Is Your M&A Contract Vulnerable to Post-Closing Litigation? We Break it Down.
Sam Gandhi, Rob Velevis, Frank Favia, and Alexis Cooper
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Sam Gandhi:
When an M&A deal closes, is it done? Not always. More and more disputes are arising after closing, and that's resulting in lost time and expense for both the buyers and sellers, as it dawns on them that they don't actually have a done deal. Not all disputes after closing can be avoided, but their effects can be minimized with the right due diligence, transparency in the process, and knowing the mechanisms for resolving them efficiently.

Rob Velevis:
We want to win, and the questions of who's deciding the issue, what are they deciding, and how are they deciding are very important to figuring out whether we're going to win at the end of the day.

Sam Gandhi:
That's Rob Velevis, a partner in Sidley's practice in Commercial Litigation and Disputes, Securities and Shareholder Litigation, and Consumer Class Actions.

Frank Favia:
I advise clients to really take the time to work with their respective accountants and lawyers to carefully consider the accounting principles, because having clarity and precision in those principles can avoid the expenditure of a lot of time, money, and frustration down the road.

Sam Gandhi:
And that's Frank Favia, also a partner in Sidley's practice in Commercial Litigation and Disputes, as well as in White Collar Defense and Investigations, and Labor, Employment and Immigration.

Alexis Cooper:
We're advising our clients to be very thoughtful about how they document their determination of the purchase price. So, it's really helpful for clients to

have clear documentation that supports how they value the business at the time.

Sam Gandhi:
And that's Alexis Cooper. She's a partner in the firm's M&A and Private Equity practices. In today's podcast, we'll discuss why post-closing disputes arise, how they're best resolved, and how businesses can avoid and mitigate the risk.

From the international law firm Sidley Austin, this is *The Sidley Podcast*, where we tackle cutting-edge issues in the law and put them in perspective for business people today. I'm Sam Gandhi.

Hello. Happy New Year, and welcome to this edition of *The Sidley Podcast*, Episode Number 38. Rob, Frank, Alexis, great to have you each on the podcast.

Rob Velevis:
Great to be here, Sam. Thanks for having us, and Happy New Year.

Frank Favia:
Thank you, Sam. Happy to be here.

Alexis Cooper:
Great to talk with you here today, Sam.

Sam Gandhi:
A recent survey on mergers and acquisitions by Grant Thornton, an audit, tax, and advisory firm, found that the number of disputes had increased, along with an increase in overall deal volume, and post-closing disputes are a particular headache for both the buyer and the seller. With M&A disputes clearly on the rise, companies, of course, have a vested interest in knowing the best ways to mitigate and resolve them. Rob, can you start us off by giving a wide lens on this for the uninitiated? What's a post-closing M&A dispute?

Rob Velevis:
So, once a transaction closes, it's common that this is just the beginning of the process, the first step, and that there are many opportunities for the

parties who have been negotiating heavily over the transaction to continue those negotiations, now often with the help of their litigators. And there's a wide variety of types of disputes that can arise in this context, but I put them into three general categories.

There are key differences across those categories in terms of the forum and the skillset of the person that's going to be resolving the dispute that are important. The first type of dispute is over whether the buyer actually got what it bargained for, and the key question here is often whether there was a breach of a representation or a warranty made by the seller in the transaction.

And the buyer often realizes, after closing, that there might be a problem, that there might have been a breach of a rep and warranty; the issues involving this are often legal questions, often in the nature of a breach of contract or, potentially, in the nature of fraud, and the forum is generally either a court or a traditional arbitration venue, like the American Arbitration Association (AAA), Judicial Arbitration and Mediation Services (JAMS), International Institute for Conflict Prevention & Resolution (CPR) for domestic disputes.

The second broad category involves how parties allocated risks that might arise after closing. And these generally take the form of indemnification claims, and they often arise in the nature of a breach of contract claim, and like the first category, parties often choose to either have a court or a traditional arbitration forum resolve them. And then, the third big category is different from the first two in several ways. There are disputes over purchase price in the transaction itself, and there's two main flavors of those disputes.

The first is what's called an earnout and an earnout is typically when the parties, in negotiating the contract, have a disagreement about the likely future performance of the business, and often, that results in a deadlock that the parties can't otherwise overcome to get the deal done; and so, to break through the deadlock, what parties often do is agree to an earnout where the buyer would pay the seller more based on the future performance of the business, and that payment is contingent on that future performance. Earnouts are notorious for creating disputes and they often have the effect of shifting the negotiation from the boardroom to the

courtroom or an arbitration forum. These, often, are like the first two disputes. Parties agree to have courts or traditional arbitrators resolve them, but there also can be unique accounting issues that relate to earnouts, and the unique accounting disputes are often resolved by independent accountants who have specialized expertise in resolving accounting disputes.

The second flavor of post-closing disputes over the purchase price comes from contractual adjustments to the purchase price that is often based on the financial position of the company at closing. These can involve very specific accounting issues and very specific accounting provisions in the contract that call for calculation of things, like working capital or indebtedness, the debt of the company at the time of the closing, and most of the time, parties agree to have these disputes resolved by independent accountants. And they agree to very bespoke processes that look different from a traditional court or arbitration processes, and while these are not as well-known of a source of disputes as earnouts, in our experience, we've seen a large number of disputes in this specific area of independent accounting processes over the last few years, and they can have a tremendous impact on the value of a transaction.

Sam Gandhi:
Frank, based on your experience with these types of contract disputes, how does the process go? Can you take us through an example in how it gets worked out on the ground?

Frank Favia:
Sure, and the process is different depending on the type of post-closing dispute. So, for example, for a purchase price adjustment, like a working capital or other closing balance sheet dispute, the seller typically delivers a preliminary closing balance sheet several days before the closing. Usually, within 30 to 90 days after the closing the buyer then prepares a final closing balance sheet using the party's agreed-upon accounting principles.

The seller often then has 30 to 60 days to review the buyer's final closing balance sheet and provide a notice of any disputed items. If the seller delivers that type of dispute notice, then the purchase agreements typically require the parties to attempt, in good faith, to try to resolve the disputed items amongst themselves within some period of time, often another 30

days. If the parties can't resolve all disputed items, then an independent expert is typically retained to resolve the matter based on specific instructions included in the purchase agreement.

The process for an indemnification and representation in a warranty insurance claim is a little different. Over the past several years, we've increasingly been doing deals with buyer-side representation in warranty insurance policies that provide the buyer with coverage and protection for breaches of reps and warranties by the seller.

These types of policies and claims under these policies are now quite common in the M&A market. This process typically begins with the buyer's delivery of a claim notice to the seller or to the insurance carrier or sometimes both. The claim notice should identify the specific reps and warranties that the buyer contends were breached and summarize the facts supporting the breach that are known to the buyer at that time.

The parties then often exchange documents and information relevant to the alleged breach in an attempt to reach a resolution. But if they can't resolve the claim amongst themselves, then it typically proceeds to arbitration or to litigation in court, depending on the dispute resolution provisions in the purchase agreement and in the policy.

I'll share an example of a recent representation and warranty insurance claim that Alexis and I handled where we obtained a great result for our client.

The claim involved the seller's breach of representations and warranties concerning the target company's financial statements and customer suppliers. After acquiring the target company, our client found out that as indicated that those seller reps and warranties were untrue as of the closing. Pursuant to the purchase agreement on the rep and warranty insurance policy, we provided notice of the alleged breach to both the seller and to the insurance carrier, along with the supporting evidence we and our client had found as of that time.

Over the next few months, the carrier asked several rounds of follow-up questions, including requests for additional documents supporting the alleged breach, as well as our client's damages. They also requested

interviews of certain key personnel at the buyer and the target company. We responded to those requests, and ultimately, the evidence and the information we provided proved to the carrier that a breach had occurred and that we had established the damages we claimed.

This resulted in a settlement with the carrier for the full policy limit under the policy, as well as a settlement with the seller for the release of monies that had been held in escrow, pending the resolution of the claim. This was a tremendous result for our client and substantially mitigated the business losses that our client would've suffered had it not pursued its post-closing remedies.

Sam Gandhi:
Let me just pause there, Frank, and Alexis is going into this in terms of rep and warranty insurance. Is it easier to do an M&A deal with rep and warranty insurance nowadays from a post-closing dispute standpoint versus negotiating every rep and warranty in an M&A deal?

Frank Favia:
It's certainly easier to get the deal done because the seller is less concerned about being on the hook for breaches of reps and warranties. In terms of the process for getting a claim resolved, clients just need to understand that it's not as simple as we bought this product, we make a claim, and the insurance carrier pays right away.

Submitting and successfully pursuing a rep and warranty insurance claim can be a lengthy process that can sometimes take up to 12 to 18 months, and it can be fairly time consuming and burdensome to respond to what are often multiple rounds of information requests from the carrier. So, I would say it is certainly easier to get deals done when parties utilize rep and warranty insurance policies, and the process for resolving a claim is often faster and less expensive than pursuing a traditional indemnification claim in court, but there still is a fair amount of effort involved in successfully bringing and proving a claim.

Sam Gandhi:
So, Alexis, let me follow up on this with you, and so, in looking back over time, it still looks like clear rep and warranty insurance has really changed the landscape of M&A, and it's now a key component of today's private

acquisitions. What do you find notable about those types of matters versus just negotiating reps and warranties the old-fashioned way?

Alexis Cooper:
We do see that the use of rep and warranty insurance allows the negotiation to the purchase agreement to go a little more smoothly between the sellers and the buyers. We're finding less pushback overall about the scope of the reps. We still have a pretty detailed process for the disclosure schedule. So, sellers are still really engaged and involved, and the buyer has to really go through the due diligence, even to a higher level than they typically would.

What we're seeing in the marketplace is pretty much consistent with what we've seen at the market studies that come out by the insurers and the underwriters. In our experience, we're seeing about an even split in deals, where, on the one hand, we have about half the deals are public-style walkaway deals where the buyer's only recourse is the respective rep and warranty insurance.

And the other half, we do see that the buyer has an avenue of recovery from both the insurer and also from the sellers. When you have dynamics where you have two different parties that are going to stand behind post-closing disputes, we see a number of complexities arise in negotiating and resolving those post-closing disputes. As Rob said, one of the common post-closing disputes are indemnity breaches, and as Frank laid out, that's something we've worked with clients through.

What we have found in that process of working it through is that it can be quite complicated to negotiate when you're trying to work with a third party. A claim comes into the company, and the company is negotiating after closing with a third party. When it's trying to do that and settle that matter, if that matter is giving rise to a breach of a rep and warranty, the company needs to get consent from both the insurer and from the sellers in this structure where you have recourse against both.

We found that can get quite complex. In one situation, we were negotiating back and forth and trying to resolve things with a third party, and every time we had to submit a settlement proposal, we had to get consent from both,

and the sellers wanted to know that the insurer was on board. The insurer wanted to know that the seller was on board, and it took some time.

That whole negotiation process took longer. In that one situation, we saw the insurer came out and said they won't expressly consent to the dollar amount of our settlement, but they agreed that they wouldn't use their failure to consent as a chip in negotiating the final settlement. So, they didn't give us express consent, but it was enough for us to get comfortable, Sam, and we were able to move forward to propose a settlement there.

So, it's important that sellers and buyers are both really aware of what the contractual rights are under all of the documents; that means it's the purchase agreement, it's the rep and warranty insurance policy, and it's also the escrow agreement, because all of those documents, they all have time, mechanics, and procedures you have to comply with. So, it's really important that both from the sell side and the buy side, that they're looking at and aware of that. When we represent sellers, we want to make sure that the sellers know where they stand in the order of recovery.

Oftentimes, when there's indemnity, the sellers will be on the hook for the retention or half of the retention, and retention means the deductible under the policy. So, when the seller is negotiating the purchase agreement, they need to make sure they know how the policy works. Typically, a policy will have a deductible or retention that drops in half at the one-year mark.

So, when the seller's negotiating the purchase agreement, they should be aware of the way the policy is written and have their exposure similarly cut in half at that one-year mark. On the other hand, on the buyer's side, when they're going through and trying to resolve a claim, they need to make sure that they're complying with the terms of the policy, they're complying with the terms of the escrow agreement, and also the purchase agreement and keeping everyone in the loop.

We've also found some complexities when we're going to release funds in escrow. In this typical structure where we have both recovery, the sellers often have an escrow, and that escrow will be hit before to the rep and warranty policy. In a situation where you're releasing those funds from escrow, it's common that sellers will want to know, if I release money to the buyer, am I done with this matter?

So, they'll want a release. Now, that makes sense from the buyer and seller, but the insurer is involved in this negotiation, as well, and the insurer will tell us, you can give a release in some situations, but that release cannot extend to fraud. So, it's important that the buyer's consulting with his counsel to know what it can and can't do in all of the steps along the way.

Sam Gandhi:
You're listening to *The Sidley Podcast*, and we're speaking with Sidley partners Rob Velevis, Frank Favia, and Alexis Cooper, about the various types of post-closing M&A disputes and how they're resolved. Rob, a lot of your work centers on M&A disputes involving accounting issues. What's showing up in your work that's underreported, and what are the issues involved?

Rob Velevis:
One of the things that litigators focus on a lot is the importance of the venue for the dispute. We want to win, and the questions of who's deciding the issue, what are they deciding, and how are they deciding are very important to figuring out whether we're going to win at the end of the day, and so, that's something that, as litigators, we focus on a lot. When you put that lens on an M&A transaction, you have the ability to customize the venue to a degree that you don't see in a lot of other contexts.

But when we're talking about purchase price disputes that go before an independent accountant, we often don't see parties customizing and really thinking about these questions of who is deciding, what are they deciding, and how are they deciding, perhaps to the degree that they should be thinking about it to get to the best outcomes. What we see is that, generally, parties are agreeing to a streamlined process.

Often, they're exchanging some notices of a dispute at the beginning of the process. There's a good faith negotiation period, and then there's, basically, the issue gets kicked to the independent accountant to resolve, often with a very short time frame for that independent accountant to resolve the issue. Those streamlined processes often gloss over those three key questions that I was talking about.

And so, on the question of who decides, one of the things that we tell clients when they're dealing with these issues, especially when you're thinking about a purchase price dispute that could be a seven-, eight-, or nine-figure issue involving a very large transaction, that there's really a very small subset of human beings in America that you would want to resolve that question, and I can really count on two hands who those people are.

And this process is not going to be at all like going to court or going to an arbitration panel before the AAA or JAMS where you get a wide variety of people to choose from, and parties often don't take that into consideration when they're entering into a transaction at the front end. Parties will sometimes choose an independent accounting firm or group of firms, without taking into consideration whether those firms can or will take on the dispute. Some major accounting firms are not taking on this work at all.

Others may have a conflict with one or the other of the parties, and as a result, would not be able to take on the work for this specific issue. And you may have to, ultimately, go to court to have that person chosen, which defeats the purpose of having the streamlined process. Sometimes, the parties also hardcode into their agreement specific neutrals, without necessarily thinking it through whether those neutrals are the right people to be resolving the specific kinds of disputes that are an issue in the case and that can create obvious problems later on down the road.

The second area where we see problems is deciding on what is going to be resolved, and the questions in this context are often dependent upon very specific accounting rules and a specific ordering of how the accounting rules kind of trump each other or govern.

The question of whether generally accepted accounting principles (GAAP) controls over the company's prior accounting practices is a very, very important question. We often see, as we get into these disputes, that one or the other of the parties may not have fully thought through the impact of making those choices at the outset, and it can have a profound impact on the value of the transaction and can ultimately win or lose a post-closing dispute.

The third issue we see relates to how the issue is being resolved, and the general instinct at the deal table is that we want this resolved fast with

limited paper, no meaningful information exchanged, no real fact-finding process for the accountant, and sometimes, that's the right outcome for the dispute that our clients want, but sometimes, it's not. Sometimes you need an information-sharing process. Sometimes you need a fact-finding process. Sometimes you need a live hearing.

And a one size fits all approach to these disputes doesn't always achieve an optimal outcome. We find it's much better to think through what the dispute will look like, what kind of information will be needed to resolve it, and then build a dispute resolution mechanism that will give the parties the best chance of getting to the right outcome.

Sam Gandhi:
Frank, as a litigator who deals with a lot of these M&A disputes, how are you advising clients about ways to mitigate these disputes?

Frank Favia:
Well, the reality is that you can't always avoid post-closing disputes, and it's often very much in a party's interest to pursue available post-closing remedies. However, there are some things that parties can do during deal negotiations to avoid certain types of disputes or at least make resolution of those disputes faster and more efficient. I want to build on something that Rob mentioned earlier.

One way to avoid at least certain types of disputes is to really give thoughtful consideration to the accounting principles that the parties will use to resolve working capital or other closing balance sheet disputes. These accounting principles often provide that certain commonly-accepted accounting rules or principles, such as GAAP, must be used in creating the closing balance sheet. But parties, particularly sellers, also often attempt to create a hierarchy or a standard, whereby the historical accounting practices used by the target company are also considered.

Disputes often arise about how to interpret these negotiated accounting principles when, for example, a buyer contends that the targets historical accounting practices did not comply with GAAP. This can lead to disputes not only about the amount of any purchase price adjustment, but also whether the purchase price adjustment process itself can even be used if,

for example, there's also a rep and warranty that the seller's financial statements complied with GAAP.

Sometimes agreements require that type of dispute to be resolved through the lengthier indemnification process rather than a more streamlined purchase price adjustment process that the parties thought they had negotiated and bargained for. Relatedly, parties often include a sample working capital or a closing balance sheet illustration in the purchase agreement.

But sometimes, as the parties negotiate and revise the accounting principles, they don't update the illustrative working capital or closing balance sheet to reflect the revised accounting principles. This can lead to disputes and confusion if the agreement requires the parties to resolve purchase price disputes in accordance with the accounting principles and consistent with that illustrative working capital or closing balance sheet.

So, I advise clients to really take the time to work with their respective accountants and lawyers to carefully consider the accounting principles, because having clarity and precision in those principles can avoid the expenditure of a lot of time, money, and frustration down the road.

Sam Gandhi:
Alexis, as an M&A lawyer, what trends are you seeing in your work regarding these contract disputes?

Alexis Cooper:
We are seeing a trend that, in sell-side auction deals, more and more of the bid form agreements that we're seeing have an express provision in the purchase price adjustment provisions that lay out exactly what happens if the buyer doesn't meet the deadline.

Before this trend, we would see, in a normal purchase agreement, there is an estimate of the purchase price components, which is working capital and debt and transaction expenses. There's an estimate of that that's delivered at the time of closing, and then, after closing, the buyer has an opportunity to confirm that and deliver a closing statement.

Now what we're seeing is that, in these big form purchase agreements, there's a provision that says if the buyer misses the date to deliver that closing statement, then the seller has the right to either (a) make the estimated statement be the final so, that means that there's no additional payment, or (b) on the other hand, if the seller thinks they're owed more money, because the estimate was too low, to higher an accountant firm to go and do the closing statement.

When we see these provisions in the contract, it's really critical for buyers to be very aware of that deadline and not only the deadline in the purchase agreement of delivering the statement within 60 or 90 days, but also the mechanics of the way the notice provisions work. Because sometimes, in a purchase agreement, the notice provisions will say, notice is deemed given on the day after information is provided.

So, when you have these new provisions and purchase agreements that have consequences for missing that 60- to 90-day window, the buyer really needs to be very, very aware and consult with their counsel on making sure they hit those deadlines.

Sam Gandhi:
As we wrap up the podcast, I'm going to ask all of you for one final thing. We're in a new year. What's on the minds of your clients, and what are the issues that they're posing for you? I'm going to go to Rob first.

Rob Velevis:
The end of the year is, obviously, a time that a lot of transactions close. For litigators, this is often the time that we're just getting started on the post-closing disputes. We're helping clients think through these issues before closing and then getting a running start on dealing with them after the disputes have closed.

Sometimes, for our clients, that's a hard adjustment to make because the deal team has been thinking through and working through a year-end push to get a deal done. They're celebrating the closing of the deal, and then the buyer may be trying to now integrate this new acquisition into its business or really understand the business that they bought, and then, all of a sudden, they now have the potential for a post-closing dispute, and they

have to ramp back up to understand and remember the deal that they just closed, which often creates resource allocation problems.

The one thing that we certainly know will be for sure is that there will always be disputes. There will always be a lot of money at issue. There's geopolitical risk. There's high interest rates. There's regulatory risk. And all of those create fruitful areas for parties to be disputing and to be trying to rehash their deal in the courtrooms, in the arbitration panels, and before independent accountants.

Sam Gandhi:
Frank?

Frank Favia:
Another trend we're seeing is a desire by both buyers and sellers to negotiate and close deals really fast. This isn't necessarily a bad thing, and there are often good business reasons for parties to do deals very quickly. But if this means that the parties are doing less diligence than they might otherwise do, this obviously increases the likelihood of having post-closing disputes.

This is particularly true in rep and warranty insurance deals where the seller knows that it's potential liability for breaches of reps and warranties is limited. A significant percentage of the deals that we're doing now are full walkaway deals for the seller, where the buyer's sole recourse for breaches of reps and warranties is the rep and warranty insurance policy.

But even in deals where the seller retains liability for breaches of reps and warranties, that liability is often capped and certain amounts held in escrow. So, while there may be good reasons to move quickly to get deals done, given the increased likelihood of post-closing disputes, it's even more important to ensure that post-closing dispute provisions in the purchase agreement are precise, well thought out, and efficient.

Sam Gandhi:
Alexis, I'm going to wrap up with you. What are you seeing?

Alexis Cooper:

Exactly as Frank said, where we know that we're going to be having the potential for having post-closing disputes over indemnification, we're advising our clients to be very thoughtful about how they document their determination of the purchase price. When we have these claims that Rob and Frank are talking about, when establishing the damages, often, we're trying to establish a multiple that's tied to the multiple that the buyer paid at the time of closing. So, it's really helpful for our clients to have clear documentation that supports how they valued the business at the time, and that documentation, whether it's in the letter of intent itself or in other documentations — like an investment committee memo or other internal records — is really supportive when we go to establish what the damages are later down the road.

Sam Gandhi:
We've been speaking with Sidley thought leaders Rob Velevis, Frank Favia, and Alexis Cooper about the trends they're seeing in post-M&A contract disputes and how they're advising clients as we head into a new year. Rob, Frank, Alexis, great look at the landscape regarding post-acquisition disputes, and thanks for sharing your insights on the podcast today.

Alexis Cooper:
Yeah, it's great to talk with you here today, Sam.

Frank Favia:
Thanks for having us on, Sam.

Rob Velevis:
Thank you, Sam. It was my pleasure.

Sam Gandhi:
You've been listening to *The Sidley Podcast*. I'm Sam Gandhi. Our executive producer is John Metaxas, and our managing editor is Karen Tucker. Listen to more episodes at Sidley.com/SidleyPodcast, and subscribe on Apple Podcasts or wherever you get your podcasts.