To draft purchase price adjustments in M&A agreements, attorneys must understand both legal and accounting principles.

**MOST M&A AGREEMENTS** for private company acquisitions include a purchase price adjustment. According to the American Bar Association’s 2011 Private Target Mergers & Acquisitions Deal Points Study, 82 percent of private company acquisitions in 2010 included purchase price adjustments.

When a buyer values a target company, the buyer’s valuation is based on the target company’s financial condition on a specific date. Typically, many months pass between that date and the closing date when the buyer acquires the target company. Purchase price adjustments are negotiated to reflect changes in the target company’s financial condition between the initial valuation date and the closing date.

The most common type of purchase price adjustment is a working capital adjustment. The target company’s working capital accounts — current assets and current liabilities — always fluctuate. Working capital adjustments ensure that the seller is not motivated to decrease the target company’s working capital prior to the closing and shortchange the buyer. Working capital adjustments also ensure that the buyer does not receive a windfall if
working capital increases between the buyer’s initial valuation date and the closing date.

This article examines working capital adjustments in private company M&A agreements.

ADJUSTING THE PURCHASE PRICE • A working capital adjustment is intended to reflect changes in the target company’s working capital between the buyer’s initial valuation date and the closing date. The value of the target company’s working capital on the initial valuation date — often the date of the target company’s most recent monthly or quarterly balance sheet — is a known amount. That amount, which may be referred to as “initial working capital” or “benchmark working capital,” is agreed upon by the buyer and the seller and set forth in the purchase agreement.

After the buyer and the seller determine the benchmark working capital amount, the buyer and the seller must agree on the mechanics of the purchase price adjustment. The purchase price is typically subject to both upward and downward adjustment. In some acquisitions, however, the purchase price is subject to a “one-way” adjustment only. A one-way adjustment usually is a downward adjustment if the target company’s working capital drops below a specified minimum level on the closing date.

Depending on the respective risk tolerances of the parties, the purchase price adjustment may be a dollar-for-dollar adjustment or a “de minimis” adjustment. If the adjustment is a de minimis adjustment, the closing date working capital is allowed to vary by a pre-determined de minimis amount from the benchmark working capital before an adjustment is required. The adjustment amount also may be subject to a cap.

The amount of the target company’s working capital on the closing date is often referred to as the “closing date working capital.” Examples of purchase price adjustments are as follows:

Dollar-For-Dollar Adjustment
• Upward adjustment: If the closing date working capital is greater than the benchmark working capital, then the purchase price will be increased on a dollar-for-dollar basis to the extent that the closing date working capital is greater than the benchmark working capital.
• Downward adjustment: If the benchmark working capital is greater than the closing date working capital, then the purchase price will be decreased on a dollar-for-dollar basis to the extent that the benchmark working capital is greater than the closing date working capital.

De Minimis Adjustment
• Upward adjustment: If the closing date working capital exceeds the benchmark working capital by more than $100,000, then the purchase price will be adjusted. The amount of the adjustment will be equal to: (i) the closing date working capital minus (ii) the benchmark working capital plus $100,000.
• Downward adjustment: If the benchmark working capital exceeds the closing date working capital by more than $100,000, then the purchase price will be adjusted. The amount of the adjustment will be equal to: (i) the benchmark working capital minus (ii) the closing date working capital plus $100,000.

Capped Adjustment
• The agreement may state that “the purchase price adjustment pursuant to this section x will be subject to a cap of $1,000,000.”

Adjustment May Include Interest
When the purchase price is adjusted after the closing, the adjustment payment is not made until after the closing date working capital is finally determined. Because there is a gap between the closing date and payment of the adjustment amount,
the buyer and the seller may agree that the adjustment amount will be paid with interest.

If the adjustment amount is to be paid with interest, the purchase agreement should provide that interest will accrue from the closing date to the payment date at a specified interest rate. When a portion of the purchase price is paid by the buyer pursuant to a promissory note delivered at the closing, the interest rate set forth in the promissory note may be an appropriate interest rate to apply to the adjustment amount. Otherwise, the buyer and the seller need to agree upon an interest rate.

Purchase price adjustments are often disputed after the closing. If the buyer and the seller dispute the amount of the working capital adjustment after the closing, there may be a significant time gap between the closing date and payment of the adjustment amount. In that situation, interest on the adjustment amount can be valuable to the party that ultimately receives the payment.

DEFINING WORKING CAPITAL • Working capital must be precisely defined. The definition of working capital must specify the working capital accounts and items to be included in the adjustment.

Working capital is defined most often as accounts receivable (net of reserves) plus inventory plus prepaid expenses minus accounts payable and accrued liabilities. If a transaction is structured as a stock acquisition, working capital usually also includes cash and cash equivalents. The working capital accounts included in the adjustment, however, are specific to the target company.

Attorneys who draft working capital adjustments must understand the target company’s balance sheet, its working capital accounts, and the accounting methodologies used to determine the value of those working capital accounts. Any ambiguity with respect to the working capital accounts included in the adjustment or the accounting methodologies used to value those working capital accounts can result in significant financial consequences to the buyer and the seller. For that reason, attorneys should work closely with their client’s financial officers, accountants, and financial advisers when drafting a working capital adjustment provision.

Assets Included In Working Capital

The target company’s balance sheet is the starting point for determining the current asset accounts to be included in working capital. Current assets typically include cash and cash equivalents, accounts receivable, inventory, and prepaid expenses. Depending on the nature of the target company’s business, however, current assets may include other accounts.

It is not necessary for all of the current asset accounts set forth on the target company’s balance sheet to be included in the working capital adjustment. The buyer and the seller should determine the current asset accounts to be included in working capital. For example, intercompany receivables typically are excluded from working capital. The accounts included in the working capital adjustment should correspond to the accounts used to calculate benchmark working capital.

If the transaction is structured as an asset purchase, there may be some current asset accounts, such as cash and cash equivalents, prepaid insurance, and prepaid taxes, that will not transfer to the buyer at the closing. Those items should be specifically excluded from the working capital definition. In addition, the working capital definition should specify that only current assets “included in the purchased assets” will be included in working capital.

Even when a transaction is structured as a stock purchase, there may be current assets that should be excluded from working capital. For example, if the target company will be purchased out of a consolidated group that has filed consolidated federal tax returns, the buyer may agree to be responsible for federal taxes for taxable periods beginning on
or after the closing date. The seller may agree to be responsible for federal taxes for taxable periods prior to the closing date. In that situation, items on the seller’s balance sheet relating to federal taxes, such as income tax receivables (tax refunds), should be excluded from working capital. The parties also may exclude deferred income taxes from working capital if there is uncertainty as to whether deferred income tax items will be utilized by the buyer after the closing.

Regardless of the structure of the transaction, attorneys who draft working capital adjustments should understand the components within each current asset account on the target company’s balance sheet. For example, prepaid assets may include various components, such as prepaid rent, prepaid insurance, and prepaid taxes. The working capital definition should specify both the current assets accounts included in working capital and the components of those accounts included in working capital.

Liabilities Included In Working Capital

Similar to current asset accounts, the target company’s balance sheet is the starting point for determining the current liability accounts to be included in working capital. Current liabilities include accounts payable and accrued expenses. Depending on the nature of the target company’s business, current liabilities may include other accounts.

As with current assets, there may be some liability accounts that will not be included in working capital. For example, intercompany liabilities usually are excluded from working capital. Deferred revenues are a working capital liability typically excluded from working capital. The current portion of long-term debt is a current liability. Debt is likely to be addressed separately from the working capital adjustment in an acquisition agreement. As a result, the current portion of long-term debt usually is excluded from working capital.

If a transaction is structured as an asset acquisition, liabilities that will not be assumed by the buyer should be excluded from working capital. For example, if the buyer is not assuming accrued employment obligations, such as accrued salary, bonuses, and vacation, those items should be excluded from working capital. When the transaction is structured as an asset purchase, the working capital definition should specify that only current liabilities “included in the assumed liabilities” will be included in working capital.

The buyer may take the position that the target company’s balance sheet is “missing” certain current liabilities. Possible examples include obsolete inventory reserves, warranty accruals, and vacation accruals. In that situation, the parties may agree to add those items to the definition of working capital.

The working capital definition should specify both the current liability accounts included in working capital and the components of those accounts included in working capital.

Working Capital Methodologies

While it is critical that the purchase agreement specify the accounts to be included in working capital, it is equally important that the purchase agreement describe in detail the methodologies to be used to value those working capital accounts.

The purchase agreement often provides that the closing date working capital will be determined in accordance with generally accepted accounting principles for financial reporting in the United States (“GAAP”), applied on a basis consistent with the basis on which the seller’s most recent balance sheet was prepared. Variations on the methodologies that can be chosen by the parties to value closing date working capital, however, are endless. Some examples include the following:

- The closing date working capital will be determined in accordance with GAAP applied on a basis consistent with the seller’s past practice;