

# A Buyer's Guide to Purchase Price Adjustments

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In the June edition of *The M&A Lawyer* we published our 2008 Survey of purchase price adjustments in private company acquisition agreements. This is a sister article to *Reevaluating Purchase Price Adjustments From a Seller's Perspective* published last month in *The M&A Lawyer* and was written in conjunction with our publication of *What to Expect When You are Expecting a Purchase Price Adjustment Dispute* (forthcoming with the *Practical Law Company*), a discussion of the outstanding case law on purchase price adjustment litigation. In this article we seek to identify many of the issues that buyers have encountered while litigating purchase price adjustment disputes and offer some alternatives to avoid these traps for the unwary.

It is quite common in acquiring a private company to have a purchase price adjustment in the calculation of the purchase price. Buyers wish to ensure that the target company is delivered at closing with a predetermined balance sheet (or components thereof) to avoid having their effective purchase price exceed the negotiated one. The purchase price adjustment should be designed to ensure that the seller is motivated to operate the business between signing the acquisition agreement

and closing in a fashion that is in the long term best interests of the target company rather than the short term best interests of the seller. The purchase price adjustment combines both accounting and legal principles and typically represents the largest unknown aspect of the purchase price; consequently, it is often considered the most frequent source of post-closing disputes between the parties to private company acquisitions.

The 2008 Survey identified the most common formula for a purchase price as a negotiated amount, net of indebtedness, plus or minus increases or decreases in working capital, as applicable.<sup>1</sup> The seller will usually estimate the amount of working capital prior to closing, with a corresponding adjustment to the purchase price at closing, and the buyer will calculate the final working capital within 60 days after closing and a true up will occur thereafter.<sup>2</sup> Almost invariably, if the parties have a dispute that they cannot resolve, they

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will look to an independent accounting firm to make a final determination as to the correct amount of working capital.<sup>3</sup> In theory, this practice is designed to be a swift and inexpensive means of resolving any dispute as to the calculations. In practice, buyers have sometimes found themselves belabored by delay and litigation when the purchase agreement fails to properly document the calculation and dispute mechanisms.

## Purchase Price Adjustment or Indemnification?

Recent surveys of private company acquisitions reveal that the average deductible for indemnification claims is 0.69% of the purchase price and the average cap on indemnification is approximately 10% of the purchase price, with certain fundamental representations and warranties carved out from both.<sup>4</sup> In the 2008 Survey, we found that in 79.3% of the purchase agreements the purchase price adjustment mechanism provided for dollar-for-dollar payment without any minimum or maximum adjustment amounts. The 2008 Survey also revealed that only 16.1% of the purchase price adjustments contained some form of deductible, and only 4.6% of the purchase price adjustments contained a maximum adjustment amount. Consequently, the question of whether a particular issue is the subject of a purchase price adjustment or an indemnification claim can have significant economic consequences to both parties.

The seminal case on the question of whether a claim is subject to the purchase price adjustment or indemnification provisions in an acquisition agreement is *Westmoreland Coal*.<sup>5</sup> *Westmoreland* involved a proceeding in which the buyer sought to compel the seller to arbitrate a purchase price adjustment dispute before an independent accountant in accordance with the acquisition agreement.<sup>6</sup> The buyer objected to the final closing date certificate delivered by the seller on the basis that many of the asset values in the certificate did not comply with generally accepted accounting principles (GAAP) and ultimately sought a \$30 million purchase price adjustment (approximately 22% of the purchase price). The seller refused to arbitrate on the basis that the buyer's claims were ones of indemnification and its exclusive remedy was a lawsuit for breach of

a representation and warranty in a court of competent jurisdiction. The two lower courts in *Westmoreland* had ruled in favor of arbitration, but the New York Court of Appeals ruled that the issue was one of indemnification.<sup>7</sup> The analysis in *Westmoreland* is notable from a drafting perspective. The *Westmoreland* court commenced its analysis by reading the purchase agreement as a whole. It noted that the guiding principles for preparing the closing date balance sheet emphasized "consistency" no less than three times.<sup>8</sup> It focused on the fact that the seller had made representations and warranties that the pre-closing balance sheet complied with GAAP.

The court also analyzed the indemnification language in the purchase agreement, which was not only quite broadly worded, but acted as an exclusive remedy and waived all other indemnification rights.<sup>9</sup> In reaching its decision, the *Westmoreland* court highlighted the importance that the purchase agreement placed on consistent application of accounting principles when preparing the final closing balance sheet. It viewed the attachment of the pre-closing balance sheet and the emphasis on consistent treatment of accounting principles as an indication of the parties' intent to have the purchase price adjustment measure only the change in value of the target company's net assets between signing and closing. The court noted that the seller had made representations and warranties as to the pre-closing balance sheet and that the buyer was entitled to seek indemnification for a breach of such representations and warranties. The *Westmoreland* court found that the buyer's use of the purchase price adjustment mechanism to address the pre-closing balance sheet's failure to comply with GAAP was inconsistent with its reading of the contract as a whole because it would subvert the exclusive remedies limitation and waiver in the indemnification language of the purchase agreement and render it meaningless.<sup>10</sup> The court therefore determined that the buyer's objections relating to noncompliance with GAAP were claims for breach of a representation and warranty.

*Westmoreland* and its progeny are healthy reminders of the importance of precise drafting. They also represent the natural dichotomy that exists in purchase agreements between purchase price adjustments and indemnification provisions. Since the courts read the purchase agreements in their entirety,

practitioners should focus on the interplay between the purchase price adjustment and the indemnification sections of the purchase agreement to eliminate conflict and ambiguity.

## Use a Pre-Closing Balance Sheet? What Happens If It Is Incorrect?

Many purchase price adjustments are calculated by comparing a final closing date calculation of net assets or working capital to a pre-closing balance sheet, which might be as of the signing date or prior fiscal period end. The pre-closing balance sheet is typically prepared by the seller and may be represented and warranted to be in compliance with GAAP. The final closing date calculation of net assets or working capital is typically prepared by the buyer.<sup>11</sup> The seller will usually seek to include language in the purchase agreement that requires that the final balance sheet be prepared on the same basis as the pre-closing balance sheet to ensure that accounting methodologies and assumptions are not changed to produce an artificial purchase price adjustment. The buyer will typically be concerned about agreeing to non-GAAP methodologies, so the purchase agreement will usually provide that both balance sheets must be prepared (1) consistently and (2) in compliance with GAAP. Buyers who have succumbed to these arguments have sometimes discovered after closing that the pre-closing balance sheet failed to comply with GAAP in one or more respects. This failure makes it impossible for the final balance sheet to be *both* consistent with the pre-closing balance sheet and compliant with GAAP. Was the parties' intention to deliver the target company with a fixed GAAP balance sheet (or components thereof) or to have the purchase price adjustment just measure the changes that occurred between the pre-closing balance sheet date and the closing date?

When determining whether GAAP or consistency should take precedent, courts look first to the wording of the purchase price adjustment provision. Where the wording clearly indicates the parties' preference, the court's determination is rather straightforward.<sup>12</sup> Where the wording is less than clear, buyers can be subject to the risk that an arbitrator will make an independent determination as to how to balance the natural tension between GAAP and consistency. *Stena Line (U.K.) Limited* involved

a purchase price adjustment provision that required both balance sheets to (1) comply with GAAP, (2) present a "true and fair view" of the company's business and (3) be consistent with prior periods and the "policies set forth in the notes" to the pre-closing balance sheet.<sup>13</sup> When the seller reviewed the final balance sheet it discovered significant adjustments to allegedly non-GAAP accounting entries used in the pre-closing balance sheet. The seller sought a court order directing the independent accountant to apply only the pre-closing balance sheet accounting methods in its review of the final balance sheet. The court refused the seller's request, finding that the purchase price adjustment's consistency requirement did not require every accounting method applied in the pre-closing balance sheet to be "slavishly followed in preparing its successor."<sup>14</sup> Rather than mandate the use of potentially incorrect accounting methods, the court allowed the independent accountant to weigh the relative importance of the consistency, GAAP, and "true and fair" view requirements.<sup>15</sup>

Similarly, two New York appellate court cases, *Rockwell Int'l Corp. v. BTR Dunlop, Inc.* and *Kim v. Transtar Metals, Inc.*, confirmed the independent accountant's authority to adjust the pre-closing balance sheet, or the target amount by which the final balance sheet is to be measured.<sup>16</sup> According to the *Rockwell* court, restricting the accountant's authority to adjust the pre-closing balance sheet would "render arbitration a futile exercise" by preventing a comparison of net asset figures arrived at "by the application of identical accounting principles."<sup>17</sup>

From the buyer's perspective, the most important goal of drafting the purchase price adjustment should be to achieve certainty of outcome. In the event the pre-closing balance sheet is incorrect, parties should be wary of the possibility that an arbitrator or court might adjust their target balance sheet. An adjustment to the pre-closing balance sheet essentially changes the net asset or working capital benchmark that the parties agreed upon. These benchmarks are often one of the key economic terms underpinning the transaction and are arrived at through extensive financial analysis and negotiation. Buyers should seek to avoid utilizing a pre-closing balance sheet for the target amount of net assets or working capital because of (1) the inherent uncertainties associated with GAAP,<sup>18</sup> (2) the risk that the independent ac-

countant will change the target number in the event that the pre-closing balance sheet is not in accordance with GAAP and (3) the risk that a court will recharacterize the purchase price adjustment as an indemnification claim, as in *Westmoreland*. For these reasons, the more common and better practice is to utilize a target number in lieu of a balance sheet.<sup>19</sup>

Buyers will still have to address the seller's common insistence that the final balance sheet be prepared consistently with the target company's prior financial statements. In such circumstances, buyers do not want to use non-GAAP accounting principles to determine the final balance sheet or components thereof (such as working capital) because they can be illusory and often cannot be used for any other purpose, such as credit agreements, financial statements, etc. Moreover, it is not uncommon for smaller private companies to not record certain liabilities such as unused vacation, certain payroll liabilities, and contingent liabilities. The compromise is often to agree to consistency, but prioritize GAAP over consistency to ensure that the target company is being delivered with real assets and appropriate liabilities. The purchase agreement may provide that the final balance sheet be prepared "in accordance with GAAP, applied consistently with the target company's prior accounting practices to the extent such practices are in accordance with GAAP."

### Justice Delayed Is Justice Denied

Most practitioners opt to use an independent accountant in lieu of litigation because it will be a swifter and less expensive process, as the time period for providing documentation and positions to the independent accountant is usually short, there is typically no extensive discovery or depositions, and it is hoped that the independent accountant will know what materials it needs to make its determinations and be able to expedite any necessary research. Practitioners believe there will be more certainty of outcome through this process because parties typically select the independent accountant from one of the largest accounting firms in the world, which are presumed to have experts on the issues at hand. A majority of the case law addressing purchase price adjustment disputes could be viewed by buyers as litigation seeking to (1) avoid arbitration, (2) have the court manage the arbitration process, or (3)

overturn existing decisions of the independent accountant. In any of these events, the corresponding litigation results in additional costs, delay and distraction to management and can decrease the certainty of outcome of the purchase price adjustment. Sophisticated buyers will want to draft their purchase price adjustments and dispute mechanisms to avoid these issues.

The single most common source of delay in the reported cases involving purchase price adjustments occurs when the seller has filed suit to avoid arbitration on the basis that the seller did not agree to have the independent accountant determine a particular matter, usually a valuation or GAAP methodology issue. "A party cannot be required to submit a dispute to arbitration unless he has agreed in writing to do so."<sup>20</sup> This question is called substantive arbitrability and is generally one for the courts to decide, based on their interpretation of the purchase agreement under state law.<sup>21</sup> If the language is unambiguous, then the court determines whether the contested issue falls within the scope of the arbitration clause. If the language in the contract is ambiguous, then the court seeks to determine the intent of the parties and can look to evidence other than the contract language. The mere appointment of an independent accountant to resolve purchase price adjustment disputes does not necessarily provide authority for the independent accountant to arbitrate GAAP issues, for example, and many buyers have been surprised to discover that their word choice was deemed inadequate by a court.<sup>22</sup> Generally, one should draft the agreement to provide the independent accountant with *full authority to arbitrate all of the issues* relating to the purchase price adjustment to prevent bifurcation of the issues between a trial court and the independent accountant. This avoids forum shopping, duplicity and potential delay if the seller seeks to litigate and avoids challenges to the outcome if the issues were properly submitted to arbitration and *res judicata* applies.

Other sources of delay typically occur when sellers (1) fail to provide documents or respond in a timely fashion, (2) fail to proceed to arbitration based on allegations that the buyer has failed to satisfy conditions precedent to arbitration, or (3) bring suit alleging one or both of the foregoing. These are issues of procedural arbitrability, which the courts

have generally left to arbitrators to decide. Buyer's counsel will be well served to address these issues in the dispute mechanism language to ensure timeliness and cooperation. However, avoid vague concepts as in the case of *Melun Industries*, where the closing statement was to be delivered 15 business days after receiving "all documents necessary" to calculate the adjustments and resulted in hundreds of days of delays.<sup>23</sup>

### Articulating How It Will Be Measured

Several buyers have encountered difficulties when their purchase agreement failed to adequately articulate how the balance sheet items would be measured. In *Twin City Monorail*, the parties had not agreed on the GAAP method of valuing inventory in the purchase price adjustment.<sup>24</sup> The buyer argued that LIFO (last in, first out) was the proper methodology, particularly since the seller/parent company used LIFO in reporting its corporate earnings. The seller advocated FIFO (first in, first out), which was used as the basis for the target company's balance sheet. The difference was \$700,000, an amount that neither of the parties had wanted to leave to chance. In *In re Marvel Entertainment Group, Inc.*, the accounting treatment of a sizeable number of accounts receivable hinged on the interpretation of "Collections of Accounts Receivable *acquired at the Closing* shall be applied first to the oldest of such Accounts Receivable."<sup>25</sup> The seller applied all cash received from customers since the closing date to the oldest accounts receivable for the appropriate customers for an upward purchase price adjustment of \$1.8 million. The buyer matched payments made after the closing to particular post-closing invoices and only applied unmatched payments to pre-closing accounts receivable for a downward purchase price adjustment of \$1.9 million. The court's determination hinged on its interpretation of "acquired at the Closing."

The 2008 Survey revealed that only 12.2% of the 2008 Agreements articulated the GAAP principles to be applied in the purchase price adjustment calculation.<sup>26</sup> Often GAAP is not precise enough for purchase price adjustments or incorporates concepts unintended by the parties.<sup>27</sup> For example, deferred revenues are a working capital liability under GAAP that are often inappropriate for a purchase price ad-

justment. They decrease working capital as sales increase and increase working capital as sales decrease, or projects are completed. We believe that a failure to detail the GAAP principles and methodology undermines the certainty of outcome of the acquisition agreement and may work to the disadvantage of the buyer. We recommend not only documenting the specific components to be measured, but also the applicable GAAP methodology to be applied to provide clearer communications between the parties and greater certainty of outcome. Sometimes this is as simple as "inventory reserves will be 3% of revenues", "inventory will be valued at the lower of cost or market, using the LIFO method of valuation", etc. More often, it involves greater analysis and enumeration.

A final thought on decreasing the likelihood of purchase price adjustment disputes relates to expenses. As evidenced by a number of the litigated cases, in many circumstances parties have taken positions that will seemingly result in an unintended windfall to them. Parties have also spent significant time and money advocating extreme positions, which increases the costs for both parties and decreases the likelihood of resolution, either before the independent accountant is engaged or prior to litigation. The purchase agreement should encourage parties to take reasonable positions on purchase price adjustment issues on the basis that two reasonable positions are more likely to result in resolution expeditiously and inexpensively. To accomplish this, some practitioners use a "baseball" method of allocating the expense of the independent accountant, which means that the party whose position is farthest from the final position of the independent accountant's pays the full expenses of the independent accountant. This often results in resolution prior to engaging the independent accountant, particularly if the parties are not far apart in their estimates, as the potential cost and effort of the independent accountant process can exceed the likely benefit of disputing the issue further.

#### NOTES

1. In 71.3% of the purchase agreements reviewed in the 2008 Survey (the "2008 Agreements") the purchase price was reduced for any target company debt outstanding at closing and 85.1%

of the 2008 Agreements adjusted the purchase price for changes in working capital (vs. 10.3% for net assets).

2. In 95% of the 2008 Agreements the seller prepared a preliminary calculation prior to closing, and in 76.2% of the 2008 Agreements the buyer prepared a final calculation after the closing.
3. The parties chose to resolve purchase price adjustment disputes using an independent accountant in 96.5% of the 2008 Agreements.
4. First Annual Private Target Mergers & Acquisitions Deal Points Study, published by the Mergers & Acquisitions Market Trends Subcommittee of Negotiated Acquisitions of the American Bar Association's Section of Business Law (March 27, 2006) at p. 56-63. More specifically, the study found that 28% of agreements reviewed had an indemnification cap of less than 10% of the purchase price; 15% of agreements had an indemnification cap of 10%; and 27% of agreements had an indemnification cap between 10-15%. *Id.* at 63.
5. *Westmoreland Coal Co. v. Entech, Inc.*, 100 N.Y.2d 352 (N.Y. 2003).
6. *Id.*
7. *Id.*
8. *Id.* at 358-59.
9. *Id.* at 359. The purchase agreement provided that the seller was required to indemnify the buyer "in respect of, and hold it harmless from and against, any and all Adverse Consequences suffered, incurred or sustained by it or to which it becomes subject, resulting from, arising out of or relating to any breach of representation or warranty ... on the part of Seller contained in this Agreement." Disputes over representations and warranties, if not amicably reconciled, were to "be resolved by litigation in a court of competent jurisdiction." Moreover, after the closing, the remedies set forth in the indemnification provisions were the parties' "exclusive remedies" for misrepresentation or breach of any warranty contained in the Agreement; and the parties were not entitled to rescission or "any further indemnification rights or claims of any nature whatsoever in respect [of the Agreement], all of which the parties ... waive." *Id.* "Adverse Consequences" were defined as:

[A]ll actions, suits, proceedings, hearings, investigations, charges, complaints, claims, demands, injunctions, judgments, orders, decrees, rulings, damages, dues, penalties, fines, deficiencies, costs, liabilities, obligations,

taxes, liens, losses, expenses, and fees, including, without limitation, court costs, interest and reasonable fees of attorneys, accountants and other experts or other reasonable expenses of litigation or other proceedings or of any claim, default or assessment. *Id.* at 356.

10. See also *OSI Systems, Inc. v. Instrumentarium Corp.*, 892 A.2d 1086 (Del. Ch. 2006) (in which a Delaware court ruled in a similar manner, notwithstanding the buyer's insistence it was not seeking indemnification).
11. In the 2008 Survey, 76.2% of the 2008 Agreements required the buyer to provide the final calculation while 23.8% required the seller to provide the final calculation.
12. See, e.g. *Melun Indus., Inc. v. Strange*, 898 F. Supp. 990, 993 (S.D.N.Y. 1990) (in which the court prioritized consistency over GAAP because the purchase price adjustment's stated purpose was to measure "the amount, if any, by which the book value . . . increased or decreased . . . during the period from [the pre-closing balance sheet date] to the Closing Date").
13. *Stena Line (U.K.) Ltd. v. Sea Containers Ltd.*, 758 F. Supp. 934, 938 (S.D.N.Y. 1991). The purchase agreement provided that: [T]he [Pre-Closing] balance sheet be prepared in conformity with the terms of this Agreement and present. . . a true and fair view of the Ferry Business as of the date thereof. The [Pre-Closing] Balance Sheet shall be prepared in accordance with the books and records of the Ferry Business [and] in conformity with United Kingdom generally accepted accounting principles [UKGAAP], applied on a consistent basis with prior periods. *Id.* The Agreement imposed the same requirements on the Post-Closing balance sheet, with the additional proviso that it "be prepared on a consistent basis with the policies set forth in the notes to the Pre-Closing Balance Sheet." *Id.* at 935-36.
14. *Id.* at 938.
15. *Id.*
16. *In re Rockwell Int'l Corp. v. BTR Dunlop, Inc.*, 192 A.D.2d 454, 456 (N.Y. App. Div. 1993); *Kim v. Transtar Metals, Inc.*, 284 A.D.2d 118 (N.Y. App. Div. 2001).
17. *Rockwell*, 192 A.2d at 456. *But see Manifest Corp. v. Random House, Inc.*, Civ. No. 07-254-KI, 2007 WL 1974911 (D. Or. 2007) (allowing the independent accountant to consider accounting procedures and their compliance with GAAP but not to make changes to the pre-closing balance sheet).

18. See, e.g. *Coty Inc. v. L'Oreal S.A.*, No. 07CV6206 (KMW), 2008 WL 331360 (S.D.N.Y. 2008) (in which the parties participated in two independent accountant arbitrations and a subsequent litigation to determine whether the seller's removal of an intercompany liability from the closing date balance sheet complied with GAAP); *20 Atlantic Avenue Corp v. Allied Waste Indus., Inc.*, 482 F.Supp.2d 60 (D.Mass 2007) (in which the court was unable to determine on summary judgment whether the parties definition of "aggregate long-term debt" should include the current portion of long-term debt); *Mehiel v. Solo Cup Co.*, C.A. No. 06C-01-169-JEB, 2007 WL 901637 (Del. Super. Ct. 2007) (in which \$5.6 million hinged on whether a target company facility should be classified as a "long-term asset" or "asset held for sale" under GAAP).
19. In 81.5% of the 2008 Agreements the parties used a target number as the basis for their net asset or working capital benchmark.
20. *Campeau Corp. v. May Dep't Stores Co.*, 723 F.Supp. 224, 227 (S.D.N.Y. 1989) (citing *McAllister Bros. v. A&S Transp. Co.*, 621 F.2d 519, 522 (2d Cir. 1980)).
21. See, e.g., *AT&T Tech., Inc. v. Commc'ns Workers*, 475 U.S. 643, 649 (1986) ("Unless the parties clearly and unmistakably provide otherwise, the question of whether the parties agreed to arbitrate is to be decided by the court, not the arbitrator"); *SBC Interactive v. Corporate Media*, 714 A.2d 758 (Del. 1998); *Mehiel v. Solo Cup Co.*, No. Civ.A. 1596-N, 2005 WL 3074723 (Del. Ch. 2005), *aff'd* 906 A.2d 806 (Del. 2006).
22. See, e.g. *Twin City Monorail, Inc.*, 728 F.2d at 1073-74 (in which the buyer could not present the independent accountant with an objection to the seller's inventory accounting methodology because the purchase agreement only allowed for objections to "item[s] contained in the Statement of Inventory", which encompassed objections to the inventory's physical count but not its valuation method); *Medcom Holding Co. v. Baxter Travenol Lab., Inc.*, No. 87 C 9853, 1988 WL 107545 (N.D.Ill. 1988).
23. *Melun Indus.*, 898 F. Supp. at 992-993.
24. *Twin City Monorail, Inc.*, 728 F.2d at 1070-72.
25. *In re Marvel Entertainment Group, Inc.*, 274 B.R. 99 (D. Del 2002).
26. Out of the 2008 Agreements, 87.8% merely stated that the balance sheet components were to be prepared in accordance with GAAP or GAAP applied consistently with past practices.
27. See *supra* note 18.