



Episode 141: Defusing Post-Closing Deal Disputes, With Jeff Golimowski

Episode Summary

When private equity clients ask [Jeff Golimowski](#) how to avoid getting sued after a deal, his answer is simple: You can't prevent every possible lawsuit. The real question is how to mitigate the risk. A litigator and McGuireWoods partner, Jeff represents buyers and sellers in post-closing disputes, which are rising as longer hold periods coincide with earnout and working capital conflicts.

In this conversation with McGuireWoods partner and host [Geoff Cockrell](#), Jeff explains how two statements in a reliance clause can prevent disputes, and why GAAP-based definitions beat hyper-technical ones when a case reaches a judge or arbitrator. Tune in for practical advice on limiting post-closing fights and knowing when one is worth litigating.

Transcript

Voice Over ([00:00](#)):

This is The Corner Series, a McGuireWoods series exploring business and legal issues prevalent in today's private equity industry. Tune in with McGuireWoods partner Geoff Cockrell as he and specialists share real world insight to help enhance your knowledge.

Geoff Cockrell ([00:20](#)):

Thank you for joining another episode of The Corner Series. I'm your host, Geoff Cockrell, a partner at McGuireWoods. Here at The Corner Series, we try to bring together deal makers and thought leaders at the intersection of healthcare and private equity. Today, I'm joined by one of my partners, Jeff Golimowski. Jeff's a litigator and focuses on disputes that can arise following the closing of a transaction. And we're going to walk through some of the more fertile areas for disagreement in just a second, but Jeff, if you could introduce yourself and tell us a little bit about your practice.

Jeff Golimowski (00:51):

Thanks, Geoff, and it's great to be here. My practice exists pretty much in the gray area between mergers and acquisitions and litigation. I really focus, particularly with those deals with a private equity overlay, on working either on the buyer side or the seller side and trying to get past the sticky situations that can arise. Not necessarily through the fault of anyone in terms of being one party acting in bad faith, but just especially with market conditions the way they are, with people holding onto their assets longer, we're seeing a noted increase in the concerns, I guess we can say, that come about from particularly earnouts and working capital adjustment and the like. So that's pretty much my world.

Geoff Cockrell (01:38):

That's a good place for us to start, earnouts. I feel like almost every deal that has an earnout has some level of dispute around it post-closing, and part of the reason for that is just the math. If every dollar of a calculation of post-closing EBITDA is going to be multiplied by 12, 15 times, that math alone raises the stakes very, very high, very, very quickly, and it can be a source of disputes. Jeff, in the context of earnouts, what are a couple of the categories of where disputes arise?

Jeff Golimowski (02:12):

I look at it in terms of those that are accounting related versus those that are business related. On the accounting side, we can all think of instances where you could shove expenses outside of an earnout period or shove them inside of an earnout period that can change your balance sheet in such a way that it could artificially increase or decrease the amount that's necessary for an earnout. Those sorts of things, because they're so obvious, often get resolved, because unless there's a truly bad actor there, there's an understanding that you've got to follow GAAP, you've got to follow the rules that were laid out in the purchase agreement and you can deal with them.

Geoff Cockrell (02:52):

On that question, let's call that manipulation, and what you described is often the source of it, of expenses landing in a particular period. And those could be just accelerating the expenses or significant expenses related to new initiatives. That's another kind of source of irritation to a seller. Meaning, let's say you have a 12-month period following closing that you're calculating EBITDA based on, and the buyer makes material investments that are completely legitimate, but those are in the period that is subject of the earnout, it's only expenses. There will be revenue and income that's generated from those investments in the future, but on the front end, the choice to make that is going to just land expenses in the earnout period. How do you see buyers and sellers navigating that, especially when the seller may not have exactly contemplated that kind of behavior, and it's not fraudulent on its face, but is a source of material irritation and could be a source of a loss of a lot of earnout? How do you see people navigating some of those things?

Jeff Golimowski (03:58):

I think a lot of it depends on the predictability of it. And so you're right, the sellers may not see it coming. And so, I mean, to some extent you have to say caveat emptor. You have to make sure that your attorneys are on top of things, your due diligence is on top of things. When I see these things escalate more towards litigation or arbitration, it tends to be a question of, "Well, what is the magnitude, and was it reasonable to begin with?" I mean, if you are a seller and you are selling specifically so you can get a capital infusion and you know that capital infusion is coming, an arbitral panel or a judge in Delaware is going to be looking at you when you try to come back and cry foul when they injected the capital and affected your earnout, because obviously that was something that you should have considered.

(04:47):

And again, it becomes order of magnitude. Is it something that wipes the entire earnout away, and could that border on bad faith? Maybe. It usually comes down to, of course they're going to look at what was the expectation of the parties, and what was the expectation as far as the interaction of that sort of injection versus a straight-up EBITDA earnout? Which honestly, I don't see a ton of those straight up just pure revenue, EBITDA-based anymore. It seems like there's always some sort of tweak to it to try to account for these situations.

Geoff Cockrell (05:22):

I mean, I've drafted on the sell side pretty intrusive guardrails, because you can think of every eventuality that would feel unfair against an EBITDA earnout. Because the seller, from their perspective, the use of the earnout is basically bridging a price differential that says the seller saying, "Well, I think our performance that I can see, that this business that I own, I can see this level of performance next year." And the buyer's saying, "I'd happily pay you for that if it's true." And the earnout is the test of that, "Is it true?" And from the seller's perspective, there's a whole host of things that I, as a seller, I could have been right about from a EBITDA performance basis, but there's changes post-closing that make the earnout unattainable. Whether that's layering in a more robust executive suite, you're adding more G&A, those kind of J-curve investments post-closing. And you can try to account for all of those eventualities. Those usually land pretty poorly with buyers. How often do you see folks really getting into a lot of heavy guardrails?

Jeff Golimowski (06:31):

The guardrails I tend to see are trying to predict the future, at least in terms of, if everything runs out the way it's supposed to run out, we are going to have expected costs, expected expenses, and those are going to be baked into the structure of the earnout. For instance, if you are selling your company and the buyer has told you, "Look, we are going to invest a great deal into point of sale," or, "We're going to invest a great deal in marketing," and that is going to juice your numbers, the guardrails that can be attached around it can account for the injection. They can get creative in terms of, "Well, are

we looking at year-over-year net of the investment? Are we looking at straight-up balance sheet? Are we looking at monthly recurring revenue? Are we looking at yearly recurring revenue? Are we looking at logos?" There's all sorts of ways to carve that out, such that you're starting to eliminate the disputes even before the deal is closed.

(07:33):

The worst situation I think a seller can be in is have a substantial earnout and have absolutely no control over the way that earnout is reached. The more it's linked to something that is absolutely going to benefit both parties, the better off the seller's going to be.

Geoff Cockrell (07:52):

Maybe shifting gears to some of the contractual mechanisms that can be the source of a post-closing dispute, what would be at the top of your list in terms of mechanisms or definitions or just the words that become the dispute?

Jeff Golimowski (08:06):

There are a lot. I'm always amazed, but the first thing I will always go to in any asset purchase agreement, MIPA, take your pick equity purchase, is going to be the integration clauses and the reliance clauses. That is so key particularly in earnout disputes, because you have to remember, and we all do this all the time, we sign the deals and we say, "Look, these are the only representations that were made." Now, we know from a practical perspective that there were all sorts of communications before the deal is signed. There's information in the LOI, there were discussions, there were promises, etc.

(08:43):

Where I see buyers and sellers get into the most trouble in this situation based on contractual clauses is when they have a poorly drafted integration clause and when they have a poorly drafted reliance clause. And specifically with the reliance, you really want to have two items in the reps and warranties section for both parties. You want to have a statement that the reps and warranties that are within the four corners of the document are the only representations and warranties that were made. And then you want to have a second statement that even if there were other representations and warranties, which there were not, we are disclaiming any reliance upon those representations and warranties.

(09:29):

And that two-pronged nature of it is important. The first says it never happened. And the second said, "Even if it had happened, we didn't rely on it." So you're double protected. If you only have one or the other, particularly in Delaware courts, you can start to get into, "Well, is that really a knowing waiver and are there ways around that?" And that's where you can start to have disputes that a stronger clause would have prevented the dispute in the first instance.

Geoff Cockrell (09:58):

And that's a setting where a buyer has suffered a loss that they're understandably grouchy about, and they're looking at the contract and they are not finding relief for that loss in the reps. Either it was timed out or the magnitude exceeded the cap, or the words were narrowly crafted to the point where it was not picking up the event that is creating the loss. Is that the nature of it where the buyer doesn't have a claim squarely on the reps?

Jeff Golimowski (10:30):

I think the buyer's always going to have a claim on the reps. You know as well as I do that there's going to be something that they're going to be able to throw out there. The question is how narrow is that going to be? I mean, how many times have you seen a general rep claim that you violated the rep saying that the financial documents you gave us gave us a fair accounting of the company? Very difficult to prove, but also very difficult to disprove at a motion to dismiss stage. Where I see buyers get more concerned is, it all comes down to the structure of any additional payouts. Are they holdbacks? Are they escrows? And then it flows all into indemnification.

(11:12):

So I think what you're getting at, and I think the flow from there is buyers are going to first look to their indemnity procedures. And you're right, that's where the caps and the baskets and everything are going to flow in. But the reps themselves, the more detailed they are, the better off both sides are going to be because you're going to be able to identify specific causation and specific ideas of where potential losses can come from. The less detailed they are, the worse off both sides are going to be.

Geoff Cockrell (11:42):

And how does that topic intersect with questions around fraud in terms of limiting an assertion of fraud just to fraud relating to the reps? Or what's the fraud overlay in the context, now there's been a loss suffered and the buyer's not able to get full satisfaction from just the reps claim, either timing of it or magnitude of it or whatever, but they're looking for something that is of a fraud nature. How does that intersect from a drafting perspective?

Jeff Golimowski (12:13):

So there you've got to look at three definitions, and those definitions can be the difference between winning and losing a case. The first is the definition of fraud itself. There are lots of different flavors of fraud. Typically, a buyer is going to be claiming fraud in the inducement, and fraud in the inducement at its most base level is the idea that you knew ahead of time that what you were saying was not true, and you intended that misrepresentation to lead to the contract. The problem with a fraud in the inducement argument from a seller perspective is, particularly in Delaware, that's not that difficult to show. If it is based on a rep or warranty, which you are allowed to do if you're seeking rescissory damages or damages in the nature of rescission, which is exactly what you're talking about, that's

how you're getting around the baskets and the limitations of liability, because you can say, "Well, look, we wouldn't have entered the agreement at all."

Geoff Cockrell (13:09):

If a buyer is successful in making the allegation of fraud in the inducement, meaning, you deceived me on purpose to get me to sign this contract, if a buyer sustains the elements of that idea, does that override other mechanisms in the contract, in the sense of, yeah, there might be different definitions of capital F Fraud that may limit it to just fraud in the making of the reps? But if I'm able to show that you defrauded me to get me to sign the contract in the first place, does that override some of those limitations?

Jeff Golimowski (13:48):

It can, and a lot of times the way to try to limit that is to limit it to actual fraud. Common law fraud is where that fraud in the inducement is going to be most easy to prove. And to the extent that you can disclaim common law fraud ... And a lot of courts will let you do that, so long as there is an adequate mechanism so that you are not given carte blanche to say whatever you want to say and do whatever you want to do to try to hurt the other party. If it's limited to actual fraud, then you're going to have to come forward at the allegation stage of pretty ironclad evidence that the parties knew it was wrong at the time. And that is often where it's key.

(14:30):

And so there you're looking at ... And again, going back to my earlier example of, "Hey, you gave us inaccurate financial statements." When you've got a broad claim like that and you've got a strong actual fraud definition, it's going to be very difficult to show exactly what it is that was in the document that they knew to be untrue at the time, and was intended to induce some sort of reliance. The flip side of that is a very specific ... I've done a lot of work in software-as-a-service, and it is not at all unusual, particularly with founder companies, to see reps about industry standard security and backup protocols and representing, "Yes, we have all of the above. We have the protocol, we have the adequate firewalls, we have separate servers," etc. And then there's a ransomware attack four months after the purchase and it turns out none of them were true.

(15:27):

That's the flip side of it, because at that point it's very, very easy to say, "Well, no, you had to have known that was not true. And if you didn't know it wasn't true, then you were willfully indifferent to the truth, or recklessly indifferent to the truth," and so you're not going to be able to use that as a get-out-of-jail-free card. That, again, is where actual fraud versus common law fraud is going to come into play, because it's kind of the idiot defense. I've literally had depositions before where the person is disclaiming virtually any knowledge, and because of the way the deal was structured, that sort of disclaiming of knowledge can actually give you an advantage because you can't say, "Well, you

should have known." It's like, "Well, no, what matters is what I actually knew." And that's the key flashpoint that often can get lost in just the pure definition of fraud in Appendix A, page 72.

Geoff Cockrell (16:19):

The amount of brain cells that get beat up in negotiating these mechanisms can be super high. It's a very esoteric gaming out potential outcomes. And it's a conversation that is uncomfortable, especially if you're having this conversation with principals, because the future fact pattern that you're trying to talk about is saying that a person who's on the call is defrauding everybody, which is an uncomfortable setup. I guess from a actual practical perspective on the discussions around fraud in particular, to what extent do you think it is overcooked, the amount of attention that it gets? And I ask because in my entire career, I've seen real fraud once and somebody spent a decade in prison over it. That's a pretty corner case event. Given the amount of angst that surrounds this topic, do you think it's a little overcooked sometimes on the front end?

Jeff Golimowski (17:16):

I do think it's a little overcooked. However, I almost think it's overcooked for the opposite reason. Because you're right, it's almost never true fraud, but it's almost always going to get asserted no matter what you do. And it's something that I've had a lot of discussions with private equity folks over the years when they always say to me as a litigator, "Well, what do I have to do to not get sued here?" And my response is always, "Don't play the game, because there's just no way you can avoid all possibility of a lawsuit." Somebody gets angry, somebody will find a lawyer to file a lawsuit. The question is always about mitigating risk and making it as difficult as possible to win, or lose, for that matter, when you are embroiled in a lawsuit.

(18:00):

So all the brain cells that go into fraud, everything that goes into playing out the scenarios, yeah, I do think it's overcooked, because I think the idea on the front end is often, "Well, if we define this in such a way, then we're not going to have to fight about it." And I think the answer often is, no, you may still have to fight about it. What matters more is, can you prove it? And you're right, the instances of actual fraud such that it was a material inducement to a deal that made the difference between a deal happening and not, you can count on ... Well, maybe not one hand. But certainly it's less common, I think, than the sheer number of fraud claims that are put forward in litigation would tend to indicate.

Geoff Cockrell (18:45):

Let's take one last categorical stab here. Net working capital, another area that becomes a dispute fairly regularly. That's probably the most common, in my experience, is questions around net working capital where the buyer, once they get in, there's a difference in belief about how a particular accounting element should be done. The buyer usually has the upper hand in that the seller, their

frustration is usually that working capital, the actual is being compared against a target and the target is just a raw number in the purchase agreement. But that raw number was generated by applying some accounting ideas that the buyer is maybe changing because they don't think those ideas were done properly before.

(19:31):

And they may be right, but the seller's frustration is, "Well, if we'd known that, we would have used that convention in calculating the target and I wouldn't have this claim now." Is that the crux of where things come up most often, or where do you see the crux coming up?

Jeff Golimowski (19:47):

In terms of those working capital adjustments, I always feel like they fall into two categories, those that can actually be negotiated, and those that are just indicators of much bigger problems. In my career, I have come close to engaging an independent accountant for looking at ... Which is the standard remedy for these sorts of situations. Actually engaging the independent accountant and bringing information to them once. What I find is, if it gets to that point, it is usually an indicator that there are a lot more things wrong here and that there are a lot more issues between the parties than were anticipated, such that this is going to become a sideshow. And so, the key is have it very clearly defined in the agreement what the basis for each number is and where that's got to come from. Once you have that information, you've got your timing.

(20:43):

And the other is the documentation piece of it. The best I see is when you have to show your work and be very clear how you're showing your work on both sides, so that if you've got a clear set of documents that are laying out exactly how you're getting to your number on the buy side, such that the seller can understand where the number is coming from and then they can come to ... The trick is, how do you understand it. It's never, "Oh, this is coming out of nowhere." It's, "Okay, I see how you're calculating your numbers. We are calculating it this way." There should have been in the actual documentation leading in, a clear understanding of where those calculations are going to come from and why they would differ.

(21:26):

If there's not and it becomes such a problem that it's going to go to an independent accountant, like I said, at that point, you've got other issues. There are some fundamental disagreements then, and there is some breakdown happening between the parties, such that this is quickly going to get overtaken by events. At least that's what I've seen in these sorts of issues.

Geoff Cockrell (21:44):

That's consistent in almost every instance as the parties, especially if you've got sophisticated attorneys, sophisticated accounting on each side, they land at an answer. It may not be fully

satisfying either direction, but they will almost always land on an answer before it advances too far. And so these things tend to be disputes fairly regularly, but disputes that land before a full-out war.

Jeff Golimowski (22:10):

Right. I mean, I can't count the number of times I've had calls where either I've been the one asking opposing counsel or opposing counsel has asked me, "Look, is this really about an accounting issue or is this your guys are trying to get some sort of purchase price, just overall adjustment because of X, Y, and Z?" And the answer, whether we admitted it or not, is almost always: this is a purchase price adjustment based on factors that were not adequately taken into account at time of closing. And if there's one thing I would tell people to take away from any sort of discussion of post-M&A disputes, it's that the practical is always, always, always going to trump the technical. You're going to spend a ton of time and a ton of effort in laying out these elaborate procedures to make sure that everything is covered.

(22:58):

But at the end of the day, it's going to come down to: What is the most practical solution? And do you really want to go to war? And nine times out of 10, you don't want to go to war, so you're going to look at all of that and say, "Yep, that's our fallback. Now let's actually chat and get this done so that we can all get back to making money."

Geoff Cockrell (23:16):

One of the thoughts I have, and I'll be curious your take on it, is purchase agreements can get very, very granular in some of the financial accounting definitions. The verbiage of what do you mean by cash. Does it include checks in transit? Which then has implications of, "Well, if you're going to count check in transit, that check in transit was probably against AR." You can't get credit for both the check in transit and the AR. You can get wound around the axle in very technical verbiage, and I'm of the view that I would rather not be technical and just have the definitions against broad categories be GAAP-based. Because I'm less certain that either by my pen or the parties negotiating these hypertechnical accounting-style definitions, I'm less optimistic that I'm going to get that exactly right. And I'd rather be a little bit more general and rely on GAAP, because GAAP will have an answer that is not a weird whipsaw answer of like, "Oh yeah, these words looked right, but you've now created a deviation from GAAP that probably wasn't your intention."

(24:22):

So what's your view on very, very specific technical, accounting-style language in a purchase agreement versus more general, but reliance on GAAP?

Jeff Golimowski (24:31):

I think the more general and reliance on GAAP is almost always the right way to go. And I'll take it one step further, because if I'm looking at a case and I'm deciding, "Okay, if we're going to litigate this, what are we going to need? How are we going to litigate it? And what are we going to put forward?" I can find a good expert on GAAP who can explain just about everything in a way that the judge is going to be able to understand or an arbitral panel is going to be able to understand and be able to make a case. The more picayune you get, the more hypertechnical, the farther away you get from it. You'll eventually get to a point where the arbitrator or the judge is just going to throw their hands up and say, "This doesn't make any sense. You guys did this. A pox on both your houses. I'm going to split this down the middle and call it good."

(25:17):

And as a litigator, now it's in a zero-sum game, I'm always trying to get to the point where I can protect the client the most. And if it's so hypertechnical that I'm worried about the judge being able to understand it, that's when I have to go back to the client and say, "Guys, we may not want to litigate this. I'm not sure this is going to come out to an ending that anybody is going to particularly like, and I can't necessarily recommend you spend the time and the effort and the money to litigate." Whereas if we've got GAAP and we've got more general rules, then we can all engage on that, and then that makes sense and people can understand it. And then if you're in the right, you have the goods, you have the right of the argument, but then you have a much better chance of winning. Whereas with super hypertechnical, you may be right, but if the judge can't understand it, it doesn't matter.

Geoff Cockrell (26:02):

Or you may have drafted an answer that is wrong. Always the background concern is, if I've gotten so technical that I'm now deviating from GAAP, I suppose it could work to my advantage, but it'd be a bad day if by my pen, I drafted something that deviated from GAAP in a way that's hurting the client's outcome. That's why I prefer the less technical approach. But obviously, Jeff, these things end up in some level of dispute on a pretty regular basis. We could trade war stories for a long time, but we've burned through our time and maybe a little extra. But this has been a ton of fun. I really appreciate you doing this. I'm sure we will get tangled up in some disputes here in the near future, as these things tend to happen that way.

Jeff Golimowski (26:44):

I'm sure we will, and I'm sure none of it will be at your pen, Geoff. It will be when the other side realizes that you were just too good for them.

Geoff Cockrell (26:52):

Too good for them. Yes, yes, yes.

Jeff Golimowski (26:53):

They're throwing things at the wall.

Geoff Cockrell (26:54):

Exactly. Exactly.

Jeff Golimowski (26:56):

And I'll be right there with you.

Geoff Cockrell (26:57):

Thanks a lot. Thanks for joining.

Voice Over (27:02):

Thank you for joining us on this installment of The Corner Series. To learn more about today's discussion, please email host Geoff Cockrell at gcockrell@mcguirewoods.com. We look forward to hearing from you.

(27:16)

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