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Purchase Price Adjustments in Technology Deals

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Buyers, sellers, their counsel and other advisers sometimes give short shrift to post-closing adjustment provisions in M&A deals. However, it is important to make sure that language and calculation methods are clear and do not invite opportunistic behavior after the closing. Getting these matters right requires a team effort and careful attention to detail by all participants.

This article focuses on purchase price adjustments for buyers and sellers in technology deals but is broadly applicable to most other industries, as well. Read on for a discussion of purchase price true-ups, including the basis of adjustments, mechanics involved in calculating the adjustment, what each party's motivations are and how to manage risk.

What is the Purpose of Post-Closing Adjustments?

Assets and liabilities of companies fluctuate as a result of business operations between the time the parties sign a letter of intent (and agree on a purchase price) and the closing of the transaction. As a result, most buyers negotiate a post-closing true-up.

The most common true-up is the difference between the company's estimated net working capital (NWC) at closing, compared to a target NWC amount expected at closing and determined in advance by the parties, and then a post-closing true-up based on the difference between the NWC estimate and the actual NWC at closing. Parties may forgo a two-part adjustment in favor of one adjustment either at closing or post-closing, but this may introduce more risk for buyers.

For a one-part adjustment at closing (often for items that can be determined with accuracy at closing), instead of a post-closing adjustment, the buyer typically negotiates an indemnification right to bring a claim for liabilities arising from those items after the closing if those liabilities are not accounted for in the closing adjustment.

In technology deals, purchase price adjustments can commonly be based on income, expense or a net tangible asset (NTA) true-up (seen in software deals). The primary purpose of the adjustment is to protect the buyer from any decrease in value between the time a purchase price for the target business is agreed upon and the closing.

As an alternative, many European M&A transactions use a "locked box" method where the parties agree to a fixed purchase price with no adjustments. The buyer is required to do more extensive upfront diligence and negotiate more strict representations and warranties. This method provides certainty that the purchase price will not be eroded post-closing and avoids post-closing disputes. However, a buyer's additional diligence is expensive and its increased reliance on representations and warranties is unpalatable for many American buyers.

As mentioned, it is customary to require the seller to calculate an estimated adjustment immediately prior to closing and true-up at closing against a target. The closing payment is calculated from a comparison of the estimate versus the final numbers. Typically, the buyer prepares a calculation of the post-closing adjustment and delivers it to the seller within a specified time after closing.

After the buyer delivers its calculation (typically around 90 days), the seller and its accountants have a specified time period to review the buyer's calculation, request and review records and

make written objections to the buyer's calculation (typically around 30 days). Sellers generally try to push out the time period to respond to these requirement deadlines in the purchase agreement.

Particularly, a technology company seller will want to ensure enough time for its team, including attorneys and accountants, to respond in a timely manner. If the seller does not send written objection by the due date, the buyer's calculation is final. However, if the seller objects, then the parties try to negotiate and resolve the seller's objections. If the parties are in deadlock, they pre-agree to appoint a mutually agreed-upon public accounting firm.

In a working capital purchase price adjustment, the buyer tries to ensure it gets a minimum level of operating capital to avoid having to put cash into the company to fund post-closing working capital needs. The adjustment also mitigates the risk of a seller manipulating working capital by accelerating account receivables collection, delaying accounts payables or otherwise increasing value to the seller pre-closing.

From the seller's perspective, it typically benefits from abnormally positive NWC fluctuations, instead of giving the buyer a windfall from excess working capital. In most U.S. M&A deals, the business is operated for the seller's economic benefit and risk until the closing, so caveat emptor.

How Do I Successfully Negotiate Post-Closing Provisions?

Buyers and sellers have to set the right target. This is often a "normal" level of NTA or NWC, but this can be a challenging and subjective determination. The buyer might start with average monthly NTA or NWC for the past 12 months or some other relevant period. However, particularly during the age of COVID-19, this might not present an accurate picture of current NTA or working capital needs for the company's normal operations. In addition to unusual events, there may be seasonal fluctuations or recent growth requiring higher levels of working capital. Good accountants and financial advisers are indispensable in making the case regarding the target level of NTA or NWC.

The parties also need to define the items included and excluded in the adjustment, along with the accounting policies and procedures applied in calculations. Drafting errors can lead to expensive post-closing disputes and material losses. Lawyers should collaborate with management, accountants and financial advisers to prevent any manipulation or dispute of these items post-closing.

Many parties include language that items shall be "determined in accordance with GAAP" (generally accepted accounting principles), but this can introduce ambiguity as GAAP often allows a range of accounting policies. Seller will negotiate that the adjustment items are calculated consistent with the seller's past accounting practices for those items.

The seller will want a consistent comparison of closing NTA or NWC to avoid the buyer gaming the adjustment by changing the accounting principles. Similarly, buyers should also strive to be aware of how the seller applies the relevant accounting policies and procedures to its financial statements so they can be applied consistently in any post-closing adjustment. Buyer may want to attach a sample NTA or NWC calculation to the purchase agreement to minimize disputes.

The seller will also want to foreclose any opportunities for the buyer to "double dip" — which would occur if the buyer claims the same items both in the post-closing adjustment and under the indemnity provisions of the agreement.

The seller should ensure that no items have been double-counted in the initial purchase price adjustments for indebtedness and the initial NTA or NWC true-up at closing.

Purchase price adjustments are usually unlimited, such that they can be adjusted both upward and downward and dollar-for-dollar. Depending on the relative bargaining position of the parties, they may instead place certain limits on the amount of the purchase price adjustment.

First, the parties may implement a de minimis threshold to avoid having the seller feel "nickel and dimed." Second, the parties may elect to cap their exposure to an adjustment by establishing a "ceiling" (a "cap") or a "floor." The ceiling represents an upper limit to any adjustment amount the buyer will be obligated to pay the seller. The floor represents a limitation on the amount a seller would give back to the buyer. The use of both a ceiling and a floor is commonly referred to as a "collar."

It's very important the parties understand what limitations apply to different types of post-closing claims, as parties may get vastly different economic results if a claim is brought under the purchase price adjustment provisions compared to a claim brought under the indemnification provisions.

Five Key Points for Risk Management and Dispute Resolution

Disagreements over the accounting principles used in preparing the financial statements are the most common type of post-closing dispute. There may be differences in each party's understanding of the accounting principles used in preparing the target's financial statements. Accounting principles may not be properly defined in the purchase agreement, or perhaps different accounting principles or different applications of GAAP are used for calculating the target amount and the actual closing amount.

1. *Work Closely With Advisors During Negotiations*. The parties should work closely with their counsel, management, accountants and investment bankers to draft and negotiate (including by conducting relevant diligence into the calculation of the seller's financial statements) the purchase price adjustment provision and its related defined terms, paying particular attention to items that may be manipulated or disputed.

2. *Pay Attention to Contractual Dispute Period Timelines*. Be vigilant about notice and objection requirements and the timeline negotiated in the purchase agreement and escrow agreement, if applicable. The easiest and cleanest way for a buyer to foreclose any dispute with its final calculations is for the seller to sit on its rights and not respond in a timely manner during the dispute windows.

   When negotiating the purchase agreement, be mindful of the dispute period timeline and push out any response windows to a reasonable time frame that works for the seller parties. Be wary of any foot faults in the purchase price adjustment procedure, both in the negotiation stage and on the back end, if a dispute arises.

3. *Ensure Accountant-Arbiter is Conflict Free & Agreement Provides for Clear Fee Allocation.* If a dispute can't be worked out between the parties and an arbitrating accounting firm is engaged, the parties should make sure there are no conflicts of interest and include a clear mechanism for allocating the designated firm's fees.

Typically, the fees of the arbitrating accountant are allocated in proportion to the amount of the disputed adjustment that is resolved for and against each party.

4. *Appropriately Limit Accountant-Arbiter's Authority*. To keep the scope tailored, the designated accounting firm's authority should be limited only to the items in dispute and to resolving those disputed items within the range of values claimed by the parties. The arbitrating accountant's decision on the disputed items and the amount of the adjustment normally is final and binding, which allows the parties to move on without the need for costly and time-consuming litigation.

5. *Pay Attention to Procedures for Releasing Escrowed Funds*. Once the adjustment amount is agreed upon or is finally determined by the arbitrating accountant, payment of the adjustment amount is due. In some transactions, a portion of the purchase price is escrowed to secure payment of any adjustment due from the seller. Sometimes the agreement also will provide for interest to begin accruing on any unpaid adjustment amounts, to discourage delayed payment. Escrow agents typically require joint written instructions from both parties to release purchase price adjustment funds held in escrow to ensure they don't get in the middle of a dispute, but a buyer may try to negotiate additional objection notice requirements which, if missed, could result in a costly foot fault for the seller.

Post-closing adjustment provisions require close attention. Disputes are common and mistakes can be very costly. A team approach to negotiating these provisions is critical — the parties' internal personnel and their respective counsel, accountants and financial advisers should all be involved to help minimize costly disputes.

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