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Trends in purchase price adjustment formulations in US, UK and cross-border M&A transactions

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While the overwhelming majority of US private M&A transactions address pre-closing value fluctuations by means of a working capital or similar purchase price adjustment, in our experience the majority of UK private M&A transactions are now completed without such an adjustment and instead rely on a 'locked box' approach. For cross-border transactions in particular, it is increasingly important to be familiar with both approaches.

In the UK, parties now tend to use a 'locked box' approach with far more frequency than in the US.

Purchase price adjustment approach

One of the key financial aspects of a private company acquisition agreement is the purchase price formulation, and whether or not the purchase price is subject to adjustment. The purchase price for a business is necessarily determined based upon information disclosed prior to signing an acquisition agreement, yet there is almost always fluctuation in the financial condition of the business between that time and the date a transaction closes. As a result, in the US, over 80 percent of private target transactions include some form of purchase price adjustment, with the substantial majority of those adjustments taking the form of a working capital-based adjustment *(Source: American Bar Association, Business Law Section, 2011 Private Target Mergers & Acquisitions Deal Points Study)*. In the UK, such purchase price adjustment formulations are typically referred to as 'completion accounts' and can be very similar to their US counterparts. Whether in the US or UK, however, a working capital-based adjustment is often accomplished by identifying a 'target' working capital amount, typically representing a 'normal' working capital level of the business being acquired, as well as defining which balance sheet line items and accounting policies should be used to calculate the working capital of the business as of the closing date. Then, if there is a difference between the target working capital and the working capital of the business as of the closing date, the purchase price will typically be adjusted up or down accordingly. There are a number of considerations as to how to implement such an adjustment, such as whether the parties will adjust the price dollar-for-dollar in either direction or only if the difference exceeds some agreed 'collar' around the target. Mechanically, the parties will often agree to adjust the price on a preliminary basis at closing based on an estimate of working capital (or the applicable adjustment metric), with a 'true-up' following closing once closing date working capital has been finalised, although sometimes the parties will adjust only once after closing based on the final determination of closing date working capital.

Adjusting for working capital (or other metrics) is not without cost. Adjustment provisions must be negotiated: the parties must agree on the working capital (or other) adjustment mechanism, as well as the appropriate working capital target, applicable accounting principles and the components of working capital. These variables, including the procedures (and nuances in those procedures) for resolving disputes, can impact the outcome. Determining closing working capital and the resulting purchase price adjustment also takes time and resources on the part of the party preparing the 'closing statement'. And, not surprisingly, buyers and sellers sometimes disagree on the calculation of closing date working capital. As a result, parties typically include provisions in the acquisition agreement to subject themselves to an intensive dispute resolution process designed to arrive at the 'right' answer by employing outside accountants to resolve the dispute. Indeed, according to one study, disputed working capital adjustments take on average four months to resolve *(Source: Shareholder Representative Services LLC, 2011 SRS M&A Post-Closing Claims Study)*.

The locked box approach

In light of the above considerations, it is perhaps not surprising that there is another way. In the UK, parties now tend to use a 'locked box' approach with far more frequency than in the US. In a locked box approach, the purchase price is typically fixed based on a set of historical and forecast financial statements (the 'locked box accounts') provided pre-signing, with there being no adjustment for fluctuations in the financial condition of the business from that date forward. This approach is often driven by the seller as it can provide a seller with certainty as to the amount of proceeds it will receive in a transaction by effectively transferring the economic risk of ownership to the buyer as of the locked box accounts date.

In evaluating the locked box approach, buyers often focus on the inherent risk (and potential reward) associated with transferring the economics of the target's business pre-closing. As a result, buyers usually take a number of actions to mitigate risk, such as ensuring appropriate due diligence of the locked box accounts and negotiating contractual protections to ensure that the target is appropriately 'ring-fenced' such that there is no extraction of value after the date ▸▸

of the locked box accounts. Ring-fencing is often achieved through acquisition agreement provisions intended to prevent such 'leakage' (e.g., restrictions on dividends, payments to management, affiliate transactions, and other payments, as well as a requirement to conduct the target business in the ordinary course and including other relevant covenants). Such 'ring-fencing' is often more easily accomplished with businesses operating as 'standalone' entities, as 'carve-out' businesses with ongoing relationships with the seller can result in increased risk of value leakage for the buyer. In any case, in circumstances where leakage is actually permitted, such as allowing a seller to extract an agreed amount of cash prior to closing, this is usually addressed specifically in the acquisition agreement and reflected in the purchase price. To address any impermissible leakage that occurs, a buyer may be able to assert contractual and other remedies, including rights to seller indemnification. While even in the locked box approach there remains the potential for dispute, overall the locked box approach minimises that potential, and avoids the costs typically associated with an adjustment process.

Locked box and adjustment considerations

The principal distinction between the adjustment approach and the locked box approach is how the risk of fluctuations in the financial condition of the target company is allocated between the buyer and the seller. If there is a purchase price adjustment for working capital, the risk (and benefit) of fluctuations between signing and closing falls to the seller as manifested in the price the buyer pays at closing. Perhaps the popularity in the US of including an adjustment mechanism relates to the fact that it seems 'fair' to US parties to transfer risk of ownership of the target business at closing. In a locked box transaction the risk (and benefit) of fluctuations in the business transfers to the buyer at the time the acquisition agreement is signed but with effect from the locked box date (which is typically in advance of both signing and closing). Because of this early transfer of effective economic ownership, sellers may insist that the buyer pay an amount of interest accruing on the purchase price from the locked box date or signing up to the closing, although a buyer with sufficient leverage may negotiate for a low rate or no interest payment requirement.

In addition to a party's views on the appropriate time for risk transfer, a number of other considerations come into play in determining the appropriate approach. For example, the value of the working capital relative to the overall purchase price, the time between the date of the reference financials on which the price is based and the closing, the ability to diligence pre-signing financials and the buyer's confidence in those financials, the parties' appetite for enduring a dispute resolution process, whether any other adjustments are required, and which party is driving the sale process.

Cross-border considerations

In cross-border transactions, parties should be familiar with both approaches. In negotiating the appropriate formulation, while choice of law and location of the relevant companies can be considerations, in our experience a more significant factor is whether there is a preference by the parties and their advisers for a UK- or US-style agreement, with the locked box approach being more likely to be used when there is an overall UK-style approach. A further attribute of the cross-border transaction is that the parties may need to consider the jurisdictional and transactional perspectives of each other, and thus may need to consider a combined approach in order to address each party's concerns or to reach a compromise on their relative positions.

Conclusion

Whether the parties choose to use an adjustment or a locked box process, it is important in making the decision and in crafting any adjustment provisions to have close coordination among the business team, accountants and attorneys. In any specific transaction, the trade-offs may not be immediately obvious and an understanding of the target's business, as well as the advantages, disadvantages and other considerations associated with each approach, are necessary to make the right decision for the transaction and to implement the desired alternative. ■

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