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Accounting Oversight

'Leave It to the Accountants—They'll Solve All Our Problems'

(Or, How to React When Your Client Makes You an Arbitrator Without Telling You)

By Aaron Krauss†

You know the call. It usually comes in just before 5 pm on a Friday. During tax season, no less. One of your clients either bought or sold a business. Now there is a dispute. Usually it is over a post-closing adjustment. Working capital adjustments are most often the culprit, but it could be a dispute over inventory write-offs, or even the value of the company. Sometimes it is a dispute over the earn-out. For some reason the results always seem to come in just short of the threshold that would result in a multimillion dollar payout under the earn-out clause.

So why is the client calling you? Because the Asset Purchase Agreement—which you have never seen before—says that the dispute is to be resolved by an ''independent accountant.'' You. While it is always nice to be thought of, and it is even nicer to get work, what are you supposed to do?

As obvious as it may seem, the first thing to do is read the Asset Purchase Agreement and see exactly what it is that you have been asked to do. Although lawyers have been known to use some rather creative language, when stripped of its ''legalese,'' the language in the Asset Purchase Agreement will usually provide either that you are supposed to perform a set of agreed-upon procedures or that you are supposed to act as an arbitrator.

Agreed Upon Procedures. A standard working capital provision in an Asset Purchase Agreement will require the seller to make an estimate of working capital just prior to closing. The buyer will then have a period of time (usually between 30 and 90 days) to prepare a final working capital statement. If the seller thinks that the buyer's working capital statement is unreasonable, the dispute (which sometimes has to go through a process of making and rejecting objections to specific items supporting the working capital statement) is ''submitted to the Independent Accounting Firm which shall make a final determination, binding on the parties'' (or words to that effect). In situations where the parties have been required to list and respond to specific items, the Asset Purchase Agreement often provides that the accountant must pick one of the two numbers proffered by the parties, and that the accountant cannot ''split the baby'' or try and come up with a third number.

Under the best of circumstances, the Asset Purchase Agreement will state that the working capital statement must be calculated according to GAAP, and that the application of GAAP must be consistent with the seller's prior practice. It will therefore be easy, although perhaps time consuming and labor intensive, for the ''independent accountant'' to analyze the working capital statement and the company's books and records to determine which party's position comports with GAAP as previously applied by the seller.

If the Asset Purchase Agreement does not require calculations to conform to GAAP, or if the dispute does not arises out of an application of GAAP, but instead arises out of how management has characterized (or worse yet, estimated) something, it is often difficult, or even impossible, to complete the agreed upon procedures. This is because resolution of the dispute will require the ''independent accountant'' to substitute its judgment for management's and/or to interpret the Asset Purchase Agreements. These are not the functions

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of accountants following GAAP. They are, however, the function of arbitrators.

Acting As an Arbitrator. Arbitrators are, for all intents and purposes, a judge and jury all rolled into one. In fact, arbitrators are in many ways more powerful than judges and juries. This is because appellate courts can (and do) review the decisions of judges and juries to see if they made legal or factual errors. An appeal from an arbitrator's decision is much more limited. It is not enough to show that an arbitrator misapplied the law or made factual mistakes. In order to overturn an arbitrator's award, a party generally has to show that the arbitrator was corrupt or somehow related to one side, that the award was procured by fraud, that the arbitrator refused to hear the evidence, or that the arbitrator went beyond the contract and decided issues that had not been submitted to arbitration. This is a very difficult standard to meet. Just as an example, in one case an arbitrator decided that a collective bargaining agreement provided ''bumping rights''—i.e. that a more senior employee whose job was being eliminated had the right to take the job of a more junior employee. The arbitrator explicitly rested his decision on what he claimed was certain language in the contract. Unfortunately, the language the arbitrator quoted did not appear in the contract (the arbitrator must have been thinking of something else). Needless to say, the losing party appealed. The federal appellate court that heard the case decided that, although it was very troubling that the arbitrator had based his decision on language that was not in the contract, there was another way that the arbitrator could have reached his decision. The appellate court therefore affirmed. To say that the appellate court would have been unlikely to have forgiven a similar mistake by a judge is probably an understatement.

In doing so, the accountant will not be confined to making ''accounting judgments.'' Instead, the accountant will be able to make business judgments and factual determinations, even if those determinations are at odds with management's position.

Although it is obviously preferable if the Asset Purchase Agreement explicitly states that the independent accountant is to act as an arbitrator with respect to any disputes arising out of the Asset Purchase Agreement, courts can find that accountants are supposed to act as arbitrators even if the Asset Purchase Agreement does not use the word ''arbitrator.'' They tend to do so because, in a court's eyes, the only people who interpret agreements and find facts are judges, juries and arbitrators. A single accountant is not a jury. And an accountant clearly isn't a judge. That only leaves one choice. As the old saying goes, if it walks like a duck and quacks like a duck, it must be a duck.

If the ''independent accountant'' is to act as an arbitrator, the only remaining question will be whether the Asset Purchase Agreement gives the accountant broad power over all disputes or only narrow power to resolve disputes related to certain accounting matters. A narrowly tailored arbitration clause may be more comfortable for the accountant because it will keep the accountant within his or her core competency. At the margins, however, narrowly drawn arbitration clauses cause problems and lead to unintended results. For example, a dispute over a working capital adjustment (which one would think should be decided by an accountant) could be viewed as a breach of representations and warranties (among other reasons, because the seller generally represents and warrants that the balance sheet is accurate). If the Asset Purchase Agreement provides that the ''independent accountant'' can only resolve ''accounting matters,'' and that ''legal matters'' have to be resolved by either a court or a ''legal arbitrator,'' many disputes that one would assume, *ex ante*, should be decided by an accountant will end up being resolved by someone else.

What to Suggest If Someone Actually Shows You the Asset Purchase Agreement Before Signing It.

If a client shows you a proposed Asset Purchase Agreement before signing it and asks your opinion, the first thing to do is consider if you will have an independence issue if you provide the services your client is requesting. If your independence will not be jeopardized, and if the client wants you to be the one to resolve any disputes, it is easier and cleaner to have the Asset Purchase Agreement include a broad arbitration clause naming you as the arbitrator. At the very least, using a broad arbitration clause naming you as the arbitrator eliminates the possibility that the Asset Purchase Agreement will refer some ''accounting'' disputes to you for your determination while referring ''contractual'' disputes to a ''legal arbitrator'' for determination. Leaving aside the fact that courts have a natural predilection to refer disputes to lawyers, rather than accountants, most disputes require at least some interpretation of the governing contract. As a result, the right and duty to interpret the contract tends to squeeze out other obligations, such as performing accounting procedures.

For sanity's sake, you might also want to suggest that the parties include either a materiality threshold or a ''basket.'' Absent a materiality threshold of some type, the parties tend to get bogged down in minutia. While all accountants have a natural inclination to try and get things right ''to the penny,'' that inclination tends to wane by the fifth day of a hearing, especially if the fifth day of the hearing falls on a sunny Friday afternoon.

While being named as an arbitrator might take you outside of your core competency, it will give you both the power and the right to resolve any disputes that may arise, even if doing so requires you to interpret the terms of the Asset Purchase Agreement, or to make business judgments. Although accountants are trained from the day they pass the CPA exam to say ''we don't make business judgments; business judgments are the responsibility of management,'' they are in a unique position to evaluate which business judgments are commonly made. After all, they have seen hundreds of businesspeople make thousands of judgments. This gives them the perspective to make neutral judgments about how agreements should be interpreted, and how balance sheets should be structured. Besides, why should the lawyers have all the fun?

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