Dispute Resolution Issues in Connection with Price Adjustments

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One of the most frequent topics of post-closing disputes in privately negotiated M&A transactions is the purchase price or working capital adjustment. These adjustments derive from the fact that buyers want to insure that they are acquiring a business on a going-concern basis that will be stocked with sufficient working capital to meet the immediate needs of the business, and sellers want to be compensated for earnings and profits they generate and for assets of the business that they created.

While it is important to carefully craft the definition of the components that are included in the price adjustment and their methodology of calculation, it is equally important to carefully construct the post-closing dispute resolution mechanism. This mechanism will ultimately determine whether the parties receive the economic deal that they expected.

Most price adjustments provide that the adjustment will be determined based on consistent application of Generally Accepted Accounting Principles (GAAP). These principles alone, however, are not a panacea and only go part of the way in providing guidance to an arbitrator as to how to calculate the adjustment. There are wide variations within the application of GAAP that could dramatically change the calculation of the adjustment. In addition, if pre-closing financial statements on which the target for the adjustment was based deviated at all from GAAP, than the application of GAAP to post-closing disputes may compromise the whole process. A better practice, albeit more difficult at the agreement stage, is to explicitly set forth the methodology for determining each component in the adjustment, including clearly delineating any items that (a) deviate from GAAP or (b) are calculated based on one of a number of acceptable GAAP methodologies.

Similarly, GAAP provides for the adjustment of financial statements based on post-preparation events. For example, if a significant receivable is collected or becomes uncollectible a short time after statement preparation, GAAP may require an adjustment to the accounts receivable reserve to account for that occurrence. This post-preparation adjustment may not be applicable or desirable in connection with determinations of working capital or purchase price adjustments where the parties intend that adjustment to reflect the state of events only at closing, without adjustment for post-closing events. To avoid this discrepancy, the agreement should guide the arbitrator to determine the adjustment only as of the applicable date, without reference to GAAP principles for post-determination adjustments.

Examples of certain items that are often the subject of post-closing disputes include the determination of slow moving or obsolete inventory, whether particular accounts receivable should be considered an uncollectible bad debt depending on the number of days past due and the condition of the account debtor, and whether deposits should be included in assets of the seller depending on the progress on the applicable contract or deliverable. In addition, revenue recognition is often a contentious issue as a buyer will want to avoid crediting the seller for sales that require substantial fulfillment on the part of the buyer post-closing. Revenue recognition issues affect multiple components of working capital, including inventory, receivables and deposits. As with other issues, the more guidance the parties can build into the purchase agreement on these issues, the greater the chance that arbitration may be avoided completely or at least be less contentious.

The way in which the arbitrator is asked to render its award can also play a big part in the dispute resolution process. Many arbitrators, especially when faced with a complex set of issues with sophisticated counsel on each side arguing strenuously, will be tempted to "split the baby" which is to find a middle ground between each position that inevitably will result in dissatisfaction for each side. To avoid this result, the parties may agree to "baseball" style arbitration, where the arbitrator is required to pick one side's position in its entirety and is not entitled to split or divide up the issues. Because of the inherent risks in this type of arbitration, it also may force the parties to stake out more reasonable and rational positions rather than posturing for a "split the baby" type award.

The identity of the arbitrator is also a key factor. Normally, the parties will want an accountant who is familiar with GAAP principles to determine the outcome. It is important that the person selected not have any ties or biases with respect to one party or the other. Both parties should represent that they have had no business relationship with the selected arbitrator. The parties should also consider whether it would be beneficial to use an arbitrator that has some legal experience, or a lawyer that has sufficient business and accounting expertise to decide the matter. Such a person could bring an understanding of evidentiary rules and mediation and arbitration techniques that could assist in a contentious process.

Finally, the manner in which the costs of arbitration are divided must be agreed upon by the parties. An equal split of arbitration costs offers no incentive to either party to either avoid or proceed with the mechanism. Alternatively, if "baseball" arbitration is chosen, costs may be allocated 100% to the loser in such arbitration. Finally, the parties may leave it to the arbitrator to assign costs as it deems appropriate; however, this may inevitably lead to the Solomonic "split the baby" result.

In sum, dispute resolution mechanisms in connection with price adjustments require careful thought and consideration. Clearly delineating a framework and guidelines for the arbitrator to render its decision and carefully selecting the arbitrator are keys to achieving a fair and predictable resolution.

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Brian Gilbert's practice is concentrated in the representation of business owners, lenders, and venture capitalists in a variety of sophisticated corporate transactions including acquisitions and divestitures, mergers and reorganizations, recapitalizations, including debt and equity raises, secured lending transactions, intellectual property licensing and equipment leasing. Mr. Gilbert is Chair of Gould & Ratner LLP's Business Counseling and Transactional Group and sits on the firm's Management Committee. He can be reached at 312.899.1690 or at bgilbert@gouldratner.com.