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Trends in M&A Provisions: Purchase Price Adjustment Provisions

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In mergers and acquisitions ("M&A") transactions, the definitive purchase agreement (whether asset purchase agreement, stock purchase agreement, or merger agreement) typically contains provisions for post-closing purchase price adjustments. [ii] Most commonly, and broadly speaking, these adjustments are intended to reconcile changes in specific aspects of the target's financial condition as of the transaction's closing (usually measured against a prior date or against "representative" or average historical financial metrics). This article examines trends relating to the use of purchase price adjustments in private company M&A transactions. [iii]

General Overview

Purchase price adjustment provisions are designed to reflect changes in the target's financial condition that occur prior to the closing of the transaction. For example, if on January 1, a transaction is valued, or priced, at $10,000,000 when the target has inventory worth $100,000, and if, when the transaction closes (all other financial metrics being equal), the seller delivers the target with $500,000 of inventory, the seller will expect to be paid (often dollar-for-dollar) for the additional $400,000 of added, measurable value. Alternatively, if at closing the target's inventory is valued at $50,000, the buyer would expect a $50,000 reduction in the purchase price due to the depleted inventory value. Because purchase price adjustment provisions are intended to put the parties on an equal footing, as of the closing date, these provisions are not normally viewed as benefitting or favoring the buyer or seller. Instead, they are considered neutral as between the parties.

Once the parties to the transaction have agreed upon a purchase price (often subject to the buyer's satisfactory completion of its due diligence or other conditions), the lawyers are often asked to memorialize three aspects regarding the purchase price: (1) the particular financial metric to be used for purchase price adjustment purposes; (2) the benchmark amount of that metric against which the corresponding closing amount is to be measured; and (3) the specific procedures pursuant to which the adjustment is to be determined (before and/or after closing).

Common Financial Metrics Used in Purchase Price Adjustments

Purchase price adjustment provisions can be based on any number of financial metrics, though most frequently these provisions are tied to changes in working capital. Working capital is typically determined under generally accepted accounting principles (commonly referred to as "GAAP") as the excess of the target's current assets (cash, inventory, and accounts receivable) over the target's current liabilities (ordinary course payables and other short-term obligations payable within one year). Because working capital is the most common metric used for purchase price adjustments, this article focuses on provisions using working capital as the adjustment metric.

A purchase price adjustment provision utilizing working capital may read:

The Purchase Price shall be adjusted dollar-for-dollar: (a) upward by the amount (if any) by which Working Capital as of the opening of business on the Closing Date shown on the Closing Statement (the "Closing Working Capital") is greater than Target Working Capital; or (b) downward by the amount (if any) by which Closing Working Capital is less than Target Working Capital.

Establishing the Benchmark Amount

In the example above, the benchmark amount of working capital is referred to as the Target Working Capital, which is often a set amount that the parties agree to during negotiations. However, getting the parties to agree on the benchmark is not always easy. For example, the parties may attempt to determine the benchmark working capital amount as of the date that the transaction was "priced." But, this is often easier said than done, as it is not often clear when the buyer priced the transaction or when exactly the parties agreed on the price. Was it when the letter of intent was signed, when the buyer completed its initial financial due diligence, or some other time?

In addition to timing difficulties, in many business sectors, the target's working capital may fluctuate seasonally or otherwise. As a result, the selection of a certain date from which to calculate the benchmark working capital may be far from perfect. Therefore, the parties may seek to determine a "representative" level (i.e., an average working capital calculated across an agreed upon time frame) of working capital as the benchmark to address any seasonal or other fluctuations.

Purchase Price Adjustment Procedures

If the parties agree to utilize a purchase price adjustment, then the procedures for the adjustment often follow the following parameters:

(1) **Timing of Adjustment**. Because it takes time to determine, with any meaningful degree of precision, the target's working capital as of the closing date, most purchase price adjustments occur after closing. However, if the parties believe at or prior to closing that the target's working capital is likely to be materially different (whether up or down) than the benchmark, they may agree to a purchase price adjustment calculated at closing based on the parties' best estimates of the target's closing working capital. The parties would then complete a second post-closing adjustment using the closing adjustment as a benchmark. For example, if the purchase price is $100 and the original target (benchmark) working capital level is $10, and the parties agree prior

to closing that the closing working capital level is likely to be closer to $25, rather than do the entire adjustment post-closing, they may decide to: (i) adjust the purchase price payable at closing to $115 to reflect the likely additional $15 of working capital ($25-$10), and (ii) conduct a post-closing adjustment using $25 as the new benchmark for working capital.

(2) **Submission of Closing Working Capital Calculation**. Following the closing, either the buyer or the seller has a set period of time to submit a calculation of closing working capital to the other party, along with the submitting party's calculation of the resulting adjustment to the purchase price.

(3) **Procedures for Disputing a Submitted Calculation**. The party receiving the calculation is typically given the opportunity, within a specified timeframe, to dispute the working capital calculation. Most purchase agreements provide that if a dispute is not sent to the submitting party within the specified timeframe, the submitting party's calculations are deemed accepted.

(4) **Procedures for Handling a Dispute**. If there is a dispute, often the purchase agreement requires the parties to first attempt to resolve their disagreements amongst themselves within a specified time period. Any disputes that cannot be resolved within the specified time period are typically sent to a third party in a non-judicial setting (e.g., a nationally recognized accounting firm or other professional expert with knowledge of the relevant industry). The parties may agree upon and identify the third-party arbitrator in the purchase agreement, or the purchase agreement may set forth the procedures for selecting an arbitrator (or arbitrators, as there may be more than one).

Trends in Purchase Price Adjustment Provisions

Every other year since 2005 the American Bar Association ("ABA") has released its Private Target Mergers and Acquisitions Deal Point Studies (the "ABA studies"). The ABA studies examine purchase agreements of publicly available transactions involving private companies that occurred in the year prior to each study (and in the case of the 2017 study, including the first half of 2017). These transactions range in size but are generally considered as within the "middle market" for M&A transactions; the average transaction value within the 2017 study was $176.3 million.

According to the ABA studies:

(1) **Use of Purchase Price Adjustments**. Purchase price adjustments continue to be commonplace in M&A agreements. In the 2017 ABA study, they were included in 86% of reported deals. This was unchanged from 86% in 2015, and up from previous studies – 85% (2013), 82% (2011), 79% (2009), and 68% (2007). [iv]

(2) **Adjustment Metrics**. Working capital is the most common purchase price adjustment metric, included in 89% of deals from 2017 study. With the exception of the 69% reported in the 2007 ABA study, working capital has been used as an adjustment metric in more than 75% of the reported deals in each ABA study – 83% (2015), 91% (2013), 79% (2011), and 77% (2009).

(3) **Preparation of Initial Adjustment Calculation**. According to the ABA studies, the buyer typically prepares the initial post-closing purchase price adjustment calculation, including preparing 95% of the initial calculations for the reported deals in the 2017 study.

(4) ***Pre-Closing True-Up***. At least 85% of the reported deals in the ABA studies conducted since 2011 have included an estimated purchase price adjustment true-up at closing, including 86% in 2017, 89% in 2015, 88% in 2013, and 85% in 2011.

(5) **Buyer Right to Approve Estimated Adjustment**. Increasingly, there is no express buyer right to approve the closing estimated adjustment. In the 2017 ABA study, 84% of the deals had no such express right, compared with 84%, 74%, 68%, 59% and 66% in the previous five studies.

Conclusion

Many provisions in an M&A purchase agreement reflect an allocation of risk between the seller and buyer, including provisions relating to financial matters, compliance with laws, labor and employment, employee benefits, contracts, operations in the ordinary course of business, title, and sufficiency of operating assets. The buyer and seller may have different views on their respective risk tolerance (for example, the seller of a service company with no owned real estate and no manufacturing may have a relatively relaxed view about allocation of environmental risk), and, as a result, some of these matters may be negotiated in favor of one party or the other. However, purchase price adjustments are considered to be neutral between the parties. These provisions are linked (often dollar-for-dollar) to the purchase price, in amounts which should be readily calculable, and determinable shortly after closing. The adjustment provisions, while usually quite straightforward, are nonetheless important to ensure that the parties receive the economic results they bargained for.

[i] Daniel Avery is a Director, and Gregory Kaden is a Director, in the Business Law Group at Goulston & Storrs, in Boston, Massachusetts. Mr. Avery is a member of the ABA's working group which published the 2015 ABA private company M&A deal points study. This article is based on, and updates, the article of the same name co-authored by Mr. Avery and Mr. Kaden, published in the Bloomberg Mergers & Acquisitions Law Report, 17 MALR 753 (2014). This article is one of a series of over 20 articles co-authored by Mr. Avery looking at trends in private company M&A deal points. The series is currently being updated to reflect the 2017 ABA private company study and will be published throughout 2018. The articles can be found on Goulston & Storrs' "What's Market" web page at https://www.goulstonstorrs.com/whats-market/ and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

[ii] Note that within this article we use the terms "seller" and "target" in the context of a stock purchase transaction—the "seller" would be the selling shareholder(s) making the representations and warranties in the M&A documents, and the "target" would be the company being acquired. In an asset purchase transaction, the "seller" would be the target company itself but for consistency we are using "seller" and "target" in a stock purchase setting.

[iii] This article looks at the usage of purchase price adjustments in private company M&A transactions as reflected in the ABA's Private Target Deal Points Studies. It does not cover purchase price adjustments in other types of transactions or in public-to-public M&A transactions.

[iv] The 2005 ABA study did not look at purchase price adjustments, so only the prior five studies are included.