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MERGER AGREEMENTS

Net Working Capital Adjustments in M&A Deals: The Buyer's Perspective

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Working capital[1] is an important measure of a company's liquidity. Without sufficient working capital, a business will not be able to pay suppliers, employees, landlords and other providers whose goods and services are required for ordinary course operations. In the acquisition of a business, if the target's closing working capital is not sufficient for ordinary course operations, the Buyer may be required to raise additional capital to fund the shortfall; an outcome that could have significant financial cost to the Buyer and possibly prevent the Buyer from closing the deal if additional financing is unavailable on acceptable terms. To address this issue, agreements with respect to the purchase of privately owned companies typically include a purchase price adjustment based on the difference between actual closing net working capital and an agreed level of net working capital.

From the Buyer's perspective, the target's closing net working capital should be an amount sufficient for the target business to generate the same amount of cash flow used in determining the purchase price. This generally is referred to as a normalized level of net working capital. The normalized net working capital level, however, may not be the same as the expected level of net working capital at the time of closing. The normalized level of net working capital is what the parties believe to be a fair level of net working capital for the business as reflected in the pricing model, adjusted to account for normal day-to-day fluctuations in net working capital.

At any particular point in time, working capital may be more or less than a normalized level of net working capital because of ordinary course fluctuations in the target's business. Many businesses experience fluctuations in working capital over time caused by such factors as seasonality, lumpiness in the business (e.g., a business characterized by large and infrequent transactions) and unusual events and circumstances (e.g., a

[1] Working capital is the difference between current assets and current liabilities. Current assets are assets that are expected to be converted to cash within one year. Current liabilities are liabilities required to be paid within one year. Agreements with respect to the purchase of privately-owned businesses typically adjust the purchase price based on net working capital which is working capital less specified current assets and specified current liabilities. Current assets excluded in determining net working capital typically include cash, deferred tax assets and assets that are not included in the acquisition. Current liabilities excluded in determining net working capital typically include debt, deferred tax liabilities, liabilities not included in the acquisition and liabilities that are the subject of a special indemnity.

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new product launch or the opening of a new facility). Growth or contraction in a target's performance also affect the level of working capital at any point in time.

M&A deal structures introduce another reason for possible fluctuation in working capital before closing of a transaction. M&A deals are typically priced based on a multiple of the target's earnings before interest, taxes, depreciation and amortization (EBITDA) assuming that the Company is debt free and cash free. Therefore, the purchase price is reduced by the amount of closing debt and increased by the amount of closing cash. As a result, the transaction creates an incentive for the Seller to increase the purchase price by increasing cash or reducing debt. Seller tactics to increase cash (which, in turn, can be used to reduce debt) include accelerating the collection of receivables, delaying the payment of payables, and deferring the purchase of inventory. These activities also impact current assets and current liabilities so that net working capital is less than what it would be if the target were operated in the ordinary course of business.

To eliminate the risk that the timing of the closing, draining of current assets by the Seller or poor performance in the target's business will cause the target to have less than a normalized level of net working capital at closing of the transaction, agreements for the purchase of private companies typically include a purchase price adjustment based on the difference between closing net working capital and a normalized or target level of net working capital. If closing net working capital is less than the target, the Buyer will receive a dollar-for dollar reduction in the purchase price in an amount equal to the shortfall. In the typical deal there is a two-way adjustment so that if the closing net working capital is greater than the target, the Seller will receive a dollar-for-dollar increase in the purchase price in an amount equal to the excess.

Failure to State the Purpose of the Net Working Capital Adjustment in the Purchase Agreement

Although parties that negotiate a normalized level of net working capital agree that the purpose of a net working capital adjustment is to ensure that the Buyer will receive a normalized level of net working capital at closing, Purchase Agreements generally never include a statement of that purpose. Such a statement would be helpful both in reducing the likelihood of a net working capital adjustment dispute after closing and in guiding an arbitrator tasked with resolving such a dispute. The reason why the parties do not include a clear statement of the purpose of the purchase price adjustment provision in the Purchase Agreement may be because the parties assumed there was a general agreement as to the purpose of the adjustment, when there was not. Or, more likely, it may be a function of the negotiation posture of the parties. In a contested auction, the Buyer may not be willing to assert its position regarding closing net working capital for fear it might reduce the attractiveness of its offer to the Seller. Nonetheless, the failure to state that the purpose of the net working capital adjustment is to ensure that the Buyer receives a normalized level of net working capital at closing is a primary reason why the net working capital adjustment is a significant source of dispute between Buyers and Sellers.

The Buyer's Expectation of How the Net Working Capital Adjustment Should Work

From the Buyer's perspective, the net working capital adjustment should ensure that at closing only actual current assets and actual current liabilities included in the adjustment are counted. Otherwise, the Buyer will be required to fund any shortfall in the realization of the closing current assets and settlement of closing current liabilities. However, in many Purchase Agreements the net working capital adjustment provision is not drafted in a manner that ensures accuracy in the determination of closing net working capital. Many Purchase Agreements provide that the adjustment is to measure the change in closing net working capital as compared to the target and not permit the introduction of any judgments, accounting methods, policies, principles, practices, procedures, classifications or estimation methodologies other than those used in the determination of the target. The accounting treatment utilized in determining the target is typically generally accepted accounting principles – GAAP –applied on a consistent basis with an earlier specified balance sheet (typically the Seller's most recent audited financial statements). From the Seller's perspective, adherence to the Seller's past audited accounting treatment is important since it prevents the Buyer (who is usually the party in the position of preparing the closing balance sheet) from manipulating the accounting treatment to artificially decrease the closing net working capital. However, as described below, there are many reasons why the accounting treatment applied in the Seller's most recent audit may not accurately measure assets and liabilities utilized in determining the net working capital adjustment.

1. GAAP versus Consistency

Many Purchase Agreements do not clearly articulate how the balance sheet items that constitute net working capital will be measured. Many adjustment provisions require that closing net working capital is to be prepared in accordance with GAAP applied on a consistent basis with an earlier specified balance sheet. However, the requirements of GAAP and its application on a consistent basis often conflict. For example, one commonly disputed account balance is accounts receivable and its associated allowance for doubtful accounts. GAAP does not provide guidance as to exactly how the allowance for doubtful accounts should be calculated. GAAP simply provides that accounts receivable should be stated at net realizable value. A Seller may have historically used a methodology for calculating the allowance for doubtful accounts by reserving an amount equal to 4% of accounts receivables greater than 90 days in order to record receivables at net realizable value. However, a Buyer may determine that the allowance for doubtful accounts should be based on a reserve of 4% for accounts receivable balances greater than 90 days but 5% for accounts receivable balances greater than 120 days. It could very well be that the historical write-off data supports the Buyer's contention for a 5% reserve on accounts receivable balances greater than 120 days, thus generating a more accurate net realizable value. Even if the Buyer changes the reserve on the closing balance sheet from a 4% reserve to a 5% reserve on 120 day plus balances, GAAP is still consistently applied given that the end result is a potentially more accurate accounts receivable balance. In this situation, each party might

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argue after closing that its calculation results in an accounts receivable balance at net realizable value and, therefore, has been determined in accordance with GAAP consistently applied. However, if the Buyer's methodology produces a more accurate determination of net realizable value of the accounts receivable and the Purchase Agreement provides that closing net working capital is to be determined in accordance with GAAP consistent with an earlier specified balance sheet of the Seller (and does not require the closing balance sheet to be prepared using the same methodology used by the Seller in preparing the earlier specified balance sheet), the Buyer would likely have the better position.

2. General Purpose User of Audited Financial Statements versus Dollar-for-Dollar Adjustments

Audited financial statements are designed to provide information for the general purpose user. In the case of special purpose financial statements such as a closing net working capital statement, the only users are the Buyer and Seller. Certain concepts that apply to general purpose financial statements could have unintended results when applied to closing net working capital statements. For example, an important concept in the preparation and audit of general purpose financial statements is materiality. Financial statement materiality is commonly viewed as an amount whose misstatement would influence the user of the financial statement in making a judgment. In the case of closing net working capital statements, unless a threshold is specified in the Purchase Agreement, materiality would be considered zero because any adjustment to closing net working capital results in a dollar-for-dollar adjustment in the purchase price.

Considering the previous example, the Seller may not have changed its historical reserve of 4% for allowance for doubtful accounts as the Seller may have considered the difference immaterial to the overall accuracy and reliability of the financial statements. However, a Buyer could argue that an adjustment to the reserve for doubtful accounts is appropriate in preparing the closing net working capital because the difference results in a dollar-for-dollar reduction in the purchase price.

3. Use of Judgment in the Preparation of Financial Statements

Depending on the nature of the target's business, a number of balance sheet accounts may require the use of judgment in determining the amounts to be recorded. These amounts can be significant. Often, the judgments of the Buyer and Seller conflict. Accordingly, specific consideration should be given in the negotiation of the Purchase Agreement to accounts that require judgment and are most often disputed, such as allowance for doubtful accounts, inventory obsolescence reserves, sales allowances and reserves, warranty reserves, litigation reserves, loss contingency reserves and reserves for losses on long term contracts.

It is commonly recognized under GAAP that if the preparer of the financial statement includes an amount that is subject to judgment and determines the amount using the preparer's best estimate, the amount is not considered to be in error as long as the estimate falls within a range of reasonableness. This is one of the reasons why it is advantageous to be the party preparing the closing balance sheet. For example, in preparing its balance sheet a medical insurance company is required to determine future liabilities to be paid for "IBNR" claims (incurred but not reported claims). The insurance company has historical data on which to base its reserve calculations, but until covered losses are actually reported, it can only estimate the reserve that may be required. If the Buyer is the preparer of the closing financial statements, it will be better positioned to construct and defend its estimate of IBNR claims (as opposed to challenging the Seller's estimate) as long as it is within a range of reasonableness.

All of these issues point to the importance to the Buyer of conducting a thorough due diligence process when evaluating the target. The Buyer should seek to obtain as much of an understanding as possible of the accounting policies, judgments and estimates that are made in the financial statements. Once those are understood and the Buyer determines that the methodology used by the target is not consistent with the manner in which the Buyer believes those policies, judgments and estimates should be determined, those differences should be resolved and dealt with in the Purchase Agreement.

4. Timing of Financial Statements

The closing net working capital may be compared to a benchmark or target net working capital that is based on a previously audited financial statement. More commonly, the target net working capital is determined based on an average of monthly unaudited financial information. If the Purchase Agreement requires closing net working capital to be determined in accordance with GAAP as applied in the most recent audited balance sheet of the Seller, this may produce an incompatible (i.e., "apples" to "oranges") comparison between certain non-fiscal year end practices used in determining the target and fiscal year end audit practices used in determining closing net working capital. For example, it may be the Seller's historical practice to "true-up" certain reserve balances at the end of the fiscal year. Depending on the timing of the closing date, the preparer of the closing statement may true-up the reserve balances on the closing statement which would lead to a difference between the target and closing net working capital. An example of this is vacation accruals. Accrued vacation pay is the amount of vacation time that an employee has earned pursuant to the target's employee benefit policy, but which has not yet been used or paid. It is common practice for companies to perform a detailed calculation of the vacation liability accrual on an annual basis, utilizing some type of percentage driven formula. However, for interim statements a more imprecise methodology such as a monthly average may be used. Accordingly, a target net working capital based on interim period financial information would have been calculated using a different methodology than the annual "trued-up" balance sheet that was the basis of the closing balance sheet. Parties can avoid an "apples" to "oranges" comparison by specifying in the Purchase Agreement the methodology for determining closing accounts which are subject to a different accounting treatment at year-end as compared to interim periods.

The parties may want to give consideration in the Purchase Agreement to the effect on closing net working capital of events that occur subsequent to the closing date. GAAP defines subsequent events as material

events or transactions that occur subsequent to the balance sheet date, but before the financial statements are issued or available to be issued. GAAP refers to Type I subsequent events which are events that provide additional evidence with respect to conditions that existed as of the financial statement date, and affect the estimates in the financial statements. Type II subsequent events are events that provide evidence with respect to conditions that did not exist at the financial statement date, but arose subsequently. Buyers typically want to maximize their ability to record post-closing events in the closing balance sheet since it will likely result in a more accurate determination of the closing assets and liabilities. For example, after the closing date, a decision may be rendered in a litigation matter that was commenced prior to the closing date or new information related to the litigation may arise that requires an adjustment to a previous estimate. If GAAP as applied in the Seller's most recent audited financial statement is the standard for preparing the closing balance sheet, the Buyer should be able to include the adjustment in preparing the closing net working capital statement as long as the new facts arose prior to the issuance of the closing balance sheet. The period of time during which subsequent information may be considered by the arbitrator can vary substantially. It is not unusual for arbitrators to consider information that becomes available much later than when the Buyer delivered the closing balance sheet to the Seller. Therefore, it is generally recommended that the parties agree to a specific subsequent events period in the Purchase Agreement.

5. Cherry-Picking by the Seller in the Dispute Resolution Process

In the typical transaction, the Buyer prepares the closing balance sheet for the Seller's review and comment. If the Seller objects to any of the components of the closing net working capital, the parties' first attempt to resolve the dispute themselves and, if that is not possible, the dispute is referred to an accounting arbitrator for resolution. In many Purchase Agreements, the arbitrator is limited to considering only those matters specifically identified in the Seller's dispute notice. This may be because giving the Buyer a second ''bite of the apple'' would be viewed as unfair and might deter a Seller from raising legitimate objections over concern that the Buyer will raise new issues not addressed in the closing balance sheet delivered to the Seller. Nonetheless, a Buyer can be unfairly prejudiced by limiting the issues in the dispute resolution process to only those matters identified in the Seller's objection notice.

Purchase Agreements usually do not specify the level of aggregation to be considered in deciding whether there is a misstatement within the financial statements. Financial statement line items usually consist of a large number of typically small amounts that are aggregated at various points within the target's records. Without a requirement in the Purchase Agreement that the methods, policies, principles, and practices used in preparing the closing statement are to be applied consistently across all similar accounts, the Seller, as the objecting party, could selectively object to certain incorrect individual balances that decrease the purchase price while ignoring others that may be similarly misstated but increase the purchase price. For example, the Seller may be aware that certain cash receipts had been misapplied in the closing balance sheet to a long term note receivable when the cash should have been applied to a customer's accounts receivable balance. In addition, the closing balance sheet prepared by the Buyer failed to accurately record a receivable from a customer. In its objection notice, the Seller disputes the accounts receivable balance on the closing statement as understated because of the failure to reflect the customer's receivable but does not include an adjustment for the error attributable to the misapplication of cash to a long term note receivable. The net result of this selective adjustment is that the closing net working capital would be incorrectly overstated to the benefit of the Seller. A Buyer, as the preparer of the closing financial statement, often argues that this ''cherry-picking'' is unfair. Some parties include a template as an appendix to the Purchase Agreement detailing the format for the closing financial statement as well as the account balance level of objections. In addition, the Buyer should consider including a provision in the Purchase Agreement that allows it to raise issues in the dispute resolution process that were not initially addressed in the closing statement (at least to the extent the issue relates to an account that the Seller is seeking to adjust in its favor).

6. Errors in the Preparation of the Target's Audited Financial Statements and/or the Determination of the Target's Net Working Capital

In preparing closing date financial statements, Buyers sometimes identify errors in previous financial statements that were used to set the target net working capital. Within the context of a purchase price dispute, there typically is no recourse for the Buyer because Purchase Agreements typically do not provide for the correction of errors identified in the target net working capital. An error in the financial statements used to calculate the target net working capital that is corrected in the closing financial statements would result in an inconsistent application of historical practices between the target financial statement and the closing financial statement if not corrected in the target net working capital. For example, the parties may discover that the methodology the Seller had historically been using was a run rate to calculate excess and obsolete inventory that had not been updated in a number of years. Updating the run rate based on data for the last two years results in a higher reserve. If the run rate is corrected in the closing net working capital statement, the result would be an artificial decrease in closing net working capital as compared to the target. As a result, an arbitrator may refuse to permit the correction of the error in the determination of closing net working capital. If the error is the result of a historical practice that was not in accordance with GAAP, the Buyer may have recourse through an indemnification claim based on breach of a representation and warranty. However, an indemnification claim may not provide the Buyer with as full a recovery as a working capital adjustment since indemnification claims are typically subject to limitations including dollar thresholds, caps, and limitations on the types of damages that may be recovered (e.g., restrictions on recoveries for consequential damages and damages based on a multiple of EBITDA or other financial criteria). In addition, indemnification claims usually require the Buyer to bear the additional time, expense and burden of proof challenges of a litigation (as com-

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pared to the relative efficiency of an arbitrator's determination of a working capital adjustment dispute). The Buyer should consider negotiating for a provision in the Purchase Agreement that would explicitly instruct the arbitrator in a purchase price dispute as to how to deal with errors in the target financial statement or target amount of net working capital.

7. Changes in the Business of the Target

Changes in the business of the target and/or the economic environment generally can impact net working capital. Such changes include: (i) an economic recession that requires the target to impose stricter credit limits on customers, shorten payment terms, or focus more heavily on collections and inventory management, (ii) a new product release that can result in increased inventory or a closure of a product line that can result in an inventory write-off, (iii) the opening of a new facility that can increase normal expenses and related accruals for such expenses; (iv) commodity and raw material price fluctuations which can significantly affect inventory values; and (v) the effect of the transaction on the target's business. For example, due to the impending sale of the target, customers may postpone signing new contracts for period of time after the closing date. Further, the Buyer may choose to change certain sales practices after closing that could result in a short-term decrease in sales as contracts are negotiated. This could result in a short term decrease in revenue and corresponding accounts receivable at the commencement of the Buyer's ownership period that was not considered when determining the target net working capital. Accordingly, in determining the target net working capital amount, the Buyer should consider the likelihood that largely operational issues not necessarily or entirely within the Buyer's control could negatively impact the target's ability to generate revenues after closing. While these operational issues influence the value analysis and the price the Buyer is willing to pay for the target, they also may have a place in the working capital discussion. In addition, the Buyer should consider whether the target net working capital amount should address factors, such as the likelihood of changes in customer payment habits, the impact of infrequent large inventory purchases or potential renegotiation of vendor payment contracts. In order for these items to be considered in the determination of closing net working capital, specific language would need to be included in the Purchase Agreement.

8. Industry and Company Specific Features of the Target's Net Working Capital

It has been said that net working capital is not one size fits all, for all industries or even all companies within one industry. Different industries will have different working capital requirements because of seasonal cycles, length and stages of the business cycle, owners' attitudes on liquidity, customer power (to delay payments), supplier power (to demand payments), and competitors' methods of operation and optimum levels of stock. Some businesses need substantial amounts of working capital, while others can operate on little to even negative working capital. Such differences in how companies manage their working capital is not usually considered in drafting Purchase Agreements. With respect to these industry and target issues, the burden is on the Buyer to understand and calculate the impact of such factors in the determination of the target working capital. These are operational issues that do not translate into good arguments in a dispute before an arbitrator as to why the Buyer believes there should be a working capital adjustment because of deficiencies in the Seller's historical accounting practices.

Recommendations and Conclusions to ensure that the Buyer Receives the Amount of Net Working Capital it Expects and Needs to Operate the Target's Business After Closing

The net working capital adjustment is, in its essence, a mechanism to protect the Buyer by assuring that at closing the target will have the level of net working capital required to deliver the financial performance that formed the basis for the purchase price. Unfortunately for Buyers, that protection is sometimes diminished by inattention in the Purchase Agreement to accounting issues that can negatively impact an accurate determination of closing net working capital. While there may be real reasons for this lack of attention including a Seller with superior negotiating leverage and knowledge of the business and accounting practices that affect the target's working capital, there also is the potential for real financial cost to the Buyer.

To ensure that the Buyer receives the amount of net working capital it expects and needs to operate the target's business after closing, the Buyer should consider addressing all or at least some of the following concepts in the net working capital adjustment provision in the Purchase Agreement:

- A statement that the purpose of the net working capital adjustment is to ensure accuracy in the determination of net working capital at closing and, in that regard, to accurately measure net working capital as of the closing date irrespective of the methodology used to measure net working capital at any earlier date;
- A one-way adjustment in favor of the Buyer so the purchase price is only adjusted if there is a shortfall in closing net working capital as compared to the target;
- A statement that changes to reserve balances in the closing financial statement are limited to a certain threshold;
- A materiality threshold for objections to the closing financial statement to prevent the Seller from objecting to immaterial amounts;
- A requirement that objections to the closing financial statement be made at the financial statement line item level to prevent cherry-picking by the Seller in its objections to the closing statement;
- A methodology for determining the closing net working capital adjustment when errors are identified in previous financial statements;
- A schedule of the accounting methods, policies, principles, practices, procedures, classifications and estimation methodologies to be used in the determination of closing net working capital or, in the alternative, a schedule of exceptions and qualifications to the accounting methods, policies, prin-

ciples, practices, procedures, classifications and estimation methodologies used in the preparation of the target net working capital;

- An explicit post-closing time period for determination of estimated or contingent liabilities;
- A right to address new issues throughout the dispute resolution process whether or not the same or related issues are raised in the Seller's objection notice; and
- Consideration of future changes in the target company's operations or events and circumstances unique to the industry in which the target operates.

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