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Avoiding Expensive Litigation after the Deal is Done

By Sara Jane Shanahan

For family business owners contemplating a sale of their business or the purchase of another's business, it is worth taking the time for an educate on the types of disputes that frequently follow merger transactions.

Litigators know, and business owners should too, that post-merger lawsuits tend to fall into three categories. First, there are disputes between the buyer and the seller, often arising from one party believing that the other misrepresented the value of the target company's assets or the consideration paid. Second, disputes frequently arise with third-party finders or brokers who claim more compensation than the parties to the transaction expected to pay. Third, lawsuits with companies doing business with the acquired entity are common, especially when the new owner would like to change the terms of a pre-existing agreement or terminate the relationship with the third party altogether.

Consideration of these potential pitfalls before the closing can help avoid litigation after the deal is done, at a time when the seller would prefer to move on to new ventures, such as retirement, and the buyer would like to focus on integration issues rather than costly and time-consuming litigation.

Suits Between the Buyer and Seller

Disputes most commonly arise when the buyer believes that the target company's assets or liabilities were misrepresented or the seller finds that the consideration it received, such as stock in the acquiring company or an earn-out arrangement, is not as valuable as originally anticipated. The best way to avoid such disappointment is to conduct careful due diligence *before* closing the deal.

In a case tried earlier this year in federal court in Boston, the founders of a company specializing in speech recognition technology sought to blame their insufficient due diligence – which led to multi-million dollar losses – on their financial advisers. In a June 2000 transaction, the owners of Dragon Systems Inc. sold their company for stock in the acquiring company, Lernout & Hauspie Speech Products. Unfortunately, shortly after the transaction closed, rampant accounting fraud at Lernout & Hauspie was revealed, which rendered its stock worthless.

The sellers of Dragon Systems brought suit in 2008 against Goldman Sachs for negligence, misrepresentation, and breach of fiduciary duty, alleging that Goldman should have uncovered the accounting fraud during due diligence. Goldman, in turn, argued that they had advised the sellers to conduct additional due diligence, but that this advice was rejected. The jury found in favor of Goldman in a January 2013 verdict, and claims under Massachusetts' unfair trade practices statute remain under advisement with the judge. This saga presents a text-book example of how substantial losses might have been avoided if adequate due diligence was conducted before the closing of the transaction. Business owners on both sides of a transaction will be well-served if they take the time to investigate the value of their deal before the closing.

Suits with Finders and Brokers

A second type of litigation that might be avoided with better planning at

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the start of a transaction stems from disputes with finders and brokers – professionals who help identify and negotiate merger transactions. It is common for sellers or buyers of closely-held corporations to identify and pursue opportunities with the assistance of business brokers who know their industry, know potential partners for a deal, and can assist with the negotiation of such a transaction. Often, the broker is paid a commission that is a percentage of the value of the consideration for the transaction.

Disputes arise when the parties do not clearly document in a written engagement letter – and state law may require such agreements be in writing – the circumstances and terms on which the broker will be paid. Taking time to think through and document the details of the broker's compensation can help avoid litigation at a later date, when the broker demands a fee that the buyer or seller did not intend to pay.

This type of dispute may frequently arise when the consideration for a transaction is not simply cash paid at the time of the closing, but instead includes earn-out payments based on profits of the company going forward, employment or consulting contracts with senior managers, or lease payments for real estate or equipment that was not transferred in the transaction. These after-the-fact payments constitute an ongoing revenue stream for the seller, and therefore, could constitute a basis for further payments to the broker. All parties to the transaction are better served when the question of how to divide the spoils is negotiated at the beginning of the deal, instead of being left for discussion later in the process.

Suits with Third-Party Contractors

A third category of disputes following merger transactions arises out of alleged breaches of agreements with the acquired company's vendors and business partners. For example, the target company may have a contract to buy coffee for its break rooms at specific prices, for guaranteed volumes, for the remainder of the year. The acquiring company, however, does not want to buy this coffee and refuses to do so. In such circumstances, the third party supplier may sue the acquired company, the individual sellers-owners under personal guarantees, or the acquiring company on a theory of successor liability.

Who, if anyone, will pay for the unwanted coffee will depend on the terms of the underlying supply contract and the terms and structure of the merger transaction. In order to avoid such litigation, the accompanying attorneys' fees, and unexpected coffee bills, companies that may be acquired, that do business with acquisition targets, and that are in the market to buy other companies and competitors (that should be everyone), should review the terms of their contracts and include provisions that address what will happen when ownership interests are realigned. Assessment of these issues before signing a contract, rather than after, will better protect the business owner's financial interests and peace of mind.

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