

Post-Closing Disputes: Inevitable or Avoidable?

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Too often the end of a difficult sale transaction doesn't mean the end of the deal but rather the start of the next phase of negotiations with the buyer. Going through the sale process is a thorough journey for the seller, including working with the intermediary to prepare the marketing material, participating in management presentations, working through the chosen buyer's due diligence, reading and understanding the definitive agreements, and preparing schedules for the definitive agreements. Having a seasoned deal team helps to make the process significantly easier for a seller. It can also help position the seller to avoid costly post-closing disputes.

Complications and disagreements arise for a variety of reasons, generally stemming from unknowns at the time of closing, including final financial data, condition of tangible and intangible assets purchased, and future financial performance (in the case of earn-outs). Post-closing disputes may never be altogether avoidable, but their potential can be greatly diminished by proactively addressing these four key areas before the deal closes.

- **Adjusted working capital.** The purchase price offered by the buyer will generally include all business assets including working capital—current assets less current liabilities. The buyer typically receives an entity that is cash-free/debt-free and has sufficient working capital to support the financial performance they are buying. On occasion, cash is part of the working capital calculation, but more typically not. Debt and liabilities remaining with the seller are also typically excluded from the calculation. It is a fundamental economic provision of the transaction to negotiate a working capital amount. The difference between that targeted amount and the actual amount delivered on closing is generally subject to a dollar-for-dollar, true-up settlement 30 to 60 days post-closing, after final financial data is available. While that seems straightforward, disputes over working capital adjustments and the accounting measurements used to reach such figures are some of the most common and contentious post-closing disagreements.

At its simplest, the seller estimates its working capital. The strong preference here is to include in the calculation only the assets purchased and liabilities assumed as part of the transaction rather than all of the Company's current assets less current liabilities. This helps to avoid working capital adjustments that have no impact on the deal price per se. In addition, the threshold should be based on measurable data and should be calculated consistent with the closing balance sheet.

In theory, when the buyer is basing the purchase price on EBITDA or some other measure of profitability and cash flow, the price derived includes the assets in the business necessary to deliver that level of profitability. This includes a "normal" amount

of working capital. Too often the threshold or target working capital is picked arbitrarily or based on the most recent financial statements. In pure theory, it should be based on the same period during which the profitability was derived, to be consistent—generally the past 12 months or some period within the last 12 months. As an example, some buyers use the most recent three or four months to account for growing working capital consistent with a growing profitability level. Some parties also prefer a range for working capital versus one target number in an attempt to reduce the probability of a closing adjustment.

Some parties take the view that any adjustment to the purchase price because of working capital is an increase or reduction in net proceeds to the seller. This attitude can lead to playing games with the number to better one's position rather than understanding the purpose and financial theory behind the metric and, in my experience, generally results in a post-closing dispute because the results are illogical to one of the parties. When the numbers are consistent with the profitability used to derive the purchase price, and the accounting is consistent as discussed below, it is more difficult to win in court or arbitration/mediation because the numbers were derived based on sound logic, and the deal documents incorporate the corresponding wording. In addition, I find it helpful to remember that if there is a purchase price reduction because of lower working capital at closing than the "normal" level, it generally means the seller has more cash at closing too. As an example, if the sales level remains steady with the prior year, and accounts receivable are lower at closing, it means there has been more cash collected. If more cash hasn't been collected, then the chosen threshold might have been inconsistent with the level of sales such that there truly are fewer accounts receivable to collect. When the threshold is based on a metric consistent with the level of sales and profitability for the period, any adjustments to the final closing balance sheet are logical, and the seller nets to zero. In the example above, a purchase price reduction because of lower accounts receivable will be offset by the seller having more cash in his or her retained cash account.

It is also critical that the closing balance sheet is calculated with accounting principles and estimates consistent with how the threshold was derived. Reserves against accounts receivable and inventory should be agreed to prior to closing or, if this is not possible, then an agreement to use the same reserves against the gross values in the threshold and closing balance sheet. Similarly, accrued liabilities need to be consistent. This is a common area for buyers to play games regarding gaining purchase price reductions from working capital true-ups. As an example, many sellers don't accrue unvested vacation, warranty

reserves, or reserves against cash discounts on accounts receivable, to name a few. Some buyers will not disclose their intent to record these liabilities, which result in lower net working capital, until after closing, preferring instead to undergo what will most certainly lead to a post-closing dispute. In my experience, seasoned buyers don't play these games but rather put their faith in their ability to properly price the deal during price negotiations rather than pick up price concessions through covert means after the fact. Sellers can protect themselves against these games by properly defining GAAP.

- Defining generally accepted accounting principles (GAAP).** Negotiations rely heavily on the seller's financial statements, and most deal documents include a seller representation that the financial statements are prepared in accordance with GAAP, consistently applied with seller's past practice. Be aware, however, that GAAP can still be quite subjective; often there's seldom one "right" answer. GAAP, by their definition, are accounting principles that are "generally accepted." In the context of a deal, there is often disagreement on exactly what is "generally accepted." The first step is for GAAP to be applied consistently with the seller's past practice. The second step, however, is for GAAP to be applied consistently between the threshold and the closing balance sheet. This can be accomplished by applicable wording in the working capital true-up section, as well as in a schedule to closing for the key working capital elements such as reserves and accrued liabilities. Often a schedule as to how the working capital is calculated is included in the purchase agreement. This can help, but wording that the closing balance sheet will be calculated consistently with the threshold is still necessary.
- Establishing earn-outs.** Deal structures that have a portion of the purchase price being contingent on future performance of the seller are common. They can bring a buyer and seller together when there is a material gap in price. They can result in more purchase price potential for a seller whose profitability is below its potential. They can protect a buyer from the downside risk of a smooth transition in ownership. The preference here is to keep it simple for the benefit of both parties. Problems arise with structures that are overly complicated or more difficult to measure during the earn-out period. Sellers prefer earn-outs based on sales, and buyers prefer those based on net income. A good compromise is often gross profit or gross margin. Clearly delineate if the gross profit or margin is based on the seller's current customers at the time of closing, the seller's customers for a period of time prior to closing, or all of the customers of the business unit during the earn-out period. Also, clearly delineate whether the gross profit or margin is based on accounting principles consistent with the seller's past practice.
- Representations and warranties.** Representations and warranties reflect allocation of risk between buyers and sellers. Buyers will require certain assurances from sellers regarding their

business, customer base, and condition of their assets, to name a few. But once the deal is done, sellers no longer have negotiating leverage. It is therefore crucial that sellers understand what they are representing—particularly in regard to financial representations about their business and assets—and err on the side of disclosure. Going back to theoretical intent again, buyers don't want surprises, they want disclosures about whether there are assets that the seller knows need to be replaced, customers that the seller knows will not be doing business with the company after closing, etc. At this point in the negotiations, the buyers have invested much time and money in the deal. It is relatively rare that something happens at this point to cause them to walk away from the deal. Sellers can better protect themselves from post-closing disputes by taking the time to disclose what they are aware of based on the representations and warranties the buyer is requesting.

Steer Clear of the Pitfalls

Consummating transactions is time-consuming enough without having to face the long difficulties of post-closing disputes. By having a seasoned deal team including an intermediary, an accountant, and an attorney, sellers can go a long way toward ensuring the working capital and legal agreements are drafted in a manner that clearly outlines accounting principles consistently used and corresponding representations and warranties made surrounding financial statement true-ups and earn-outs. There will always be post-closing disputes, but with good communication, articulation, and disclosure, the probability can be greatly reduced.

About the Author

Karen Monfre, Managing Director of WCF Advisors, possesses expertise in assisting clients in acquiring a business or in the sale of their business. Her time is spent exclusively doing merger and acquisition, business valuation, litigation support, and related engagements. Because of her loyal client following, Karen is highly sought after for her experience and forthright consultation services.

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