Floyd Advisory

Expert Tips for Avoiding Common M&A Pitfalls

Part 2: Navigating Post-Transaction Issues and Disputes

Introduction

Despite even the best of efforts from buyers and sellers to ensure smooth M&A transactions and post-deal processes, some degree of issues and/or formal disputes may arise. A multitude of reasons may be the cause, and as we discussed in our previous article, there are steps both buyers and sellers can take pre-deal to prevent or mitigate these issues. These include drafting explicit contract language, performing thorough and detailed reviews beyond the typical "quality of earnings" reviews, and/or identifying and addressing conflicts of interest during the negotiation. Nevertheless, should a dispute arise, parties will be much better prepared and have an improved likelihood of a positive outcome if they are well-versed in the best practices of handling post-acquisition disputes.

In this article, we leverage our prior experiences in post-acquisition disputes to offer some expert tips to consider should you find your transaction headed towards a dispute.

1. Have the Proper Resources (Internally and Externally) in Place

The ability to maximize the likelihood of your success in a dispute is often dependent on maximizing all the resources available to support your positions, including both people and documentation.

"The ability to maximize the likelihood of your success in a dispute is often dependent on maximizing all the resources available to support your positions, including both people and documentation."

Importantly, retaining access to as much contemporaneous institutional knowledge as possible is paramount to presenting and supporting your positions. This is why we recommend documenting everything possible during pre-transaction processes, such as written records confirming an understanding, example schedules showing the form of an anticipated calculation, memorialization of accounting practices in place at the time of the transaction (especially in areas of significant judgment or estimation), and other items where having evidence of "what the parties intended at the time of the deal" would be helpful. Additionally, maintaining contact with and having access to those who "lived the transaction" can similarly yield benefits and add credibility to positions taken throughout a dispute process, as firsthand knowledge is always preferable to trying to recall (or reconstruct) intent after the fact as a third party.

Furthermore, the advantage of having knowledgeable and experienced advisors involved throughout the process of an M&A dispute cannot be understated. Having an independent assessment of positions can be invaluable during negotiation and settlement efforts to better elucidate stronger positions (and potentially advise against elongated and costly dispute resolution processes in favor of a settlement, if positions dictate that approach).

Experienced advisors will frequently have familiarity with, and insight into, specific arbitrators or neutral accountants, adding value through and beyond the selection process. They are familiar with how individual arbitrators typically operate and can anticipate the best way to present one's position and/or make recommendations on which arbitrators would be the best fit for the case.

Having experienced advisors involved will also help with the preparation of comprehensive expert opinions – often via experience in similar matters, specialized industry or technical knowledge, and confidence from experience in testimony – or oral presentations, if necessary. They can further assist in generating a positive impression with an arbitrator, neutral, or judge throughout the resolution process.

To be successful and retain credibility, accounting experts must have the experience to opine on a variety of issues (e.g., causation, economic damages, mitigation, application of industry-specific contractual language, or authoritative guidance, etc.) and are often required to attain a minimum level of reasonable certainty.[1] Above all, experts must remain

[1] One prominent judge, the Honorable Richard A. Posner, sums it up nicely when he writes that reasonable certainty is simply code for "[D]oes the court think that, given all of the circumstances, this plaintiff has presented sufficient evidence to make it fair to award it the damages in question?" *AICPA Forensic & Valuation Services Practice Aid – Attaining Reasonable Certainty in Economic Damages Calculations*, at page 4. Further definitions of the reasonable certainty standard are compiled in this practice aid based on a review of authoritative case law. *Id.*, at pages 4, 9.

objective and avoid written or verbal advocacy. Without proper experience or objectivity, experts risk having their credibility questioned, which could render their report or testimony unreliable, ultimately resulting in wasted time and resources while simultaneously putting the affected party at an evidentiary disadvantage.

CASE STUDY 1

In a post-acquisition dispute, the claimants hired experts that were neither well-versed in the specific type of dispute at hand nor familiar with the selected arbitrator. The respondents, on the other hand, hired expert advisors with deep experience in litigation support and relevant experience with the type of dispute at issue. Approaching the arbitration from a well-informed perspective, the respondents' experts used their wealth of knowledge on how various arbitrators had made past decisions to recommend one that would be favorable to the facts and circumstances of the client's situation. Following selection, the claimants' experts were unprepared for the specifics the arbitrator was looking for and were unable to present their positions effectively, whereas the respondents' experts were able to present their position in an appealing and effective way while maintaining their evidence-based objectivity.

"Regardless of how accurately a plaintiff or claimant believes they have represented or calculated its damages, overlooking or failing to act on opportunities to mitigate such amounts will often discredit one's own position and could result in flawed damages figures."

Regardless of your (or your client's) position as the claimant or respondent, ensuring all available resources are in place is a crucial element to success in the dispute process. For example, maximizing the ability to clearly lay out positions, calculating any applicable damages, and mounting an effective rebuttal report to expose flaws and neutralize opposing allegations are all areas where having the right documentation and personnel (including external advisors) are beneficial.

2. Exhaust Reasonable Avenues for Mitigation

When entering a dispute, it is important to make reasonable efforts to minimize damages. Regardless of how accurately a plaintiff or claimant believes they have represented or calculated its damages, overlooking or failing to act on opportunities to mitigate such amounts will often discredit one's own position and could result in flawed damages figures. The inverse also holds true: actively working to reduce losses bolsters the credibility of a plaintiff or claimant and its position.[2]

CASE STUDY 2

In a representations and warranties insurance claim, the buyer alleged that the seller breached its representations of compliance with certain laws and regulations. Resulting damages included various consultant fees paid during remediation efforts, capital expenditures needed to retrofit facilities, and additional personnel headcount needed to maintain compliance with the regulations on a go-forward basis. The claim ended up in arbitration, and the arbitrator decided in favor of the buyer and its claims regarding the consultant fees and capital expenditures, as these were expenses incurred in an effort to mitigate further issues of non-compliance. However, the arbitrator did not side with the buyer on its claim regarding a specific headcount related "loss" because the buyer had failed to hire for the new role, even many months after the breach came to light. This hurt the credibility of the buyer's claim, leading the arbitrator to believe that the "need" for extra headcount was not legitimate.

While mitigation can often take the form of actions, such as spending time and money for remediation purposes, it can also sometimes mean refraining from taking actions that would exacerbate the losses.

[2] Additionally, excess costs or incidental damages incurred in mitigation efforts may even be recoverable damages. *See AICPA Forensic & Valuation Service Practice Aid – Calculating Lost Profits*, at page 71.

CASE STUDY 3

In a purchase price dispute, the buyer attempted to change the tax treatment on revenue resulting from the implementation of a significant accounting change – an issue where the IRS allows filers to defer tax recognition over a multi-year period from implementation date (a commercially favorable election in most circumstances). The buyer attempted to change the company's course and forgo this election, instead opting to file to pay all its potential taxes in year one (or more precisely, asking the seller to pay all potential taxes upfront). In adopting this position, the buyer would have failed to properly mitigate losses. By deferring payment of three quarters of the taxes, the company could have invested the cash and partially offset the tax impacts. The company could also find additional opportunities to offset future tax liabilities with post-closing deductible costs and expenses. The arbitrator ultimately ruled against the buyer in full, undoubtedly in part due to these mitigation considerations.

Ensuring reasonable mitigation can look different depending on the situation. But one thing is certain – failure to even attempt to mitigate damages will rarely help your position.

3. Refrain From Abusing the Purchase Price Adjustment Mechanism

A common source of M&A disputes involves the purchase price adjustment mechanism. Often, this mechanism includes some form of working capital adjustment, which can be a source of conflict for many transactions. Purchase price or working capital adjustments are made when there is a variance in amount of target operating items that are used to determine the purchase price (e.g., cash or accounts receivable) between the negotiated purchase date and the closing date. However, sometimes buyers will use the purchase price adjustment as a means of indemnification against possible future losses by attempting to adjust the economics of how the purchase price was negotiated. For example, the buyer of a company may negotiate for an uncertain tax position that it has no intention of realizing – one that could be adverse to the company or simply unlikely to occur – solely to drive down the purchase price and provide a cushion for potential losses in the future. If at least one of the negotiating parties follows the expert tips included in Part 1 of this article series (i.e., use explicit contract language), such attempts at abusing the purchase price adjustment will typically fall flat, with the working capital adjustment calculation being mechanistic in nature without room to include or exclude extraneous line items. Absent clear language, however, the buyer in this situation would still need to demonstrate that the circumstances

"[I]t behooves respondents and their experts to actively identify areas where the claimants' calculations lack reasonable certainty, as doing so can call into question the validity of their entire claim."

leading to the uncertain tax liability would be more-likely-than-not to occur. If they cannot, the buyer risks a significant loss of credibility in the eyes of the arbitrator.

For these reasons, it behooves respondents and their experts to actively identify areas where the claimants' calculations lack reasonable certainty, as doing so can call into question the validity of their entire claim. Additionally, while a claimant may believe it to be advantageous to overestimate an initial claim of damages, doing so instead opens the door for a respondent to rebut such claims more easily, especially if they are not supported by clear, consistent evidence.

CASE STUDY 4

In one dispute, the buyer tried to argue for an aggressive and uncertain tax position in which the taxing authority would treat an intercompany loan receivable as a dividend and would therefore be taxed as such (rather than as an intercompany receivable) under very specific circumstances. The buyer also admitted to having no intention of submitting this information to the taxing authority, nor was it ever reflected on its financial statements. For this reason, the arbitrator ruled in favor of the seller, stating that the buyer failed to demonstrate facts, circumstances, and information that indicated it was more-likely-than-not that the company would have to pay those taxes.

"When approaching a post-acquisition dispute, acting in good faith – that is, being consistently clear, upfront, and honest – will ultimately benefit your position in the long run."

This is not to say one should refrain from arguing for what they believe is fair and appropriate. There are plenty of instances where the contracts or facts are not clear cut, and a legitimate case can be made for each side. The goal is to be cognizant of the credibility that is at risk, especially when one's position may be seen as overzealous.

4. Stay Cognizant of Long-Term Ramifications

It can be tempting to take aggressive positions for purposes of establishing a stronger starting point in negotiations, or when anticipating that an ultimate ruling on a disputed item will "split" the parties' positions. However, devolving a true commercial dispute into a battle of hyperbole or unsupported assertions can harm one's ability to ultimately prevail.

Post-acquisition accounting disputes, while lacking legal "discovery" phases, will still often include the production of key information, the use of key witnesses, either via contributions to submissions, separate disclosures or even live oral testimony, and (almost always) the ability for the adjudicator to make additional requests or ask additional questions of the parties if facts are in dispute or assertions appear unsupported. As withheld information is revealed throughout this process (as is almost always the case), the credibility of the responsible party will be tarnished.

Additionally, one of the key tenets of GAAP is acting in good faith.[3] When approaching a post-acquisition dispute, acting in good faith – that is, being consistently clear, upfront, and honest – will ultimately benefit your position in the long run. Not only does acting in good faith positively impact the credibility of the parties and any advisors involved, doing so is beneficial to maintaining a relationship between the parties, which can be commercially profitable after the completion of the dispute process.

CASE STUDY 5

In one post-acquisition dispute, the seller was supposed to maintain access to the books and records of the company for several months after the closing date. The buyer, however, denied the seller such access and refused to negotiate in good faith by failing to communicate any objections to the net working capital calculations (the main component of the closing adjustments to the base purchase price).

(continued on pg. 5)

[3] One of the main principles of the GAAP framework is the "Principle of utmost good faith: Every person involved in the accounting process is acting honestly." The Office of Justice Programs Territories Financial Support Center (OJP TFSC).

"[I]n situations with continuing working relationships, it is prudent to maintain a long-term perspective, even if it means failing to maximize a one-time gain."

CASE STUDY 5 (CONTINUED)

When the buyer eventually raised its issues, the parties were forced into expensive arbitration. By withholding documentation and failing to act in good faith, the buyer not only prolonged the dispute process but also lost credibility and subjected itself to increased scrutiny by the arbitrator. The arbitrator ultimately sided heavily with the seller, as the arbitrator was able to see through the bad-faith acts of the buyer after gathering sufficient background and understanding of the case. The seller – which pursued certain fringe claims that were not as strong as its core claims (which could also be viewed as not pursuing claims in good faith) – still ended up paying more fees than it otherwise would have, due to having "lost" these weaker claims. Legal, arbitrator, expert, and other fees add up, so it is beneficial to act in good faith to prevent delays and avoid unnecessary costs. Above all, acting in good faith goes a long way in protecting one's credibility and reputation.

Behavior in post-acquisition disputes should be tailored to the relationship you have with the parties involved. In many M&A deals, the various parties may never interact again and are thus incentivized to minimize cost or maximize value (for the buyer or seller, respectively). However, in situations with continuing working relationships, it is prudent to maintain a long-term perspective, even if it means failing to maximize a one-time gain.

CASE STUDY 6

Another dispute involved a parent company and its former subsidiary that was spun off and began operating independently with a revenue sharing agreement. The agreement specified that one division of the subsidiary did not have to share its revenues – yet when this division experienced explosive success, the former parent company claimed they had a right to such revenues. Even though the contract was explicit, as the dispute materialized, the newly independent company had to thoughtfully consider its approach. There was significant potential for the new company to find itself on the bad side of the parent company, with whom it would continue a working relationship. Throughout the dispute, it was necessary to be mindful of this and act in good faith to preserve their relationship. A win on the merits would not be a full win if it meant damaging the relationship or the firm's ability to generate future revenue.

Acting in good faith does not just entail honesty and legality but involves upfront communication and working together for a mutually positive outcome, especially in the long run. It may also be more time efficient and cost effective to settle claims through good-faith negotiation efforts.

Conclusion

As no perfect solution exists to prevent disputes, companies engaged in M&A activity would be well served to consider their preparedness when disputes inevitably arise. Key areas of consideration heading into a dispute include ensuring proper resources (including respected experts) are in place, ensuring reasonable mitigation avenues are explored, refraining from abusing the purchase price adjustment, and maintaining a long-term perspective, while acting in good faith.

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.

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.

Floyd Advisory is a member of the AGN International association, as well as other international alliance networks.[4]

"[C]ompanies engaged in M&A activity would be well served to consider their preparedness when disputes inevitably arise."

[4] AGN International Ltd is a company limited by guarantee registered in England & Wales, number 3132548, registered office 6 Hays Lane, London Bridge, London SE1 2HB, United Kingdom.

AGN International Ltd (and its regional affiliates; together "AGN") is a not-for-profit worldwide membership association of separate and independent accounting and advisory businesses. AGN does not provide services to the clients of its members, which are provided by Members alone. AGN and its Members are not in partnership together, they are neither agents of nor obligate one another, and they are not responsible or liable for each other's services, actions or inactions.

www.floydadvisory.com

ACKNOWLEDGEMENT
We wish to acknowledge the valuable contribution to this analysis by Jamie Xie, Ami Chauhan, and Michael Phillips.

For more information, please contact William Shea at 646.884.9652 or Danniel Baer at 617.586.1074.

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, data analytics, as well as business strategy and valuation.

New York
1 Penn Plaza, Suite 3310
New York, NY 10119
212.845.9018

Boston
155 Federal Street, 11th Floor
Boston, MA 02110
617.586.1040