

## Litigation Support Accountants – How We Help Clients Avoid Contract Ambiguity

From assisting in specific contract clauses to helping resolve disputes faster, Litigation Support specialists can provide valuable support to legal teams

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Contracts are some of the essential tools that provide shape and support to business relationships across Canada and around the world. Significant time and energy are required to limit ambiguity and clearly set out terms, responsibilities and rewards. While it is impossible to entirely eliminate the possibility of a disagreement between contracted parties, it is possible for lawyers to take steps that can reduce the likelihood of certain disputes and mitigate the impact of any that do arise.

Litigation Support professionals, including forensic accountants and chartered business valuers, bring specialized financial knowledge, deep industry experience, and an independent perspective to bear on contracts and contract-related disputes. While we're usually best known for independently assessing compliance with contract terms and spirit and determining damages or valuations in dispute settings, our exposure to these disputes has allowed us to see causality patterns which may be useful during contract drafting – potentially helping avoid certain disputes altogether.

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## Financial Terminology – Turning the Grey into Black and White

One of the most common dispute matters we come across relates to the use of financial (accounting or valuation) terms in business contracts. When we become involved, it generally isn't because financial terms have been excluded – it's because the terms are unclear or unintentionally misused. Unless definitions are clearly laid out, contracted parties may hold quite different views on what those financial terms do (and do not) encompass.

Accounting terms can be particularly vague. For example, seemingly innocuous terms such as "net income" or "gross margin" can have a wide range of interpretations. Net income is an accounting term that is impacted by, among other things, a company's depreciation policy, changes in accounting standards, the effect of foreign exchange, and accounting versus cash taxes. Many of these elements of net income can be, to a certain extent, influenced by management. Gross margin can be similarly malleable.

Business agreements, such as joint ventures, often include clauses to the effect of "the parties agree to split any profits at year-end." This seems fairly straightforward, however the terms "profit," "split" and, to a lesser degree, "year-end," are all somewhat ambiguous. From a financial accounting perspective, "profit" has no universal definition – the term is subject to interpretation and can be described in a number of different ways. Is "profit" on an after-tax basis? Before capital expenditures or discretionary bonuses? After "other" income? Each party may be operating under a different understanding of what that "profit" represents, opening the door to potential disputes. Moreover, while usually not an issue, we have seen instances where the term "split" should have had more precision and where "year-end" should have been clearly defined as calendar or fiscal year-end (which could differ between the parties to the contract).

We regularly act as experts in shareholder dispute matters arising due to unclear terminology in shareholders' agreements – usually when a shareholder is being bought out – in the normal course, or forcibly. Two common issues stand out for us:

- The term "value" has been defined inappropriately; and,
- The individual identified to perform the valuation is unqualified.

There are a number of ways to describe "value," so where the term isn't defined in shareholders' agreements, differences in the interpretations of value between the buyer and seller can lead to significant tension. Fortunately, most shareholder agreements do include the definition of value but the problem is that it's often defined incorrectly.

Some common value terms and when they are used are as follows:

### Fair market value:

This is the most commonly used valuation term.<sup>1</sup> We generally recommend referencing fair market value, however it should be noted that the definition includes the concept of a minority discount when the shareholding is equal to or less than 50 percent of the shares. If a minority discount is to be excluded, it should be addressed in the agreement.<sup>2</sup>

### Fair value:

We often see fair value is often used where the concept of fair market value was intended. Fair value has been described in Canadian courts in cases of oppression and includes concepts that distinguish it from fair market value – most notably excluding the concept of a minority discount.

### Book value:

Book value (or net book value) is simply the value of a company's assets less its liabilities as stated on its balance sheet. While some agreements intentionally include this term, the agreement drafter should be aware of the following:

- The assets and liabilities, as stated on the balance sheet, may not be at fair market value. For example – if a company has a large land holding, it is held on the balance sheet at historical cost. That value could have changed materially since it was purchased.
- The balance sheet is at a point in time, usually at year-end. If the buy-out happens well after year-end, the book value may have changed significantly.
- Book value does not include a company's goodwill.<sup>3</sup> The market value of a company generating decent returns is almost always greater than its net book value. Goodwill is often a company's largest asset – if it is not included, the conclusion will be materially lower than fair market value.

<sup>1</sup>The highest price, expressed in terms of cash equivalents, at which property [shares] would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts," The Canadian Institute of Chartered Business Valuators ("CICBV")

<sup>2</sup>We also see the term "market value" used where "fair market value" was intended. "Market value" is generally acknowledged to be fair market value but has no formal definition in the Canadian valuation domain – therefore we recommend identifying a more frequently adopted term.

<sup>3</sup>The company may have goodwill on the balance sheet as the result of a prior acquisition, but it generally won't reflect fair market value.



### Formula value:

A formula-based value, such as a multiple of EBITDA, usually has the right intentions but can have a host of issues. While this approach is usually easy for shareholders to understand and provides consistency to the process, some things to be aware of include:

- The original multiple is usually selected based on the company's performance and/or market conditions as they existed when the Unanimous Shareholders' Agreement (USA) was drafted. If the company's risk has decreased or if market conditions have permanently changed, the company's multiple will have inevitably been impacted.
- As discussed above, financial terminology is often open to interpretation. If an EBITDA multiple is used, a wide range of normalizing items such as below-market management salaries, above-market rents (to a non-arm's-length party) and extraordinary bonuses should be addressed.
- The formula-based approach often fails to address other assets and liabilities. A company may be carrying excess working capital or holding redundant assets – both which would act to increase value over what is implied by the simple formula.

### Retained earnings:

While rare, the term "retained earnings" is sometimes used in shareholders' agreements. While it sounds like the amount of earnings or value a company has held onto or retained, retained earnings is an accounting term that is usually less than book value and, therefore, excludes goodwill.



## CASE STUDY

### Wrong Terminology, Wrong Formula

MNP was engaged to assist counsel in dispute after a majority shareholder (59%) fired the minority shareholder (41%). The shareholders' agreement buy/sell clause included the following:

- Absent value determination in the prior 12 months, value to be set as greater of (1) latest value determination and (2) book value adjusted for any value increment on real estate,
- Valuation formula noted to be: "Total value of common shares is revenue on the latest balance sheet divided by number of common shares."

Apart from basic terminology being incorrect (revenue is not on a balance sheet, it is found on the income statement), arguments arose around the value of common shares not being representative of price, and the absence of any contemplation of preferred shares or debt in the equation. Any change in share or capital structure would most certainly impact common share value (or price).

In this case, while litigation may not have been avoided entirely, it would have made the valuation component far less complex and far less open to interpretation if only the basic terminology and valuation concepts had been vetted.



Shareholder agreements, when referencing various buyout scenarios, occasionally include wording such as “the determination of value to be performed by the company’s accountants.” Reference to the company’s accountants is usually included to ensure the valuation is being performed by a third party, rather than by someone internally. Many private companies rely on an accountant with limited (or no) experience in formal valuations and often don’t have an expert such as a chartered business valuator (CBV) on staff. Valuation can be highly a complex undertaking, even for the simplest of companies, therefore identifying in the USA that an expert will perform the valuation can help avoid at least some of the issues that could arise in shareholder buyout.

## Contract Language – Avoid Confusion

Contract language that touches on practical matters of business management or control can also be misconstrued and provide fertile ground for disagreements. In a contractual arrangement where a shared operation is split, for example, 51/49, the party owning 51 percent has effective control from a legal perspective. An accountant will look at the contract and ask how the split plays out on a practical, day-to-day level. How are decisions made? What role does the minority partner play? Who has access to the books and financial records? Is there a right to audit clause that provides the non-controlling party with access to the books and financial records? For how long does the non-controlling party have a right to audit? Issues often arise months or even years after an instigating event or transaction — a right to audit clause that permits access for only 60 days post-transaction would hardly be sufficient.



### CASE STUDY

## A Completely Unbalanced Contract

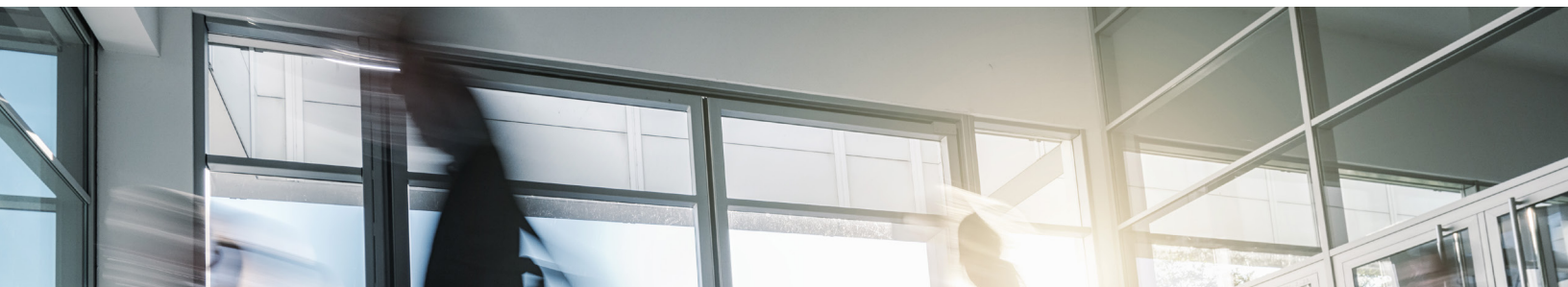
MNP was engaged to review the agreement for a construction-related investment opportunity on behalf of a client who wanted to ensure their understanding of its terms and conditions prior to signing.

We found some all-too-common issues with the contract wording. Key terms such as “management,” “profit,” and “operating expenses” were not defined. The financial pro-forma lacked detail, didn’t include customary business expenses, and was overly optimistic. The agreement required the establishment of a “management company” or “general partner” that was in fact solely controlled by the other party. Terms such as “four-star hotel” were included without any attached specifications. Accounting and finance matters were controlled entirely by the other party, and the agreement lacked any right to audit clauses or avenues for mediation or arbitration. Even worse, the client was left with sole responsibility for environmental or site remediation.

## Due diligence – Know Who You’re Getting Involved With

When companies contemplate teaming up with another party to pursue a business opportunity, they may be inclined toward optimism and view their potential partner in a positive light. In recent years we have been involved in a number of disputes in the related to the cannabis industries. While new companies were seeming to launch near-daily – contracts were being signed and investments were being made with near reckless abandon. Over time it became clear some of these fledging companies lacked the relevant experience or expertise to live up to their promises – often ending in disputes.

A skilled forensic accountant can do the kind of digging needed to ensure the party on the other side of the contract is representing themselves honestly and accurately. The accountant can explore the company’s business history and assess their level of experience and expertise and ability to deliver on their contractual commitments. They can evaluate their potential partner’s financial statements and debt loads to assess its liquidity and investigate prior or ongoing litigation and offer insights into other potential operational, financial or reputational risk areas. Without performing an appropriate level of due diligence, one party could be left holding the bag.





## CASE STUDY

### Too Good to Be True

Our client was on the cusp of signing a contract with a land developer who touted their extensive resume featuring detailed summaries of their experience with a number of significant developments. The opportunity looked promising. As part of their normal business practices, MNP was brought in to conduct due diligence on the potential partner.

MNP investigated the developer's background, checking references and consulting various information sources from corporate registries to lawsuit databases. We discovered the developer had entirely falsified their experience and qualifications – and most details of their resume, including images of projects completed. They had been sued for breach of contract, negligence, and fraud multiple times by former business partners, and owed a significant amount of back taxes to Canada Revenue Agency. The individual wasn't even the owner of the company.

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## Measurement: Contract Compliance

Once parties enter business contracts, a forensic accountant's work may not be done. Assessing parties' compliance with contractual agreements is a common – and important – reason for lawyers to reach out and engage a forensic accountant.

The financial terms, conditions, and obligations described in many contracts, especially those found in resource-based industries, often require complex calculations involving a dozen or more separate inputs. Moreover, many of these inputs may themselves be subject to careful calculation and interpretation. Not surprisingly, these complex calculations are often the source of contractual concerns or disagreements.

Where the input data is fairly straightforward, an accountant can review underlying data check calculations for completeness, accuracy, and reasonableness. Where input data can be interpreted in a number of ways, an accountant will perform calculations under various possible interpretations and offer an opinion as to which interpretation is the most accurate – and the most reasonable.



## CASE STUDY

### Contract Non-Compliance

A company held legacy royalty rights to a Canadian natural resource extraction operation, under the terms of an agreement many decades old. The company engaged MNP to assess whether the partner to the agreement, a foreign company, was correctly honouring the agreement.

We found many of the terms and conditions related to the royalty calculation deviated from the agreement's terms and conditions – and furthermore, because profits directly affected royalties, the foreign project operators had a clear motivation to keep net revenues down. On examining the general ledger, we discovered the operator had been out of compliance with the contract for several years. The foreign operator relied upon its own accounting policies and not the precise terms and conditions of the agreement.

### Measurement: Earn-Outs and Employment Contracts

Another common area that can lead to disputes relates to the measurement and payment of earn-outs and employment contracts. These agreements contain the terms around how much is paid out if certain corporate or personal performance targets are (or are not) met. Because the dollar amounts are usually material to both sides, we often see disagreements around how the targets are measured and who should take the credit for meeting various targets. In these cases, we review the contracts and underlying financial information and offer insight as to the appropriateness and reasonableness of the metrics, the attribution, and the calculations involved.

### Measurement: Insurance Claims and Other Losses

Business losses are a common source of disagreement between companies, or between companies and their insurer. Companies can find their claimed losses disputed and arguments can arise over whether a loss is covered under the terms of the contract. While most companies and their lawyers don't have a great deal of experience in quantifying losses, there are accountants who specialize in insurance claims and can determine whether a party's claim or counterclaim is valid and reasonable based on their analysis of the financial information and the interpretations of the relevant accounting standards. These specialists can both quantify and characterize eligible losses in a way that meets the expectations of insurers.

### When It Comes to Contracts, Accountants Are Lawyers' Secret Weapon

This article is intended to identify areas where accountants can help lawyers and their clients minimize the potential for contract disputes. Unfortunately, this is not always possible. Fortunately, those you can lean on to assist in understanding potential contract weaknesses, performing due diligence, or proving contract compliance measurements or losses are the same specialists who can help when things haven't gone according to plan.







## About MNP

MNP is a leading national accounting, tax and business consulting firm in Canada. We proudly serve and respond to the needs of our clients in the public, private and not-for-profit sectors. Through partner-led engagements, we provide a collaborative, cost-effective approach to doing business and personalized strategies to help organizations succeed across the country and around the world.

