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The Well-Adjusted Purchase Price Adjustment

While the appeal of purchase price adjustments is indisputable, they are often subject to postclosing disputes. One of the drivers of these disputes is inattention to the details of drafting the adjustment provisions, often exacerbated by the fact that these clauses straddle the realm controlled by the legal practitioners and that managed by the financial and accounting experts.

A significant majority of purchase agreements involving a private target contain one or more post-closing purchase price adjustments. In valuing an acquisition target, buyers typically will focus on historical and projected income statement items while assuming a "normalized" or fixed balance sheet. The purchase price agreed at signing will reflect these assumptions, and a true-up mechanism is often required to ensure that these assumptions in fact match the reality at closing. For example, a working capital adjustment (the most common post-closing price adjustment and therefore the focus of this M&A Update) is used to compensate the relevant party for growth or decline in working capital as measured at closing relative to an agreed baseline balance. Without such an adjustment, an increase in the working capital balance between signing and closing could result in a windfall to the buyer, while a decrease in the balance might result in the buyer having to invest additional funds in the target, thereby increasing the dollar cost of the deal. While the utility and appeal of purchase price adjustments, particularly when two-way, is indisputable, our experience is that post-closing disagreements over such adjustments are all too common. While the ubiquity of these disputes is largely attributable to the fact that one or the other party is being asked to fork over cash so soon after closing, we believe that one of the key drivers of the depth, breadth and duration of these disputes is inadvertent inattention to the details of drafting the adjustment provisions, often exacerbated by the fact that these clauses uncomfortably straddle the realm controlled by the legal practitioners and that managed by the financial and accounting experts. Below we briefly explore a handful of issues that, if properly addressed, may reduce the potential for, or at least the scope of, post-closing disputes.

Properly Defining Working Capital. A very basic definition of "net working capital," and a default that is often used in purchase price adjustments, is current assets *minus* current liabilities. While the appeal of such a simple measure is obvious, in practice it will often be fertile ground for post-closing disagreement. For example, using such a broad definition may draw

into the adjustment certain current asset or liability balances that are already otherwise addressed in the purchase agreement, potentially resulting in a party being "dinged" twice for the same item—examples include cash or debt (which may be the subject of a separate purchase price adjustment if the acquisition is structured on a "cash-free, debt-free" basis), income tax assets or liabilities (which often are allocated to the parties on a pre-closing/post-closing basis), and litigation or other reserves (the liability for which is often addressed in the general indemnification). A 2007 Federal court decision in 20 Atlantic Avenue Corp. highlights these perils—the buyer successfully argued that an increase in the current portion of long-term debt should be included as a debit on the closing working capital adjustment notwithstanding the fact that the buyer benefited from a separate debt-based purchase price adjustment that took account of the full balance of such debt (current or otherwise). As such, parties should strongly consider foregoing the generic working capital definition in favor of a deal-specific express listing of the line items that will be included in the working capital measure. Attaching a sample calculation as a schedule to the agreement is another further means of narrowing the risk of misunderstanding.

Setting the Baseline. Parties sometimes overlook the fact that the typical working capital adjustment is not a dollar-for-dollar payment for the amount of net working capital at closing, but rather a payment based on the delta between the net working capital balance at closing and a predetermined baseline amount. A separate dollar-for-dollar adjustment (or a pay-off/dividend out covenant) must be used if the parties are seeking adjustments to account for a cash-free and/or debt-free purchase price. Within the working capital adjustment itself, parties need to exercise the same degree of care as described in the prior paragraph in identifying the line items to be included in fixing the working capital target if the goal is an "apples-to-apples" comparison of the actual closing balance to the target balance. If the target is heedlessly derived from the net working capital balance on the balance sheet on which the buyer was asked to bid, the comparison of that target to the

actual closing balance may be distorted by including changes resulting not from business-related fluctuations (that the parties intend to compensate for), but rather from the specific structure of the deal at hand. As a basic example, if tax accruals or debt or cash balances are excluded from the closing working capital balance for reasons described in the prior paragraph, care may need to be taken to ensure that the integrity of the comparison is preserved by perhaps excluding those entries in calculating the dollar amount of the working capital target. In addition, determining the proper source for the baseline target may not be as simple as using the bidding balance sheet. In some cases, certain working capital items (e.g., compensation accruals) may not be conducive to a snapshot comparison because they fluctuate significantly over the course of a year-in such cases, the timing of setting the benchmark and the timing of closing may result in unintended distortions to the purchase price adjustment that incorporates the difference in those balances as of those two random dates. In such cases, as an alternative to excluding those line items, it may be appropriate to use a normalized working capital baseline amount for the relevant line items. Finally, using a specified dollar amount as the target, as compared to a formulaic expression of the target balance (e.g., "net working capital on the June 30 balance sheet"), may be advisable as a means of narrowing the risk and scope of post-closing disputes by limiting the range of potential disagreement to one (the closing) rather than two different working capital calculations.

Accounting Principles and Methods. In articulating the adjustment mechanics, parties will often default to GAAP, naively assuming that it represents objective principles to be used for calculating the closing net working capital balance. However, experienced practitioners will know that in many cases GAAP provides little certainty insofar as it recognizes multiple acceptable bases for accounting for the same item. For example, parties that used a GAAP-based standard have litigated whether a buyer violated that requirement by applying a LIFO method to value inventory in calculating the closing balance as compared to seller's prior use of the FIFO method, as both such methods are recognized as valid under GAAP. While some of these uncertainties can be addressed by qualifying the basic GAAP standard with a reference to "consistently applied with the historical financial statements" (and therefore presumably the baseline target calculation), even this qualified standard leaves room for disagreements around such issues as appropriate levels of litigation or environmental reserves or new issues that arise between signing and closing as to which historical practice offers no guidance. Again, parties may want to consider the benefits of a detailed explication of relevant methodologies and principles, with particular attention to "hot-button" items for the target in question, as an alternative or a supplement to a GAAP standard, along with a statement of hierarchy if multiple standards could apply.

Interaction with Indemnification. The interaction of the working capital adjustment with the broader postclosing indemnification for breaches of seller representations and warranties also merits attention. Post-closing disputes relating to financial statement issues may very well implicate elements of these two disparate "adjustment" mechanisms. For example, in OSI Systems a Delaware court held that a buyer's claim for a very large purchase price adjustment, rooted in large part in an assertion that the baseline target was improperly calculated in accordance with GAAP, should instead be brought as an indemnification claim as to the accuracy of the seller's representation on GAAP compliance of its financial statements. The practical significance of such a distinction can be meaningful—an indemnification claim may be subject to negotiated baskets and caps and will not qualify for the fast-track arbitration resolution that is typical for purchase price adjustment disputes. While much will turn on the actual words of the specific agreement, courts have shown a propensity to treat a purchase price adjustment as an appropriate forum for resolving a limited range of disagreements over measuring the delta between the target and closing balances and resist attempts to use the adjustment mechanism to address wider arguments over financial statement accuracy or integrity (especially where such matters are expressly covered in the representations and warranties). Potential for "double dipping" or an item "falling through the cracks" is another concern resulting from the overlap between a working capital adjustment and indemnification. Courts have sometimes allowed a buyer arguably to be compensated twice for the same loss where a purchase agreement provides a specific indemnification for certain losses (e.g., a specific litigation or bonus and retention payments) without also carving reserves or accruals addressing those same "losses" out of the liabilities incorporated into the working capital adjustment. Equally, an agreement formulation that broadly excludes from indemnification

any item taken into account in calculating the closing working capital adjustment could shortchange a buyer because of the different basic goals of the two mechanisms—while indemnification seeks to compensate the buyer for the absolute amount of the loss, as discussed above the purchase price adjustment only addresses the difference in the balance related to such loss between the target and closing measurements.

Post-closing purchase price adjustments are an important tool in ensuring that the assumptions used in the valuation process to determine the purchase price remain valid for the actual financial status of the target delivered to the buyer at a closing that can occur many months later. Crafting these provisions requires no less attention and precision than applied by the parties to the valuation process because of the potentially significant (and often unexpected) financial consequences.

If you have any questions about the matters addressed in this M&A Update, please contact the following Kirkland authors or your regular Kirkland contact.

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