"DisHarmonix" — Dispute Resolution for Earnouts and Purchase Price Adjustments

A recent Delaware decision highlights the need to focus on agreement provisions relating to the resolution of seemingly inevitable disputes regarding post-closing earnouts and purchase price adjustments, as well as the careful attention to detail required to properly protect a party's interest during a later dispute resolution process.

We have written before of certain pitfalls that await dealmakers utilizing earnouts and purchase price adjustments. An oft-shared aspect of those two deal provisions was the subject of a recent Delaware decision by Chancellor Strine — the employment of an independent accountant to resolve post-closing disputes between the parties. The outcome, while hardly surprising, offers some timely reminders of some of the hazards presented by this popular dispute resolution mechanism.

The case arose from Viacom's 2006 purchase of Harmonix, the maker of the *Guitar Hero* and *Rock Band* video games. A substantial portion of the consideration was in the form of a contingent earnout based on a multiple of "gross profit" for the acquired business for the two years following closing. Following a dispute relating to the 2008 earnout, the parties, per the merger agreement, submitted the disagreement to an independent accountant for review. The accountant decided in favor of the sellers awarding them $239 million, and Viacom sought court review of the decision. Chancellor Strine's opinion largely focused on two key issues:

- The merger agreement stated that the resolution by the accountant will be "final, binding and conclusive…non-appealable…and not…subject to further review", and the court was inclined to respect this stated intention of the parties. While the agreement did state that the reviewing accountants were to act "as experts and not as arbitrators", the court looked at the totality of the agreement and determined that the only basis for review of their award was the very limited scope provided under the Federal Arbitration Act - generally, fraud or "evident material mistake" (and not "mere error").
- The buyer's initial earnout notice sought to deduct the cost of unsold inventory from gross profit for the year, a contention disputed by the seller in its responsive dispute notice as being inconsistent with the merger agreement calculation principles. The court upheld the reviewing accountant's refusal to entertain a new alternative argument from the buyer first raised during the dispute resolution process - *i.e.*, that the cost of writing down the inventory per a decision made after the expiration of the notice period should be deducted - noting that both the merger agreement and the engagement letter for the reviewer provided strictures for the review process limiting its ambit to those matters raised in the initial notices.

Dealmakers should consider a number of practice pointers in drafting these resolution provisions or engaging in post-closing disputes subject to such a mechanism:

1. The awards made by accountants or other independent parties in resolving disputes regarding earnouts, purchase price adjustments or other similar matters will likely be viewed as arbitration decisions and therefore subject to the substantial deference accorded arbitrators in the court system. Even with token references to the reviewers acting as "experts and not arbitrators", the courts are unlikely to upset an award if the reviewer discharged its duties in good faith and in accordance with its reading of the contract. Parties agreeing to this type of dispute resolution mechanism should assume that the award will, for all intents and purposes, be final.
2. Courts will likely take an expansive view of the competence of reviewers to decide a broad range of matters, including procedural questions as well as interpretation of contract and applicable law (even if they are accountants, and not legally trained). For example, the court is unlikely to engage in judicial second-guessing of the scope of the arbitrator's review (*e.g.*, whether a party should have been allowed to raise a new argument) lest the intended efficiency of the arbitration process, and the public policy supporting this benefit, be undermined.
3. Agreements typically provide that one party (usually the buyer) must provide a post-closing statement of its calculation of an earnout (or purchase price adjustment) by a specified date, with the other party (usually the seller) required to deliver a "dispute notice" outlining any objections to that initial statement within a

specified period of receipt. Careful attention should be paid to the crafting of initial calculation statements and dispute notices which are often victims of the tight timelines applicable to delivery of these instruments and waning attention in the post-closing period. For example, parties may want to consider including multiple, or alternative, bases for their positions on disputed items. Failure to do so may result in a party being precluded from raising any additional issues (or alternative arguments or theories) during a subsequent independent review to resolve remaining disputes.

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Parties often focus significant substantive and drafting attention to addressing some of the well-known challenges of using earnouts to bridge valuation gaps and purchase price adjustments to protect balance sheet value. This recent Delaware decision highlights the need to also focus on agreement provisions relating to the resolution of seemingly inevitable disputes as well as the careful attention to detail required to properly protect a party's interest during a later dispute resolution process.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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