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Closing Adjustment Provisions in M&A Transactions: Avoiding Common Disputes

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In most M&A transactions, there is a delay (sometimes significant) between the negotiation of the purchase price (the "Purchase Price") and the closing of the transaction (the "Closing"). During that period, numerous events can occur that may affect the transaction and the reasonableness of the negotiated Purchase Price. Recognizing such possibilities, M&A practitioners may attempt, particularly in private company transactions, to protect their clients through the negotiation of provisions that address events which may occur prior to Closing. For example, in many private company transactions, the purchase or merger agreement (the "Agreement") provides for an adjustment (the "Closing Adjustment") to the Purchase Price to reflect the changes in certain of the target company's assets and/or liabilities typically between a specified date prior to the execution of the Agreement and the date of Closing.

The purpose of the Closing Adjustment is obvious. In determining the Purchase Price, the buyer considers, *inter alia*, the target company's assets and liabilities. As a consequence of the continuing operation of the target company (or certain conduct by the seller) those assets and liabilities will change prior to the Closing. The Closing Adjustment is intended to adjust the Purchase Price (either higher or lower) based on the changes in certain assets and liabilities, such as the components of working capital ("Working Capital"), prior to Closing.[1]

Although the determination of the Closing Adjustment would appear to be a rather straightforward exercise, it can have a significant impact on the Purchase Price. As a result, disputes often arise regarding the determination of the Closing Adjustment, which can result in litigation between the parties.[2] Set

1 Although the Closing Adjustment may be based on the change in any assets or liabilities identified by the parties, it is common to use the components of working capital or some variation thereof. For the purposes of this article, it will be assumed that the Closing Adjustment is based on the change in Working Capital.

2 As subsequently addressed, many agreements provide that disputes relating to the Closing Adjustment must be presented to arbitration, and therefore, the disputes that result in litigation before courts likely represent only a small fraction of the total disputes relating to Closing Adjustments.

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forth below is a summary of certain disputes that may arise with respect to the determination of the Closing Adjustment, how the courts have resolved such disputes, and how the disputes may be avoided through careful drafting of the Agreement.[3]

The Closing Adjustment Provision

Although there is no uniform Closing Adjustment provision, the first step in the process typically is to determine the pre-closing Working Capital balance that will be used to calculate the Closing Adjustment (the "Reference Balance"). That amount is compared to the Working Capital balance as of the Closing Date (the "Final Balance"), and the Purchase Price is adjusted based on the difference between those two amounts.[4] The preparation of the final statement of the target company's assets and liabilities as of the Closing (the "Final Statement") that is used to determine the Final Balance and the resulting Closing Adjustment is typically done during the period following the Closing.

The Court of Chancery's decision in *OSI Systems* provides the following summary of a typical Closing Adjustment:

> To arrive at a final purchase price, that provision begins by stating a nominal purchase price of $57.384 million, which then is adjusted primarily through the so-called "Closing Adjustment" .... The "Closing Adjustment Formula" is driven by a comparison of [the target company's] Modified Working Capital as of June 30, 2003 and a Final Modified Working Capital Statement as of the Closing Date, March 19, 2004.[5]

As explained below, each step in the process of determining the Closing Adjustment raises issues that may result in disputes.

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3 Along with the inclusion of closing adjustment provisions, purchase or merger agreements in private company transactions also typically include certain other provisions that raise unique issues under Delaware law. For example, it is common for private company merger agreements to include provisions purporting to withhold a portion of the merger consideration and to require the deposit of such amounts into escrow accounts in order to facilitate certain post-closing adjustments and indemnification obligations, as well as provisions purporting to have the stockholders (including non-signatory stockholders) appoint a stockholder representative. Although beyond the scope of this article, we note that such provisions raise unique, and often overlooked, issues under Delaware law. Such provisions are fraught with enforceability concerns under Delaware law to the extent they are drafted as affirmative obligations of non-signatory stockholders, and not as neutral mechanics that provide both for the proper conversion of shares in accordance with Delaware law and for the proper implementation of "facts ascertainable" procedures as permitted by Delaware law. M&A practitioners negotiating merger agreements with such provisions should proceed with caution and consider engaging Delaware counsel.

4 Because it is not feasible to specifically determine and agree upon the Final Balance as of the Closing, it is common for the Agreement to require the seller to provide an estimated Working Capital balance as of the Closing Date (the "Estimated Balance"), which is used to make a preliminary adjustment to the Purchase Price. *See, e.g.*, *OSI Systems, Inc. v. Instrumentarium Corp.*, 892 A.2d 1086, 1088 (Del. Ch. 2006) (noting that the seller was required to prepare "a Statement of Estimated Closing Modified Working Capital ... two days before the anticipated Closing Date").

5 892 A.2d at 1087.

The Reference Statement

A critical component of the Closing Adjustment is the Reference Balance, which is typically based on the balance of certain assets and liabilities (*e.g.*, the components of Working Capital) as set forth on a financial statement prepared prior to the execution of the Agreement (the “Reference Statement”). Essentially, the Reference Statement sets forth the target company’s assets and liabilities that the buyer considered when determining the Purchase Price, and the Closing Adjustment is intended to reflect the changes in those assets and liabilities during the intervening period prior to the Closing. In negotiating the Reference Balance, it is important to understand and clearly state in the Agreement what assets and liabilities are included.

Another important consideration, which is sometimes overlooked, is whether any of the assets or liabilities included in the Reference Balance (or the Final Balance) are separately addressed in the Purchase Agreement. If such assets and liabilities are separately addressed, unintended consequences may result.

For example, in *Brim Holding Company, Inc. v. Province Healthcare Company*,[6] the Court of Appeals of Tennessee enforced the express terms of a purchase agreement, which resulted in what appeared to be an unintended double recovery for one of the contracting parties. At issue in the case was a purchase agreement pursuant to which Brim Holding Company, Inc. (“Brim”) acquired Brim Healthcare, Inc. (“Healthcare”) from Province Healthcare Company (“Province”). Pursuant to the agreement, Province agreed to indemnify Brim for losses related to certain specified litigation. Brim paid $50,000 to settle the litigation and then made a demand upon Province for indemnification. Province, however, rejected the demand on the ground that Brim had already recovered the payment through a working capital adjustment. Specifically, Province asserted that the closing balance sheet already included a $50,000 reserve for the litigation, which had the effect of reducing working capital (and the amount paid by Brim at closing) by $50,000. As such, Province asserted that requiring it to indemnify Brim for the $50,000 settlement would result in a double recovery for Brim. Although that argument had some logical force, in granting Brim’s motion for summary judgment, the Court held that “the parties anticipated the loss now at issue and made express and unequivocal provisions to assure that the loss, if any, would be paid by [Province].”[7] Therefore, the Court refused to “nullify the indemnity provision” based on Province’s assertion that requiring such payment was unfair in light of the working capital adjustment and inconsistent with the intentions of the parties.[8] Simply put, the Court enforced the express terms of the contract as written.

The import of the decision in *Brim* is clear. To avoid a potential double recovery, if the parties have agreed to indemnify with regard to specific losses, any reserve with respect to such losses should be excluded from the Working Capital used

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6 2008 WL 2220683 (Tenn. Ct. App. May 28, 2008).

7 *Id.* at *5.

8 *Id.*

to determine the Closing Adjustment. Such a provision would not prejudice the buyer because it should be protected with regard to such losses pursuant to indemnification provisions.

Another important consideration when determining the Reference Balance is the fact that the Final Balance typically will be required to be prepared in the same manner as the Reference Balance. For example, as noted by the Court in *OSI Systems*, the balances used to determine the Working Capital at Closing were to be:

> prepared in accordance with the Transaction Accounting Principles *applied consistently with their application in connection with the preparation of the Reference Statement of Working Capital* ... and shall otherwise contain at least the same line items as the Reference Statement of Working Capital....[9]

Accordingly, the parties likely will be required to consistently apply the same accounting principles used in the Reference Statement – *even if the buyer contends that the accounting principles did not comply with GAAP or the applicable contractual standard.* For example, if the Reference Balance is overstated by $10 million because the Reference Statement was not prepared in accordance with GAAP, that error most likely cannot be fixed in connection with determining the Final Balance, which must be prepared consistently with the Reference Balance. Moreover, if the overstatement of Working Capital increased to $25 million as of the Closing (as a result of consistently applying the alleged erroneous accounting principles used in preparing the Reference Balance), that $25 million overstatement would be included in the Final Balance, which (all other things being equal) would result in a $15 million increase in the Purchase Price – notwithstanding the fact that the Final Balance was not calculated in accordance with GAAP.

Of course, the buyer is not necessarily left without a remedy for the overstatement of Working Capital. Rather, any challenge to the application of the accounting principles used in preparing the Reference Statement (as carried through to the Final Statement) most likely could be pursued through a breach of representation claim relating to the Reference Statement.[10] As such, it is necessary to ensure that the Agreement contains a representation with regard to the Reference Statement (*e.g.*, that it was prepared in accordance with GAAP) that survives Closing.[11] It is important to note, however, that establishing a claim for breach of a financial statement representation is different than resolving a dispute regarding the amount of the Closing Adjustment. For example, unlike the calculation of a Closing Adjustment, whether a financial statement is prepared in accordance with GAAP may implicate materiality considerations – *i.e.*, a financial statement may contain immaterial errors or misstatements and still comply with GAAP. Moreover, in

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9 *OSI Systems*, 892 A.2d at 1088 (emphasis added).

10 *OSI Systems* 892 A.2d at 1091-92 (stating that the “assertion that the Reference Statement did not comply with U.S. GAAP is also necessarily an assertion that [the seller] breached a representation and warranty”).

11 *Id.* at 1092.

contrast to a Closing Adjustment, any purported damages arising from a breach claim may be subject to contractual minimums and caps.[12] In addition, as noted by the Court in *OSI Systems* (and as further addressed below), the Purchase Agreement may set forth different processes to resolve a breach claim (*e.g.*, legal arbitration) than is applicable to a dispute relating to a Closing Adjustment, which may be required to be submitted to an accountant.

The Final Statement

The Final Statement is generally prepared post-Closing following the buyer's receipt and review of the target company's financial information. Typically, in connection with preparing the Final Statement, the buyer will carefully scrutinize the target's financial information in an attempt to find any basis to lower the amount of the Final Balance and thereby reduce the Purchase Price. Although the Agreement may require that the Final Balance be prepared in accordance with the same accounting principles used to determine the Reference Balance (consistently applied), it is important to note that, as a result of intervening events and/or business developments, the classification of an asset or liability may change under the applicable accounting principles, which could have a significant impact on the Closing Adjustment. An example of such a situation is illustrated by the Delaware Superior Court's decision in *Mehiel v. Solo Cup Company.*[13]

In *Mehiel*, the merger agreement provided for a post-closing adjustment based on changes to Working Capital between the time the parties entered into the agreement and the closing, and further provided that any disagreements regarding the closing adjustment must be presented to an arbitrator. One of the parties' disputes related to a facility located in St. Thomas, Maryland with a value of $5.6 million, which had been treated as an asset held for sale and included in working capital by the seller. The buyer, however, asserted that the facility should be treated as a long-term asset and excluded from working capital when determining the Closing Adjustment. The arbitrator accepted the buyer's position, which resulted in a $5.6 million decrease in the purchase price. The seller filed litigation challenging the arbitrator's ruling asserting as follows:

> Count V alleges that [the buyer] was unjustly enriched by persuading the Neutral Auditor to treat St. Thomas as a long-term asset and remove it from working capital. In reference to St. Thomas, Mehiel stated in a letter to the Neutral Auditor that "[the buyer's] proposed adjustment is inequitable, and if accepted, would result in [the buyer] receiving monetary benefit (to Mehiel's detriment) for its post-closing decision to not complete the sale of the St. Thomas facility. Further, "[i]f this asset held for sale is removed from Final Working Capital, [the buyer] will enjoy the following windfall: it will have reduced the purchase price of

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12 *See, e.g., id.* at 1094-95. It should also be noted that, in connection with a breach claim, a buyer would be required to establish the damages resulting from the alleged breach, which may be different than the amount that could be recovered if the dispute was resolved as part of the Closing Adjustment process.

13 2007 WL 901637 (Del. Super. Ct. May 26, 2007).

> the merger (through this adjustment) and at the same time retained the benefit of keeping the St. Thomas facility – at no cost to itself – which it could then sell for cash.[14]

Without addressing the merits of the argument, the Court concluded that the seller's argument had been presented to and resolved by the arbitrator, and therefore, the seller was barred from attempting to litigate that issue in Court.

Thus, in *Mehiel*, as in *Brim*, the application of the Closing Adjustment resulted in an unintended windfall for the buyer. Such a situation, however, potentially could be avoided by specifically identifying the assets and liabilities to be included in determining the Reference Balance and the Final Balance, and further providing that the accounting treatment of the assets or liabilities must be consistent in calculating both the Reference Balance and the Final Balance.

The Process for Resolving Closing Adjustment Disputes

It is common for the Agreement to set forth a post-Closing process to determine the Closing Adjustment and also to resolve any disagreements between the parties relating to the Closing Adjustment. For example, the Purchase Agreement may provide that the buyer has sixty days to prepare and provide the Final Statement and supporting documentation to the seller. The seller then will have a period of time to review the proposed Final Balance, and provide the buyer with a list of any disagreements (the "Notice of Disagreement").[15] The parties typically are required to work in good faith for a period of time to attempt to resolve the disagreements. If such efforts are not successful, the disagreements typically are required to be submitted to a third party (*i.e.,* the court or an arbitrator) for resolution. As noted below, disputes often arise regarding the process for resolving disagreements regarding the Closing Adjustment, which must be addressed before the actual merits of such disagreements can be resolved.

One issue that may arise in this context relates to the buyer's failure to deliver the Final Statement within the period set forth in the Agreement (*e.g.*, 60 days). The Agreement is often silent with respect to this issue, including the consequences that flow from the failure to timely deliver the Closing Statement. To avoid any uncertainty, the Agreement could expressly provide that the buyer loses his right to seek an adjustment to the Purchase Price if it fails to timely submit the Final Statement. In this respect, it is important to note that the Closing Adjustment as determined by reference to the Final Statement may result in either an increase or a decrease in the Purchase Price. Thus, the buyer would have little reason to submit the Final Statement within the contractual period if it resulted in an increase in the Purchase Price.

In that case, however, it would be in the seller's interest to prepare the Final Statement and obtain the resulting increase in the Purchase Price. As such, the seller

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14 *Id.* at *4 (emphasis omitted).

15 *See, e.g.*, *HDS Investment Holding, Inc. v. Home Depot, Inc.*, 2008 WL 4606262, at *2 (Del. Ch. Oct. 17, 2008) (describing contractual process for determining the Closing Adjustment).

may want to have the Agreement expressly provide that the seller has the right to prepare the Final Statement if the buyer fails to timely do so.[16] In order to prepare the Final Statement, however, the seller typically will need access to the target company's financial records, which usually are in the possession of the buyer after the Closing. Accordingly, the Agreement also should provide that the seller shall have sufficient access to the target's financial information so as to prepare the Final Statement if it so elects.[17]

Finally, as previously noted, the Agreement typically will set forth a time period (*e.g.*, 60 days) for preparation of the Final Statement, and a process to resolve disputes relating the Final Balance. It is not unusual, however, for the parties to identify "additional" adjustments to the proposed Final Balance after the submission of the Final Statement.[18] The Agreement, however, usually does not expressly address whether a party may pursue such additional adjustments as part of the Closing Adjustment process. Thus, to the extent that the parties intend that the Closing Adjustment process shall be limited solely to the items/adjustments raised in the Final Statement (as originally submitted by the buyer to the seller), the Agreement should expressly so provide. Otherwise, the Court or the arbitrator will be required to determine whether the parties intended to allow such additional items/adjustments to be raised as part of the determination of the Closing Adjustment.[19]

Submission of the Dispute to Arbitration

The Agreement will often provide that disagreements regarding the Closing Adjustment must be presented to arbitration before an accountant, and may even identify the accounting firm. Such provisions are intended to provide for a quick and less expensive resolution of the disagreements by an individual with expertise in the accounting issues that may be implicated in the determination of the Closing Adjustment. Disputes, however, often arise regarding the determination of which specific disagreements/adjustments are required to be submitted to the accounting arbitration (often called substantive arbitrability) and whether a party has properly or timely commenced the arbitration under the Agreement (often called procedural

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16 Alternatively, the seller could assert that the buyer breached the Agreement by failing to timely submit the Final Statement, and seek to recover damages equal to the amount of the Closing Adjustment that would otherwise have been due under the Agreement.

17 The Agreement typically provides the seller with access to such financial information, which it can use to review the Final Statement prepared by the buyer. *See, e.g.*, *HDS Investment Holding*, 2008 WL 4606262, at *2 (noting that the buyer was required to provide the seller with the closing statement and "related schedules and work papers"); *Aveta Inc. v. Bengoa*, 2008 WL 5255818 (Del. Ch. Dec. 11, 2008) (considering dispute regarding whether the buyer delivered sufficient financial information to the seller such that the seller could evaluate the proposed closing adjustment).

18 *See, e.g.*, *HDS Investment Holding*, 2008 WL 4606262, at *7; *Nash v. Dayton Superior Corp.*, 728 A.2d 59, 61 (Del. Ch. 1998) (noting that a party attempted to raise in the arbitration "New Items" that "had not been raised or even indicated in either the Closing Balance Sheet or the Notice of Disagreement").

19 *See, e.g.*, *HDS Investment Holding,* 2008 WL 4606262, at *8; *Nash*, 728 A.2d at 63.

arbitrability).[20] These issues usually must be decided by the court before the arbitrator can begin to address the merits of the actual disagreements regarding the Closing Adjustment.

Significantly, the threshold issue is often simply whether the Court – or the arbitrator – is required to resolve the issue of substantive or procedural arbitrability. For example, in *Nash v. Dayton Superior Corporation*,[21] the agreement of sale provided that the buyer had 60 days to submit a closing balance sheet to the selling stockholders. The stockholders then had 45 days to deliver a notice of disagreement laying out any disputes they had with the closing balance sheet. If the parties could not come to an agreement, the dispute would be submitted to an independent accounting firm for resolution. After following the process provided for in the Agreement, the buyer attempted to submit certain "new items" to the accounting firm that were not included in the closing balance sheet.[22] The selling stockholders of the target corporation filed a complaint seeking to enjoin the buyer from submitting the new items to the accounting arbitrator, and the buyer moved to dismiss the complaint on the ground that the issue was required to be resolved by the arbitrator and not the Court. The Court of Chancery held that the dispute over whether the acquirer could submit the "new items" to the accounting firm was a question of substantive arbitrability, and because the "new items" did not "'on [their] face, fall [] within the arbitration clause of the contract,'" it was a factual question for the Court to decide whether the parties agreed to submit such items to the accounting firm.[23] Therefore, the Court denied the motion to dismiss as to the closing balance sheet claim.

Similarly, the contracts at issue in *Matria Healthcare, Inc. v. Coral SR LLC*[24] and *OSI Systems*[25] both provided for two different arbitration procedures, pursuant to which post-closing adjustments relating to Working Capital were to be submitted to accounting arbitration, and other claims (such as claims for breach of warranty or misrepresentation) were to be submitted to legal arbitration. In each case, the court was required to determine whether the disputes at issue were required to be submitted to accounting or legal arbitration. And, in each case, the Court adopted a narrow view of the disputes that were required to be submitted to the accounting arbitration, and determined that the claims at issue involved potential

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20 Substantive arbitrability involves questions regarding the scope of the arbitration provision at issue. *RBC Capital Mkts. Corp. v. Thomas Weisel Partners, LLC*, 2010 WL 681669, at *7 (Del. Ch. Feb. 25, 2010) ("The question of whether parties have agreed to arbitrate a particular dispute, *i.e.* the 'question of arbitrability,' is 'an issue for judicial determination [u]nless the parties clearly and unmistakably provide otherwise.'"). In contrast, procedural arbitrability involves questions of "whether prerequisites such as time limits, notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate have been met,' as well as 'allegation[s] of waiver, delay, or a like defense to arbitrability." *RBC Capital,* 2010 WL 681669, at *7.

21 728 A.2d 59 (Del. Ch. 1998).

22 *Id.* at 61.

23 *Id.* at 63 (citation omitted).

24 2008 WL 401125 (Del. Ch. Feb. 14, 2008).

25 892 A.2d 1086 (Del. Ch. 2006).

misrepresentations – as opposed to pure accounting disputes relating to the calculation of working capital – and were required to be submitted to legal arbitration.

Ultimately, the goal would be to avoid separate litigation regarding the scope of the arbitration provision and/or procedural issues regarding whether the arbitration was properly or timely commenced, which necessarily delays and increases the expense associated with resolving the real disagreements regarding the Closing Adjustment. To avoid the uncertainty as illustrated by *Nash,*[26] the Agreement should expressly state who (*i.e.*, the accounting arbitrator, the legal arbitrator, or the court) is empowered to decide issues such as whether the arbitration was timely commenced or whether the parties could raise "new items" in arbitration. Similarly, if the Agreement provides for both legal and accounting arbitrations, so as to avoid litigation in court, the Agreement could make clear that any dispute as to whether a claim falls within the accounting or legal arbitration shall be resolved by the legal arbitrator, who is likely better able to resolve such issues of contract interpretation.[27]

Conclusion

The Closing Adjustment is an important part of the Agreement, and can have a material impact on the Purchase Price. Therefore, it is not surprising that disputes often arise as to both the amount of, and the contractual process to determine, the Closing Adjustment. As explained above, however, it may be possible to avoid (or at least more quickly resolve) some of the potential disputes through careful drafting of the sections of the Agreement relating to the Closing Adjustment.

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26 728 A.2d at 63 (noting that there was a "factual question as to whether the parties intended the arbitration to permit [the buyer] to revise the Closing Balance Sheet in response to objection raised by the Notice of Disagreement").

27 *OSI Systems* 892 A.2d at 1095 (noting that the "Legal Arbitration process should be completed first and the parties can work with the Legal Arbitrator, who has broad interpretative powers regarding the Purchase Agreement, to determine the issues that would then remain for determination in the Closing Adjustment Arbitration").