, final and binding on the parties. In other words, the dispute resolution process is often not an opportunity to successfully argue what one party thought a specific provision "meant". The accounting arbitrator will want to stay within the four corners of the purchase agreement in rendering a determination to prevent a potential challenge from one of the parties that the ruling was beyond the scope of the accounting arbitrator's authority. These factors only further highlight the importance of clarity in the purchase agreement provisions that may have a bearing on post-closing mechanisms and disputes.

Common Purchase Price Adjustment Provisions Warranting Your Attention

There are typically several provisions related to the post-closing purchase price adjustment process, some of which are obviously related (e.g., the formula for calculating any purchase price adjustment), some of which may not be so obvious (e.g., the selected applicable accounting guidance). The remainder of this article will focus on several post-closing purchase price adjustment provisions, which, based on experience assisting companies in resolving purchase price adjustment disputes, can lead to unintended purchase price adjustments and disputes if not addressed appropriately in the purchase agreement.

1. <u>Transaction Specific Adjustment Provisions</u>

In considering provisions in purchase agreements with net working capital or closing accounts post-closing purchase price adjustment mechanisms, the most critical provisions are those related to the determination of any potential purchase price adjustment, which is ultimately based on the relevant financial metric (net working capital, EBITDA, etc.). On the surface, the financial metric calculation may sound very simple – net working capital is current assets less current liabilities – and you would be correct, in concept. In actual practice, it is the rare occurrence, if ever, when all current assets and all current liabilities transfer with the sale. For example, it is not uncommon for cash or restricted cash and certain liabilities to be excluded from a transaction. To further complicate matters, it is common for the exclusions from current assets or current liabilities to only be partial exclusions of specific general ledger accounts. These transaction specific adjustments can include certain components of inventory, certain accounts receivable (or payable) and similar items. There is a way for the transaction parties to clearly define such exclusions from the calculation of net working capital.

A separate, but related, complexity present in many transactions is what I refer to as non-GAAP (generally accepted accounting principles) (or non-IFRS (international financial reporting standards)) provisions. It is very common for purchase agreements to require consistency with the seller's "past practices in accordance with GAAP" in purchase price adjustment mechanisms, but it also common to provide for non-GAAP adjustments in the post-closing purchase price adjustment mechanism. For example, the purchase agreement may provide for the exclusion from net working capital (for purposes of any purchase price adjustment) of certain warranty liabilities that will be paid by the seller; or the purchase agreement may provide for a fixed level of inventory obsolescence reserves, regardless of the actual expected (i.e., GAAP compliant) reserve. Any purchase agreement specific adjustments that create non-compliance with the applicable accounting guidance should be thoroughly explained in the purchase agreement, including any potential impact on purchase price adjustment provisions, indemnity provisions or representation and warranties. An issue related to such provisions may not arise until months after the closing date, at which time recollections about the specifics of the implementation can differ. Addressing such items may require a much more detailed provision than anticipated, or previously experienced, by the parties.

As noted above, it is common for transaction parties to partially exclude or limit the balances of certain accounts that are part of net working capital. The reasons behind this vary widely from assets being retained by the seller, to inventory not desired by the buyer, to portions of account balances that cannot be agreed upon as having value equal to the recorded value, or limiting the amounts that are to be included in net working capital regardless of the actual GAAP / IFRS - compliant balance. In practice these are commonly referred to "transaction specific adjustments". Obviously, such partial exclusions or limitations are not in compliance with the governing accounting guidance, whether that guidance be GAAP, IFRS or other local GAAP. As a result, regardless of the underlying reason(s), the provisions governing such exclusions or limitations should be carefully and thoughtfully documented in the purchase agreement.

To be clear, there is absolutely nothing wrong with including such provisions in the purchase agreement. The terms of the transaction are for the parties to determine and agree upon and anything the parties wish to include is fair game. However, when the parties begin to deviate from accounting guidance that can be referred to, and which has documented standards and guidelines, the parties are effectively eliminating any reference point for the resolution of any disagreement relate to such items beyond the actual language of the purchase agreement. Importantly, in a dispute situation, an accounting arbitrator will not necessarily be able to rely on GAAP to resolve the dispute related to the balance of an account that has been adjusted to be non-GAAP compliant. As a result, because any such special provision is non-GAAP and inconsistent with the seller's past practices, agreement as to the specific exception and detailed implementation is critical to avoiding a potential post-closing dispute.

By way of example, during due diligence, the parties identify the inventory allowance as an item for which they anticipate disagreement regarding whether the company's accounting treatment is in accordance with GAAP. They have several options for handling this in the purchase agreement, including:

- The parties can do nothing and leave it to be sorted out post-closing based on *past practices in accordance with GAAP.*
- The parties can carve-out the inventory allowance from the net working capital calculation, making sure to do the same in the target net working capital and closing net working capital.
- The parties can agree to accept the company's accounting method as being in accordance with GAAP.
- The parties can agree on an alternative amount or calculation, such as the inventory allowance will be $1.1 million or will be 5% of the inventory balance as of the closing date.

All of the above options, and others, are available to the parties in dealing with such issues. The second, third and fourth options listed above will require special attention from the parties in drafting provisions that specifically document the parties' agreement related to these transaction specific adjustments. Further, the second and fourth options will require specific definitions and linking such provisions to the post-closing purchase price adjustment provisions to ensure consistency in application.

The example above is fairly simplistic in definition and the related provision that can be included because it is involves the entire inventory allowance. In practice, however, many carve-outs only involve part of an account balance. These partial carve-outs create unique considerations for the parties. To fully understand the inherent complexities, it is necessary to understand that the net working capital items included in most purchase price adjustment calculations are consolidated balances of more than one general ledger account or sub-ledger accounts, while the exclusion or limitation may be at the sub-ledger level (i.e., only one part of the net working capital account being limited).

In the example above, it would be easy to assume that ALL inventory reserves are limited to a total $1.1 million or 5% or carved-out of net working capital. However, what if the actual intent was to carve-out or cap only the obsolescence reserves, which is recorded in a separate sub-ledger account that is consolidated with several other sub-ledge accounts that comprise the consolidated general ledger account called Inventory Reserves? To eliminate confusion or dispute several months later, when different representatives of the buyer and seller may be involved, it is critical that the specific sub-ledger account (or partial sub-ledger account) being carved-out or capped be clearly identified in the purchase agreement.

An additional example is provided below to illustrate some of the complexities with such issues in practice.

A company services laptop computers, leases out laptops, rents service time on company operated laptops, and sells laptop parts. In the purchase agreement, the parties agreed to exclude laptop service repair parts from the net working capital calculation. Service repair parts are specifically defined in the purchase agreement as those parts used to maintain and repair the laptop infrastructure. None of the terms in the definition are otherwise separately defined in the agreement. The company has the following general ledger accounts for parts:

- 1001 computer parts catalog
- 1002 parts on vehicles
- 1003 service parts
- 1004 parts inventory at maintenance facility
- 1005 retail parts
- 1006 miscellaneous parts

In the post-closing purchase price adjustment process, the parties disagree regarding the implementation of the transaction specific adjustment to exclude service repair parts, resulting in an accounting arbitration to resolve the dispute. The parties present the following positions and arguments in the purchase price dispute arbitration:

- Buyer argues that the inventory in general ledger accounts 1001-1006 should all be excluded from net working capital, stating that ultimately, all parts are used for the maintenance and repair of laptop infrastructure.
- Seller argues that the company keeps a large inventory of repair parts to keep its laptop infrastructure online under all circumstances. The seller recognized that the buyer could have an argument from a GAAP perspective that there is an excess of repair parts inventory for maintaining the laptop infrastructure in

GL account is 1004. Seller's position is that account 1004 is the only account that should be excluded.

- Throughout the arbitration process, the accounting arbitrator becomes aware that the company routinely utilizes parts for other purposes than the documented purpose per the general ledger account. For example, retail parts are routinely used as a source for service parts when the service team needs a part that is in retain inventory.

The above example highlights the need for specific clarity in the partial exclusion or limitation of amounts in transaction specific adjustments. Without specific and detailed definition of the excluded/limited amounts, often down to the sub-ledger level, disputes as presented in the example can and do occur. Transaction parties should make the time investment to do so, which can mitigate, or even eliminate disputes related to transaction specific adjustments.

2. Applicable Accounting Guidance

A seemingly obvious, yet important, issue is the selection of the accounting guidance applicable to the transaction. This selection can have a very real, but unintended impact, on the post-closing provisions. For example, if the seller is a US company and the buyer is a Spanish company, the parties have to decide whether US GAAP or IFRS will be used as the applicable accounting guidance. If the decision is to use IFRS, the US based company may be unfamiliar with the various differences between the two accounting standards, which could result in non-compliance in the balance sheet and the net working capital statement. While not intended, the purchase agreement provisions could be used to obtain a potential unwarranted windfall for the buyer or the seller. There are methods to capture such differences in the purchase agreement to avoid later confusion.

The selection of the applicable accounting guidance, which is a part of purchase agreements with net working capital based purchase price adjustments, is not without issues from more than one perspective. The parties will need to choose US GAAP, IFRS, or other local GAAP as the basis upon which all of the pre-closing and post-closing calculations will be performed. This selected accounting guidance will also need to be clearly defined in the definitions section. Sounds fairly straightforward so far, but there are deeper considerations.

As a first consideration, selecting an applicable accounting standard that is different from the seller's historical accounting basis for its financial statements can create unintended issues with a real monetary impact. These issues are the unintended consequences of requiring a seller to present its financial information using a new accounting basis, which may result in errors that cost the seller in any post-closing purchase price adjustment process. Neither party should seek to create unnecessary complexities in the purchase agreement, therefore such an accounting change is not advisable.

A separate accounting guidance issue that can arise is how to deal with potential changes in the accounting guidance between the drafting of the purchase agreement and the closing date. Should the post-closing calculations reflect the currently applicable guidance or the previous accounting guidance? This is not a common issue, but with the continued convergence of US GAAP and IFRS on topics such as fair value, revenue recognition and similar items, this can become a significant consideration if not appropriately addressed in the purchase agreement.

Many purchase agreements address this potential issue by requiring that all financial statements, financial metrics and purchase price calculations be prepared on a basis consistent with the seller's "past practices in accordance with GAAP". But what if one or more aspects of seller's past practices are deemed not to be in accordance with revised GAAP standards? Does the dispute resolution process default to the previously GAAP compliant accounting treatment or the newly implemented GAAP guidance?

Eliminating conflicting opinions related to implementing, or not, a change in accounting guidance in post-closing calculations should be fairly easily accomplished. The parties should create a detailed provision that describes the parties' selection of the applicable accounting guidance in general and the agreed upon selection of accounting guidance to be used in instances of changes to such guidance.

3. Provisions Creating Overlap in Purchase Price Adjustment and Indemnification Provisions

In practice, it is not unusual to encounter post-closing purchase price adjustment dispute provisions that can create an opportunity for buyers to receive a potential windfall when they overlap with indemnification provisions. This can be the case for items such as contingent liabilities for which the downside risk is eliminated through the indemnification, but for which the buyer may receive more than actually incurred through a purchase price adjustment award in the arbitration. This can be a difficult issue to address because there is more than one issue related to the overlap of purchase price adjustment provisions and indemnities. Regardless, attempting to eliminate an unjust windfall is one aspect that is worth the parties' time.

This may seem like an unusual provision to mention given that many purchase agreements include language that limits indemnification amounts to those not already included in net working capital. In such cases, the parties may believe that their bases are covered. Without considering the implications of potential overlap in net working capital adjustments and indemnity provisions, however, may make one party painfully aware that such reliance was misplaced.

Due to the nature of some balance sheet accounts, such as contingent liabilities, the quantification of net working capital is partially based on estimation. The ultimate amount of the liability can be higher or lower than the estimated amount recorded. As shown in the following example, the indemnification payment eliminates the risk of under-estimation in net working capital, while not eliminating the risk of over-estimation.

- The seller's company has a known environmental exposure with probable clean-up expenses in the range of $20 million - $30 million. The most likely outcome is $25 million. Appropriately (under US GAAP), the seller includes a $25 million current contingent liability in its balance sheet, which is included in net working capital.

- If the environmental clean-up ultimately costs $25 million, there is neither a net benefit nor a net loss to the buyer. The ultimate expense matches the amount included in net working capital and it has already been deducted in the purchase price calculation.

- If the environmental clean-up ultimately costs $30 million, there is also neither a net benefit nor a net loss to buyer. The buyer would receive $25 million as a purchase price reduction through that amount being included in net working capital and an additional payment of $5 million through the indemnity provision.

- If the environmental clean-up ultimately costs $20 million, however, the buyer would receive a net benefit of $5 million on an *ex post* basis. It received a $25 million purchase price discount through the net working capital provision and only incurred $20 million.

- On an overall *ex ante* basis, the buyer can either break even or receive a net benefit. The combination of provisions, however, would never lead to a net loss for the buyer.

As shown in the example above, the net working capital adjustment for indemnifiable items is an opportunity for an unjustified windfall to the buyer for certain net working capital items. So, how should such items be addressed in purchase agreements? The example of a contingent liability was not chosen at random. Such liabilities are subject to significant judgment because they are contingent - they are likely to be incurred, but the exact amount is not certain. As a result, these items can be carved out of net working capital calculations to be resolved through a future indemnity claim based on the amount actually incurred.

Carving out items such as contingent liabilities is fairly straightforward. Other items that involve estimate may not be so easily accomplished and may actually provide opportunities for subsequent disputes. For example, carving out the allowance for doubtful accounts or inventory reserves, while also estimate, is more difficult and can be open to interpretation as to how such items were ultimately written off by a buyer at a later date. Carving out such items is not advisable, but one option is to arrive at an agreed upon limitation of exposure for the buyer and seller for such items, which actually limits the amount that could be subject to dispute.

The proposed carving out solution may not be ideal for sellers that want to be done and move on, but in reality the seller is on the hook for indemnity claims throughout the indemnification period. Adding a few more items does not delay the closing of the transaction or create future obligations that did not exist. It could potentially save the seller some money, but more importantly carving out such items should result in each party receiving what it bargained for in the transaction. The buyer should not be unjustly enriched through a purchase price adjustment mechanism and the seller should not receive payment for less than what was delivered to the buyer.

4. Earn-Outs - Magnifying the Impact and Importance of Purchase Agreement Provisions

All of the above items can come into play, and even be magnified, for transactions involving some form of an earn-out provision. A joke related to purchase agreements involving earn-outs is that "you can go ahead and put an exhibit sticker on the document". This is due to the relative frequency with which earn-outs involve some form of dispute when it comes time to calculate the earn-out amount. In such cases, the provisions discussed above can, if not sufficiently addressed in the purchase agreement, have a significant impact on the earn-out calculation and the success in any dispute resolution process.

Earn-outs are commonly used for instances where the buyer and seller cannot agree on the purchase price. The seller believes the company is worth more than does the buyer. To resolve the difference, the parties agree to include an earn-out provision in the purchase agreement. The deal closes at the price the buyer believed was fair, with the agreement to pay the seller a specified earn-out at some future date or dates depending on the specific earn-out mechanics agreed upon. The difficulty with earn-outs is that the ultimate "closing" of the transaction is pushed out into the future. Much can change from the time the purchase agreement is drafted to the end of the earn-out period.

This lengthy delay in the final settlement of the transaction creates a critical need for clarity in the purchase agreement provisions. Most of us cannot remember the exact basis for an agreed upon provision a year or years into the future without specific unambiguous documentation. All of the provisions discussed earlier can and do come into play in earn-out calculations, which are really just future purchase price adjustment calculations. For example, the odds that the applicable accounting guidance will change increase significantly in a transaction with a multiple year earn-out period. How will the parties address such possible changes? Many earn-out are based on sales or profits or EBITDA. With changes coming to revenue recognition guidance this should be a key consideration for parties to transactions with earn-outs.

The specific considerations for earn-outs could fill a book. The dollars at stake can be significant, the time-delay lengthy, and the potential for a dispute more likely. As a result the need to pay specific attention to the provisions discussed herein cannot be overstated.

5. Other Considerations Regarding Dispute Resolution Provisions

Even if many of the provisions discussed herein are implemented, disputes will still arise. If a post-closing purchase price adjustment does result in a dispute, there are a few provisions the parties should consider to help expedite the process and avoid a protracted dispute resolution process, at least from an administrative perspective. These provisions are of equal importance to the others already discussed, even though they may appear more procedural in nature.

Don't Forget Target Net Working Capital

In most purchase agreements with net working capital based purchase price adjustments there is also a target net working capital. Target net working capital is agreed upon by the parties and while it can be any amount agreed upon by the parties, it is commonly based on some variation of the company's historical net working capital, normalized based on the results of the due diligence process. This target net working capital is agreed upon prior to closing and provides the basis for comparison in calculating any closing date purchase price adjustment and any post-closing purchase price adjustment. There can be closing date purchase price adjustments based on the comparison of target net working capital to the seller's calculation of closing date net working capital, but disputes at this point are not common.

The critical point related to target net working capital is for the parties to make sure that the provisions discussed earlier (and any other provision that could impact net working capital or any other purchase price adjustment calculation), especially those involving transaction specific adjustments, non-GAAP measures, and applicable accounting guidance, are captured in the agreed upon target net working capital. Otherwise the comparison of the target net working capital to any post-closing calculation of net working capital for purposes of a purchase price adjustment will not be an apples-to-apples comparison. This can lead to unintended negative consequences for one or both parties that have no basis other than the fact that the parties failed to provide for identical net working capital calculation methodologies.

Defining the Purchase Price Adjustment Dispute Resolution Process

If a dispute does arise, the resolution process should be about resolving the dispute, not a protracted negotiation about the process itself. Sometimes this negotiation about the process becomes a dispute unto itself, separate and apart from the substantive issues in dispute between the parties. The cause of this potential unnecessary negotiation is that the purchase agreement fails to adequately address some specifics of the process. If included, such provisions could assist in streamlining the process.

One such item is the identification of the arbitrator (accounting expert) or firm to be used in the event of a dispute. As noted earlier, this is a very important consideration with many factors, but the parties should identify, at a minimum, a firm that is free of conflicts at the time it is selected to be included as the selected firm to resolve the dispute. Failing to do so can result in weeks or months of delay in the process for the parties to identify and agree on firms to consider, followed by more delays for the parties to agree on the specific firm, followed by more delays for the parties to agree on an individual from that firm to serve as the accounting arbitrator. Much of this can be avoided by agreeing on this pre-close and including the selection in the purchase agreement. This does not mean that the firm or the individual named in the purchase agreement will not have a conflict at the time a dispute ultimately arises, but if chosen carefully the odds of this occurring are greatly reduced and it avoids even having to discuss this selection at a time when the parties are already in a dispute.

Another factor to consider and document in the purchase agreement is the specific dispute resolution process to be followed. Recall that earlier it was noted that there are not defined rules, processes and procedures for accounting arbitrations. There are, however, some fairly common procedures that result in a fair process. For example, most arbitrations of which I am a part include an initial submission by each party, submitted simultaneously to the arbitrator; followed by rebuttal submissions, submitted simultaneously to the arbitrator; followed by requests and interrogatories from the arbitrator; followed by responses from the parties, submitted simultaneously; followed by the determination from the arbitrator.

This common process allows for adequate information to be provided to the accounting arbitrator and allows the accounting arbitrator to request additional information from the parties to assist in evaluating the disputed items. This common process, however, can be altered in any way desired by the parties. For example, the parties may wish to provide for the possibility of an in-person or telephonic hearing to present their positions on the disputed items to the arbitrator. If so, the parties should include such a provision in the purchase agreement. I have seen cases where during the dispute resolution process one party wishes to have a hearing and the other party does not, while the purchase agreement is silent on the matter. In such cases, it is left to the arbitrator to determine if a hearing is warranted. Ultimately, the goal should be a fair process designed to provide the arbitrator with sufficient information to reach a fully informed determination on the items in dispute. Including a fairly well defined process in the purchase agreement will avoid having to figure it out later, at a time when the parties are already in a dispute.

Include Examples of All Calculations

Any calculation impacting the determination of net working capital and the purchase price adjustment should have an example calculation included in the purchase agreement. Such examples should be very detailed with nothing left open to interpretation, if at all possible. This means that the example calculation of net working capital should not simply list the balance sheet accounts that are to be included. Rather, it should include detail down to the sub-ledger components, if necessary, to attempt to avoid any misinterpretation when this may need to be referred to months after the closing date. Months after closing, in a dispute process, is when memories become vague because one interpretation of a provision negatively impacts a party’s position on a disputed item, while an alternative interpretation supports its position. Don’t assume that those pre-close negotiations when the buyer and seller traded some concessions related to specific net working capital accounts will be remembered later. In addition to the example calculations, some calculations are complex enough to warrant a narrative to describe the unique aspects. This does not take much time to create and can potentially avoid an unnecessary headache in a post-closing dispute.

This particular item is even more important in a dispute setting. As a general rule if it is not part of the purchase agreement an accounting arbitrator will not consider it relevant because it is outside of the “four corners” of the agreement.

Conclusion

The provisions discussed touch on the most common, and often most significant, areas that transaction parties can address in the purchase agreement to help avoid or mitigate post-closing purchase price disputes. The dispute resolution process, while less expensive and quicker than traditional litigation, can be still be an expensive process, especially considering the amounts often at stake. Further, if a dispute does arise, let’s focus efforts on resolving the actual items in dispute, not the process. Implementing just a few of these suggestions will pay dividends far in excess of the time invested.

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Forensic Risk Alliance specializes in cross-border litigation, multi-jurisdictional investigations, M&A disputes, and accounting related litigation. We are experts in analyzing large, complex transactional data sets, with experience working on projects encompassing decades of data and transactions. We have delivered critical evidence to regulators and clients that rely on our experience in complex, long-tail transactional analysis, Anti-Bribery and Corruption (ABC) investigations, disputes, regulatory probes, disgorgements, sanctions, debarment, anti-money laundering and terror financing cases.

Our team includes former specialists from the Securities and Exchange Commission (SEC), the Federal Bureau of Investigation (FBI), Certified Public Accountants (CPAs) and Certified Fraud Examiners (CFEs), software engineers, financial analysts, database experts, and legal project managers. Several members of our leadership team are former investment bankers or traders with global market experience (Lazard, HSBC, Deutsche Bank, JP Morgan, Citibank) in London, New York, Paris and Asia.

We have worked in over 75 countries, and have credentials with regulators all over the world, including the US Department of Justice (DOJ), the US Securities and Exchange Commission (SEC), The UK Serious Fraud Office (SFO), several European financial authorities and multilateral development banks.