Floyd Advisory

Expert Tips for Avoiding Common M&A Pitfalls

Part 1: Pre-Deal Risk Mitigation

Introduction

M&A transactions come in all shapes and sizes. Thus, it follows that no two M&A disputes are ever the same. That being said, they do all have at least one thing in common: the requisite use of valuable resources, especially time and money. Although these disputes may seem inevitable at times, we have leveraged our experience within the industry to distill several key precautions that can be taken pre-deal to either avoid disputes altogether, or to improve your position(s) should a dispute arise.

1. Use Explicit Contract Language

Loose or vague contract language can create significant obstacles to a successful transaction. While there are instances where specificity cannot be employed, the use of explicit contract language is one of the most imperative preventative measures to secure your position.

Clear and concise contract language that preemptively addresses potential situations can protect your company from unreasonable claims. Not only is clear language helpful in guiding processes early in a dispute – for example, identifying timelines and channels for communications or specifying the selection process of a potential arbitrator – but if parties cannot agree on a resolution, such language is helpful in reducing risk as the dispute heads towards arbitration or trial. Certain arbitrators will rely purely on contract language in making their decision without looking at additional submissions or arguments, or without considering fairness. Others may focus on the equitable nature of an agreement, or the "spirit" of a negotiated contract, which opens the door for interpretation. Laying out explicit rules and practices for potential issues protects you from future misinterpretation by the opposing side, as well as by an arbitrator (if applicable), particularly in areas that contain room for judgment within GAAP (or IFRS). Relatedly, the AICPA Practice Aid for M&A Disputes ("AICPA M&A Guide") states:

> "Most agreements contain a clause requiring that the closing balance sheet conform to GAAP consistently applied over a relevant period or point in time that predates the sale. Parties involved in transactions often mistakenly believe that GAAP clearly defines one right number. Arguments then arise about whether the accounting method that the seller applied is more appropriate than the accounting method that the buyer prefers."[1]

Preemptively addressing ambiguous language and other common pain points in negotiated contracts will help avoid some M&A disputes. However, certain disputes may arise regardless of contract language, and when this happens, the quality of the contract has a significant impact on the strength of your position.

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CASE STUDY 1

In a dispute involving the sale of a company with existing lease agreements for certain leased facilities, amendments to the agreements (including extension terms and renewal options) were negotiated with the properties' landlord to facilitate the transfer of the leases from seller to buyer. The buyer contended that these amendments required the reclassification of two of the leases from operating leases to finance leases and the increase in obligations of a third lease that was already classified as a finance lease, resulting in an increase in indebtedness and subsequent downward adjustment to the base purchase price at closing.[2] (Note, the sale agreement required obligations of finance leases, but not operating leases, to be included in indebtedness).

(continued on pg. 2)

[1] AICPA Forensic and Valuation Services Practice Aid – Mergers and Acquisitions Disputes, at pg. 29.

[2] Understanding that the base purchase price of an agreement (i.e., the accepted offer price prior to the closing of a transaction when transferred account balances can be measured) is often measured on a cash-free, debt-free basis, and based on an assumed normalized level of NWC, adjustments for any actual cash transferred, debt assumed (i.e., indebtedness), or working capital in excess/deficit of such normalized level creates a need to adjust the base purchase price at closing.

CASE STUDY 1 (CONTINUED)

However, the sale agreement also contained several provisions governing how the closing statements, including indebtedness, were to be prepared. Specifically, one provision provided that the closing statements were to be prepared to exclude the impact of any change in ownership of the company. A second provision provided that no leases classified as operating leases in the seller's closing statement would be reclassified as finance leases in the buyer's closing statement. A third provision provided that the closing statements should be prepared based on facts and circumstances as of a specific date and time, without adjustments for events after such time – the lease amendments were dated and signed after this time. The specificity of these provisions provided significant protection for the seller in this dispute, which contributed to the parties reaching a settlement.

Negotiating explicit contract language can help mitigate unreasonable claims and a protracted dispute resolution process.

2. Review Accounting Policies, Including for Consistency with Past Practices and GAAP

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A diligent assessment of a company's accounting policies, practices, and procedures (in the case of a seller, well in advance of a liquidity event) can facilitate a smoother closing process, as many contracts include language requiring consistency with past practices when generating closing statements. It is helpful to both buyers and sellers for a company to maintain well-documented policies and to consistently apply its accounting practices and procedures under those policies, as this sets the limited framework within which either party can prepare its closing statement. For example, a seller may try to subtly switch accounting methods between financial statements prepared in the negotiation and execution of the acquisition agreement and those prepared for closing, while a buyer may try to switch accounting methods between a seller's estimated closing statement and final closing statement.

Many arbitrators refer purely to consistency with past practice when making their arguments or decisions. As the AICPA M&A Guide states:

> "… the consistent use of an acceptable accounting method will typically prevail over a claim to change to a preferable accounting method. If the preparer of the financial statements has consistently applied an accounting method that is in accordance with GAAP, a neutral accountant would not normally take exception."[3]

GAAP is a set of standards designed to improve consistency and comparability of financial information, but it does not, in all cases, define a specific accounting practice or calculation. Some contracts prescribe the hierarchy of accounting treatment in the event of arbitration. Absent explicit direction, however, arbitrators may indeed rely on consistency in their determination so long as accounting treatment complies with GAAP.

CASE STUDY 2

In another dispute, a buyer reviewed the books and records of the company it acquired and discovered that there were many contingent liabilities that were undisclosed and unidentified prior to closing. The buyer thus alleged that the company's net working capital ("NWC") was significantly lower than what the seller had calculated, and that it may have been overpaying for the acquisition. Compliance with GAAP and consistency with past practice were both provisions contemplated in the contract, and while the arbitrator noted that these contingent liabilities were in accordance with GAAP,[4] they wanted confirmation that the company had recorded contingent liabilities similarly throughout the past. Since the seller had never recorded similar contingent liabilities in size or nature, the arbitrator ruled against the buyer.

[3] AICPA Forensic & Valuation Services Practice Aid – Mergers and Acquisitions Disputes, at pg. 29.

[4] A loss contingency should be accrued if it is both probable and reasonably estimable. A loss contingency generally does not need to be disclosed unless there is at least a reasonable possibility that a loss will be incurred. GAAP categorizes the range of likelihood that a future event will confirm the incurrence of a liability from probable to remote. The Contingencies Topic uses the terms probable, reasonably possible, and remote to identify three areas within that range. *See* ASC 450-20-25-1, 450-20-25-2, and 450-20-50-3.

"Comprehensive due diligence procedures help identify potential risks before ever proceeding with a transaction."

Of course, parties must consider any potential conflicts with a company's accounting methodology and the application of GAAP. The AICPA further states:

> "Another common issue involves the concepts of GAAP and consistency. Conflicts often arise regarding whether GAAP or consistency takes precedence in applying an accounting method to a particular transaction or particular account balance. When GAAP and consistency requirements appear to conflict, practitioners usually consider GAAP to be the higher and controlling standard. Though important, consistency typically is a secondary consideration to the use of GAAP, unless the acquisition agreement specifically mandates something to the contrary."[5]

The consistent application of accounting methods mitigates some risk of accounting manipulation, allowing buyers and sellers to take greater comfort in a company's methodology and financial reporting within a transaction. It is an important reminder for both buyers and sellers to consider past accounting practices and whether said accounting practice is in accordance with GAAP.

3. Do Not Skimp on Regulatory or Contractual Due Diligence

When buying a company or asset, it is important to invest adequate resources into due diligence, as doing so will result in a better understanding of a target company's operations and historical accounting policies and procedures as well as its regulatory compliance. Comprehensive due diligence procedures help identify potential risks before ever proceeding with a transaction. Sellers are incentivized to use skillful financial advisors that aim to maximize sales proceeds and achieve other benefits for themselves (such as transaction structure and limitations on post-transaction recourse), even if a transaction is conducted on a noncompetitive basis.[6]

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[5] AICPA Forensic & Valuation Services Practice Aid – Mergers and Acquisitions Disputes, at pg. 29.
[6] Gole & Hilger – Due Diligence – An M&A Value Creation Approach, at pg. 90.

For the seller of a company or asset, disclosure and remediation of regulatory or compliance issues are also meaningful precautions. Negotiation periods often last several months and involve significant fees – the emergence of such issues during negotiations can result in failed deals with significant sunk costs or post-acquisition disputes with potential breach of contract and damages claims.

CASE STUDY 3

In one dispute, a buyer acquired the subject company during a competitive bidding process where the initial suitor dropped out, causing deal negotiations to occur within a shortened time frame. While the buyer performed financial and legal due diligence, it did not perform thorough regulatory due diligence before closing. After the purchase, the buyer uncovered significant regulatory compliance issues. While the buyer spent millions of dollars attempting to remediate the situation, the issues proved too vast to overcome and fundamentally contributed to the business's bankruptcy. The buyer later discovered that less than a year prior to the acquisition, another potential buyer had considered making the same acquisition, but backed out after completing a detailed regulatory diligence review that identified the company's extensive history of regulatory noncompliance.

"While it is obvious that opposing parties in a negotiation will have interests that do not align ... there may be other parties involved in transactions whose interests may inappropriately or unknowingly lean towards one party."

CASE STUDY 4

In another matter, a private equity firm invested in a new portfolio company without fully understanding or appreciating the detailed covenants of the portfolio company's credit facility. The investment professionals were under the impression that their investment was over-collateralized due to the nature of the portfolio company's balance sheet. However, the portfolio company continued its historical pattern of operating with significantly negative cash flows, and within a few months after closing, the portfolio company was starting to breach various financial covenants of its credit facility. In this case, the credit agreement was very favorable to the lender, and the lender ended up foreclosing on the business a few months later. The private equity firm lost its entire investment in less than one year.

Regulatory compliance involves more than just checking the box for various laws and regulations. Maintaining regulatory compliance has real financial impacts on the bottom line, whether in the form of ensuring the company's headcount is adequate, anticipating the need for consultants for training, implementation, or remediation, or understanding additional future capital expenditure needs to address specific requirements. Compliance also goes beyond legal considerations – it is important to understand the macro and micro considerations of significant contractual obligations. Thus, it is wise to conduct extensive due diligence, especially as it pertains to regulatory and contractual compliance, to best identify as many potential risk areas as possible and to either address any items of concern or adjust the purchase price before entering into a transaction.

4. Be Wary of Conflicts of Interest

It is always important to consider that negotiating parties may have conflicts of interest, including the buyer and seller in an acquisition. Each side is acting according to its own best interests, which often leads to disputes.

While it is obvious that opposing parties in a negotiation will have interests that do not align – for example, working capital adjustments are a zero-sum conflict for a buyer and seller – there may be other parties involved in transactions whose interests may inappropriately or unknowingly lean towards one party. In many negotiated contracts or agreements, multiple third-party advisors such as law firms, investment banking firms, or advisory firms, are hired and expected to assist the party who hired them in achieving the best deal. But what if the parties jointly hired these third-party firms? Or what if they have multiple interests in the negotiation at hand (for example, the existence of other clients who may be affected by the negotiation)?

"It may cost more time or money up front, but requesting conflict checks and having someone (or a team) solely devoted to protecting your interests, starting at the negotiating table, is invaluable."

CASE STUDY 5

In one case, a single law firm represented two parties entering a partnership. We have often seen this type of arrangement arise due to the perceived financial cost savings as compared to hiring separate counsel. Both parties are typically happy and amenable at the start of the transaction, so why rock the boat with an elevated level of professional skepticism? The truth is that this situation should never occur. In this example, the lawyers prioritized the interests of one party (financially and even informationally) to the detriment of the other, even though they each held an equal interest in the joint venture.

CASE STUDY 6

In another case where two partners in a joint venture engaged one law firm to represent both sides, there was no evidence that the law firm itself did anything untoward, unfair, or unequal. Nevertheless, when a dispute eventually arose, one of the parties seized on the fact that there was a shared counsel to levy claims against the other partner of engaging in bad faith and tainting counsel's independence and objectivity. Thus, even the appearance of a conflict of interest presents a risk to either party.

It is an advisor's responsibility to represent an individual (whether a person or a company, etc.), and as illustrated in these examples, having one law firm advocate for two separate parties forming a joint venture or partnership will always result in some degree of conflicting interests. At a fundamental level, each individual's interests are different, and so by definition, one advisor cannot be an advocate for more than one person at the same time. It may cost more time or money up front, but requesting conflict checks and having someone (or a team) solely devoted to protecting your interests, starting at the negotiating table, is invaluable.

Another area to be cautious of regarding conflicts of interest is when company leadership stays with the acquired company after a deal closes. If certain retained employees have a strong relationship with the seller, there could be instances where such employees communicate sensitive information to the seller outside of normal course, or the employees may retain incentives that do not align with the buyer's best interests. Gaining an understanding of pre-existing relational dynamics is therefore also a useful precaution.

Conclusion

There are several factors that can lead to, or exacerbate, disputes in the pre-deal phase of an M&A transaction or other agreement. That is why it is imperative to take preemptive action to bolster your position and prevent such disputes, or at the very least, minimize their potential impact. Common pitfalls, such as vague terminology in contract language, inconsistent accounting methods, failure to conduct thorough due diligence, and failure to consider the conflicting interests of the parties involved, often lead to or complicate disputes and impact the success of a deal.

Floyd Advisory assists parties in managing complex issues that come with engaging in a transaction process, starting with pre-deal risk mitigation efforts – helping to review accounting practices, crafting language in purchase and sale agreements related to post-closing adjustments, and accounting records – and through to any post-transaction dispute processes, including the preparation of damage claims when breaches of representation and warranties arise in post-acquisition disputes.

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Our professionals have served in many roles within transaction service advisory matters, including financial due diligence, ABAC due diligence, risk mitigation pre- and post-close consulting, and accounting experts or triers of facts during arbitration. Our team has worked on thousands of transactions where we have served as financial reporting and accounting experts. Our depth of experience helps our clients protect value during each phase of the M&A Transaction Timeline.

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ABOUT Floyd Advisory
Floyd Advisory is a consulting firm providing financial and accounting expertise in areas of SEC reporting, transaction advisory, investigations and compliance, litigation services, as well as business strategy and valuation.

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