

## Asset Management

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William K. Perry, Partner



Marc A. Alpert, Partner

# “It ain’t over ,til it’s over”

**AVOIDING PROTRACTED—AND**

**COSTLY—PURCHASE PRICE**

**ADJUSTMENT DISPUTES AFTER**

**A BUSINESS IS SOLD TAKES**

**METICULOUS PLANNING.**

BY WILLIAM K. PERRY AND MARC A. ALPERT

There is a scenario that every CFO and controller should seek to avoid when their company buys or sells a business. The problem arises when the purchase price takes into account the net asset value of the business, but months are expected to pass before the sale actually closes, and the net assets may change in the interim. In such cases the parties might agree on an initial purchase price based on a benchmark net asset number, typically taken from historic or projected financial statements of the business. To account for any change in net asset value prior to closing (and to protect against pre-closing asset and liability manipulations), the parties agree to a simple purchase price adjustment process to take place after closing.

Under this process, a closing date net assets statement (referred to as the “closing statement”) is prepared, and the net asset value from that statement is compared to the benchmark net asset number. The buyer agrees to pay more if closing date net assets are greater than the benchmark number, the seller agrees to refund a portion of the purchase price if closing date net assets are less than the benchmark number, and both parties agree that any disputes will be resolved by arbitration.

In fact, the process seems so simple that parties often negotiate the purchase price adjustment provision in the sale contract almost as an afterthought. As a result, few details are specified as to how to prepare the closing statement, and even less is said about how disputes should be resolved other than to refer broadly to arbitration.

After the sale closes, one side is suddenly seized with 20-20 hindsight. Concluding that it paid too much or accepted too little, the party decides to renegotiate the purchase price through the price adjustment mechanism. Numerous items are disputed as being improperly included in (or excluded from) the closing statement, and the treatment of various items big and small is challenged. The arbitrator, unconstrained by any limits on the process, allows both parties to submit numerous written position papers, permits more discovery than is really necessary, and determines that several hearings will be required to address all of the complaining party’s objections. The result? Months of acrimonious arguments by lawyers and accountants, a “runaway” arbitration that takes on a life of its own, and substantial efforts by each company’s CFO, controller, and their supporting staff that distract from the business of doing business.

Of course, it may be impossible to completely avoid disputes whenever a purchase price must be adjusted after closing, and the type of adjustment process that’s best for a particular transaction will depend on the specific circumstances. It’s also true that a large change in net asset value may not always signify a problem, particularly in cyclical businesses, where a significant change may be inevitable between the execution of the purchase agreement and closing. Nevertheless, taking the following three steps should help avoid the contentious and expensive post-closing dispute scenario described above.

## STEPS TO AVOID DISPUTES

**Carefully choose the assets and liabilities to be used in the adjustment.** The closing statement might capture all assets and liabilities of the business being sold, only working capital items, or perhaps even more selectively negotiated assets and liabilities. Whether a full or partial balance sheet approach is appropriate may depend on such factors as the type of assets being acquired and li-

abilities being assumed by the buyer, whether the purchase price was premised on a certain amount of net assets or current assets, or whether the parties agreed to a price adjustment feature to prevent pre-closing manipulations of current asset accounts.

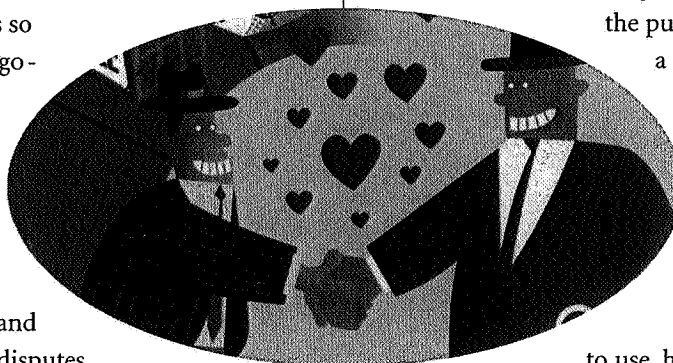
In deciding which approach to use, however, you should always

keep in mind that *the more asset and liability items you include, and the more judgmental those items are, the more likely it is that disputes will arise*. For example, inventory and bad debt reserves and loss contingency accruals are frequently disputed. The parties may have radically different views as to whether inventory is excess or obsolete, whether particular items in accounts receivable are collectible, or whether a certain product line will be subject to a low or high warranty return rate. If such items are included in the price adjustment process, the parties should seek to negotiate as specifically as possible the manner in which these items—and any other judgmental items—are to be calculated.

The parties also should carefully consider whether to specifically exclude certain items. For example, if there’s a separate arrangement in the purchase agreement for allocating environmental liabilities between the parties, the parties may wish to exclude such liabilities from the purchase price adjustment mechanism.

### **Clearly state how the closing statement will be prepared.**

It might seem obvious that the accounting standard for preparing closing statements is typically GAAP. But GAAP often authorizes a range of approaches for various balance sheet items, including inventory, which may be valued on a LIFO or FIFO basis, with reserves calculated based either on a formula or an item-by-item review. For this reason, a closing statement prepared in accordance with GAAP typically should be prepared using the same GAAP that was used to calculate



the benchmark amount. Otherwise, an “apples to apples” comparison can’t be made, and the true economic change in the value of an asset or liability can’t be ascertained.

What if the benchmark amount is taken from an unaudited financial statement that doesn’t conform to GAAP? One solution is to specify the accounting treatment that must be followed for the non-GAAP items. But even if both the benchmark financial statement and the closing statement fully conform to GAAP, it may still be wise to identify the specific treatment of certain items in order to avoid later disputes. Such items include the process for determining reserves, exchange rate calculations, and excluding reserves for management decisions made after closing.

**Negotiate a clear, specific, and limited mechanism for resolving disputes.**

The typical dispute-resolution method for closing statement disputes is arbitration, with a noninterested “Big 5” accounting firm being named in the purchase agreement to act as arbitrator. If the parties can agree on a second “backup” firm in case their first choice can’t serve or develops a conflict, that firm also should be named in the purchase agreement. As a general matter, the more specific the arbitration mechanism, the better, as long as it doesn’t unfairly skew the process in favor of one party. Limits can be imposed on the process itself as well as on the arbitrator, although the wisdom of any particular limits should be considered in the context of the particular transaction.

Some examples of limits on the *process* include:

- ◆ Restricting disputes to those above a monetary threshold (to prevent one party from launching a “nickel and dime” assault on the other);
- ◆ Requiring the objecting party to include an auditor’s certificate agreeing with the objections (to avoid frivolous objections in the hope that the arbitrator will “split the baby”); and
- ◆ Specifying the number and type of written submissions the parties can offer to the arbitrator in support of their position.

Some examples of limits on the *arbitrator* include:

- ◆ Requiring the arbitrator to select either the buyer’s or the seller’s number for a particular item, or at least

prohibiting an adjustment in an amount lower or higher than the amounts claimed by the parties;

- ◆ Specifying that the arbitrator shall decide disputes based only on the terms of the purchase agreement and the parties’ submissions to the arbitrator and not on the arbitrator’s own audit or independent review; and
- ◆ Specifying the arbitrator’s authority regarding discovery, the use of experts, and compelling witnesses to appear and testify.

**ADDITIONAL ISSUES BEFORE CLOSURE**

There are many other important issues to be considered in negotiating an effective purchase price adjustment mechanism. For example, should the buyer or the seller prepare the closing statement? Should there be a “band” around the benchmark number within which no price adjustment will occur? What role should the concept of “materiality” play in the price adjustment process? What kind of access to the records and employees of the other party should be allowed to the party preparing or reviewing the closing statement? Should the statement be audited or unaudited? What impact does the price adjustment mechanism have on other provisions of the purchase agreement? Although specific discussion of these points is beyond our scope here, if you follow the steps and principles described above they should provide a good starting point for negotiating an efficient and effective price adjustment mechanism. With further planning and a little luck, that mechanism should allow both parties to move quickly through the process instead of finding themselves ruefully paying fees to accountants and lawyers while they quote Yogi Berra’s “it ain’t over ’til it’s over” for many months after closing. ■



*William Perry and Marc Alpert are partners in Chadbourne & Parke LLP, a New York-based law firm. Chadbourne frequently negotiates contracts for the purchase and sale or merger of businesses containing purchase price adjustment provisions and, when necessary, represents clients in purchase price adjustment arbitrations. The views in this article are those of the authors and do not necessarily represent the views of their clients. William Perry, located in the Washington, D.C. office, can be reached at [William.Perry@Chadbourne.com](mailto:William.Perry@Chadbourne.com) and Marc Alpert, located in the New York City office can be reached at [Marc.A.Alpert@Chadbourne.com](mailto:Marc.A.Alpert@Chadbourne.com)*