

*Best Practices Discussion*

# Disputes and Litigation in Merger and Acquisition Transactions

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*Merger and acquisition (“M&A”) transactions are often complex, and such transactions can result in a dispute between the buyer and the seller. Two of the more frequently disputed components of M&A transactions involve (1) transaction price earnout provisions and (2) post-closing purchase price adjustments. This discussion addresses (1) the advantages and disadvantages of various M&A transaction structures, (2) typical types of earnout provision and post-closing price adjustment disputes, and (3) transaction structuring and transaction procedures to minimize the likelihood of M&A transaction disputes and litigation.*

## INTRODUCTION

It would be an unusual day to open the *Wall Street Journal* (or more likely click the WSJ icon on your tablet or laptop)—or tune into your favorite business talk show—and not read or hear a story about a dispute involving participants in a merger and acquisition (“M&A”) transaction.

Such disputes often lead to lengthy and costly litigation. Such disputes typically involve disagreements over (1) the price paid (or the value received) for the M&A transaction, (2) various transaction price earnout provisions, or (3) some other small detail hidden in one of the hundreds of pages of the transaction purchase agreement.

The standard practices of confidential settlements and nondisclosure agreements often preclude analysts from determining the actual cost of litigation in these transactions.<sup>1</sup> However, a quick look at the largest law firms in the United States provides some perspective on the legal resources focused on M&A transactions.

Data from the Am Law 100 shows that it is not unusual for a larger law firm to have over 500 part-

ners and associates focused on M&A. In fact, several Am Law firms have more than 650 lawyers assigned to their M&A practice group.<sup>2</sup>

Legal representation is a necessary expense for the transacting parties, especially during the document drafting and the transaction negotiation phases. However, costly post-transaction litigation should be avoided.

While buyers and sellers often utilize insurance to offset a portion of the cost of disputes, disagreements between the parties do occur. And, such disagreement may lead to lengthy and disruptive arbitrations and litigation. This discussion highlights possible considerations for transactional parties with a focus on preventing future disputes.

An M&A transaction typically begins when the buyer approaches the seller—and, ideally, ends when the seller receives funds and the deal is closed. This period could take anywhere from a few months to several years.

It is important to draft, negotiate, and ultimately agree upon the specific terms of the transaction before close. If one party is unhappy after the transaction, it may lead to litigation—the terms may fall

under rigorous and expensive scrutiny. Transaction participants—and transaction advisers—should understand how companies end up in these predicaments. This discussion starts at the beginning with transaction structuring and negotiation.

This discussion considers the advantages and the disadvantages of three typical M&A transaction structures:

1. Asset purchase transactions
2. Stock purchase transactions
3. Mergers

Next, this discussion considers typical disputes in M&A transactions, more specifically, earnout provision and post-closing price adjustment provision disputes.

Earnout provisions provide contingency compensation to the sellers of the target company after the close of the transaction. Post-closing price adjustment provisions address changes in the assets and liabilities of the target company between:

1. the initial agreement on price and
2. the close of the transaction.<sup>3</sup>

This discussion summarizes many of the typical earnout provision and post-closing price adjustment disputes. Additionally, this discussion describes disputes over changes in account valuations, representations and warranties, material adverse changes, and issues of control.

Finally, this discussion recommends procedures that may be performed to minimize the risk of litigation in M&A transactions. These recommendations include mutually beneficial provisions and drafting considerations for accounting standards and for asset value calculations.

## ASSET PURCHASE TRANSACTIONS

In an asset purchase transaction, the buyer purchases working capital accounts, tangible property, intangible property, and intangible value in the nature of goodwill. In addition, the buyer assumes agreed-upon liabilities. The seller receives the transaction compensation and retains ownership of the existing legal entity.<sup>4</sup>

Tangible property may include assets such as machinery, equipment, and real estate. Intangible property may include intellectual property and human capital. Agreed-upon liabilities may include accounts payable and notes payable. Goodwill may be considered the amount paid by the buyer over

and above the value of the working capital, tangible assets (net of liabilities), and identified intangible assets.

An asset purchase transaction may be advantageous from the buyer's perspective. However, both parties still have several advantages and disadvantages to consider before entering into such a transaction.

Exhibit 1 provides a list of the primary advantages and disadvantages of an asset purchase transaction structure.

Exhibit 2 provides a simplified diagram of a typical asset purchase transaction.

From the buyer's perspective, one of the more apparent benefits of an asset purchase transaction is the selective assumption of liabilities. Generally, the buyer negotiates to assume a narrow list of liabilities within the ordinary course of business and broadly excludes any other obligations.<sup>5</sup>

For example, a buyer may assume the accounts payable and the liabilities associated with assignable contracts, but the buyer may exclude litigation-related and unidentifiable liabilities. The ability to carve out liabilities may save the buyer time and money while conducting due diligence.

Asset purchase transactions also have favorable income tax implications for the buyer. Generally, both parties agree on a purchase price allocation into seven identified asset classes, as required by Internal Revenue Code Section 1060.<sup>6</sup> This purchase price allocation agreement typically establishes both the income taxes to be paid by the seller and the new asset tax basis for the buyer.

The buyer may step up the depreciable basis of the acquired tangible assets and may amortize the acquired goodwill on a straight-line basis over 15 years.<sup>7</sup> The depreciation and amortization increase future tax deductions and decrease future taxable income. The resulting income tax savings may allow the buyer to generate more cash flow from the assets post-acquisition. These depreciation and amortization deductions enable the buyer to recoup a large portion of the purchase price from the government.

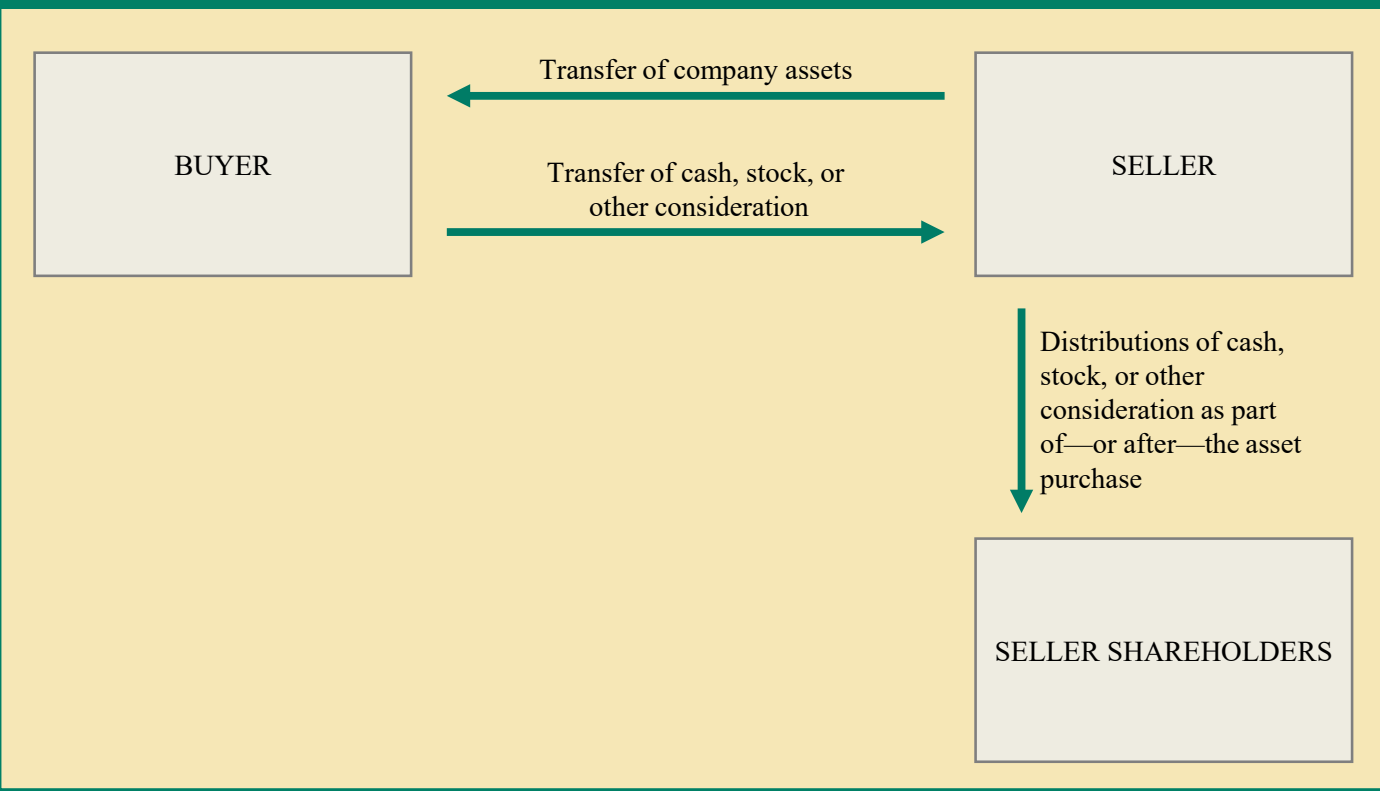
Further, an asset purchase transaction may allow the buyer to bypass the target's noncontrolling shareholders—because the target entity remains intact. Finally, the buyer may elect to forego any unfavorable existing employment agreements and selectively retain employees.<sup>8</sup>

The primary disadvantage to the buyer is that the seller often demands a higher transaction purchase price. The buyer may have to renegotiate vendor,

**Exhibit 1**  
**Asset Sale Transaction Structure**  
**Transaction Structure Advantages and Disadvantages**

ASSET PURCHASE TRANSACTION CONSIDERATIONS		
	BUYER	SELLER
<b>TRANSACTION STRUCTURE ADVANTAGES</b>	<ul style="list-style-type: none"> <li>• Income tax benefit: Step-up in the depreciable basis of acquired tangible assets</li> <li>• Income tax benefit: Amortization of the acquired intangible assets</li> <li>• Selective assumption of liabilities</li> <li>• Due diligence may be less costly</li> <li>• Noncontrolling shareholders have less price negotiating power</li> <li>• Selective retention of company employees</li> </ul>	<ul style="list-style-type: none"> <li>• Stronger price negotiation position for a higher transaction sale price</li> </ul>
<b>TRANSACTION STRUCTURE DISADVANTAGES</b>	<ul style="list-style-type: none"> <li>• Weaker price negotiating position</li> <li>• May need to renegotiate vendor, supplier, and employment contracts</li> <li>• May need to retitle all of the transferred assets</li> </ul>	<ul style="list-style-type: none"> <li>• Income tax burden: Double taxation</li> <li>• May need to liquidate any residual assets</li> <li>• Retention of many recorded and all contingent liabilities</li> <li>• Responsibility to terminate leases and other contracts</li> </ul>

**Exhibit 2**  
**Asset Sale Transaction Structure**  
**Simplified Transaction Structure Diagram**



supplier, and employment contracts as well as retitle the purchased assets. But all these issues may be worth the price premium paid by the buyer due to (1) the income tax benefit and (2) the avoidance of contingent and unknown liabilities.

From the seller's perspective, the only substantial advantage is a strong price negotiation position. The seller may leverage the multitude of benefits for the buyer (1) to secure a higher purchase price or (2) to negotiate a favorable carve out of liabilities and a favorable purchase price allocation.<sup>9</sup>

Upon completion of the transaction, the primary disadvantage to the seller is a higher income tax liability. The seller of a C corporation typically faces double taxation at the entity and owner level.<sup>10</sup>

The agreed-upon allocation of the sale price determines any gain recognized by the seller. The target company pays federal and state income tax on the gain; then, the shareholders pay taxes on the distribution of the sale proceeds to the individual shareholders. Tax pass-through entities—such as S corporations—may avoid double-taxation issues and may be more willing to enter an asset purchase transaction.<sup>11</sup>

Finally, if assets or obligations remain with the target company, the sellers may be unable to walk away until they wind down the company's legal entity. Assets on the target company's balance sheet may need to be managed or liquidated. Liabilities may need to be paid off—either from the proceeds of the sale or from income-generating assets. And existing leases, contracts, and employee agreements may need to be renegotiated or terminated.<sup>12</sup>

## STOCK PURCHASE TRANSACTIONS

From an income tax perspective only, a stock purchase transaction is often structured as either a Section 368 tax-free exchange or a Section 338 election (where the sale of stock is treated—for income tax purposes only—as a sale of assets). Both structures accomplish the same goal of transferring ownership of a corporate entity without changing the ownership of the underlying assets and liabilities. However, a Section 338 election treats the transaction as a sale of stock for legal purposes and as a sale of assets for federal income tax purposes.<sup>13</sup> Both types of income tax structures have advantages and disadvantages for the buyer and the seller.

Exhibit 3 provides a list of the primary advantages and disadvantages of an asset transaction.

Exhibit 4 provides a simplified diagram of a typical stock purchase transaction structure.

In a tax-free exchange stock transaction (e.g., the typical cash-for-stock or stock-for-stock exchange), the seller may benefit from a lower income tax liability and from the retention of fewer contingent and unknown liabilities. The sale of the corporation stock does not create a taxable gain or loss at the target company level. Instead, both C and S corporation shareholders incur capital gains on the sale of their stock.<sup>14</sup> Any disadvantage to the corporation stock seller is the likely discount to the transaction sales price for any potentially unknown liabilities.

In a stock purchase transaction (compared to an asset purchase transaction), the buyer will primarily benefit from simplicity. Since the buyer purchases the stock—and not the individual assets of the corporation—the assets do not need to be revalued or retitled. Typically, any existing contracts with the corporation, such as nonassignable licenses and permits, remain intact. In some jurisdictions, the buyer may avoid transfer taxes because the legal title of the asset remains with the corporation.

There are also several disadvantages to the buyer for structuring an M&A transaction as a stock purchase. The buyer would not receive a step-up in the tax basis of the individual acquired assets. Such assets transfer at a carryover tax basis.<sup>15</sup> Essentially, the buyer cannot benefit from the higher depreciation and amortization deductions that decrease the future tax expense in an asset purchase transaction.

The buyer generally assumes all liabilities unless the seller agrees to take back or pay off any existing liabilities. The buyer may inherit future unknown liabilities such as lawsuits, environmental concerns, employee issues, or other liabilities that carry over with the corporation—unless such liabilities are mitigated in the representations, warranties, and indemnifications agreements.<sup>16</sup>

The buyer may also have to deal with complicated securities laws associated with the acquisition of a corporation with many shareholders.<sup>17</sup> The level of shareholder support required to pass the deal will depend on the transaction structure and the jurisdiction. Noncontrolling shareholders that do not want to sell may lengthen the process and increase the purchase price.<sup>18</sup>

Finally, the buyer is not able to claim amortization tax deductions in a stock purchase structure.

In 1982, the United States Congress enacted Internal Revenue Code Section 338. A Section 338

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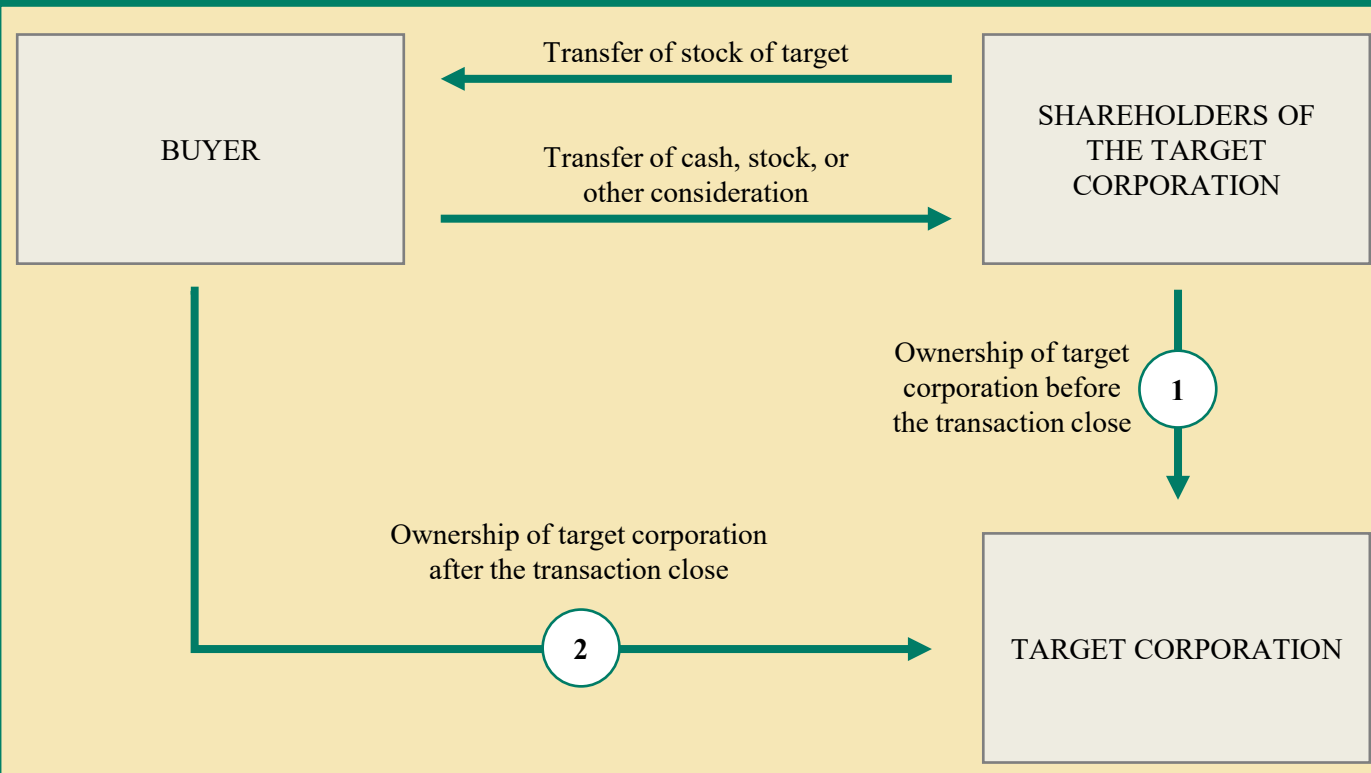
**“In a stock purchase transaction (compared to an asset purchase transaction), the buyer will primarily benefit from simplicity.”**

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**Exhibit 3**  
**Stock Purchase Transaction Structure**  
**Transaction Structure Advantages and Disadvantages**

STOCK PURCHASE TRANSACTION CONSIDERATIONS		
	TO THE BUYER	TO THE SELLER
<b>TRANSACTION STRUCTURE ADVANTAGES</b>	<ul style="list-style-type: none"> <li>• No need to revalue and retitle the transferred assets</li> <li>• Assumption of all licenses and permits</li> <li>• May avoid transfer taxes in some jurisdictions</li> <li>• Simplified structure</li> </ul>	<ul style="list-style-type: none"> <li>• No entity-level taxable gain</li> <li>• Fewer contingent and unknown liabilities</li> </ul>
<b>TRANSACTION STRUCTURE DISADVANTAGES</b>	<ul style="list-style-type: none"> <li>• No step-up in the depreciable tax basis of acquired tangible assets</li> <li>• No tax amortization of acquired goodwill</li> <li>• Assumes all liabilities unless the parties agree otherwise</li> <li>• Potential for future lawsuits</li> <li>• Requires compliance with state securities laws</li> </ul>	<ul style="list-style-type: none"> <li>• Pricing in the transferred liabilities may lower the corporation sale price</li> </ul>

**Exhibit 4**  
**Stock Sale Transaction Structure**  
**Simplified Transaction Structure Diagram**



tax election allows the buyer to treat the stock purchase as an asset purchase for federal income tax purposes.<sup>19</sup> The main downside to a Section 338 election is that it could increase the seller's income tax burden. This is because both the corporation level and the shareholder level are taxed. The Section 338 election only makes economic sense if the present value of future income tax savings exceeds the immediate income tax cost of the election.<sup>20</sup>

Accordingly, for a C corporation seller, a Section 338 election only makes sense in rare instances. Section 338 includes two separate elections: Section 338(g) and Section 338(h)(10). The Section 338(g) election only applies to a C corporation and it is made unilaterally by the acquirer after the transaction. The Section 338(h)(10) election is made jointly by the buyer and the seller before the transaction.<sup>21</sup>

## MERGER TRANSACTIONS

The third M&A transaction structure is the merger. A statutory merger consolidates two or more corporations that are distinct legal entities into a single legal new or surviving entity that holds the combined assets and liabilities of the original companies.<sup>22</sup>

Generally, the acquired company receives cash, stock in the surviving company, or a combination of the two for compensation. Statutory mergers fall under the state law that governs the parties in the transaction.<sup>23</sup>

The buyer may prefer a merger structure because it only requires the majority consent of target shareholders. In other words, noncontrolling shareholders (1) may be forced into the merger and (2) may be required to sell their equity at fair value.<sup>24</sup>

Additionally, the buyer may be able to complete the merger without using any cash. Further, the buyer may avoid the costly and time-consuming revaluing and retitling that is involved in an asset purchase transaction.

Exhibit 5 provides a list of the primary advantages and disadvantages of a merger transactions.

Exhibit 6 provides a simplified diagram of a typical merger transaction structure.

Exhibit 7 provides a simplified diagram of a triangular-type merger transaction.

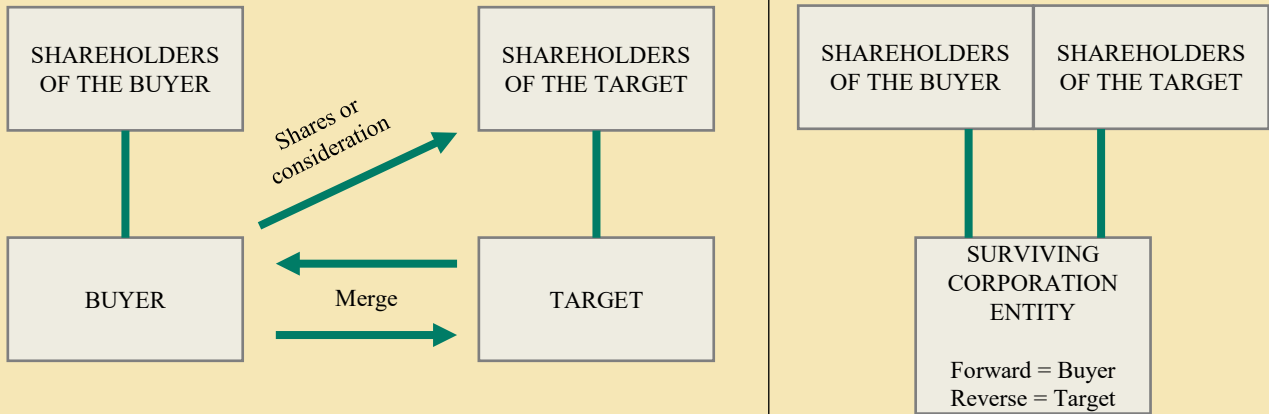
In contrast to the merger transaction advantages, merger transactions also present several disadvantages to the buyer. The buyer may need to create a new corporate structure or subsidiary, depending on the type of merger. The buyer also assumes all liabilities, known and unknown, which increases deal-related risk. Finally, the buyer may need an assortment of third-party consents to remedy anti-assignment provisions.<sup>25</sup>

A seller may benefit from a merger transaction structure because the stock compensation allows the seller to reap the future benefit of a successful, merged entity. Noncontrolling shareholders usually do not have the power to block the merger. However, the target company shareholders have the benefit

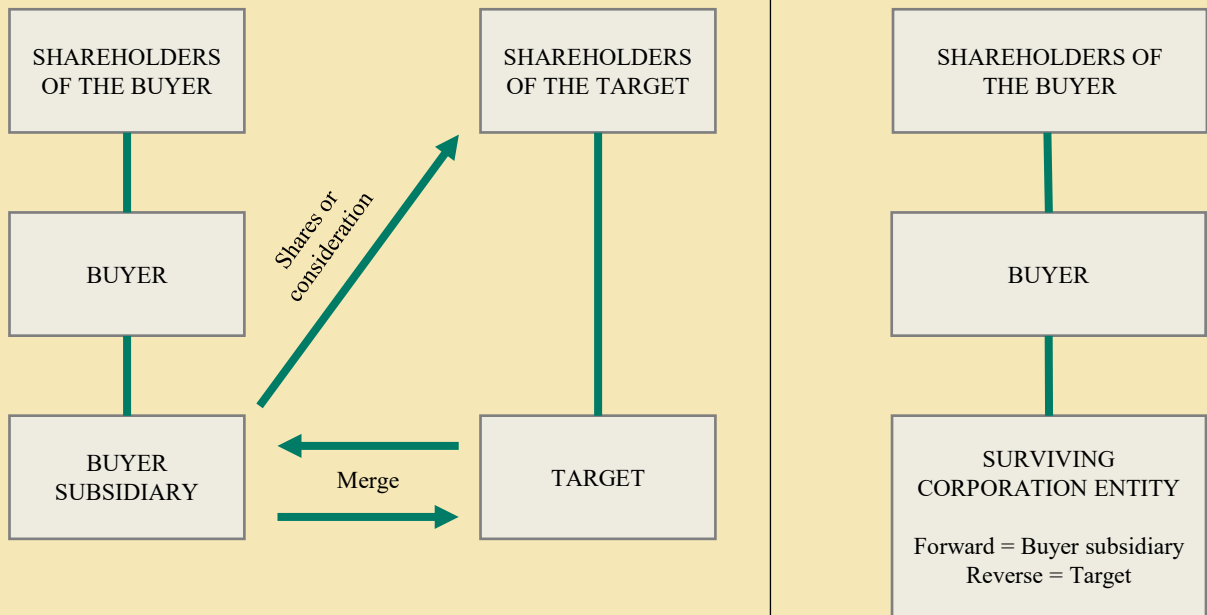
**Exhibit 5**  
**Merger Transaction Structure**  
**Transaction Structure Advantages and Disadvantages**

MERGER TRANSACTION CONSIDERATIONS		
	TO THE BUYER	TO THE SELLER
<b>TRANSACTION STRUCTURE ADVANTAGES</b>	<ul style="list-style-type: none"> <li>• Usually requires majority consent of the target company shareholders</li> <li>• Possibility of a cashless transaction</li> <li>• Avoidance of revaluing and retitling the transferred assets</li> <li>• Tax treatment as a tax-free reorganization</li> </ul>	<ul style="list-style-type: none"> <li>• Equity compensation tied to the future success of the buyer</li> <li>• Dissenting shareholder appraisal rights</li> <li>• Potential income tax treatment</li> </ul>
<b>TRANSACTION STRUCTURE DISADVANTAGES</b>	<ul style="list-style-type: none"> <li>• May need to create a new corporate structure or subsidiary</li> <li>• Assumption of all of the liabilities</li> <li>• Third-party consents may be required</li> <li>• Requirement for federal, state, and regulatory filings</li> </ul>	<ul style="list-style-type: none"> <li>• Noncontrolling shareholders usually lack the power to block the merger</li> <li>• Potential income tax treatment</li> <li>• Requirement for federal, state, and regulatory filings</li> </ul>

**Exhibit 6**  
**Merger Transaction Structure**  
**Simplified Transaction Structure Diagram**



**Exhibit 7**  
**Triangular Merger Transaction Structure**  
**Simplified Transaction Structure Diagram**



of dissenting shareholder appraisal rights—that is, the right to receive the appraised fair value of their shares.

While this shareholder right provides a clear way out for noncontrolling shareholders who do not wish to sell, it also could lead to disputes regarding the “fair value” of the target corporation shares.<sup>26</sup>

Regarding the income tax treatment and the paperwork involved, there are both advantages and disadvantages to the buyer and the seller. Mergers could have an income tax treatment similar to an asset purchase, a stock purchase, or even a tax-free reorganization.<sup>27</sup>

Both transaction parties also have to fulfill the federal, state, and regulatory filing requirements, which may result in high legal costs.

## TRANSACTION PROCESS AND TIMING

Much of the analysis related to the transaction structure discussed above occurs after a tentative “go/no-go” decision is made by the buyer and the seller. After considering all of the strategic, financial, regulatory, and risk issues, the parties determine whether or not to move forward.

If both parties are a “go,” the next procedures generally involve performing due diligence, nego-

tiating a definitive agreement, and executing the transaction.<sup>28</sup>

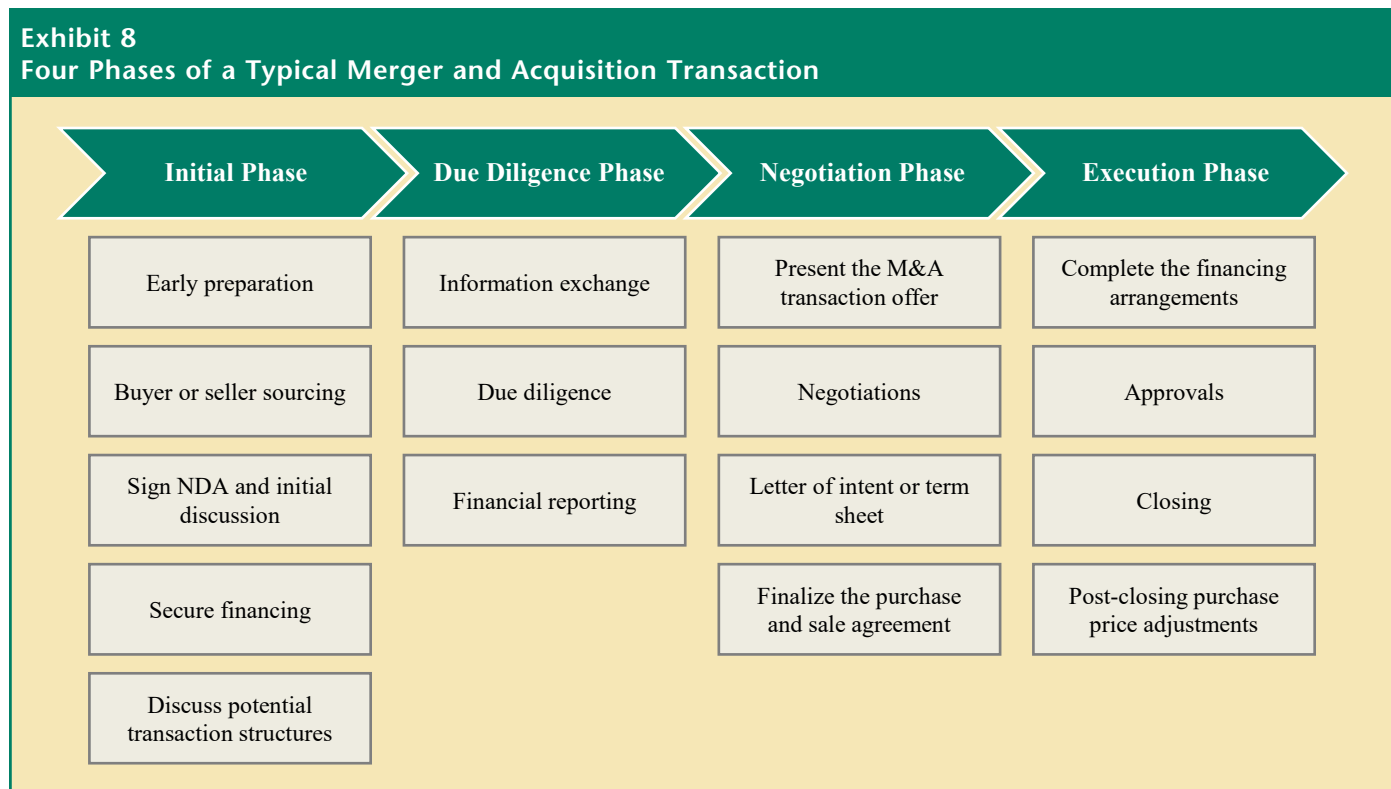
Exhibit 8 provides a simplified diagram of the four phases of a typical merger and acquisition transaction profile.

During the valuation process, the buyer determines a range of fair values for the transaction. These values may include scenarios that may or may not consider post-merger synergies.

Some merger synergies may consist of the elimination of duplicative functions (such as accounting or human resources). In contrast, other merger synergies include more speculative items, such as increased margins due to decreased competition.

The due diligence process often takes place concurrently with the valuation analysis. The purpose of due diligence, from the buyer’s perspective, is to understand the details of the operational and financial aspects of the target corporation. Areas of inquiry during due diligence may be extensive and include the following considerations:

- Financial—Financial statements, audits, EBITDA (earnings before interest, taxes, depreciation, and amortization) calculations, GAAP considerations, risk of cash flow, unrecorded accounts, off-balance-sheet assets and liabilities





## Exhibit 9 Hypothetical Example of a Transaction Earnout Provision

### SIMPLE EARNOUT EXAMPLE:

BigCo recently bought SmallCo using an earnout. Based on the historical financials for SmallCo, the buyer was confident that SmallCo could achieve \$15,000,000 in sales the next year at a 10 percent EBITDA margin. However, the seller strongly believed that SmallCo would be able to achieve \$16,000,000 in sales the next year at the same 10 percent EBITDA margin. Both parties agreed that 6.0x EBITDA was a fair valuation multiple for SmallCo. The different sales assumptions created a \$600,000 difference in value of SmallCo. BigCo agreed that the seller should have the opportunity to earn the additional value. Initially, the seller wanted to earn the additional consideration in proportion to the sales generated next year in excess of \$15,000,000 up to \$16,000,000. The buyer disagreed with a sales milestone fearing that the seller would increase sales without regard to profitability. The buyer suggested the earnout be tied proportionally to the EBITDA for next year in excess of \$1,500,000 up to \$1,600,000. The seller was concerned over the buyer's ability to manage the financials to minimize an earnout tied to EBITDA. The parties compromised by tying the earnout to gross profit. The seller had the opportunity to earn a sliding percentage of \$600,000 proportional to the gross profits generated in excess of \$5,250,000 up to \$5,600,000 for the next fiscal year.

VALUATION PROJECTIONS		
	Seller	Buyer
Revenue	16,000	15,000
Gross Profit	5,600	5,250
<i>Gross Margin</i>	35%	35%
EBITDA	1,600	1,500
<i>EBITDA Margin</i>	10%	10%
EBITDA Multiple	6.0	6.0
<b>Target Value</b>	<b><u>9,600</u></b>	<b><u>9,000</u></b>

EARNOUT DECISION	
\$600,000 ×	$\frac{\text{Gross Profit for next FY} - \$5,250,000}{350,000}$

- Intellectual property—Assessment of patents, trademarks, copyrights, trade secrets, customer lists
- Customers/contracts—Concentration and quality of customers, agreements, and contracts
- Litigation—Pending litigation, contingent liabilities
- Tax issues—Litigation, disputes, aggressive positions
- Regulatory issues—Governmental disputes, compliance issues
- Insurance—Analysis of insurance agreements
- Corporate—Legal, board issues, corporate structure
- Environmental—Unrecorded liabilities, contingent liabilities, area of concern
- Related-party issues—Family members, affiliated entities, controlling parties

The next procedures in the M&A process are the negotiation of the price and the detailed written purchase agreement. In this process, both the buyer and the seller attempt to maximize their self-interests and minimize risks. For the buyer, this means reducing the cash paid at closing. Generally, the seller wants to collect all of the sale proceeds up front.

To bridge the gap between the cash wants of the buyer and the seller, some type of earnout payment may be offered. An earnout payment is additional future compensation paid to the sellers of the target company after the transaction close date.

Generally, any earnout payment depends on the company meeting specific predetermined targets in the periods following the sale. Earnout agreements have become popular in middle market, private company M&A transactions. However, both buyers and sellers should beware that these agreements frequently end in disputes and litigation.<sup>29</sup>

Finally, once a purchase price is determined and the purchase agreement signed, there is typically a balance sheet of the acquired entity prepared by the seller as of the agreement date. Due to the passage of time between the agreement date and the transaction close date, most M&A transaction agreements include a mechanism to adjust the purchase price after closing. The adjustment will account for the change in balance sheet accounts. Such adjustments are referred to as “post-closing adjustments.”

As with earnout agreements, post-closing price adjustments are often disputed, subject to opportunistic behavior, and frequently litigated.

## EARNOUT PROVISIONS

Earnout provisions are popular, especially with private equity buyers who wish to retain the previous

management. For example, a buyer may propose annual earnout payments (1) for each year that key management personnel stay in place or (2) for meeting specific employee retention or customer retention goals.

There are other reasons why earnout provisions are used in M&A transactions. Earnouts may bridge valuation opinion or profitability projection differences between the buyer and the seller.

For instance, Exhibit 9 provides a simplified hypothetical example of an earnout provision.

While an earnout provision seems like a perfect compromise to bridge any valuation gap, the sellers may want to consider (1) whether the buyer is offering the earnout as an opportunity to capitalize on future performance or (2) whether the buyer is trying to undercut the current fair value by leaving a portion of the total consideration to chance.

An earnout provision can be tied to nearly any target or metric that affects the likelihood of a payout. The parties should take care before entering into an earnout agreement.

The Delaware Court of Chancery commented on the tendency of earnouts to lead to disputes saying:

disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time. . . . But since value is frequently debatable, and the causes of underperformance equally so, an earnout often converts today's disagreement over price into tomorrow's litigation over the outcome.<sup>30</sup>

There are several types of disputes that may result from earnout agreements. First, earnout metrics and targets are often disputed either informally or through arbitration or litigation. A partial list of such metrics includes gross revenue, gross profit margin, working capital, EBITDA, adjusted EBITDA, earnings before interest and taxes ("EBIT"), revenue growth, employee retention percentage, profit per customer, regulatory approvals, units sold, and the like.<sup>31</sup>

Even financial metrics such as working capital and EBITDA may be interpreted and calculated differently. For example, is cash on hand included in working capital? Are changes in revenue recognition policies consistent across periods?

Buyers and sellers should consider the following ways to minimize disputes over earnout metrics and the targets in an earnout agreement:

- Metrics should be clearly defined in the earnout agreement—along with specific examples of the earnout calculations.
- Earnout formulas are preferable to narrative text. For example, the illustrative earnout formula (Q2 20xx EBITDA – \$2.5 million) × 5 percent is clear and concise.
- Define even the typical financial terms and include historical examples. For example, EBITDA is defined as earnings before interest, taxes, depreciation, and amortization. It may be important to be specific about other noncash items, if applicable.
- Agree on how to account for restructuring and integration expenses. These expenses may be significant and may drive down EBITDA and other metrics in early post-transaction periods.

Second, vague language in the earnout agreement often leads to disputes. It is typical for the agreement to state that financial targets should be calculated "in accordance with generally accepted accounting principles ("GAAP")." Alone and without context, this language can present problems.

Generally, GAAP does not require one method but instead provides guidance to the accounting practitioner. Two completely different accounting methods may be consistent with GAAP—but may also generate significantly different calculations.<sup>32</sup>

Additionally, a savvy buyer may change the target company's GAAP accounting post transaction to its benefit, creating inconsistent treatment. This can lead to additional questions, such as the following:

- Does the earnout agreement require consistency?
- Would the buyer or the seller have enough information to know if the calculations were inconsistent?

Consistency with GAAP can be problematic. This is because alternative calculations can all be consistent with GAAP.

The following suggestions may clarify the language in earnout agreements and help to avoid post-transaction disputes:

- Define the relevant accounting policies used by the corporation at the time of the agreement. For example, define and show examples of revenue recognition and account valuation policies and procedures.
- Include in the agreement that the buyer will continue to use "consistent" GAAP through

## Exhibit 10 Transaction Purchase Price Adjustments The Net Working Capital Adjustment Illustrative Examples of Price Adjustments

Actual Net Working Capital at Close	\$ 1,200,000	Actual Net Working Capital at Close	\$ 800,000
Target Net Working Capital	<u>\$ 1,000,000</u>	Target Net Working Capital	<u>\$ 1,000,000</u>
Excess Net Working Capital	\$ 200,000	Shortfall in Net Working Capital	\$ (200,000)
<b>Buyer Pays to the Seller <u>\$200,000</u></b>		<b>Seller Pays to the Buyer <u>\$200,000</u></b>	

the earnout period. Exceptions to this policy should be agreed to by both parties.

Third, the length of the earnout agreement may be problematic for either the buyer or the seller. Generally, earnouts range from 12 months to three years. However, it is not unusual to see longer or shorter earnout periods.<sup>33</sup>

Longer earnout periods tend to run into problems with the integration into the buyer's other companies and changes in accounting methods and principles. For example, the buyer may integrate the target company into existing businesses or other acquisitions and eliminate separate financial statements for the original entity.

In addition, both accounting guidance and GAAP change frequently. Such changes can lead to a change in the earnout calculation. Certain accounting and GAAP changes may have a material impact on the earnout calculations.

Shorter earnout periods have issues with "just missed" targets.<sup>34</sup> For example, if the seller was due a significant earnout payment for reaching a \$10 million EBITDA milestone in the first quarter after the sale, but EBITDA totaled only \$9.9 million, then the seller may argue that actions by the buyer precluded reaching the target.

Providing an extended earnout period to meet targets or including pro-rate payments for targets in the earnout agreement may minimize the likelihood of transaction disputes.

Finally, the purchase should be structured where the seller receives an up-front contribution for the value of the target company at the closing date. Any earnout provision should award future performance.<sup>35</sup>

Deferring too much of the purchase price to future periods may leave the seller feeling cheated and may lead to disputes and expensive litigation.

The parties may also develop a dispute resolution plan and include the details of such a plan

in the earnout agreement. One way to minimize dispute costs is to seek the assistance of a forensic accountant. The forensic accountant may assist in putting together the plan and be the first line of defense in any initial dispute.

## POST-CLOSING PURCHASE PRICE ADJUSTMENTS

A majority of private-company M&A transactions include a mechanism to adjust the purchase price on a post-closing basis. Such adjustments are performed through post-closing purchase price adjustments. Such post-closing adjustments range from simple to complex.

Perhaps the most typical purchase price adjustment relates to changes in net working capital ("NWC"). However, price adjustments due to income, expense, assets, liabilities, and net assets also occur in M&A transactions.

NWC is the difference between current assets and current liabilities and measures the short-term liquidity of the company.<sup>36</sup> Generally, NWC disputes between buyers and sellers focus on whether (1) a particular account should be included or (2) a specific account is accurately measured. Such determinations are typically based on GAAP.

The primary purpose of such purchase price adjustments is to protect the buyer from fluctuations or changes in the target company's financial condition from the time the purchase price is agreed upon to the time of closing. The NWC adjustment is often included in the purchase agreement to ensure that the transacting parties (1) arrive at an agreed upon purchase price and (2) are not negatively affected by changes in working capital.

Generally, the parties establish a targeted level of working capital in the purchase agreement. This target NWC is used as the basis for the adjustment at the close. As seen in the example below, the buyer

would generally pay the seller if NWC is greater than the target NWC. When actual NWC is lower than the target NWC, the seller generally pays the buyer.<sup>37</sup>

Exhibit 10 provides a simplified example of a net working capital purchase price adjustment.

Negotiating the terms and other aspects of any purchase price adjustments is important to avoid disputes. For the NWC example above, the determination of target NWC is important, and it may have a significant impact on the final purchase price.<sup>38</sup>

Whether the purchase price adjustments include provisions for NWC, net assets, or other metrics, the buyer and the seller should agree in principle on both the definition and the calculation of these items. Generally, it is helpful to include examples of the calculations and historical information in the purchase and sale agreement. This procedure mitigates some of the potential misunderstandings between the parties, and it provides more consistent treatment between periods.

The parties should agree on the manner of calculating NWC. The buyer will often prefer calculations in accordance with GAAP, whereas the seller will often prefer to maintain the target's previous practices for calculating NWC.<sup>39</sup>

As with earnout agreements, accounting principles and estimates may significantly affect purchase price adjustments. The buyer and the seller should agree to exclude changes in accounting principles that may occur during the transaction period for post-closing adjustment purposes. This agreement may eliminate one party using changes in accounting rules to harm the other.

Accounting estimates can be important to post-closing adjustment measurement. A list of potential accounting estimates affecting post-closing price adjustments includes the following:

- Inventory valuations
- Allowance for doubtful accounts
- Contingent liabilities
- Accruals

The accounting profession provides significant guidance on inventory valuation methods, but it leaves many of the decisions to the practitioner. FIFO (first-in, first-out), LIFO (last-in, first-out), and WAC (weighted average cost) are all inventory valuation methods acceptable under GAAP. Each inventory valuation method may produce different cost of sales for the target company.

In addition, the write-off of unusable or obsolete inventory may be used to manipulate the adjustments. The buyer and the seller should agree to consistent accounting treatment, and any changes to

the accounting principles or asset write-offs should be agreed to by both the buyer and the seller.<sup>40</sup>

The allowance for doubtful accounts is the amount of the accounts receivable balance that is estimated to be uncollectible. Generally, this amount is based on a historical percentage of accounts receivable. As with inventory valuation, the buyer and the seller should agree to consistent treatment. Both parties should approve any variation to the historical calculation of net accounts receivable and any specific (material) write-offs.

The accounting treatment for contingent liabilities is somewhat subjective. For example, an expense is accrued (1) if the liability is probable and (2) if the expense can be estimated. Warranties and litigation are types of contingent liabilities, and both are difficult to estimate. The buyer and the seller should reach a consensus on how to treat contingent liabilities before the transaction close.

Accruals typically contain some type of estimate, and estimates are subjective in nature. Disputed accruals may include estimates for bonus compensation, pension obligations, legal fees, litigation costs, remediation, and tax expense.<sup>41</sup> The buyer and the seller should agree in advance on all relevant accruals. This procedure minimizes the likelihood of disputes.

Other potential disputes involving post-closing adjustments include the following:<sup>42</sup>

- Cross border accounting—Transactions across borders with different accounting and tax regulations may complicate post-closing adjustments. The implementation of the International Financial Reporting Standards minimized differences in accounting for public companies, but accounting treatments may significantly differ across borders for private entities.
- Interim versus year-end reporting—Many companies make adjusting and valuation-type entries to the books and records only at the end of fiscal quarters or years. Therefore, without adjustments or updates, balance sheet or NWC calculations at interim dates may be incomplete or inaccurate.
- Subsequent events—Unanticipated events occurring after the agreement date and before the close date may have a significant impact on the closing balance sheet or NWC calculations. For example, a global pandemic like COVID-19 may hinder a company's ability to collect accounts receivable.
- Materiality—The buyer and the seller may argue that a post-closing adjustment dispute is immaterial to the transaction. Generally,

courts and arbitrators disregard the materiality argument unless there are specific dollar amounts or thresholds specified in the purchase agreement. The reasoning is that the proposed adjustment (usually) causes a dollar for dollar adjustment in the purchase price, and any additional dollars are material to both the buyer and the seller.

Risk-averse buyers and sellers typically consider cross-border accounting, interim versus year-end financial reports, subsequent events, and materiality when drafting the purchase agreement. Specific language and examples contained in the agreement may minimize the risk of transactional disputes.

Finally, as with the earnout provisions, the buyer and the seller should avoid the boilerplate GAAP language. GAAP rarely requires specific accounting treatment and generally leaves the final decision on the application to the experience and judgment of the practitioner. The buyer and the seller should agree to consistent GAAP unless both parties agree to changes.

## OTHER M&A DISPUTES

In addition to the earnout provisions and the post-closing price adjustment disputes discussed above, representations and warranties and material adverse change disputes also occur in M&A transactions.

The purchase agreement often contains a lengthy list of promises made by the seller to the buyer. These are known as the representations and warranties clauses. If breached by the seller, such clauses may allow the buyer to recover escrow funds or provide a basis for the buyer to sue for damages. Examples of potential representations and warranties include the following:

- Accuracy of financial statements—Any error or omission in the financial statements, regardless of materiality, may be a basis for representations and warranties claims.
- Undisclosed litigation—All potential litigation should be disclosed, including unfiled matters, and filed matters where management believes there is little chance of success.
- Undisclosed liabilities—Unpaid bills, litigation settlements, environmental claims, and so forth.
- Legality—Is the corporation properly formed? Are the articles of incorporation and other documents in good order? Is the corporation legally allowed to do business?

Are the employees legally authorized to work? Are other documents in good order? Are there any tax or financial statement audit inquiries?

- Status of inventory—Is the inventory salable, obsolete, legal? Are the cost components correct? Are the inventory counts accurate and up to date?
- Employee benefits—Have employee tax withholding deposits been made? Are benefits records accurate, including vacation, sick, and comp time accruals?

The intention of each representations and warranties clause included in the purchase agreement is to protect—and provide potential remedies to—the buyer. The seller should carefully understand the representations and warranties and ensure that some immaterial amount or lack of disclosure does not lead to a dispute.

Material adverse change (“MAC”) provisions are often used in purchase agreements to allow buyers to terminate M&A transactions should a significant (and material) impact to the company occur.<sup>43</sup> As with representations and warranties, MACs primarily protect the buyer and may be damaging to the seller.

Generally, MACs are used as negotiating tools by both the buyer and the seller. For example, in the Microsoft and LinkedIn acquisition in 2016, LinkedIn included the following exceptions to the MAC clause that would not qualify as a MAC:<sup>44</sup>

- Changes in general economic conditions
- Changes in conditions in the financial markets, credit markets or capital markets
- General changes in conditions in the industries in which the company and its subsidiaries conduct business, changes in regulatory, legislative or political conditions
- Any geopolitical conditions, the outbreak of hostilities, acts of war, sabotage, terrorism or military actions
- Earthquakes, hurricanes, tsunamis, tornados, floods, mudslides, wildfires or other natural disasters and weather conditions
- Changes in proposed changes in GAAP
- Changes in the price or trading volume of the company’s common stock
- Any failure, in and of itself, by the company and its subsidiaries to meet any public estimates or expectations of

the company's revenue, earnings and other financial performance or results of operations for any period

- Any transaction litigation

Interestingly, there is no mention of a pandemic in the above list of exclusions.

## RESOLVING DISPUTES

The best procedure to avoid disputes and costly litigation in an M&A transaction is to think through the potentially contentious issues while negotiating the transaction. Once the agreement is signed, the earnout period begins, and the parties make the post-closing adjustments, it is difficult to resolve issues without expensive third-party involvement.

Leaving the negotiation and drafting of the purchase agreement to the lawyers is not always a best practice. The involvement of forensic accountants can provide the perspective of a party that understands the company's financial position.

If a dispute is unavoidable, there are several procedures to potentially resolve the dispute in a cost-effective manner.

First, consider a confidential conversation with the opposing party. Sometimes a resolution may be reached without moving to mediation, arbitration, or litigation.

Second, consider seeking a neutral forensic accountant to review the transaction and the related earnout and post-closing adjustment issues. Often a neutral third-party accountant can explain terms and expectations to one party that the other party cannot. By this point, if both sides of the dispute have "dug in" and find it difficult to move from their stated position, an unbiased accountant may be able to bridge the communication gap.

Third, attempt a mediation resolution. A day with a mediator is typically much less expensive and time-consuming than arbitration. Involving the finance people on both sides may be one strategy with mediation. Often the finance teams can work through issues that the company executives and lawyers cannot.

Finally, if arbitration is warranted and an accounting firm is engaged, it may be advantageous to limit the scope of the arbitrator to the items of dispute and specify the ranges of potential changes to the earnout or the purchase price. This process generally focuses the efforts of the arbitrator, minimizes time and cost, and avoids opening up new areas of inquiry.

## SUMMARY AND CONCLUSION

In today's operating environment, post-transaction litigation occurs often. However, such litigation may be avoidable if the transacting parties take extra care before a transaction is closed. An understanding of the motivations behind specific deal structures—such as asset transactions, stock transactions, and mergers—and an understanding of clauses that are particularly vulnerable to dispute—such as earnouts and purchase price adjustments—may positively influence the manner and magnitude to which the transacting parties address deal clauses in the negotiation and drafting stages.

By having such a high-level understanding, the transacting parties may know where to focus legal resources and may ultimately lower the possibility of a future dispute.

### Notes:

1. Chubb reported in 2018 that the average settlement cost with the insurance company for M&A claims was \$4.5 million for the years 2012 through 2016.
2. "Rising Volume and Cost of Securities Class Action Lawsuits is a Growing Tax on U.S. Business, Chubb Data Reveals," Chubb, accessed June 30, 2020, <https://news.chubb.com/2018-07-10-Rising-Volume-and-Cost-of-Securities-Class-Action-Lawsuits-is-a-Growing-Tax-on-U-S-Business-Chubb-Data-Reveals>.
3. Robert F Reilly and Robert P. Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis* (Ventnor City, NJ: Valuation Products and Services, 2019), 966–967.
4. Some courts can rule an asset transaction as a de facto merger, and as such, attach all rights and liabilities of a merger to the original deal. The four general exceptions are "(1) the successor expressly or impliedly assumes the liability of the predecessor, (2) the transaction is a de facto merger or consolidation, (3) the successor is a mere continuation of the predecessor, or (4) the transaction is a fraudulent effort to avoid liabilities of the predecessor." Glenn West, "An Asset Purchase That Wasn't – Beware the De Facto Merger Doctrine in Distressed M&A," Weil, Gotshal & Manges LLP, May 4, 2020, <https://www.jdsupra.com/legalnews/an-asset-purchase-that-wasn-t-beware-11698/>.
5. "Asset Purchase vs Stock Purchase," Corporate Finance Institute, <https://corporatefinanceinstitute.com/resources/knowledge/deals/asset-purchase-vs-stock-purchase/>.
6. Internal Revenue Code Section 1060 mandates that the buyer and seller allocate the purchase price of the assets using the residual method to the asset classes in order of cash, actively traded personal property, receivables and assets marked-to-market, inventory or stock-in-trade,

- other tangible property, intangibles other than goodwill and going-concern value, and goodwill and going-concern value. The parties individually report the allocation using Internal Revenue Service Form 8594.
7. "Asset Purchase vs Stock Purchase," Corporate Finance Institute.
  8. *Ibid.*, 7.
  9. *Ibid.*
  10. Lemuel Lim, "Basic Structures in Mergers and Acquisitions (M&A): Different Ways to Acquire a Small Business," Genesis Law Firm, PLLC, accessed June 30, 2020, <https://www.genesislawfirm.com/asset-acquisition-stock-purchase-and-merger-structures>.
  11. David Boatwright and Agnes Gesiko, "Tax Strategies For Selling Your Company," Latham & Watkins LLP, accessed June 30, 2020, [https://www.lw.com/upload/pubcontent/pdf/pub1311\\_1.pdf](https://www.lw.com/upload/pubcontent/pdf/pub1311_1.pdf).
  12. "Asset Purchase vs Stock Purchase," Corporate Finance Institute.
  13. "Section 338 Elections," macabus, accessed June 30, 2020, <https://macabacus.com/taxes/section338>.
  14. David Boatwright and Agnes Gesiko, "Tax Strategies For Selling Your Company," Latham & Watkins LLP, accessed June 30, 2020, [https://www.lw.com/upload/pubcontent/\\_pdf/pub1311\\_1.pdf](https://www.lw.com/upload/pubcontent/_pdf/pub1311_1.pdf).
  15. "Asset Purchase vs Stock Purchase," Corporate Finance Institute.
  16. "Asset Sale vs. Stock Sale: What's The Difference?," Mariner Capital Advisors, <https://marinercapitaladvisors.com/resources/asset-sale-vs-stock-sale-whats-the-difference/>.
  17. "Asset Purchase vs Stock Purchase," Corporate Finance Institute.
  18. Majority shareholders can compensate noncontrolling shareholders for their support in what is known as a side payment. The IRS and U.S. Tax Court have historically held differing views on the treatment of side payment as either unrelated or related to the underlying transaction.
  19. "Section 338," Corporate Finance Institute, <https://corporatefinanceinstitute.com/resources/knowledge/accounting/section-338/>
  20. "Section 338 Elections," macabus, accessed June 30, 2020, <https://macabacus.com/taxes/section338>.
  21. *Ibid.*, 21.
  22. "Outline of Legal Aspects of Mergers and Acquisition in the United States," no. 15 (September 2003): 1–8.
  23. *Ibid.*, 23.
  24. *Ibid.*
  25. "Outline of Legal Aspects of Mergers and Acquisition in the United States": 1–8.
  26. *Ibid.*, 27.
  27. Boatwright and Gesiko, "Tax Strategies For Selling Your Company."
  28. Lemuel J. Lim, "Overview of M&A Process," Genesis Law Firm, PLLC, accessed June 30, 2020, <https://www.genesislawfirm.com/overview-merger-acquisition>.
  29. Reilly and Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis*, 966–967.
  30. Airborne Health, Inc. v. Squid Soap, LP. 984 A.2d 126, 132 (Del. Ch. 2009) quoted in Kevin R. Shannon and Michael K Reilly, "Post-Closing Earnouts in M&A Transactions: Avoiding Common Disputes," *Deal Points: The Newsletter* (Winter 2011).
  31. Roman L. Weil, Daniel G. Lentz, and Elizabeth A. Evans, *Litigation Services Handbook: The Role of the Financial Expert*, 6th ed. (Hoboken, NJ: John Wiley & Sons, 2017), Chapter 24, 1–36.
  32. *Ibid.*, 33.
  33. *Ibid.*
  34. *Ibid.*
  35. *Ibid.*
  36. Current assets include cash, cash equivalents, short-term investments, receivables, inventory, and prepaid expenses. Current liabilities include payable, accrued expenses, and the current portion of long-term debt.
  37. Reilly and Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis*, 966.
  38. George Haramaras, "Post-Acquisition Disputes: Working Capital Adjustments and Working Capital Disputes," *Willamette Management Associates Insights*, (Spring 2019): 44–50.
  39. *Ibid.*, 40.
  40. *Ibid.*
  41. Weil, Lentz, and Evans, *Litigation Services Handbook: The Role of the Financial Expert*, Chapter 24, 1–36.
  42. *Ibid.*, 43.
  43. *Ibid.*, (n 43).
  44. "Material Adverse Change: The ABCs of MACs," Wall Street Prep, accessed June 30, 2020, <https://www.wallstreetprep.com/knowledge/material-adverse-change-mac/>.



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