How to guard against rising M&A disputes

Almost half of M&A deals get disputed.
Stay in the other half.

It happens more often than you think – the strong relationships, thorough research and careful diligence that are woven into a merger or acquisition suddenly unravel post-closing.

"Both buying and selling parties often have the sense that 'it won't happen to me,'" said Grant Thornton Head of Purchase Agreement Advisory Services Max Mitchell. "Nobody thinks they're going to be the one facing a working capital dispute or earn-out dispute until soon after closing, when suddenly there's a shift in mindset and a difference in approach. Things that were nonissues can suddenly become problems."

In a survey of almost 200 US-based M&A professionals (including private equity investors, corporate development officers and legal counsel) who had completed more than 1,300 deals last year, Grant Thornton recently found that approximately half of their deals wound up in some form of accounting dispute.

The survey respondents, and individuals interviewed as part of the survey, included an even representation of buyers and sellers across a variety of industries. Their feedback revealed some common themes about the factors that raise the risk of disputes occurring, and how you can guard against them.

Average deals resulting in:

46%

working capital dispute

51%

earn-out dispute

The following report outlines our findings, with commentary from our industry specialists and selected survey interviews.

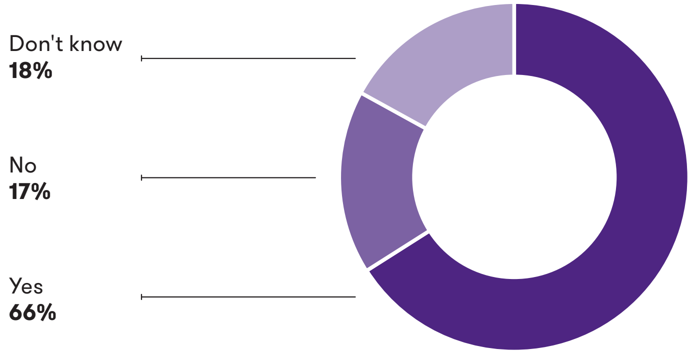
The most common causes for disputes

While approximately half of M&A deals wound up in some form of accounting dispute last year, 66% of survey respondents indicated that the COVID-19 pandemic has increased the likelihood of disputes even more.

“The sudden drop-off in the economy has created a perfect storm, where buyers may dispute historical judgments and estimates used by sellers in measuring working capital that the buyers think are no longer appropriate,” said Grant Thornton Forensic Advisory Services Managing Director Charles Blank. “Earn-outs will also become more prone to disputes if the performance of past acquisitions significantly declines.”

“When the economic environment deteriorates, and it looks like the buyer may have overpaid for a target company, the buyer will sometimes look to claw back value through the purchase price adjustment process, or by making claims for breaches of the agreement,” said one law firm partner in the recent survey.

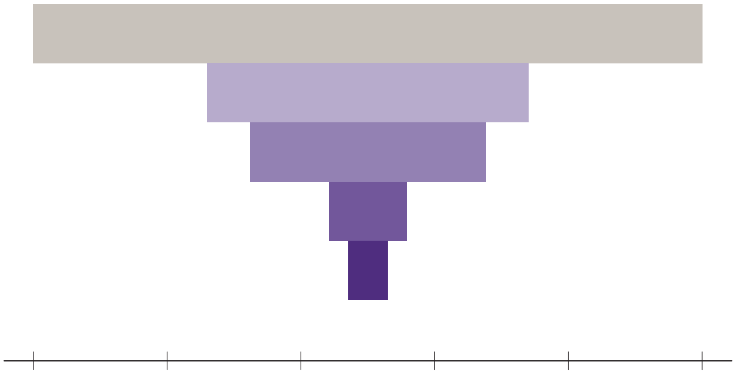
When considering deals so far in 2020, has COVID-19 increased the likelihood of working capital or earn-out disputes?



Dispute lifecycles: working capital versus earn-outs

Survey responses helped illustrate the dispute lifecycle, indicating how disputes progress to resolution:

Of deals with **working capital** adjustments, how many became disputed?



Total deals with working capital = 100%

Total disputed = 46%

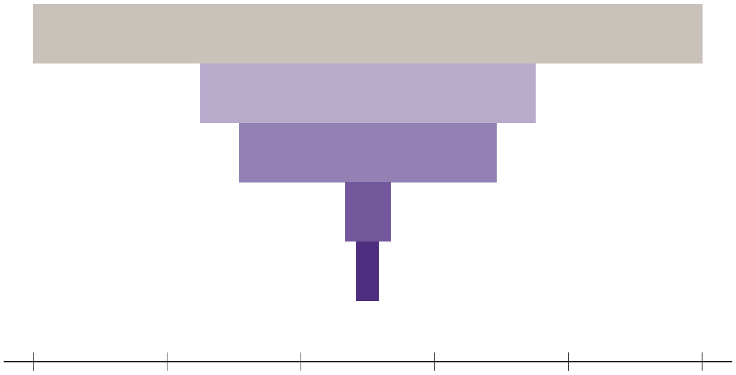
Total resolved before formal dispute/objection notice = 30%

Total resolved in good faith negotiations = 10%

Total referred to expert = 5%

Base size = 657 deals with working capital adjustment

Of deals with **earn-out** adjustments, how many became disputed?



Total deals with earn-out = 100%

Total disputed = 47%

Total resolved before formal dispute/objection notice = 38%

Total resolved in good faith negotiations = 6%

Total referred to expert = 3%

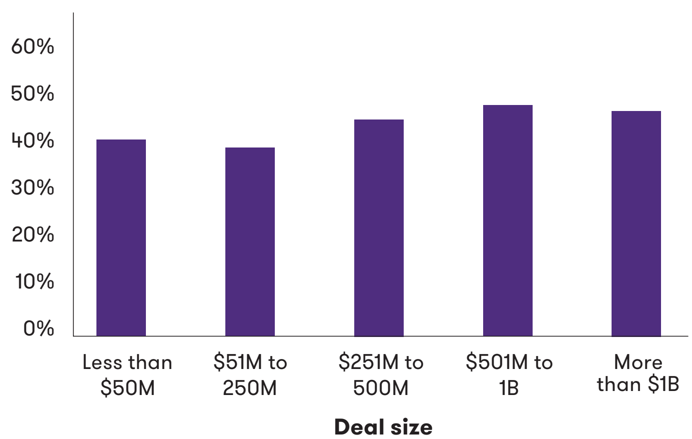
Base size = 1,314 deals with earn-out adjustment

Key factors

So, what are the key factors that not only increase the risk of an initial dispute, but increase the time required to reach a resolution?

"Generally speaking, you have more risk for a dispute when you have more areas that require judgment," said Blank. The more complex the balance sheet, the greater the likelihood of dispute. However, even a seemingly simple business can still require myriad judgments to be made within their accounting, so disputes are prevalent in deals of all sizes. Whether a deal has a headline price of $10 million or $1 billion, it is the complexities of the balance sheet that drive working capital disputes; and the nuances of the income statement that will impact earn-out disputes. Parties to a deal should not think that they are less likely to be affected, solely due to the size of the deal.

Percent of deals where working capital true-up is disputed



1. Vague language

There has been a move toward including more prescriptive language in calculating purchase price adjustments in the last few years, with 50% of respondents noting increased use of an "Accounting Hierarchy" or "Specific Accounting Policies." Yet, many agreements still suffer from imprecise language around the calculation of working capital and earn-outs, or from an over-reliance on GAAP as a panacea.

Our survey found that dealmakers are more frequently using specific accounting policies, either on their own or together as part of an accounting hierarchy (such as specified accounting policies, then GAAP, consistently applied).

Interviewees indicated that vague language is not uncommon because the parties are looking to get the deal done, and the working capital or earn-out provisions are often some of the last to be drafted. While using imprecise language can help avoid disagreements at the time, it often results in disputes later. Parties can proactively mitigate disputes by drafting the accounting principles as soon as the first draft of the purchase agreement is available and involving accounting advisors from the start, rather than only when it is time to sign.

For example, the parties might agree to calculate the allowance for doubtful accounts consistent with the seller's past practice, as this is more straightforward than codifying a specific practice. But then they may later disagree, if the buyer believes the assumptions used by the seller do not conform with GAAP or if they take a more prudent approach. Often, a buyer's view and a seller's view can differ, even though both are still in accordance with GAAP.

How has your use of guiding principles in purchase agreements evolved in recent years?

50%

Use an accounting hierarchy more frequently

44%

use specific accounting policies more frequently

23%

rely on "GAAP consistently applied" less

2. Purchase price adjustments

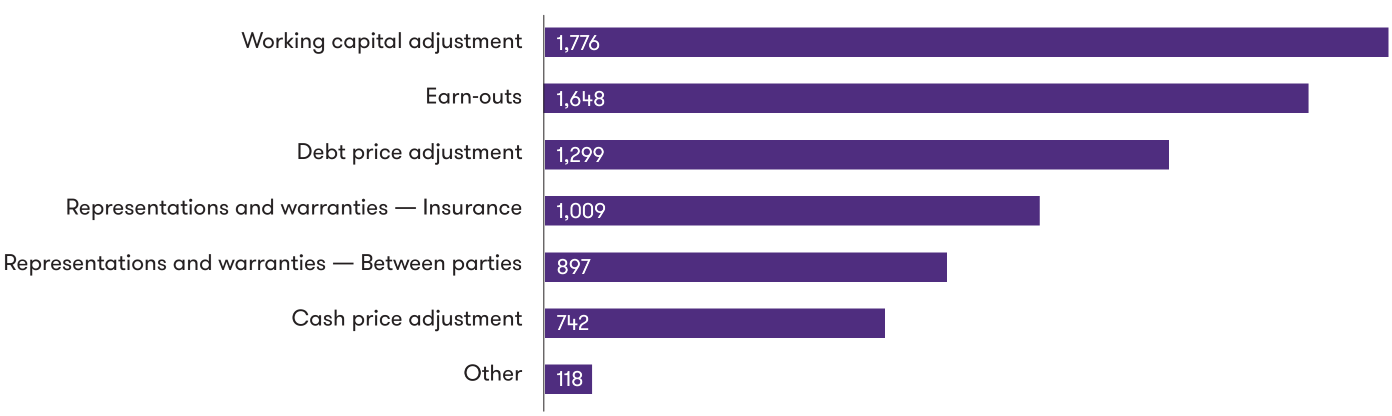
Survey results indicated that working capital and earn-outs top the list for the most commonly disputed types of purchase price adjustments.

The post-closing process serves as an easy and immediate way for buyers to contest the value of a transaction immediately after the closing, when compared to a representation and warranty claim. Representation and warranty claims may require a higher standard of proof of loss, or breach of contract with the counterparty, and are subject to resolution by litigation that is usually more costly and involves minimum claim thresholds that make it harder to recover smaller claims.

The purchase agreement typically has a standard mechanism that not only allows but facilitates the true-up of the value of a transaction, which lends itself to abuse and manipulation when there are unclear definitions or contractual terms.

Purchase price adjustment disputes have become increasingly common in recent years, and are more common than breaches of representations and warranties. The methodology used to calculate working capital is often at the center of the dispute, and now warrants more attention when the deal is negotiated. Parties risk unanticipated changes to the value of the transaction through the purchase price adjustment process, when definitions are not clear or are misinterpreted.

Rank your top three areas that have typically resulted in post-acquisition disputes: (Ranking Points)



Working capital calculations

Working capital disputes often arise because working capital is broadly defined as "GAAP, consistently applied" (with the seller's past accounting methods), and the buyer disagrees with the judgments and estimates historically applied by the seller.

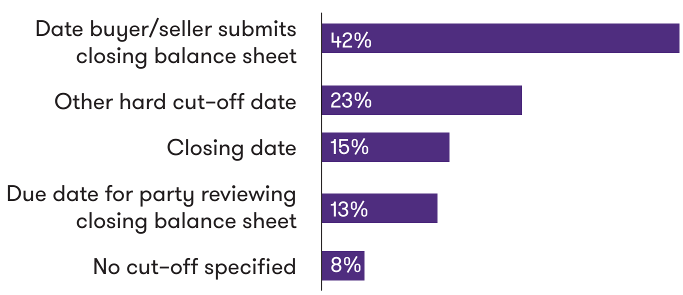
The survey found that the components of working capital that are subject to the most judgments and estimates are the most common areas of dispute, such as the allowance for doubtful accounts for accounts receivable and inventory valuation (excess and valuation, and lower of cost or market / net realizable).

Certain topics that pose the most post-acquisition working capital disputes can be resolved by proactively considering them and drafting the purchase agreement accordingly. For example, parties can avoid disputes over currency exchange rates by simply agreeing to a source for the rates that they can both refer to and agree upon.

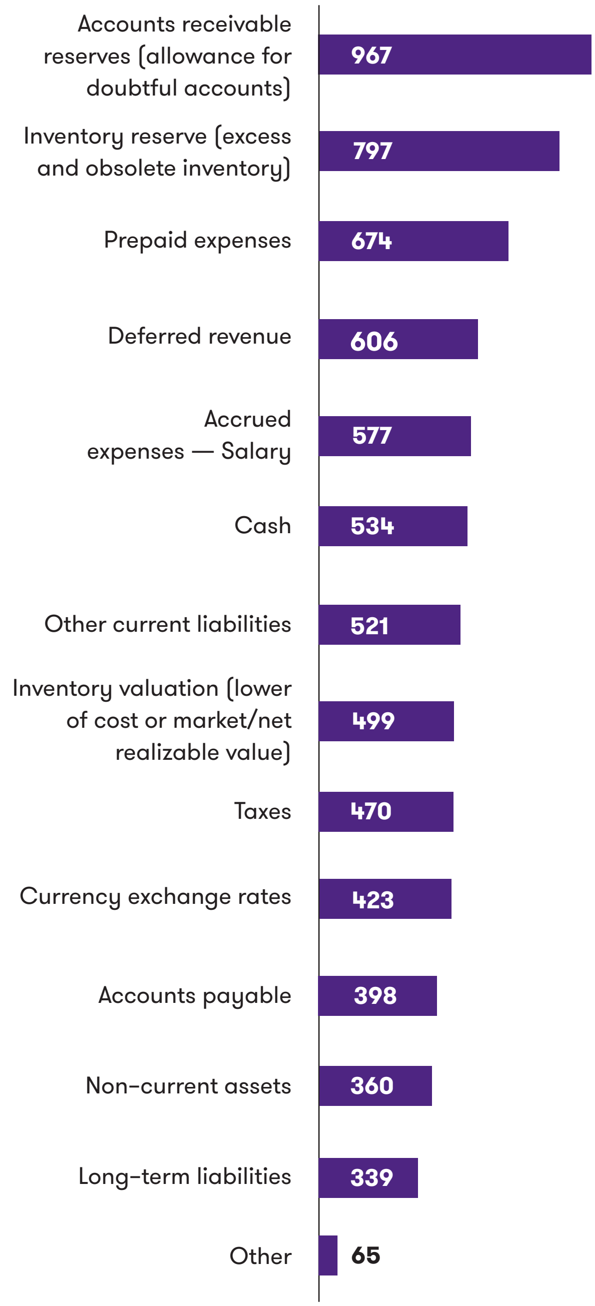
The survey found that the most popular cut-off date to consider new information in preparing a working capital statement is when the closing statement is submitted by the party preparing it. This approach allows the buyer to apply judgment in evaluating subsequent events, and therefore increases the opportunity for more disputes.

The current economic environment has highlighted where buyers and sellers might apply different judgments and estimates in measuring assets and liabilities. Disagreements can arise when events after the closing date, such as an economic downturn, create disagreement about whether such items represent evidence of conditions that existed on or before the closing date.

When preparing the working capital adjustment post-closing, up to which point do you typically consider new information?



Pick the top balance sheet statement areas that pose the most post-acquisition working capital disputes?



Earn-outs

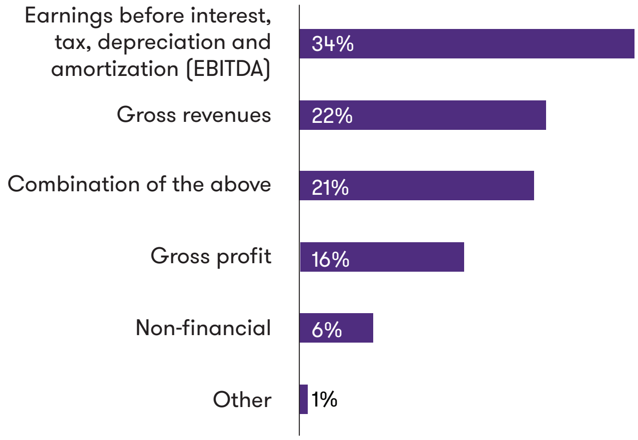
Earn-out disputes often arise because the measurement basis of the earn-out includes expenses of the acquired business (such as EBITDA or measures based on net profit), where the buyer has more discretion to determine which expenses to allocate to it, versus basing an earn-out on revenue alone.

Despite this, the survey results showed EBITDA as the most common earn-out metric even though these are most likely to result in disputes. Further, only 22% of dealmakers use revenue as the measurement basis. Using revenue is not without issues, but it can be more tightly defined and may result in fewer disputes.

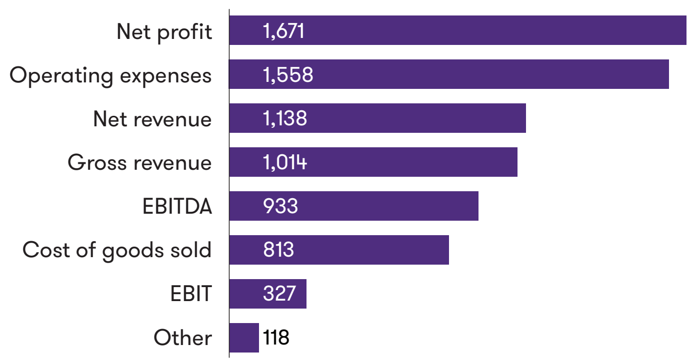
51%

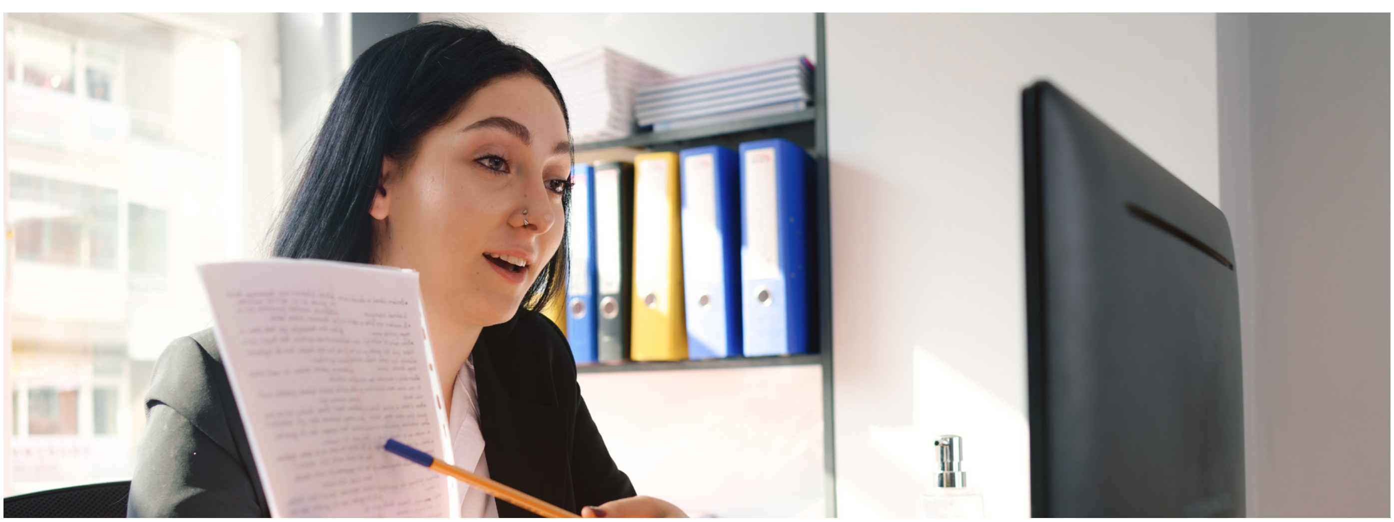
Average deals using earn-outs

What do you typically use as the measurement basis for earn-outs?



Pick the top income statement areas that pose the most post-acquisition earn-out disputes: (Ranking Points)





The survey found that net profit and operating expenses pose the most disputes, with revenue (gross and net) following.

Earn-outs are used to bridge the valuation gap between buyers and sellers. Given the current uncertainty in the economic environment, there is an expectation that earn-outs will work their way into more deals. Unless parties agree to rely less on an expense-based measurement basis, this means we can expect more earn-out disputes in the coming years.

Even if revenue is used as the measurement basis, it is still subject to interpretation, particularly if different people are negotiating the deal versus implementing the earn-out calculation. Another factor that may lead to earn-out disputes is the desire to increase the length of the earn-out period to get past the current economic environment.

It is not always possible to avoid the factors that might create a risk of disputes arising. However, it is important to be aware of these risk factors, and to take action that guards against disputes.

If parties cannot agree on contractual terms pre-signing, they will likely not agree to calculations when there are significant dollars at stake. It is not appropriate to use an earn-out to bridge a valuation gap, without considering the effects this can have later. Parties should take the time to identify issues that may arise, define the terms of an earn-out and proactively consider what is measured.

Time spent on this during the planning stages pre-signing will pay off by avoiding costly disputes post-closing.

How unclear earn-out language in a purchase agreement can impact valuation of earn-out liabilities

For more complex earn-out structures (such as earn-outs that include caps, floors, and catch-ups), in cases where measuring fair value using an option-pricing methodology is appropriate, the fair value of the earn-out can be significantly impacted by the variability of the earn-out metric (such as revenue or EBITDA) around the expected case. If the measurement basis in the agreement is not clear, this can impact the calculation of the expected case and the corresponding fair value measurement."

Oksana Westerbeke, Principal, Valuation, Grant Thornton

How to guard against disputes

The current pandemic climate has further increased the risk of disputes, so it is now more important than ever to proactively mitigate these risks and plan for the future.

Top 3 approaches that would have resulted in fewer disputes

1. Using the 'Locked Box mechanism'
2. Drafting an accounting hierarchy with specific accounting policies
3. Applying consistency with pre-closing target working capital calculations

It is hard to plan for the unexpected, but there are some guidelines that can help you guard against disputes:

1. Clarify your methodology

You should anticipate potentially contentious judgment areas and proactively describe how they will be accounted for at, or after, the closing.

Survey respondents indicated that they would have had fewer disputes had there been an accounting hierarchy or specific accounting policies.

Vague language that is left open to interpretation can be taken differently after the closing date. While comparability is helpful, a reliance on consistency might not adequately detail how to account for items at or post-closing – particularly when the target calculation is just numbers on a page without any explanation, and it is left to parties post-close to decipher pre-signing intent.

It is a best practice for parties to agree on the specific accounting treatment of certain items to be adopted in a closing balance sheet or earn-out statement. These can either take precedence over past practices, address new areas of accounting that have arisen since the date of the last financial statements (such as where consistency would not define accounting), clarify areas of material judgment or address commercially negotiated treatments.

Hierarchy

The Closing Balance Sheet is bespoke to each transaction, and therefore the basis of its preparation should be tailored and prescribed in each purchase agreement. The best practice hierarchy for this is as follows (with 1 taking precedence over 2 and 3, and 2 taking precedence over 3):

- Specific accounting policies
- Consistency with a specific set of financial statements
- Applicable GAAP/IFRS

Each of these are detailed below.

Specific accounting policies

Below is a list of circumstances that may warrant inclusion of specific accounting principles:

Circumstances	Considerations	Example items to consider agreeing for a specific accounting treatment
No accounting policy stated in financial statements or stated policy does not provide adequate details	Consider items not covered by a specific accounting policy, particularly if the item was not material historically but will be at / post-closing	• Revenue recognition • Accrued PTO • Bonus accruals • Restructuring reserves • Long-term contracts
No historical balance in reference period	Consider changes in factual circumstances that may introduce new items into post-closing statements	• Impact of COVID-19 • Changes in lease terms (end of rent-free period / onerous leases) • Revaluation of assets • Legal / environmental / warranty provisions
Account estimate is subjective	Consider key balances that may be reliant on significant judgments or management estimations	• Doubtful account reserves • Revenue recognition and deferred revenue • Long-term reserves • Returns reserves / warranty reserves
Specific commercial treatments	Consider fixing $ amounts for assets/ liabilities, agreeing there will be no change to carrying values, or agreed deviations from past practice and/or GAAP	• Agreed debt-like deduction for capital expenditure shortfall below budget • Agreed cash-like addition for off balance sheet assets • Reserves for off balance sheet liabilities
Foreign currency balances	Consider the impact of fluctuations in underlying foreign currency on material working capital balances. The enterprise value may be derived from a different currency to functional currency, particularly with cross border transactions, which can create inconsistencies when measuring working capital at closing.	• Agree on basis and source of exchange rate to be adopted • Agree on treatment of any hedging arrangements

Consistency with a specific set of financial statements

Specific accounting policies will address certain matters, as detailed above, but it is still relevant to refer to consistent practice, otherwise there would need to be a specific accounting policy for every accounting treatment. The key to this is being specific in which financial statements are used, rather than simply "consistently applied" – which may refer to numerous balance sheets or accounting dates. This lack of specificity can cause difficulties if the target company's management applies different accounting practices month-to-month, or in their year-end financials.

The best practice is to specify consistency with a defined reference point.

If the target business has prepared and issued annual financials recently, these statements can provide a convenient reference point for the basis of preparation of the closing balance sheet.

Applicable GAAP/IFRS

Items not covered by a specific accounting policy or consistency can be accounted for in accordance with an agreed-upon accounting framework, such as US GAAP. The best practice is to clearly define such a framework in the purchase agreement, including the effective date (particularly relevant given the changes in US GAAP for leases and revenue recognition).

This provides a helpful 'catch-all' for any new circumstances that did not exist at the previous financial statement date, where consistency cannot be applied.

Where there are differences between GAAP adopted in the relevant financial statements and GAAP adopted for the closing balance sheet, the best practice is to identify the impact of adopting a different GAAP treatment and ensure that the appropriate accounting treatment is agreed to and prescribed in the agreement. All parties should consider being clear on the impact of changing GAAP on their agreements.

"Keen attention to the components of working capital and the accounting methodology is extremely important. Using very clear language helps to make sure everyone is on the same page on the front end, which can go a long way toward avoiding disputes later on," said one law firm partner.

2. Provide an example (but understand the limitations)

Prior to signing an agreement, or even as early as the Letter of Intent stage, parties can prepare *an illustrative enterprise value-to-equity price bridge*, illustrating the price adjustments. If a seller prepares an illustrative enterprise value-to-equity price bridge early in the process, they can effectively compare multiple bids from potential buyers. Even in instances where enterprise value / EBITDA offers may be comparable, the resultant equity price may differ significantly – even more so when it comes to quantifying assets and liabilities post-closing, when there are differences in opinion. This comparison and illustration of value can help sellers avoid frustrated transactions, by understanding intentions from a dollar perspective, rather than from each side's unspoken views on the words of the agreement.

Buyers and sellers can avoid post-closing contention by proactively agreeing on components of cash, debt and working capital, quantifying cash-like items, restricted cash, all components of debt and calculations of working capital. By illustrating these, all parties then have a clear view of what potential proceeds from the deal might be, and can avoid unexpected surprises later.

A sample calculation of working capital pre-closing can be a useful reference point in post-closing preparation and review. Parties can refer back to pre-signing intentions in instances where drafting does not give a definitive direction.

A pre-signing illustration will have limitations, since unforeseen circumstances may arise by the closing, so it is not a best practice that it serves as the guiding principle itself.

In the survey, 14% of respondents felt that calculating the closing working capital on the same basis as the peg / target working capital calculation would have resulted in fewer disputes. While parties often look for there to be some consistency between the calculation of closing working capital compared to the target calculation, there can often be variations that will not provide a clear methodology for calculations post-closing.

Further to this, the calculation of a target typically contemplates pro-forma adjustments, normalizations, and exclusions. It is key that the closing net working capital calculation contemplates *all* current assets and current liabilities, as they exist at the closing, whether they are one-off or not, unless otherwise specifically addressed in the agreement (either through a definitional exclusion, or a specific accounting policy). **What gets delivered should be measured.**

In addition to this, there may be variances in how balances are calculated month-to-month within the target (such as a bad debt provision that is recorded some months, but not others). If the agreement says "calculate on the same basis as target", but the target is 12 months and includes two or more different accounting interpretations, then there is no clear guideline on how a closing balance should be calculated.

It is a best practice when using a hierarchy for this to govern, rather than simply a table of numbers. There is less subjectivity or need to interpret a table, when one can instead refer to a specific, stated guideline.

Asset purchase agreements and carve-outs

Where the target working capital is based upon a percentage-allocated asset/liability base, this does not mean that the same percentage will transfer at closing.

A seller may allocate a percentage of insurance prepayments to the carved-out entity for purposes of establishing a target calculation, but if these do not form part of the transaction basis (that is, they are not "assumed assets") then there will naturally be a shortfall at closing.

The buyer should not simply calculate a deemed percent of the non-transferring asset for purposes of calculating closing working capital.

3. Use a diligence provider

Involving an external financial provider can help reduce the risk of working capital or earn-out disputes after close.

According to the survey, on average, dealmakers are using diligence providers on 59% of deals.

Using a diligence provider gives buyers and sellers deeper insight into the accounting of the target company. Parties are more likely to find a reasoned, balanced approach to the calculation of target net working capital when involving specialists in this area.

As a matter of best practice, the diligence provider can help craft detailed accounting hierarchies, or specific accounting policies, to manage the risk associated with the specific accounts requiring judgment that may lead to working capital or earn-out disputes. Their familiarity with the underlying financials positions them well to assist in this regard. Diligence teams can consult with forensic professionals to understand potential areas of dispute. Then, they can propose steps to mitigate disputes by avoiding vague language in the purchase agreement and instead drafting detailed methodologies to include in the purchase agreement.

Also, diligence providers can aid buyers in closing the books for the purposes of preparing the closing balance sheet, given they have gained familiarity during the pre-closing diligence process.

One managing director at an investment banking firm said, “On nearly all of our sell-side deals for the last five years, we have gotten a sell-side QOE from a group like Grant Thornton. As my firm works with our clients on a working capital methodology, we work closely with the sell-side QOE provider to put forth a bulletproof methodology and backup schedules.”

59%

Deals that use diligence providers (on average)

“Sell-side due diligence has become an increasingly common feature in transaction processes. It helps the seller to be best prepared, control the process and protect shareholder value - providing a robust and independent report for the buyer. It ensures everyone has the information and analysis they need to make informed decisions. Issues can be addressed proactively, while accommodating the transaction timetable and minimizing disruption to the business during a sales process.”

Elliot Findlay, National Managing Principal, Mergers & Acquisitions, Grant Thornton

4. Be careful and comprehensive with resolution clauses

Failing to outline dispute resolution clauses in the purchase agreement can add further topics to negotiate when the parties find themselves facing a dispute.

The survey found that 85% of respondents said they included a detailed post-closing dispute resolution process. It is a best practice to define:

- the timeline for this process, including:
  - the number of days the buyer has to prepare working capital or earn-out schedules
  - the number of days the seller has to respond
- the number of days they have to negotiate a resolution in good faith
- the basis by which they can extend these processes if necessary
- guidance on the neutral arbitration process, with a named independent accountant agreed to by both parties

Some dealmakers also embed the submission process in the purchase agreement, to limit the components that disputing parties have to negotiate post-close:

- For smaller disputes, some parties are comfortable submitting only one submission to the neutral accountant
- For larger disputes, parties often submit initial submissions then rebut their oppositions initial submission, along with the neutral accountant having the ability to ask questions or request documents it deems necessary to come to a final and binding conclusion

In the purchase agreement, do you include a detailed post-closing dispute resolution process (such as the number of submissions, the days between each submission, etc.)?

The purchase agreement may specifically prohibit or encourage the neutral accountant to ask questions of the parties, with the goal of ensuring a fair approach for both sides.

One director in a U.S. middle-market-focused private equity firm expanded on why a detailed resolution process can be important, saying "In the ones that I've seen and the ones I knew of, it has been helpful to have parameters set, such as 'We have this amount of time to bring something together.' For the most part, neither party really wins if you end up litigating, so I think it is best to have the process outlined ahead of time."

"Parties should take the same care with the dispute resolution provisions as they do with substantive deal provisions … Accountants should be named up front to promote the independence of the accountant. And parties should also define the scope of the purchase price adjustment determination and predetermine how to allocate the accountant's fees for the dispute resolution process," said one law firm partner.

5. Manage earn-out timing, scheduling and metrics

When earn-outs are used correctly, they can provide both parties with another opportunity post-deal to true-up and validate the headline price. The parties can share the risk of post-closing performance; a confident seller can see greater upside, and the buyer will see the benefit in the performance of the business post-closing. Earn-outs can also incentivize management, who remain with the business for a transitional period, to deliver further growth or profits that benefit both themselves and the buyer.

When earn-outs do not receive enough focus or attention, or are poorly drafted, they can damage the business and can create significant contentious post-deal disputes. Survey respondents reported that earn-out clauses were one of the most disputed areas of purchase agreements post-deal.

- **Timing:** Think through the implications of the earn-out mechanism and clauses in the agreement at an early stage of drafting. Parties are more likely to take a reasonable and objective approach to any earn-out during the Letter of Intent (LOI) phase or prior to signing exclusivity, rather than as a last-ditch value-bridge attempt late in any negotiation process. Parties should ask themselves, “Are the conditions attached to any earn-out clauses clearly described, objectively measurable and fair?” If targets are unreasonable, or are not within the seller’s influence, this may damage a future working relationship with the seller and could be a demotivating factor with a detrimental impact on post-deal results. Usually, it will be in both parties’ interests that the business meets its targets, that the earn-out is achievable and that the parties are sharing in the risk appropriately.

Timely input and insights from the principals and all advisers on both the buy-side and sell-side can ensure that the earn-out is realistic, achievable, appropriate, practical and that the legal drafting of the schedule accurately reflects the intentions of the parties. Parties should involve accounting input during the LOI phase, to ensure the metrics set forth are calculable and considered. It can be difficult to revise metrics set forth in the LOI once agreed to without causing frustration.

- **Metrics:** Earn-outs can be tied to more than one metric, which may include a combination of financial and non-financial measures. For example, the earn-out could be payable if the target company satisfied one or two out of three of the following: a certain level of EBITDA, a revenue target and/or retained a set percentage of customers.

  Linking to multiple financial metrics reduces the opportunity for a buyer who gains control of the business to manipulate the preparation of the earn-out statements to seemingly underperform and miss any earn-out targets to the detriment of the seller.

  Conversely, if sellers are motivated primarily to meet revenue targets, they may cause the company to enter low margin or even loss-making contracts to boost the top line. If profits are the primary driver, the seller management may avoid incurring development expenditure and cut corners, resulting in poor quality products or services, which could damage customer relationships and be harmful to the business long-term. Assessing non-financial metrics - such as the number of retained customers – may encourage seller management to operate the business in a way that promotes longer-term success.

- **Accounting basis:** Setting out sensible targets and metrics are only useful to the extent that parties can calculate the balances after the closing. Similar to working capital, the best practice is to set forth an 'accounting hierarchy' focused upon the income statements to be prepared post-closing. Parties should consider whose interpretation of GAAP shall apply post-closing, particularly if the financials of the seller will be absorbed into the accounting system of the buyer post-closing.

In all cases, it is a best practice that parties think carefully about whether the selected measures and metrics will incentivize and motivate the right behaviors, or if there is a risk of damage to the business. The purpose of the metrics should be to encourage management to meet the goals of the buyer. Parties risk focusing so much on the earn-out that they forget to focus on the importance of the long-term performance of the business post-acquisition.

"We have started to see some teams come forward and ask 'Can we extend our earn-out period because of the pandemic? We're just not getting anything done for the next 6 – 12 months, and our earn-out is stalled,'" said an executive vice president at a real estate firm. "We've basically tried to remove things like corporate allocations and other areas where the acquired business really has no control. That's been the biggest evolution over the last few years – it's really structuring earn-outs to keep the acquired business focused on the things that it can control, and not worrying about things that it can't control."

Earn-outs and COVID-19

Earn-out targets are commonly based on EBITDA or similar financial metrics, such as revenue or net income. Purchase agreements already signed might not have factored in the impact of market changes due to COVID-19, and parties want to work together to consider revisions, proactively avoiding dispute by instead renegotiating targets.

Parties might have agreed that post-closing EBITDA calculations could add back or exclude any one-time events or extraordinary items — which might now include any insurance recoveries, supply chain cost increases or shutdown periods as a result of COVID-19. All parties of the deal should consider working together and including calculation examples under various circumstances, as an appendix to the agreements. This can help produce amicable solutions concerning any earn-out calculations, to reduce the risk of any post-deal disputes arising.

6. Use a locked box mechanism

30% of respondents used a locked box mechanism (LBM) – almost 400 of the 1,300 deals considered. Using an LBM was the top response for how to reduce post-closing disputes.

With an LBM, the purchase price adjustments for cash, debt and working capital are derived from a historic balance sheet. This "locked box balance sheet" is typically subject to diligence and detailed review by both parties, and acts as a proxy for the closing balance sheet.

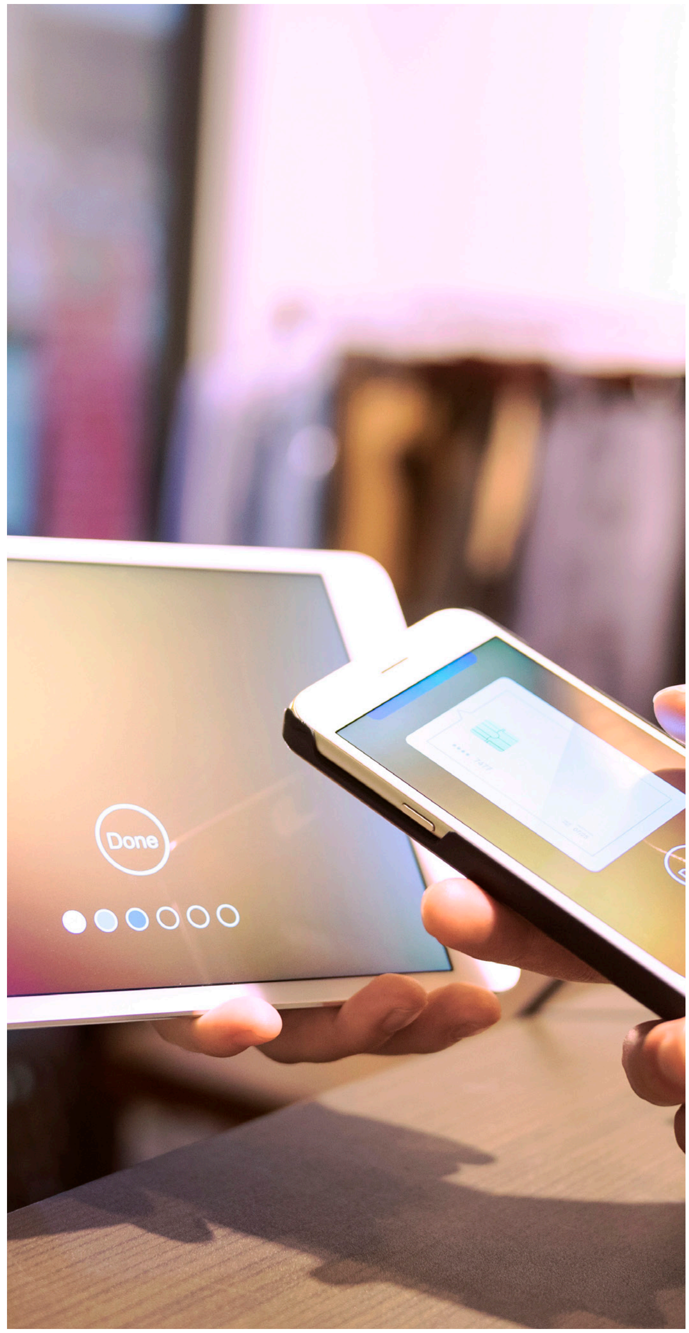
For further details on LBMs,
see **Appendix: Locked box mechanisms.**

Many US dealmakers are not familiar with LBMs but, when used effectively, LBMs can yield a range of benefits compared to the traditional closing balance sheet approach, such as:

- Avoiding the need to prepare, review and potentially dispute the closing balance sheet
- Buyers can concentrate on integrating or operating the business post-closing
- Private sellers can receive full payment at closing and private equity sellers can have all funds available in full immediately after the closing – for distribution

LBMs are not perfect – disputes still arise from:

- Reviewing leakage (which requires carefully considered language)
- Understanding what the "value accrual" is, and reflecting the changes in commercial reality between the locked box date and close
- Significant unanticipated delays between signing and closing that change the financial position, without adequate compensation through the value accrual



Best practices in arbitration

If a dispute advances to arbitration, consider these factors to help reach an amenable resolution:

1. Quality and not quantity

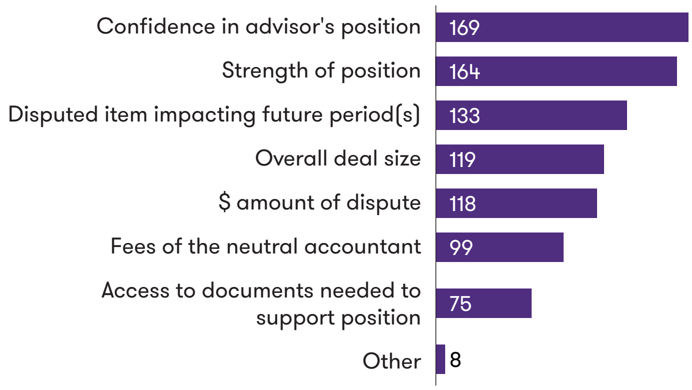
Remove emotion from the equation and focus on the underlying accounting and strength of arguments.

The survey found that the top three variables dealmakers consider when deciding whether to engage a neutral arbitrator versus settling were:

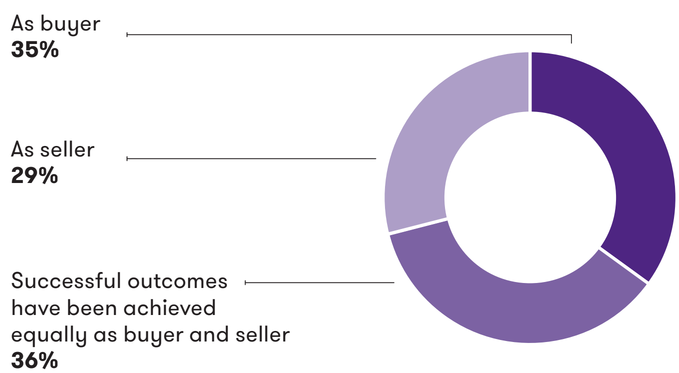
- confidence in the advisor's position,
- strength of position and
- disputing items impacting future periods.

The survey also found that dealmakers should not be afraid to enter the neutral arbitration process as a seller. In spite of the common perception that buyers have the upper hand in the post-acquisition dispute process, respondents have had equal success as the buyer and seller.

Rank the top 3 variables you consider when deciding whether to engage a neutral accountant versus settling: (Ranking Points)



In what role have you found yourself more successful in prevailing in dispute resolution?



> "As someone guiding clients through post-acquisition disputes, I was surprised to see that the quantitative factors such as amount in dispute were not at the top of the list."
>
> **Holly Johnson, Senior Manager, Forensic Advisory Services, Grant Thornton**

2. Choose reasonable access

Draft purchase agreement dispute resolution clauses to allow for "reasonable access" for sellers.

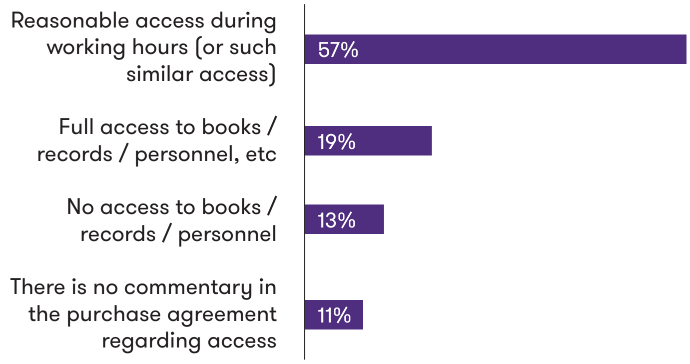
Survey results indicated that while vague language can be a risk, 57% of respondents identified the somewhat general "reasonable access" as the access level granted to sellers in their purchase agreements.

Reasonable access typically grants the seller rights to request data and conduct discussions with personnel. By using the term "reasonable," the parties might ultimately need to negotiate what is "reasonable" – but the term offers flexibility, since the disputed items are unknown when the purchase agreement is drafted.

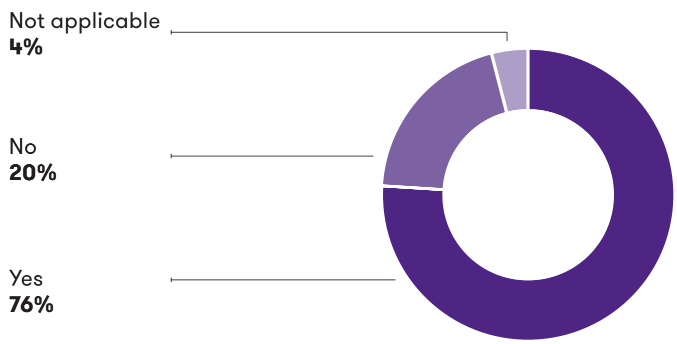
Further, 70% of survey respondents were happy with their access as a seller, and of those who were happy, 82% said they had "full" or "reasonable" access to records.

In any case, the purchase agreement should at least specify the level of detail allowed. 11% of respondents noted their purchase agreements did not disclose this detail, which seems likely to cause dispute later – as sellers will claim full access is allowed, while buyers will claim no access.

With regards to the sellers' level of access after the closing date, what level of access do your purchase agreements typically set forth that the seller should have:



In instances where you were on the sell-side, were you satisfied with the level of access you had?



3. Engage external help in the dispute process

Navigating a post-acquisition dispute requires both strategy, experience and time – which some dealmakers might not have available. However, our survey results showed that dealmakers engage external accounting, forensic or legal service providers less than half the time.

Surprisingly, respondents stated they are only using their in-house accounting team 55% of the time.

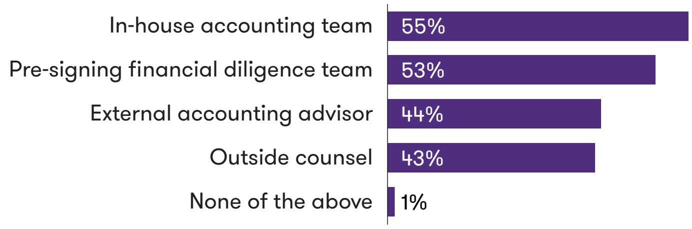
External accounting advisors can offer extensive expertise in the strategy of post-acquisition disputes as well as the communication of positions to neutral accounting arbitrators. In-house accounting personnel might be most familiar with an organization's underlying financials, but they might not have the expertise or experience to navigate the complexities of a dispute process, nor understand what a neutral accountant is looking to ascertain from their requests. Additionally, given the additional demands of a separation/integration process (potentially coinciding with a fair value review of financials), in-house accounting personnel may not have the capacity to take on additional demands. That is where it can help to engage an external service provider.

Further, only 43% of respondents involved outside counsel – it is helpful to have legal counsel to help interpret the purchase agreement from a legal perspective, despite the financial focus of the dispute.

“Grant Thornton’s forensic professionals have experience as neutral accountants, which is great expertise we can bring to support buyers and sellers to guide them through their neutral arbitration process, having been on the other side of the table.” Johnson said.

Some of the risks and guidelines might seem familiar, and yet dealmakers don’t always heed them. Why is that, and what can you do to ensure your deals stay on the right side of disputes?

Separate from engaging the neutral accountant, who else assists you in the dispute process?



Put good advice into practice

In turbulent times, **more effective due diligence** is beneficial to understand the risks at stake, and involving specialists will help ensure a smooth transaction process. Dealmakers need to consider whether they have sufficiently detailed policies and procedures, so that any independent party would interpret them the same way.

If parties are relying on their existing practices, they have to question whether those practices are sufficiently clear so that no one could interpret them in a different manner post-closing, particularly where they could take a more aggressive view. The best practice is to set forth an accounting hierarchy, proactively addressing material judgement areas with specific accounting policies, which specifically outlines how each account balance will be determined.

Blank emphasized, “The more detailed and process-driven you are, and the less judgment is present in your policies and procedures, the better your chances of success.”

Full survey results

Demographic profiles

189
Total respondents

1,314
Deals

100%
US respondents

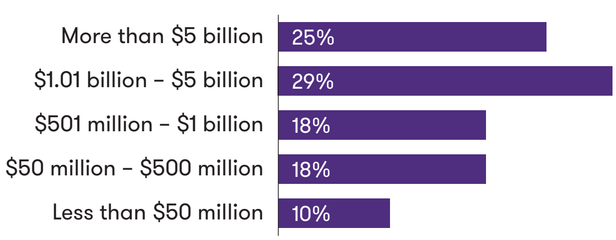
47%
Sell side

53%
Buy side

Approximately how many deals were you part of in 2019 (buy-side and/or sell-side)?

# of Deals	Respondents	Total # of deals
1–4	86	226
5–9	58	376
10–14	28	319
15–19	10	161
20+	7	232
Total	**189**	**1,314**

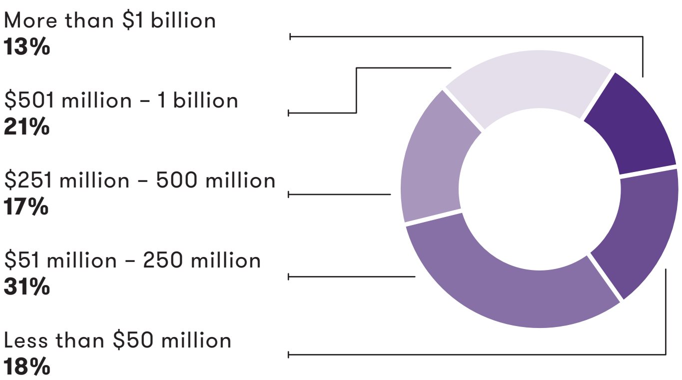
Annual revenue of respondents' companies



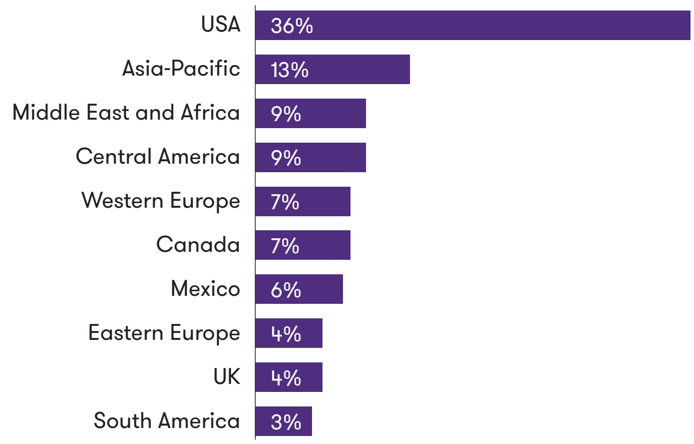
Respondent roles

Deal profiles

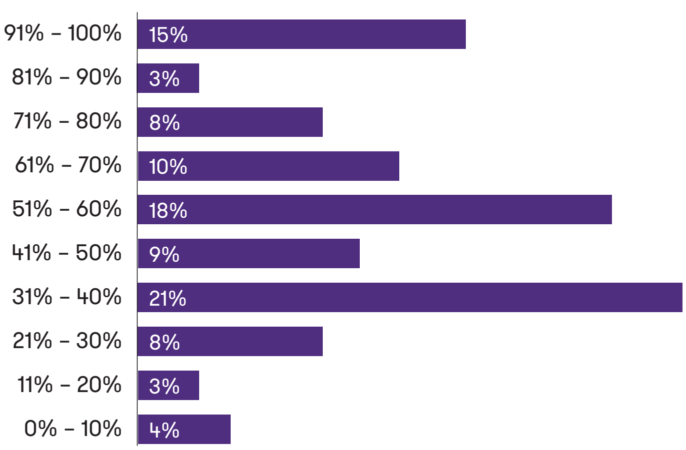
What size (enterprise value in US$) are the deals you are typically involved in?



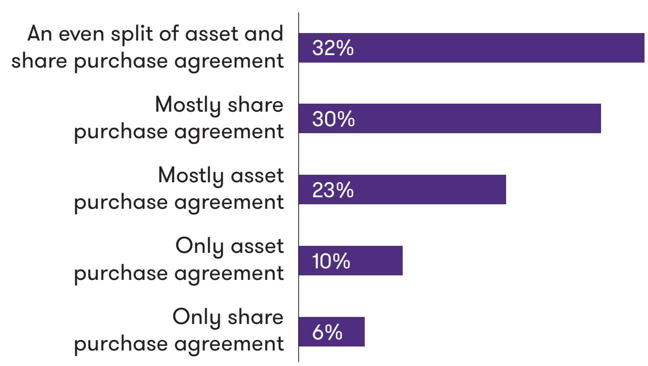
Where do most of your deals take place?



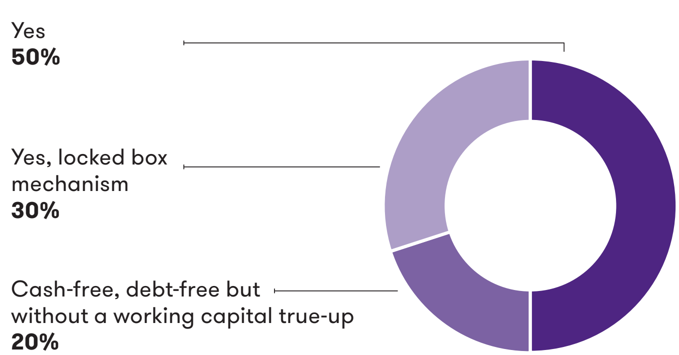
On what percentage of your deals do you involve an external financial diligence provider?



What form do your deals typically take?



Are your deals typically on a cash-free, debt-free basis, with a working capital true-up?

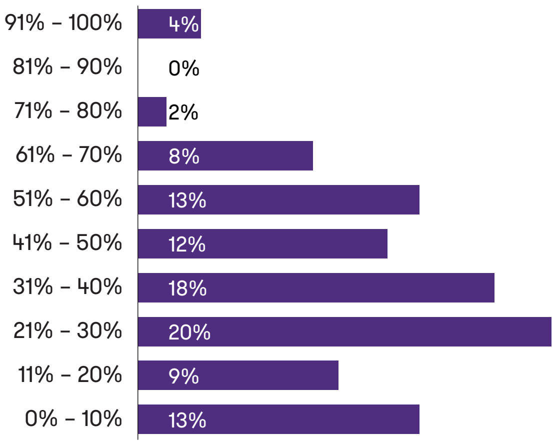


"APAs are going to be more popular during COVID-19, because you protect yourself from acquiring certain liabilities. One very pandemic-specific consideration is that certain buyers wish to avoid acquiring PPE loans right now, as an acquisition might affect forgiveness."

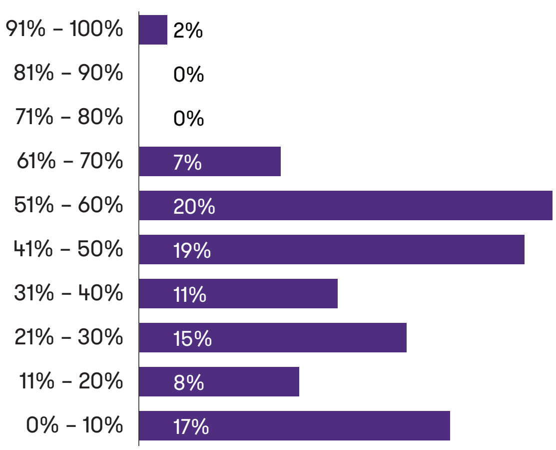
Max Mitchell, Head of Purchase Agreement Advisory Services, Grant Thornton

Deal trends

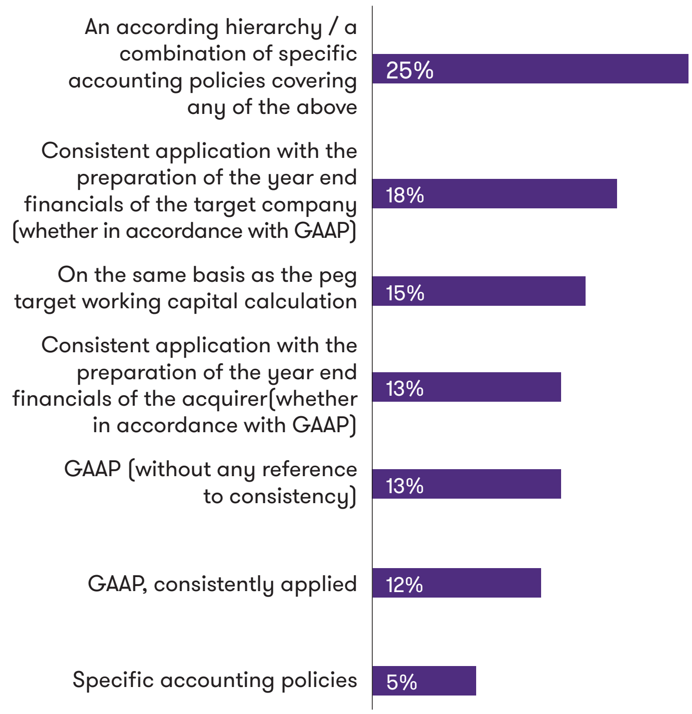
On average, what percentage of your deals include a $ cap of the purchase price adjustment?



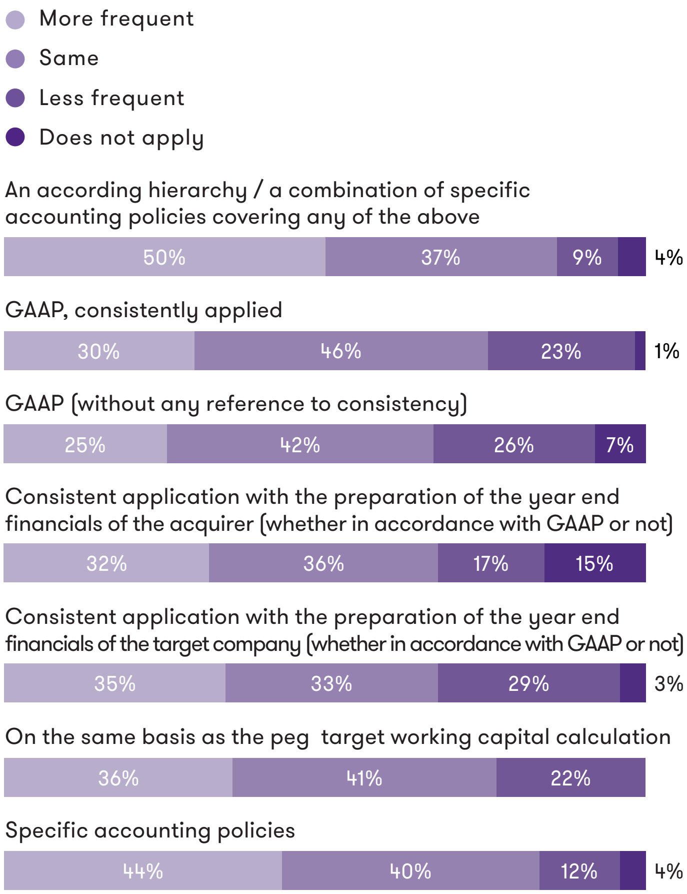
On average, what percentage of your deals include a $ collar of the purchase price adjustment?



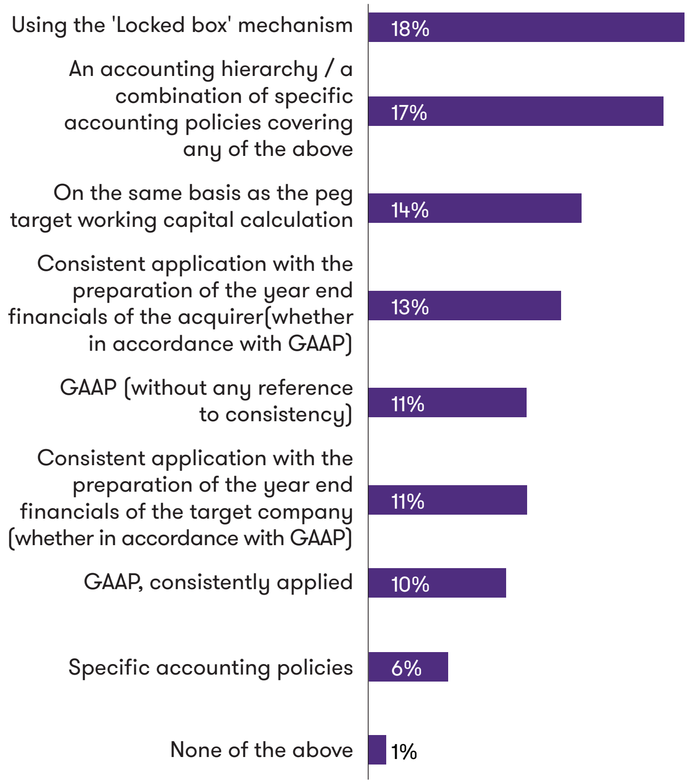
When outlining the guiding principles for how to calculate working capital, which of the following do you use?



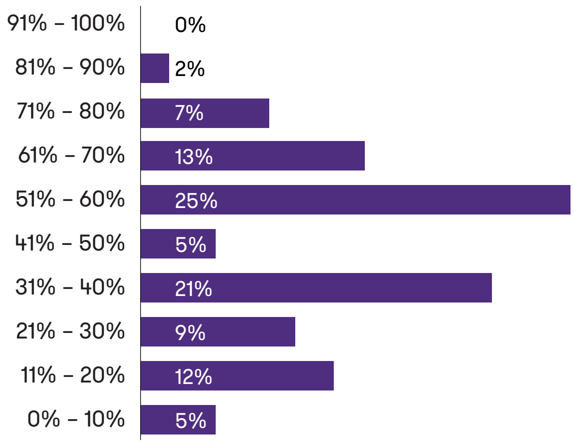
How has the frequency of guiding principles typically used in your purchase agreements evolved over the years?



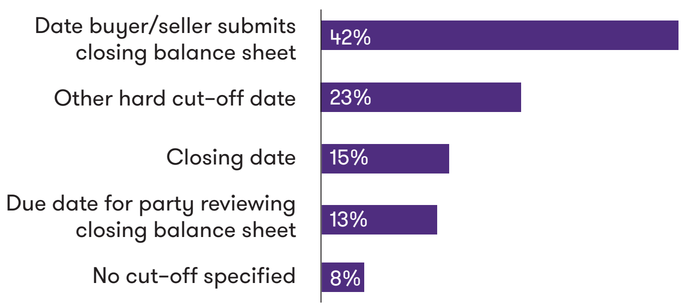
Based on your experience, which approaches would have resulted in fewer disputes in your deals?



On what portion of deals do you see earn-outs being used?

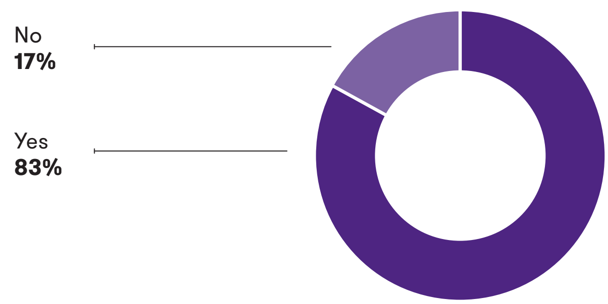


When preparing the working capital adjustment post-closing, up to which point do you typically consider new information?

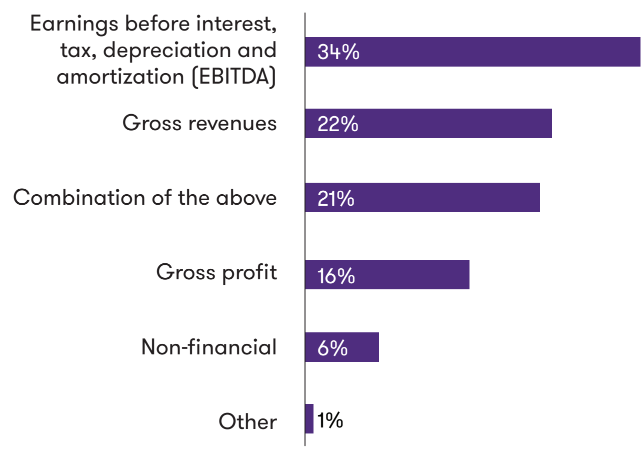


In the purchase agreement, do you include a detailed post-closing dispute resolution process (such as the number of submissions, the days between each submission, etc.)?

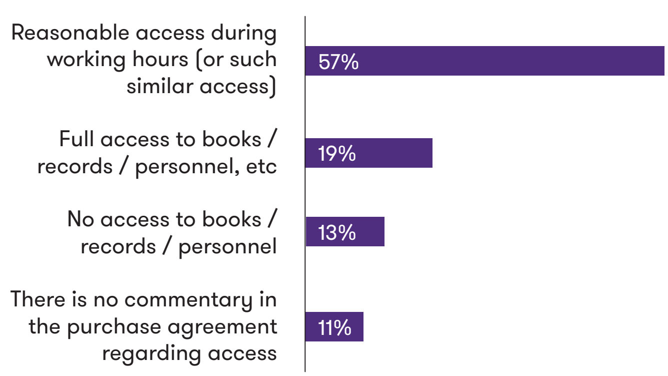
You said you include a detailed post-closing dispute resolution process in the purchase agreement. Do you follow it?



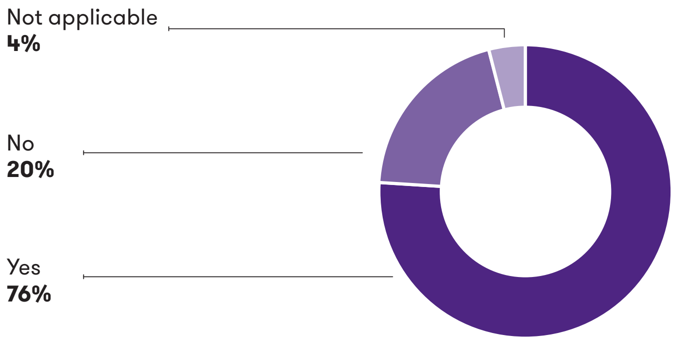
What do you typically use as the measurement basis for earn-outs?



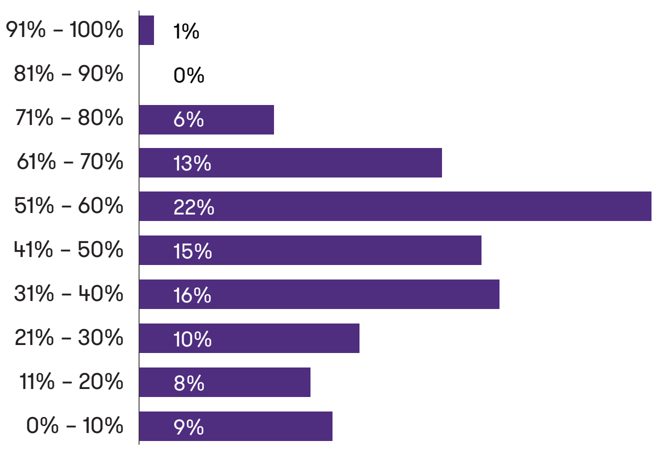
With regards to the sellers' level of access after the closing date, what level of access do your purchase agreements typically set forth that the seller should have:



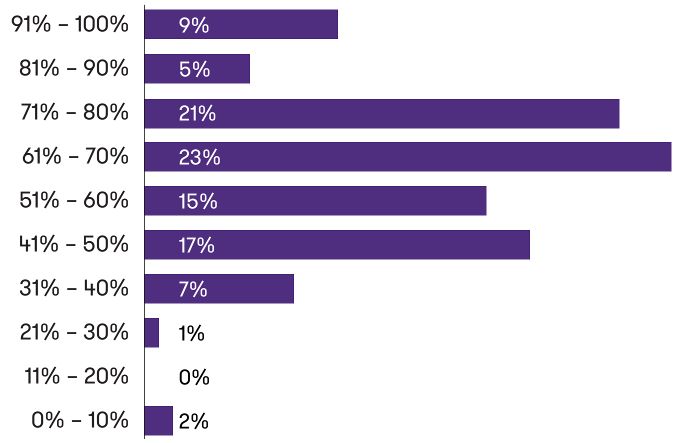
In instances where you were on the sell-side, were you satisfied with the level of access you had?



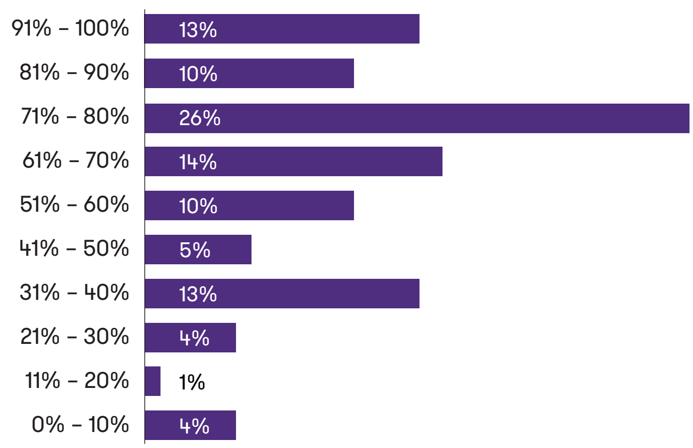
On what proportion of deals with a working capital adjustment does the working capital true-up typically become disputed?



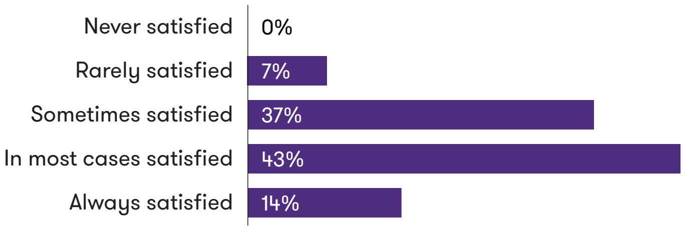
What percentage of your working capital disputes are typically resolved during the post-closing statement review period, before a formal dispute / objections notice is issued?



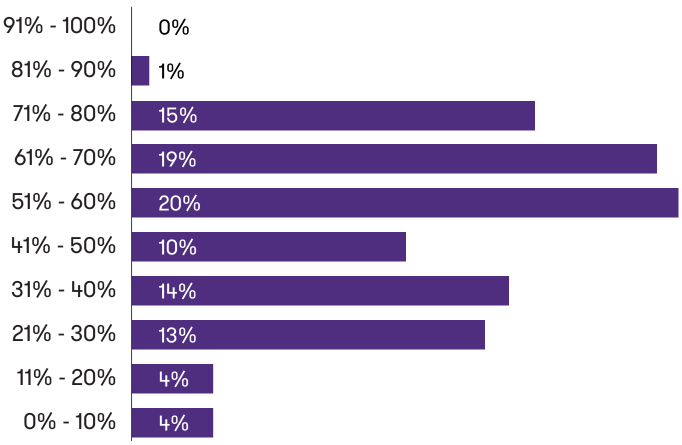
Of those not resolved before a formal dispute / objections notice is issued, what percentage are resolved during the 'good faith' negotiations period that follows any notice?



For the remaining percentage of disputes that are resolved by a neutral accountant, are you typically satisfied with the result?



On what proportion of deals with an earn-out adjustment does the earn-out typically become disputed?



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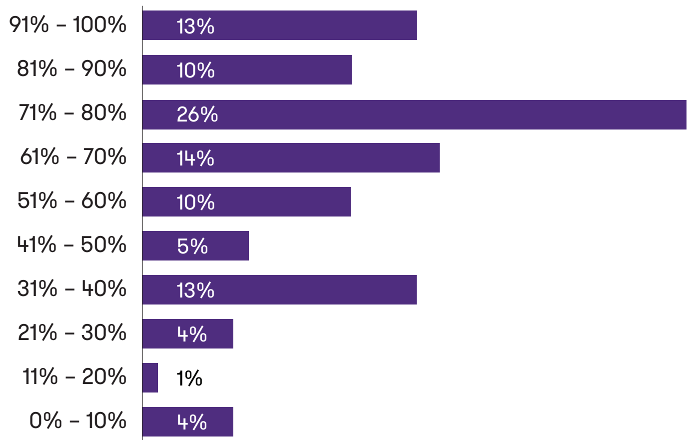
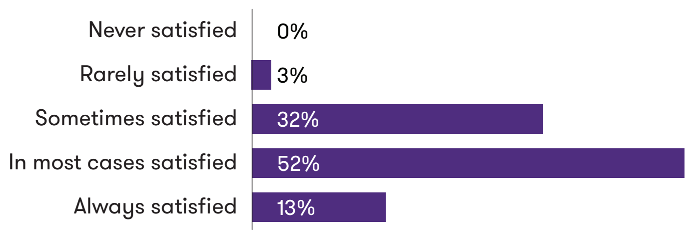
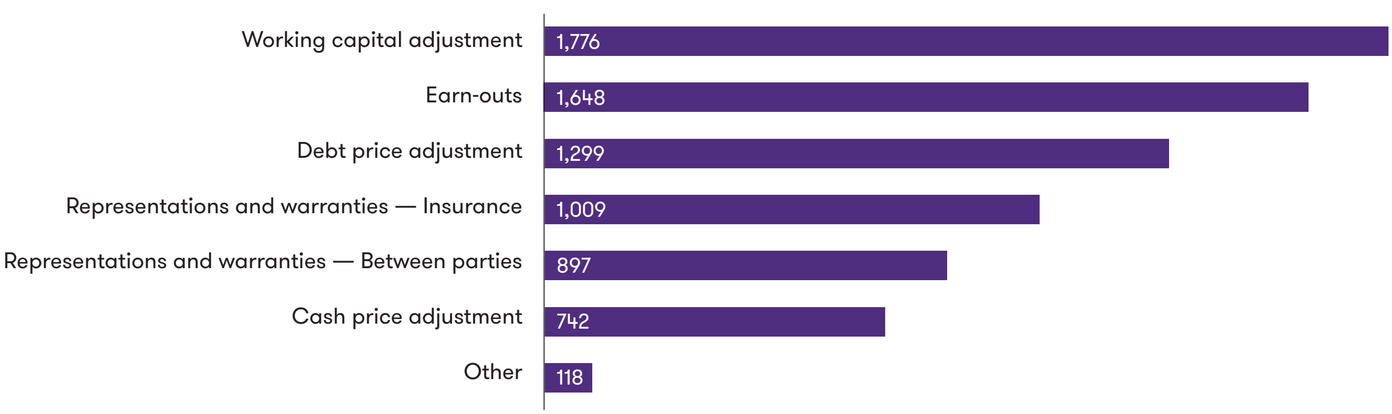


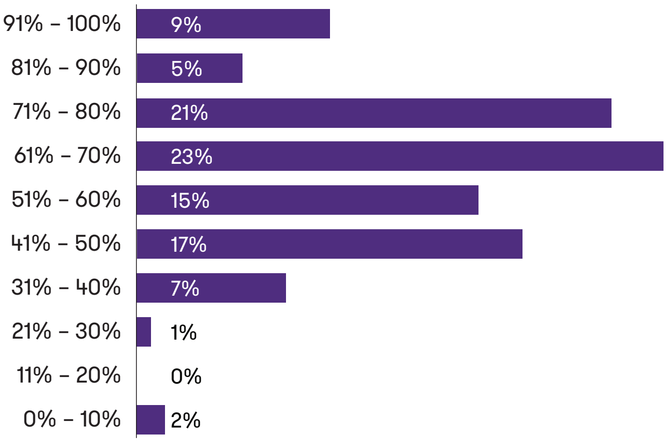
For the remaining percentage of disputes that are resolved by a neutral accountant, are you typically satisfied with the result?



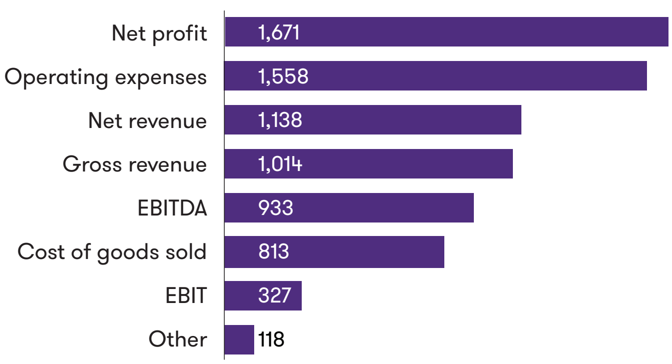
Rank your top three areas that have typically resulted in post-acquisition disputes: (Ranking Points)



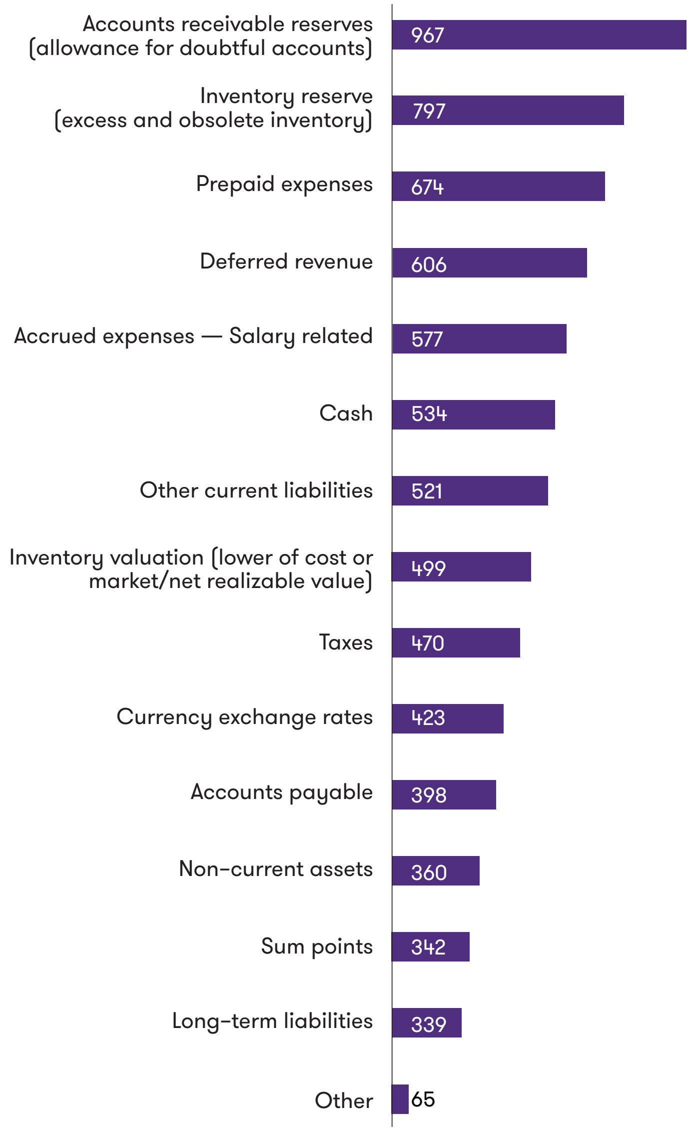
What percentage of your working capital disputes are typically resolved during the post-closing statement review period, before a formal dispute / objections notice is issued?



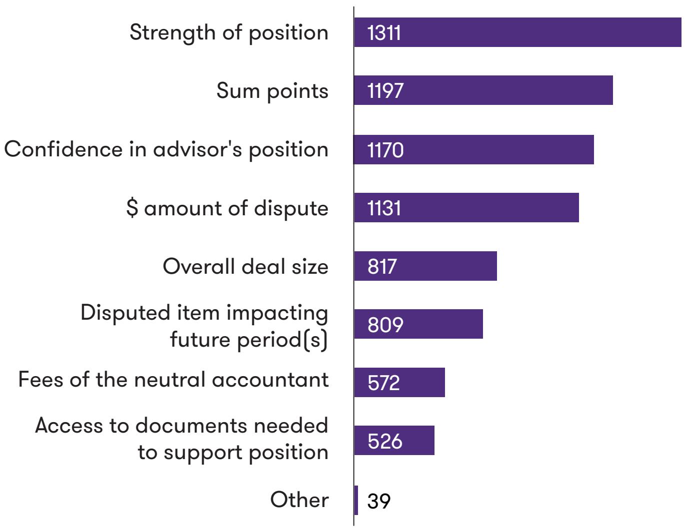
Pick the top income statement areas that pose the most post-acquisition earn-out disputes: (Ranking Points)



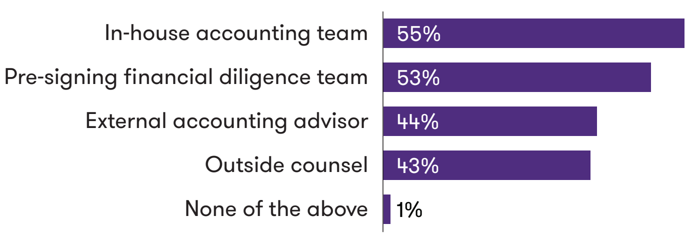
Pick the top balance sheet statement areas that pose the most post-acquisition working capital disputes?



Rank the top 3 variables that you consider when deciding whether to engage a neutral accountant versus settling: (Ranking Points)



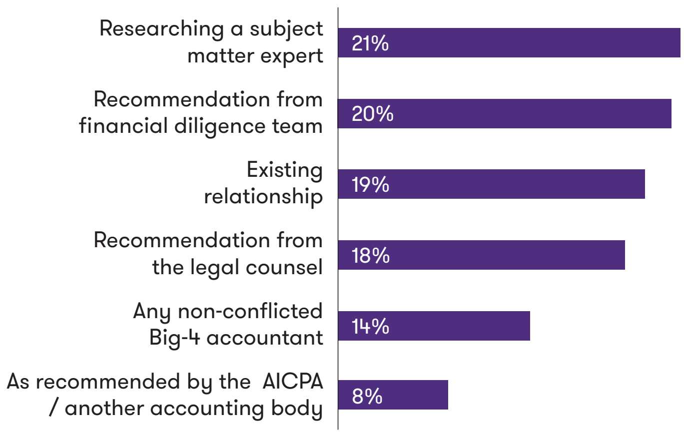
Separate from engaging the neutral accountant, who else assists you in the dispute process?



"If you want to win, there's a strategy to this game and it pays to have people with experience – whether that's legal experience or forensic specialists. They help guide the process and present a position in an understandable way, so that a neutral party can have everything they need to make their decision," Johnson said.

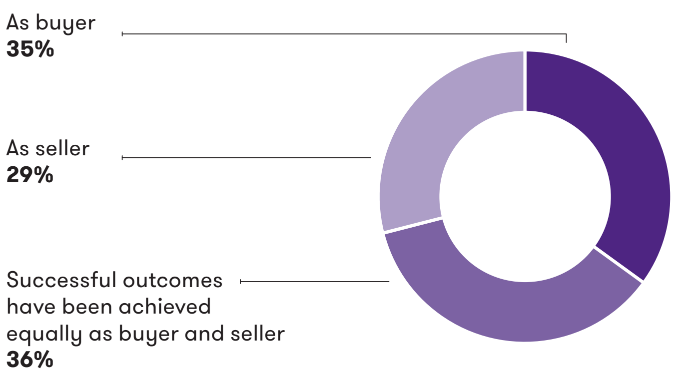
"I think you should either be using an external accounting advisor or your financial diligence team and accountant close to 100% of the time," Mitchell said.

How do you typically select your neutral accountant?

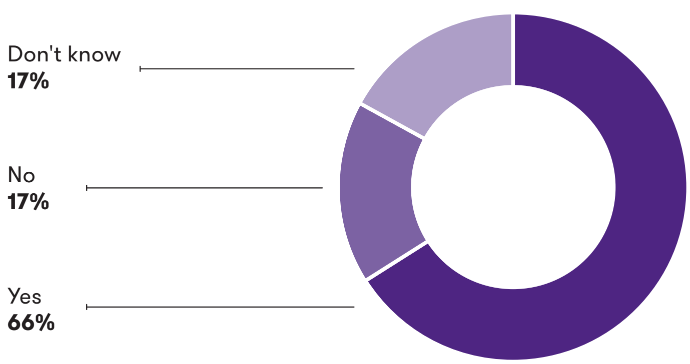


"I think sellers often think that they have the short end of the stick in disputes, but our results show that buyers and sellers are succeeding evenly," Johnson said.

In what role have you found yourself more successful in prevailing in dispute resolution?



When considering deals so far in 2020, has COVID-19 increased the likelihood of working capital or earn-out disputes?



Appendix: Locked box mechanisms

The traditional approach to establishing the total consideration for a deal is to measure cash, debt and working capital as of the closing date. This ensures that the balances are accurate as of that date, but it cannot be done until after closing – and sometimes this can be a lengthy process, particularly when disputes arise.

Difficulties can occur when the preparer discovers balance sheet items that had previously not been discussed or considered, undisclosed or unidentified liabilities, or the valuation of assets may be called into question – and parties need to work together to derive the equity value adjustments. As the locked box mechanism (LBM) measures cash, debt and working capital at a historic balance sheet date, the parties have full clarity on the purchase price adjustments prior to signing the deal. Parties can even agree on these terms prior to signing exclusivity, perhaps including a locked box purchase price bridge at the Letter of Intent stage.

The purchase price adjustments are "locked in" as of an effective date and the parties mitigate the need to recalculate these post-closing. By omitting a post-close adjustment, the parties can alleviate the risk of post-close disputes arising. The date of the locked box balance sheet used to derive the price adjustments must be carefully considered. Sufficient time will be necessary to prepare an accurate set of accounts, but this should not be so long that it no longer accurately represents the business, and there is an increased risk of leakage during the period to closing. If timing permits, it can be advantageous to use an audited set of financials, though this is not necessary.

The seller will typically provide a warranty to the buyer as to the accuracy of the locked box balance sheets. If the locked box is subsequently found to be inaccurate, the buyer may be able to make a warranty claim for losses suffered as a result. While this may not offer the same level of protection as the closing balance sheet process, there are typically fewer disputes around this when compared to the traditional method.

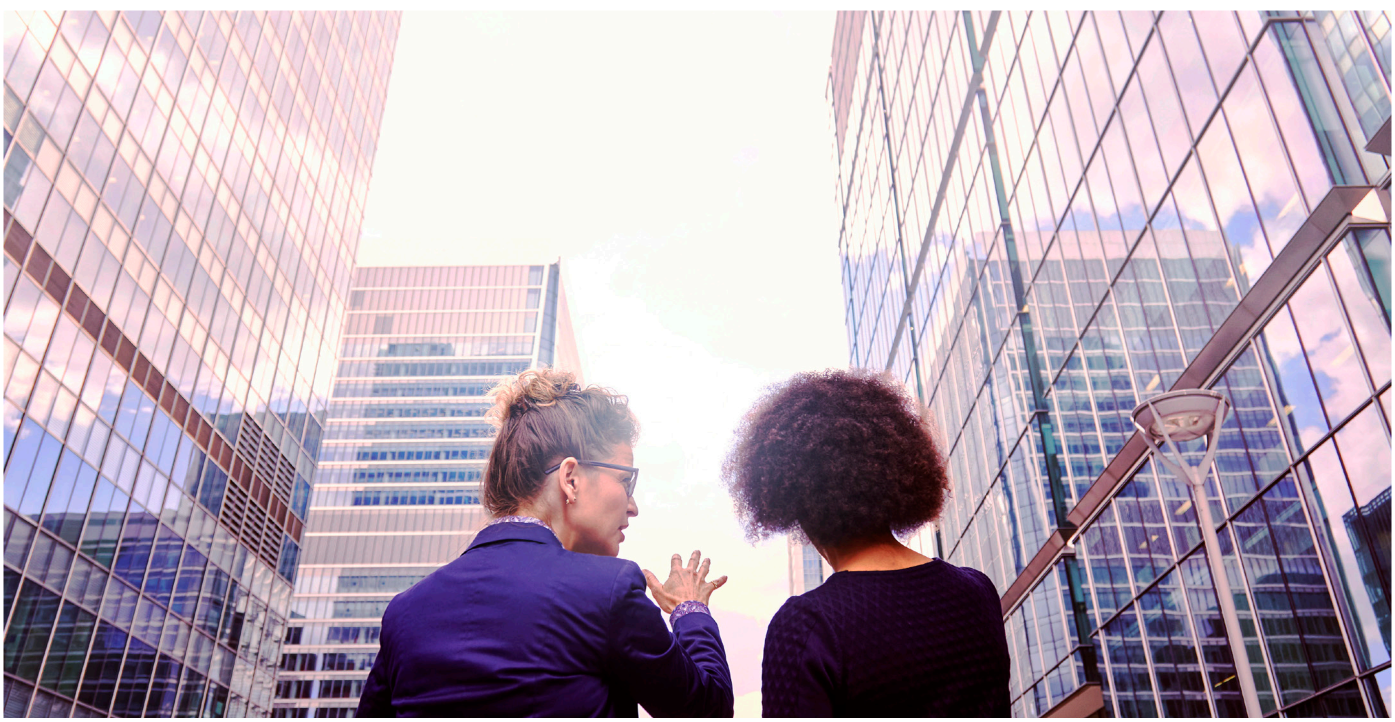
The value accrual

Literature around the LBM can lead you to believe that the key distinction between the mechanisms is in the date the economic risks and benefits are transferred. With the traditional closing balance sheet approach, risks and rewards transfer as of closing. With the LBM, the price is derived as of an historic date, and the subsequent risk of gains and losses sits with the buyer. However, if the value accrual concept is used appropriately, combined with sensible leakage protections, the seller can be effectively compensated for the economic returns through to closing – as if they had calculated the purchase price adjustments at that date, leaving only a narrow window of uncertainty determined by how quickly and accurately the company can produce financials and forecasts for the stub period since the locked box date through to close. This will typically be subject to diligence and buyer scrutiny, to ensure the proposed value accrual reflects the change in value between the two dates.

Sellers may wish to ensure that they put forth a credible suggestion, to ensure that they are compensated for their management of the business through to closing, given they have capital tied up until the closing date when the consideration is paid. There will always be some uncertainty in this calculation, as neither party will know the exact profits generated daily in the days prior to closing. As such, this calculation normally comprises both actual results to the extent known and forecasts for the remaining stub period.

What about leakage?

LBMs can leave the buyer open to manipulation of the seller's financial position and extractions of value between the locked box date and close. To avoid this, the seller can guarantee not to extract value from the target business in this period, with the exception of narrowly defined items specifically agreed by the buyer and outlined in the sales and purchase agreement. This is often called "permitted leakage" and can cover transactions between the business and the seller, such as agreed salaries, dividends or management fees payable to the seller in this period – which are factored into the calculation of the purchase price.



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