

Trends in M&A Transactions: Separate Escrows for Purchase Price Adjustments

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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.^[2] Generally, these adjustments are intended to reconcile changes in 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). In many M&A agreements with a purchase price adjustment, the parties agree to escrow a portion of the purchase price for a limited period following the closing. This article examines trends relating to the use of separate escrows for purchase price adjustments in private company M&A transactions.^[3]

Purchase Price Adjustment Provisions

Purchase price adjustments are designed to ensure that the parties receive the full benefit of the bargain that was agreed to at signing. 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 adjustments are intended to put the parties on an equal footing, as of the closing date, these provisions are not normally viewed as favoring the buyer or seller.

Once the parties have agreed upon a purchase price (often subject to the buyer's satisfactory completion of its due diligence or other conditions) and to include a purchase price adjustment, the lawyers are often asked to memorialize three aspects regarding the purchase price adjustment: (1) the particular financial metrics to be used; (2) setting the benchmark amount against which the corresponding closing amount is to be measured; and (3) the specific procedures for calculating the adjustment (before and/or after closing).^[4]

In addition to these aspects, buyers and sellers are increasingly considering establishing a separate escrow to secure payments due as a result of a purchase price adjustment.

M&A Escrows

In most M&A transactions, a portion of the purchase price otherwise payable to the seller is placed into escrow, for a defined period of time, to secure one or more obligations of the seller to the buyer following closing. Escrows are typically set up as security for the seller's general indemnity obligations regarding its representations and warranties, but they need not be limited to those obligations. The parties may agree to establish a single escrow to secure all potential claims, or establish multiple, separate escrows with each providing recourse for different seller obligations. For example, if the buyer discovers something in diligence that warrants negotiation of enhanced rights and remedies, it may also negotiate for a separate escrow, apart from the standard "general indemnity escrow," to ensure funds are available if any of the enhanced remedies are triggered.

A seller's potential obligation to make payments to the buyer as a result of a post-closing purchase price adjustment could, like any other seller obligation, be the subject of a separate escrow. However, historically separate escrows for purchase price adjustments have not been widely used. The relative scarcity of such escrows is likely the result of differences in risk assessment as between the applicable seller obligations. Typically, a post-closing purchase price adjustment is determined quickly after closing (within 6 months), whereas a seller's general indemnity obligation may last much longer. Perhaps even more important is buyers and sellers usually have (or at least desire to have), at closing, a reasonable understanding of the likely financial parameters for a post-closing adjustment, particularly if the adjustment is based on fundamental financial measures (e.g., working capital). This allows the parties to implement part of the expected adjustment at or prior to closing, thereby reducing the risk that either party will owe the other an unexpected material amount following the closing.

However, despite the historical scarcity, over the past 10 years it has become more common to include separate purchase price adjustment escrows in private company M&A deals.

Trends as to Purchase Price Adjustment Escrows

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.

The ABA studies show that the use of separate escrows for purchase price adjustments has been increasing. While not the majority approach, in the 2017 study, 45% of the reported deals^[HA2] included a separate purchase price adjustment escrow. Ten years earlier, less than a quarter of reported deals included a separate purchase price adjustment escrow.

Conclusion

Many provisions in an M&A purchase agreement reflect an allocation of risk between the seller and buyer (e.g., those relating to financial matters, compliance with laws or labor and employment) that taken together reflect a compromise of the parties' different perspectives. In contrast, 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 that should be determinable shortly after closing. The adjustment provisions, while usually straightforward, are nonetheless important to ensure that the parties receive the economic results bargained for, and therefore may be the subject of a separate escrow. Separate escrows for purchase price adjustments are increasingly being seen in private M&A deals, and counsel for buyers and sellers should be prepared to address these escrows as they become more common.

[1] Daniel Avery is a Director at Goulston & Storrs, in Boston, Massachusetts. Mr. Avery is a member of the ABA's working group which published the 2017 ABA private company M&A deal points study. 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 <http://www.goulstonstorrs.com/WhatsMarket> and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

[2] 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.

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

[4] An earlier article in this series looked at deal trends regarding the types of purchase price adjustments. See Daniel Avery & Gregory Kaden, [*Trends in M&A Provisions: Purchase Price Adjustment Provisions*](#), Bloomberg Law, Feb. 2018, reprinted at <http://www.goulstonstorrs.com/WhatsMarket> and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

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