

Reevaluating Purchase Price Adjustments From a Seller's Perspective

BY JORGE L. FREELAND AND NICHOLAS D. BURNETT

Jorge Freeland is a partner in the M&A group of White & Case LLP specializing in leveraged buyouts and related financings. Nicholas Burnett is an associate in White & Case's M&A group. Contact: jfreeland@whitecase.com.

We recently completed a survey of 87 publicly available private company acquisition agreements to ascertain the current state of market practice of purchase price adjustments in acquisition agreements (the 2008 Survey)¹ as well as a comprehensive review of the 57 published opinions on purchase price adjustment disputes to better understand the judicial view of the related litigation.² This article incorporates the results of these two endeavors and offers some alternatives to avoid many of the pitfalls that have befallen prior sellers in the unfortunate, but common event where the buyer's proposed purchase price adjustment seeks to adjust for indemnification issues that go beyond the purchase price adjustment.

In today's M&A environment, it is standard practice in acquiring a private company to have a purchase price adjustment in the calculation of the purchase price. The purchase price adjustment is designed to ensure that the target company is delivered at closing with a predetermined balance sheet (or components thereof) or the purchase price is adjusted upward or downward. At the same

time, most acquisition agreements have specific limitations on the buyer's indemnification rights in the form of caps and deductibles to provide the seller some assurance as to the net proceeds of the transaction.³ Because the purchase price adjustment incorporates both accounting and legal principles and is intertwined with indemnification, its complexity and visible effects on the economics of the transaction have resulted in the most frequent source of post-closing disputes between the parties to private company acquisitions. More often than not, when the parties have gone to court to resolve these issues, the seller has come out on the short end of the litigation.

In a typical acquisition agreement for a private company, the purchase price will be

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a negotiated amount, net of indebtedness and plus or minus increases or decreases in working capital, as applicable.⁴ 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 of closing and a true up will occur thereafter.⁵ Almost invariably, if the parties have a dispute that they cannot resolve, they will look to an independent accounting firm to make a final determination as to the correct amount of working capital.⁶ In a number of cases, sellers have sought judicial relief from the contractual dispute resolution process as well as the outcome of the independent accountant arbitration.

Enumerating What Will Be Measured

The single largest contributor to purchase price adjustment disputes results from a failure of the parties to clearly enumerate what will be measured. In our 2008 Survey, we found that, of the 2008 Agreements that had a working capital adjustment, 52.7% measured working capital using some variation of the standard generally accepted accounting principles (GAAP) definition of “current assets minus current liabilities”. Likewise, of the 2008 Agreements that measured net assets, all of them used some variation of “assets minus liabilities”. The case law has shown that from the seller’s perspective, these are the least favorable metrics because GAAP is not precise enough for purchase price adjustments. For example, in *Mehiel v. Solo Cup Co.* the seller classified its Maryland facility as an “asset held for sale”, which is a current asset, because the seller intended to sell it.⁷ When the parties calculated the post closing working capital though, the \$5.6 million facility was not included because the buyer decided to hold the facility as a long term asset. In *Accel International Corp.*, the parties agreed to make a Section 338(h)(10) election under the Internal Revenue Code in connection with the sale of the company’s stock.⁸ This election caused the transaction to be treated as an asset sale for tax purposes, which gave the buyer a step up in the tax basis of the target company’s assets and caused the seller to recognize the target company’s deferred tax liabilities as income. In the post-closing audited calculation of net assets, the

seller discovered to its dismay that \$2.6 million of deferred tax liabilities would be listed as liabilities on the audited balance sheet of the target company under GAAP, notwithstanding the fact that the 338(h)(10) election would relieve the target company of the liability post-closing.

Even more problematic is that current liabilities can include a number of liabilities that are not normally associated with working capital adjustments, such as the current portion of long term debt and liabilities associated with litigation, environmental remediation, etc., essentially any liability that is payable within one year of the balance sheet date. In *20 Atlantic Avenue Corp.* the purchase agreement included one purchase price adjustment based on working capital and another based on long term debt.⁹ Realizing after the closing that an increase in the current portion of long term debt affected it twice, the seller argued to exclude it from both calculations to avoid double counting, but was unsuccessful in the summary judgment opinion. Similarly, net asset tests will usually pick up all material GAAP liabilities. This is problematic for a seller because it may invite controversy over booking liabilities for litigation, environmental remediation and other contingencies that may otherwise be disclosed and therefore not otherwise indemnifiable under the purchase agreement.

A related problem for sellers is the unintended double counting of indemnified liabilities. In *Brim Holding Co., Inc.* the purchase agreement required the seller to indemnify the buyer for losses resulting from an ongoing lawsuit.¹⁰ After the closing, the parties calculated their purchase price adjustment and included a \$500,000 reserve attributable to the litigation. When the suit subsequently settled for the same amount, the buyer made an indemnification claim for the loss associated with the settlement. The seller argued that the buyer suffered no loss from the settlement because the reserve fully compensated the buyer by way of a purchase price adjustment. The court focused on the indemnification language which clearly and unambiguously required the seller to indemnify the buyer for the litigation and ruled in favor of the buyer.¹¹ The Delaware Chancery Court arrived at a similar result with respect to employee liabilities in *HDS Investment Holding Inc.*¹² As a result, we advocate that

sellers articulate the precise components of working capital to be included in the purchase price adjustment, such as “(i) cash, plus (ii) accounts receivable, plus (iii) inventory, plus (iv) prepaid expenses, less (i) trade payables, less (ii) accrued expenses.” A better practice is to reference the accounts on the general ledger that will be compared before and after closing. This practice also has the benefit of requiring the parties to go through the details of what will be analyzed in the purchase price adjustment and should facilitate flagging items that are more appropriate for indemnification.

Articulating How It Will Be Measured

A second and related problem is the failure to articulate how the balance sheet items will be measured. 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.¹³ 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 seller. In *Twin City Monorail*, the parties had not agreed on the GAAP method of valuing inventory in the purchase price adjustment.¹⁴ 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. We often find that documenting the GAAP methodology for calculating the purchase price adjustment provides clearer communications between the parties, which creates 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 a greater analysis.

Using Precise Language

The third largest contributor to purchase price adjustment disputes is the failure to utilize precise drafting in the acquisition agreement. This issue arises not only in the measurement metrics, but

in the arbitration language, the dispute resolution language and more importantly the interplay between the purchase price adjustment and the indemnification language. For example, in *Matria Healthcare Inc.*, the seller discovered to its dismay that the arbitration clause would extend the independent accountant’s authority too far.¹⁵ The purchase agreement stated unequivocally that any matters that “*could have been*” the subject of an adjustment or dispute related to the purchase price adjustment. . .had to be resolved “*solely*” through the purchase price adjustment. The seller admittedly had an issue with one of its larger customers that the buyer initially claimed created a \$1.5 million liability. However, when the buyer settled the claim for \$4 million, it received (i) a release of any claims prior to the closing and for nearly a year thereafter, (ii) a two year extension of its \$20 million per year contract, (iii) revision of the contract’s termination provision to allow termination only “for cause,” and (iv) a cash payment of \$1.5 million for a public relations campaign regarding its services to the customer’s clients. The buyer amended its purchase price adjustment to \$4 million and the court found the broad granting language allowed the claim to be part of the purchase price adjustment rather than an indemnification claim subject to the \$4,450,000 deductible.

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.”¹⁶ 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 applied only 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”, which it ruled in favor of the buyer. In *Melun Industries, Inc.*, the seemingly innocuous timeline language hurt the seller.¹⁷ The seller sought to throw out an arbitration award in favor

of the buyer on the basis that the buyer failed to comply with the purchase agreement's requirement to deliver its proposed purchase price adjustment "no more than 15 business days after receiving all documents necessary" to calculate the adjustments.¹⁸ The buyer submitted one low adjustment within 15 business days and then some 100 days later submitted a significantly higher calculation in its favor. The buyer defended the untimeliness of its revised post-closing statement by claiming that the seller had not provided "all documents necessary" until shortly before the second post-closing statement was delivered. The court deferred to the independent accountant who had resolved the issue in favor of the buyer.

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.¹⁹ In the 2008 Survey, we found that 79.3% of the purchase price adjustment mechanisms surveyed 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 a 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*.²⁰ *Westmoreland* involved the not-uncommon issue of a buyer's challenge to the balance sheet used as a reference for the purchase price adjustment. The buyer claimed that the reference balance sheet was not in conformity with GAAP and sought a \$30 million (approximately 22% of the purchase price) adjustment to the purchase price in lieu of

indemnification. The analysis in *Westmoreland* is notable from a drafting perspective. Most importantly, the New York Court of Appeals read the purchase agreement as a whole and sought to give meaning to the interplay between the indemnification provisions and the purchase price adjustment provisions. It found that the guiding principles for preparing the closing date balance sheet emphasized "consistency" no less than three times. It also focused on the fact that the seller had made representations and warranties that the reference balance sheet complied with GAAP. The court then 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. It viewed the attachment of the reference balance sheet and the emphasis on consistent treatment of accounting principles as evidencing an intent by the parties to have the purchase price adjustment measure only the change in value of the target company's net assets between signing and closing. Because the seller had made representations and warranties as to the reference balance sheet, the buyer was entitled to seek indemnification for a breach of such representations and warranties. The *Westmoreland* court found that the buyer's utilization of the purchase price mechanism to address the reference balance sheet's failure to comply with GAAP would subvert the exclusive remedies limitation and waiver in the indemnification language of the purchase agreement and would be inconsistent with a reading of the contract in its entirety.²¹

While *Westmoreland* worked to the seller's advantage, other courts have decided to reset the purchase price adjustment target when a reference balance sheet did not conform to GAAP.²² Consequently, these cases had the full effect of adjusting the purchase price without the corresponding use of the deductible and the cap. In either event, use of a reference balance sheet in lieu of a numerical target can create greater uncertainty as to outcome because of the inherent difficulties of reconciling the accounting principles and methodology of the reference balance sheet with the post closing balance sheet.

Conclusion

In conclusion, in today's sophisticated M&A environment sellers should be taking greater steps to ensure that the purchase price adjustment does not open the door for claims that are more appropriately the subject of indemnification. This requires greater articulation of what will be measured and how it will be measured. In addition, sellers should be precise not only in the language used in the measurement metrics, but also in the choice of arbitration language and the interplay between the purchase price adjustment and the indemnification language.

NOTES

1. Jorge L. Freeland & Nicholas D. Burnett, *2008 Survey of Private Company Purchase Price Agreements*, The M&A Lawyer, June 2009.
2. Jorge L. Freeland & Nicholas D. Burnett, *What to Expect When You Are Expecting a Purchase Price Adjustment Dispute*, (forthcoming 2009).
3. See 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.
4. The 2008 Survey found that 85.1% of the 2008 Agreements used a working capital adjustment and in 71.3% of the 2008 Agreements the prices were net of outstanding indebtedness.
5. 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.
6. The parties chose to resolve purchase price adjustment disputes using an independent accountant in 96.5% of the 2008 Agreements.
7. *Mehiel v. Solo Cup Co.*, C.A. No. 06C-01-169-JEB, 2007 WL 901637 (Del. Super. Ct. 2007).
8. *Accel Int'l Corp. v. Lyndon Life Insur. Co.*, No. C2-98-486, 2002 WL 193697 (S.D. Ohio 2002).
9. *20 Atlantic Avenue Corp. v. Allied Waste Indus., Inc.*, 482 F.Supp.2d 60 (D.Mass. 2007).
10. *Brim Holding Co. v. Province Healthcare Co.*, No. 06-1597-I, 2008 Tenn.App.LEXIS 325 (Tenn. Ct. App. 2008).
11. The purchase agreement provided "After the Closing. . . Seller agrees to indemnify, defend and hold harmless Buyer. . . from and against any and all Losses. . . reasonably paid or incurred by the Buyer Indemnities, or any of them, and resulting from, based upon or arising out of...any Losses related to or in connection with [the CHAMA litigation]." *Id.*
12. *HDS Investment Holding Inc. v. Home Depot, Inc.*, No. 3968-CC, 2008 WL 4606262 (Del. Ch. 2008).
13. 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.
14. *Twin City Monorail, Inc. v. Robbins & Myers, Inc.*, 728 F.2d 1069 (8th Cir. 1984).
15. *Matria Healthcare, Inc. v. Coral SR LLC*, C.A. No. 2513-N, 2007 WL 763303 (Del. Ch. 2007).
16. *In re Marvel Entertainment Group, Inc.*, 274 B.R. 99 (D.Del 2002).
17. *Melun Indus., Inc. v. Strange*, 898 F. Supp. 990 (S.D.N.Y. 1990).
18. See also *In re Allegiance Telecom, Inc.*, 356 B.R. 93 (Bankr. S.D.N.Y. 2006) (allowing an independent accountant to consider calculations submitted by the buyer several months beyond the 60 day post-closing deadline because the deadline began to run only after the seller fulfilled its contractual obligation to provide access to its books and records).
19. Mergers & Acquisitions Deal Points Study, *supra* note 3.
20. *Westmoreland Coal Co. v. Entech, Inc.*, 100 N.Y.2d 352 (N.Y. 2003).
21. See also *OSI Systems, Inc. v. Instrumentarium Corp.*, 892 A.2d 1086 (Del. Ch. 2006) (citing *Westmoreland* favorably in reaching a similar holding).
22. See *Kim v. Transtar Metals, Inc.*, 284 A.D.2d 118 (N.Y. App. Div. 2001); *In re Rockwell Int'l Corp. v. BTR Dunlop, Inc.*, 192 A.D.2d 454 (N.Y. App. Div. 1993).