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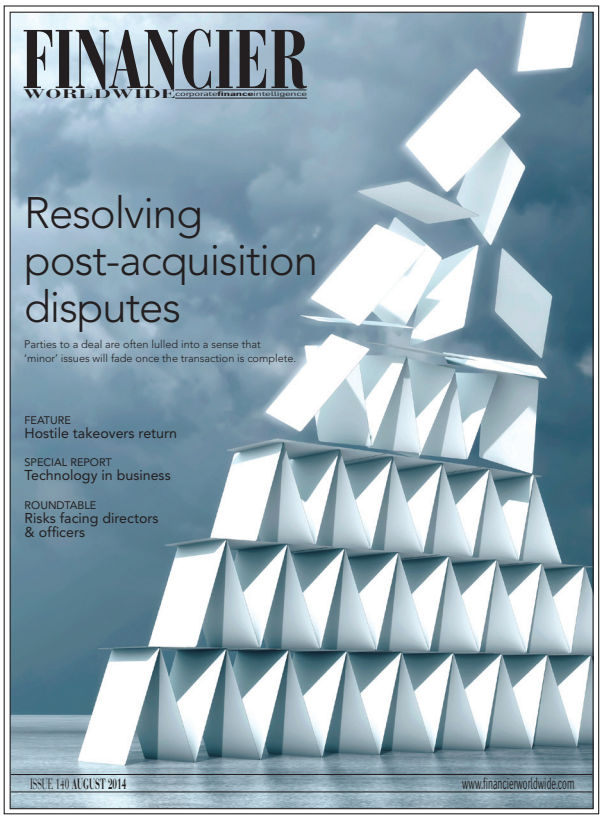
COVER STORY

Resolving post-acquisition disputes



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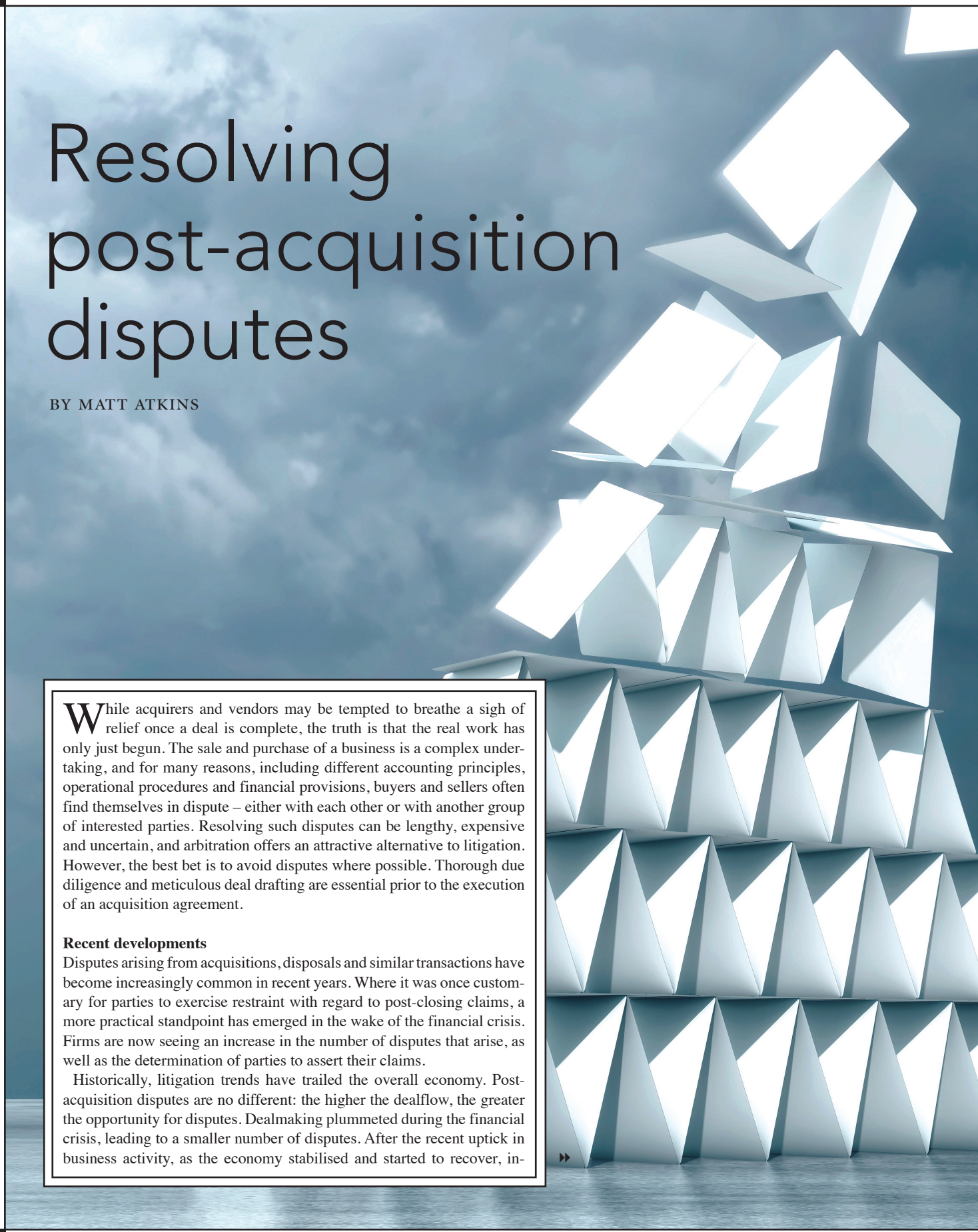
Resolving post-acquisition disputes

BY MATT ATKINS

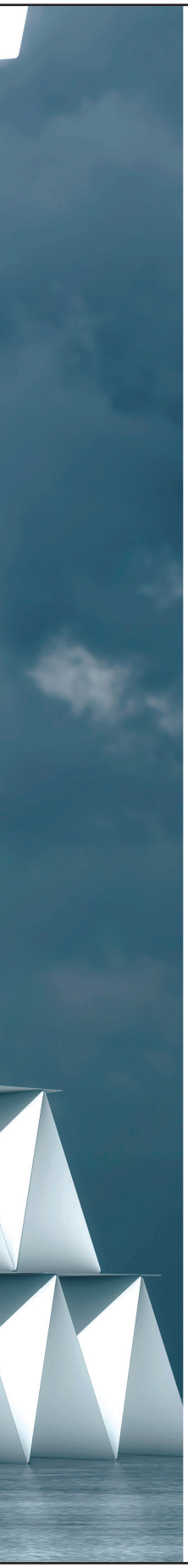


While acquirers and vendors may be tempted to breathe a sigh of relief once a deal is complete, the truth is that the real work has only just begun. The sale and purchase of a business is a complex undertaking, and for many reasons, including different accounting principles, operational procedures and financial provisions, buyers and sellers often find themselves in dispute – either with each other or with another group of interested parties. Resolving such disputes can be lengthy, expensive and uncertain, and arbitration offers an attractive alternative to litigation. However, the best bet is to avoid disputes where possible. Thorough due diligence and meticulous deal drafting are essential prior to the execution of an acquisition agreement.

Recent developments

Disputes arising from acquisitions, disposals and similar transactions have become increasingly common in recent years. Where it was once customary for parties to exercise restraint with regard to post-closing claims, a more practical standpoint has emerged in the wake of the financial crisis. Firms are now seeing an increase in the number of disputes that arise, as well as the determination of parties to assert their claims.

Historically, litigation trends have trailed the overall economy. Post-acquisition disputes are no different: the higher the dealflow, the greater the opportunity for disputes. Dealmaking plummeted during the financial crisis, leading to a smaller number of disputes. After the recent uptick in business activity, as the economy stabilised and started to recover, in-



creased litigation was bound to follow.

Others have seen little change in the number of disputes. The depth of the 2008 financial crisis was unprecedented, and this difficult landscape forced some parties toward litigation, where once they would not have considered it, says Jonathan Sablone, a partner at Nixon Peabody LLP. "The financial crisis created a litigation trend among large financial institutions. In the past, many of those financial groups shied away from litigation, but could no longer do so in the face of such huge losses during the credit crisis. That comfort level with litigation may carry forward into the more positive business environment, and result in a greater appetite to litigate post-acquisition matters," he adds.

Recurring themes

Typically, post-acquisition disputes relate to claims under representations and warranties contained in the M&A contracts, such as financial guarantees. These guarantees are linked to key financial figures like EBITDA in the closing accounts. "If the accounts are established post-closing, the potential for dispute is high, as the seller has an interest in meeting the guaranteed figure while the buyer will carefully scrutinise the accounts with a view to establishing a claim, often assisted by forensic accountants," says Jan Schaefer, a partner at King & Spalding. "If the financial guarantee is not clearly drafted, and substantial detail is required in this context to pre-empt later areas of dispute, issues will for instance arise as to whether consistency trumps other criteria. As accounting rules provide for some discretionary decisions, a new owner might well exercise such discretion in a manner favourable to him rather than ensuring a consistent application."

Disputes frequently arise in connection with purchase price adjustments, earn-out provisions, and claims for breach of representations and warranties, explains Kathryn L. Alessi, a partner at Goodwin Procter LLP. "Post-closing indemnification claims for breach of contractual representations and warranties, in particular, are prevalent; buyers sometimes pair these contractual claims with fraud claims, which may allow for recovery beyond any applicable escrow cap," she says. "Although parties cannot expect to eliminate altogether post-closing disputes, these disputes can at least be mitigated by anticipating post-closing litigation risk points and carefully defining terms and outlining obligations in the operative agreement."

Also common in private deal post-acquisition disputes are disagreements over what counts as 'working capital'. "Any ambiguity in the definition of working capital, or any other components of a purchase price adjustment, often leads to a dispute," says William H. Gussman, Jr., a partner at Schulte Roth & Zabel LLP. "With respect to breaches of representations and warranties, tax issues – because they can be so complicated, especially with changes in tax law – are often where disputes arise."

Disagreements between former personnel and current management, over the effort and results attributed to those at the acquired firm, also appear regularly. Such disagreements can lead to distrust on both sides and a dysfunctional operating environment. If current management tries to remove former officers, litigation may be brought by the employees. Alternatively, former officers may stay employed but bring suit alleging breach of the post-acquisition agreement. Neither scenario is preferable, and both can place the entire acquisition in the spotlight for the wrong reasons.

Minimising risks

Given the complexities and cost of the dispute resolution process, prevention rather than cure would seem the most sensible strategy. However, all too often, at the point of making a deal, parties are content to leave issues unresolved or to mask them with language that has multiple interpretations.

Parties to a deal are often lulled into a sense that 'minor' issues will fade once the transaction is complete, and that resolving them immediately is not worth slowing down the deal process. But, while this may be true in many cases, very occasionally such issues erupt into full-fledged litigation. Parties must therefore attempt to ensure there is complete agreement on all material terms, and that there is no room for differing interpretations of the terms of the acquisition agreement. This approach may be somewhat idealistic, however. And even when parties are convinced they have all the bases covered, unimagined risks may lurk beneath the surface.

With this in mind, parties should consider the wide range of contractual provisions that can be built into the deal. Various contractual provisions can potentially reduce the likelihood that claims will be asserted or the possibility that disputes progress to litigation or arbitration, notes Ms Alessi. "For instance, parties may agree to a monetary amount, or 'deductible', below which the buyer may not pursue a claim for indemnification. Parties may also include a 'prevailing party' provision in the operative agreement that requires the loser of a lawsuit or a claim to pay the winning party's legal fees and costs. The selling shareholders may also set up a fund at closing to cover the fees and expenses that might be incurred by the selling shareholders and their representative in defending against any post-closing claims by the buyer." Such funds may act as a deterrent to a buyer that might otherwise be inclined to pursue litigation, but, understanding that the selling stockholders have a ready-means to defend the claims, declines to pursue the claims.

Contractual clauses offer firms a yardstick by which any potential disputes can be measured. If the management of an acquiring firm suspects that the company it purchased is not in the agreed condition, it may avoid taking the matter further if it suspects this would be difficult to prove. Clear and unambiguous provisions in an M&A agreement can assist firms when deciding whether or not to assert claims. And though contractual clauses may not completely prevent disputes, they can significantly reduce the costs.

It goes without saying that thorough due diligence is essential, but although many firms believe they conduct ▸▸

adequate investigations prior to close, a closer inspection of their technique may find them lacking. Companies should go beyond in-house counsel and basic financial due diligence, and outside expertise may prove critical. Getting the right advisers in place can limit scope for future disputes.

Firms may also be wise to consider the interplay between experts – particularly between independent accountants and arbitrators – and the scope of their responsibilities, which can have a profound impact on the proceedings. "With respect to financial guarantees, accountants often play a role as experts who are tasked to issue contractually binding decisions," says Mr Schaefer. "If they deal with legal issues relevant to sorting out accounting issues, they might take legal views which are later difficult to challenge before the courts or an arbitral tribunal. Hence, it is necessary to carefully delineate the turfs of juridical and accounting decision-making. Similarly, the appointment and instruction of accountants who review and opine on the accounts established by management and already checked by the accountants can be a source of frustration as parties might not be able to agree on the terms but the contract requires a joint-instruction." Such expertise is essential when a dispute arises, according to Mr Gussman. "It is important that when a dispute, or potential dispute, arises, the party – buyer or seller – involve both accountants and litigators with experience working on post-acquisition disputes. Accountants and litigators think differently, and if a dispute does evolve to arbitration or litigation, both sets of professionals will be needed. So it is best to get them both involved early."

Regardless of what precautions are taken, there is no watertight means of preventing post-closing disputes. Firms must therefore be prepared for them whenever they enter a deal. When disagreements arise, every effort should be made to dissolve and resolve the dispute as early as possible. Disputes that drag on are detrimental to all parties involved. "Post-acquisition disputes can become very emotional and personal. Intense and prolonged litigation only exacerbate such emotion," says Mr Sablone. "Companies should engage in a concerted effort to discuss, negotiate and mediate disputes at the earliest stages, if possible. Focus should be on the drivers of the dispute and the overall impact that litigation will have on the company, including its brand. What may seem like an expensive settlement at the front end of a dispute often looks like a bargain after years of prolonged litigation which results in large professional fees, continued risk of liability, misdirection of management focus and negative publicity which tarnishes the acquisition."

Resolution methods

When it comes to resolving post-acquisition disputes, arbitration offers a number of advantages over litigation. The arguments in favour of arbitration include the shorter duration of proceedings, and the better background knowledge of M&A topics. As far as costs are concerned, arbitration proceedings tend to be more advantageous. "Although there is no universally applicable answer and each situation must be evaluated individually, arbitration may in some cases lead to a quicker resolution, with less expenditure of legal fees, particularly if the parties have drafted contractual provisions with an eye towards limiting the scope of post-closing arbitration proceedings," says Ms Alessi. "For instance, parties can, through their purchase agreement or at the outset of arbitration proceedings, agree to limit the scope of discovery, motion practice and oral testimony, which can result in significant time and costs savings. Arbitration may also be more convenient and less costly as there can sometimes be flexibility as to the scheduling and location of certain arbitration proceedings. In addition, parties in arbitration will have some control over the selection of the adjudicator of the dispute and may be able to select an arbitrator who is immediately familiar with the concepts that are germane to the particular dispute, which also can make for a more efficient and predictable outcome."

Arbitration proceedings are also private, and, although not guaranteed, it may be possible to keep proceedings and the ultimate resolution confidential. Privacy and confidentiality can provide a significant advantage, particularly to parties that are repeat players and may face similar claims in connection with other transactions, reports Ms Alessi. That said, including arbitration provisions as part of a deal may not guarantee that firms avoid the spotlight if a dispute arises. "While forcing buyer and seller to litigate in the public eye does sometimes deter litigation because of the confidentiality concerns, it is also true that arbitration provisions requiring commercially-experienced arbitrators are usually effective in deterring very aggressive claims," says Mr Gussman. "Ultimately, the parties often end up in court despite an arbitration provision, including, for example, when a party disputes the scope of an arbitration clause or challenges an arbitration award. Accordingly, an arbitration provision cannot properly be viewed as a guarantee that the dispute will avoid the public eye."

Arbitration, though, is certainly viable and often the preferred method of resolving post-acquisition disputes. It is certainly preferred over litigation in international disputes, according to Mr Schaefer. "If a matter is cross-border, the easier enforcement also plays a role in favour of arbitration. As arbitration is an inherently flexible process, parties are able to structure the interplay with accountants and getting legal views on abstract questions of contract interpretation more easily than suing in a remedy based court system. In addition, flexibility with language is an advantage and can help save costs."

There is, however, no one-size-fits-all approach. Some of the disadvantages of arbitration include the potentially unlimited duration of the factual inquiry and evidence taking process, the number of rounds of pleadings and the length of pleadings, as well as the submission of expert opinions by the parties. "Arbitration, in my view, is often a poor substitute for court-sanctioned resolution," stresses Mr Sablone. "Post-acquisition disputes tend to be large and complex matters which require extensive discovery and, in many instances, preliminary injunctive relief. In such cases, arbitration can be just as expensive, if not more so, than traditional litigation, and often falls short of providing a satisfactory forum for resolution. The one perceived benefit to arbitration in such matters is the privacy afforded to the proceedings, but such concerns can be addressed in the court system through confidentiality orders, under seal filings and agreements between the litigants related to the use of discovery materials." ■