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Managing Purchase Price Adjustment Disputes

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Today's Presenters

Stephen Glover is a partner in Gibson Dunn's Washington, D.C. office and has served as Co-Chair of the firm's Mergers and Acquisitions Practice Group. Mr. Glover has an extensive practice representing public and private companies in complex mergers and acquisitions, strategic alliances and joint ventures, as well as other corporate matters. Mr. Glover's clients include large public corporations, emerging growth companies and middle market companies in a wide range of industries. He also advises private equity firms, individual investors and others.

Michelle M. Gourley is a partner in Gibson Dunn's Orange County office and is a member of the firm's Corporate Department. Ms. Gourley practices general corporate and business law, with a focus on mergers and acquisitions and general corporate counseling. Ms. Gourley has significant experience with domestic and international transactions, including acquisitions, mergers, round financings and buy-out options across numerous industries such as manufacturing, medical device and software. Ms. Gourley regularly provides advice to senior management and boards of private companies in connection with their day-to-day operations.

Ron Hauben is senior counsel in Gibson Dunn's New York office and Co-Chair of the firm's Accounting Firm Advisory and Defense Practice Group. Mr. Hauben's practice focus is on bringing the full scope of the firm's legal services to the accounting profession, including regulatory enforcement and litigation defense, corporate governance, counseling and advice on a wide range of risk, crisis management and professional practice issues. Mr. Hauben also has extensive experience counseling with public and private company boards and management on the role of independent auditors and the importance of the independent audit to stakeholders and capital markets.

Marshall R. King is a partner in Gibson Dunn's New York office and is a member of the firm's Class Actions and Securities Litigation Practice Groups. He has extensive experience in commercial and business litigation matters, with particular focus on securities litigation, bankruptcy litigation, and disputes arising out of acquisitions. He often represents buyers or sellers in disputes arising out of acquisitions and has advised companies in disputes concerning their rights under bond indentures.

Christen Morand is a partner at Ernst & Young LLP in the Forensic & Integrity Services practice. She provides litigation support services and alternative dispute resolution services on a variety of matters, including expert testimony, post-transaction disputes, purchase price disputes and analysis and resolution of transaction or contractual provisions. Ms. Morand's experience in providing arbitration and expert testimony services includes net working capital disputes, earn-out disputes, GAAP vs historical consistency issues, GAAP vs IFRS issues and other complex accounting issues. She also has experience conducting accounting and financial fraud investigations, including revenue recognition, asset misappropriation and earnings management.

Topics to be Covered

- Mechanics of Purchase Price Adjustments
- Common Sources of Post-Closing Disputes: An Accountant's View
- Litigating Purchase Price Adjustment Disputes

Mechanics of Purchase Price Adjustments

Purchase Price Adjustments

Why do private purchase agreements include purchase price adjustments?

- Ensure target business is delivered with a "normalized" level of working capital
- Ensure target business has strong enough balance sheet to operate on day one
- Ensure sellers are compensated for profits of the business through closing
- Charge sellers for extraordinary expenses in connection with sale
- Validate buyer's valuation assumptions

Purchase Price Calculation

Overview of Construct, Components and Timing

Typical Construct:	Purchase price to be calculated on a cash-free, debt-free basis, and assuming a normalized level of working capital
Components:	Cash Debt Working Capital
Timing of Calculation(s):	Calculation at Closing Calculation of Adjustment Post-Closing

Purchase Price Calculation Components – Cash

"Estimated Purchase Price" means (i) the Enterprise Value, plus (ii) the Estimated Cash, plus (iii) the Working Capital Overage, if any, minus (v) the Estimated Indebtedness, minus (vi) the Working Capital Underage, if any, minus (vii) the Escrow Amount, minus (ix) the Estimated Transaction Expenses.

Cash:

"Cash" means, as at a specified date, the aggregate amount of all cash and cash equivalents of the Company required to be reflected as cash and cash equivalents on a balance sheet of the Company as of such date prepared in accordance with GAAP, net of (i) any outstanding checks, wires and bank overdrafts of the Company, and (ii) any amounts relating to credit card receivables or Restricted Cash, in the case of each of clauses (i) and (ii), whether or not required to be reported as such under GAAP.

"Restricted Cash" means all Cash and Cash equivalents that are not freely useable and available to the Company because it is subject to restrictions, limitations or taxes on use or distribution either by contract, for regulatory or legal purposes, or is cash and cash equivalents that is collected from customers in advance, is being held on behalf of customers and represents a liability to such customers.

Cash is adjusted on a dollar for dollar basis. Other considerations may include (1) a cap on cash at closing and (2) negotiations on the components of cash that are specific to the target's business, including, for example, the treatment of cash that is "trapped" in foreign jurisdictions for tax or regulatory reasons or that will otherwise be "restricted" on a post-closing basis.

Purchase Price Calculation Components -- Indebtedness

Indebtedness:

Indebtedness is adjusted on a dollar for dollar basis. The components of Indebtedness are subject to negotiation and may include components specific to the target's business (i.e., earnouts, deferred purchase price on acquisitions, etc.).

"Indebtedness" means, without duplication (but before taking account the consummation of the transactions contemplated hereby), (i) the unpaid principal amount of accrued interest, premiums, penalties and other fees, expenses (if any), and other payment obligations and amounts due (including such amounts that would become due as a result of the consummation of the transactions contemplated by this Agreement) that would be required to be paid by a borrower to a lender pursuant to a customary payoff letter, in each case, in respect of (A) all indebtedness for borrowed money of the Company and its Subsidiaries, and (B) indebtedness evidenced by notes, debentures, bonds or other similar instruments; (ii) all obligations of the Company and its Subsidiaries evidenced by any surety bonds, letters of credit or bankers' acceptances or similar facilities; (iii) all obligations under capitalized leases with respect to which the Company or any of its Subsidiaries is liable, determined on a consolidated basis in accordance with GAAP; (iv) any amounts for the deferred purchase price of goods and services, including any earn out liabilities associated with past acquisitions; (v) all liabilities with respect to any current or former employee, officer or director of the Company or any of its Subsidiaries that arise before or on the Closing Date, including all liabilities with respect to any Plan, all accrued salary, deferred compensation and vacation obligations, all workers' compensation claims, any liability in respect of accrued but unpaid bonuses for the prior fiscal year and for the period commencing on [first day of fiscal year] and ending on the Closing Date, and any employment Taxes payable by the Company or any of its Subsidiaries with respect to the foregoing; (vi) unpaid management fees; (vii) all deposits and monies received in advance; (viii) all indebtedness created or arising under any conditional sale or other title retention agreement with respect to property acquired by the Company or any of its Subsidiaries; and (ix) all obligations of the type referred to in clauses (i) through (viii) of other Persons for the payment of which the Company or any of its Subsidiaries is responsible or liable, as obligor, guarantor, surety or otherwise, including any guarantee of such obligations.

Purchase Price Calculation Components – Working Capital

Working Capital:

"Target Net Working Capital" means $[__].

"Net Working Capital" means, as at a specified date and without duplication, an amount (which may be positive or negative) equal to (i) the consolidated current assets of the Company and its Subsidiaries minus (ii) the consolidated current liabilities of the Company and its Subsidiaries, in each case before taking into account the consummation of the transactions contemplated hereby, and calculated in accordance with the Applicable Accounting Principles; provided, however, for the avoidance of doubt, Net Working Capital shall exclude any amounts relating to or included in Cash, Indebtedness, Transaction Expenses or Taxes (including current or deferred) to the extent such amounts are reflected in the calculation of the Purchase Price (to avoid any double-counting with any other adjustments).

"Estimated Net Working Capital" means the Net Working Capital based on the Preliminary Closing Statement.

"Working Capital Overage" shall exist when (and shall be equal to the amount by which) the Estimated Net Working Capital exceeds the Target Net Working Capital.

"Working Capital Underage" shall exist when (and shall be equal to the amount by which) the Target Net Working Capital exceeds the Estimated Net Working Capital.

Working capital results in a dollar for dollar adjustment only to the extent the Net Working Capital differs from the Target Net Working Capital. Both the amount and the components of Net Working Capital are subject to negotiation and may include components specific to the target's business.

Setting the Working Capital Target

The purchase price for a company to be acquired typically contemplates a "normal" level of working capital. A working capital adjustment seeks to adjust for any deviation in the delivered working capital versus this assumed "normal" level.

- Target working capital amount will be a specific agreed amount set forth in the acquisition agreement
  Target will typically be fixed to approximate what working capital should be as of the anticipated closing date (including, in appropriate cases, the effect of seasonal variations)
  - Actual working capital amount will depend on what happens between signing and closing
- Purpose of working capital adjustment
  - Protects Buyer and Seller against changes from the company's normal operating working capital level, which can significantly impact deal economics
  - Ensures Buyer that acquired company will have sufficient working capital for a smooth transition and continued operations in the ordinary course after the acquisition is complete
    - Buyer does not want to have to borrow or contribute additional capital for the acquired business to run normally
  - Prevents Seller from depleting working capital during the period between signing and closing to increase the effective purchase price
    - Accelerate collection of debts
    - Delay purchase or sale of inventory
    - Delay payment of liabilities
  - Protects Seller if additional capital influx is needed due to unusual liabilities or other atypical adverse changes

What is Working Capital?

"**Working capital**" represents the capital necessary for a company to fund its normal commercial activities on a day-to- day basis. It is defined in its most basic form as "**current assets less current liabilities**"

Components Generally Included	Components Generally Excluded
Trade receivables	Cash (depends on treatment of cash)
Inventory	Interest receivables
Prepaid expenses	Fixed assets
Trade accounts payable	Goodwill
Accrued wages and bonuses (< 1 year)	Lines of credit
Accrued vacation (< 1 year)	Long-term debt
Accrued medical insurance	Current portion of long-term debt
Other accrued operating expenses	Past-due accounts payable
Deferred revenue (if cannot negotiate as net debt)	Restructuring reserves
	Pension liability
	Deferred taxes

Tax assets and liabilities are often excluded from the calculation of net working capital and treated as Indebtedness (under a "your watch, our watch" approach. Sometimes parties negotiate to include the current portion of certain tax liabilities in the calculation of the target and actual working capital numbers.

Preliminary Considerations in Calculating Working Capital

- Parties have different objectives for the adjustment
  - Buyer seeks to have working capital target set as high as possible, to prevent upward adjustment of purchase price
  - Seller seeks to have working capital target set as low as possible, to prevent downward adjustment of purchase price
- Working capital adjustment may not be a dollar for dollar adjustment, and can be made via various mechanics
  - Closing working capital v. target working capital
    - Requires an adjustment only when amounts are greater or lesser than a stipulated peg dollar amount
  - One-way only (cap or floor)
    - Cap is the upper limit to any adjustment Buyer would have to pay Seller
    - Floor is limitation on amount Seller would have to pay or return to Buyer
  - Collar/band
    - Includes both cap and floor
  - De minimis threshold
    - Range within which neither party has to pay adjustment

Working Capital Benchmark Considerations

Target working capital and components of working capital need to be defined in the purchase agreement. But there is no “right” or “wrong” in the definition – this is a construct of the contract and is negotiated by the parties.

Typical factors to consider in pegging benchmarks:

- Seasonality
- Acquisitions during the measurement period, whether planned or permitted by the purchase agreement covenants
- Accounts receivable with extended terms
- Growth versus mature business
- Company’s past practices of managing working capital, including stretching payables and accelerating collection of receivables, adjusting reserves, etc.
- Payment of income taxes during the measurement period or post-closing
- Intercompany payables/receivables
- Unusual transactions
- Industry factors
- Interim versus year end accounting (true-up of bonuses, reserves, etc.)
- Multinational business and currency fluctuations

Purchase Price Calculation Components (Continued)

Other Adjustments to Purchase Price:

"Transaction Expenses" means the aggregate amount of any and all fees and expenses incurred by or on behalf of, or paid or to be paid directly by, the Company Subsidiaries or any Person that the Company pays or reimburses or is otherwise legally obligated to pay or reimburse (including any such fees and expenses incurred by or on behalf of the Seller) in connection with the negotiation, preparation or execution of this Agreement or the Ancillary Agreements or the performance or consummation of the transactions contemplated hereby or thereby, including (i) all fees and expenses of counsel, advisors, consultants, investment bankers, accountants, auditors and any other experts in connection with the transactions contemplated hereby; (ii) any fees and expenses associated with obtaining necessary or appropriate waivers, consents, or approvals of any Governmental Authority or third parties on behalf of the Company or any of its Subsidiaries in connection with the transactions contemplated hereby; (iii) any fees or expenses associated with obtaining the release and termination of any Encumbrances in connection with the transactions contemplated hereby; (iv) all brokers', finders' or similar fees in connection with the transactions contemplated hereby; and (v) any change of control payments, bonuses, severance, termination, or retention obligations or similar amounts payable in the future or due by the Company in connection with the transactions contemplated hereby, including any Taxes payable in connection therewith.

"Inventory Amount" shall mean the physical count of Inventory, as rolled forward or backward from the date of the account, so as to be the amount of Inventory existing as of the Closing Date, as agreed to by the Seller and the Buyer in accordance with this Section 2.4. If the parties cannot agree on the results of such count, the Buyer shall use its calculation of the Inventory Amount for purposes of the Final Closing Statement, and any disputes shall then be settled by the Independent Accounting Firm in accordance with Section 2.4(d).

Preliminary and Final Closing Statements

Estimated Purchase Price	
Enterprise Value	65,000,000
(+) Estimated Cash	902,900
(+) Estimated Net Working Capital Overage	115,098
(-) Estimated Indebtedness	(364,899)
(-) Estimated Net Working Capital Underage	-
(-) Adjustment Escrow Amount	(3,000,000)
(-) Indemnity Escrow Amount	(5,000,000)
(-) Estimated Transaction Expenses	(506,250)
Estimated Purchase Price	**$ 57,146,849**

Estimated Purchase Price	Original Amount	Final Amount	Difference
Enterprise Value	65,000,000	65,000,000	-
(+) Estimated Cash	902,900	795,094	(107,806)
(+) Estimated Net Working Capital Overage	115,098	66,999	(48,099)
(-) Estimated Indebtedness	(364,899)	(332,543)	32,356
(-) Estimated Net Working Capital Underage	-	-	-
(-) Adjustment Escrow Amount	(3,000,000)	(3,000,000)	-
(-) Indemnity Escrow Amount	(5,000,000)	(5,000,000)	-
(-) Estimated Transaction Expenses	(506,250)	(575,000)	(68,750)
Estimated Purchase Price	**$57,146,849**	**$56,954,550**	**($192,299)**

Purchase Price Adjustment Timeline

CD – 3 to 5: Pre-Closing Calculations

- Seller prepares closing statement with reflecting estimated cash, indebtedness, working capital and transaction expenses
- Buyer may have opportunity to comment upon or challenge Seller's estimate
- Often, not enough time to resolve disagreement prior to closing

Closing Date ("CD"): Closing

- Closing of acquisition
- Payment of purchase price based on estimated cash, indebtedness, working capital and transaction expenses

CD + 30 to 60: Post-Closing Calculations

- Buyer typically prepares actual closing statement based on closing accounts
- Seller may want to prepare post-closing statement, but Buyer will be in a better position as it controls the books and records
- Preparing party has an advantage in dispute resolution due to narrow parameters for challenge

CD + 60 to 120: Review

- Seller reviews Buyer's closing statement and either accepts or challenges statement
- Generally, silence is presumed to be agreement
- Final closing statement becomes binding unless challenged within specified time period

CD + 75 to 150: Arbitration

- In the event of dispute, parties will negotiate further
- If cannot resolve dispute, calculations are submitted to independent accounting arbitrator

CD + 80 to 160: Final True-Up

- Final settlement of working capital adjustment

Purchase Price Adjustment – Potential Sources of Dispute

A primary driver of working capital adjustment disputes concerns the accounting principles used to calculate working capital.

- What accounting policies will govern?
  - Buyer generally wants "in accordance with GAAP, consistently applied" (i.e., typically termed a GAAP override)
  - Seller generally wants consistency with the prior accounting methodology and practices used as the basis for calculating target working capital
- Conflicts often arise as to whether GAAP or consistency takes precedence
  - Seller may have used a consistent practice, but historical amounts may not have been in compliance with GAAP, or may simply have resulted from Seller's bad accounting practices
  - Buyer wants ability to go back and challenge the GAAP basis of original balance sheet amounts
  - Seller wants to close off Buyer challenges to original balance sheet amounts, arguing that purpose of the adjustment is solely to measure change between signing and closing
  - Past poor accounting practices may distort the results, but lack of consistency in application (or less than optimal, but still acceptable, practices) when the actual working capital is calculated can also cause distortion
- Even if GAAP is followed, it may not be followed consistently
  - GAAP itself in many circumstances permits different methodologies in producing GAAP-compliant financials
  - Variations in GAAP methodologies, such as for inventory valuation, can dramatically affect the working capital calculation
  - Often, the acquisition agreement will provide for "GAAP, applied on a basis consistent with the preparation of the company's audited financial statements"
    - Prevents Buyer from seeking that "preferable" GAAP policies be followed

Impact on Drafting

Buy-Side Language

Closing Net Working Capital shall be calculated in accordance with GAAP applied on a basis consistent with the preparation of the Balance Sheet (provided, that in the event of a conflict between GAAP and consistent application thereof, GAAP shall prevail), subject to such differences in accounting principles, policies and procedures as are set forth on Schedule A hereto (GAAP as so modified pursuant to Schedule A, the "Applicable Accounting Principles").

Sell-Side Language

Closing Net Working Capital (i) shall be calculated on a basis consistent with Schedule A hereto and the accounting principles, practices, assumptions, conventions and policies referred to therein, including any exclusions or deviations from GAAP therein (the "Applicable Accounting Principles") and (ii) shall be based exclusively on the facts and circumstances as they exist prior to the Closing and shall exclude the effects of any event, act, change in circumstances or similar development arising or occurring on or after the Closing Date. To the extent any actions following the Closing with respect to the accounting books and records of the Company on which the Closing Net Working Capital is to be based are not consistent with the Company's past practices, such changes shall not be taken into account in calculating Closing Net Working Capital.

Key Considerations in Dispute Resolution

- Selection of arbitrator
  - Select arbitrator in advance (agreement as between Buyer and Seller)
    - Industry qualifications – typically a big four or regional accounting firm
  - Arbitrators may differ in how they view their role
    - Strict construction v. parties' business intentions
    - Will arbitrator want to "split-the-baby"?
  - Arbitrator is a financial expert, not a legal arbitrator
- Scope of authority of arbitrator
  - Seller may want arbitrator to be able to determine solely whether amounts were calculated in accordance with agreed accounting principles
  - Buyer may want broader scope of authority, including ability to decide that original amounts calculated were not in accordance with GAAP or were incorrectly determined
  - Review only items in dispute
  - Cannot go back and challenge adequacy of target working capital amount or other "fairness" issues
  - Cannot specify amounts outside of range parties have determined
  - Sometimes must choose between positions of each of the parties, not in between ("baseball arbitration") – often the goal of the dispute resolution mechanism is to limit discretion
- Access to arbitrator working papers and other information
  - Parties may be unable to compel arbitrators to produce their working papers due to the accounting firm's disclosure policies
- Arbitrator fees
  - Can be split evenly, paid in inverse proportion to parties' wins, or paid by party furthest away from arbitrator's decision

Careful crafting of the dispute resolution provisions is critical to the eventual outcome of any working capital dispute.

Common Sources of Post-Closing Disputes: An Accountant's View

What Causes Transaction Purchase Price Disputes?

- The purchase/sale agreements don’t give full consideration to the potential for disagreement
- Lack of clarity around specific terms gives one party a potential opportunity to exploit ambiguous clauses in the sale and purchase agreement
- The buyer identifies key issues only post-closing, whether because diligence was limited by agreement (e.g., auction process) or there were gaps in diligence
- Parties defer clear resolution of terms during the contract negotiation process and attempt to “renegotiate” through the dispute resolution process (i.e., seeking “another bite at the apple”)
- Purchase price disputes are sometimes seen as a more efficient and less costly means for adjustment vs. breach of warranty claims through the courts

Closing Mechanism Considerations and Common Disputed Components

Net working capital

- How is the accounting mechanism/post-closing purchase price adjustment defined (e.g., GAAP applied on a consistent basis)?
- How are assets and liabilities defined?
- Does the SPA include an example calculation?
- What are the relevant financial statements (e.g., audited or unaudited?)

Earn-outs

- Consider how the earn-out definition compares to GAAP definitions of revenue or earnings (or another benchmark for the earn-out) and/or audited financial statements
- Consider references or requirements to be GAAP- compliant

Reserves

- Accounts receivable
- Inventory
- Other reserves or areas of the balance sheet requiring management judgment (e.g. warranties, contingent liabilities, etc.)

Revenue recognition

- Balance sheet accounts related to revenue recognition (e.g. unearned revenue, deferred revenue)
- Effect of new revenue recognition standards (i.e. ASC 605 vs ASC 606)

Non-typical accruals

- Legal accruals
- Tax or other payables
- "New" accruals not historically recorded by the company

Subsequent events

- Timing of cutoff for consideration of subsequent events

Inventory

- Valuation
- Consideration of true-up for physical inventory count

Leases

- Capital vs. operating lease classification
- Impact of ASC 842

Example 1

SPA Language:
The Estimated Closing Statement and the Parent Closing Statement, which set out, among other things, the Closing Cash, the Closing Working Capital, the Closing Indebtedness, and Company Transaction Expenses, shall be prepared in the following order of priority, as provided in the definition of Specified Accounting Principles in the Purchase Agreement:

i. The specific accounting principles set out in paragraphs 2-4 below;

ii. **In accordance with GAAP**; and

The Parent Closing Statement shall be prepared, and the components thereof shall be calculated**, in accordance with this Agreement and the Specified Accounting Principles**. The Parties agree that the purpose of preparing the Parent Closing Statement is to measure the amount of Closing Working Capital, Closing Indebtedness, Closing Cash and Company Transaction Expenses, and the resulting Adjustment Amount, in accordance with this Agreement, and **such processes are not intended to permit the introduction of different judgments, accounting methods, policies, principles, practices, procedures, classifications or estimation methodologies for the purpose of preparing the Parent Closing Statement or determining the Adjustment Amount or the components thereof.**

Example 1

<u>SPA Language:</u>
The Estimated Closing Statement and the Parent Closing Statement, which set out, among other things, the Closing Cash, the Closing Working Capital, the Closing Indebtedness, and Company Transaction Expenses, shall be prepared in the following order of priority, as provided in the definition of Specified Accounting Principles in the Purchase Agreement:

i. The specific accounting principles set out in paragraphs 2-4 below;

ii. **<u>In accordance with GAAP</u>**; and

The Parent Closing Statement shall be prepared, and the components thereof shall be calculated**, in accordance with this Agreement and the Specified Accounting Principles**. The Parties agree that the purpose of preparing the Parent Closing Statement is to measure the amount of Closing Working Capital, Closing Indebtedness, Closing Cash and Company Transaction Expenses, and the resulting Adjustment Amount, in accordance with this Agreement, and **<u>such processes are not intended to permit the introduction of different judgments, accounting methods, policies, principles, practices, procedures, classifications or estimation methodologies for the purpose of preparing the Parent Closing Statement or determining the Adjustment Amount or the components thereof.</u>**

<u>Issue:</u>

- The Specified Accounting Principles indicate GAAP prevails.
- However, typically if something is <u>not</u> in accordance with GAAP you have to introduce different judgements, accounting methods, policies, practices, procedures, etc. to correct the accounting to be in accordance with GAAP.
- There is an inherent conflict between the GAAP requirement and the requirement to not introduce new accounting practices.

Example 2

SPA Language:

The Pre-Closing Statement and the Post-Closing Statement shall be calculated… in accordance with the same accounting policies, practices, principles, rules, estimation techniques and procedures and applied in good faith **as were actually used in the preparation of the Audited Financial Statements** (including in relation to the exercise of accounting discretion and judgement);

Example 2

SPA Language:
The Pre-Closing Statement and the Post-Closing Statement shall be calculated… in accordance with the same accounting policies, practices, principles, rules, estimation techniques and procedures and applied in good faith **as were actually used in the preparation of the Audited Financial Statements** (including in relation to the exercise of accounting discretion and judgement);

Issue:

- The notes to the Audited Financial Statements stated that the Company recorded a 100% reserve for AR aged over 365 days.
- Despite the note, within the Audited Financial Statements the Company did not record a 100% reserve for certain AR aged over 365 days.
- At Closing Buyer discovered the Company did not record a reserve for certain AR aged more than 365 days and proposed a $9 million reserve in the Closing Statement.
- In the dispute resolution process, the decision-maker will likely focus on language in the Agreement that required the parties use the estimation techniques and procedures "as were actually applied"

Example 3

SPA Language:
"Accounting Principles" means (i) with respect to Entity A and Entity B, US GAAP standards, (ii) with respect to Entity C and Entity D, Israel GAAP standards, and (iii) with respect to Entity E, UK GAAP standards.

"Net Working Capital" means, as of 12:01 a.m. local time on the Closing Date, the Current Assets minus the Current Liabilities, in each case **determined in accordance with (i) the methodology set forth on Schedule 2.2(c)**;

Schedule 2.2(c) is an illustrative calculation of Working Capital using the Company's historical financial reporting.

Example 3

SPA Language:
"Accounting Principles" means (i) with respect to Entity A and Entity B, US GAAP standards, (ii) with respect to Entity C and Entity D, Israel GAAP standards, and (iii) with respect to Entity E, UK GAAP standards.

"Net Working Capital" means, as of 12:01 a.m. local time on the Closing Date, the Current Assets minus the Current Liabilities, in each case **determined in accordance with (i) the methodology set forth on Schedule 2.2(c)**;

Schedule 2.2(c) is an illustrative calculation of Working Capital using the Company's historical financial reporting.

Issue:

- Buyer identified millions of dollars of slow-moving and unsaleable inventory post-Closing.
- The Company historically did not record a reserve for slow-moving and obsolete inventory
- Buyer thought it could include a reserve for slow-moving/unsaleable inventory in closing Net Working Capital in accordance with the Accounting Principles. HOWEVER, the Company did not include a reserve when calculating the working capital amounts set forth on Schedule 2.2(c)

Example 4

SPA Language:

"Accounting Principles" means: (i) IFRS in effect as of the date hereof; and (ii) to the extent not inconsistent with (i), the accounting methods, practices, procedures and policies used in the preparation of the Financial Statements, including the reporting period closing dates, consistently applied.

Seller shall prepare and deliver to Buyer **on the basis of, and as determined in accordance with, the Accounting Principles**: (i) its estimate of Cash as of the Reference Time ("Estimated Cash"); (ii) its estimate of Working Capital, as of the Reference Time (without giving effect to the Closing)…

Buyer will prepare and deliver to Seller on the basis of, and as determined **in accordance with, the same principles used to prepare the Estimated Statement**, as promptly as reasonably practicable following the Closing Date, and in any event no later than 60 days following the Closing Date: (i) its calculation of Cash as of the Reference Time; (ii) its calculation of Working Capital, as of the Reference Time (without giving effect to the Closing)…

Example 4

SPA Language:
"Accounting Principles" means: (i) IFRS in effect as of the date hereof; and (ii) to the extent not inconsistent with (i), the accounting methods, practices, procedures and policies used in the preparation of the Financial Statements, including the reporting period closing dates, consistently applied.

Seller shall prepare and deliver to Buyer **on the basis of, and as determined in accordance with, the Accounting Principles**: (i) its estimate of Cash as of the Reference Time ("Estimated Cash"); (ii) its estimate of Working Capital, as of the Reference Time (without giving effect to the Closing)…

Buyer will prepare and deliver to Seller on the basis of, and as determined **in accordance with, the same principles used to prepare the Estimated Statement**, as promptly as reasonably practicable following the Closing Date, and in any event no later than 60 days following the Closing Date: (i) its calculation of Cash as of the Reference Time; (ii) its calculation of Working Capital, as of the Reference Time (without giving effect to the Closing)…

Issue:
- Buyer included certain items in its Closing Statement arguing that these liabilities were required in accordance with the Accounting Principles/IFRS including Provision for uncollectible receivables which the Seller had not reported to the customer, finance leases and AROs

Example 5

SPA Language:

"Transaction Expenses" means: (i) any change of control payment payable by a Group Company as a result of the consummation of the transactions contemplated by this Agreement …. (v) **any retention or change of control bonus payments, severance payments payable under any change in control agreements**, tax gross-up payments or similar liabilities (and the employer portion of any payroll, employment or similar Taxes associated with any of the foregoing amounts) payable by any Group Company to any employee in connection with the transactions contemplated by this Agreement, **to the extent established prior to Closing**…

Example 5

SPA Language:
"Transaction Expenses" means: (i) any change of control payment payable by a Group Company as a result of the consummation of the transactions contemplated by this Agreement …. (v) **any retention or change of control bonus payments, severance payments payable under any change in control agreements**, tax gross-up payments or similar liabilities (and the employer portion of any payroll, employment or similar Taxes associated with any of the foregoing amounts) payable by any Group Company to any employee in connection with the transactions contemplated by this Agreement, **to the extent established prior to Closing**…

Issue:

- Buyer included change in control payments in Transaction Expenses for employees that had a bonus in their employment agreement if (i) a change-in control occurred and (ii) the employee left for "good reason" or was terminated within 12 months of the change in-control. These employees announced they were leaving 3 months after Closing.

Example 6

SPA Language:
"Capital Expenditures" means out-of-pocket expenditures **actually paid or payable** (and, if payable, reflected as a current liability in Working Capital) by the Regulated Utility Subsidiaries that are **properly capitalized in accordance with U.S. GAAP.**

Base Purchase Price will be…. increased, dollar for dollar, by the total amount that **actual aggregate Capital Expenditures**, by the Regulated Utility Subsidiaries **from November 1, 2018 through the Measurement Time** exceed the Budgeted Capital Expenditure Amount, or decreased, dollar for dollar, by the total amount that **actual aggregate Capital Expenditures**, by the Regulated Utility Subsidiaries **from November 1, 2018 through the Measurement Time** are less than the Budgeted Capital Expenditure Amount for such period (a "Capital Expenditure Adjustment");

Example 6

SPA Language:
"Capital Expenditures" means out-of-pocket expenditures **actually paid or payable** (and, if payable, reflected as a current liability in Working Capital) by the Regulated Utility Subsidiaries that are **properly capitalized in accordance with U.S. GAAP.**

Base Purchase Price will be…. increased, dollar for dollar, by the total amount that **actual aggregate Capital Expenditures**, by the Regulated Utility Subsidiaries **from November 1, 2018 through the Measurement Time** exceed the Budgeted Capital Expenditure Amount, or decreased, dollar for dollar, by the total amount that **actual aggregate Capital Expenditures**, by the Regulated Utility Subsidiaries **from November 1, 2018 through the Measurement Time** are less than the Budgeted Capital Expenditure Amount for such period (a "Capital Expenditure Adjustment");

Issue:
- Buyer excluded capital expenditures for items recorded in AP at the start of the Measurement Period because these amounts were expended and capitalized in accordance with GAAP prior to Measurement Period and included capital expenditures in AP as of Closing Date.

Example 7

Arbitration/dispute resolution clause

1. Neutral arbitration with an SPA restriction – must agree 100% with one party's amount
   1 item in dispute: accrual
   $0 or $2M
2. Recent trend towards "all or nothing" language in SPAs
3. Extreme example: the arbitrator must agree with the entire balance of either buyer's or seller's position

Consistency clause

1. Recent trend for consistency with past practice without consideration for facts/circumstances post-close
   More extreme cut-off than as required by GAAP
   Increasingly common in competitive deals

Contractual Language Considerations and Tips

- Analysis of relevant contract terms, definitions and schedules, and construction of the accounting mechanism
- Price mechanism – does it work? How does the SPA calculate net working capital or the earn-out?
- Who will prepare the statement? What is the closing account process?
- Definitions of indebtedness, working capital, net assets, etc.
- Are the contractual terms unambiguous?
- Accounting standards: IFRS vs. US GAAP vs. local/foreign GAAP
- Accounting warranties and indemnities

- Contractual language should not be generic.
- Discuss the potential impact of all due diligence findings and reflect the due diligence findings in the contractual language.
- Consider the underlying motives of all parties.
- Consider an example computation for all post-closing mechanisms for the avoidance of doubt.
- Consider which party should prepare the post-closing mechanism and understand the potential implications.
- Consider the relevant governing accounting standards (e.g. GAAP vs IFRS), and any conversion adjustments
- Maintain a high level of skepticism.
- Understand *brand exposure* . . . including the management and control of intellectual assets.
- Understand how the *arbitration process* will play out . . . including the selection of an arbitrator.
- *Document everything* in the agreement.

Litigating Purchase Price Adjustment Disputes

The Litigator's Perspective – Typical Dispute Resolution Process

- Parties select and engage the independent accounting firm and/or the specific accountant
- Preliminary conference with the independent accountant to set ground rules, timelines
- Initial submissions – typically due in 2-4 weeks
- Rebuttal submissions – typically another 2-4 weeks
- Questions from the independent accountant
- Responses due in 1-2 weeks
- Decision – usually within 30 days

Even in the best of circumstances, resolution almost always takes longer than envisioned in the purchase agreement

The Litigator's Perspective – Strategic Considerations in Submissions

- Remember your audience!
  - The decisionmaker here is an accountant, not a judge
  - Technical arguments and jargon are not only acceptable, but sometimes necessary
  - The specific issues in dispute will determine who is best suited to draft – lawyers and accounting advisors working together produce the best product
    - Arguments about contractual language and definitions/priorities
    - Accounting standards/practices

The Litigator's Perspective – Potential Areas of Dispute

There are many ways the "typical" process can go awry – for legitimate reasons or otherwise

- Selection of independent accountant and negotiation of engagement letter
- Timing/extensions
- Scope of accountant's authority ("arbitrator" vs. "expert")
  - Adequacy of information provided
  - What information can the accountant consider?
  - Intersection of purchase price adjustments and breaches of representations
- Enforcement of accountant's award

The Litigator’s Perspective – Accountant vs. Court

- There is a well-developed body of law in Delaware that addresses the scope of an arbitrator’s authority
  - Generally, issues of substantive arbitrability (e.g., scope of an arbitration clause) are for the court to decide
  - Issues of procedural arbitrability (e.g., satisfaction of conditions precedent, information to be considered) are for the arbitrator
- Many purchase agreements provide, however, that “the Independent Accountant shall act as an expert and not an arbitrator”
- If so, that shifts nearly all of the contractual interpretation to a court, and limits the accountant strictly to the functions provided by the contract, unless the contract expressly provides otherwise
- This can mean disputes in court about, for instance:
  - whether the parties “negotiated in good faith” prior to commencing the dispute resolution procedure
  - whether the buyer has provided the seller with adequate information in response to requests, and whether that is a condition precedent to the accounting procedure
  - what information the accountant can consider

The Litigator's Perspective – Breach of Representation

- Depending on how the contract is written, the buyer may have choices to make between seeking redress through the purchase price mechanism or a claim for breach of representation or both
  - Consider a contract with agreed accounting principles that prioritize GAAP compliance over consistency with past practices
  - Buyer could both "correct" the accounting for purposes of the purchase price adjustment <u>and</u> assert an indemnification claim for breach of the financial statement representations
  - Damages for the indemnification claim could be based on an earnings multiple, rather than the dollar-for-dollar adjustment in the purchase price dispute resolution
- Where representations and warranties do not survive closing, buyers sometimes try to challenge GAAP compliance via the purchase price adjustment process
  - *Chicago Bridge & Iron Co. v. Westinghouse Elec. Co.*, 166 A.3d 912 (Del. 2017) – court interpreted the purchase agreement as prioritizing consistency of practices, and held that buyer could not mount a back-door challenge to GAAP representation through the purchase price adjustment process

The Litigator's Perspective – Enforcement of the Accountant's Award

- Accountant's award is typically a written decision that addresses and explains each of the items in dispute
- Purchase agreements almost always provide that the accountant's determination is "final and binding"
- Procedures for enforcement of or challenges to awards depend on whether the accountant is an "arbitrator" or an "expert"
  - Arbitration awards: Delaware and most states have specific "expedited" procedures for enforcement of an arbitration award, and very limited grounds for challenging arbitration awards
  - Expert decisions: Enforcement is (presumably) via an action for specific performance
- More opportunity for delay and obstruction by the "losing" party
  - Fee shifting provisions can help deter bad faith obstruction

Questions?

Thank you for joining. If you have any other questions, please reach out to:

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