Floyd Advisory

Brian Loughman is a partner and Meghan Mellott is a senior manager at Floyd Advisory LLC. Mr Loughman can be contacted on +1 (646) 449 7268 or by email: bloughman@floydadvisory.com. Ms Mellott can be contacted on +1 (646) 449 7265 or by email: mmellott@floydadvisory.com.

Published by Financier Worldwide Ltd
©2024 Financier Worldwide Ltd. All rights reserved.

Permission to use this reprint has been granted by the publisher.

SPOTLIGHT ARTICLE REPRINT August 2024

Common M&A disputes and lessons learnt

BY BRIAN LOUGHMAN AND MEGHAN MELLOTT

Around 10 percent of all M&A deals end up in some sort of dispute. Often, these disputes are addressed in a private arbitration forum, and sometimes in open court litigation. In our experience, common dispute issues include the use of accounting judgments and estimates, materiality thresholds, monthly close practices, preparation of carve-out financial statements, calculation of 'earn out' thresholds, and potential fraud. In this article, we will summarise some of the practices that can be followed to help avoid or minimise a post-acquisition dispute.

Often, vague or poorly drafted contract language will lead to disagreements over the ultimate purchase price, subsequent earn outs or other benchmarks relevant to the deal structure. These disagreements can be disruptive to the acquired organisation and are also time consuming and expensive. As such, it is critical that companies entering a transaction are cautious and properly equipped with the knowledge to help avoid a dispute.

Pre-deal: risk mitigation

Contract language that is vague or subject to interpretation can result in a dispute down the line. That is why having clearly defined wording and phrases in a contract is imperative. Clear, concise and unambiguous contract language that pre-emptively addresses potential situations can protect a company from unreasonable claims. Also, proper due diligence on behalf of both parties can get a deal to the finish line more easily and quickly. However, even when a deal goes through, more than 75 percent of transactions result in a greater amount of costs and generate lower than expected returns. The buyer should ensure it fully understands the business it is acquiring, including all key financial, operational and compliance areas. The seller should disclose all relevant information regarding the company, including known challenges to the business and any regulatory issues to avoid such issues being found post-closing. It is important to review key accounting policies for consistency with past practices and compliance with generally accepted accounting principles (GAAP).

The due diligence phase is one of the most important phases of an acquisition for the buyer and should be performed by diligence experts. Performing due diligence essentially provides the buyer with comfort knowing that key deal aspects have been verified, investigated and confirmed by independent experts. This process provides assurance to the buyer as to the integrity of the financial and other information provided by the seller and, most importantly, provides assurance that there are no obvious legal issues that are likely to arise post-acquisition.

Post-close: common disputes

Common areas of disagreement post-close include whether the buyer prepared its financial statements in accordance with GAAP and the related impact on the deal pricing, earn outs and working capital adjustments. Deal pricing is typically model driven but will also be influenced by the strategic nature of the acquisition, industry metrics and other factors. Earn outs are contractual provisions that provide the seller with additional compensation post-close if the business satisfies certain targets or goals within a specified period. The intention of an earn-out provision is to align the buyer's and the seller's interests, by providing the seller with a higher purchase price in the long run and protecting the buyer from overpaying at the time of the deal.

The parties sometimes disagree about the targets or calculation used to determine the actual payout amount. Sometimes, the seller may argue that the buyer intentionally operated the company post-close in a manner that would prevent an earn-out payment to the seller, when the business model post-close is entirely different or has been revamped making the calculation of such targets different to the seller's original expectations. Regardless of the nature of the earn-out dispute, it is imperative that the targets agreed upon by the parties are objective and easy to measure, and that the contract terms are clearly defined, including how performance will be measured and calculated. In addition, parties will benefit from including their dispute resolution process within the contract terms to avoid a drawn-out litigation and costly legal fees, such as establishing that any disputes will be resolved through mediation or arbitration.

A working capital dispute arises when the parties disagree over the working capital adjustment to the purchase price post-close. Prior to the close date, the buyer will review financial information of the target, but often there are changes between that date and the actual close date, and therefore, working capital is updated or adjusted to reflect the company's latest financial position as of the close date.

Working capital in simple terms is the difference between a company's current assets and current liabilities. It is generally used to purchase inventory, pay short-term debt and pay day-to-day operating expenses. The working capital adjustment is important because it ensures the company has enough liquidity to support day-to-day expenses post-close.

The purchase agreement should include pre-closing covenants which restrict the seller's ability to manipulate the company's operations or financial condition to manage the working capital in its favour before close. Typically, a few days prior to closing, the seller provides an estimate of working capital that it expects to deliver to the buyer on the closing date as part of the acquisition. Then, the buyer typically has between 60 and 120 days after the closing to calculate the actual working capital delivered, which is compared to the estimate, and the difference is calculated. If the buyer proposes a higher working capital than the seller's estimate, the buyer must repay the seller the difference. If it is lower, the seller must pay the buyer the difference.

While the process seems straightforward, it is often more complex because the purchase contract language may not be clear or precise enough regarding the methodology to be used to calculate the components that make up the adjustment. For example, a lack of precision regarding the accounting method to determine the adjustment, the approach to estimating the collection of certain receivables, or the valuation of inventory can lead to different approaches and a dispute.

When the acquisition target is a division, group of brands or other non-standalone entity, the buyer will prepare carve-out financials to show the performance of the target in recent periods. There can often be disputes over how the carve-out financial statements were prepared and whether such financials are in accordance with GAAP. As the name suggests, carve-out financials are 'one time' financials that are only prepared due to a pending transaction and will be typically subjected to scrutiny of the accounting estimates and judgments made by the buyer. This scrutiny can often result in a post-acquisition dispute centred around compliance with GAAP.

Acting in good faith

M&A transactions include a multitude of agreements between the parties with the intent of providing as much certainty around the transaction as possible. Underlying these agreements is the obligation of each party to act in good faith. Although both parties have their own self-interest, acting in good faith can help avoid a potential negative outcome in a dispute further down the road.

Good faith extends to third parties as well. Between diligence professionals, legal advisers and other experts such as accountants, there may be instances where one or more of these parties have a vested interest in either the company or the buyer's or the seller's position in the transaction, creating a conflict of interest. It is important that all parties have confirmed the independence of third parties assisting with the deal. This also extends to professionals hired to assist in the dispute resolution phase, such as an arbitrator or a mediator.

The buyer and the seller are obligated to disclose any changes in the deal to one another. This includes an initially unforeseeable event occurring that may impact the value or status of the company to be acquired. When a party becomes aware of a change, it needs to consider whether it is required to disclose it. Good faith is not just following the law. It means the buyer and the seller should maintain respect for one another and maintain open and honest communication. This also translates to the parties' actions during a dispute by negotiating in good faith, resulting in parties being more likely to compromise and achieve the most optimal solution for each side.

Conclusion

Often, post-acquisition disputes can be avoided by ensuring clear and concise contract language upfront that both parties agree upon, including the method by which a dispute will be resolved should it arise. In addition, proper due diligence, performed by experienced professionals, is key to ensuring that the company being acquired will satisfy the buyer's expectations post-close.

Another key requirement for a successful M&A deal is transparency from both parties throughout the process. This includes all relevant disclosures from the seller and honesty from the buyer regarding the company's operations once the deal is closed. Sometimes a dispute cannot be avoided, but it may be possible to minimise the impact of the dispute by exhausting all reasonable avenues for mitigation in good faith. ■

This article first appeared in the August 2024 issue of Financier Worldwide magazine. Permission to use this reprint has been granted by the publisher. © 2024 Financier Worldwide Limited.

FINANCIER WORLDWIDE corporatefinanceintelligence