

M&A Post-Closing Disputes: Minimizing and Resolving Disputes Over Working Capital Adjustments and Earnouts

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Agenda

I. Overview of a Purchase Price Dispute

1. Earn-outs & Common Disputes
2. Key Drivers of Earn-out Disputes
3. Working Capital & Common Disputes
4. The Working Capital True-up Process and Key Drivers of Working Capital Disputes

II. Purchase Price Dispute Examples

1. Earn-out Disputes
 - Challenges (covenant of good faith, performance measurements, other challenges)
 - Common Disputes (post-closing conduct of target, measurement of target performance and accounting)
2. Working Capital Disputes
 - Basis of Presentation Sample Language
 - Dispute Categories, “GAAP Consistently Applied” and Key Dates

III. Best Practices to Minimize a Purchase Price Dispute

- a) Earn-out Dispute Minimization Techniques
 - a) Unambiguous Language
 - b) Exhibits & Sample Calculations
- b) Working Capital Dispute Minimization Techniques
 - a) Carve-outs
 - b) Contractual Exhibits
 - c) Closing “Rehearsal”

IV. Resolving a Purchase Price Dispute

1. Litigation Considerations
2. Role of the CPA in Post-closing Dispute
3. Typical Accountant Arbitration Process

I – Overview of a Purchase Price Dispute

Earn-outs

- 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



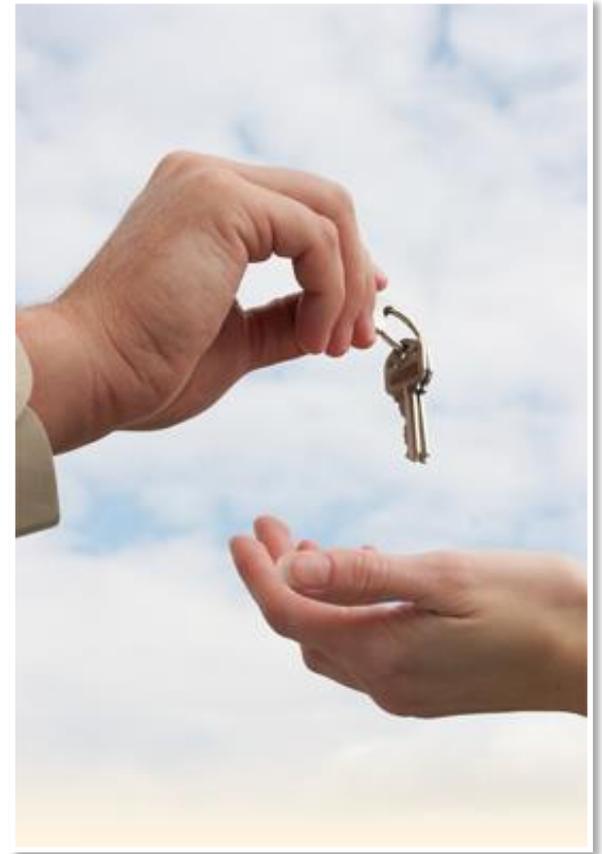
Why Do Earn-outs Appeal to Sellers?

- 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

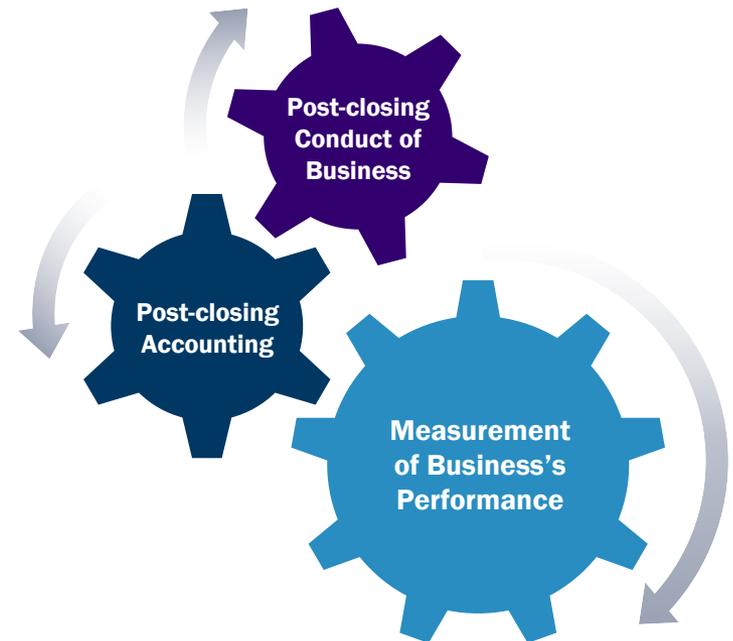
Common Disputes: Earn-outs



Two common Earn-out disputes:

- Was the earn-out target satisfied?
 - Fees/expenses and classification
 - “Earnings” and definitions

- If not, why was the earn-out target not achieved, and who is to blame?
 - Post-closing management
 - Specified post-closing investment¹



1. *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126 (Del. Ch. 2009).

I – Overview of a Purchase Price Dispute

Key Drivers to Earn-out Disputes: Satisfying Targets

■ 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.

1. *Comet Systems, Inc. Shareholders' Agent v. MIVA Inc.*, 980 A.2d 1024 (Del. Ch. 2008).

I – Overview of a Purchase Price Dispute

Key Drivers to Earn-out Disputes: Satisfying Targets

- 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 Adjustment

- 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.

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 of Working Capital Dispute: “GAAP vs. Consistency”

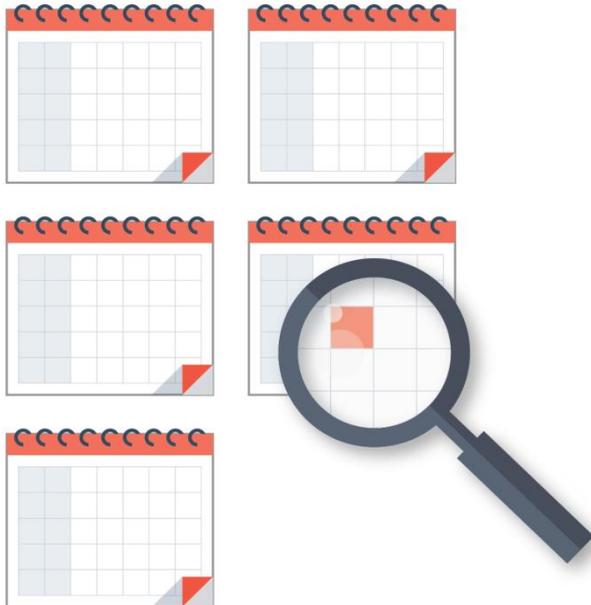
- The most hotly contested issue in a purchase price dispute
- Seller’s position is that its consistent, past practice results in a GAAP compliant presentation
- Buyer’s position is that Seller’s past practice is not GAAP and results in an incorrect accounting treatment
- Agreement language re: “basis 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 Drivers: Calculation of Timing

Earn-Out

Working Capital



Purchase Price Dispute Examples: Earn-outs

II. Purchase Price Dispute Examples

Earn-out Disputes

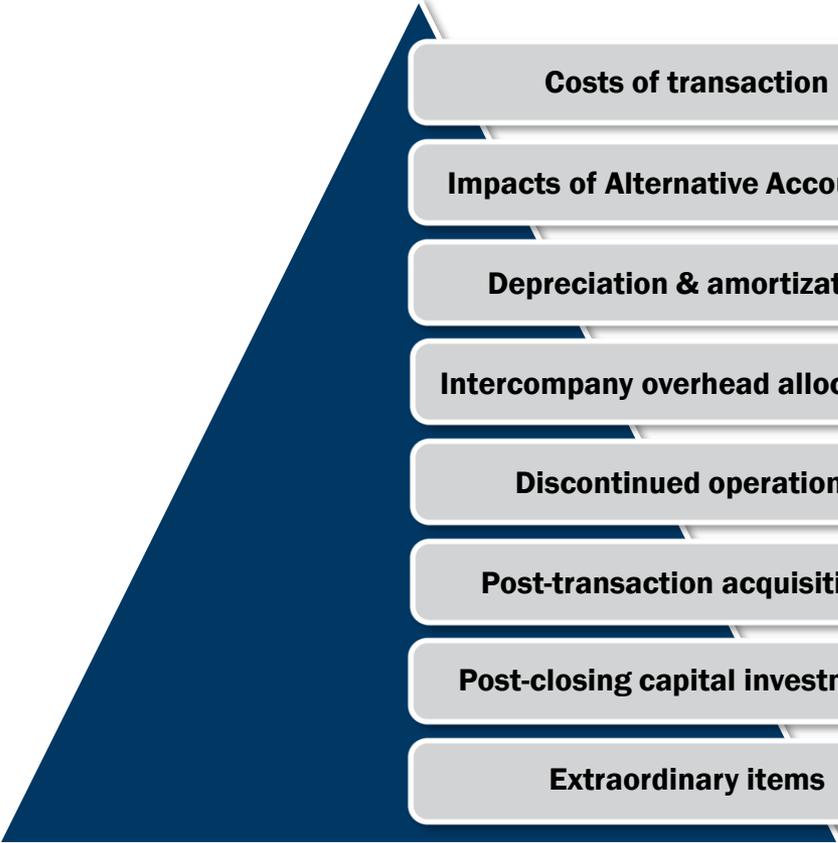
Implied covenant of good faith and fair dealing

- 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
- **Fortis Advisors v. Dialog Semiconductor**, Del. Ch., Jan. 30, 2015
(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

Earn-out Disputes, continued

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	✓ X
Post-transaction acquisitions	✓
Post-closing capital investments	✓
Extraordinary items	✓

II. Purchase Price Dispute Examples

Earn-out Disputes, In Summary

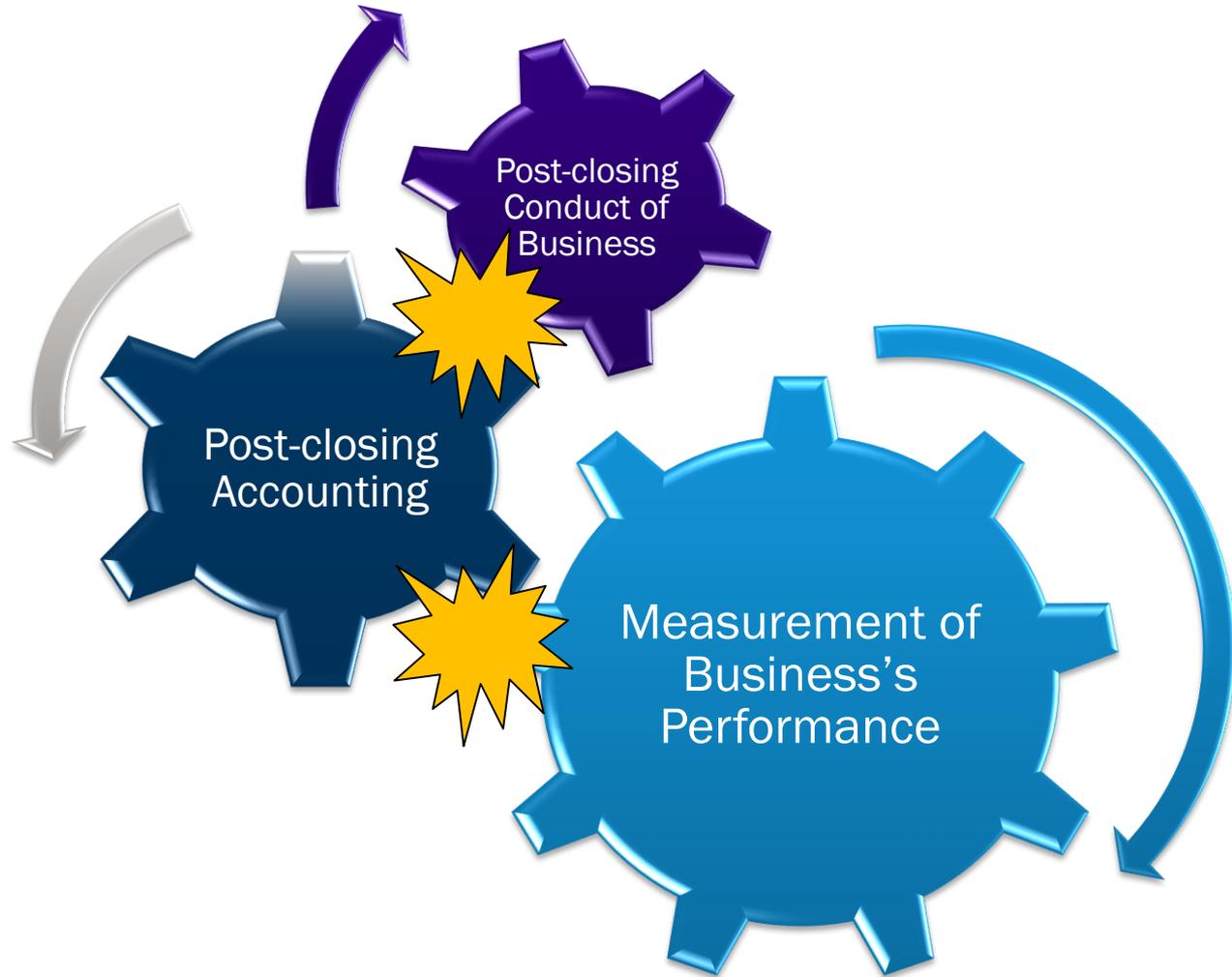
Earn-outs can be challenging because:

- 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!

II. Purchase Price Dispute Examples

Common Disputes Involving Earn-outs



II. Purchase Price Dispute Examples

Earn-outs: Post-Closing Conduct of Business

...By Buyer...	...By Seller Management...
<p>Agreements will often include covenants by Buyer to operate business consistent with past practice or in normal course.</p>	<p>Buyer will seek to ensure Seller management does not operate business solely to maximize earnout payment.</p> <ul style="list-style-type: none"> • Excessive risk taking • Failure to invest in business
<p>Seller desires operation that maximizes earnout, minimizes risk of manipulation.</p> <ul style="list-style-type: none"> • Limit risk of mismanagement • Limit risk of Buyer's operational choices on earnout. 	
<p>Buyer desires to limit influence of Seller on its operation and integration of target.</p>	

II. Purchase Price Dispute Examples

Earn-outs: Post-Closing Operation of Target

When business is operated by Buyer post-closing...

- Perceived management of business to minimize performance measures and in turn the earnout.
- Alleged deviation from consistent historical operating norms.
- Alleged failure to invest in the business / provide for adequate capital.
- Alleged failure to pursue opportunities.
- Alleged impairment of earnout due to discontinuation of business.
- Alleged shifting of sales or customer relationships from target to other Buyer entities.

When business is operated by Seller management post-closing...

- Perceived management of business to maximize performance measures and in turn the earnout.

II. Purchase Price Dispute Examples

Earn-outs: Buyer Operation of Target

- Buyer elects to incur \$2 million of legal fees in order to avoid a \$12 million earnout payment tied to EBITDA.
- Buyer elects to not pursue renewal of a contract with a key distributor resulting in 15% decline in sales.
- In an effort to realize cost savings post-closing, Buyer elects to buyout the contracts of two members of senior management, resulting in \$400,000 of salary/benefit avoidance in the earnout period but costs of \$1 million.
- Buyer accelerates R&D spending post-closing.
- Buyer transfers customer relationships to another operating company.

II. Purchase Price Dispute Examples

Earn-outs: Seller Management Operation of Target

- Seller management made large sales to customers who were ultimately unable to pay their bills, where the earnout was calculated based on gross sales revenues. Buyer alleges Seller management knew the customers would be unable to pay.
- Seller management failed to perform proper maintenance on equipment during a three year earnout period, increasing depreciation expense instead. The earnout was based on EBITDA, thus the impact was that the earnout was enhanced by not incurring maintenance costs.

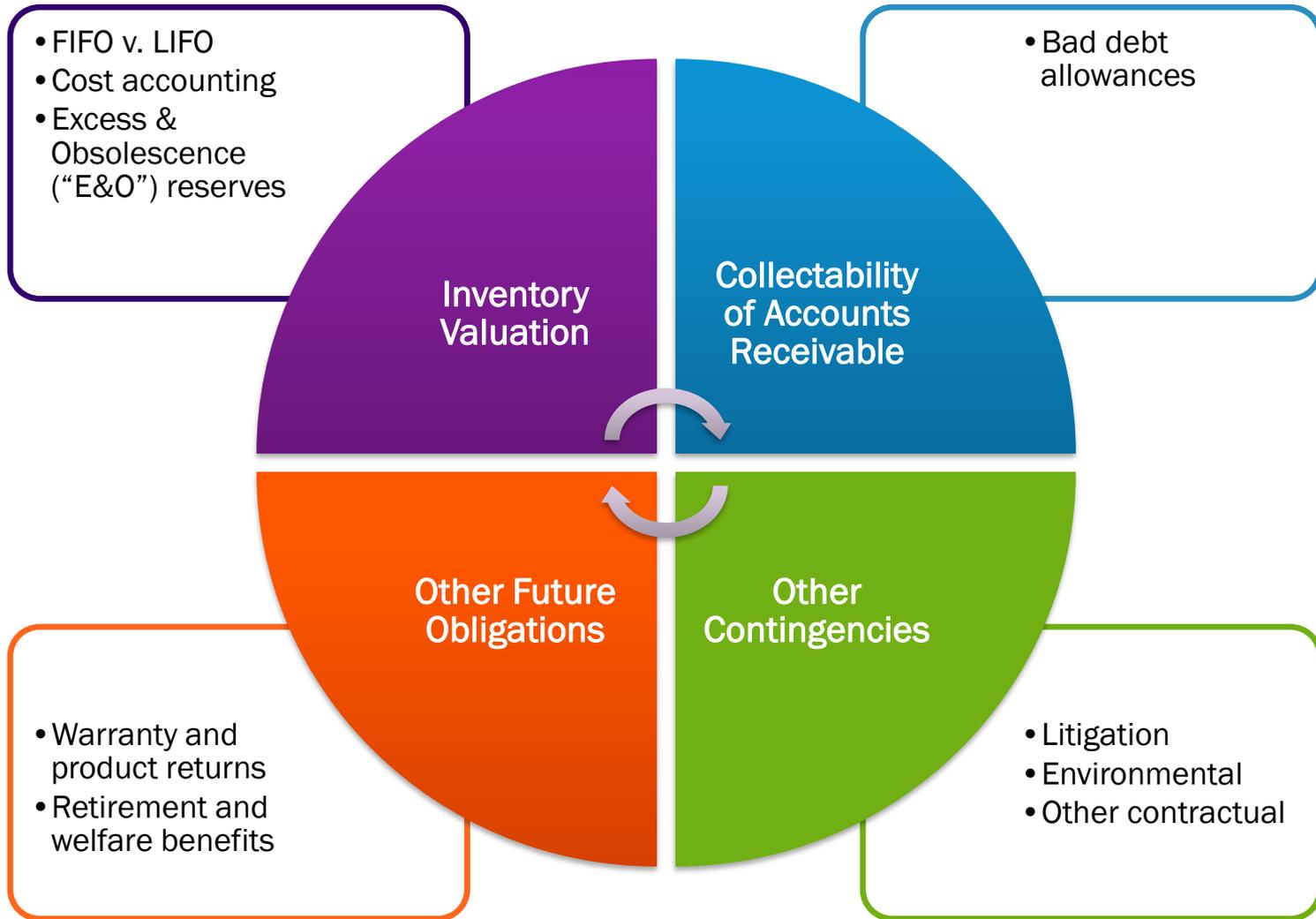
II. Purchase Price Dispute Examples

Earn-outs: Post-Closing Accounting Methodologies

- Many agreements include a covenant to continue accounting for the target's activities "in accordance with GAAP, consistently applied" with target's historical accounting policies.
- Generally disputes arise from:
 - Adoption of alternative to historical accounting policies.
 - May be an alternative GAAP consistent with Buyer's accounting.
 - May assert historical accounting was not GAAP.
 - Changes to conform with newly promulgated GAAP.
 - Should Seller's earnout compensation be impacted by such changes in GAAP?

II. Purchase Price Dispute Examples

Earn-outs: Accounting Areas Prone to Dispute



II. Purchase Price Dispute Examples

Earn-outs: Costs of Transaction

- During 2013, Buyer acquired the target business for \$100 million. The acquisition included an earnout in 2014, such that Seller would receive additional consideration if the target achieved 2014 net income of \$7.5 million.
- As part of the acquisition, the Buyer incurred certain costs and interest expense associated with financing post-closing.
- As a consequence of these expenses, 2014 net income fell below the \$7.5 million.

II. Purchase Price Dispute Examples

Earn-outs: Examples: Goodwill Amortization

- During 2013, Buyer acquired the target business for \$100 million. The acquisition included an earnout in 2014, such that Seller would receive additional consideration if the target achieved 2014 net income hurdle of \$7.5 million.
- As part of the acquisition, Buyer recorded goodwill of \$10 million. During 2014, Buyer determined \$5 million of goodwill was impaired based on projected future cash flows and carrying value of assets.
- As a consequence of the \$5 million impairment charge, 2014 net income was \$4.0 million.

II. Purchase Price Dispute Examples

Earn-outs: Depreciation Expense

- During 2013, Buyer acquired the target business for \$100 million. The acquisition included an earnout in 2014, such that Seller would receive additional consideration based on 2014 EBIT.
- Post-closing, Buyer initiates new depreciation policy that shortens useful life and increases 2014 depreciation expense (change in estimate accounted for prospectively).
- Buyer asserts change is warranted and that Seller has artificially enhanced earnings historically by exaggerating useful lives of equipment.
- Seller asserts a deviation from past-practice.

Purchase Price Dispute Examples: Working Capital

II. Purchase Price Dispute Examples

Working Capital: Basis of Preparation Sample Text

SPA/APA “GAAP Working Capital” Sample Excerpts

1. The Closing Date Working Capital (CDWC) 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?”

	Per Seller	Per Buyer	Difference
Current Assets			
Cash	\$ -	\$ -	
Certificate of Deposit	-	-	
Accounts Receivable	153,752,000	153,752,000	-
Less: Allowance for Bad Debt	(5,500,000)	(13,187,600)	(7,687,600)
Merchandise Inventory	158,446,465	150,446,465	(8,000,000)
Prepaid Expenses	3,950,000	3,800,000	(150,000)
Total Current Assets	\$310,648,465	\$294,810,865	(15,837,600)
Current Liabilities			
Accounts Payable	\$114,508,000	\$114,508,000	-
Accrued Liabilities	6,750,000	10,950,000	(4,200,000)
Taxes Payable	758,000	758,000	-
Wages Payable	20,000	20,000	-
Total Current Liabilities	\$122,036,000	\$126,236,000	\$(4,200,000)
Closing Date Working Capital =	\$188,612,465	\$168,574,865	-\$20,037,600

II. Purchase Price Dispute Examples

Working Capital: “GAAP Consistently Applied”

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

Buyer’s Position

Seller’s method is inadequate for estimating uncollectible A/R since it is prudent to reserve at 90% of all A/R > 120 days outstanding.

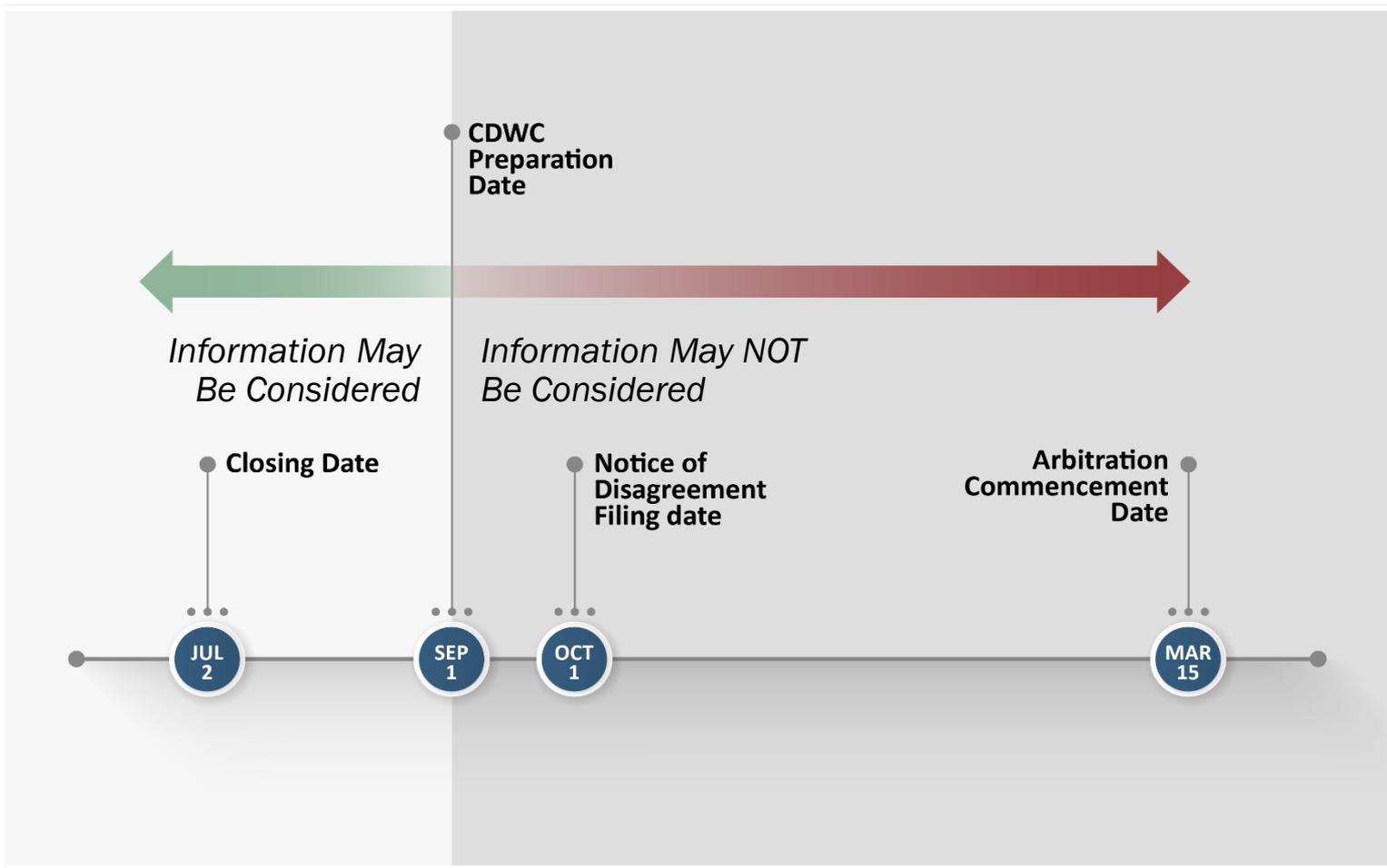
Seller’s Position

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.

■ **Question: Which version is “GAAP consistently applied?”**

II. Purchase Price Dispute Examples

Working Capital: Key Dates for Closing Date Balance Sheet & Net Working Capital Calculation



Best Practices to Minimize Disputes

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

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.

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

IV. Resolving a Purchase Price Dispute

The Role of a CPA in a Post-Acquisition Dispute



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:





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

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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.

Professional Affiliations

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Education

University of North Carolina School of Law, 1995, JD, with high honors

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Bar & Court Admissions

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Court of Appeals for the State of Georgia

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About

Jeff Litvak is a Senior Managing Director at FTI Consulting and is based in Chicago. Mr. Litvak is a Certified Public Accountant (CPA), Accredited in Business Valuation (ABV), an Accredited Senior Appraiser (ASA) in business valuation, and is Certified in Financial Forensics (CFF) with the AICPA. Mr. Litvak specializes in forensic accounting investigations and valuation matters, assessment of economic damages, analysis of lost profits and unity of interest/separateness matters. Mr. Litvak is one of FTI Consulting's National Product Leaders in merger and acquisition disputes and was the former Co-Chair of the AICPA Task Force on merger and acquisition disputes, where he received the 2009 AICPA Award for Volunteer of the Year for his achievements. He has also served as a National Valuation Instructor for the American Society of Appraisers. In 2010, Mr. Litvak was appointed to the AICPA's Executive Committee for the Forensic and Valuation Section and sits on the AICPA Bankruptcy and Insolvency Task Force. This task force focuses on restructuring challenges and bankruptcy and solvency disputes. Mr. Litvak is a National Instructor for FTI Consulting and teaches a three day course on economic damages. Further, Mr. Litvak is the primary damages instructor for the AICPA related to its boot camp on expert testimony.

Mr. Litvak has experience in a cross section of industries such as insurance, real estate, manufacturing, wholesaling, construction, high tech, automotive, financial services, healthcare, and pharmaceutical. His extensive experience in accounting and auditing, market penetration analysis, and corporate finance provide a strong background for analyzing damages in many types of business litigation. He has worked on significant matters for the United States Department of Justice and Internal Revenue Service on valuation and other corporate finance matters. Lastly, Mr. Litvak and others from FTI Consulting were asked to teach valuation and damages applications of mergers and acquisitions to members of the Chinese Appraisal Society, who made a special trip to the United States to gain perspective on performing valuation work in the United States.

Mr. Litvak has provided expert opinions in federal, state, and municipal courts throughout the United States on matters involving post-acquisition disputes, breach of contract damages, employee termination, lender liability, healthcare fraud and abuse, antitrust, lost profits, and destruction of business within the financial services, internet and healthcare industries.

I. Matthew Ogurick

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About

Mr. Ogurick is a partner in the firm's corporate practice. He has broad experience in counseling public and private companies based in the United States, Europe and Asia, private equity firms and their portfolio clients, hedge and venture capital funds, sponsors, and entrepreneurs across a broad spectrum of legal matters with particular emphasis on mergers and acquisitions, joint ventures, public offerings and private placements of convertible debt and equity securities including ADR listings, SEC reporting and compliance, national exchange listings, corporate finance, legal opinion practice and early stage company structuring, formation and funding. Mr. Ogurick represents clients across a broad range of industries including infrastructure, commercial real estate, online advertising, federal government contracting, nuclear medicine, solar, health care laboratory, nanotechnology, and augmented and virtual reality. In addition, Mr. Ogurick counsels corporations and their boards of directors on matters of corporate governance.