Litigation support case study: a good deal gone bad.

When two business organizations look at each other, spend a significant amount of time understanding their respective businesses and ultimately decide to merge (or in some cases the arrangement is actually one company effectively buying the second) the stage may either be set for a good business combination or a good deal gone bad. This case study will discuss some of the issues with regard to a good deal gone bad. Most of the facts are real, although the names have all been changed.

When Oak Company began the discussions to acquire Acorn Company, Mr. Jones (the president and chief shareholder of Oak) began his discussions with Mr. Smith (the president and chief shareholder of Acorn) over lunch. They had known each other for several years as friendly competitors, and occasionally bought merchandise together from major distributors. Over the course of approximately a year and a half, Jones and Smith continued to talk, meet and eventually exchange some financial information. In the exchange of financial information, they each signed confidentiality agreements. Eventually, Jones and Smith arrived at a methodology for merging their businesses. Although it was referred to as a merger, effectively, Oak was buying Acorn, and Smith would have a one-year employment agreement with the new Oak Company. Smith would also manage the facility that he previously owned. Agreements were drawn, financial and other information was exchanged, and approximately one month before the anticipated closing date Oak contacted their accounting firm to perform due diligence on Acorn. Acorn's balance sheet consisted primarily of some cash, accounts receivable, inventory, significant fixed assets for their warehouse, accounts payable and a significant note payable to a bank. The accountants for Oak began to put together a due diligence program. The president of Oak, Mr. Jones, wanted to keep the fees to a minimal level, and instructed the accounting firm to only do "the least due diligence work you can" to arrange for the closing. The accounting firm performed approximately four hours of due diligence work, limited to looking at the historical financial statements and tax returns of Acorn, and a few of the other accounting records. It was determined during the due diligence that the accounts receivable were out of balance between the subsidiary ledgers (the detailed listing of an account by account basis) with the general ledger (the books of the company). Acorn agreed to reduce the share it would have in the new Oak Company (effectively selling itself for less) on the basis of the lower accounts receivable number. No other additional due diligence was done. The merger occurred almost simultaneous with the conclusion of the due diligence (the documents actually had to be changed at the last minute due to the findings of the accountant).

The closing occurred on April 1, and by July, Mr. Jones was already concerned with regard to the performance of Acorn. The financial statements that he received based on internally prepared documents from Acorn's old computer system—they had not yet made arrangements for Acorn's books to be moved over to Oaks computer system—showed a significant reduction in the gross profit margin from historical levels. Gross margin is generally referred to as the difference between the selling price and the direct cost of goods sold. This means that widgets that were historically purchased for $1.00 and sold for $1.50 (creating a gross margin of 33%--$1.50 - $1.00 = $.50/$1.50=33%) were now producing only a gross margin of 25% based on the financial statement from the first three months of combined operation. Jones contacted his attorney and expressed his concerns. At that point, Jones and his attorney engaged outside forensic accountants. Their charge initially was "go up and see what's wrong with the inventory". The forensic accountants made arrangements to visit Acorn's facility, interview Acorn's accounting, administrative and executive personnel, and look over the inventory records. Upon arriving it was determined that the inventory as of June 30 had not yet been completed. The information that had been included on the financial statements was preliminary and estimated. It was further determined that it would be weeks before the June 30 inventory was complete. he forensic accountants requested the detailed inventory that was done for closing, three months previously. It was clear after an initial analysis that this inventory was not in accordance with generally accepted accounting principles, and had not been prepared on a "first in-first out basis" as was stated in the financial statements. Because inventory is impacted both by purchases of merchandise as well as sales, the forensic accountants began looking at the purchase side of the equation. Once this occurred, and the forensic accountant looked into the purchase transactions, it became clear that the accounts payable of Acorn were understated at the time of the closing. An understatement of accounts payable would indicate two things: The first is that the balance sheet was overstated with regard to the net worth of the company; and the second thing is that at some point in history, the income statement was overstated because inventory was overstated, and/or accounts payable were understated.

The new findings led the accountant to call Mr. Jones and his attorney and indicate that the scope of the forensic accounting engagement might need to be expanded. The accountant received permission to talk to the accountant for Acorn. The telephone conversation with the accountant for Acorn was relatively brief and relatively cordial. Yes, the accountant for Acorn agreed, he knew that the subsidiary ledgers did not tie in for accounts receivable or accounts payable. He indicated that Mr. Smith was aware of this for several years but that he had been unwilling to invest the time, effort and money necessary to find the difference. He also acknowledged that the financial statements that he had prepared and which he knew would have been submitted to Acorn's bank over the years, were probably misstated and the amount could be material. He also indicated that he had never made any inquiries with regard to the methodology being used for the pricing of the inventory.

The forensic accounting engagement continued well beyond the original scope. It was ultimately determined that the balance sheet had been overstated as to net worth at the time of the closing by approximately $750,000, or the balance sheet only had a net worth of $1.1 million in total. This resulted in a decrease in the net worth of almost 70%. In addition, it was unclear which time period the errors had occurred, and because the pricing of the deal had been predicated primarily on earnings before interest, depreciation, taxes and amortization, it was clear that the likelihood was very high that the price of the purchase had been materially misstated based on the agreement of the parties. In addition, as if Oak and Mr. Jones didn't have enough difficulty, during the review of the inventory itself, the forensic accountants noted several barrels of potentially caustic chemicals were sitting in a portion of the warehouse and were leaking. It was later determined that Acorn had previously had an Environmental Protection Agency audit which had resulted in a fine and sanctions against Acorn (none of which had been reported to Oak during the due diligence process). In consultation with legal counsel for Oak, Jones determined that he would seed restitution from Smith and Acorn for the fraudulently prepared financial statement and for the various breaches of representations warranties that were included in the purchase agreement. Litigation ensued in a case effectively entitled Oak v. Acorn, and Acorn brought in their accountant as an additional defendant, claiming that all of the errors and irregularities on the financial statement were the accountant's fault, that Acorn and Smith knew nothing of any of the errors or irregularities, and that any error that occurred, or any shortfall or damage was the result of the accountant and his acts.

After several weeks of discussions, negotiations and additional discovery requests, a meeting occurred between the forensic accountant for Oak, Mr. Jones and his attorney, as well as Mr.

Smith, his attorney and a forensic accountant that they had retained to try to dispute the findings of Oaks forensic accounting firm. At that meeting, after all the discussion between the two forensic accountants ensued, it was effectively was agreed by Acorn's forensic accounting firm that Oaks forensic accountants' findings were accurate, certainly to within any reasonable degree of certainty. The attorneys went off into another room and came back with the suggestion that the deal be "unwound", that Oak and Acorn each go their separate way, that Acorn return to Oak all of funds that had been paid on account of the purchase plus an additional amount to make recompense to Oak for their out of pocket costs in putting the deal together as well as in undertaking the forensic accounting. Acorn went on to attempt to sue their accounting firm, which suit ended up being deemed without merit.

The lessons of this case gone awry, are primarily those with regard to due diligence. At the time of the deal being contemplated, on the purchase or merger business entities, it is imperative that a full amount of due diligence be performed by competent accountants and lawyers to assist their clients in understanding the legal, financial, economic, and tax repercussions of the deal. In addition, on the part of the sellers, it is always important to understand what the representations and warranties entail and whether or not they can properly be agreed to. The buyer will always want representations of warranties that cover essentially every item on which they relied. The sellers will always want to limit the representations and warranties to those items that they actually know about and/or have control over. Sufficient time must be provided for to allow the due diligence process to go forward on a timely basis, for the findings to be reported and understood, and in some cases discussed, and any additional changes to the documents made. The frequent request to keep the due diligence costs down below those that may be required, together with the time pressures to "get a deal done" will often put legal counsel and forensic accountants in a position of great difficulty in properly advising their clients.