

Purchase Price Adjustments in an M&A Transaction

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Whether you are involved as the purchaser or seller in an M&A transaction, you should be aware of events that may trigger adjustments to the purchase price.

WORKING CAPITAL ADJUSTMENTS

In a *stock transaction*, the buyer will assume liabilities, which can be included in the working capital adjustment or provided for elsewhere in the purchase agreement. In an *asset transaction*, the buyer will not assume liabilities, so they are excluded from calculations.

No deduction is made for short- or long-term debt in calculating working capital. To protect the buyer against short- or long-term debt, a separate adjustment is made in the section of the purchase agreement stating that the business must be provided to the buyer debt free; any debt on the balance sheet will be deducted from the purchase price.

Accounts receivables must be calculated net of reserves. To calculate reserves for doubtful accounts, the purchase agreement could say that receivables over 90 days old on the closing date will be reserved against, and only the net shall be treated as an asset. Similarly, to account for obsolete inventory, inventory not sold in the year in which it was produced can be excluded. Other calculations that should be spelled out include accrued salaries, bonuses, vacation, sick pay, and sales commissions.

TIMING OF PURCHASE PRICE ADJUSTMENTS

Purchase price adjustments to working capital can occur at different times. For example, the transaction usually starts with a letter of intent, which normally precedes the closing by several months. When it is drafted, the buyer will have reference to the seller's balance sheet (which may have been prepared several months previously). Frequently, the letter of intent will state that there will be a purchase price adjustment to working capital. However, a significant amount of time may pass from the date the purchase price is set forth in the letter of intent and the date the buyer's due diligence is completed, the purchase agreement is drafted, and then signed.

To make a purchase price adjustment from the price in the letter of intent to the price in the purchase agreement, a pre-signing balance sheet must be prepared, comparing the balance sheet before the letter of intent was signed and the balance sheet at the purchase agreement signing.

If the transaction is structured as a "sign and close later," another significant time gap could occur between the pre-closing balance sheet and the balance sheet on the closing date. The parties may either provide for another balance sheet to be prepared 3 days before the closing, or provide for a post-closing balance sheet. If possible, the buyer prefers to make the adjustment before closing, rather than fight with the seller over a post-closing adjustment.

ESCROW TO HOLD FUNDS FOR PURCHASE PRICE ADJUSTMENTS

A reserve hold-back from the purchase price is useful to the buyer. By establishing a reserve and placing it in escrow, the buyer has some certainty of access to cash against which the adjustment to the purchase price may be made. When the transaction is structured for a post-closing adjustment to the purchase price, it is highly advisable to place a percentage of the purchase price into escrow at closing.

NON-WORKING CAPITAL PURCHASE PRICE ADJUSTMENTS

The following are examples of non-working capital purchase price adjustments that may need to be made. The seller's pension fund is not adequately funded; the net asset value is less than set forth in the balance sheet; EBIDTA (Earnings Before Interest, Taxes, Depreciation and Amortization) is less than set forth in the income statement. Pension liabilities and deferred compensation (normally categorized as long-term liabilities and not captured in working capital) may trigger adjustments elsewhere in the purchase agreement. Deferred tax assets are controversial: sellers would like to include them in working capital, but buyers object to including them because it may be difficult to use them after the closing.

AVOID DOUBLE COUNTING

If the buyer discovers a liability as of the closing date that was not reflected on the pre-closing balance sheet but is on the post-closing balance sheet, the buyer will reduce the purchase price by the amount of that liability. However, the purchase agreement also provides a representation and warranty by the seller that the company has no liabilities except those disclosed on the closing balance sheet, so the seller will be liable for the amount of the undisclosed liability (even though it will already have been deducted from the purchase price). To prevent the seller from paying for the liability twice, the purchase agreement should include provisions that preclude double counting of liabilities.

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