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2008 Survey of Private Company Purchase Price Agreements

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Private company purchase agreements customarily include a purchase price adjustment in the calculation of the purchase price. While commonalities exist among most purchase price adjustments, practitioners regularly use a broad range of different methodologies and approaches when drafting them. In an effort to ascertain current market practice, we surveyed 87 private company purchase agreements that were publicly filed in 2008 and contained purchase price adjustments (the "2008 Agreements"). The following analysis sets forth certain key findings of our 2008 Survey.

Working Capital v. Net Assets

Practitioners generally base purchase price adjustments on one of two balance sheet metrics: (1) working capital or (2) net assets. The working capital test compares a company's current assets to its current liabilities. Generally accepted accounting principles (GAAP) define (i) "current liabilities" as liabilities that will be discharged by use of current assets or the creation of additional current liabilities within one year and (ii) "current assets" as assets that will be realized in cash, sold, or consumed within one year. The net asset test compares total assets to total liabilities. The 2008 Agreements revealed a strong preference among practitioners for the working capital test. A number of perceived advantages of working capital likely contribute to this preference. For example, many believe that working capital's focus on current assets and current liabilities better gauges a target company's operating requirements and therefore better ensures delivery of the target company with the appropriate balance sheet.[1] Practitioners might also choose to exclude long-term assets because their recorded values often reflect accounting conventions more than economic realities.

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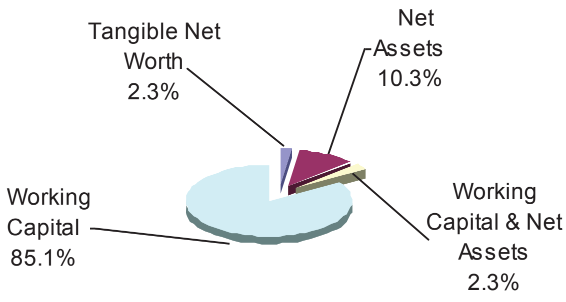
TYPES OF PURCHASE PRICE ADJUSTMENTS*



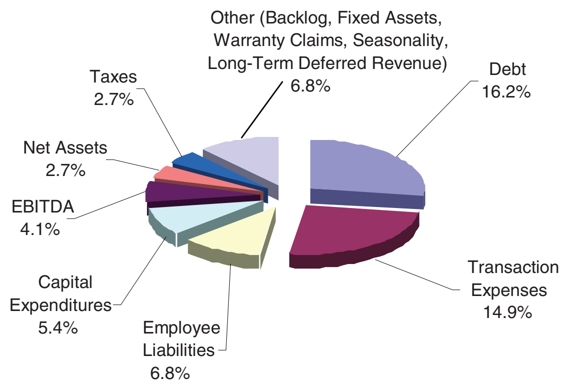
* Numbers represent the percentage of 2008 Agreements using the indicated type of purchase price adjustment.

Though clearly less popular than working capital adjustments, net asset adjustments remain part of the M&A landscape, and can be particularly useful where a target company has long-term assets essential to its profitability or the economics of the transaction.

Breakdown of Working Capital

Roughly half (52.7%) of the 2008 Agreements defined working capital as current assets minus current liabilities, while the remainder (47.3%) enumerated the balance sheet components included in the calculation.[2] Catchall phrases like current assets and current liabilities are expedient and easy to use, but can increase the likelihood of post-closing disputes over the exact balance sheet items included in the working capital calculation. We conducted a survey of 56 reported cases involving purchase price adjustment disputes and found that in 14.3% of the cases the parties' underlying disputes related to whether items should be included or excluded from general GAAP terms such as current assets, current liabilities or nets assets. For instance, current liabilities can draw in items more often associated with indemnification claims than purchase price adjustments, such as obligations falling due within a year for litigation, environmental remediation or off balance sheet liabilities. Of the agreements that defined working capital as current assets minus current liabilities, 77% carved out specific balance sheet items from the calculation. When parties chose to enumerate the assets and liabilities included in, or excluded from, working capital, they typically did so using GAAP terms such as accounts receivable, deferred revenue, prepaid expenses, accounts payable, etc. This reflects a trend toward specificity, although many of the 2008 Agreements retained some of the catchall provisions of the working capital definition. We believe the trend toward enumerating the balance sheet components included in working capital adjustments will continue because of the uncertainties associated with GAAP definitions, which undermine certainty of outcome with respect to the purchase price adjustment.

ITEMS ADDED TO WORKING CAPITAL*



* Numbers indicate the percentage of 2008 Agreements with working capital adjustments that added the indicated item to working capital. Because only 59.6% of the 2008 Agreements with working capital adjustments added any items to working capital, the percentages above total 59.6% rather than 100%.

Additions to Working Capital

More than half (59.6%) of the 74 agreements with working capital adjustments added components to the calculation beyond those included in GAAP's definition of working capital. Some of the more common additions are discussed below.

Debt (16.2%)

In most (71.3%) of 2008 Agreements the cash purchase price (or other consideration) paid to the seller at closing was reduced by the target company's estimated outstanding debt. To true-up inaccuracies in their pre-closing debt estimates, 16.2% of the agreements readjusted the purchase price for debt after closing. All but one of these agreements used a separate purchase price adjustment for debt, while the remaining agreement merely added debt to the working capital adjustment.

Transaction Expenses (14.9%)

Private company purchase agreements typically require the seller to pay the target company's transaction expenses as well as its own. This is usually accomplished through covenants, but in 14.9% of the 2008 Agreements the parties provided for a true up mechanism by specifically adding transaction expenses to working capital. Presumably, the true up enables the buyer to capture any transaction expenses that were not paid or invoiced at closing, but remain obligations of the target company. Interestingly, only 63.6% of the 2008 Agreements that added transaction expenses to working capital specifically excluded those paid by the seller on the closing date or thereafter. In the remaining agreements a GAAP liability could presumably remain on the closing date balance sheet for transaction expenses paid by the seller.

Employee Liabilities (6.8%)

Although many employee liabilities fall within the GAAP definition of working capital, those attributable to pension, deferred compensation and similar obligations are often long-term and do not. Buyers may insist on including these obligations in working capital when they cannot be accurately quantified, or are subject to significant change, prior to closing.

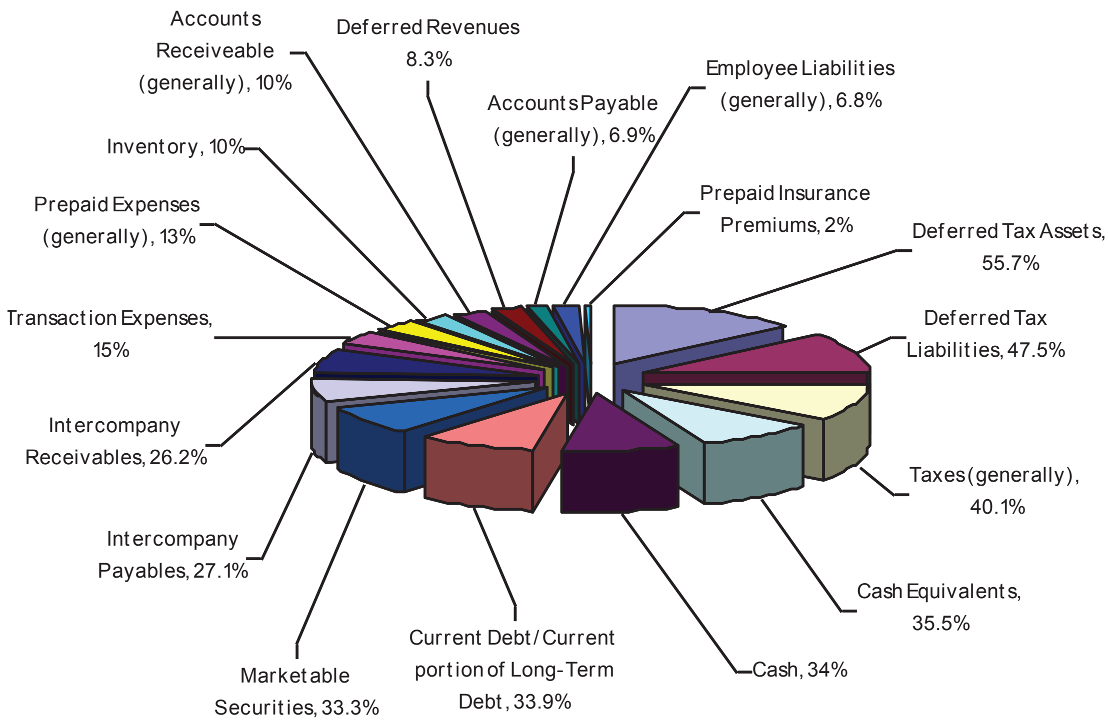
Capital Expenditures (5.4%)

We were surprised to see that capital expenditures were not part of a greater number of purchase price adjustments involving working capital. As capital expenditures are typically financed by working capital (spending cash or incurring trade payables) or incurring debt (borrowed money or capital leases), they represent potential change to a purchase price with a working capital and/or debt adjustment. In a net asset test, the long-term 'capitalized' asset created by these financing activities offsets the corresponding reduction in short-term assets (*i.e.* cash) or increase in liabilities (*i.e.* trade payables or debt). As a result, sellers would normally be incentivized to increase working capital by reducing ordinary course capital expenditures or avoiding incurrence of debt for capital expenditures immediately prior to closing. Invariably there is a pre-closing covenant regarding capital expenditures, but the covenant is usually not precise enough to capture all the economics. Consequently, adding capital expenditures to a working capital adjustment eliminates the seller's incentive to reduce capital expenditures prior to closing.

EBITDA (4.1%)

Earnings before interest, taxes, depreciation and amortization ("EBITDA") is a commonly used measurement of a target company's operational profitability. Since many private company acquisitions are priced based on a multiple of the target company's EBITDA, it is not surprising that parties sometimes adjust the purchase price based on inaccuracies in their EBITDA projections. Earn-out provisions accomplish this by adjusting the purchase price upward upon the target company's achievement of EBITDA targets for post-closing periods. Several of the 2008 Agreements instead adjusted the purchase price up or down for inaccuracies in the parties' estimates of EBITDA for the pre-closing period. In each of these agreements the adjustment was based on a multiple of the difference between estimated and actual EBITDA, ranging from five to 12 to times, presumably corresponding to the originally negotiated purchase price.

ITEMS REMOVED FROM WORKING CAPITAL*



* Numbers indicate the percentage of 2008 Agreements with publicly available working capital definitions in which the indicated item was removed from the definition of working capital. Because approximately 4.05 items were removed from each such definition, the percentages above total approximately 405% rather than 100%

Exclusions from Working Capital

Parties to the 2008 Agreements excluded specific components from working capital in 85.1% of the agreements with working capital adjustments. On average, parties excluded four of the balance sheet components that generally comprise working capital under GAAP from each surveyed working capital adjustment. Some of the more common excluded items are discussed below.

Cash (34%)

Private company purchase agreements often allow the seller to sweep any cash owned by the target company at closing. These arrangements have led to disputes over whether the swept cash should be included in working capital as an asset of the target company.[3] While intuition and the case law suggest that swept cash should not be considered a target company asset, parties sometimes exclude cash from working capital entirely to eliminate the potential for confusion. For the seller, excluding cash can be dangerous since it will not be compensated through the purchase price adjustment for cash it fails to sweep at closing.[4] To avoid this potential pitfall, we would normally expect to include cash in working capital, but only net of amounts swept by the seller. Only one of the 2008 Agreements provided for such netting.

Deferred Tax Assets (55.7%)

Buyers often resist including deferred tax assets in working capital when the target company's ability to use them after closing is questionable. This is often the case in a leveraged acquisition because the increased interest expense may reduce or eliminate the target company's taxable income for the foreseeable future. The value of certain deferred taxes, such as net operating losses, is also greatly diminished by tax code limitations on their use following a change in ownership. Taxable income might also be diminished after closing if the buyer receives a stepped-up tax basis in the target company's assets as a result of a Section 338 election in the transaction.

Deferred Tax Liabilities (47.5%)

GAAP requires accrual of deferred tax liabilities when the tax basis of certain assets is lower than their recorded value for GAAP purposes. This typically results from accelerated depreciation schedules and other accounting conventions allowed under tax regulations but not under GAAP. These liabilities are expensed over time as a matter of accounting practice but do not require actual cash payments by the target company and are therefore often excluded from working capital adjustments. Their exclusion is especially important in asset sales or stock sales subject to a 338(h)(10) election because the buyer receives a stepped up tax basis in the target company's assets and the seller recognizes any deferred tax liabilities as income.[5]

Taxes (40.1%)

Parties often excluded taxes from working capital when the seller agreed to pay them to the extent attributable to pre-closing periods. Notably, five of the 24 2008 Agreements that excluded income taxes from working capital included property and/or payroll taxes. A working capital calculation that includes payroll and property taxes may better reflect the target company's operational liquidity since these taxes are assessed on instrumentalities necessary to produce revenue. In contrast, income taxes are assessed on a target company's pre-tax profits, which can be a product of the target company's capital structure.

Intercompany Receivables (26.2%) / Intercompany Payables (27.1%)

The purchase of a target company or business from a parent company is often net of intercompany receivables and payables.[6] The 2008 Survey found that in 60.5% of the acquisitions from parent/sellers the purchase agreement eliminated these intercompany debts prior to closing. It is therefore not surprising that parties frequently eliminated intercompany debt from their working capital adjustment as well. The most common scenario in which the parties did not eliminate intercompany debt occurred where the target company would continue to be a customer of the parent/seller (or vice versa) and the intercompany debt was an ongoing component of working capital.

Methodology

Setting the Benchmark

Regardless of the type of purchase price adjustment used, the vast majority (81.5%) of the 2008 Agreements used a numerical benchmark as the reference point for the calculation. The remaining 2008 Agreements referred to a prior balance sheet of the target company as the basis for the parties' benchmark. One of the 2008 Agreements used a numerical benchmark that grew larger as time elapsed between signing and closing. Use of a numerical benchmark can favor the buyer by creating greater certainty as to the balance sheet that will be delivered at closing since it should not fluctuate based on errors in any prior balance sheet of the target company. Where parties have based their benchmark on a prior balance sheet that failed to comply with GAAP, some courts have found that the parties intended merely to measure changes in working capital from the prior balance sheet date to the closing date rather than deliver the target company with a predetermined balance sheet (or working capital).[7] On the other hand, some courts have changed, or allowed arbitrators to change, benchmarks calculated from a prior balance sheet when entries on the pre-closing balance sheet failed to comply with GAAP.[8] These decisions were split as to which party benefited. Numerical benchmarks can also favor the seller if the buyer disputes entries on a pre-closing balance sheet because any resulting claims would clearly be indemnification claims subject to any applicable cap or deductible. As a result, it is increasingly common for parties to utilize a numerical benchmark for greater certainty of outcome.

One Way v. Two Way Adjustment

Most of the 2008 Agreements (81.6%) used a two-way adjustment in which the purchase price could be adjusted upward or downward based on the final calculations. In the remaining 18.4% of the 2008 Agreements, 15 of 16 had a one-way adjustment in which the purchase price could only be adjusted downward if working capital (or other metric) at closing was less than the target number, while the remaining agreement had a one-way upward adjustment.

Dollar for Dollar v. Cap, Floor or Collar

The vast majority of the 2008 Agreements (79.3%) allowed recovery of the purchase price adjustment on a dollar for dollar basis, while only 20.7% placed some type of limit on the adjustment. Of the 2008 Agreements that limited the adjustment, 22.2% placed a cap on the maximum amount recoverable, 77.8% placed a floor on the minimum amount before adjustment and no agreement used a collar (i.e. both a cap and a floor). Of the six 2008 Agreements that had a floor and two way pre-closing and post-closing adjustments, five had the floor apply to both the pre-closing adjustment and the post-closing adjustment, whereas in the remaining 2008 Agreement, the floor applied only to the post closing adjustment. On the whole, the floors averaged 6.15% of the base purchase price (though the agreements ranged from 0.13% to 30%), while the caps averaged 11.51% of the purchase price.

These findings are consistent with the philosophy that the purchase price adjustment should neither encourage nor discourage the seller from operating the business differently between signing and closing than it had prior to signing. While one can argue that a floor is designed to eliminate unnecessary haggling, it clearly favors the seller by creating the potential for additional purchase price.

Mechanics

Pre-closing and Post-closing Adjustment v. Post-closing Adjustment Only

A majority (52.3%) of the 2008 Agreements used both a pre-closing and post-closing purchase price adjustment, while the remainder used only a post-closing adjustment. The seller prepared the pre-closing calculations in 95% of the 2008 Agreements that had pre-closing adjustments, which is consistent with the fact that the seller would be in the best position to do so. Of such agreements, 14.6% provided that the purchase price could only go down, whereas in the remaining 85.4% the purchase price could be adjusted up or down prior to closing. Curiously, in the 2008 Agreements that allowed the seller to adjust the purchase price up or down, the buyer had the right to object to the seller's adjustment in only 16.1% of pre-closing adjustments, whereas all of the post-closing adjustments allowed for objections to the other party's calculation. We believe that allowing the seller to increase its purchase price prior to closing without input from the buyer will become the exception to market practice in the future. The more equitable approach is to have the seller make the pre-closing adjustment and only adjust the purchase price downward as determined by the seller. It was common practice (76.2%) in the 2008 Agreements for the buyer to prepare the final balance sheet calculations. This obviously facilitates the calculation since the buyer is in the best position to finalize and gather the data after closing.

Deadlines

The party delivering the post-closing calculations had a median time period of 60 days after closing to do so. Once the buyer or seller submitted the finalized calculations, the other party had a median time period of 30 days to object to them. The parties then had a median time period of 30 days to resolve their disputes before either party could engage the independent accountant (or other arbitrator). In 78.6% of the 2008 Agreements the independent accountant's engagement was mandatory after such time whereas in 21.4% the parties could continue attempts to resolve the objections until either party submitted the dispute to arbitration.

Dispute Mechanism

Independent Accountant v. Legal Arbitrator

Of the 2008 Agreements, 84 out of 87 selected an independent accountant to resolve disputes over the purchase price adjustment. Of these agreements, 51.2% pre-selected an accounting firm to serve if able while 48.8% provided that the parties would select a mutually acceptable accounting firm only after a dispute arose. The remaining three agreements referred the purchase price adjustment dispute to a legally trained arbitrator. This is consistent with prior surveys where practitioners prefer accounting experts to address purchase price disputes because they invariably involve complex issues under GAAP. What is surprising is that more buyers have not insisted on pre-selecting the independent accountant, as disputes over who will serve as the independent accountant can be lengthy and costly.

Common Procedural Rules

All of the 2008 Agreements required the independent accountant to consider only issues still disputed by the parties, while 23% required the independent accountant to base its decision solely on the parties' presentations and prohibited any independent review. None of the 2008 Agreements established comprehensive procedural rules, although one required the parties to submit all of their supporting information in a single binder and prohibited any further communication with the independent accountant except for jointly attended meetings requested by both parties or the independent accountant.

The Final Determination

The independent accountant had a median time period of 30 days after its engagement to render a final determination. In 33% of the 2008 Agreements, the parties required the independent accountant's final determination to be within the range of values proposed by the parties, while the remaining 67% of the agreements placed no limitation on the amount of the final determination.

Fees and Expenses

The 2008 Agreements generally allocated the independent accountant/arbiter's fees and expenses in one of three ways: (1) 38.5% of the agreements did so in proportion to the amount by which each party's respective calculation varied from the arbiter's final determination, (2) 39.8% split the arbiter's fees and expenses equally without regard to the relative accuracy of the parties' proposed calculations, and (3) in 21.7% of the agreements the party furthest from the independent accountant's determination paid the arbiter's fees and expenses entirely. We believe that that latter practice encourages parties to submit more reasonable positions to the arbiter and therefore may result in less use of an arbiter when the parties' positions are not too far apart.

Payment Issues

Interest

In 30% of the 2008 Agreements the parties provided for interest to accrue on payment of the purchase price adjustment. In all but one of these agreements interest accrued from the closing date of the transaction, while in the remaining agreement interest began to accrue on the date payment became due. Most of the interest rates (84.6%) were floating and based on WSJ Prime Rate, LIBOR, EURIBOR or STIBOR; the remaining 15.4% used a fixed rate ranging from 5%-7% per annum.

Escrow Accounts

In 28.7% of the 2008 Agreements a portion of the purchase price was held back in an escrow account to fund a potential downward purchase price adjustment. This data is difficult to interpret without meaningful information as to the financial strength of the seller or the degree of difficulty of collecting from multiple sellers.

Setoff

Of the ten 2008 Agreements that involved a seller note, eight provided for setoff of a downward purchase price adjustment against the seller note. A number of other agreements allowed the seller to setoff a purchase price increase against indemnification claims brought by the buyer, while one agreement allowed the buyer to setoff a purchase price decrease against amounts owed to the seller under a related supply agreement.

Conclusion

While most of the 2008 Agreements used working capital as the basis for their purchase price adjustment, parties defined working capital in many different ways to adapt to the particularities of the target company and transaction. This customization demonstrates an increasing sophistication in the drafting of the measurement criteria, which is designed to enhance certainty in the outcome of the purchase price adjustment. The 2008 Agreements also revealed trends in market practice towards use of numerical benchmarks rather than pre-closing balance sheets, and continued avoidance of caps and floors on recovery of the purchase price adjustment. We expect there will be further commonalities in the mechanics of the purchase price adjustment dispute mechanisms, but there will always be variations to reflect the diverse and complex nature of particular transactions.

NOTES

1. In 71.3% of the 2008 Agreements the purchase price was reduced for any target company debt outstanding at closing.
2. For purposes of comparison, none of the agreements with net asset adjustments enumerated the components included in the net asset calculation.
3. *See Perry v. Wolaver,* 506 F.3d 48 (1st Cir. 2007) (in which the parties disputed whether cash swept by the seller should be included in the working capital adjustment and the court held that it should not).
4. *See HDS Investment Holdings Inc. v. Home Depot, Inc.,* Civ. No. 3968-CC, 2008 WL 4606262 (Del. Ch. 2008) (in which the parties did not include cash in the working capital adjustment and the buyer was not compensated for cash it failed to sweep at closing).
5. *See Accel Int'l Corp. v. Lyndon Life Insur. Co.*, No. C2-98-486, 2002 WL 193697 (S.D.Ohio 2002) (in which the parties made a 338 election, but GAAP required that a $2,664,395 deferred tax liability remain on the closing date balance sheet).
6. *See Coty Inc. v. L'Oreal S.A.*, No. 07CV6206 (KMW), 2008 WL 331360 (S.D.N.Y. 2008) (in which the seller's elimination of an intercompany liability between signing and closing was not allowed to be included in the purchase price adjustment).
7. *See Westmoreland Coal Co. v. Entech, Inc.,* 100 N.Y.2d 352 (N.Y. 2003) (holding that the buyer's proposed purchase price adjustment, which was based on errors in the pre-closing balance sheet, could only be addressed as an indemnification claim because the purpose of the purchase price adjustment was merely to capture changes in working capital between signing and closing of the purchase agreement). *See also OSI Systems, Inc. v. Instrumentarium*, 892 A.2d 1086 (Del. Ch. 2006); *Melun Indus., Inc. v. Strange*, 898 F. Supp. 990 (S.D.N.Y. 1990).
8. *See Kim v. Transtar Metals, Inc.*, 284 A.D.2d 118 (N.Y. App. Div. 2001) (in which a downward adjustment to the pre-closing balance sheet benefitted the seller); *In re Rockwell Int'l Corp. v. BTR Dunlop, Inc.*, 192 A.D.2d 454 (N.Y. App. Div. 1993) (in which an upward adjustment to the pre-closing balance sheet benefitted the buyer).