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Tips on Preparing for and Navigating through Working Capital Disputes

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# Tips on Preparing for and Navigating through Working Capital Disputes

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When engaged in M&A activity, companies and their counsel must be well prepared to address working capital disputes (post-acquisition disputes that arise due to working capital adjustments). Working capital adjustments, which protect buyers and sellers from working capital volatility after they agree upon a purchase price (and a related working capital target), involve a mix of both legal and accounting concepts and are often filled with contract interpretation and accounting-related nuances.





It is particularly important that counsel understand the intricacies of working capital adjustments in order to best serve clients and address working capital disputes, which most often arise when final working capital is significantly different from target working capital. Although each deal's working capital adjustment is unique, below we provide some guidance for counsel on addressing working capital matters and navigating disputes if and when they arise.

## Guidance for Counsel

We find it is most common for sellers to prepare estimated closing balance sheets and the related working capital, for buyers to prepare final closing balance sheets and the related working capital (in transactions other than carve-outs), and for sellers to prepare objection notices. Therefore, we have made these assumptions in the comments below.

Pre-Closing Target and Estimates: The process begins with the parties agreeing on a target working capital amount. Immediately before or after closing, the seller provides an estimated closing statement to determine the amount the buyer is to pay at closing.

The majority of issues and dollars associated with a working capital dispute are decided based upon the wording in the purchase agreement. Buyers often negotiate language favoring a generally accepted accounting principles (GAAP) based closing balance sheet (and associated working capital). Sellers often negotiate language favoring accounting consistent with past practices for the closing balance sheet (and associated working capital). Therefore, counsel should be focused on the working capital and associated definitions as well as the dispute resolution process when constructing the purchase agreement.

Closing Statement: Within a specified number of days after closing, the buyer prepares the closing statement (including the closing balance sheet) with calculations of net working capital, cash, transaction expenses and/or debt as of the closing date in accordance with the terms of the purchase agreement.

Counsel should consider advising clients to be thorough in identifying potential adjustments in their favor at this stage, since buyers normally have only one bite at the apple. In most post-closing disputes, the original buyer-prepared closing statements will be considered final if a dispute arises. Buyers will not normally have an opportunity to make additional adjustments in their favor after issuing the closing statements. Keep in mind, buyers can subsequently agree to sellers' objections and effectively adjust closing statements when the adjustments are in sellers' favor.

Objection Notice: After the buyer issues the closing statement, the seller identifies any objections within a specified number of days and issues its objection notice.

Counsel should advise clients to ensure their listings of objections are complete because, similar to buyers' closing statements, sellers' objection notices cannot normally be adjusted in their favor after the objection notice is issued. Especially in circumstances in which sellers struggle to get the information needed to properly analyze working capital accounts, objections to entire account balances at the trial balance level can be an effective way to encourage buyers to provide the information needed to analyze accounts and/or continue settlement discussions with buyers.

Settlement Negotiations and Arbitration: Following the issuance of an objection notice, the parties engage in settlement discussions. If they cannot settle the disputed items, the matter is submitted to arbitration.

We suggest buyers and sellers extend the settlement process if they are making progress. Progress includes removing items from an objection notice thereby narrowing the items to be brought to an arbitration. It is normally in both parties' interests to settle as many items as possible rather than bring all objections to arbitration.

If arbitration is imminent, ensure the parties select a knowledgeable arbitrator experienced in interpreting purchase agreements, addressing discovery requests and structuring the process to ensure both parties receive due process without expanding the scope of the arbitration beyond that mandated in the purchase agreement.

## What You Should Know About the Common Types of Working Capital Disputes

As mentioned earlier, working capital disputes are unique. That said, many disputes have common themes. Below we present some common types of working capital disputes and what you should be aware of with each.

### 1. GAAP vs. Consistency

One of the most common types of disputes centers on whether an item should be accounted for consistently or in accordance with GAAP (if indeed an argument can be made that the item is not accounted for in accordance with GAAP). This may involve, for example, corrections to historical errors. Note that if an item was historically accounted for in a certain manner and the related financial statements were audited and received, an unqualified opinion does not necessarily mean the item was accounted for in accordance with GAAP. One reason for a difference might be materiality. Materiality normally does not apply in accounting arbitrations unless specified in the purchase agreement. Further, accounting arbitrators typically do not rely on another firm to determine whether or not an item was accounted for in accordance with GAAP. Instead, they make that decision themselves.

This issue can be especially contentious because in nearly all cases, an arbitrator is unable to adjust the target. Therefore, it is possible an item in dispute may be accounted for one way in the target working capital and another in the final working capital.

We recently consulted the buyer of a company with significant amounts of inventory recorded on its balance sheet. The purchase agreement required net working capital be calculated in accordance with GAAP consistently applied. After closing, the buyer performed a physical inventory count and determined more than 25 percent of the non-rental inventory balance did not physically exist as of the closing date. The buyer asserted the balances had built up over a number of years due to the seller's failure to properly relieve inventory as items were used / sold and failure to historically perform physical counts. The seller argued the buyer's count methodology was inappropriate and that a physical count could not be used to calculate net working capital because similar counts had not been performed historically. The arbitrator agreed with the buyer's adjustment and concluded the results of the physical count needed to be considered under GAAP per the terms of the purchase agreement.

### 2. Consideration of Subsequent Events

Working capital disputes often involve a disagreement over the relevance of post-closing events to the closing date net working capital, such as the settlement of contested accounts receivable, write-downs of inventories and settlement of contingent liabilities. Buyers should beware of making post-close business decisions such as granting credit to a customer for a disputed invoice in exchange for future business and believing the disputed invoice (accounts receivable) will be reserved and result in a reduction to the closing working capital calculation.

We were the neutral arbitrator for a dispute involving a distributor of residential and commercial products. The purchase agreement provided for baseball-style arbitration, in which the arbitrator must fully rule in favor of one or the other party's position. Prior to the closing date, the seller began the process of transitioning its product lines to a different vendor. That action arguably rendered certain inventories obsolete. The buyer's net working capital calculation included a reserve to account for this obsolescence. The seller argued the buyer's obsolescence reserves were overly aggressive in light of the liquidation value of the inventory and that they resulted from the buyer's post-closing actions to aggressively change the vendor rather than making the change over a longer time period. The arbitrator agreed with the buyer's position that the seller's pre-closing actions reduced the value of the inventory and considered the post-closing events as seller-initiated events. Although the seller's arguments had some merit, because the arbitration was baseball-style, the arbitrator was forced to accept the full value of the buyer's reserve rather than give the seller credit for some of its liquidation value arguments.

### 3. Procedural Objections

Typical procedural issues involve the arbitrability of disputes, as well as the timeliness of disputes or the ability to introduce new disputes. Lawyers should advise their clients that entering into an arbitration does not mean a party can introduce new disputes. Quite the contrary, disputes are limited by closing statements, objection notices and even the engagement letter with the neutral accounting arbitrator.

We consulted on behalf of the seller of a manufacturing company. The purchase agreement contained separate purchase price adjustment mechanisms for debt and net working capital. The buyer's closing net working capital calculation included the balance of outstanding checks as a liability, causing the seller to dispute the calculation because the purchase agreement stated outstanding checks were to be included in the calculation of debt, not net working capital. The buyer argued that even if the outstanding checks liability could not be included in net working capital, it should

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be reclassified to debt, which would have the same net effect on the purchase price. The accounting arbitrator agreed with the buyer's position; however, the arbitrator also determined he had no authority to consider the buyer-proposed offsetting adjustment to debt because the seller did not dispute the buyer's calculation of debt within its objection notice.

## Conclusion

Understanding why working capital disputes arise and how they are most often resolved can help counsel bring value to clients when constructing the purchase agreement. It can even help avoid these types of disputes altogether. Advising clients on what purchase agreement language best positions them for potential disputes, how to prepare an effective closing statement or objection notice, what they can expect when requesting closing statement accounting information and support, how to handle discovery and settlement discussions, how to negotiate the arbitration process should settlement discussions fail, how to select an arbitrator, and what type of support and presentations are necessary to be best positioned to win an arbitration are all things on which counsel should be ready to advise its clients regarding each deal.

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