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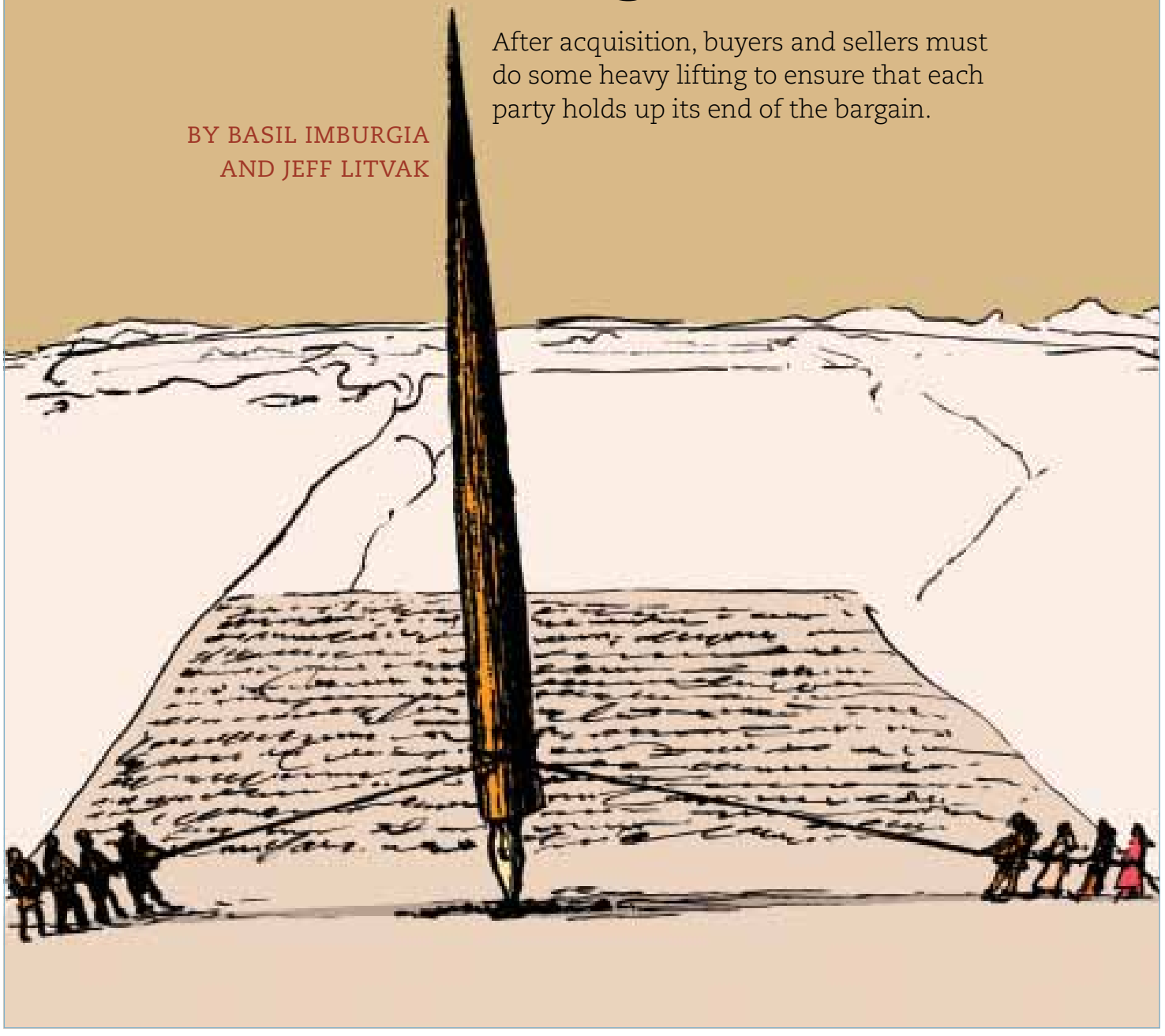
Summary

During integration, firms are now more likely to uncover errors in what was agreed upon. If problems do arise, determining the right channel to address them — from early dispute resolution and mediation to arbitration and litigation — is critical.

After acquisition, buyers and sellers must do some heavy lifting to ensure that each party holds up its end of the bargain.

BY BASIL IMBURGIA AND JEFF LITVAK



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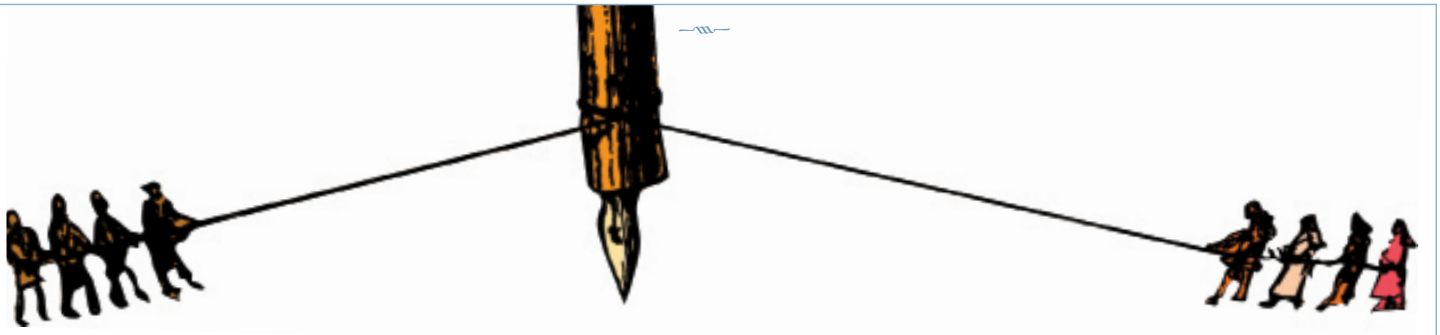


As the global economy struggles to shake off the lingering effects of the recession, private equity firms, with approximately $500 billion in uncommitted funds, are facing mounting pressure to identify desirable targets that will deliver a solid return on investments. The resulting competition has driven up the purchase prices in many deals: To outbid more than a dozen firms for Virtual Radiologic Corp., Providence Equity Partners paid a 41% premium. While private equity firms have always been known for their exhaustive due diligence, the postrecession climate has made them more susceptible to the misstatements of companies desperate to be acquired. As many buyers are discovering, the frenzied rush to close a deal can obscure issues that later come back to haunt the buyer. It's been said that "love may be blind, but marriage is a real eye-opener." The hard work of post-acquisition integration is now more likely to uncover errors and misrepresentations that can have a significant impact on the purchase price. As a result, an increasing number of M&A deals are involving some litigation. Since 2% to 5% of the purchase price — often a substantial sum — can be kept in escrow until disputes are resolved, companies have added incentive to settle matters expeditiously.

By understanding the common trouble spots in typical acquisitions, private equity firms can put themselves in a better position to resolve potential disputes. If problems do arise, determining the appropriate channel for addressing them — from early dispute resolution and mediation to arbitration and litigation — can be critical.

TRADITIONAL SOURCES OF DISPUTES

The complexity of M&A deals has the potential to create a range of issues, but certain areas are more likely to result in post-acquisition disputes.

During the deal, the seller will make certain assurances and formally confirm facts and figures. Representations (an account or statement of facts, allegations or arguments) and warranties (allocating financial responsibility for the accuracy of those statements of fact) can range from verifying that interim financial statements have been prepared according to GAAP and/or disclosing pending lawsuits to stating the value of inventory and outstanding accounts receivable.

Indemnification provisions. These measures are intended to protect the buyer and seller from each other's actions. Indemnification provisions can cover representations and warranties and covenants. During negotiations on the purchase price, each side will insert language to cap damages arising from specific areas. However, these caps can be negated in the case of intentional fraud or on public-policy grounds, such as in disputes arising from gross negligence.

Working capital. Within a certain time period after the closing date, the seller must provide a closing balance sheet that includes its working capital. The working-capital "true-up" determines the amount of actual working capital at closing compared with what the seller estimated. Since the buyer will seek to deduct any shortfall (a potentially substantial sum) from the purchase price, calculating the true-up can be particularly contentious.

Earn-outs. An earn-out is a contingent element of the acquisition's purchase price that is determined after the closing based on the target business's performance against contractually defined criteria or benchmarks. Disputes can arise, for example, from business decisions that negatively affect the performance of the purchased entity, how that performance is measured or how amortization and depreciation is recorded for accounting purposes.

THE EFFECT OF THE RECESSION ON M&A

In the postrecession landscape, several trends have emerged that are affecting not only how deals are being structured but also the most effective channels for resolving disputes.

Financial constraints slow deals. The overall decline of deals can be directly attributed to financing constraints. Private equity firms can no longer rely on banks to provide ready funding for

highly leveraged buyouts. Because of this, not only have acquirers been pulling out of deals prematurely after failing to secure the necessary credit, but financial institutions have also backed out of acquisitions they deemed too risky. As a result, other arrangements such as club deals, where two or more firms form a consortium to acquire a company, have become more prevalent.

Increasing reliance on earn-outs. As buyers look for ways to finance deals that require less cash up front, purchase agreements are featuring earn-out provisions more frequently. Indeed, more than 30% of deals now include such provisions. The structure of earn-outs, however, lends itself to disputes over control, business decisions and accounting practices. The buyer can face allegations of acting in its own interests in ways that adversely affect the acquired company's performance and, thus, the earn-out payment to which the seller is entitled. Attempts by the seller to exert its influence can be perceived by the buyer as maximizing the target's performance at the buyer's expense. Agreements will often include covenants by the buyer to operate the business consistent with past practice or in normal course, although that can still allow for substantial variance in interpretation. So if earn-outs are such magnets for disputes, why are they being included in more and more deals? The postrecession landscape and lack of available credit are two drivers. For the buyer, an earn-out not only reduces the cash necessary at closing but also acts as an incentive for the seller to perform up to expectations after the closing. Indeed, private equity firms want additional assurance that the companies they are buying will meet their high expectations. On the seller side, earn-outs offer potential for increasing total compensation, especially advantageous given the current climate. For these reasons, we expect to see more earn-outs over the next two to three years — and a corresponding rise in resulting post-acquisition litigation.

More MAC litigation. Purchase and sale agreements typically include a clause on material adverse change (MAC), defined as any event, development, circumstance, change or effect that would have a materially negative impact on the business, financial condition or results of the operations of the acquired company. MAC actions involve disputes that emerge from the failure on the part of the seller to disclose material contingencies and liabilities, a loss of a key customer, or other developments that represent a significant and lasting change in the business. Since the recession destroyed the value of many companies, litigation offers an opportunity for acquirers to recoup a portion of their losses. A MAC is very difficult to prove, however; in fact, the Court of Chancery of Delaware, the forum for 30% of all M&A litigation, has never issued a MAC ruling in favor of the buyer. Therefore, buyers should incorporate specific economic targets into the purchase agreement's MAC clause. Clearly defining what is meant by the term "economic downturn" (in terms of duration and dollar amounts), what constitutes a material difference between projected and actual results, or a material loss of customers can more concretely define failed performance and can provide a more defensible basis for adjusting the purchase price. In addition, the recession has created a breed of professional bargain hunters that have honed their skills in using disputes as a strategic tool to wring more value out of deals. Suits based on the MAC clauses of purchase agreements have become a way for the buyer to get a second bite at the apple during the post-acquisition closing.

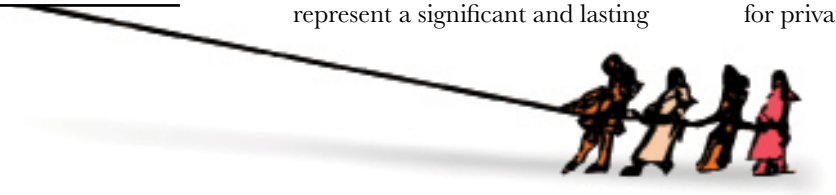
The postrecession climate has made firms more susceptible to the misstatements of companies desperate to be acquired.

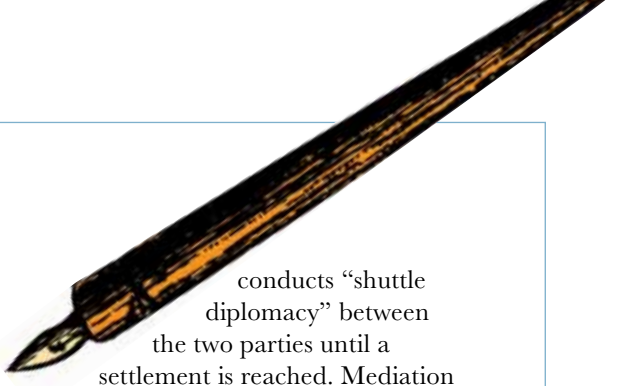
30%

Purchase agreements that feature earn-outs — a growing trend as buyers seek ways to finance deals that require less cash up front

RESOLVING POST-ACQUISITION DISPUTES

Given the complexity and the compressed time frame of most acquisitions, it's nearly impossible for private equity firms to foresee





and preempt all potential issues. If disputes do emerge, buyers have several tools at their disposal that they should evaluate based on the type of dispute and the dollar amount under consideration.

Early dispute resolution. Corporations that are well versed in M&A often devote significant time and resources to resolving disputes as soon as they are identified. Some agreements call for senior executives of each company to meet and try to resolve the problem before it can proceed to arbitration. Given the recessionary climate, companies are increasingly turning to mediation as a means to avoid more costly litigation. In this non-binding process, the companies agree on a judge, an attorney or an accountant to help them reach a settlement. The mediator then conducts "shuttle diplomacy" between the two parties until a settlement is reached. Mediation is especially effective when both parties are motivated to settle and when the legal issues underlying the dispute aren't complicated. Similarly, if both parties have a lot to lose, mediation is a natural channel to pursue. Some companies, however, treat mediation

REDUCING THE RISKS OF DISPUTES

With myriad details and a compressed time frame, even the most dogged companies can leave themselves vulnerable to future disputes. A few basic strategies can help private equity firms mitigate this risk.

CONDUCT THOROUGH DUE DILIGENCE AT EVERY STAGE

Certain due diligence steps traditionally regarded as routine have taken on added importance. The seller's interim balance sheet should receive particular scrutiny, since in uncertain economic times or cyclical businesses it often isn't as precise as the quarterly or annual statements. In addition, buyers should augment the accounts prepared specifically for the acquisition process by reviewing the management accounts, which may be more detailed and provide a different picture.

Due diligence tends to be focused on a tightly controlled "data room" where the buyer sees only what the seller wants it to see. Therefore, the challenge for a buyer is to gain access to the people who know about the business, such as employees in key functions who might inadvertently share information. Acquirers should also obtain representations from the seller regarding key valuation assumptions and high-risk accounting areas, such as inventories, accounts receivable and the like.

ESTABLISH CLEAR LINES OF COMMUNICATION

Companies should agree on the accounting policies and methods that the deal is based on — for example, by explicitly discussing the target working capital and how it will be calculated prior to signing the merger agreement. Since issues can emerge once the acquirer transitions the seller's information to its systems and uncovers discrepancies in how assets and liabilities have been recorded, reaching consensus on accounting standards beforehand can reduce the likelihood of such claims. Access to information can be a key advantage in the event of litigation, so the buyer should seek to "freeze the scene" — that is, retain a copy of all the accounting records that could be used to resolve a dispute. If possible, this information should extend to the e-mail accounts of directors and senior staff as well as file servers. The seller should also keep a full copy of the accounting records on its system; in fact, many companies have been unable to defend themselves adequately because they relinquished access to this information during the course of the deal. Both sides will want to negotiate to prepare the closing balance sheet in an effort to maintain control.

PREPARE FOR THE WORKING-CAPITAL TRUE-UP

Since working capital can constitute a significant portion — 10% to 20% — of the deal price, both the buyer and the seller should devote the necessary resources to verify its value. The seller is in a position to have knowledge, such as of the cyclical nature of the business, that could affect the true-up, so including this information in purchase price negotiations can help avoid disputes down the line. Parties should also agree on a specific definition of working capital and make sure it's consistent with the rest of the purchase agreement.

PREEMPT COMMON EARN-OUT DISPUTES

The buyer should clearly define the accounting methods to be used during the earn-out period in order to develop sufficient reserves for balance sheet items such as inventory obsolescence, collectibility of receivables, warranties, returns and other contingencies. Companies should also keep earn-out criteria simple, easily measurable and unambiguous — for instance, by addressing whether or not overhead expenses will be included in earn-out calculations. Last, an earn-out should avoid cliff-vesting earn-out amounts — for example, when revenue hits $20 million, the seller receives $5 million. By making targets and related payments more gradual, sellers can significantly reduce the risk of intentional manipulation.

merely as a tactic to demonstrate to the courts that they have exhausted every means at their disposal before pursuing litigation.

Neutral accounting arbiters. For claims that arise from accounting-related disputes, such as those involving working-capital true-ups, earn-outs and interpretation of GAAP, companies may opt to retain a neutral accounting arbiter to adjudicate the dispute. Purchase agreements will often require the use of a neutral arbiter and provide a list of accounting firms that the buyer and seller have deemed acceptable. The arbiter will engage in a multistep process, including interviews, a review of position statements, interrogatories and hearings. Once all of the facts have been presented, the arbiter renders a binding judgment. By highlighting the strengths and weaknesses of each party's claims, the arbiter can facilitate an expeditious settlement. A neutral accounting arbiter offers several benefits: The process is a truncated version of arbitration, so it saves the buyer and seller time and money. Since the arbiters are drawn from accounting and consulting firms, they are very well versed in the intricacies of these disputes, ensuring an informed judgment. Last, a neutral arbiter can be empowered by the parties to settle disputes regarding access to information and people and the production of documents, serving to expedite the process.

Arbitration. Arbitration can be a useful path for disputes involving more substantial claims that relate to such issues as benefit of the bargain, fraud, and warranties and representations. The majority of sale or asset agreements include arbitration as the dispute resolution mechanism. While arbitration isn't necessarily less costly than litigation, it can offer several important advantages that must be weighed against the other factors of the case. First, arbitration generally offers a speedier resolution than litigation: A final judgment can be reached in as little as six months, which allows each party to focus on business operations rather than on the disputes. Second, companies can select arbitrators who have expertise in accounting, specific industries or certain areas of law. Since complex cases can often be misunderstood by juries, arbitration can represent the best path to an informed ruling. Last, arbitration proceedings are private, allowing companies to keep the details of a case from being dissected in the marketplace. One potential disadvantage of arbitration is a perceived tendency for the arbitrator to "split the baby" — that is, to settle somewhere in the middle rather than granting one side or the other full redress. If a company has identified the potential for a large settlement or if it has built a strong case, litigation may be a more beneficial course to pursue. In addition, the right to appeal a decision is not part of arbitration proceedings, so a company must abide by the ruling. In some cases the buyer or seller might make a claim of fraud in an effort to bring the matter out of arbitration and into litigation. This strategy has been used by companies looking to avoid escrow limits, for example. If the dispute qualifies as a game changer, with a significant amount of damages at stake, litigation may end up being the best course. However, many companies are still favoring settlements rather than going to trial to avoid reputational damage, the disclosure of private information and drawn-out court proceedings.

Given the degree of complexity in M&A, companies that recognize the common sources of disputes during negotiations will be in a much better position to address them during the post-acquisition phase if they do occur. Since litigation often represents the most costly and least efficient channel for resolving disputes, private equity firms that understand the alternatives will be able to devote more of their energy to the core objective of any acquisition: creating value.

Complex cases can often be misunderstood by juries, and arbitration can represent the best path to an informed ruling.

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