

One of the most important issues in any transaction is the price. Both buyer and seller will spend a great deal of time and effort calculating the value of a business being sold. Unfortunately, they may come up with very different prices due to both the difficulty in predicting the future success of the business and the difference in information held by buyer and seller.

Any buyer will want to be sure that it does not pay too much for a business and that the business will not have unexpected liabilities. A seller, on the other hand, will want to receive a high price and limit its postclosing exposure. Given the tensions inherent in such a negotiation, the buyer and seller will often agree to a base price, subject to adjustment based on terms agreed to in advance. Common purchase price adjustments include working capital adjustments, pension adjustments, and earn-out payments.

Working Capital Adjustments

Working capital is a measure of the net short-term assets of a business. There are several reasons for adjusting the price to reflect the working capital. Buyers are often concerned that the business will not have enough working capital following the acquisition and will need additional cash from the buyer after closing. Working capital adjustments also help the parties adjust for seasonal business cycles by setting a target working capital at historical levels.

Working capital is typically defined as current assets (e.g., inventory, accounts receivable, cash) minus current liabilities (e.g., accounts payable, short-term debt), although other definitions can be used for business that have more unique income or expenses.

The simplest form of working capital adjustment is a “one-step” adjustment. In a one-step working capital adjustment, the buyer and the seller agree to a target working capital amount as of the closing. Following the closing, the buyer will have a certain amount of time to review the books and records of the company to determine the final working capital. If the final amount is less than the target, then the seller owes the buyer the difference; if the amount is more than the target, then the buyer owes the seller the difference.

However, a “two-step” adjustment is more common. Under a two-step adjustment, the seller provides a working capital estimate a few days prior to closing and the purchase price paid on the closing is adjusted accordingly (the first step). After closing, the price is adjusted again (the second step) after the buyer has reviewed the books and records of the company.

It is best to be as specific as possible when defining working capital in order to limit disputes. However, because disputes as to the valuation of working capital often do arise, purchase agreements typically include a dispute resolution procedure specifically for the working capital adjustment. Under common procedures,

disagreements can be referred to a mutually agreed upon accounting firm to determine the value of working capital, or any specific component that is in dispute.

Pension Benefit Obligation Adjustments

One of the largest contingent liabilities typically assumed in the acquisition of an existing business is the pension obligations due to current and former employees. A company that provides its employees a pension will have both liabilities (what it owes to its retired employees) and assets (the money held in a pension fund to pay those liabilities). Whether the pension fund assets are enough to pay the liabilities will depend on when employees retire, how long they live, and the future financial returns of the pension fund. Companies calculate whether there is a shortfall between the pension plan liabilities and the pension fund assets using complex actuarial and financial methods.

Buyers generally insist that the target's pension fund should be fully funded at closing. But, given the difficulties of calculating the pension liabilities and pension fund assets, it is difficult for the parties to be sure this will be done. In order to avoid unexpected pension liabilities, buyers and sellers often agree to a post-closing adjustment of the purchase price to reflect any unfunded pension shortfall.

As with a working capital adjustment, the buyer and seller will often agree to a "two-step" adjustment. The seller will provide an estimate of the closing pension benefit obligation and pension plan assets a few days prior to closing. The purchase price paid on the closing date can then be adjusted to reflect any estimated shortfall (step one).

After closing, the buyer will review the financial and actuarial assumptions used by the seller, calculate the actual pension fund shortfall or surplus, and adjust the price accordingly (step two).

Most companies do not have the expertise to calculate pension liabilities, and usually neither do their financial and legal advisors. It is important to engage an outside expert with the actuarial expertise to calculate the pension liability and with the financial expertise to calculate the pension fund assets.

Finally, it is important to keep in mind that pension contributions are often subject to jurisdiction-specific tax and/or labor laws. Any payments from the seller to the buyer for pension contributions should be reviewed to ensure compliance with labor laws and to optimize the tax result.

Net Asset Value

Net asset value is the total book value of the assets of the company minus the total book value of its liabilities. It is common to adjust the price for net asset value if the buyer is paying net book value for the company; the buyer will want to pay the actual net book value at closing.

But net asset adjustments can be used even when the price is not based strictly on the book value of the company sold. For example, an adjustment might be used when there is expected to be a long time between signing and closing. The buyer will want some protection for a downturn in the business before closing, and the seller will want to be able to get some benefit if it manages the business well during the transition. Net asset value can be used as a simple measure of the company's

performance, and an adjustment of the price for net asset value can protect both buyer and seller.

As in the other examples, it is typical to use a “two-step” adjustment for net asset value.

Earn-Out Adjustments

All of the prior price adjustment examples given enable buyers to be sure they get what they bargained for. Although similar in purpose, an “earn-out” adjustment is not an adjustment to the closing price; it is a portion of the purchase price paid by the buyer after closing if the business meets certain benchmarks.

If the buyer and seller have very different opinions on the future performance of the company, or even of one business unit, an earn-out adjustment can help them to reach an agreement. The buyer may pay a lower initial price than the seller would like, but receive a high earn-out if the business is successful.

The benchmarks for an earn-out adjustment are generally financial targets, such as a future revenue target or an *Earnings Before Interest, Taxes, Depreciation and Amortization* (EBITDA) target. However, nonfinancial benchmarks may also be appropriate in some circumstances, such as the launch of a new product or receipt of regulatory approvals.

Sellers generally want to be as specific as possible when drafting the earn-out in order to limit the ability of the buyer to manipulate the target following closing. For example, a buyer may try to shift revenue and expenses between different entities to avoid triggering an earn-out payment. Buyers, on the other hand, will be concerned if the earn-out is too restrictive, preventing them from making necessary management decisions. If the earn-out terms prevent the buyer from shifting assets out of the purchased company, for example, the buyer may lose synergies it had hoped to acquire.

Conclusion

Purchase price adjustments are extremely effective tools for allocating risk between buyer and seller, particularly when the parties are having difficulty agreeing on the value of the business. However, because such adjustments generally prolong the life of the purchase agreement and the relationship between the parties, it is important that both buyer and seller understand the future implications of the adjustments and take as much care as possible in drafting them.

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