Drafting M&A Purchase Price Adjustment Clauses

Structuring Provisions to Mitigate Buyers' Financial Risks and Achieve Fair Compensation for Sellers

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PURCHASE PRICE ADJUSTMENTS

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I. THE OBJECTIVE OF PURCHASE PRICE ADJUSTMENTS

A. Businesses are often priced based on multiple of revenues or earnings, but the applicable metric could change between negotiation of the deal (LOI) and closing of the acquisition.

B. To bridge the gap, the purchase price is specified in the purchase agreement, but is adjusted based on the amount of the applicable metric as of closing.
II. DIFFERENT TYPES OF PURCHASE PRICE ADJUSTMENTS

A. The most common is “net working capital” (“current assets” minus “current liabilities”, so only <1 year assets and liabilities), but many other adjustments, including the following:

B. “Net worth” (i.e., “assets” minus “liabilities”, so include >1 year assets and liabilities).

C. “Minimum cash at closing” (be careful to avoid double counting with NWC adjustment).

D. Do sellers guarantee collection of accounts receivable (distinguish from calculation of A/R reserves in accordance with GAAP)? If so, are uncollected receivables assigned to sellers?

E. Need to confirm no overlap/double-counting of purchase price adjustment with seller indemnification obligations (e.g., seller retains liabilities for taxes, pension plan liabilities, transaction expenses, liability items discovered during due diligence, etc.).
III. WHAT IS INCLUDED IN NET WORKING CAPITAL

A. Baseline is “current assets” (cash + A/R) minus “current liabilities” (A/P and other short-term liabilities), but there are many nuances.

B. Industry-specific items – e.g., earned but unbilled revenue, prepaid items, customer deposits

C. Reserves on accounts receivable (a component of “current assets”) and accounts payable (a component of “current liabilities”) are often contested issues. Receivables outstanding >90 days are sometimes written down to zero as there is less likelihood of collection. Payables outstanding more than 90 days are cause for concern because seller may be “stretching out” payables due to cashflow issues. Receivables and Payables may be reserved due to disputes with customers or suppliers.

D. How are inventories (a component of “current assets”) valued? LIFO, FIFO. Stale inventories not sold within 1 year of manufacture are sometimes written down to zero.
III. WHAT IS INCLUDED IN NET WORKING CAPITAL cont.

E. Need to specify treatment of other “current liabilities” – for example, accrued salaries, bonuses, vacation, sick pay and sales commissions.

F. In “asset purchase” deals, only include “current assets” to the extent included in the “Purchased Assets” and “current liabilities” to the extent included in the “Assumed Liabilities”.

G. In “cash free/debt-free” deals, exclude cash from “current liabilities” and borrowed money debt from “current liabilities”.

H. In “debt-free” deals, buyer often gets indemnification from sellers for any seller debt, in addition to NWC adjustment, since long-term debt (more than 1 year) would not be a “current liability” included in NWC.

I. Exclude from “current liabilities” the sellers’ “transaction expenses” (i.e., attorneys, accountants and investment banker fees and expenses, sale bonuses paid to employees and other deal-related expenses), since sellers will be required to pay those at closing out of the transaction consideration and any unpaid items will be subject of indemnification.
IV. HOW IS NET WORKING CAPITAL DETERMINED?

A. “Bottoms-up” or “True-up”.
   • Parties can use straight GAAP standard and, if the seller’s historical accounting practices weren’t GAAP, then the adjustment process corrects the errors. This is the “buyer favorable” formulation.
   • Alternatively, the parties can do an “apples to apples” true-up process in which GAAP is interpreted using same policies, practices, assumptions as company's historical/audited financial statements. This is the “seller favorable” formulation.

B. Example NWC Statement or NWC Calculation Rules.
   • Sometimes the parties attach an “example NWC statement” (e.g., pro forma closing balance sheet) as an exhibit to the purchase agreement, to minimize disputes later about the way in which the NWC calculation is performed.
   • The alternative is to attach “NWC calculation rules” (e.g., procedures for accruing and reserving against accounts receivable and accounts payable).
IV. HOW IS NET WORKING CAPITAL DETERMINED?

C. Determining the NWC Target.

- Objective is “normalized” level of NWC, so seller should benefit from increase over LOI NWC amount or be penalized for drop since LOI NWC amount, since LOI NWC amount was used to determine purchase price.

- However, sometimes it is not advisable to use NWC in most recent balance sheet as target for the working capital adjustment if working capital fluctuates over time:
  - Seasonality
  - Intra-month variations as A/R is collected and A/P paid down

- Sometimes, the NWC target is set as an average amount of NWC, as reflected on the company’s balance sheets over several quarters during the year or over several years.

- Sometimes, there are multiple NWC targets depending on when during a month or the year the closing occurs.
V. TIMING OF PURCHASE PRICE ADJUSTMENTS

A. Adjustment Prior to Signing Purchase Agreement.
   • Purchase price adjustments to working capital could come up in different ways, at
different times and for different purposes. For example, since the transaction usually
starts with a letter of intent which normally precedes the closing by several months, at
the time that the letter of intent is drafted the buyer will have reference to the seller’s
balance sheet prepared sometime before the date of the letter of intent, sometimes
several months before the date of letter of intent.
   • Frequently the letter of intent will state that there will be a purchase price adjustment
to working capital, however, since a significant amount of time will have passed from
the date that the purchase price is set forth in the letter of intent and the date that the
buyer’s due diligence is completed, the process of drafting the purchase agreement is
completed and the date the purchase agreement is actually signed, the question arises
whether there will be a purchase price adjustment from that set forth in the letter of
intent and that put into the purchase agreement.
V. TIMING OF PURCHASE PRICE ADJUSTMENTS

B. Pre-Signing Balance Sheet Variance.

• To achieve a purchase price adjustment from the price mentioned in the letter of intent to the price set forth in the purchase agreement it becomes necessary to do a pre-signing balance sheet comparing the balance sheet that was available prior to the date that the letter of intent was signed and the balance sheet at signing the purchase agreement.

• For example, if the letter of intent said the purchase price was $50 million based upon working capital shown in the balance sheet provided to the buyer before the date of the letter of intent, and then the parties prepare another balance sheet three days prior to signing the purchase agreement and that balance sheet shows a $1 million decline working capital, assuming a dollar-for-dollar agreed adjustment to the purchase price, the purchase agreement would provide for a $99 million purchase price.
V. TIMING OF PURCHASE PRICE ADJUSTMENTS

C. Post-Signing Balance Sheet Variance.
   • If the transaction is structured as a sign and close later there could be another significant time gap between the pre-closing balance sheet and the actual balance sheet on the date of close, in which case, the parties may provide for either another balance sheet to be prepared 3 days prior to the closing for purposes of calculating the adjustment to the purchase price at closing or may provide for a post-closing balance sheet for purposes of calculating a post-closing adjustment to the purchase price.

D. Buyer Preference for Pre-Closing Adjustment.
   • Assuming there are no logistical problems involved in preparing a pre-signing balance sheet or a pre-closing balance sheet, the buyer would prefer to have the adjustment made before the closing rather that to fight with the seller over a post-closing adjustment.
VI. PURCHASE PRICE ADJUSTMENT PROCESS

A. Process typically involves the following steps, each with its own timeframe: delivery by the preparing party of proposed Closing balance sheet/PPA calculation; response by the other party; if the other party raises an objection, a response from the preparing party; and a negotiation period, following which either party may submit the remaining issues to a third party for resolution.

B. The purchase price adjustment can be “downward only” (buyer favorable) or upward & downward (more “fair”, but buyer needs to be prepared to pay more)

C. Sometimes a “buffer” concept is used in which there is no adjustment if the final amount in within a defined band around the target amount

D. Will there be two adjustments - one at closing based on seller's estimate and another adjustment 60, 90 or 120 days post-closing based on buyer's determination, or just a post-closing adjustment?

E. If there is an “at-closing” adjustment, will the estimated closing balance sheet be prepared "in consultation with" buyer or be "reasonably acceptable" to buyer?

F. Does estimated closing balance sheet become final if buyer fails to deliver its post-closing NWC statement by end of specified 60/90/120 day period post-closing?
VII. PURCHASE PRICE ADJUSTMENT DISPUTE RESOLUTION MECHANISM

A. Generally. The purchase price adjustment (“PPA”) provision will typically include a process for resolving PPA disputes, in order to expedite resolution in a cost-effective manner relative to litigation or arbitration.

B. Dispute resolution provision will address the following:
   - Process/timetable for dealing with objections to the Closing balance sheet/PPA calculation.
   - Identification of a neutral party that will resolve the dispute.
   - Scope of the neutral party’s authority.
   - Process for submission to the neutral party of the dispute and the parties’ respective positions.
   - Who pays the costs of the resolution process?
VII. PURCHASE PRICE ADJUSTMENT DISPUTE RESOLUTION MECHANISM

C. Process/Timetable for Dealing with Objections to the Closing Balance Sheet/Estimated PPA calculation:

- Notices of objection:
  - Some agreements require form and scope of objection to be specific (e.g., it must identify and explain in detail each item in dispute and state the dollar amounts of such objection). Others take a more general approach.
  - Some agreements limit the types of objections that can be raised
    - “…the Buyer objections shall be limited to claims that the Closing Balance Sheet (i) was not prepared in accordance with the accounting principles set forth on Schedule __, and (ii) contains mathematical errors.”

- Time limits for responses - Most agreements require each party to object within a set time period after receipt of the other party’s submission, after which it will be deemed to have accepted the submission.

- Access to information - Most agreements require the submitting party to provide access to its work papers and other items necessary to evaluate the submission, which is necessary because, after the closing, the sellers will no longer have access to company records.
Parties should consider addressing the following:

- Can objecting party amend or revise its objection after submission?
- The interplay between the access to information requirement and the time periods for responses
- *Melun Indus.*, 898 F. Supp. 995 (S.D.N.Y. 1992): Agreement required Buyer to deliver closing statement 15 business days after Seller provided “all documents necessary” to determine the purchase price adjustment. Seller provided financial statements to independent accountant and accountant provided an internal memo identifying a minimal purchase price adjustment (~$20k). Months later, Buyer provided a closing statement reflecting a Buyer favorable adjustment of about $250k. Seller challenged the closing statement as untimely. The court rejected that argument based on the vague language used in the agreement.
- What happens if the submitting party doesn’t provide the closing balance sheet/PPA calculation?
  - Party loses right to seek adjustment if it fails to submit calculation or prepare closing statement.
  - Allow other party to prepare the calculation in the event responsible party fails to do so—to protect other party when calculation is likely to result in price increase.
D. Identification of a Neutral Party to Resolve the Dispute.

- Most agreements provide for an “independent accountant” to resolve PPA disputes.
- Considerations when selecting an independent accountant include:
  - Industry experience (knowledgeable about industry-specific accounting practices);
  - Arbitration or litigation experience (preferably including PPA disputes); and
  - Independence (no prior business relations with buyer or seller).
- Options in selecting independent accountant
  - Specify the independent accountant in the purchase agreement.
  - Specify in the purchase agreement that the independent accountant be a “nationally recognized” accounting firm that is “reasonably acceptable” to both parties.
  - The problem is that if parties can’t agree on PPA, they may not be able to agree on independent accountant. As a result, purchase agreement should have procedure for determining an independent accountant that is reasonably acceptable:
    - Each party picks 2-3 accounting firms and if there’s a match, the matching firm is selected; or
    - Each party picks a firm and those two firms will work together to select a third firm to resolve the dispute.
VII. PURCHASE PRICE ADJUSTMENT DISPUTE RESOLUTION MECHANISM

E. Scope of Independent Accountant’s Authority.

- To avoid potential for unnecessary delays and costs, parties should draft with precision the scope of the disputes which are within the purview of the independent accountant’s authority and consider addressing the following:
  - Whether the independent accountant may undertake a wholesale review of the accounting calculations, or is limited to addressing the specific “issues remaining in the dispute”.
  - Whether the independent accountant may resolve procedural disputes (e.g., whether requirements related to specificity of objections access to information and/or time deadlines have been met, and the consequences of non-compliance).
  - Whether the independent accountant may review and if needed correct errors in the target balance sheet/working capital calculation.
• Other related issues the parties may wish to address include:
  ➢ Whether there are any limitations on the independent accountant’s decision:
    – Cannot be higher or lower than the parties respective final positions on the disputed items.
    – “Baseball” limitation: must pick one party’s position or the other.
  ➢ Whether the independent accountant is acting as an arbitrator (“split the baby”) or as an accounting “expert”.
    – Circumstances if any, under which the independent accountant’s decision may be appealed/overturned – e.g., independent accountant’s determination is “final and binding on the parties absent fraud or manifest error”.
    – If the purchase agreement provides for arbitration of disputes, clarifying whether enforcement of the accountant’s decision is subject to arbitration or handled by the courts.
VII. PURCHASE PRICE ADJUSTMENT DISPUTE RESOLUTION MECHANISM

F. Process for Submission of the Dispute and the Parties’ Respective Positions.
   • What information will be available to the independent accountant?
     — Limited to the parties’ submissions; or
     — ability to request additional briefings, documents, conduct hearings, etc.

   • Within what time period must the independent accountant render a decision?
     — Non-specific: “as promptly as possible”.
     — Specific: Within 30, 60, 90 days after matter submitted to independent accountants.
VII. PURCHASE PRICE ADJUSTMENT DISPUTE RESOLUTION MECHANISM

G. Who Pays the Costs of the PPA Dispute Resolution Process?
   • Buyer and seller split the costs, 50/50.
   • Loser pays all.
   • Each side pays proportionally to independent accountant’s resolution of disputed items as compared to its position - party whose position is closer to the final determination of the independent accountant pays a smaller percentage of the fees.
   • “Baseball method” - party whose position is farthest from the final position of the independent, pays the full expenses of the independent accountant. This approach incentivizes the parties to take reasonable positions and usually results in a resolution prior to engaging an independent accountant.
   • Independent accountant decides.
   • Accountants sometimes require payment before issuing decision.
VIII. HOW IS PURCHASE PRICE ADJUSTMENT SATISFIED?

A. Holdback/Escrow to Secure Post-Closing Purchase Price Adjustment Obligation.
   • Buyer holding back a portion of the purchase consideration or placing in into escrow with a third party bank can be useful to buyer, as buyer has some certainty that it will have access to cash to use to satisfy the purchase price adjustment.
   • Holdback is more buyer-favorable, but third party escrow is more common.

B. Distinction Between Reserves for Purchase Price Adjustments and Indemnification.
   • Escrow used to satisfy purchase price adjustment is different from escrow used to satisfy indemnification claims for breaches of representations and warranties in the purchase agreement.
   • Typically duration of purchase price adjustment escrow is relatively short as it only pertains to the time necessary post-closing (60, 90, 120 days) to complete purchase price adjustment process.
   • By contrast, duration of indemnification escrow is usually 12-24 months after closing because it might take buyer more time to discover breaches of representations and warranties in the purchase agreement. Furthermore, the indemnification is subject to baskets, caps and other provisions not normally associated with a purchase price adjustment.
VIII. HOW IS PURCHASE PRICE ADJUSTMENT SATISFIED?

C. Non-Cash Transaction Consideration.
   • If there is non-cash transaction consideration (e.g., buyer stock, seller notes, earnout), is downward purchase price adjustment satisfied just from cash transaction consideration or also from non-cash transaction consideration?
   • If so, in what order?
   • Buyer usually prefers only cash consideration, seller the reverse

D. What if Adjustment Exceeds Escrow? If purchase price adjustment exceeds escrow, are sellers jointly & severally liable for excess or is each only liable for his or her pro rata share?

E. Effect of Failure to Pay Purchase Price Adjustment. If a party fails to pay within specified time period after final NWC is determined, unpaid amount accrues interest at prime rate plus 5 percentage points, which is non-exclusive remedy (can also sue for damages)