ACCOUNTING

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Deal Litigation Set to Rise

Economic volatility and M&A litigation go hand in hand. Here are tips on how to ensure the deal stays closed

THE INK IS DRY, the closing party's over, the seller's cashing the cheque, and the buyer's got his prize. Everybody's happy — or are they? It is becoming apparent that more of the Canadian dealscape – comprising 2,500 to 3,000 transactions per year – is mired in post-closing litigation.

Our situation is nothing compared to the United States, which saw some 96 per cent of deals struck post-2008 accompanied by litigation. Canadian dealmakers, however, should take note: pre-financial crisis, the Americans were at 53 per cent — still high compared to here, but the meteoric post-crisis rise drives home the point that, when economic times are tough, deal litigation spikes. And that's a trend to which the Canadian market is not immune. As Torys LLP notes in *M&A 2013: Top Trends*, more deal-related litigation is coming to Canada and savvy dealmakers and advisors need to be prepared.

When one of the parties is sufficiently dissatisfied after the deal's closing, it can lead them to plunge into litigation. Frequently, it's a shareholder (or a group of shareholders organized in a class action) that feels hard done by in the transaction for a reason that's usually about the price, disclosures or process-related issues. But it can also be a buyer who, post-closing, discovers sins of commission or omission in the representations and warranties or disclosures, and demands a post-closing adjustment from the seller.

While the particulars of each litigated deal are unique, the fight is almost always about the price tag. While lawyers pore over the documents, financial specialists offer opinions on what the company/assets would have been worth if the information garnered post-closing would have been available to the buyer (or the buyer's shareholders) during the negotiation period.

If arriving at a fair market valuation of a company pre-closing is a complex art and science, calculating what the price of a business would have been if the seller had not misrepresented certain facts – e.g., earnings, working capital, accounts receivable, environmental liability, supplier contracts, the write-down on a failed project – is even more challenging. And perhaps unavoidable, as a certain level of exposure to post-closing litigation is simply a consequence of getting the deal done.

> IN THE US, SOME 96% of deals struck post-2008 were accompanied by litigation, compared to 53% prior to the financial crisis. When times are tough, deal litigation spikes. And that's a trend to which the Canadian market is not immune. More deal-related litigation is coming to Canada and savvy dealmakers and advisors need to be prepared

It's when the mud starts flying post-closing that greater scrutiny often comes into play. If the deal contracts were tighter and more precise, if the definitions of key terms were nailed down and not just referred as being in accordance with GAAP, if there were formulas in the contracts instead of broad principles open to interpretation and argument, then putting a revised price on the company would be simple. And, in an ideal world, the negotiated contracts would be so tight, there would be no room for post-closing disputes.

But real-world deals are often not ideal, and include ambiguity. "The art of the deal is about striking a balance between precision in drafting and accepting some ambiguity for the sake of getting the deal done," says Steve Tenai, a litigator at Norton Rose Fulbright Canada LLP. "All deals carry risk, and every deal involves risk allocation. How much risk is the buyer going to accept through due diligence, and how much risk will it shift onto the seller through representations and warranties and 'out' clauses?"

Tenai's advice is to take a page from the playbook of US dealmakers and negotiate each deal as though it would be accompanied or followed by litigation. "That doesn't mean perfection at the expense of completing the deal," he says, "but it does mean that, as you are going through a deal, you need to give some regard to what will happen if someone comes along later and challenges this deal. If you had to fight on a key issue — how would you?"

Make sure you clearly understand the closing adjustment mechanisms. In fact, test them with real numbers to ensure you know how they work. Better yet, have an advisor test them alongside you and compare notes. And once you understand how the mechanisms work, memorialize them in an appendix to the agreement.

Consider all of this as you work with the financial specialists who help you value and paper the deal. The numbers, metrics and definitions they're using — if they are the subject of a fight, can they be defended? How will they look to a securities commission? To a judge?

Because a closing does not close the door on litigation.

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