§1.03 DEFINITIONS AND COMMONLY USED TERMS

Throughout this publication the term '**deal mechanics**' is used to refer to a range of completion mechanisms, completion accounts, purchase price adjustments, and locked box arrangements. For the sake of clarity, these terms are defined below:

- Completion mechanism: a transaction procedure involving completion accounts and purchase price adjustments or alternatively a locked box.
- Completion accounts (or 'closing date accounts'): the accounts drawn up as at the completion date, by either purchaser or seller, in accordance with the provisions of the SPA, in order to establish, under the terms of the SPA, the purchase price adjustments to be made to the preliminary (or provisional) purchase price agreed by the parties.
- Purchase price adjustments: the adjustments to the preliminary purchase price to reflect the actual values in respect of, most commonly, net debt and working capital and, in some transactions, certain other defined items and which, added to or deducted from the preliminary purchase price, represent the final purchase price and from which equity value is derived.
- Locked box: the arrangement whereby the parties to a transaction agree on a fixed price with no subsequent adjustments, based on a balance sheet date before signing. The date is often that of the last audited financial statements. This avoids the necessity to prepare completion accounts. The purchase price is fixed on the basis of that historical balance sheet date and reflects, *inter alia*, the levels of cash, debt, and working capital at that date. Locked box transactions are economically, though not legally, backdated transactions.

§1.04 CASES

The cases referred to in this book have two sources:

- A proprietary data set of over sixty cases with over 1,000 individual claims. These are primarily international arbitration cases which the author and his colleagues have worked on over the last fifteen years. Given the confidentiality of these cases, they have not provided any specific information on any actual case. In all instances names and details have been changed in order to maintain confidentiality.
- Cases in the public domain which the author references as appropriate.

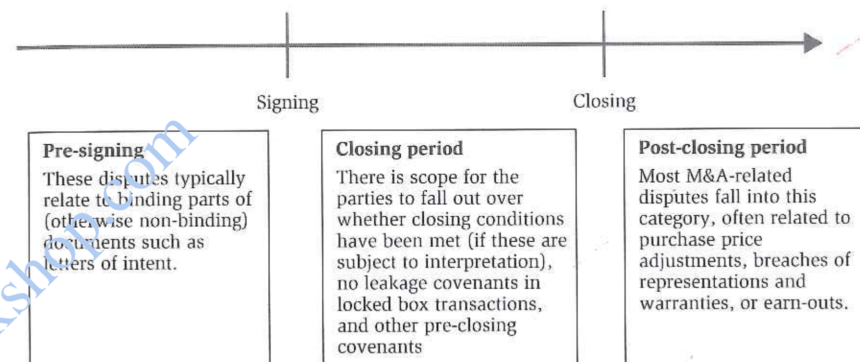
It should also be pointed out that the discussion of the cases in this book, which come from a variety of different legal jurisdictions, relate to financial and accounting questions, not points of law.

§1.05 TYPES OF M&A DISPUTES

An M&A-related dispute is defined here as any dispute, whether litigated, arbitrated, mediated, or prosecuted, arising from the sale of one business, or part of one business, to another or a merger of two businesses.

M&A transactions are often long processes, and disputes arise at different stages. Most M&A-related disputes occur after closing. However, this is not necessarily the case as shown in Figure 1.1.

Figure 1.1 Transaction Timeline



[A] Pre-signing

A typical pre-signing dispute relates to letters of intent, exclusivity, confidentiality agreements, or break-up fees. The example below is a dispute about an exclusivity agreement that is part of an otherwise non-binding indicative offer. An exclusivity agreement is an agreement used in M&A transactions to ensure that the counterparty deals only with a single, named party for a certain period.

Example of a Pre-signing Dispute over Exclusivity Agreement (United States Court of Appeal for the 1st Circuit)[3]

Gemini v. AmeriPark is a US case that relates to an exclusivity agreement entered into by buyout firm Gemini to finance the proposed acquisition by AmeriPark of MileHi, a competitor. AmeriPark and Gemini executed an 'Outline of Key Transaction Terms', which specified the terms of the proposed financing. While the rest of this term sheet was expressly non-binding, the paragraphs entitled 'Exclusivity' and 'Confidentiality' were binding. The exclusivity provision in the term sheet mirrored that in a separate arrangement between MileHi and AmeriPark. The part of the exclusivity agreement relevant here included the following wording:

3. United States Court of Appeal for the 1st Circuit, *Gemini Investors Inc.–v. Ameripark Inc.* 2011.

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> AmeriPark 'agrees not to discuss this opportunity or reach any agreement with *any person or entity* regarding financing for this Transaction or the pursuit of any sale or major other financing'[4] for a certain period.

The term sheet contemplated a recapitalisation of AmeriPark and a redemption of the shares of Greenfield Partners LLC, a large shareholder in AmeriPark. AmeriPark therefore required Greenfield's approval for the proposed financing.

As work on the MileHi acquisition progressed, AmeriPark management began to distrust Gemini and, before the exclusivity period expired, asked its shareholder Greenfield whether Greenfield would be interested in financing the MileHi acquisition instead of the Gemini-led financing. Also during this period, AmeriPark management approached the CEO and sole shareholder of MileHi, the acquisition target, about the possibility of seller financing. After some negotiation, the CEO and shareholder of AmeriPark agreed to finance the acquisition, and AmeriPark purchased MileHi using seller financing. Gemini had been dropped from the deal.

Gemini sued AmeriPark for breach of the exclusivity provision by pursuing financing for the MileHi acquisition from both Greenfield and the MileHi shareholder. At trial, the parties had differing views about the meaning of the exclusivity provision in the term sheet. AmeriPark argued that the phrase 'any person or entity' referred to the persons or entities expressly set forth elsewhere in the term sheet – investment banks, PE funds, etc. As the funding did not come from any of those sources, AmeriPark argued that it was not in breach.[5] Gemini's counter-argument was that the exclusivity provision was unambiguous and prohibited discussions with 'any person or entity' which included Greenfield and the shareholder.

Gemini lost in a jury trial in Federal court. The court concluded that the exclusivity provision was ambiguous (which an appeals court confirmed). Further, the court considered that the discussions with Greenfield about the Gemini financing were necessary in the context of a redemption of the Greenfield stake.

It was pointed out by attorneys Kirkland & Ellis that if the court's logic is extended, a PE sponsor 'obtaining a broadly-worded exclusivity at the end of an auction nevertheless would be exposed to being displaced, during the exclusivity period, by a management buyout or a transaction led by a significant target shareholder. Equally, a lender which bargains for exclusivity to finance an acquisition would be at risk of being dislodged by the target's or buyer's existing lender whose consent may be required'.[6] It can be important to consider carefully when drafting exclusivity agreements how to specify the parties to whom exclusivity shall apply.

[B] Closing Period

Signing and closing typically do not occur on the same day as there are usually conditions to be met prior to closing. The purpose of closing conditions is to ensure that

4. *Ibid.*, emphasis added.
5. *Ibid.*
6. 'Exclusivity' – Not as Preclusive as It Sounds?, Kirkland & Ellis LLP, Kirkland M&A update, 19 Jul. 2011.

legal and other requirements have been satisfied, and that, when control is transferred to the buyer, the business is the one that the buyer contracted to buy. Closing conditions may include regulatory approvals, financing, third-party and shareholder consent, bring down of representations and warranties, the retention of key employees, or the non-occurrence of a material adverse change (MAC) since an agreed date, just to name a few.

There is scope for the parties to fall out over whether closing conditions have been met or over breaches of pre-closing covenants if these are subject to differing interpretations.

An example of a closing condition that can lead to disagreement is the MAC clause.[7] The purpose of a MAC clause (if a closing condition) is to protect the buyer by avoiding that a deal closes if a materially adverse change has occurred. There are different types of MAC clauses. A 'Company MAC' is tested relative to the target company. It references material adverse changes in the target company, such as a reduction in sales or EBITDA by a certain percentage. A 'Market MAC' references changes in the overall market situation. A MAC clause in an SPA may be aligned with that in an acquisition debt financing agreement (especially in PE transactions), the idea being that, in the event the senior lender considers an adverse change to be a MAC event and debt financing is not available, the buyer can avoid closing.[8]

A key element of a MAC clause is the definition of what changes or events are 'material'. A MAC clause may specify specific changes or events or include only general wording (often in combination with carve-out clauses that exclude certain events). Buyers will prefer broad MAC clauses. A broad MAC clause, however, increases the scope for disagreement.

The bar to establishing a material adverse event is generally high, and most MACs do not lead to the transaction not closing. For example, Delaware courts had never allowed a MAC clause to invalidate a deal until *Akorn, Inc. v. Fresenius Kabi* (C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018)) in which a combination of multiple serious misrepresentations and a sustained and substantial decline in financial performance of Akorn's business led to the court's conclusion that a material adverse event had occurred (Akorn is appealing). After signing, Akorn had announced year-over-year declines in quarterly revenues and earnings per share of 29% and 96%, respectively, followed by even greater declines in subsequent periods.

In almost all other cases, rather than leading to a transaction not closing, alleged MACs create leverage for renegotiating the price to avoid or settle a legal challenge. This is what happened in the acquisition of Yahoo by Verizon.

Example: MAC Clause in the Acquisition of Yahoo by Verizon

In Verizon's acquisition of Yahoo for USD 4.8 billion in July 2016, the SPA included a MAC clause; the MAC event was defined as one that would 'reasonably be expected to

7. MAC clauses are often closing conditions, but can also be representations (or both).
8. Even if very similar or identical wording is used, however, there can be a disconnect between the two MAC clauses. For example, cases may be heard in different courts.

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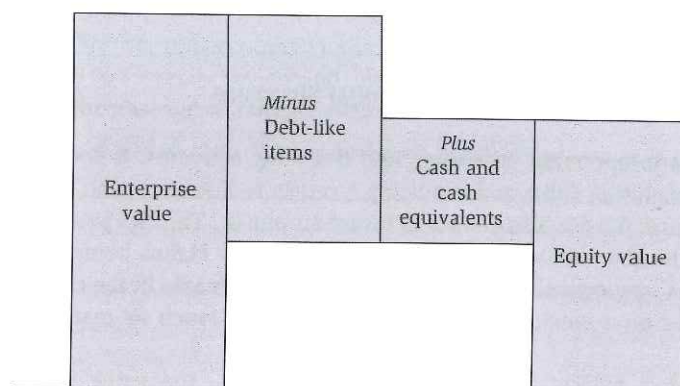
In a transaction, the value of the firm is commonly referred to as 'enterprise value', but also as the 'headline price' (often in the letters of intent issued in the early stage of a deal), the 'value of the operations', or the 'cash and debt free price'.

[B] The Equity Value Bridge

In a share deal, the buyer and seller ultimately have to agree on the price for the equity. While a number of valuation approaches are available, the starting point for valuation in most (though not all) transactions is enterprise value, to which adjustments are made for debt and debt-like items and for cash and cash equivalents in order to arrive at a value for the equity. In practice, cash and debt-like items are usually combined under one heading, 'net debt'.

This is depicted in Figure 2.1 in a simple version of what is known as the equity value bridge:

Figure 2.1 Equity Value Bridge



Enterprise value is typically measured by discounting free cash flows or using a multiple-based method, such as a multiple of Earnings before Interest and Taxes (EBIT) or Earnings before Interest, Taxes, Depreciation and Amortisation (EBITDA). (Some valuation approaches value the equity – for example, the dividend discount model and the discounted net abnormal earnings models – however these are less common in practice.) Common approaches to valuation are discussed in Chapter 11.

Enterprise value encompasses all the operating assets and liabilities necessary to carry on the business. It assumes, critically for transactions, an appropriate, or normal, level of working capital at the date on which closing takes place (or other relevant date). The level has to be agreed between the parties. The value they agree is commonly referred to as the 'reference values' with any variances from this being reflected in an adjustment. Enterprise value also assumes that capital and revenue expenditure have been maintained at appropriate levels and that the business is not

'underinvested'. What level of investment is considered 'appropriate' is a matter for negotiation between the parties.

Hence, as well as an adjustment in respect of net debt, the final purchase price in a transaction will typically also incorporate adjustments in respect of working capital and, less frequently, capital and revenue expenditure. These are collectively referred to as purchase price adjustments. They are discussed in outline later in this section and in depth in Chapters 4, 5 and 6.

To the layman purchase price adjustments may seem quite straightforward. However, even in a relatively uncomplicated transaction, an inordinate amount of time can be expended, particularly by the accountants and lawyers acting for each side, in rehearsing the various arguments as to whether an item should or should not be treated as an adjustment and how it should be measured.

[C] The Uncertainty Inherent in a Transaction

Ultimately, the buyer and seller have to reach agreement on the items to be treated as purchase price adjustments, namely: what items are to be treated as an adjustment, how they are to be defined and measured, and the process for doing this. All this – or at least a detailed mechanism to this end – needs to be formulated clearly in the SPA. One of the difficulties, however, is in knowing precisely what assets and liabilities will be in the balance sheet when the deal closes. A business is not static, it (and its balance sheet) changes every day: sales are made, inventory levels rise and fall, creditor accounts are settled, capital expenditure is incurred, and so on. The latest independently verified figures available to the purchaser are probably the audited financial statements prepared at the previous year end. For more up-to-date figures he or she will rely on information obtained during the course of the due diligence. Inevitably there is an element of uncertainty (in some transactions anxiety) in the mind of the buyer as to what assets and liabilities he will get when ownership transfers. This concern may become heightened once the SPA is signed: there is generally no going back.

[D] The Transaction Timeline

As indicated above, there are usually conditions to be met prior to closing, and it can take some time before these are fulfilled. A typical timeline for a transaction where signing and closing occur on different dates is shown in Figure 2.2.

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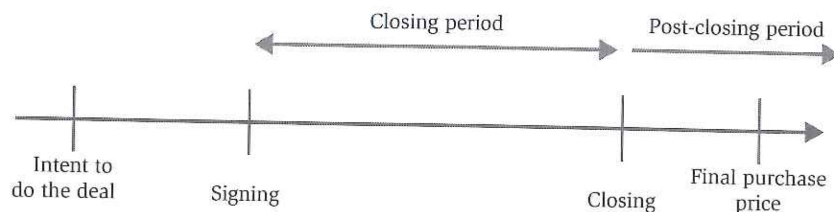
Figure 2.2 Transaction Timeline



Examples of closing conditions include governmental or regulatory approvals, transaction financing, third-party and shareholder consent, bring down of representations and warranties, the retention of key employees, and the non-occurrence of material adverse changes. Closing periods can range from a few weeks to several months and can be significantly longer, for example, in regulated industries or where antitrust issues are involved.

The existence of this interval between signing and closing, which can be difficult to predict accurately, gives rise to further uncertainty as to the precise assets and liabilities to be transferred at closing. Clearly, the longer the closing period, the greater the uncertainty; however, even in a relatively short closing period, significant changes can occur.

[E] The Purpose of the Completion Mechanism

The purpose of a completion mechanism is to set out a clear and unambiguous process which will ensure that the parties to the SPA obtain what they bargained for. Ironically, many post-M&A disputes originate from disagreements over the very mechanisms that were put in place precisely for this purpose. A sound completion mechanism should ensure that both buyer and seller get what they understood they negotiated, resulting in a 'clean' transaction.

More often than not, the main concern (at least up to completion) is on the part of the buyer. The buyer will seek to incorporate into the SPA measures to safeguard his or her interests, including for the period from signing to completion, during which the target business remains under the stewardship of the seller. This is not limited to financial and accounting matters; the buyer will usually be protected by covenants concerning the operation of the business during the closing period.

One of the buyer's principal worries here is that the seller could 'extract value', or that value could 'leak', between signing and closing, and that this is not reflected in the final purchase price, resulting in the buyer taking over a business worth less than what it believed it was getting.

If the SPA does not contain a completion mechanism that adjusts the purchase price or prevents value leakage, then there are a number of ways in which a seller could potentially extract value. These include:

- dividend payments;
- adjusting transfer prices used in transactions between related parties;
- inter-company charges;
- management compensation;
- advisory fees;
- waiving liabilities.

Value leakage is discussed further in §7.03.

Leaving aside the possibility of a seller's less than honourable intentions, it is sensible for both parties to protect themselves from being disadvantaged as a result of movements in the balance sheet in the period up to closing. While the buyer's concerns probably outweigh those of the seller during that time, the boot is rather more on the other foot when it comes to the preparation of completion accounts, as shall be seen later.

Traditionally the solution to the problems outlined above has been to prepare a set of completion accounts. These incorporate the various purchase price adjustments, computed on the basis agreed by the parties and documented in the SPA, and result in the establishment of the final purchase price.

However, an alternative approach has emerged in the early 2000s, namely the 'locked box'. In this scenario, the parties agree on a fixed price in the SPA with no subsequent purchase price adjustments.

Figures 2.3 to 2.5 show the two principal completion mechanisms that are available in a private M&A transaction, the purchase price adjustment and the locked box, as well as a combination of the two, a hybrid completion mechanism. Each option is discussed further below.

Figure 2.3 Purchase Price Adjustments

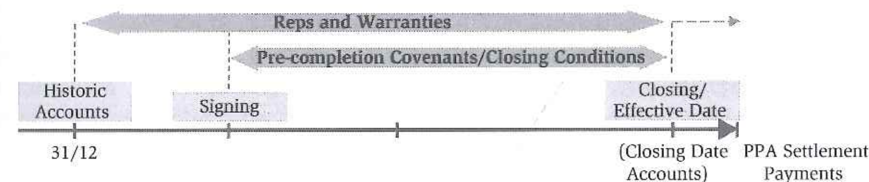


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Figure 2.4 The Locked Box

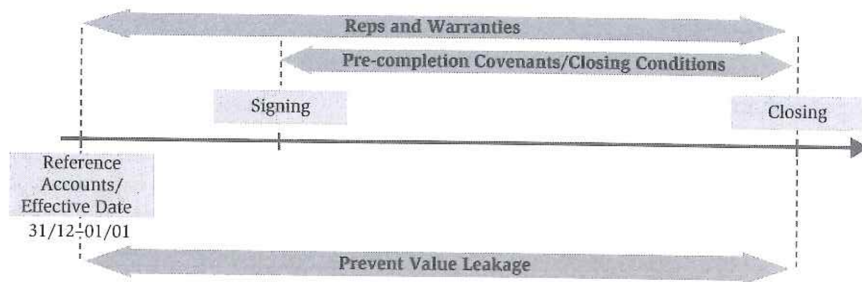
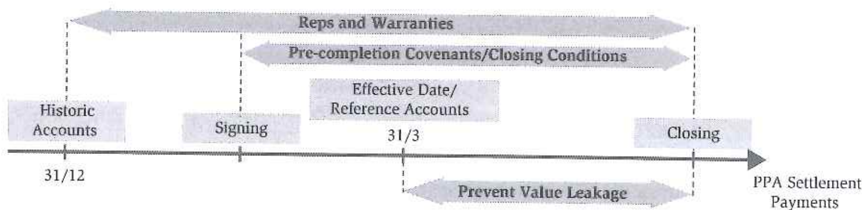


Figure 2.5 Hybrid Completion Mechanism



[F] Relevance of Items Leading to Purchase Price Adjustments in a Locked Box Transaction

The purpose of a locked box mechanism is to eliminate adjustments to the purchase price subsequent to closing by computing an equity value based on a historical balance sheet, i.e., *prior to* the closing date. The agreed equity value is a fixed purchase price that is not subject to any post-closing adjustments. It is a final price.

The term 'purchase price adjustments' typically refers to adjustments made to the preliminary purchase price following the completion accounts process. It should be noted that similar adjustments are made, or should be made, in agreeing the fixed purchase price in locked box transactions, only they are incorporated into the fixed purchase price.

The use of the term 'purchase price adjustments' here is therefore generic: it refers to transactions involving completion accounts as well as to those made in agreeing the fixed purchase price with a locked box mechanism.

Example of Enterprise Value, Equity Value, and Double Counting (German courts)[14]

14. BGH, 8 Sep. 2004 – XII ZR 194/01, NJW-RR 2005, 153, OLG Koblenz, 13 Jul. 2001 – UF 248/00, OLGR Koblenz 2002, 152, (simplified here). *See also* a discussion in: Wächter, M&A Litigation, 3rd Edition 2017, RWS Verlag Kommunikationsforum GmbH, p. 665.

The case shows that the interaction between the individual elements of the equity bridge in Figure 2.1 can lead to confusion and double counting. This is a divorce case, and the aspects of interest here concern the valuation of the husband's business, a machinery, and equipment maker. The owner's wife was entitled to one-half of the value of the husband's increase in net assets over the duration of the marriage. The dispute was over the valuation of the increase in the value of the shares in the business which were part of the husband's net assets.

The balance sheet of the husband's company is shown in Table 2.1.

Table 2.1 Balance Sheet as of 31 December 1995

	EUR Thousand
Manufacturing facility (building)	132
Other assets	54
Total liabilities	-492
Net assets	-306

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On 31 December 1995, the company reported negative net assets of EUR 306,000. According to a property expert, the fair value of the manufacturing facility (with a book value of EUR 132,000) amounted to EUR 319,000.

An expert valued the business at EUR 260,000 (enterprise value). The expert then deducted the negative net assets, arguing that a buyer of the business would be willing to pay a positive amount only if the net asset value was not negative. On this basis he determined the equity value to be –EUR 46,000 (=260,000–306,000). Note that this figure included the same net operating assets – in particular, the facility – twice: in enterprise value and in the deduction of the book value of net assets. However, possibly because this was a negative number, the judge at first instance decided to add to the equity value the fair value of the manufacturing facility of EUR 319,000. The value of the shares was thus determined as -EUR 46,000 + EUR 319,000 = EUR 273,000. By adding the fair value of the facility, this value now included the manufacturing facility three times, with three different values:

- book value of EUR 132,000;
- the value included in the enterprise value of EUR 260,000;
- property value of EUR 319,000.

The first Court of Appeals[15] decided to eliminate the book value of the facility from the negative net assets which is calculated as -EUR 306,000 – EUR 132,000 = -EUR 438,000. It determined that the equity value amounted to EUR 260,000 (EV) – EUR 438,000 = -EUR 178,000. The court then added the fair value of the manufacturing facility of EUR 319,000 to obtain EUR 141,000. As the book value of the facility had been removed, this valuation of EUR 141,000 included the facility two times.

15. OLGR Koblenz 2002, 152 – FamRZ 2002, 1190.

The German Federal Court of Justice (BGH) sent the case back to the lower court instructing the court to review whether the manufacturing facility was a necessary part of the operations. This suggests that the value of the facility could only be added if it was determined that it was not part of normal operations. It is not known how the lower court ruled.[16]

§2.02 PURCHASE PRICE ADJUSTMENTS: OVERVIEW

[A] Introduction

As discussed above, purchase price adjustments represent adjustments between enterprise value (a debt and cash-free basis with a normal level of working capital and investments in fixed assets) and equity value (after the deduction of net debt at closing).

In a 'traditional' transaction involving a completion accounts process, purchase price adjustments are made to a preliminary purchase price by measuring (subsequent to completion) the relevant balance sheet at the closing date. In a locked box transaction, such adjustments are made to a historical balance sheet, i.e., at a date prior to closing. Purchase price adjustments are summarised in Table 2.2.

Table 2.2 Purchase Price Adjustments

Adjustment	*Purpose*
Net debt	To arrive at a debt-free, cash-free valuation
Working capital*	Primarily protects buyer against a seller reducing working capital to decrease net debt
Capital expenditure*	Protects buyer against a seller slowing down capital expenditure to decrease net debt
Revenue expenditure*	Used, notably, in businesses where certain revenue expenditure, e.g., marketing, research and development, are key metrics. Protects buyer against a seller cutting expenditure to reduce net debt
Net assets/equity	Typically used instead of – sometimes as a 'floor' in addition to – a net debt adjustment. Far less prevalent in recent years
Enterprise value	Used in relatively rare cases where there is unusual uncertainty over enterprise value

*Used in combination with net debt adjustment.

Each of these adjustments is discussed briefly below. More detailed analysis, together with examples of disputes, is included in later chapters.

16. BGH 8 Sep. 2004 – XII ZR 194/01, NJW-RR 2005, p. 155.

Earn-outs should not be confused with purchase price adjustments which have a different purpose from addressing changes in the closing period. Earn-outs are deferred compensation, whereas purchase price adjustments are not deferred, only calculated at closing. Earn-outs are discussed in Chapter 8.

[B] Net Debt Adjustment

The net debt adjustment results in a valuation on a 'cash-free, debt-free' basis. Thus the buyer is compensated for the level of debt taken over at closing; similarly, the seller is compensated for any surplus cash (free cash) in the business at closing.

[C] Working Capital Adjustment

Since variations in cash and debt are, in part, directly attributable to changes in the level of working capital, a net debt adjustment typically requires a corresponding adjustment in respect of (net) working capital. Net working capital and net debt represent the most common combination of purchase price adjustments.

The basic purpose here is to protect the buyer from actions by the seller that maximise the cash – or minimise the net debt – position of the target business at closing by reducing net working capital. This is achieved as the buyer pays – on a dollar-for-dollar basis – for working capital in excess of a level that is agreed by both parties to be 'normal' (commonly referred to as the working capital 'reference value' or working capital 'target'). Correspondingly, the buyer receives a purchase price reduction for any shortfall against the reference value. If the completion mechanics work properly, every movement in net debt that has to do with working capital is offset by the working capital adjustment so that the net purchase price is unaffected.

[D] Capital Expenditure Adjustment

A seller may be motivated to slow down capital expenditure in order to maximise the cash position of the target business at closing. As a consequence, the buyer would obtain an 'underinvested' business with an artificially high cash position (which it would pay for as part of the net debt adjustment).

The rationale behind a capital expenditure adjustment is that it offsets this higher cash position by correcting for any shortfall in expenditure in the closing period compared with an agreed amount of aggregate capital expenditure (or reference level). The adjustment may be limited to a decrease in the purchase price, or go both ways and also increase the purchase price if capital expenditure is higher than the reference level. Adjustments in respect of expenditure incurred in excess of the agreed reference value are often subject to a ceiling in order to protect the buyer from expenditure it considers excessive. A capital expenditure adjustment also has the merit that it can be used in some cases to enable a buyer to exercise greater influence over what specific expenditure is incurred by the target business up to closing if specific expenditures are identified in the SPA.

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(a) a detailed, formal plan identifying the main aspects of the restructuring (IAS 37.72); and
(b) a valid expectation in those affected that the entity will carry out the restructuring by starting to implement the plan or by announcing its main features to those affected (IAS 37.10).

A restructuring provision should include only direct expenditures caused by the restructuring, not costs that associated with the ongoing activities of the entity. As their measurement requires considerable judgment. It is not surprising that restructuring provisions have been used as a way to manipulate earnings. An example is 'big bath' accounting, a manipulation that reduces a period's income significantly (often the first period under new management) by deliberately overestimating restructuring costs, only to 'bleed' those costs back to income and report earnings improvements in subsequent periods. There can be similar dynamics at work in a sales process. It is for the quality of earnings analysis to identify these manipulations.

A way to reduce the risk of a dispute is to agree a fixed amount as a net debt deduction for restructuring measures before signing. This amount may be determined independently of the accounting and should be consistent with the business plan on which the bid is based.

[E] Derivate Securities

[1] Introduction

So far in this section debt-like items that represent direct obligations to third parties such as financial institutions (banks, lessors, factors, institutional investors, etc.), former employees (deferred compensation), or government agencies (taxes) have been discussed. Companies can also enter into commitments that derive their value indirectly (from underlying assets). Such arrangements are derivatives. Common types of derivatives are options, futures, forwards, and swaps. For example, the price of a call or put option on a stock depends, among other factors, on the stock price to which it bears a (no-arbitrage) relation. Derivatives can be structured to depend on the prices of a variety of underlying variables, including share prices, commodity prices, debt securities, indices, weather events, emissions, electricity prices, and many others.[58]

The principal use of derivatives is to shift risk among investors. In the case of an interest rate swap, for example, a company may have borrowed at a variable interest rate and uses a swap to effectively convert variable into fixed interest rate payments. As a result, the borrower has effectively removed its exposure to interest rate volatility.

Derivatives can relate to financing or operating activities. An interest rate swap that swaps variable against fixed interest payments can be considered an extension of the underlying loan agreement, and therefore a financing activity. On the other hand, a forward sale is a common way of selling commodities and can be viewed as an

58. John C. Hull, *Options, Futures and Other Derivatives*, (6th ed., Pearson 2006), p. 552.

operating activity. The cost associated with derivatives used for hedging (whether or not charged to the income statement) is essentially the cost of removing exposure to volatility from everyday business activities, bringing the business to a less volatile state. Again, this cost could be an operating cost or a financing cost, depending on the underlying security or variable.

Accounting for derivative instruments, or hedge accounting, saw a significant reform with the recent introduction of IFRS 9, the new financial instruments standard that replaced IAS 39. The reform can be viewed in part as a response by the standard setter to accounting issues that were highlighted by the global financial crisis.

This section discusses the most common derivatives and then turns to their treatment in a transaction.

Financial Options

Options give their holder the right, but not the obligation, to buy or sell a fixed quantity of an asset either at some future date or during a specified time period in the future, and at a specific price. There are two basic types of options: 'call options' give the right to buy an asset at a certain price, and 'put options' the right to sell an asset at a certain price. The most common type of financial options are stock options.

An option is considered a derivative security as its price depends on the price of the underlying share. The price at which an option can be exercised is called the 'exercise price' or 'strike price'. When the exercise price of a stock option is equal to the current price of the share, then the option is *at-the-money*. A call option with an exercise price below the current share price is *in-the-money*. The same is true for a put option with a strike price above the current share price. A call option with a strike price above the current share price and a put option with a strike price below the current share price are all *out-of-the-money*.[59]

Futures Contracts

A futures contract is an agreement to buy or sell an asset in a specified quantity, at a certain time in the future, and for an agreed price. It is a derivative instrument as its value depends on the price of an underlying asset. Futures contracts are usually standardised instruments and traded on exchanges at a publicly observable price, allowing the parties to buy or sell them at any time when the markets are open.

Forward Contracts

Like a futures contract, a forward contract is a contract that requires the holder to buy or sell an asset for a specified price at a specified future time. The difference between the two types of derivatives is that forward contracts are not normally traded on an exchange but in the over-the-counter market. Forward contracts are often used to hedge foreign exchange exposure.

59. *Ibid.*, n. 28, p. 657.

Swaps

A swap is an agreement to exchange cash flows in the future at a certain formula. For example, an interest rate swap may exchange floating interest payments for fixed payments. At the inception of the swap, the total value of fixed interest rate cash flows over the life of the swap is typically equal to the expected value of floating interest rate cash flows. The swap is *at-the-money*. After some time, as the floating rate changes, the swap moves *in-the-money* or *out-of-the-money*. For a corporate, the purpose of a swap is usually to reduce or eliminate risk posed by interest rate volatility.

[2] Treatment in Transactions

It is sometimes suggested in negotiations that all out-of-the money-derivatives should be treated as debt-like. This makes sense when their holder has an obligation to make a payment to a counterparty. This is the case, for example, for an interest rate swap where (from the target entity perspective of a fixed-rate payer) the fixed rate exceeds the variable rate. Such an obligation represents an economic burden at closing which a buyer acquires and which – if not already reflected in the carrying value of the loan – can be moved to the seller as a net debt deduction.

If a target company that is not a financial institution has entered into a currency swap which, for example, requires it to make up the difference in value of a weakening pound against US dollar, then it can also be argued that this commitment should be treated as debt.

However, out-of-the-money derivative securities do not necessarily represent an obligation to transfer value to a third party. For example, a call option that has a strike price above the share price is out-of-the-money (from the perspective of the option holder). Similarly, a put option on a share with a strike price below the spot price is also out-of-the-money. These out-of-the-money derivative instruments represent only a right, not an obligation, to transfer value to a third party. If they remain out-of-the-money, the option will not be exercised and their value will be zero at the time of expiration. However, before they expire, given the possibility that the share price moves above the strike price and the options move into-the-money, even out-of-the-money options have a positive value. (While the intrinsic value of the option is zero, the time value is not zero.) There is therefore usually no reason to deduct an out-of-the-money option in these cases.

For most businesses that are not financial institutions, call or put options are not a necessary part of operating the business. Acquirers should therefore value them separately and (even if out-of-the-money) their fair value may be added to the enterprise value. This essentially treats them like cash (or other non-operating assets), reducing net debt.

Another case is the acquisition of a company that has issued share options (e.g., as employee remuneration). IFRS 2 requires a company to measure and recognise share-based payment awards (to employees or other parties) in its financial statements at the fair value of the goods and services received. They are expensed as vesting

conditions are satisfied.[60] Expensing share options has been required since IFRS 2 was issued in 2004. US GAAP has similar provisions in ASC Topic 718, Compensation--Stock Compensation and in ASC Subtopic 505-50, Equity – Equity-Based Payments to Non Employees.[61]

In general, once the awards have vested, they represent a reward for work already performed, similar to other kinds of deferred compensation.[62] At the time a share-based award is expensed, it reduces EBITDA; however, until an option is exercised, it has not yet diluted the existing shareholders (if equity-settled), or become cash-relevant (if cash-settled).

The treatment of stock options in an acquisition depends on whether or not outstanding options survive the transaction. The buyer may assume or substitute the target company's options; the options may alternatively be cashed out or cancelled. In some countries, an acquirer is required to make an appropriate offer for convertible securities in acquisitions (under certain circumstances).[63] A discussion of these alternatives is beyond the scope of this book. As a general rule, however, any cost of a target company's outstanding options to the shareholders of the acquiring company should be reflected in the purchase price at fair value. In the (small) fraction of private M&A acquisitions in which options are assumed by the acquirer, a net debt deduction can be appropriate to reflect the cost of dilution to existing shareholders.

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[F] Deferred Revenue

[1] Introduction

Deferred revenue is revenue that has not been earned although cash has been collected from customers in the form of a prepayment. It is usually (though not necessarily) reported in a company's balance sheet in current liabilities. Deferred revenue is one aspect of revenue recognition that can directly affect net debt (for a discussion of revenue recognition, *see* Chapter 9).

[2] Treatment in Transactions

Whether deferred revenue should be treated as debt or as working capital in a transaction is a frequent source of debate and negotiation.

The case for treating deferred revenue as debt (usually advanced by the buyer) is as follows: the target company has received cash from customers that is recorded in the balance sheet at closing. If there is no deduction in this respect, the buyer pays for the cash by way of a dollar-for-dollar increase in the purchase price. However, it is the

60. Applying IFRS, Accounting for share-based payments under IFRS 2 – the essential guide, EY, April 2015, p. 2.
61. Expensing stock options was part of the reforms after the dot-com bubble of the late 1990s. The resistance to expensing stock options from lobbyists was significant.
62. *See* §4.02.
63. For example, The UK Takeover Code, Section D, Rule 15.

buyer who will incur the cost associated with earning the deferred revenue, and this cost will be incurred after closing. The receipt of cash (in the form of customer prepayments) and the disbursement of cash (to suppliers or employees to fulfil the contract) do not match. A net debt deduction moves the economic burden of servicing the contract to the seller.

The counterargument for treating deferred revenue as working capital (usually advanced by the seller) is this: receiving prepayments from customers is a recurring part of operations, and a constantly revolving level of prepayments exists at any given time. The target company will be able to fund the cash outflows to fulfil the contract out of future prepayments that will have been received by the time the costs become cash-relevant.

As can be seen, the treatment of deferred revenue is by no means clear-cut and depends to a large extent on the nature of the target company's business and/or the prepayment. To illustrate, consider the following two extremes.

Example 1: Businesses Engaged in Large-Scale Construction

Two (almost) identical target companies are engaged in the construction of large power plants. They are about to commence the construction of one such plant. On the day before closing, Company A receives a prepayment from a customer of 30% of the contract value. It defers revenue. Company B receives a similar payment, but a day *after* closing.
At closing, should a buyer pay the same amount to acquire the shares of the two companies?

It seems clear that the amount of deferred revenue at closing (assuming no construction work takes place on the two dates in question) should be the difference in price. This suggests a net debt deduction is appropriate. If the seller insisted on customer prepayments falling into the definition of working capital, it would be reasonable for the buyer to argue that reference working capital should not include any such prepayments, so that, on closing, any prepayments over and above reference working capital are effectively treated as reductions to working capital and hence, to the purchase price. This would achieve the same economic result as a net debt deduction. Nevertheless, as discussed above (*see* §4.03), a buyer may still prefer a net debt deduction.

Example 2: Business Engaged in High-Volume, Individually Low-Value Transactions

A newspaper publisher routinely receives payments on (prepaid) subscriptions from a large number of subscribers. The aggregate prepayments vary from day to day and may spike during the holiday season, but individual amounts are small and it makes little if any difference when they are received. Whether any particular prepayment is received the day before or after closing is not material; there is always a level of prepayments in deferred revenue on any day of a month.

In this case, the prepayments meet the criteria of working capital: operating nature, short-term conversion into cash, constantly revolving (*see* §5.03) and the deferred item is more likely working capital.

The criteria that are touched upon in Chapters 2 and 5 when considering the treatment as debt or alternatively working capital generally apply here. When considering the treatment of deferred revenue, a question to ask is whether either the buyer or seller should be concerned about the exact closing (or locked box) date. If a party has reason to be concerned about the timing of a particular prepayment (as in example 1 above), then there is a case for a net debt adjustment. The more important the timing of payments, the stronger the case to treat as debt. If, on the other hand, the timing is not important (as in example 2), then deferred revenue (if recurring) is more likely working capital. It is the cases in between these two extremes that are often controversial in negotiations.

An approach that is occasionally advocated is a net debt adjustment only for the *future cost* of fulfilling the contract to which the prepayment relates, not the entire prepayment received. The result is that, economically, the seller retains the profit margin on the contract while the buyer recovers the future cost of fulfilling their obligations under the contract, the reasoning being that the seller originated the contract and should therefore obtain the reward. There are two arguments against this approach. First, it is not clear why the seller should retain the economic rewards relating to a particular contract only because cash has already been collected (as there would be no reallocation of the contract margin if cash had not been received). Second, agreeing an expected profit margin can be complex: The extent to which a seller should be entitled to retain profits by moving certain costs to the buyer is not at all clear, not even in concept.

[3] Deferred Revenue in Post-M&A Disputes

One reason deferred revenue is comparatively uncommon in disputes is that the amount of cash received and deferred at closing leaves relatively little discretion on the part of preparers of accounts.

The sample includes a dispute in which the parties had agreed on a net debt deduction for the costs of fulfilling a contract for which the target company had received a prepayment. When the completion accounts were drafted, the parties disagreed on the allocation of overheads into the contract. This shows that, if the method of measuring profit is not adequately defined in the SPA, the risk of a dispute is heightened. But even if it is defined, estimating costs to completion can be far from straightforward. Consequently, if the parties to a transaction wish to adopt this approach, it may be preferable to use a fixed percentage margin to avoid problems after closing.

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[G] Capital Expenditure Creditors

[1] *Introduction*

Capital expenditure creditors are usually reported in a company's balance sheet in current liabilities within an aggregate figure for creditors, and not separately disclosed. Hence they tend to be regarded, prima facie, as part of working capital.

A net debt deduction for capital expenditure creditors is different from the capital expenditure purchase price adjustment discussed in §2.02[D]. The purpose of the latter is to protect a buyer from a seller delaying capital spend in order to maximise the cash position at closing, and it acheives this by measuring actual (cumulative) capital spending against a target level, adjusting for any deficit. Spending that was deferred during the closing period would not necessarily be captured by a net debt deduction for capital expenditure creditors *at closing*.

[2] *Treatment in Transactions*

The reasons to treat capital expenditure creditors as either working capital or net debt are similar to those discussed for deferred revenue earlier in this chapter. To the extent that the creditors relate to routine expenditure in the ordinary course of business, they would normally be included in working capital and taken into account in the computation of reference working capital. Exceptions to this would be:

- Where the target business is capital intensive and property, plant and equipment additions involve large sums which make it difficult to calculate accurately a reference working capital position at any given time (including the closing date);
- The target business incurs individual sums of capital expenditure from time to time which could result in actual working capital at closing not bearing comparison with reference working capital.

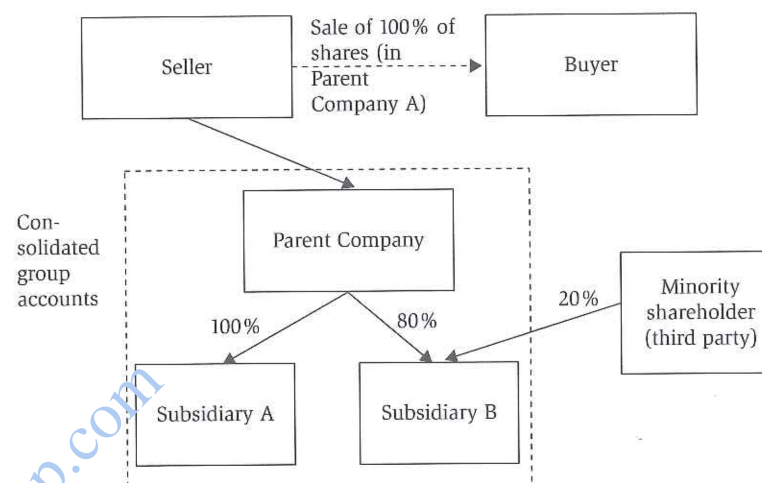
As mentioned elsewhere in this publication it is important to ensure that balances are not double counted, for example capital expenditure creditors included in working capital *and* as a net debt adjustment.

[H] Non-controlling Interest (Or Minority Interest)

[1] *Introduction*

A non-controlling interest (called 'minority interest' before IFRS 3 was introduced; in this publication both terms are used interchangeably) is the interest in a subsidiary company not attributable to the parent that owns a controlling interest. This is depicted in Figure 4.6.

Figure 4.6 Example Group Structure Showing Non-controlling Interest in Subsidiary



If Parent Company holds an 80% interest and an unrelated third party holds a 20% interest in Subsidiary B, the 20% interest is the minority – or non-controlling – interest. The minority interest may have come about for different reasons. For example, it may be held by the founder of a business who previously sold the majority stake, or perhaps by management as a form of incentive.

In the consolidated financial statements, Parent Company presents non-controlling interest within equity, separately from the equity of the owners (IFRS 10.22).

[2] *Treatment in Transactions*

[a] *Overview*

Continuing with the example above, let us assume that Seller intends to dispose of 100% of the share capital in Parent Company. Buyer values the enterprise using both a DCF (on a free cash flow basis) and a multiple method, in each case based on consolidated financial information (which includes 100% of the results of Subsidiary B).

Subsidiary B's value is then included in full in the enterprise value attributed to the group. The enterprise value for the group as a whole does not reflect the fact that a minority owner is entitled to a share in the surpluses that Subsidiary B will generate in the future. If dividend payments correspond to the ownership proportions, the acquisition of 100% of the shares of Parent Company entitles Buyer to only 80% of Subsidiary B's dividends.

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Management judgment and estimates play a key role in revenue recognition for long-term contracts where revenue is recognised with the degree of completion (which requires judgment about the extent to which the earnings process is complete). The accounting for long-term contracts and related disputes are discussed in §9.03.

Revenue recognition does not usually give direct rise to a purchase price adjustment (with the exception of a net debt deduction for deferred revenue (see §4.04[F])). Disputes involving revenue recognition therefore often relate to misrepresentations or warranty breaches. One such dispute is *Sycamore Bidco Ltd v. Breslin & Dawson*.[93]

Example Dispute about Revenue Recognition (High Court of England and Wales)

The central figure in this case was 'total revenue'.[94] The buyer and claimant, Sycamore Bidco, a PE-owned company, acquired Gissings Advisory Services Ltd from two sellers and claimed damages for misrepresentation against the sellers in relation to the inclusion of a monthly reduction in the charges by an IT supplier (granted as compensation for previous problems with the supplier's services) in revenue of the target company. Net income and cash flow in the relevant period were not affected by this error. However, the buyer argued – successfully – that its valuation model meant that the inflated revenue led to an overstated valuation. The SPA included the following accounts warranty:

> 4.1: The Accounts:
> 4.1.1 show a true and fair view of:
> (a) the state of affairs;
> (b) the assets and liabilities; and
> (c) the profit or losses
> of each Group Company to which they relate and the Group (on a consolidated basis) as at the Accounts Date;
> 4.1.2 have been prepared in accordance with relevant generally accepted accounting practice ...

The relevant accounting standard in this case was UK GAAP. The relevant definition of 'turnover' was defined as:

> The revenue resulting from exchange transactions under which a seller supplies to customers the goods or services that it is in business to provide.[95]

The judge found that the reduction should not have been included in turnover, as there was no evidence that there was any un-recouped expenditure or any unremunerated provision of services at the date of the agreement, and it could not be treated as compensation in respect of any such matters. Accordingly, the turnover figure was overstated. Further, the judge found that the compensation should probably have been treated as 'other income', and that including the supplier's compensation sum in

93. *Sycamore Bidco Limited v. Sean Breslin/Andrew Dawson* [2012] EWHC 3443 (Ch).
94. *Ibid.*, para. 116.
95. *Ibid.*, para. 216.

turnover for the relevant year failed in a material way to present a true and fair view of the state of affairs of the company or its profit and losses.

The question of damages in this case is discussed below in §9.03.

§9.02 NEW REVENUE RECOGNITION STANDARDS

IFRS 15, applicable to accounting periods beginning on or after 1 January 2018, has been developed in parallel with equivalent changes to US GAAP.[96] The purpose of the new standard is to remove inconsistencies in current revenue recognition practice, provide a more robust framework for addressing revenue issues, and improve comparability of revenue reporting across sectors and jurisdictions.

In the short and medium term, the transition between the old and new rules is expected to create challenges in an M&A context. For example:

- Under the new rules, revenue recognition may be accelerated or delayed, affecting reported profitability, working capital, net debt, or other deal metrics, potentially impacting the closing balance sheet or earnings adjustment mechanism.
- Forecasts stated using the new rules may differ materially from those provided during due diligence, or those forming the basis for the transaction price.
- Changes in earnings could impact profits available for distribution or could result in non-compliance with loan covenants, triggering indemnity clauses.
- Earn-out clauses negotiated using accounts prepared under the old rules may result in materially different compensation when the agreed earn-out methodology is applied using accounts prepared under the new rules.

In the long term, there is no reason to expect that revenue recognition will be less relevant to M&A-related disputes. The new standard continues to have important areas of judgment (even if different from those in existing standards). For example, IFRS 15 has the following requirements:

- For long-term contracts where revenue may be recognised over time, the percentage of the performance obligations satisfied will be subject to estimates, including appraisals of results achieved, surveys of work completed, time elapsed, milestones reached, units produced, costs incurred, or labour hours expended. Appraisals, surveys of work completed and estimation of total hours or costs of a project involve technical knowledge and judgment.
- For contracts with variable consideration or where some goods are expected to be returned by customers, estimates will be required. These and other estimates of probabilities or amounts can be biased or, in hindsight, turn out to be incorrect.

96. This section draws significantly from 'This is How IFRS 15 will Impact M&As', Financial Director, 32 May 2017, Phil Hersey, Heiko Ziehms and Anna Hartley.

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IFRS 15 will not only lead to different accounting treatments once the transition to the new standard has occurred, but also to uncertainty during the transition itself. Beyond affecting reported earnings, IFRS 15 may require wider changes to customer contracts or loan agreements – legal matters that may not receive sufficient attention during busy negotiations.

The motivation behind the changes is improved comparability in financial reporting between companies and across industry sectors. This is a desirable objective. However, in the short and medium term, the changes introduce additional complexity into the financial and accounting aspects of M&A transactions. In the long term, revenue recognition issues will likely continue to play a prominent role in M&A-related disputes.

§9.03 REVENUE RECOGNITION FOR LONG-TERM CONTRACTS

[A] Accounting Rules

When a performance obligation is satisfied over time, a firm may, under certain conditions, recognise revenue before the obligation has been performed in full, by measuring the progress towards completion (IFRS 15.39). The degree of completion may be assessed using either an output or an input method.

Output methods measure revenue on the basis of direct measurements of the value to the customer of goods or services transferred to date, relative to the remaining goods or services promised under a contract. Input methods recognise revenue on the basis of the entity's efforts or inputs to the satisfaction of a performance obligation; for example, costs incurred relative to the total expected costs for the satisfaction of that performance obligation. In both cases, the firm recognises a profit margin along with revenue. Two key estimates enter into reported profitability when reporting earnings: the degree of completion and the overall contract profit (of which a fraction is realised). Both are open to bias.

IFRS 15.4 requires a company to update its estimates continuously relating to the measure of progress. In case long-term contracts are expected to be loss-making, IAS 37 requires the immediate recognition of a loss.

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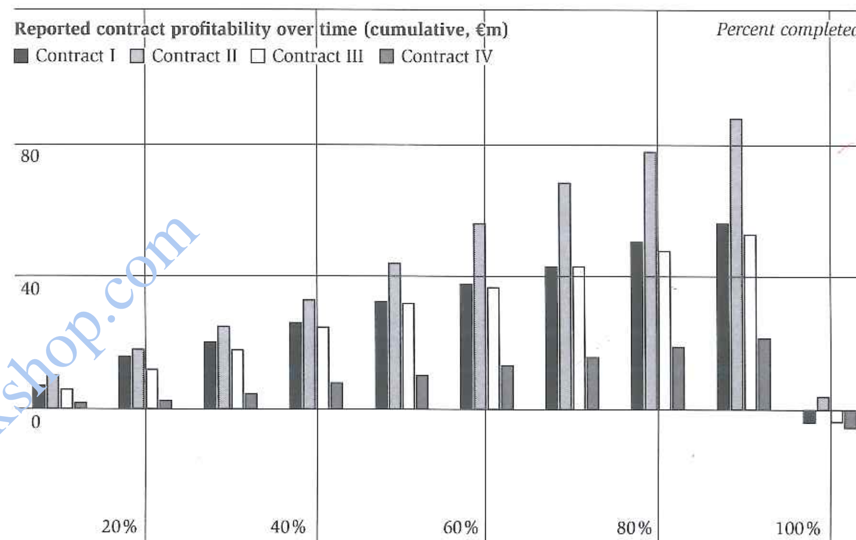
[B] The Degree of Completion and Cost to Complete

Estimating the degree of completion of large projects and the remaining costs to complete requires both technical engineering expertise and judgment. It is easy to overestimate the degree of completion or an entire contract's expected profitability before it has been completed, only to find at its end that actual profits are much less (or the contract was loss-making).

The unbiased exercise of judgment would mean that new information that comes to light during long-term contracts would increase or decrease contract profitability in an approximately equal number of cases (all else being equal). As IFRS requires the immediate recognition of expected losses in full, a typical pattern would be that entities

recognise losses earlier rather than later. In fact, the opposite may be more often the case. To illustrate, Figure 9.1 shows a summary of cumulative profits reported (under IAS 11) over the lifetime of a portfolio of four long-term contracts for an undisclosed target company. While each contract had a different term, the terms were scaled here to be comparable.

Figure 9.1 Evolution of Reported Contract Profitability over Time



Over the contract terms, management was consistently too optimistic about total contract profitability. This led to overstated profits up until completion of each contract. Only at the end of each contract, with no future periods were available to defer losses to, did the company report the losses actually incurred. In three out of four cases, these cumulative losses exceeded all previously (incorrectly) reported profits.

Earnings of long-term contracts can generally be overstated in two ways:

- Underestimating the costs to complete work under the contract. In this case, the real costs were only reflected in the accounts when no further periods were available and the contract was completed, and the costs associated turned out to be much higher than the previous estimate suggested.
- Overstating the degree of completion in the periods up until the last reporting quarter. This moves the recognition of contract profitability ahead in time (e.g., into a financial year on which the valuation is based) even when the estimate of overall profitability is correct. In this case, it moved (non-existent) profits into earlier reporting periods.

the deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users. Note that financial statement fraud, much like all types of fraud, is an intentional act.[101]

High profile fraud cases show the variety of ways fraud can enter into a transaction. Examples include:

- The acquisition of Autonomy by HP in 2012, the second-largest acquisition in HP's history, in which HP executives alleged that they were misled by Autonomy which accounted for most of a USD 8.8 billion write-down after the transaction.[102] In a public statement, Hewlett-Packard announced that '... some former members of Autonomy's management team used accounting improprieties, misrepresentations and disclosure failures to inflate the underlying financial metrics of the company, prior to Autonomy's acquisition by HP. These efforts appear to have been a wilful effort to mislead investors and potential buyers, and severely impacted HP management's ability to fairly value Autonomy at the time of the deal'.[103]
  In early 2018, Autonomy's former CFO was convicted of fraud in the US after being found guilty of artificially inflating the firm's financial position before it was sold (he intended to appeal against the judgment).[104] (Other lawsuits were ongoing at the time of writing).
- The acquisition of mobile operator EE by BT from Deutsche Telekom and Orange, the French telecoms group. The transaction closed in early 2016. Part of the consideration of GBP 12.5 billion was paid in BT shares. Orange and Deutsche Telekom became shareholders of BT in 2016 as a result (Deutsche Telekom owned 12%). In early 2017, BT issued a profit warning after discovering a complex fraud in its Italian business unit that led to a GBP 530 million write-down at BT. This triggered a decline in BT's share price by almost 25% in the first half of 2017.[105] Deutsche Telekom wrote down its interest in BT by EUR 2.2 billion, and subsequently by a further EUR 1.1 billion. In order to avoid a potential dispute, BT struck a GBP 225 million settlement that ruled out further legal disputes with Orange and Deutsche Telekom.[106] This case is similar in the following respect to the *The Hut Group Ltd v. Nobahar-Cookson and another*, discussed further below.[107] In both cases, the consideration consisted in part in shares in the buyer's group, and it

101. ACFE's 2015 Fraud Examiner's Manual.
102. Autonomy deal is a lesson for managers, Financial Times, 2 Dec. 2012.
103. HP Issues Statement Regarding Autonomy Impairment Charge, HP, 20 Nov. 2012, http://www8.hp.com/us/en/hpnews/press-release.html?id=1334263#.UnPvQPleY4k.
104. BBC Business News 1 May 2018, Autonomy ex-executive guilty of fraud, https://www.bbc.co.uk/news/business-43959468.
105. Financial Times, Deutsche Telekom takes further EUR 1.1 billion hit from BT stake, 3 Aug. 2017.
106. *Ibid.*
107. *The Hut Group Ltd v. Nobahar-Cookson and another* [2016] EWCA Civ 128, discussed in §10.03.

emerged after closing that financial statement fraud had occurred that dated from the time before the transaction which meant that the consideration shares – the acquisition currency – were worth less than the seller had expected.
- Caterpillar Inc's USD 677 million acquisition in 2012 of ERA Mining Machinery Ltd, the holding company for Zhengzhou Siwei Mechanical & Electrical Equipment Manufacturing Co Ltd, one of China's biggest makers of hydraulic coal-mine roof supports. The purchase was billed as a coup for Caterpillar, the world's top maker of tractors and excavators, and Caterpillar's advisors even received an award for 'cross-border deal of the year'.[108] Shortly thereafter, Caterpillar announced that it had discovered 'deliberate, multi-year, coordinated accounting misconduct' at Siwei and Caterpillar took a goodwill impairment charge of USD 580 million, 86% of the value of the deal.[109]
- Numerous cases of (alleged) fraud In Chinese reverse mergers on American exchanges.[110]

While these types of disputes tend to make prominent headlines, fraud is not the most common cause for M&A-related disputes. According to a recent survey, misrepresentation – whether deliberate or not – was named as the most common area of disputes by only 17% of respondents, behind earn-out clauses and completion accounts disputes (33% each).[111] Misrepresentation in the survey included fraud cases, but likely also cases of unintentional misrepresentation (though the survey does not indicate how many), so that the share of disputes involving fraud is likely lower than 17%. An analysis of the cases in the sample of disputes (*see* §1.04), though not representative of all M&A disputes, suggests that in approximately 10% of cases at least one claim related to fraud.

Financial statement fraud often relates to misrepresentations by the seller or the target entity's management about the target business. The seller may withhold information during the transaction process, or the target's financial statements may be misrepresented. As a consequence, the buyer acquires unknown liabilities or later discovers that the target business has in fact less earnings potential than it assumed. However, misrepresentations may also be made by the buyer, not the seller.

Another type of fraud risk is corruption, a type of occupational fraud for which the ACFE distinguishes four major categories: bribery, conflicts of interest, illegal gratuities, and economic extortion. Of these, allegations of bribery have received

108. The M&A Atlas Awards Asia Pacific Middle Markets, 8 Nov. 2012, Category: Asia Pacific Deal Award Winnder Cross-Border Deal of the Year – Large.
109. Special Report: How Caterpillar got bulldozed in China, Reuters World News, 23 Jan. 2014, https://www.reuters.com/article/us-caterpillar-china-special-report/special-report-how-caterpillar-got-bulldozed-in-china-idUSBREA0M03720140123.
110. Fraud In Chinese Reverse Mergers on American Exchanges – And We're Surprised?, Forbes, 8 Apr. 2011.
111. Grant Thornton, A smarter way to get deals done International Survey: Identifying international market practice for equity value adjustments and Sale and Purchase Agreements, November 2017, p. 18.

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significant press coverage in recent times as enforcement of anti-foreign corruption statutes has been stepped up in numerous countries.

§10.02 THE FRAUD TRIANGLE

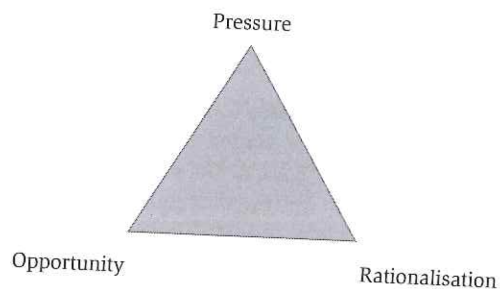
[A] Introduction

The fraud triangle is a framework for analysing fraud that was first introduced by the American sociologist Donald Cressey.[112] Cressey's original hypothesis from which the fraud triangle originated is as follows:

> Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.[113]

The factors identified by Cressey that cause someone to commit occupational fraud are usually summarised as in Figure 10.1: The circumstances present in M&A transactions can be a fertile breeding ground for all three factors.

Figure 10.1 The Fraud Triangle



[B] Pressure

The parties in an M&A transaction are often subject to a variety of pressures: Sellers naturally want to make the target business look as good as possible. There can therefore be the temptation to conceal obligations that would expose a less favourable financial situation of the target entity or that the buyer would have otherwise deducted from the purchase price. As the transaction progresses, sellers may come under

112. Donald R. Cressey, *Other People's Money* (Montclair: Patterson Smith, 1973) p. 30.
113. *Ibid.*

pressure to withhold new information such as disappointing earnings numbers or the loss of a key customer. As pressure builds, a downward spiral begins.

A seller who stays silent about recent adverse developments (e.g., the loss of a key customer) may be guilty of fraudulent misrepresentation if the buyer relies on information presented to him or her. This happened in *Erlson Precision Holdings Ltd v. Hampson Industries plc* in which the buyer learned on the day following the sale that a key customer would be terminating all business with the target.[114] This information meant that various forecasts which the seller had provided to Erlson over a period of ten months prior to the transaction were incorrect. It transpired that the seller's CEO had been informed of the customers' decision much earlier. The judge held that the seller was guilty of fraudulent misrepresentation.

The principals working on a transaction may be the first to feel pressure. However, pressure can be passed on to the target's management or the seller's or target's accountants, and even outside advisors who prepare the financial information or assist in the sale process. Exit bonuses or success fees may be linked to achieving specific results. The pressure is both obvious and implicit.

Finally, it is not just the sellers who feel pressure, but also buyers. For example, buyout firms that face limited fund terms may come under pressure to deploy funds. Or consider *The Hut Group Ltd v. Nobahar-Cookson and another*, discussed in detail below in §10.03, in which the sellers received consideration shares valued on the basis of the buyer's accounts (which later turned out to be misstated). The buyer's senior management allegedly put its finance team under pressure to hit figures which were consistent with the 'growth story' which the buyer wished to present to the outside world, whether or not it reflected reality.

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[C] Opportunity

The natural opportunity to commit fraud in an M&A process follows from the asymmetry between the buyer and seller in a transaction. The seller usually knows far more about the business it is selling than the buyer, and it is the seller who can decide to influence accounting choices or disclosures pre-closing, or withhold information.

Buyers attempt to level the playing field by conducting comprehensive due diligence, but access is limited, in particular in a competitive auction. And a seller who is attempting to deceive will often make sure that access is even more restricted than usual. In *Erlson Precision Holdings Ltd v. Hampson Industries plc* the seller not only withheld information of a customer loss from the buyer, but, in fact, had gone to some length to ensure that the buyer did not learn of these developments, including asking the relevant customer to keep the information confidential.[115]

Detecting fraud is not the focus, nor even within the scope, of standard buy-side financial due diligence. Only when concerns over the numbers arise, or 'red flags' are

114. *Erlson Precision Holdings Limited (formerly GG132 Ltd) v Hampson Industries plc* [2011] EWHC 1137 (Comm), 20 Apr. 2011.
115. David v Goliath, New Law Journal, 22.7.2011, Available at https://www.newlawjournal.co.uk/content/david-v-goliath.

starting to emerge during the negotiations does this typically trigger further analysis by the buyer. If the buyer then decides to bring forensic expertise and fraud examination tools to the buy side financial due diligence, the transaction is no longer following a normal process. A discussion of red flags that may suggest potential fraud is in §10.03.

[D] Rationalisation

The third element of the fraud triangle, rationalisation, is the ability of the person who commits the fraud to convince him- or herself that their actions are acceptable or justifiable.

In a transaction context, this may develop out of a (tacit) understanding that sellers are expected to 'dress up the bride', or that 'earnings management' is what all sellers do. It may also appear that the sums involved are immaterial (from the perspective of a seller who commits fraud), or that a customer who announces its intention to leave does not really mean it.[116]

It is generally true that sellers do their best to present the target company in the best possible light, and purchasers in most situations accept that the lily is often gilded. Consider *The Hut Group Ltd v. Nobahar-Cookson and another* again, in which the buyer submitted that 'there is nothing wrong in principle with presenting your numbers in the best possible way, though of course you must do so honestly rather than dishonestly'.[117] However, intentional misstatements are a different matter.

§10.03 RED FLAGS FOR FRAUD

Identifying fraud before signing is made all the more difficult when, as is the case with fraudsters, the other party is actively attempting to conceal it. A seller who intentionally conceals fraud will also attempt to restrict access during the due diligence phase as much as possible. Even without such efforts, access and time are limited.

The following is a list of common 'red flags' to look out for:

(1) The analyses of cash flow and profitability:
  - (i) sales that do not turn into cash – red flags include deteriorating collection ratios, receivables ageing, inventory turns, and sustained cash outflow from operations despite profit growth;
  - (ii) pressures on profitability as evidenced by declining profit margins;
  - (iii) straight line or 'hockey stick' earnings/profit growth; and
  - (iv) high financing costs compared to debt levels.

(2) The analysis of organisational structure:
  - (i) impending/recent flotation or buy-out;
  - (ii) high level of related party transactions;

116. *Evlson Precision Holdings Ltd v. Hampson Industries plc*, CMS eAlerts, Share sale unwound for fraudulent misrepresentation, 11.10.2011, available at http://www.cms-lawnow.com/ealerts/2011/10/share-sale-unwound-for-fraudulent-misrepresentation?cc_lang=en.

117. *The Hut Group Ltd v. Nobahar-Cookson and another* [2014] EWHC 3842 (QB), para. 253.

  - (iii) unnecessarily complicated corporate structure or financing arrangements;
  - (iv) dominant, overbearing, or bullying CEO/Chairman;
  - (v) weak finance function;
  - (vi) consistent adoption of 'racy' but acceptable accounting policies; and
  - (vii) involvement of non-financial management in accounting.

It is useful to distinguish between fraud itself and the triggers that lead to its discovery. Once the transaction closes, the new owner takes control and has ample opportunity to find out more about the target's financial statements and disclosures. A trigger for detecting fraud is often that the target entity is in need of additional liquidity soon after closing. This, mostly likely, comes as a surprise to the buyer. In such circumstances, it is often appropriate to conduct post-closing due diligence. If this reveals unknown off balance sheet liabilities or that the seller's accounting for the target company has gone beyond optimism, then there might be a case for fraud. This is the start of a difficult process: unpicking financial statements can be a complex task and sometimes requires a combination of expertise of transaction specialists, forensic accountants, fraud examiners, and even intelligence professionals. In the absence of a trigger event, there is often no effort to uncover fraud, and it is, therefore, safe to assume that many frauds remain undetected.

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Example: *The Hut Group Ltd v. Nobahar-Cookson and another* (High Court of England and Wales)[118]

In May 2011 the Hut Group Ltd (THG), acquired an online sports nutrition business known as 'MyProtein', the trading name of a company, Cend, owned by the defendants. The purchase price amounted to GBP 58 million, of which GBP 30 million was paid in cash and GBP 28 million in shares in THG. The sellers were the founder and manager of Cend and the family trust.

The SPA included sellers' warranties in relation to Cend's management accounts and warranties by THG, the buyer, that its draft statutory accounts gave a true and fair view of its state of affairs, assets and liabilities and profit and loss as at 31 December 2010 (the THG Accounts Warranty) and that THG's management accounts fairly presented its assets and liabilities and profits and losses for the period from 31 December 2010 to 31 March 2011 (the THG Management Accounts Warranty). The SPA limited the parties' liabilities for claims for breaches of warranty 'save insofar as it results from the fraud of [THG]' or '... the fraud of any of [the sellers]'. The relevant limitation was GBP 7.24 million for claims by Sellers against THG.

The sellers' warranties will be discussed in Chapter 12.

Shortly after closing, THG commenced preparations for an initial public offering (IPO). As part of the IPO preparations, THG's group audit firm carried out a half-year audit of THG's accounts. In September 2011, it came to the auditors' attention that there had been a falsification of documentation provided to it in its capacity as the

118. *The Hut Group Ltd v. Nobahar-Cookson and another* [2014] EWHC 3842 (QB).