GUEST ARTICLE

New Lessons To Avoid Disputes Post-Closing

By Michael Kendall, Goodwin Procter LLP, John LeClaire, Goodwin Procter LLP and Wayne Mack, Alta Communications

Few things are more frustrating (not to mention costly and time consuming) than successfully executing an acquisition or investment transaction only to become embroiled in a post-closing dispute. Buyers and sellers spend untold hours negotiating the fine points of representations and warranties and indemnification terms, which result in disputes relatively rarely. But ask yourself, how many times have you argued over net working capital after a closing?

Working capital, net worth and other purchase price adjustments are fundamental economic provisions of many acquisition and investment transactions. Seemingly minor differences in word choices (sometimes unintentional) can result in protracted disputes and multi-million dollar adjustments in favor of one party or the other. Over the years, lawyers have developed relatively standardized provisions for determining these adjustments and resolving disagreements over them. However, until recently, few courts had weighed in on how these provisions would be interpreted if challenged.

Prior to 2005, there were virtually no cases decided in Delaware construing purchase price adjustment provisions. Since then, however, there have been five reported decisions out of the Delaware Court of Chancery directly involving disputes over post-closing adjustments. These cases provide valuable guidance to buyers and sellers alike for drafting provisions that will lend greater certainty and efficiency to the process of buying and selling private companies.

As a quick refresher, purchase price adjustments typically establish a target level of the financial metric to be measured (working capital, net worth, etc.) and then provide a mechanism for comparing the actual value of that metric as of the closing of the transaction against the target and adjusting the purchase price accordingly. The adjustments occur following closing as they usually involve items that cannot be measured precisely at closing. They also establish procedures for resolving disputes, which typically involve appointment of an accounting or similar firm, which is charged

Michael Kendall

Wayne Mack

John LeClaire

with deciding whose calculation is correct should the parties be unable to come to agreement themselves.

Accountants versus Judges

The first issue buyers and sellers should address in light of these recent cases is who they want to ajudicate their disputes. Most purchase price adjustment mechanisms provide for disputes to be resolved ultimately by a designated accounting or similar firm. Other disputes under a typical purchase agreement, on the other hand, such as indemnity claims, will typically be resolved either by a judge or jury through litigation or by a legal arbitration process, usually overseen by a lawyer or retired judge. Sounds simple, right? Accountants resolve accounting issues; lawyers or judges resolve legal issues. Yet it is not so simple.

In one of the recent cases, *OSI Systems Inc. v. Instrumentarium Corporation*, the buyer's claims, brought under a working capital adjustment provision, were based principally on its argument that the seller's calculation of working capital did not comply with GAAP as required under the agreement, It would be logical to assume that an accountant would be best able to make a determination about whether financial statements comply with GAAP. The court, however, concluded that the buyer's claims were essentially claims for breaches of representations and warranties about the financial statements and, therefore, must be decided by the legal arbitrator provided for in the indemnification provisions of the agreement, rather than by the accountant the parties designated for working capital disputes. While it is impossible to know for certain which outcome the parties in this case actually intended, what is clear is the agreement they produced together did not provide a clear answer and litigation ensued.

Perhaps trying to avoid the result in the *OSI Systems* case, the drafters of the acquisition agreement in *Matria Healthcare Inc. v. Coral SR LLC* (decided after *OSI Systems*) provided that any matter that "could be subject to adjustment or dispute" pursuant to the working capital adjustment provision must be resolved through that process, and that no indemnity claim could be made for those matters. After settling a dispute for $4 million after the closing with an unhappy customer, the buyer brought a claim under the working capital provision arguing that the potential liability to the customer was technically capable of being estimated and recorded on the pre-closing balance sheet as a working capital item since the sellers knew about the customer's complaints. Thus, according to the buyer, the dispute over the claim should be resolved by the accountant, rather than by the legal arbitrator pursuant to the indemnity provisions. The court appeared to agree with the seller's position that the type of claim in that case would be

most appropriately decided by legal arbitration rather than accounting arbitration, but determined it was bound by the plain words in the agreement to assign the dispute to the accountant. An important backdrop to both of these cases is that the buyer in each case brought its claim under the working capital adjustment provision in part because it would otherwise have been limited by the contractual indemnification terms, which provided for a liability cap and a deductible, unlike the working capital adjustment provision.

Process and Procedure

In the interest of simplicity and reducing points of negotiation to get deals closed, some purchase price adjustment provisions are remarkably light on process and procedure. As evidenced by the recent cases, this approach can create at least two fundamental problems. First, the failure of the parties to agree in advance on basic procedural matters is an invitation to creative litigators to dispute a whole host of matters before even reaching the underlying issue, making final resolution even costlier and more time consuming. Second, the courts have been clear that, once it is established that the parties agreed to submit their disputes to an arbitrator (such as the accountant designated in an agreement), the arbitrator will have the power to decide virtually all procedural issues in its discretion, taking those matters out of the hands of the parties. Issues left for the arbitrator to decide in the recent cases including the following:

- Can one party have access to the work product of an accounting firm hired by the other party to assist it with its working capital calculation?
- What kind and how much discovery should be allowed by the parties?
- Did e-mails from counsel to one party citing "agreements" by his client in the pre-dispute negotiations preclude the client from disputing those items in the arbitration?
- Is the arbitrator entitled to consider information arising after the closing (e.g., with respect to reserves established at the closing) in determining what working capital was as of the closing?

Arbitration Provisions

Beyond the cases directly addressing post-closing adjustment disputes, there has been continued wrangling in the Delaware courts over other procedural matters involving arbitration provisions generally. These cases also have important dispute-avoidance lessons for parties drafting post-closing adjustment provisions.

There are two threshold questions that typically arise in disputes involving arbitration provisions (including working capital accounting arbitrations): 1) whether the provision applies to the particular dispute at all; and 2) who gets to decide the first question, a judge or an arbitrator. In the context of disputes over working capital and other purchase price adjustments, the first question frequently involves resolving the overlap often present in hybrid matters that are both legal and accounting in nature, such as matters relating to accounts receivable. Answering the second question is much more straightforward, although the recent cases illustrate it can nevertheless be the subject of a protracted dispute if not clearly addressed in advance by the parties in their agreement.

In a recent case involving disputed payments under a license agreement Bayer Corporation filed suit after initially losing in arbitration and being ordered to pay over $121 million in past fees under the agreement. This case illustrates how failure to provide clear dispute resolution mechanics can ensnare the parties in an endless procedural loop of litigation or arbitration—or in many cases, both. Bayer's lawsuit made a number of claims for equitable relief, based on the view that these claims were not governed by the arbitration provision. Rather than disposing of this preliminary issue by deciding whether the claims were subject to arbitration, however, the court instead answered only the question of who should decide whether the claims were subject to arbitration or litigation. Concluding the agreement assigned that decision to the arbitrator, the court sent Bayer back to the arbitrator (who had originally decided the case against it) for resolution of that question. If the arbitrator determined the equitable claims were properly to be decided in court, the parties would ping-pong right back to Delaware for yet another legal proceeding.

Another recent case, *Brown v. T-Ink LLC*, also involved an initial skirmish over who should decide whether the underlying dispute should be arbitrated or litigated. In that case, an agreement requiring arbitration of disputes relating to the "interpretation or performance" of the agreement was found to be sufficiently unclear in scope as to require a court initially to determine who decides what matters should be arbitrated. The court there went on to conclude that some of the claims should be arbitrated and some litigated, a dual-track process likely to be extremely expensive.

Conclusion

Purchase price adjustment provisions are intended to promote dispute-avoidance and, when disputes cannot be avoided, to provide efficient dispute resolution mechanics. The spate of recent litigation over these provisions, however, suggests that many such provisions in fact foster disputes and lead to unintended results. Attempting to anticipate and address every conceivable issue obviously would be impractical and impede getting deals done, but a well-drafted provision should do at least the following:

- Clearly delineate which matters should be addressed by accounting experts and which should be left to legal arbiters (either judges or arbitrators).
- Account for the fact that, while claims under adjustment provisions typically are not subject to standard indemnification limitations (such as caps and deductibles), it is also not generally possible (or should not be possible) to bring claims for multiple-based or similar damages under those provisions. Well-drafted agreements address the interplay between adjustment and indemnity provisions in areas that are relevant to both.
- Establish whether the arbitrator or a court should decide the arbitrability of specific issues in the event an unforeseen circumstance arises requiring interpretation of the agreement.
- If avoidance of all litigation is what the parties intend, use a broadly-worded arbitration provision, such as "all controversies or disputes arising out of and related to" the agreement, which the cases suggest will ensure claims are arbitrated, not litigated. Note, however, that sending all disputes to arbitration may not be desirable: An arbitrator, for example, may be less expert in dealing with the interpretation of preferred stock provisions than the Delaware Chancery Court.
- Establish the basic discovery rules for the arbitration process, such as what information and personnel the parties will have access to and whether the arbitrator will have the power to order additional discovery beyond what is in the agreement.
- Define precisely the scope of the arbitrator's review by establishing whether new matters (not previously raised between the parties) can be brought before the arbitrator for the first time, whether the parties' pre-arbitration settlement discussions will have binding effect in the arbitration, and whether the arbitrator's review is limited solely to information provided by the parties without any independent analysis by the arbitrator.

John LeClaire is co-founder and chair of the Private Equity Group at Goodwin Procter LLP; reach him at jleclaire@goodwinprocter.com. Michael Kendall is a partner in the Business Law Department of Goodwin Procter LLP; reach him at mkendall@goodwinprocter.com. Wayne Mack is a partner of Alta Communications, where he identifies and manages investments in all aspects of the media and communications industries. ❖