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Being Prepared For Post-Transaction Disputes

Law360, New York (July 25, 2011) -- Transactions are rarely over when the closing is complete. The deal often contains one or more post-transaction steps. These could be related to the purchase price in the form of earn-out payments or buy-out payments, or some sort of adjustment, such as a working capital adjustment.

Often, disputes over these post-transaction steps are governed by alternative dispute resolution clauses in the deal documents. Most often, an agreement to arbitrate before an accounting firm or other agreed body.

However, with the focus on finalizing and closing the deal, counsel and clients understandably often are not concentrating on what will happen if there is a post-transaction dispute. They rely on boilerplate and stock alternative dispute resolution provisions, which leads to uncertainty and inefficiency.

Drafting Transaction Documents

Everyone starts with boilerplate language. The question is: Do you stop there? Not every transaction is the same, not every post-transaction step is the same, and not every dispute is the same. Therefore, in drafting the transaction documents, parties should first consider whether they are a buyer or a seller, as each will have different interests.

Also, consider questions such as which party will have the money in the dispute, which party will want a speedier resolution, and which party is likely to have ownership of the information and documents relevant to the claim. That is, spend time anticipating the most likely areas of dispute or claims, and tailor the dispute provisions to fit your interests.

For example, many post-transaction disputes require some sort of initial notice and then a dispute notification. A seller may require access to documents and information after the sale to analyze any sort of notice or dispute notification. However, these materials may only be in the possession of the buyer post closing. If the seller agrees to a 30 day time frame to provide a dispute notice, the seller may inadvertently restrict its ability to gain access to such documents.

By the same token, is there any mechanism at all in the deal documents that allows one party or the other access to documents or information that might be necessary to analyze a position? It is very common for parties to think of arbitration, in particular post-transaction arbitration, as having limited or no discovery. Therefore, if contracting parties do not consider whether they will need or have access to necessary materials after close, they may be left with no way to obtain them.

Other important issues to consider are the forum and jurisdiction, discovery, the time frame, and whether there is any cost or fee shifting agreed between the parties depending on the outcome of the dispute. Not addressing, and agreeing to, these details will lead to more uncertainty and negotiation after the closing of the deal in the event of a dispute.

The Arbitration Engagement Letter

The arbitration engagement letter normally starts out as a form from whomever is the arbitrator. It is written with the arbitrator's interests at heart and not the parties.

Most important, the parties must specifically and expressly define the arbitrator's scope. On what precisely will the arbitrator rule? Define the scope too narrowly, and the arbitrator's ruling may leave disputes between the parties unaddressed resulting in serial litigation trying to resolve one dispute after another.

Conversely, define the scope too broadly, and parties may arrive at the end of the proceeding with rulings that go beyond that which was in dispute. These rulings could be used as collateral estoppel in later disputes between the parties. Part and parcel with identifying the scope of the arbitrator's authority is explicitly identifying the disputed issues to be resolved in the arbitration, directly in the engagement letter.

Another key part of the engagement of the arbitrator is conflicts. Lawyers and accountants have different standards for what creates a conflict of interest. Professional conflicts generally prohibit a person from serving as a neutral arbitrator, but business conflicts may not.

The key is to seek to obtain an agreement in the engagement letter of full disclosure of any potential conflicts of interest. Moreover, parties should seek assurances that any subsequently created conflicts of interest that may arise for the arbitrator and the company are also disclosed. This way, the parties can make informed decisions about what conflicts, if any, the arbitrator may have both when the engagement letter is signed and throughout the engagement itself.

Commonly Missed Issues

The single biggest wildcard in post-transaction disputes is discovery. Parties routinely expect that arbitration will reduce discovery costs. However, if not properly planned for or addressed in the transaction documents, discovery can be a runaway cost sinkhole.

Commonly, transaction documents allow a party to request "all relevant documents" or "all necessary documents" or some similarly broad language. The buyer is likely to have sole possession of these documents. With such broad language, the seller could ask for almost any document and every document — every invoice, every check, every document of support for any line item on any ledger. This can lead to sky rocketing discovery costs.

So what can be done? In the transaction documents, parties should agree to what level of detail will be made available. Parties should also agree that summaries can be provided to help limit the amount of administrative work necessary to collect, produce and review lower levels of documents.

Similarly, parties must ensure that whoever has the documents keeps them. An obligation to adopt and implement an agreed document retention policy can be essential to preserving the information that a party needs in a dispute.

Another issue that is routinely neglected involves the accounting procedures that a buyer is required to use. Understandably, acquiring entities tend to desire to establish their own rules and procedures, including how the corporate accounting will be done.

On the other hand, a seller wants to make sure that any changes to accounting policies or procedures do not affect how a post-transaction adjustment is calculated. In transaction documents, there is routinely a requirement that the accounting be done "consistent with past practice." Not surprisingly, parties rarely agree on what that past practice was. The more general a description, the more likely that during the dispute the parties argue over what the past practice was.

Lastly, one acquisition often begets another. This leads to the need to anticipate how to account for any subsequent acquisitions (or divestitures). For example, if the buyer later acquires assets that generate substantial revenue, how will that be segregated from the revenue that applies to a post-transaction adjustment? The failure to agree in advance on how such revenue should be segregated to ensure the integrity of a post-transaction adjustment similarly leads to disputes, uncertainty and increased costs.

Getting the deal done is not the end of the deal. Understanding how the post-transaction dispute process works, what issues to be aware of, and how to prepare for it will provide most companies something that they value highly: certainty and predictability. Failure to consider these issues tends to lead to protracted litigation, even in an arbitration forum.

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