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• Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
• Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today’s program.
• Double click on the PDF and a separate page will open.
• Print the slides by clicking on the printer icon.
M&A Post-Closing Disputes: Minimizing and Resolving Disputes Over Working Capital Adjustments and Earn-outs

Gregory Brow, Esq.
Frank Lazzara, CPA, CFE
Bobby Majumder, Esq.
Agenda

I. Overview of a Purchase Price Dispute
   1. Earn-outs & Common Disputes
   2. Key Drivers
   3. Working Capital & Common Disputes:
   4. The Working Capital True-up Process and Key Drivers

II. Purchase Price Dispute Examples
   1. Working Capital – Basis of Preparation Sample Language
   2. Working Capital Dispute Categories & Examples
      GAAP & Consistency; Subsequent Events & Key Dates
   3. Earn-outs
      Covenant of Good Faith; Measurement Challenges

III. Best Practices to Minimize Disputes
   a) Working Capital Dispute Minimization Techniques
      a) Carve-outs
      b) Closing “Rehearsal”
   b) Earn-out Dispute Minimization Techniques
      a) Unambiguous Language
      b) Exhibits & Sample Calculations

IV. Resolving Disputes
   1. Litigation Considerations
   2. Accounting Arbitration
      a) The Role of a CPA in a Purchase Price Dispute
      b) The AICPA Practice Aid
I – Overview of a Purchase Price Dispute

**Earn-outs:**

- “...[A]n earn-out often converts today’s disagreement over price into tomorrow’s litigation over the outcome.”

- A **contingent** element of the acquisition’s purchase price determined post-closing based on the target business’s performance against certain contractually defined criteria or benchmarks:
  - Revenue
  - Earnings per share
  - EBITDA
  - Net Equity
  - Net Income

- Used to close the valuation gap between Buyer and Seller

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Why Do Earn-outs Appeal to Sellers?

- Protect Seller from failing to realize value in their business.
- May allow Sellers to obtain greater consideration that they might receive otherwise.
- Can be advantageous in competitive economic climates (such as today).
- May allow Seller to control its own destiny when Seller management will continue to be involved in business post-closing.
Why Do Earn-outs Appeal to Buyers?

- Protect Buyer from overpaying for the target business.
- Effectively Seller financing – reduces cash necessary at closing.
- Can distinguish Buyer’s bid in when multiple suitors for target.
- Indicates confidence of Seller.
- Motivation of Seller management when Seller management will continue to be involved in business post-closing.
I – Overview of a Purchase Price Dispute

Common Disputes: Earn-outs:

Two common disputes

1. **Was the earn-out target satisfied?**
   a) Fees/expenses and classification
   b) “Earnings” and definitions

2. **If not, why was the earn-out target not achieved, and who is to blame?**
   a) Post-closing management
   b) Specified post-closing investment\(^1\)

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I – Overview of a Purchase Price Dispute

Key Drivers to Earn-out Disputes:

- Discerning Whether Earn-out Targets Were Satisfied
  - How parties classify fees and expenses in a Transaction Agreement can influence whether targets are met.
  - Ex. Comet Systems, Inc. Shareholders’ Agent v. MIVA Inc.\(^1\)
    - Comet, the seller, paid an $800,000 bonus at closing to employees, and MIVA, the purchaser, classified the bonus as an operating expense rather than a “one-time non-recurring expense.”
    - If the bonus was classified as a “one-time non-recurring expense,” the revenue-based earn-out target would have been met.
    - Court found that charges and costs resulting from the transaction are not expected to represent likely future costs of the business, thus, target was met.

I – Overview of a Purchase Price Dispute

Key Drivers to Earn-out Disputes:

Discerning Whether Earn-out Targets Were Satisfied (cont.)

- Clarity in drafting process is key.
- GAAP or custom definitions?
  - Ex. Chambers v. Genesee & Wyoming Inc.²
    - Earn-out target revolved around EBITDA reaching a certain level.
    - EBITDA as derived by GAAP-defined earnings reached target level.
    - EBITDA as derived by the contractual definition had not reached the target level.
    - Court held EBITDA was to be calculated by the terms of the contract, thus the target was not met.

I – Overview of a Purchase Price Dispute

Working Capital:

- In addition to an agreed-upon purchase price; A negotiated target amount of Working Capital (“WC”); Estimated as of closing then trued-up by the Parties within a certain period of time.

- Transaction Agreement includes representations (“reps.”) by the Seller; One typical rep. is that the financial statements provided to the Buyer are in compliance with GAAP, consistently applied.

- Key Driver: GAAP vs. Consistency

- Key Driver: Subsequent Events
I – Overview of a Purchase Price Dispute

The Working Capital True-up Process:

- Seller Prepares Estimated Closing Date balance Sheet (CD = July 2, 201X)
- Buyer Submits “True-Up” of Closing Date Balance Sheet (CD + 60 = September 1, 201X)
  - Seller Files Notice of Disagreement
  - Parties Attempt to Resolve Disputed Items
- Parties May Commence Arbitration
  - Select Neutral Accountant
  - Define the Process and Timing
I – Overview of a Purchase Price Dispute

*Key Driver: “GAAP vs. Consistency”:*

- The most hotly contested issue in a purchase price dispute
- Seller’s position is that its consistent, past practice results in a GAAP compliant presentation
- Buyer’s position is that Seller’s past practice is not GAAP and results in an incorrect accounting treatment
- Agreement language re: “basis of preparation” is key
- Generally, if Seller’s past practice or methodology does not result in a GAAP-compliant presentation, then GAAP would typically prevail over consistency (depends on the facts and circumstances)
I – Overview of a Purchase Price Dispute

**Key Driver: Subsequent Events:**

- Seller’s position is that available information through the Closing results in a GAAP-compliant presentation and subsequent events should not be considered.

- Buyer’s position is that all information, sometimes through the arbitration, must be considered to determine a GAAP-compliant presentation.

- Generally, a GAAP-compliant presentation considers what is known or knowable at the date of the preparation/delivery of the closing balance sheet, or “true-up”.
I – Overview of a Purchase Price Dispute

Additional Key Driver: Timing

- Working Capital
- Earn-Out
Purchase Price Dispute Examples: Working Capital
II. Purchase Price Dispute Examples
Agreement Language: Basis of Preparation

**SPA/APA “GAAP Working Capital” Sample Excerpts**

1. The CDWC\(^1\) shall be prepared in accordance with GAAP, consistently applied;

2. The CDWC shall be determined in accordance with GAAP, subject to the policies described in the GAAP Exceptions Schedule.

3. The Parties agree that the CDWC shall be prepared in accordance with GAAP, and ... there shall not be introduced any different accounting methods, principles, classifications or estimation methodologies from such accounting methods, principles, classifications or estimation methodologies used in calculating the:
   - Target Working Capital
   - Interim Financial Statements

4. The CDWC shall be determined in accordance with the Seller’s Practices and Procedures.
II. Purchase Price Dispute Examples
Working Capital Dispute Categories

“Could this be the Same Company?”

<table>
<thead>
<tr>
<th>Current Assets</th>
<th>Per Seller</th>
<th>Per Buyer</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ -</td>
<td>$ -</td>
<td>-</td>
</tr>
<tr>
<td>Certificate of Deposit</td>
<td>-</td>
<td>-</td>
<td>-</td>
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<tr>
<td>Accounts Receivable</td>
<td>153,752,000</td>
<td>153,752,000</td>
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</tr>
<tr>
<td>Less: Allowance for Bad Debt</td>
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<td>(13,187,600)</td>
<td>(7,687,600)</td>
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<tr>
<td>Merchandise Inventory</td>
<td>158,446,465</td>
<td>150,446,465</td>
<td>(8,000,000)</td>
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<tr>
<td>Prepaid Expenses</td>
<td>3,950,000</td>
<td>3,800,000</td>
<td>(150,000)</td>
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<td><strong>Total Current Assets</strong></td>
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<td>(15,837,600)</td>
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<th>Current Liabilities</th>
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<td>Accrued Liabilities</td>
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<td>(4,200,000)</td>
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<td>Taxes Payable</td>
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<td>Wages Payable</td>
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<td><strong>Total Current Liabilities</strong></td>
<td>$122,036,000</td>
<td>$126,236,000</td>
<td>($4,200,000)</td>
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</table>

**Closing Date Working Capital =**

<table>
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<th></th>
<th>Per Seller</th>
<th>Per Buyer</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
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<td></td>
<td>$188,612,465</td>
<td>$168,574,865</td>
<td>-$20,037,600</td>
</tr>
</tbody>
</table>
II. Purchase Price Dispute Examples
“GAAP Consistently Applied”

**Accounts Receivable Reserve:** Buyer’s claim = $7.7 million.

<table>
<thead>
<tr>
<th>Buyer’s Position</th>
<th>Seller’s Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seller’s method is inadequate for estimating uncollectible A/R since it is prudent to reserve at 90% of all A/R &gt; 120 days outstanding.</td>
<td>The $5.5 million reserve was sufficient based on historical collection rates, application of calculation methodology, and experience through Closing, in spite of it’s apparent shortfall noted during the period since Closing.</td>
</tr>
</tbody>
</table>

**Question:** Which version is “GAAP consistently applied?”
II. Purchase Price Dispute Examples
“GAAP Consistently Applied”

- **Accounts Receivable Reserve:** Buyer’s claim = $7.7 million.

- **Question:** What about information – known or knowable - available at F/S preparation date?

A Balance Sheet will typically be different depending on its preparation/delivery date – more/better information
II. Purchase Price Dispute Examples Key Dates for Closing Date Balance Sheet & Net Working Capital Calculation

- **CDWC Preparation Date**
  - **Information May Be Considered**
- **Closing Date**
  - **Information May NOT Be Considered**
- **Notice of Disagreement Filing date**
  - **Arbitration Commencement Date**

- **JUL 2**
- **SEP 1**
- **OCT 1**
- **MAR 15**
Purchase Price Disputes: Earn-outs
II. Purchase Price Dispute Examples

Earn-out Disputes

1. **Implied covenant of good faith and fair dealing**

- Where contract does not address matter expressly and affords parties some discretion in performance of duties, neither party will take actions designed to defeat other party’s realization of fruits of its contract.

  (Plaintiff must allege that purchase agreement contains gap or implied covenant claim fails)

- Courts reluctant to find breach of implied covenant absent evidence that buyer took deliberate steps to defeat achievement of earn-out

- Business judgment
II. Purchase Price Dispute Examples
Accounting Area Disputes in an Earn-out

What should / should not be included when measuring the target’s performance against earn-out benchmarks?

- Costs of transaction: X
- Impacts of Alternative Accounting: X
- Depreciation & amortization: X
- Intercompany overhead allocations: X
- Discontinued operations: ✓
- Post-transaction acquisitions: ✓
- Post-closing capital investments: ✓
- Extraordinary items: ✓
II. Purchase Price Dispute Examples
Earn-outs, In Summary

**Earn-Outs can be challenging because:**

- The impression that the buyer may tend to manipulate the accounting to make it difficult to achieve the earn-out
- Business decisions including growth pursuit and spending are overseen by the new owner
- Small increases in discretionary expenses may eliminate large earn-outs
- Revised accounting may be necessary to reflect changed circumstances

*Lesson Learned: Keep earn-out criteria simple, easily measurable and unambiguous; define terms!"
Best Practices to Minimize a Purchase Price Dispute
III. Common Techniques to Minimize: Working Capital Disputes

- Carve-outs
  - Consider excluding certain financial statement line items from the estimation and subsequent true-up

- Contractual Exhibits
  - Incorporate a detailed, descriptive calculation as an example, along with step-by-step instructions
  - State accounting policies to be applied

- Quick-Close Rehearsals
  - Prepare (Seller) for and rehearse a “quick-close,” limiting traditional hard-close procedures to those accounts posing the greatest risk of W/C dispute: reserves, inventory LOCOM, liability classification.
III. Common Techniques to Minimize: Earn-out Disputes

- **Clear and Unambiguous Language**
  - Language used to identify the time-periods, measurement criteria and exceptions should strive to:
    - Utilize industry- or company-specific historical reporting periods and terminology;
    - Define terms when the possibility of ambiguity exists;
    - Specifically state limitations on buyer’s operation of target

- **Exhibits and Sample Calculations**
  - Example calculations and worksheet attachments should be utilized, whenever possible
  - Calculation templates with detailed instructions will help to eliminate creative alternatives
Resolving a Purchase Price Dispute
IV. Resolving a Purchase Price Dispute
Litigation Considerations

- Court or Arbitration?
- Court: Jury or nonjury?
- Arbitration: Accountant or Lawyer as Arbitrator?
IV. Resolving a Purchase Price Dispute
Litigation Considerations

- What Issues Are Arbitrable?
  - Procedural issues – e.g., specificity or timeliness of notice
    - Weiner v Milliken Design, Del Ch. Jan. 30, 2015 (gateway
      procedural questions are for the arbitrator to decide)

- Arbitration: Discovery or none?

- How to select arbitrator(s)
IV. Resolving a Purchase Price Dispute Litigation Considerations

*Matters of proof in Earn-out Litigation*

- Instructing Buyer’s management/employees regarding standard for operating company
- Retention of documents from outset
- Special problems with Sellers who remain as management – two “hats”
- Proving damages – would have achieved earn-out but for breach
- Proving benchmark/target was unrealistic
IV. Resolving a Purchase Price Dispute Litigation Considerations

**Working Capital Adjustment or Indemnification Claim?**

- Some claims can arguably be characterized as both
- What difference does it make?
  - Working capital adjustments
    - Dollar-for-dollar
    - No limit
    - Accounting firm arbitrator; expedited; limited discovery
    - Escrow
IV. Resolving a Purchase Price Dispute
Litigation Considerations

- Indemnification claims:
  - Deductibles, caps and baskets
  - Court or lawyer arbitration

- Which is it?
  - When item giving rise to claim occurred
  - When it was discovered
  - Whether it impacted pre-closing calculation of working capital
IV. Resolving a Purchase Price Dispute
The Role of a CPA in a Post-Acquisition Dispute

- Expert Consultant
- CPA Roles
- Advisor to the Attorney as Arbitrator
- Mediator
- Arbitrator
IV. Resolving a Purchase Price Dispute

Typical Accountant Arbitration Process

- Generally, there are no set guidelines for how to conduct the process.

- Should consider that some contracts may refer to third-party guidelines such as AAA or CPR Institute of Dispute Resolution rules.

- The actual process may take various forms depending on what the parties agree to (e.g. baseball arbitration).

**Common elements of the arbitration process:**

1. Preliminary Conference
2. Discovery
3. Written Statements
4. Interrogatories
5. Hearings/Conferences
6. Decision/Award
IV. Resolving a Purchase Price Dispute:
The AICPA M&A Disputes Practice Aid

M&A Task Force and Forensic and Valuation Services Section of the AICPA

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Intent of This Practice Aid:

The objective of this practice aid is to serve as a useful source of information for practitioners who provide merger and acquisition (M&A) dispute consulting services, whether as a neutral accountant, a consultant, or an expert witness. This practice aid will focus on the theoretical, legal, and accounting basis of M&A dispute consulting. [p. 8]
Conclusions/Takeaways

- Get litigator involved as early as possible
  - Working capital: Before proposed closing statement or dispute notice
  - Earn-out: At first indication targets may not be achieved
  - Litigator review of draft provision in M&A agreement

- Work with accounting advisors early
  - Collaborate on preparation of proposed closing statement / dispute notice / earn-out report / discovery requests
  - Analyze how an Arbitrator would rule on the issues
Panelist Bios
Greg Brow

Partner, Dentons US LLP

Atlanta, GA
+1 404 527 4000
greg.brow@dentons.com

About
Greg Brow represents publicly-traded corporations, privately-held businesses, and corporate executives in trials, arbitrations, and appeals of complex business litigation matters throughout the United States. Greg has successfully litigated numerous M&A purchase price adjustment disputes, including working capital adjustments, earn-out disputes, and indemnification claims before accounting firm arbitrators, international and domestic legal arbitrators, and courts.
Frank A. Lazzara, CPA/CFF, CFE

Managing Director, FTI Consulting

New York, NY
+ 1 1 212 841 9336
frank.lazzara@fticonsulting.com

About

Frank Lazzara is a Managing Director at FTI Consulting and is based in New York. Mr. Lazzara has over 20 years of experience in public accounting, internal audit, financial operations consulting and private industry expertise. Mr. Lazzara provides accounting, investigative and auditing expertise to attorneys in litigation and arbitration. Prior to joining FTI Consulting, Mr. Lazzara supervised teams in the execution of internal and independent audits. His private industry experience is in telecommunications where he served as CFO and Controller for a competitive local exchange carrier (CLEC). For the telecommunications startup, he was directly responsible for building all aspects of the financial organization including policies & procedures, billing processes, systems, staffing and reporting.

Mr. Lazzara has public accounting experience with PricewaterhouseCoopers with industry expertise in the leasing, manufacturing, and retail sectors, and he served as an internal auditor for Goldman Sachs with an emphasis in compliance and internal controls reviews. While at Goldman Sachs, he supported the firm’s internal control environment by devising and implementing fraud prevention initiatives.

Mr. Lazzara has extensive experience directing acquisition-related purchase price dispute assignments and has teamed with FTI Consulting colleagues to serve as neutral accounting arbitrators. He has managed international arbitration cases involving corporate mergers and acquisitions in the financial services, beverages and automobile accessories manufacturing industries.

Mr. Lazzara was retained and provided his expert opinion in a $5 million Purchase Price dispute within the telecommunications industry dealing with GAAP interpretations of lease accounting and the adequacy of accounts receivable reserves. Domestically, he has advised on post-M&A disputes in the security alarm, software, metals manufacturing, wholesale eyewear, insurance, packaging and government defense industries.

Mr. Lazzara has experience with class action litigation within the mortgage industry and has advised on complex commercial disputes in the telecommunications, monoline insurance, retail, and uranium mining industries.

He has directed forensic investigations in the hedge fund industry centering on allegations of fraud by investment advisors, has led audit committee and SEC inquiries involving allegations of accountant’s malpractice, and has conducted investigations in support of financial reporting restatements. He has international experience investigating alleged violations of the Foreign Corrupt Practices Act in Asia and Europe.

Mr. Lazzara has led cases involving NYSE regulatory compliance examinations, and has advised on high profile securities litigation cases involving the interpretation and expert application of Generally Accepted Accounting Principles (“GAAP”) and auditor compliance with Generally Accepted Auditing Standards (“GAAS”).

Professional Affiliations
American Institute of Certified Public Accountants
Association of Certified Fraud Examiners
New York State Society of CPAs

Education
B.B.A. in Public Accounting, Pace University.

Certifications
Certified Public Accountant, New York
Certified Fraud Examiner
Certified in Financial Forensics
I. Bobby Majumder

Partner, Perkins Coie LLP

Dallas, TX
+1 214 965 7700
bmajumder@perkinscoie.com

About

Bobby Majumder is a partner in the firm's Corporate practice and Firmwide Co-Chair of the firm's India Practice who focuses on corporate and securities transactions primarily in the following industry verticals: energy (oil & gas and coal), mining, healthcare and information technology. He represents underwriters, placement agents and issuers in both public and private offerings of securities; public and private companies in mergers and acquisitions (both cross-border and domestic); private equity funds, hedge funds and venture capital funds in connection with both their formation and their investments; and companies receiving venture capital and private equity funding.

Bobby advises established companies as well as new and emerging issuers on raising capital from both the public and private markets in the United States and Europe (including Rule 144A/Regulation S offerings). He also advises U.S. and foreign companies in connection with their SEC reporting and compliance requirements, damages at a number of national professional organizations.

Professional Affiliations
- Dallas Bar Association
- Rocky Mountain Mineral Law Foundation
- The Indus Entrepreneurs (TiE), Dallas Chapter
- Cox School of Business, Associates Board
- State Bar of Texas
- Essentials of Business Law Conference, Planning Committee
- University of Texas Securities Regulation and Business Law Conference, Planning Committee

Education
- Washington and Lee University School of Law, J.D. 1993
- Trinity University, B.A., 1990

Bar & Court Admissions
- Texas
- West Virginia
- U.S. Supreme Court
- U.S. District Court for the Eastern District of Texas
- U.S. District Court for the Northern District of Texas
- U.S. District Court for the Southern District of West Virginia