PERSPECTIVES

Navigating M&A Post Closing Disputes: Insights into Strategic Acquisitions

Our perspectives feature the viewpoints of our subject matter experts on current topics and emerging trends.

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INTRODUCTION AND OVERVIEW

Mergers and acquisitions (M&A) have been common in the U.S. and global economy for over a century and are undertaken to accomplish a range of economic objectives by deal participants. Within the subset of M&A that are acquisitions, buyers are bifurcated into two primary categories defined by the motivation for the acquisition: financial versus strategic. Financial buyers are most often represented by the private equity industry whose participants seek to purchase a target company with the intent to sell the improved acquiree at some future date, for a profit. Strategic buyers, on the other hand, are most often companies looking to acquire a target to exploit perceived synergies between the buyer and the target to increase the value of the overall combined enterprise. Strategic acquisitions were the focus of a recent survey and analysis we conducted, and the following information may be of particular interest to strategic acquirors and their external corporate counsel.

OBJECTIVE OF OUR ANALYSIS

Our survey and analysis were undertaken to identify correlations between the pre-acquisition expertise of the buyer and the frequency of post-closing purchase price disputes between the parties. In addition to the buyer's resident expertise with the acquisition target's industry, we also considered the impact of retained expertise as evidenced through a buyer's retention of third-party advisors for assistance with pre-deal diligence. Our analysis is based on our survey of closed deals from 2021 through 2022.

Our analysis is not intended to portray results that are statistically significant; rather, we intended to corroborate trends observed during, and consistent with, our experience in resolving post-closing purchase price disputes.

TWO OVERARCHING DRIVERS IN STRATEGIC ACQUISITIONS

Two overarching drivers are observed when analyzing a company's strategic goals for an acquisition:

- Increased "scope."
- Heightened "scale."

Scope pertains to acquiring related technology, expertise, or markets that may propel the buyer toward new directions, encompassing diversified products/services or an expanded geographic region. Scale aims to unlock the efficiencies derived from expanded production, distribution, and market presence. Our survey explored the correlation between the nature of a strategic deal (namely, scope versus scale) and the frequency of post-closing purchase price disputes. Scope transactions equip the buyer with complementary services, technologies, or expanded markets. However, these newly acquired avenues for growth often necessitate alignment among the parties' pre- and post-closing expectations and forecasts. Consequently, an increased occurrence of post-closing discord can arise.

SURVEY METHODOLOGY AND HYPOTHESIS

Through our survey, we analyzed the scope and scale of acquisitions with the objective of gaining a deeper comprehension of the rates of post-closing disputes, and we pinpointed the financial statement line items most frequently subject to contention.

Our core hypothesis can be summarized as follows:

> *There is a greater likelihood of encountering post-closing disputes for scope-oriented transactions, rather than scale-oriented transactions, and transactions where the acquiring party aims to enhance their business with one that they may not be thoroughly acquainted.*

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Our survey was conducted anonymously, soliciting active mergers and acquisitions (M&A) legal counsel without seeking the identity of the parties or targets. We asked the respondent legal counsel to “consider a single strategic M&A transaction […] that closed […] from January 2, 2021, through December 31, 2022.” However, it is noteworthy that 24% of our subject deals self-identified as “non-strategic,” which allowed for added comparative elements.

Once the transaction was identified, we asked the respondents to differentiate between the type of strategic transaction for which they were responding or, to specify that it was non-strategic.

Our survey proactively solicited corporate counsel during the period from November 2022 through April 2023.

BROAD PARAMETERS OF RESPONDENT DEALS

For those that identified as strategic transactions, 69% were categorized as scope deals, while only 31% were consummated exclusively to increase the scale of the acquirer.

The size of the deals in our response was weighted to the lower middle market with 58% below $100 million, 35% between $100 million and $250 million, and only 7% with purchase prices greater than $250 million.

To evaluate post-transaction disputes, we considered the expectations of the parties related to working capital. 94% of respondent deals contained a working capital target as a component of the purchase price. Among these transactions, a seller-prepared estimate was present in 88% of cases, accompanied by a corresponding buyer true-up.

In all deals with a working capital element, irrespective of the party responsible for preparing the estimate or presenting the final calculation proposal, a formal mechanism was required for addressing any disputes arising from the proposed final working capital calculation. This requirement entailed the submission of a written objection notice within specific timeframes. This notice was to be lodged within 61 – 90 days (38% of our respondents), 31 – 60 days (31% of our respondents), or within 30 days (31%) after receiving the counterparty’s computation.

THE ROLE OF PRE-DEAL DILIGENCE

Given that all M&A transactions are undertaken to generate positive financial results for the post-closing entity in comparison to the pre-deal independent companies, the practice of conducting a Quality-of-Earnings (Q of E) financial analysis remains an essential aspect of buy-side diligence. It has become almost an expectation that buyers will enlist external experts to conduct such Q of E evaluations. As observed among our respondents, a Q of E analysis was conducted by a third-party advisor for every deal, where a third party was retained.

In contrast to this consistent trend, it was surprising to discover that approximately 12% of the polled transactions did not engage a third party for any form of diligence. We interpret this result as further evidence of a discernible trend wherein many sophisticated buyers engaged in the pursuit of strategic acquisitions rely on their in-house corporate development professionals to perform financial diligence, particularly the financial Q of E.

Our respondents indicated that third parties were utilized to conduct other non-financial diligence encompassing reputational, legal, property and industrial, and billing and coding.

At J.S. Held, we are proponents of reputational diligence, which is a cornerstone of our Pre-Transaction Diligence and Business Intelligence services offering within our Global Investigations division. We anticipate that the capacity to gather actionable intelligence during an M&A proves invaluable to making informed and risk-balanced decisions. The diagram below summarizes the primary sources of information and their role in assessing the reputation of transaction counter-parties.

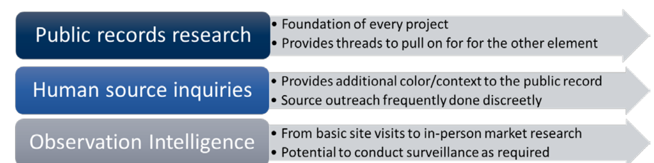

Figure 1 *- Pre-transaction reputational diligence sources.*

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THE RESULTS

In defining a dispute for our survey, we focused on what turned out to be a purchase price element in 100% of the deals: working capital. To further clarify, this dispute could involve a formal resolution process, but it was not a necessity. In fact, within our respondent deal set, only 6% necessitated the initiation of formal arbitration when confronted with a disputed working capital element in the purchase price. Notably, this 6% exclusively comprised non-strategic M&A.

Regarding the strategic deals identified by our respondents, 55% encountered disputes related to working capital adjustments on the closing date, resulting in changes to the purchase price. This subset was comprised of 44% scope deals and 11% scale deals. This supports our hypothesis: there is an increased frequency of disputes in strategic transactions categorized as *scope* transactions, compared to strategic transactions categorized as *scale* transactions.

AVOIDING WORKING CAPITAL DISPUTES

Our research yielded an additional outcome: it offers a deeper understanding of the balance sheet line items contributing to the 55% occurrence rate of disparities and subsequent purchase-price adjustments. This essentially manifests as a balanced division, with current assets (i.e., accounts receivable and prepaid assets) and current liabilities (i.e., deferred revenue, warranty reserves, and other current liabilities) forming a 50/50 split.

Our experience consistently demonstrates that the root causes of most post-closing working capital disputes are not the application of complex accounting principles. Rather, they often stem from more mundane factors, including transaction timelines and deficiencies in accounting infrastructure. These factors, combined with the differing perspectives between the seller and buyer regarding GAAP compliance before and after closing, compounded by the hindsight gleaned months after the transaction's closure, create a fertile ground for significant post-closing purchase price disagreements and subsequent adjustments.

Often, we see that the closing date itself, which does not occur at a traditional reporting period like quarter- or month-end, lacks the benefit of the financial closing processes a company may have in place. Furthermore, the closing frequently occurs simultaneously with the date of the financial statements from which the closing date's working capital is derived. Both the buyer and seller are acutely aware that a subsequent true-up is necessary to resolve this hastily assembled estimate.

Given this landscape, it is advisable for sell-side clients to proactively prepare for the closing estimate by developing and rehearsing a quick close. Essentially, this entails directing their financial reporting staff to focus on traditional period-end financial closing procedures that pertain to accounts heavily reliant on management's judgment and estimates, thereby representing the greatest risk for post-closing disputes. This involves accounts such as reserves for collectability, assessments of inventory obsolescence, and current liabilities determined by analysis of outstanding service delivery obligations (like deferred revenue) and accruals for recurring expenses.

The image below, assembled from a compilation of resolved disputed closings overseen by J.S. Held practitioners serving as the appointed Accounting Neutrals, offers valuable insight into the portrayal of hypothetical differences arising between the seller- and buyer-prepared working capital calculations. It sheds light on the relevant topic or guidance governing the assessment of these subjective account balances which frequently lie at the core of working capital disputes.

	Per Seller	Per Buyer	Difference	Relevant Topic/Guidance
Current Assets				
Cash	$ -	$ -		
Certificate of Deposit	-	-		
Accounts Receivable	153,752,000	153,752,000	-	
Less: Allowance for Bad Debt	(5,500,000)	(13,187,600)	(7,687,600)	Loss Contingencies; Subsequent Events
Merchandise Inventory	158,446,465	150,446,465	(8,000,000)	Lower of Cost or NRV; Obsolescence
Prepaid Expenses	3,950,000	3,800,000	(150,000)	Rollforward, Loss Contingencies
Total Current Assets	$ 310,648,465	$ 294,810,865	(15,837,600)	
Current Liabilities				
Accounts Payable	$ 114,508,000	$ 114,508,000	-	
Accrued Liabilities	6,750,000	10,950,000	(4,200,000)	Cut-off Accruals and Loss Contingencies
Taxes Payable	758,000	758,000	-	
Deferred Revenue	20,000	970,000	(950,000)	Revenue Recognition
Total Current Liabilities	$ 122,036,000	$ 127,186,000	$ (5,150,000)	
Closing Date Working Capital =	**$188,612,465**	**$167,624,865**	**-$20,987,600**	

Figure 2 *- Accounts most frequently disputed and the relevant topic/guidance to which management's judgement is applied.*

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By implementing a practice akin to a rehearsed performance in theatre, this condensed period-end closing enables finance and accounting staff to focus their scrutiny on working capital accounts that are most material to the balance sheet. Consequently, this approach enhances the likelihood of encountering fewer post-acquisition disputes.

By focusing their analysis on these discretionary and recurring working capital account balances, the parties will not only reduce the likelihood of disputes arising from current asset and liability balances transferred, but they will also minimize the potential for fostering a contentious environment. Moreover, they may curtail the often-linked "P&L multiples effect," which is invoked by extrapolating alleged balance sheet misstatements in both strategic and financial M&A contexts.

EXECUTIVE SUMMARY

- Scope transactions have an increased frequency of disputes compared to scale transactions.
- Working capital was an element in each deal surveyed.
- Focused diligence on discretionary and recurring working capital account balances reduces the likelihood of disputes.

ACKNOWLEDGMENTS

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MORE ABOUT J.S. HELD'S CONTRIBUTOR

Frank Lazzara is a Managing Director in J.S. Held's Global Investigations Practice. Based in New York, he provides advice for dispute resolution, forensic accounting, and investigative expertise to attorneys in arbitration and litigation. He also serves as party-advisor, expert witness, and neutral accounting arbitrator in acquisition-related purchase price disputes. Frank also has experience with domestic and international arbitration cases involving corporate M&A in the beverages, technology, retail, consumer packaging, software, government defense, and auto accessories manufacturing industries.

Frank can be reached at flazzara@jsheld.com or +1 718 702 7527.

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