



# Getting What You Paid For

**Steve Navarro** and **Michael Pedrick** discuss making certain the remedies included in the acquisition of a U.S. company support the purchaser's pricing model

When acquiring a business, a purchaser will take numerous steps to value the target and seek assurances from the seller that the valuation assumptions are correct. In a U.S. acquisition, this process is not substantially different from comparable transactions outside the United States. The process typically begins with preliminary discussions between the purchaser and the target company or its owners, designed to assist the purchaser in developing a valuation of the target business both as a stand-alone operation and as combined with the purchaser's own business. Depending on the size and value of the combination synergies that can be obtained, the Purchaser can use some of this self-generated value as a kind of piggy bank to increase the purchase price it is willing to pay, particularly in a competitive bidding situation.

If the parties come to an understanding over price and other key business terms, they may enter into a heads of agreement or "letter of intent," setting forth their general agreement with respect to the key aspects of the transaction. When public companies are parties to this process, care should be taken to avoid prematurely triggering public disclosure obligations under home country or local securities laws.

At this stage, more substantive due diligence would commence. This will provide the purchaser the opportunity to validate its business assumptions and expand its knowledge of the business, assets and the liabilities of the target. In addition to its business due diligence, the purchaser will typically involve its legal counsel, accountants and, depending upon the size and complexity of the transaction, may also utilize investment bankers in this exercise.

Each of these efforts is aimed at satisfying the purchaser that it is paying a price it feels is appropriate, and protecting

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the Purchaser from the unpleasant surprise of deficiencies in the business and assets of the target and unanticipated liabilities after the transaction is completed. In particular, the purchaser's management will have determined the key economic criteria that justify the agreed price. Often this will include, in addition to the purchaser's assumptions as to the future success of the business, specific assumptions about the value at closing of key assets, whether fixed assets, the level of working capital, or other measures of assets. The purchaser will be keen to make certain that this pricing criteria is valid - that the purchaser has "gotten what it paid for."

However, due diligence efforts ultimately rely upon asking the right questions, getting a full response in a manner that the purchaser can accurately interpret, and making certain the assets are still present at closing.

Purchasers are well advised, therefore, to include within the final acquisition agreement protections that specifically address the purchaser's pricing criteria. One approach that is frequently used when acquiring a privately-held business

in the U.S., and that focuses precisely on this necessity, is including in the acquisition agreement a combination of a post-closing purchase price adjustment and representations designed to support key business assumptions.

A post-closing purchase price adjustment typically begins with the agreed assumption that the purchase price is in part dependent upon the satisfaction as of the closing date of certain metrics that the purchaser has determined are critical to its pricing model. These metrics may take account of limited categories, such as the level of specific components of working capital, or broader measurements, such as net worth. However, these are but a few typical examples, and the test should be driven by what the purchaser has determined to be critical to its pricing model.



Shortly following closing, the purchaser's or seller's accountants, as may be determined through negotiation, will prepare a closing date balance sheet, determining if an adjustment to the purchase price is required based upon the formula included in the agreement. The other party and its accountants then will have an opportunity to review this calculation and the related work-papers. Often any disputed calculation is settled between the parties, but in the event of an unresolved dispute, arbitration with accountants independent of both parties generally is contemplated by the agreement. This price adjustment has the advantage of occurring promptly after closing, and is often not subject to the initial thresholds, or limitations on amount, commonly applicable to general indemnification claims.

As a second line of defense, the purchaser will rely on key representations given by the seller as to the financial statements and other matters deemed particularly important by the purchaser, in addition to the more general representations of the Seller. Typically, financial statement representations confirm that the financial statements have been prepared from the books and records of the target, conform to United States generally accepted accounting principals ("US GAAP") and fairly and accurately present the financial condition and results of operations of the target as of the date of the financial

statements. The purchaser may be able to negotiate further representations, confirming the absence of liabilities not required to be disclosed under U.S. GAAP, and the absence of liabilities arising subsequent to the date of the financial statements. These representations will typically be broader than the specific criteria agreed for the balance sheet adjustment. While representations made in the purchase of a public company are typically extinguished at completion, with no further right of the purchaser to make a claim for breach, in the purchase of a private company, the purchaser will negotiate indemnification rights for harms suffered due to breach of representations and warranties. The terms of indemnification may provide for a post-closing period to determine the accuracy of representations, typically ranging from one to three years, may include a threshold for claims (to avoid de minimis claims) and will almost certainly provide a maximum liability for the seller.

The combination of a post-closing balance sheet adjustment and general financial representations, warranties and indemnity, provide a useful "package" whereby the purchaser is assured that the financial criteria it used in evaluating the target company and framing its purchase price model is accurate, or causing the seller to shoulder the risk if it is not.

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