akerman

Practice Update

Purchase Price Adjustments: How True is Your True-Up?

April 30, 2013

By Carl D. Roston and Kenneth R. Wiggins

A substantial majority of acquisitions involving private targets include uncapped post-closing purchase price adjustments, or "true ups," tied to the target's balance sheet. Since a target's value typically is assessed based on its historical financial statements, these adjustments were originally designed to adjust the purchase price after closing for fluctuations in the target's balance sheet between the date of the historical balance sheet and closing and to ensure that the target had an agreed and sufficient level of working capital at closing. Because purchase price adjustments are the most common category of post-closing escrow claims (and such claims are typically uncapped and often material), the legal and financial aspects of these provisions both in letters of intent and acquisition agreements deserve careful attention. In addition, as auction processes for acquisitions have become increasingly competitive and driven valuations higher, a prospective buyer often is forced to set a lofty purchase price in a letter of intent before completing financial diligence in order to obtain exclusivity, leading to all-too-common pre-closing disagreements about working capital adjustments.

Addressing purchase price adjustments in sufficient detail at the letter of intent stage adds value in two ways. First, doing so decreases the risk that the

Related People

Carl D. Roston
Kenneth R. Wiggins

Related Work

Corporate
M&A and Private Equity

Related Offices

Miami

transaction will not close at the price expected by each of the parties or otherwise be the subject of pre-closing tension resulting from the parties' differing expectations as to the impact of the adjustment. Second, the buyer will have a tougher time seeking in good faith to use the adjustment as a purchase price reduction tool.

Carefully Delineating What to Measure

Choice of the right metric for a purchase price adjustment to reflect the economic expectations of the parties is obviously important. While working capital adjustments are the most common metric, shareholders' equity may be a more desirable tool in certain situations (e.g., for a buyer of a business with high levels of capital expenditures). Also, where working capital is the metric selected, the interim operating covenants — particularly those relating to capital expenditures and sales of fixed assets — should be crafted to ensure that the target does not unfairly manipulate the adjustment (for example, by deferring capital expenditures).

Once a metric is selected, early and extraordinary attention to clearly identifying the specific components of (and definitions used in) the adjustment mechanism increases the chances that the deal will close on the economic basis mutually expected by the parties at the time the letter of intent is signed and decreases the chances of a post-closing dispute. While parties often default to a "current assets minus current liabilities" definition of working capital, doing so may cause purchase price adjustments inconsistent with one or both of the parties' real economic expectations or inadvertently lead to overlapping or double-counting between this mechanism and other adjustment mechanisms in the acquisition agreement — such as provisions designed to provide for a "cash-free, debt-free" transaction, the payment of transaction expenses or tax indemnities. Also, using a specified dollar amount (rather than a formulaic definition) to set the baseline amount or "peg" to which the closing amount is compared may also decrease certain post-closing disputes. However, in doing so, a target must be especially vigilant to ensure that the underlying calculations are accurate. Regrettably, it is all too common that the target's insufficient attention to this process from the letter of intent stage leads to a failure of the transaction to close on the economic basis initially expected by the target or to a material post-closing downward purchase price adjustment.

It's More Than Just GAAP, Consistently Applied

Clarity with respect to the accounting principles and methodologies to be incorporated into the adjustment mechanism is also critical to ensuring that the parties have consistent expectations and thus to mitigating potential conflict. While most purchase price adjustment provisions provide that the target's balance sheet be prepared and that the purchase price adjustment be calculated in accordance with generally accepted accounting principles, this merely provides a good starting point, as the parties should keep in mind that GAAP may recognize multiple practices for the same balance sheet item. The target will want to ensure that the application of GAAP to the purchase price adjustment is consistent with the target's past practices, policies, methodologies, classifications, assumptions and procedures.

Even the consistent application of GAAP, however, can lead to disputes as the calculation of some items, such as reserves, is based on subjective judgments. So, it is important for the parties to specify the details of the target's GAAP policies — say, a specified percentage of reserves for doubtful accounts — and to provide for consistency between pre-closing and post-closing judgment calls. The parties also may wish to consider establishing specific parameters, such as thresholds, caps or collars, for certain balance sheet items that are especially subject to manipulation. The target should also carefully consider whether exceptions to GAAP exist in its historical financial statements, in which case those exceptions should be incorporated into the adjustment mechanism.

In properly addressing accounting procedures and methodologies, a well-crafted adjustment mechanism should go one step further and anticipate the possibility that such GAAP (or other agreed principles) and consistency requirements may conflict. The letter of intent and acquisition agreement should make clear which standard takes precedence if they conflict. While the target may be focused principally on an “apples-to-apples” adjustment designed to reflect changes in the business between the date of the historical balance sheet and the closing date balance sheet (in which case consistency is paramount), the buyer typically also is focused on ensuring that the target is delivered with a sufficient and expected level of working capital, with the risk of inadequacies in the target’s pre-closing financial statements being borne by the target (in which case GAAP compliance is paramount).

In formulating an adjustment mechanism, the parties should also consider whether anticipated changes in the business through closing should be addressed. While these mechanisms typically adjust for changes between the date of the most recent balance sheet prior to signing and the closing date balance sheet, if seasonality, rapid growth, compensation accruals or other factors suggest that the anticipated working capital needs of the business will change markedly between these dates, then such changes may need to be reflected in the adjustment mechanism. Providing detail in the letter of intent on this topic, rather than seeking to negotiate an appropriate level of “normalized” working capital thereafter, will avoid pre-signing tensions over amounts that can be quite material.

Interplay Between Indemnification and Purchase Price Adjustment

The parties also should pay careful attention to the interplay between the purchase price adjustment and indemnification provisions of the acquisition agreement. One important concern for the target is the potential for double recovery by the buyer in the event that an item, such as a breach of a litigation or financial statement representation or a special tax or other indemnification provision, gives rise to both a purchase price adjustment claim and an indemnification claim. The distinction also is important because in most cases indemnification claims will be subject to negotiated limitations, while purchase price adjustment claims are typically not so limited. Additionally, agreements usually provide that purchase price adjustment claims will be subject to a speedy arbitration process, while indemnification claims must be brought through litigation.

Defining Procedures

After these substantive issues have been addressed, careful attention to procedural matters is also necessary to minimize the chances of post-closing disputes. While virtually all of these mechanisms authorize an independent accountant to arbitrate any purchase price adjustment dispute, they also should delineate clearly the scope and procedures to be followed by the independent accountant. These mechanisms also should be drafted to encourage reasonable behavior by the parties. Best practices include ensuring that the purview of the independent accountant's review is broad enough to encompass the entirety of matters related to the adjustment; limiting the review to matters raised by the parties; limiting the determination to amounts between those the parties advocate for; using "baseball arbitration"; requiring that the parties cooperate and provide information to one another; requiring the payment of all fees by the losing party or by the party whose estimate is furthest from the final adjustment amount; ensuring that any exclusive remedies and venue provisions in the agreement carve out the arbitration provisions; and providing for consequences for the failure to comply on time with deadlines.

The implementation of these best practices early in the negotiation adds value and certainty to an aspect of the sale process that is ripe for disputes. When the parties focus on these issues early, they are more likely to understand and address the key items that if overlooked may frustrate negotiations or lead to a transaction failing to close (at the price initially expected) after exclusivity has been granted and substantial time and expense have been incurred. Careful attention to detail in the negotiation and drafting of purchase price adjustments increases the likelihood that the parties have common expectations from the outset and decreases the likelihood of post-closing disputes over matters that otherwise could have been avoided.

[This article was originally published on *The Deal Pipeline* on March 18, 2013.]

This Akerman Practice Update is intended to inform firm clients and friends about legal developments, including recent decisions of various courts and administrative bodies. Nothing in this Practice Update should be construed as legal advice or a legal opinion, and readers should not act upon the information contained in this Practice Update without seeking the advice of legal counsel. Prior results do not guarantee a similar outcome.