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# M&A Deal Dispute Resolution: Proactive Strategies

## Evaluating ADR Alternatives and Crafting Merger Agreements that Minimize Post-Closing Litigation

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Vincent P. (Trace) Schmeltz III, Counsel, **Dewey & LeBoeuf**, Chicago


**Thursday, October 21, 2010**

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# Resolution of Purchase Price Disputes

Issues, Outcomes and Recommendations

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## Introduction

While a number of issues are commonly raised in purchase price disputes (PPDs), there are no decision rules that can be set for all situations or for all arbitrators. It is the unique aspects of each dispute, the readiness of the parties to assert and skillfully defend their positions on disputed amounts, and the informed judgment of the specific firm or person serving as the accounting neutral (also referred to herein as “arbitrator”) who will ultimately drive what is paid or refunded in the final purchase price.

The following discussion provides insight on these questions and issues from the perspective of a practitioner who has been engaged as an advisor to buyers and sellers as the accounting neutral.

The final purchase price in a Sales and Purchase agreement (SPA) involving the acquisition of a business is typically determined based on a closing date accounting of some or all of the acquired assets and liabilities. A sound and reliable practice that closes the deal, right? Well, most of the time. But what happens if the buyer and seller don’t agree? When the amount of purchase price is determined and fixed to a sum certain by an accounting, is it not surprising that a buyer and seller may not agree.

What happens next? What does the occasional or even frequent participant in a purchase price dispute need to know? What are the likely accounting issues that will be disputed? What are the risks when the basis of the closing date accounting is generally accepted accounting principles (GAAP) as opposed to “GAAP consistently applied” or simply the “past practices” of the entity? How will an arbitrator decide the issues presented? What is the right strategy for a disputant to follow?

## How final purchase prices are calculated

Whether the SPA is an asset purchase agreement (APA) or a merger agreement, the usual sequence of events in determining the final purchase price involves the negotiation and agreement of the SPA terms, conditions, representations, and warranties based on “benchmark” date financial information. A delay then ensues between the execution of the definitive agreement and the closing of the transaction. This delay may extend over several weeks or months for reasons related to:

- Regulatory notice and clearance
- Transfers or issuance of ownership rights, licenses, etc.
- Execution of employee contracts or benefit program amendments
- Completion of contract novation or assumption
- Finalization of buyer financing or other conditions of closing

During this period, changes in the acquired operations' balance sheet or results of operations and cash flows may occur that require an adjustment of previously agreed on consideration, sometimes by a large amount. The changes giving rise to an adjustment of the final purchase price consideration are identified in the SPA and may be calculated based on, for example, the book values of net worth, working capital, specific individual financial statement line items, or other specific formulae—for example, earnings before interest, taxes, depreciation and amortization or (EBITDA)—based on the acquired entity's results of operations. After the conditions for closing are satisfied, consideration may then be exchanged based on an estimate of the closing date financial results just prior (often within a day or two) to the actual closing date.

Some SPAs may stipulate that changes in the acquired business' assets, liabilities, or results of operations from the benchmark date through the closing date are to be used as the basis for adjustments in the consideration paid at the closing. Other SPAs refer only to the closing date amounts, and require a purchase price adjustment when such amounts are greater or lower than a stipulated dollar amount. Be careful here—the two constructions are not the same. One presumes that the benchmark amounts are stated on the basis of accounting stipulated in the SPA such that only the change from a benchmark is applicable. The other presumes nothing about the benchmark presentation such that only the final amounts on the closing date accounting are relevant in the determination of final purchase price. In either case, an estimate must be made when the purchase price is increased or decreased by the closing date amounts so that the purchase price consideration can be tendered on the closing date, but before the books are fully closed and all necessary accounting adjustments are made.

The time necessary to do an accounting closing will necessarily vary by company. Most SPAs allow several weeks, often 30 days, for the buyer or seller identified in the SPA to complete the closing date accounting. The estimated amounts are changed and the purchase price is adjusted to reflect the actual closing date accounting, provided there are no disputed amounts in the accounting. Even after the closing date accounting is agreed to as exchanged between the parties, there may be additional contingent payments based on the future performance of the acquired operations. Thus, the final purchase price can take months if not years to quantify, even if there are no disputed amounts.

## Limiting the likelihood of disputes

Before we discuss how purchase prices disputes are resolved, let's look at how the parties to a SPA can avoid the likelihood of a dispute. One objective in drafting the SPA is to avoid an accounting dispute later. There are a number of potential steps that buyers or sellers can take to help achieve this objective. The suitability of any of these steps depends, however, on the particular deal construction and the objectives of the parties involved.

- Define the basis for determination of the final purchase price as narrowly as possible or based on as few financial statement line items as possible (e.g., net worth is a broader measure than net working capital, which, in turn, is a broader measure than the change in net accounts receivable, inventory, or trade payables).
- Avoid late changes to the SPA without review by financial personnel.
- Be careful with formulaic adjustments for selected amounts, such as cash, debt, or income taxes, while at the same time having other adjustments, such as net working capital, that may duplicate amounts in the closing date adjustment mechanism.
- Avoid long-term contingent payments based on multiples of earnings or EBITDA.
- Set the closing date at a month end.
- Assume responsibility for preparation of the closing balance sheet or statement.
- Set a dollar threshold that must be exceeded before disputed amounts can be asserted.
- Agree to or limit the changes to contra asset accounts between the benchmark and closing dates.
- Provide for full access by either the buyer or seller to information germane to the closing balance sheet throughout the final closing process.
- Take a physical inventory at the closing date observed by representatives of the buyer and seller.
- Agree on procedures that will be used to verify the existence of certain high-value property, plant and equipment.
- Shorten the time period between the benchmark date and the closing date.
- Allow buyers to complete a reasonable level of due diligence.
- Perform sell-side due diligence.
- Select a buyer that has had historical transactions with the seller or may reasonably be expected to have future such transactions.
- Document the basis of the closing balance sheet in unambiguous terms and detail the dispute resolution process in the SPA.

## Purchase price dispute resolution

When the recorded amounts on the closing balance sheet are in dispute and the amount of the final purchase price is affected, a mechanism to resolve the dispute efficiently and knowledgeably is necessary. The parties in dispute often prefer arbitration because considerable control of the process can be retained and closure obtained at a reasonable cost. In PPD proceeding, a determination is made with respect to each matter submitted. One particular appeal is that the issues in dispute can be defined narrowly enough to allow an expert in accountancy and dispute resolution to expeditiously resolve the amounts in question. Such an expert is not expected to need legal precedent as a guide to conclude the PPD, particularly if an established standard such as GAAP is governing. These benefits are generally perceived to outweigh some of the risks in arbitration, such as the lack of precedent to guide the disputants, uncertainty about the individual or firm arbitrator, the lack of formal discovery, and the binding nature of the outcome.

Buyers or sellers who are unfamiliar with the issues likely to arise in a PPD, however, should beware. This caution is particularly important when:

- The perception that dispute resolution costs will be lower in arbitration compared to litigation makes it more likely that a buyer or seller will take an issue to arbitration.
- The relative cost of adding additional discrete items to be disputed is marginal once the decision is made to dispute at least one component of a closing date financial statement.
- The desire to close transactions with minimal delay or out-of-pocket costs results in many closing balance sheets being unaudited and, therefore, more likely to require adjustment to conform to GAAP.

## The arbitrator's role (arbitrator as expert, expert as arbitrator, and arbitrator as auditor)

Language now migrating into SPAs provides that when disagreements cannot be resolved, the chosen firm shall, "acting as experts and not as arbitrators," determine the final amounts. In other arrangements, the dispute may be referred specifically to an "independent auditor" for resolution. Does it matter what the neutral is called, whether an expert, independent auditor, arbitrator, or something else?

At least as to the accounting basis for the determination findings there should be no difference. The type of information considered by the neutral would not typically be any different; certain accounting records, schedules and related source documents such as invoices or contracts would be relevant regardless of what the neutral party is called. Nor would the impact of the decision on the parties be different. In most cases, the agreement will expressly stipulate

that the chosen firm's determination will be conclusive and binding, whether acting as experts or as arbitrators.

So why refer to an expert rather than as an arbitrator, as in the above example? One possible reason is to provide the parties' flexibility to follow any agreed process in reaching the determination. The parties do not necessarily have to follow the AAA Commercial Arbitration rules or other arbitration rules, such as UNCITRAL, nor must the individual responsible in the chosen firm be expert in such rules. Another reason may be to broaden the type of information that may be considered in reaching the determination, since experts are not limited to the information presented by the parties and could request, independently seek, and obtain other relevant information, including hearsay information.

Other SPAs call for the PPD to be resolved by an "independent auditor" rather than an arbitrator. Similar to the expert language discussed above, the intent of this reference is to allow wide latitude in what can be considered in making the determination. However, the resolution of a PPD is not an audit in any technical sense. Specifically, the consulting standards governing professional services in a dispute are different from generally accepted auditing standards applicable to an audit function. For example, the named "independent auditor" is not expected to and would not obtain representation letters or third-party confirmations, as would customarily be done in an audit under generally accepted auditing standards. Thus, the identification of an "independent auditor" in a PPD context is more related to the type of person or firm selected than how the determination is done or what professional standards will be followed.

### Selection of the arbitrator

When selecting the arbitrator, it is beneficial to name a firm believed to be capable and conflict-free as early as possible in the SPA process to help avoid potential conflicts that otherwise could arise. It is important also to inform the named firm that it is referenced in the SPA as the arbitrator. The firm can then monitor potential new matters that may be relevant later should a dispute arise. Surprisingly, parties to a SPA rarely inform the named arbitrating firm and the named firm may not even know it has been referred to in the SPA. Instead, the SPA often includes language that refers to the engagement of a similar firm should the named firm not be able to proceed with the requested service when asked.

The office location of the chosen arbitrating firm is also occasionally named in advance. Normally, this is not necessary because all or most of the PPD resolution process does not require a particular geographic presence. In fact, identifying a particular office may work against the parties' interests by limiting the chances of getting the best possible arbitrator. Conversely, if the parties

prefer to use a particular arbitrator, naming an office location can serve as a mechanism to effectively identify the individual arbitrator in advance, if not by name.

What happens if a specific arbitrating firm is not identified in advance and a dispute arises? Typically, the parties will each identify firms acceptable to them and select a mutually agreeable firm. The chosen firm will still need to do a formal conflict check before its selection can be finalized.

Once the arbitrating firm is selected, the SPA parties need to choose an individual arbitrator within the selected accounting firm. Start by obtaining the curriculum vitae of multiple candidates. Look for someone with both accounting and auditing experience combined with arbitration experience, particularly PPD experience. Both are required skills in managing the overall process to secure closure of the dispute. Accounting and auditing skills may qualify someone to judge the PPD in a clinical sense, but dispute-oriented experience allows the neutral arbitrator to credibly respond to process issues, such as how changes to the agreed plan might be handled or how to draft a final report that is satisfactory to both parties.

Depending on the unique issues involved, the parties may prefer an arbitrator who is experienced in the related industry. Certain industries, such as financial services, utilities, or technology companies, often have specialized accounting rules that may increase the overall importance of industry accounting expertise. Because GAAP is applicable across industries, specific industry expertise is typically not the primary consideration in choosing the arbitrating firm or person. For disputes handled by nationally recognized accounting firms, it is often helpful to identify a partner familiar with unique industry issues or accounting requirements to work as a consulting or concurring partner to the identified neutral arbitrator.

Once potential candidates are identified, disputants often choose to jointly interview nominated individuals to get a feel for style, flexibility, and availability. Checking with contacts in and outside of the selected firm about the individuals being considered is a wise step in arbitrator selection due diligence.

**Questions to ask the potential arbitrator prior to selection by the parties**

- What accounting, auditing, and purchase price dispute experience do you have? What industry experience do you have?
- Will there be a concurring or second review of your decision within your firm? Is this required by firm quality control policy?
- Does your opinion get cleared through the national technical support professionals in your firm (i.e., a national accounting services department)? What does this do to timing or costs?
- Who else will work with you and what will their roles be?
- What process will be used to present information to the arbitrator and to each party? What is the timeline for this process? If the SPA defines this process already, does it need to be amended, particularly as to deadlines for completion of the arbitration?
- Will you work with the parties to minimize costs? What suggestions can you offer to minimize costs of the proceeding? What have you charged in similar engagements?
- How will you respond if a disputant requests to change an agreed process or deadline?
- What options exist in the form and content of the final report? What detail will the final report include? How will the issuance of the final report be handled?
- How will you address questions to the parties? Will each side be aware of all questions asked? Will each side be able to respond to all questions asked?
- How do you evaluate materiality in the context of the subject dispute?
- On what basis is a hearing appropriate? How and when might it be scheduled? How would it be conducted?
- What key terms and conditions will be included in the arbitrator's engagement letter?
- Will the arbitrator consult with and consider the input of the parties in advance of taking actions that might increase the cost of the arbitration?
- What is the expected timing and cost of the proceeding? What is the potential arbitrator's experience in meeting the deadlines set by the parties?

## Panel versus sole arbitrator: How many arbitrators are enough

If the parties to a SPA are considering using a panel of arbitrators, they should think again to evaluate carefully whether other approaches might work better. If, for example, the panel would include two partisans chosen by the parties and one neutral, consider instead conducting a formal hearing as part of the arbitration process to present the issues to a sole arbitrator. This allows the parties to have their say directly rather than indirectly through a nominated panelist. Some may think that the combined expertise of several neutrals comprising a panel would be more informed or predictable. However, quite the contrary may be true, particularly if the panel has difficulty forming a consensus and makes compromises to reach agreement. At the very least, expect additional costs and extended delay in getting the final arbitration report from a panel, particularly if it is a long form report (i.e., explaining the rationale and bases for conclusions).

## The arbitrator's parameters

Quite often, the SPA simply states that the determination of the arbitrator is binding. But will the arbitrator be limited to an amount within the dollar range in dispute? Can the arbitrator make a determination outside the amounts submitted by either party? Will the arbitration be limited to an issue-by-issue basis or can it be based on the aggregate of all disputed items?

The parties should decide on as much of the decision criteria for the arbitration as possible. Again, one of the main advantages of the arbitration process is that it allows the parties some control over the outcome. Here are a few approaches often used in arbitrating SPAs:

- The arbitrator picks one of the amounts submitted (referred to as Baseball Arbitration). Note, however, that Baseball Arbitration allows the possibility that the technically correct accounting is unable to be done if it is not submitted by one of the parties. In addition, one anomalous situation can arise when it is clear what amount one of the parties will submit, such as may have been evidenced in the dispute notice. In this case, the other party may challenge this known amount, not with the appropriate amount for the disputed item under the SPA, but with an amount that is even further from the other party's amount, as long as it is closer to the appropriate amount under the SPA.
- The arbitrator picks an amount within the range of amounts submitted by the parties. This approach increases the flexibility that the arbitrator has in making the determination; however, it adds additional risk in that it may encourage more extreme, less credible positions be taken to broaden the bracket of the range in dispute.

- The arbitrator determines whatever amount is appropriate, consistent with the SPA, but independent of the amounts claimed by either of the parties. To find an amount not supported by the parties themselves typically requires the arbitrator to request and obtain additional information or to find that neither party has properly applied the requirements of the SPA.

**Considering what is fair to the parties**

While it may be counterintuitive, do not expect the arbitrator to decide issues of fairness or equity. The arbitrator is not likely to rehabilitate part of an agreement for or against either of the parties, independent of the rest of the negotiated agreement. Do expect that the arbitrator will interpret the SPA as it is and will determine the intent of the parties manifested by the SPA's express contract terms. While the intent of the parties can be construed under contract law based on prior performance or other considerations, the course of dealings between the parties or trade practices[1] is rarely applicable in the context of a SPA. Specifically, the parties may never have had a prior agreement, there may be no unique or customary trade practices, and the SPA will likely have an integration clause referring to the totality of the agreement as represented only as expressed in the SPA. Thus, the arbitrator should be expected to decide the PPD based on the SPA interpreted under contract principles, not on other factors outside of the SPA.

This sounds implausible, but what happens when the adjustment formula in the SPA is constructed poorly? For instance, one agreement separated a cash adjustment as defined from an additional net working capital adjustment, as also defined; however, the agreement did not remove the cash line item from net working capital so the cash balance was determined to count twice in an adjustment. Another agreement acknowledged that the seller would pay identified merger-related bonus expenses, but that such expenses would be accrued at the closing. The seller did in fact pay such bonuses (post-closing) as accrued on the closing date financial statement (thereby reducing the amount paid by the buyer at closing). However, the expected tax benefit of such accrued expenses was appropriately recorded as an asset in pre-closing working capital. Unfortunately for the buyer, this tax benefit was not specifically addressed in the SPA. As a result, it was determined that the buyer paid (as purchase price) for the tax benefit (current asset) of the accrued bonus obligations. The parties to the SPA and their counsel should carefully review these types of anomalous adjustments in SPAs to ensure each parties' intent is properly reflected and individual amounts are not double or even triple counted in the adjustment formula.

[1] Restatement of Contracts—Second, Chapter 9: The Scope of Contractual Obligations, Section 202 (5) in Selections for Contracts, compiled by Farnsworth and Young, Foundation Press, NY, 1998, p. 115.

### Arbitrator fees

The arbitrator's fees must be paid before the determination is released. The most common arrangement is to split such fees equally or in some predetermined percentage among the parties. Sometimes the costs are split among the parties based on the amounts awarded by the arbitrator. But more recent agreements have the prevailing party pay a greater pro rata share of the costs of the arbitrator. When the outcome of the arbitration determines the amount each side will pay, expect to put some arrangement in place to ensure that the required arbitration fees are paid in advance of the determination. One solution is to have each disputant advance the maximum fees they could potentially be liable for under the agreement. After the determination is reached, the arbitrator would immediately return the amount in excess of what is actually owed. Another solution is for each party to pay half of the fees, with the parties then settling up themselves later. The key point is that the arbitrator does not want to have the final fee allocation revealed before the determination is released.

## Purchase price dispute resolution process

Two arbitrations are rarely handled identically, but the following sequence of events most often follows once the parties determine that they cannot resolve the disputed items:

### Step 1: Define disputed issues

Before arbitration can commence, the parties must agree on and define what the disputed issues are. While this might sound like a simple task, it is not as easy as it sounds because the disputants are generally not in a very agreeable disposition. Yet, it is critical that each disputed item be clearly identified in amount and nature in order for the dispute to be resolve in an efficient and cost-effective manner. For example, in one engagement in which I was involved, the parties could not agree on what specific accounts were in dispute, let alone the amounts involved, all as a result of an earlier ambiguous dispute notice. This problem is not rare; the extent to which something is properly disputed under the SPA does sometimes arise. In a different case, one dispute notice referred simply to a disagreement with the amount of working capital, without specifying the accounting line items or accounts involved. In another case, the dispute involved the line item "other accrued liabilities" without identifying the specific accrued liability account in question. In this case I offered to make an initial determination of what specific claims would be moved forward into the determination phase of the PPD. When the parties agreed to have me resolve this foundational issue, they were able to proceed with the determination process without the additional cost or delay of going to court on this isolated issue.

### Step 2: Execute the arbitrating firm retention letter

Key points in the letter typically include:

- Scope
- Timetable
- Fees
- Terms and conditions
- Governing law
- Conflicts of interest

It is good practice to also include in the retention letter:

- A commitment that, in the event decisions need to be more about the arbitration proceedings, the parties acknowledge that after their input, the arbitrator will decide the process used to proceed. This stipulation will help avoid unnecessary or dilatory steps that might be requested or imposed by any of the parties.
- No ex parte communication will be initiated with the arbitrator on substantive issues. Generally, the assistant to the arbitrator can handle coordinating or administrative requirements for the parties (e.g., set up conference calls, confirm receipt or delivery).
- All written submissions to the arbitrator are required to be concurrently submitted at a stipulated time to the adverse party. Generally, it is preferable to have the parties handle this exchange without the intervention of the neutral. For example, in one engagement, I became concerned that a party sought to gain an advantage by delaying filing of their submission until the opposing submission was sent to them. Having the submissions sent directly to the accounting neutral with the accounting neutral copying the adverse party adds a step in the process, but largely mitigates against misbehavior by one party.

### Step 3: Define the timetable and decision process

The timing should be clear and the process flexible. The arbitrator works with the parties on a submission protocol that reasonably allows each side to present their respective positions and therefore get closure.

A typical process includes initial submissions and, generally, rebuttal submissions to the arbitrator. Additional rebuttals or a hearing might be scheduled in more complex disputes. Another approach sometimes used is a sequential process, particularly if the parties have not fully vetted issues

with each other. One side submits its position, followed by the other side in reply, and then by sequential rebuttals. This process improves the ability of the parties to directly respond to each other rather than have issues disconnect in a contemporaneous submission. However, the sequential process may take longer and be unnecessary when the disputants have an understanding of the issues and respective positions in dispute. One variation on this process involves the sequential filing of initial position statements, followed by contemporaneous rebuttal submissions. This ameliorates the question of which party makes the final submission and may be particularly advantageous for the respondent. Specifically, the respondent's initial submission becomes a first rebuttal statement focused entirely on just those issues raised by the claimant. The second respondent rebuttal becomes more challenging, however, since, in the contemporaneous phase of the exchange, there is nothing new on the table for the respondent to address.

To illustrate this situation, in a complicated and large dispute, the disputants asked me to proceed with a group of related individual disputed items and process them as a batch through to a determination. The parties anticipated that this would keep the process moving toward closure while allowing a focused effort on a few disputed amounts at a time. The parties also expected that this process would give them a basis to settle the remaining disputed items—once they saw how it was going based on my piecemeal determinations. I concluded, however, that this approach would not work in the subject situation because it would result in a determination being made for some issues without consideration of other issues that may be relevant. For example, a decision on the amount of accrued liabilities could change the amount recorded as inventories, each of which were in dispute. In such a case, the amount of a determination on one element could depend in part on a determination of another item that was yet to be made. Thus, while the process of submissions might still be batched and sequenced, it may simply not be possible for the arbitrator to determine one disputed amount with finality without determining all of the potentially related disputed amounts. As a general rule, it is unlikely a neutral would be interested in such a piecemeal approach unless the parties both felt strongly that it was necessary.

### Step 4: Communication

Maintain ongoing interaction, confirmation of the receipt of documents, and communication with the parties. The assistant to the arbitrator typically coordinates these activities

### Step 5: Resolve the issue

This step may include questions put to the parties by the arbitrator, formal responses by the parties, and, possibly, a hearing or conference to present key evidence or summarize arguments. At any phase in the process the

arbitrator may request information from the parties. A recommended practice, in advance of and often in replacement of a hearing, is for the arbitrator to direct questions to both parties in writing, allowing each to respond as they choose. Although some questions may apply to only one party, this approach allows both parties full visibility on the questions raised and provides the opportunity for comment by either party to any question. This is done only after the planned written submissions have been completed, including rebuttals. Unless prohibited by the SPA, this is a cost-effective and useful step that enables the arbitrator to gain more information on a key point not fully addressed in the parties' submissions.

The arbitration is most effective when the parties' submissions are focused, supported by facts, and clear. The arbitrator will expect that positions taken are credible and are supported by contemporaneous data, documents, affidavits, etc. There is rarely a need for expert opinion reports in such a proceeding. The arbitrator is effectively the only expert whose final opinion matters.

### Step 6: Submit the arbitration report

In a long-form report, the arbitrator explains the reasons for a decision on an issue-by-issue basis. The preference of the arbitrator, however, may be to provide a short-form report, which will minimize the possibility that an error may be revealed. A recommended practice is that, unless there are other considerations, the arbitrator should provide a long-form report. The long-form report reveals whether the arbitrator "got it" and enables the disputants to consider the results in subsequent PPDs. Expect, however, that a long-form report may add another 10 to 20 percent to the total cost of the arbitrator's effort.

### Power of the pen and other supporting evidence

When a dispute is asserted, does it matter to the arbitrator whether the buyer or seller is responsible for preparing and submitting the closing balance sheet? While this may well be a very important negotiating item, it should not matter to the arbitrator which party prepares the closing date accounting. In the context of the PPD, the arbitrator should not have a presumption that because an amount appears in the closing balance sheet it is per se more credible than another amount proposed by a disputant.

However, this is not the same perspective as in an audit where there is a basis from prior audit work for expecting the company being examined to report accurately. In the context of an audit, the focus is on whether the amounts presented in the financial statements taken as a whole are fairly stated, or in other words, whether an adjustment is demonstrated to be necessary. Absent other credible information to the contrary and given a basis for relying on the internal controls of a company, the recorded amount in a particular financial

statement line item will likely be the ending amount. Thus, it is important to find an arbitrator who appreciates the distinction between a PPD and an audit. Unless otherwise established in the SPA, there should be no implied credibility to the closing date financial information provided by the preparer and neither party has a higher burden of proof than the other.

Is it important to submit affidavits and other evidence in support of positions taken? It is not only important, but it is necessary. It is unlikely that an abundance of support will harm your position with a CPA arbitrator who is familiar with evaluating and interpreting large amounts of data. At the very least, the submission should offer to provide the support later if the arbitrator deems it necessary.

### Don't "split the baby"

What is the likelihood that the arbitration will result in a division of the claims on some split basis—a "splitting the baby" approach?

Put simply, do not hire an arbitrator who believes splitting the award is ever a consideration. The reason to arbitrate the PPD is to get a competent technical decision on an issue-by-issue basis. More often than not, when a party is presenting a credible, supported position consistent with the SPA, it ought to prevail entirely on that issue, not partly. The time for discounting the value of a claim is in settlement discussions, not as part of the arbitration and certainly not by the arbitrator. At the same time, don't be surprised if the outcome appears as if some split approach was a consideration, particularly if a number of issues are to be determined. Unless the arbitrator submits a long-form report, what may appear as splitting the overall amount in dispute may in fact be various determinations, with each party prevailing entirely on some claims and losing entirely on others.

### Limiting costs

The cost of resolving a PPD includes internal management costs, outside legal and financial advisory costs, and a share of the arbitrator costs. What can the disputing parties do to limit the total cost of this process?

First, try to resolve open issues to reduce the number of issues for arbitration to a critical few. Try to settle those issues that are errors or mistakes—matters of fact more than accounting principle—as well as data-intensive disputes, which take more time for the neutral to resolve.

Second, when left with unresolved matters to be arbitrated, secure legal and financial expertise to provide guidance on the selection of the arbitrator and on the arbitration strategy, submissions, rebuttals, and settlement options. While a disputant may have considerable resources, the rigors of the process will tax most in-house capabilities. Moreover, outside legal and financial

expertise can help to objectively set expectations independent from the management team involved in the transaction, settlement, or prosecution of the PPD.

### Overturning the decision of the arbitrator and relevant criteria

An effort to overturn the arbitrator's decision is fundamentally a legal call and subject to the applicable state law. For example, the Texas State Arbitration Statute illustrates typical conditions under which a court could vacate an arbitration award:

- The award was procured by corruption or fraud.
- There was evident partiality, corruption, misconduct, or willful misbehavior by the arbitrator.
- The arbitrator exceeded his or her powers.
- The rights of a party were prejudiced by the refusal to postpone the hearing, the manner in which the hearing was conducted, or the refusal to hear evidence.
- There was no agreement for arbitration to have occurred.[2]

As a result, these criteria provide very limited opportunities to overturn the determination.

## Purchase price dispute issues

No two purchase price disputes are the same. However, many share common underlying issues or themes. This section explores some of the more pervasive issues that often occur in these types of disputes.

### Contract compliance issues

One frequent point of contention in PPDs involves SPA compliance with regard to the preparer's (can be the buyer or the seller based on the SPA) closing date accounting statement and the respondent's (whomever is not the preparer) dispute notice. The specific compliance issues often in dispute relate to either:

- Timeliness of delivery of the preparer's closing date accounting or the respondent's dispute notice
- Reasonable detail of the closing date accounting, so the respondent can agree or object, or of the dispute notice, so the preparer can know what part of the accounting is disputed and why

[2] Section 171.014 Vacating an Award, part (a), Texas Arbitration Statute. Also see www.adr.org/law/statutes/texas_statute.html

Such disputes may have aspects that are as much legal as accounting, since an interpretation of specific language in the SPA is needed. In situations requiring a legal call to be made, the parties have essentially three choices, none of which may initially appear to be satisfactory:

- Go to court to resolve the particular contract compliance or discovery issue.
- Go through the arbitrator to arrange for a neutral legal counsel to evaluate the legal issue.
- Let the non-lawyer arbitrator decide.

To illustrate these options, let's look at some recent experiences I've been involved with:

- In one dispute, the parties wanted to first litigate a dispute relating to the timeliness and terms of the buyer's notice of disagreement so as to define what is properly asserted as a dispute under the SPA, and then proceed with the purchase price arbitration. As the arbitrator, I offered instead to engage special counsel as an advisor to me to address the legal aspects of the eligibility issue. The parties quickly agreed. This arrangement was consistent with the provisions of the SPA, which required the accounting arbitrator to resolve the PPD, thus, no amendment to the SPA was necessary. As a result, the final arbitration report addressed both the determination of the matters in dispute and the amount of the related closing balance sheet adjustment, at far less cost and time than the litigation alternative.
- In another dispute, I was asked to and did resolve these similar issues when the parties were comfortable that I could interpret certain contract language related to the meaning of "net revenues."
- In a third matter the parties were having a number of discovery disputes, not an uncommon occurrence, given that the seller may no longer have access to necessary books and records. In that situation the parties agreed that I would make a binding decision to resolve each discovery dispute based on what I believed was necessary for each party to reasonably evaluate the disputed items.

Thus, for any of these situations, the neutral party selected should be able to suggest an approach that will satisfy the parties.

### Purchase price issues

Aside from the SPA compliance issues, the disputed amount may arguably be a PPD, an indemnification claim, or both. For example, most SPAs will have indemnifications for breach of representations or warranties, such as for regulatory noncompliance, tax exposures, environmental conditions, and other

identified matters. It is possible that these indemnifications may overlap with issues germane to the closing balance sheet. Unless the SPA is clear, disputes may arise as to whether an issue should even be properly raised in the closing date accounting dispute or as an indemnification item. For example, costs associated with future customer warranty claims may be indemnified. Yet, there may need to be an accounting reserve for probable and estimable warranty claims on the closing balance sheet. Typically, indemnification disputes are outside the purview of the PPD submitted to the accounting arbitrator. If a liability for the specific warranted item is required to be recorded under GAAP, however, then the issue is appropriately part of the PPD.

One recent case handled by another arbitrator included a dispute as to whether a purchase price claim could be asserted if indemnification provisions were found to also apply. In this case, an accounting arbitrator ultimately decided that there was no limitation on what could be disputed under the purchase price adjustment section of the agreement and that, precluding a purchase price claim because it may also be a representation and warranty claim, was not within the authority of the arbitrator or provided by the SPA. This did not mean the particular accounting claim was meritorious, only that it could not be stopped from being asserted as a PPD if it was also covered by an indemnification. This is not to say how a judge would respond to an indemnification claim that was previously asserted and decided in a PPD, only to suggest that the accounting arbitrator found no basis to remove a claim from the PPD because it might also be an indemnification claim.

### Dates through which information is relevant in a PPD

The key question here is: Through what date is information considered in terms of the closing date accounting, particularly in connection with the carrying value of receivables, inventory, accounts payable, and accrued liabilities?
The answer can be complicated, but some possibilities include:

*Information as of the closing balance sheet date*

This is sometimes confused with the accounting as of the balance sheet date, which must be done. At issue is what, if any, information after the closing date is considered. Some arbitrators consider only information dated as of, or created prior to, the closing date. This view is in the minority, however. Any “closing” of financial accounts at a point in time necessarily occurs after the “as of” date has passed. Type I subsequent events, as these events are defined in generally accepted accounting and auditing standards, should be expected to be reflected in the closing date balance sheet,[3] unless there are contractual provisions or other clear manifestations of the parties’ intent to the contrary.

[3] Statement of Auditing Standards No. 1, Section 560.03 provides that the “The first type (of subsequent events) consists of those events that provide additional evidence with respect to conditions that existed at the date of the balance sheet and affect the estimates inherent in the process of preparing financial statements. All information that becomes available prior to the issuance of the financial statements should be used by management in its evaluation of the conditions on which the estimates were based. The financial statements should be adjusted for any changes in estimates resulting from the use of such evidence.”

*Information available through the date the closing balance sheet or working capital calculation is to be submitted to the other party*

This approach follows a typical financial "closing" and reflects Type I subsequent events through the delivery of the required closing statement. But what if the preparer submits the closing balance sheet in advance of the maximum time allowed under the contract, say delivery in 30 days when 60 days are allowed by agreement? Does that mean later events in days 31 through 60, prior to the deadline in the contract, are not considered? The answer depends, in part, on what the respondent objects to. Neutrals follow no general rule to handle such a situation. The predominant view appears to be that if the parties bargained for a stipulated period, the preparer should not be able to cut off consideration of subsequent events by trying to establish a premature cut-off of information that might otherwise be considered.

*Information available through the date the respondent is given in the contract to object to the closing balance sheet provided to them*

If the preparer can use information that arises after the closing date until the date stipulated for delivery of the closing balance sheet, does it follow that the respondent can use information that becomes available through the due date in the contract for acceptance or disagreement with the closing balance sheet? Not necessarily. In fact, I was involved in a situation in which the arbitrator did not consider any subsequent event information introduced by the respondent after the deadline for delivery of the closing date balance sheet by the seller, even Type I subsequent events. Typically, the SPA will allow a relatively short period for the respondent to accept or dispute the information, so at least the period in question is likely to be brief. If, for example, the seller is preparing the closing date balance sheet, the buyer likely has access to the people and records largely responsible for this information. As a result, the buyer has the opportunity to become aware of new information during the period prior to delivery of the closing balance sheet by the seller, making the time period for the buyer's response less consequential. However, in most of my recent cases, the buyer has prepared the closing date information. Either way, if Type I subsequent events arise during the respondent's time period, how an arbitrator will consider this information, if at all, is uncertain. One thing is certain, however. The parties should consider the potential impact of the timing of the preparer and respondent periods in the context of the relevant window of information a neutral may consider in the event of PPD.

*Information after the respondent dispute date*

Here things get even murkier, as the information window goes beyond the deadlines in the SPA. On one hand, the SPA aims to get timely closure of a transaction using an accounting that necessarily involves the use of estimates.

The use of a full hindsight approach may be objected to as a true-up of accounting estimates that was not contemplated in the SPA. Indeed, the use of estimates is expected in virtually every accounting under GAAP.

On the other hand, a comparable situation exists involving a period of delayed issuance of audited financial statements. One party is likely to suggest that the date of the determination of the arbitrator is comparable to that of the independent auditor in the context when all subsequent information is relevant up to the time of the arbitrator's report issuance.

The short answer is that disputants should expect that as time elapses after the closing date, the less likely an arbitrator is to consider subsequent event type information in connection with the PPD. In addition, the likelihood that Type I subsequent events even occur becomes more unlikely as time elapses.

### GAAP versus consistency

When a contract says the closing balance sheet will be prepared on the basis of GAAP consistently applied, which is more important, GAAP or consistency? This is an overarching issue frequently embedded in disputes. Let's look at several scenarios and expose the related closing balance sheet issues.

*GAAP is followed, but not consistently*

Typically, more preferable GAAP is not a reason to change the closing balance sheet as long as the accounting principle used in the closing balance sheet is GAAP. For example, a change to the percentage of completion method of accounting for long term contracts may be preferable. But if the beginning balance sheet was prepared on a completed contract basis such a change would not be appropriate under a SPA that required both GAAP and consistency.

*A consistent practice or principle is followed, but it is not GAAP*

When GAAP conflicts with consistency, GAAP is usually considered to be the higher standard unless the SPA clearly states otherwise. For example, when the SPA says "GAAP consistently applied," it is likely that non-GAAP treatment in the closing balance sheet will be successfully challenged absent compelling reasons to the contrary.

*An error is made in the beginning balance sheet that is unknown until after the SPA is executed and before the closing balance sheet is prepared*

In one case, a party creatively argued that the same error should be repeated in the closing balance sheet so as not to disadvantage either party, i.e., the change in the line item without correcting the error would be the adjustment amount. The respondent contended that errors are errors and you fix them when you have them. The arbitrator's analysis was that there was nothing in the

SPA or in GAAP that would allow for significant errors to remain unadjusted or to be ignored. To the extent that an error was made to a beginning balance sheet that was warranted by a seller, there may be a basis for an indemnification claim, but this would be outside of the closing balance sheet determination.

The SPA provides that closing balance sheet amounts will be presented on a GAAP basis, with no mention of consistency.

This point seems straightforward, but really is not. For example, one party may apply a formula-based method to derive allowance amounts for accounts receivable. The other party may look at specific subsequent events, such as payments, credits, or write-offs, to establish the net receivables amount, regardless of how prior accounting was done. Both approaches may be deemed GAAP, regardless of prior approaches used.

What an arbitrator does in this situation will reflect the unique facts and circumstances of the issue. In many respects, consistency in the application of accounting principles is expected under GAAP, regardless of whether it is specifically mentioned in the SPA. To the extent that past accounting practices were well established, more empirical than judgmental, communicated to the buyer, and applied at the closing date, the position is better for the preparer. When the converse is true, the arbitrator may be more likely to conclude that a net economic wash to the parties is the appropriate course of action (i.e., neither buyer nor seller gains or loses from say, the purchase of accounts receivable). In this event, the arbitrator might consider subsequent event information as a primary determinant of the required receivables allowance under GAAP.

**Principles or practices**

How does the arbitrator decide what to do if GAAP isn't mentioned and the contract refers to past accounting principles, past accounting practices, or use of the same methodology in the beginning and closing balance sheets?

In one case, the disputants disagreed about whether "past principles" or "past practices" applied in the closing balance sheet, since both were referred to in different sections of the SPA. As a not-so-surprising corollary, the parties defined past principles and past practices differently and, therefore, a dispute arose as to how certain closing balance sheet amounts were to be derived.

The difference between a principle and a practice, when there is one, can be quite subtle. In the aforementioned case, accounting "principles" were understood as the methods chosen to guide the recording of transactions. This differed from accounting "practices," which related to the calculations the company employed in applying the principle. Specifically, one party

calculated a warranty reserve as a percentage of sales on the basis of past practices and argued that this practice had to be followed consistently. The other used a direct-projection approach based on claims asserted and engineering estimates of the associated repair costs. This party argued that the accounting principle of accruing for probable and estimable warranty repairs had to be consistently followed, even as the accrual amount was calculated differently. The absence of documented company policies or standardized approaches in deriving recorded amounts further compounded the problem for the arbitrator. In this specific dispute, the arbitrator decided to deny the claim based on the direct-projection approach, and concluded that past practices governed the calculated amount based on the SPA. If the SPA had required the use of GAAP, the outcome would likely have been different. Thus, how an arbitrator decides purchase price issues is more uncertain when the SPA provisions explaining the basis on which the closing balance sheet must be prepared is ambiguous, particularly if GAAP is not referenced.

### Due diligence

To the extent differences arise between the accounting principles or practices explained in due diligence and the closing balance sheet, the buyer's arbitration submissions normally dispute such inconsistent treatment. A "strict constructionist" arbitrator may determine that when the SPA requires consistent application of accounting principles between a benchmark date and the closing date, the representations made to a buyer in due diligence are irrelevant in the context of the PPD. Accordingly, the differences are ignored in the arbitration. A "business approach" arbitrator may consider such differences in the determination, especially when the seller did or should have known the information was inaccurately presented to the buyer in due diligence and the buyer relied on such information. Generally, this is a slippery slope for the arbitrator. The quality of due diligence and the information learned or not learned is not directly relevant to what the arbitrator is tasked to do. Nonetheless, avoiding the uncertainties that arise from this issue in a PPD is in the best interest of both parties. Sellers avoid this issue by taking care to accurately disclose the accounting principles used in the benchmark balance sheet; buyers avoid this issue by prioritizing the identification of significant accounting principles in their due diligence and comparing representations made to them with their due diligence findings.

### Materiality

One of the most pervasive issues in PPDs is how to determine to what extent the materiality or immateriality of amounts is relevant. The issue arises most acutely in those transactions in which there is no threshold amount in the SPA that must be exceeded before the purchase price is adjusted.

So what is different in the PPD context that would not otherwise normally exist? Several things, including the following:

- There is no established context outside of the financial statements taken as a whole for the arbitrator to evaluate materiality in the context of selected line items of a financial statement, such as a net working capital amount.
- There are typically no other users of the closing date statement but the buyer and seller. Each disputed amount is therefore raised by a party who is explicitly asserting its significance and materiality as a "user" of the closing date statement.
- It is well established that GAAP need not be applied to immaterial items in the context of traditional financial statements. Therefore, a prior financial statement of the seller may have applied non-GAAP principles in error when the effect was immaterial to the financial statement taken as a whole. These prior financial statements may well have been audited and received clean auditor opinions. But if this particular non-GAAP principle were challenged in a PPD, the arbitrator will most likely adjust for the item by applying the contract basis of accounting (e.g., GAAP) specifically to those claims presented for determination.

As a result, a recommended practice is to include a threshold amount in the SPA to avoid at least some of the issues that arise with materiality arguments. I say only some issues because once the threshold is exceeded, each dollar in dispute likely again becomes a relevant consideration independent of normal financial statement materiality criteria.

**Adjustments submitted for arbitration not previously identified in the dispute notice under the SPA**

Can new issues be disputed that were not previously noticed? Can the amounts claimed in the notice of dispute be adjusted in dollar amount in submissions to the arbitrator?

In general, SPAs are written so that only issues previously challenged in a dispute notice can be arbitrated—otherwise, the seller may be pressured to concede matters to avoid the risk that the buyer may later find ways to "pile on" adjustments. However, to hold the parties rigidly to the amounts previously asserted is often not logical or necessary, particularly when errors are identified or the parties agree to make concessions.

This is not to say that how the closing date statement or dispute notice is crafted is unimportant. For example, in a recent situation, the respondent disputed everything in the closing date accounting because it claimed it had no basis to concur. My suggestion is to weigh carefully the possible outcomes if the entire accounting is disputed. Once disputed, the original accounting

is, by definition in the SPA, likely to still be unresolved and might again be changed by the preparer. In most situations, the respondent disputes specific line items of the closing date accounting.

How the disputed elements are noticed is also often critically important. If the dispute is about, for example, the aggregate amount of a line item reported as accrued liabilities, then more has been noticed in dispute than the amount of accrued payroll, one of the constituent accounts in accrued liabilities. The parties should exercise caution in deciding whether to dispute a subaccount balance, a general ledger account balance, a line item on the closing date statement, or some other composition of balances that comprise the total on which a post-closing adjustment will be made.

In any case, the buyer and the seller should be encouraged to submit to the arbitrator credible information for their position, and, in most cases, should not be locked into defense of an amount that neither supports once the amount has been disputed. Does this mean that a closing balance sheet amount submitted by the preparer can also be changed after it has been submitted? Possibly, depending on the nature of why a change is necessary and providing that the respondent has disputed that portion of closing statement.

## Accounting issues common to purchase price disputes

It doesn't take prescience to predict that most PPDs will involve one or more of the following general areas of accounting:

- Reserves and provisions
- Inventory
- Accounts receivable
- Fixed assets
- Taxes
- Other assets

The following is a list of some specific accounting issues I have known to be addressed in a PPD:

- Whether interim or year-end GAAP principles apply
- Whether country-specific GAAP applies
- Whether an unrecorded but proposed adjustment to an audited benchmark balance sheet requires a comparable adjustment to the closing balance sheet under a contract basis of GAAP consistently applied
- The classification of amounts in working capital; specifically, whether it is more appropriate to classify items consistent with the benchmark balance

sheet or more appropriate to consider the expected liquidation of the asset or liability within 12 months from the closing date

- Whether calendar days or business days should be used in deriving amounts accrued or expensed as of a midmonth closing date or, more broadly, how costs should be allocable to midmonth periods
- The extent to which certain cash balances were assets sold in a SPA
- The treatment of negative cash balances and, specifically, the extent to which outstanding checks should be reflected as outstanding accounts payable amounts with an offsetting and equal increase in the book cash balance; this issue often arises when working capital, excluding cash, is the basis for a closing date adjustment
- Whether billing errors historically reflected as adjustments to recorded amounts on the date corrected should be pushed back to the specific receivable at the closing date
- The treatment of negative customer accounts receivable as contra-assets/liabilities at closing or as amounts that should be reversed to revenue/bad debt expense, and therefore outside of net working capital under the SPA
- Whether amounts adjusted on the basis of new events occurring over the passage of a fixed period of time—such as customer returns for two weeks after the balance sheet date—should be considered for a longer duration
- The extent to which additional specific and judgmental provisions may be needed for credit risks or disputed amounts in allowances for doubtful accounts
- The amount and valuation of employee receivables
- The specific elements of costs included in inventory and the related method of absorption of overhead costs
- The determination of reserve amounts for physical inventory shrinkage, excess and obsolete inventories, or damaged goods; and the extent to which valuation reserves are needed to reduce book values to lower of cost or market values
- Whether the existence of a long-term commitment by a customer to use automotive parts allows that customer's parts provider to maintain part inventories at full book value, without adjustment for slow-moving items
- The level of aggregation for which a lower of cost or market evaluation of inventories should be done (e.g., by individual unit, inventory type, plant, segment)
- Whether abnormal unfavorable production variances exist that should be recognized as period expenses rather than absorbed into inventory costs under FAS 151, Inventory Costs, an amendment of ARB No. 43, Chapter 4

- The extent to which consigned-out inventory exists, is useful, and is fairly valued
- The extent to which certain suspense accounts, such as for "goods received without an invoice" or "invoices received without the goods," were properly recorded
- Whether amounts associated with prepaid advertising, job costs, uniforms, supplies, or spares are assets or operating expenses
- The amount, continued utility, and remaining economic life of deferred costs, deposits, and prepaid advances
- The amounts related to percentage of completion accounting, particularly for those projects that are large in scope, time, or dollar amount; that are more than 50 percent completed but still in process; have costs associated with unexecuted change orders; or have large amounts of unbilled receivables or work in process
- Whether and to what extent adjustments to the recorded amounts for long lived assets are necessary
- The extent to which engineering costs are properly classified as development costs under FAS No. 2, Accounting for Research and Development Costs, or as overhead costs capitalized as either inventory or plant and equipment
- Whether any unrecorded liabilities should have been recorded, particularly those related to environmental reserves, litigation, or contract losses
- Whether construction liens on recorded assets existing at the closing date constitute recordable liabilities
- Whether liabilities exist with regard to trade-in rights given to customers
- The timing of recognition of professional fees based on the period benefited or when services are incurred
- Whether business expenses reasonably incurred by employees prior to closing are liabilities at the closing date when not yet reported or reimbursed on individual expense reports
- Whether liabilities able to be compromised at amounts less than recorded values should be reduced from their face amount
- Whether accrued liabilities constitute, by definition, trade payables, as that term may be defined in the SPA (when trade payables were subject to special treatment based on the SPA)
- The accounting for customer claims and warranty reserves, particularly for new product offerings
- The accounting for vacation accruals

- The amount of discretionary bonus accruals historically accrued by the seller at interim dates but not awarded or paid by the closing date, which occurs prior to the end of the bonus year
- The accounting for employee benefit liabilities and other actuarially determined amounts
- The calculation of liabilities for discounts, coupons, or rebates, particularly for consumer product companies
- The amount of income tax amounts receivable or payable, particularly those receivables associated with the tax period ending as of the closing date, those receivables arising from a carry-back of tax deductible losses to prior periods as a refund, and those deferred assets or liabilities arising from temporary differences
- The amounts of unpaid management fees as of the closing date

Disputes related to additional contingent consideration (earn-outs) owed to the seller based on post-closing performance of the business often give rise to the largest claims. This occurs because the amounts due are often based on performance over a year or multiple years and may be calculated as a multiple of EBITDA, operating earnings, or other measure of profitability or cash flow. Any of these measures may be significantly affected by the operating and accounting policies used by the buyer, which may differ from those historically used by the seller. These earn-out arrangements, even if carefully structured, cannot anticipate some of the unique issues that may arise. For example, one case required the buyer to manage the acquired business based on commercially reasonable efforts to maximize EBITDA. Other cases have expressly addressed these or other “best effort” type arrangements. The key point is that these are highly subjective criteria that are viewed against many independent decisions the buyer may later make involving product development, marketing, customer service, staffing levels, reporting lines, and other routine operating decisions—all decisions that could be second-guessed. Other non-routine conditions also drive earn-out disputes. One such unique dispute involved whether a payment made by an underwriter after its client’s IPO was an adjustment of underwriting fees and therefore an adjustment of the cost of the underwriting (outside of earnings) or whether it was other income (unrelated to the underwriting) and therefore contributing to an earn-out due to the former owners of the now public company.

### EBITDA issues

Earn-out disputes frequently involve problems with an EBITDA-based measure related to either the accounting classification of certain transactions or the timing of the recognition of transactions. The longer the period for contingent payout, the linkage of the payout with future earnings, and the use of a multiple for deriving the amount to be paid as future purchase price, the greater the likelihood that a dispute will arise. For example, in one case, an earn-out based on a percentage of EBITDA declined over a three-year contingent pay-out period. Not surprisingly, the extent to which EBITDA-influencing events were recorded in later periods rather than earlier periods became an area of disagreement. In another case, the core issue was whether a purchase price paid based on a multiple of trialing 12-month EBITDA gives rise to damages as a result of one-time contingent liabilities that were not recorded in the pre-closing period. In a third case, the core dispute involved whether certain costs were classified as research and development and therefore a deduction in deriving EBITDA, or as capitalized expenses that were amortized and therefore added back in deriving EBITDA. As EBITDA is commonly used in the context of transactional valuation and earn-out agreements, it is also common as a foundational element of post-closing disputes.

### Buyer decisions impacting closing date amounts

What impact will a buyer's change in business strategy have, for example, on inventory obsolescence or impairment? The closing balance sheet is based on the seller's business practices and plans. The buyer's decision to discontinue a product line or business unit is not "downloadable" to the closing balance sheet. Even so, there are some accounting issues that aren't quite as predictable. For example, what constitutes excess or obsolete inventory (E&O) is still a judgment call. In one instance, the extent to which E&O existed depended in large part on the sales forecast, which in turn depended on the seller's view of future business opportunities over an extended period. The higher the unit sales forecast, the lower the E&O and the higher the purchase price. When the buyer concluded that a different sales forecast was appropriate and that the seller's view of future product prospects was inflated, it also disputed the seller's E&O reserve amount.

In another case, the seller cancelled a substantial number of open orders to one of its affiliates after the closing date. Should the seller's cancellation of orders after the closing be reflected in an E&O reserve calculation? To not reflect the cancellation may result in the seller benefiting from the cancelled orders. To the extent the sales forecast was credible at the time the closing balance sheet was developed and new factors arose that caused the orders to be cancelled, the closing date E&O reserve would be less likely to require adjustment.

These types of issues aren't related only to asset valuation. An accrual related to an unfavorable lease, for example, may depend on how a leased asset will be used. Buyer and seller could understandably disagree on whether a loss accrual should be recorded in such a situation. It would not be expected, however, that the buyer's plans to restructure the acquired business or any related accruals would be reflected on the closing balance sheet.

### Balance sheet audits

If the closing balance sheet is audited, are potential disputes between the parties eliminated? If an audit is done as of a date between the beginning and final balance sheet dates, how does that effect the arbitration consideration? If the benchmark balance sheet is audited, but the ending balance sheet is not, what issues are raised?

A full audit of the closing balance sheet is relatively uncommon for a number of reasons, including:

- Cost and time are limiting factors.
- The buyer has done due diligence and may perceive a lesser need for an audit.
- There is no perceived future benefit to the buyer if an audit is done by the seller's (not continuing) independent accountants.

That said, an audit of the closing balance sheet will not avoid the likelihood of a PPD, and in some cases, the likelihood may increase. For example, if the closing balance sheet is audited but previous periods were not (e.g., in carve-out situations) then the likelihood of purchase price disputes at closing may increase because errors may be identified that were never known in benchmark financial information.

What about audits for periods between the benchmark balance sheet and closing date? Under a typical SPA, an "in between" audit will probably not matter in the quantification of the purchase price adjustment. However, the audit will likely be for a discrete annual period and APB No. 28, *Interim Financial Reporting*, provisions for accounting for a fraction of an annual period will not apply. Thus, some amounts on both the benchmark and closing balance sheets may differ from the audited balance sheet, even as to accounting principle, because they each may include APB No. 28 normalization accruals or deferments.[4]

Finally, what about the situation where the benchmark is audited but the closing date is not. In general, an audit of the benchmark balance sheet does not give rise to any further issues beyond those already mentioned. However, such an audit does sometimes raise the question of whether a

[4] Accounting Principles Board Opinion No. 28 paragraph 9 states: "However, the Board has concluded that certain accounting principles and practices followed for annual reporting purposes may require modification at interim reporting dates so that the reported results for the interim period may better relate to the results of operations for the annual period."

GAAP imprimatur has been given to every individual accounting done in the benchmark balance sheet. It is possible, for example, for a non-GAAP amount to be unadjusted in an audited GAAP balance sheet based on the immateriality of that potential adjustment to the financial statements as a whole.

In one case, the closing balance sheet reflected the allocation of manufacturing overhead to the cost of inventories under GAAP. In this case, the same cost categories were included in manufacturing overhead at both the benchmark and closing dates. Manufacturing overhead was also allocated to inventory the same way (e.g., based on labor or machine hours as applicable). However, the duration of the inventory turnover period was calculated differently which resulted in less manufacturing costs absorbed into inventory. Does a contract which requires GAAP consistently applied mean that in each part of an accounting calculation be done at closing as done at the benchmark date? Does this change cause a GAAP inconsistency between the benchmark and closing dates? Depending on the facts and circumstances, these subtle issues make it harder to predict the outcome of the arbitration process. An audit of the subject's benchmark balance sheet at least gives the perception of such detail calculations as GAAP, even though GAAP may be more general than explicit about how overhead costs must be absorbed into inventory.

## Common dispute mistakes in handling purchase price disputes

**What mistakes are commonly made by disputants?**

- Not expecting the dispute to arise
- Failing to engage outside legal and financial expertise
- Neglecting to secure the assistance of people familiar with the closing date accounting or worse yet, terminating or alienating employees who may be helpful in the arbitration
- Not retaining documents or arranging for supporting affidavits for issues germane to the dispute
- Not being thorough in selecting a competent arbitrating firm or arbitrator
- Underestimating the strength of the adversary position
- Arguing equity or fairness without linkage to the provisions of the SPA
- Expecting the arbitrator to act with the equanimity of a judge when he or she is a CPA and less comfortable with evidentiary rules and hearing protocol than with accounting principles
- Overreaching in the claim on the premise that the arbitrator will likely resolve issues somewhere in the middle
- Providing insufficient proof in support of an argument presented
- Criticizing an opposing position, but failing to provide a credible alternative amount
- Growing ever more confident in the rightness of positions taken earlier with some uncertainty
- Viewing prior settlement offers received as a likely floor to what will be eventually decided by the arbitrator
- Responding inadequately to questions raised by the arbitrator
- Compromising legitimate positions that should be taken to arbitration as a result of a concern about the cost of the arbitration

**What mistakes are commonly made by arbitrators?**

- Failing to communicate known or potential conflicts prior to retention
- Failing to agree on a clear arbitration process
- Failing to get a clear definition of what is disputed and what must be decided
- Not limiting ex parte communication with the parties
- Not controlling the exchange of submissions made by both sides with the adverse party
- Failing to allow disputants reasonable opportunity to fully and completely provide their input
- Allowing the process to extend unnecessarily over a protracted period
- Not requiring or inadequately reviewing evidential matter in support of a position
- Not considering the integrative effect of the determination of one issue on other issues that must be determined (e.g., a decision involving the amount of an asset or liability may create tax attributes that change current or deferred income tax assets or liabilities)
- Failing to engage specialized professionals to help evaluate a claim where appropriate
- Failing to get a second concurring review or access relevant industry expertise for the determinations proposed to be made
- Aiming to mollify the disputants by splitting the amounts claimed in some perceived-to-be-fair fashion

## Conclusion

So there you have it—a glimpse into the world of purchase price disputes from the perspective of the accounting arbitrator. I hope that this discussion has not only helped you better understand the process itself and the role of the arbitrator, but has given you insight into the issues and potential outcomes you may encounter in your next purchase price dispute—which will likely follow after your next sale or acquisition. Above all, obtain good advice to help you in the selection of the arbitrator and in making your submissions. It is a rare situation when an accounting determination translates into a dollar-for-dollar transfer between parties—this is one of those unique and potentially high-stakes situations.

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