Working Capital as a Purchase Price Adjustment Tool

Working capital adjustments were originally designed to ensure that enough cash remains in an acquired business to allow it to operate in the ordinary course post-closing without requiring a capital infusion by the new parent or shareholder(s), or to compensate the purchaser or vendor in the event that there is too little or too much cash, respectively, in comparison with what is needed to support the business' ordinary course operations. This is typically accomplished by specifying a working capital "peg" (an estimate calculated based on normalized historical averages) as of the closing date. Within a 60 or 90 day period after closing, the actual normalized working capital as of the closing date is calculated and compared against the peg, and the purchase price is typically adjusted up or down accordingly.

The way working capital adjustments are being used is changing, however. With a more competitive environment for transactions and with the speed at which letters of intent and term sheets are being negotiated for transactions, we have seen additional pressure on selecting a purchase price in advance of completion of due diligence or in setting a purchase price high enough in order to win in an auction or competitive bid situation. As a result, working capital adjustments may be used as a purchase price adjustment mechanism, and particularly with respect to issues which may arise in due diligence, after the target purchase price is set or once exclusivity has been negotiated.

As working capital adjustment provisions evolve beyond their traditional purpose, either intentionally or unintentionally, the risk of dispute also rises. This article summarizes some of the issues that may arise with working capital adjustments and some issues to consider while drafting to ensure more certainty in working capital adjustments.

Calculating the Peg

"Working capital" is defined as current assets less current liabilities. Current assets are those assets which are turned into cash within a period of a year, including cash and cash equivalents, inventories, accounts receivable and prepaid expenses. In most purchase transactions, cash is retained by the seller (and thus excluded from working capital) and prepaid expenses for such purposes are often limited to those prepaids that will provide a benefit to the buyer going forward. Current liabilities are those liabilities which are due within a year and would typically include short-term debt, accounts payable and accrued liabilities or "reserves". In a purchase and sale transaction it is often necessary to ensure that the items included in both current assets and current liabilities are consistent with the deal, as reflected in the other terms of the purchase agreement. For example, in an asset purchase transaction, if the buyer is not assuming accrued employment obligations at closing (such as accrued salary, vacation pay or sick days) such items should be excluded from current liabilities for working capital purposes, otherwise there is duplication. Similarly, in an asset purchase transaction, if the buyer is not assuming ongoing litigation costs, any accrual or reserve for such litigation should be excluded as a current liability.

At the time of negotiating the term sheet, parties may have very different ideas as to what the correct working capital number may be for the business to be acquired. Take an early stage business, for example. There, a purchaser may consider a more significant level of working capital to be necessary in order to transition the business to the next level, while the seller may have been operating the business with very little cash and engaging in such growth activities only when the excess cash was available. In such a case, is the "ordinary course" of the business a course of growth (with the regular investment that that entails) or a course of stability (with investment in growth being exceptional and reliant on funds outside the scope of "working capital")?

Another significant issue in calculating the peg is what should or should not be "normalized". Typically adjustments for normalizing working capital may be such things as head office charges where the company being sold is a subsidiary of a larger enterprise, and non-arm's length contracts or employment relationships. Many others are unique to each business, including accruals for liabilities, aged inventory or receivables, insurance premiums or other prepaid accounts, and matters disclosed in the agreement. Businesses with large cyclical changes to working capital, like retail businesses, may also require special mechanisms to address the period in which closing will occur, which may otherwise advantage or disadvantage the seller or purchaser. It is important to ensure that all of the definitions relating to working capital are tailored to the specific business being sold or purchased, to address the unique aspects of the business.

Consistency and the Reference Balance Sheet

There are a number of ways in which consistency can be an issue when dealing with working capital adjustments. First, and most importantly, the manner in which the peg is calculated must be consistent with the manner in which the actual working capital number is calculated. We often see a reference balance sheet included as a schedule to the working capital adjustment provision to help to ensure consistency in the approach. If a reference balance sheet is included, it is important that all line items over which an adjustment may be expected are included, even if such items have a zero balance at the time the peg is calculated. Second, should the balance sheet be consistent with GAAP and/or consistent with previous audited statements of the target company and which should trump? As wide variations can be found within GAAP compliant approaches, this question merits some consideration. Consider also the representations and warranties or indemnities surrounding GAAP compliance that may be applicable to your transaction and perhaps also to the reference balance sheet to ensure that there is no double counting or overlap.

The following cases are instructive:

Asset Classification

Without ensuring for consistency of the final working capital number with the peg, the accounting classification of an asset could be affected by intervening events, resulting in a different treatment in the reference balance sheet than applies in the final statement. An example of this can be found in *Mehiel v. Solo Cup Company* (2007 WL 901637 (Del. Super. Ct. May 26, 2007)), where the merger agreement had a post-closing adjustment for working capital, with an arbitrator to resolve disputes. At issue was a real property asset with a value of $5.6 million which had been treated as a current asset at the time of the negotiation of the peg, due to the fact that the facility was up for

sale. The buyer argued that the facility should be a long-term asset and excluded from working capital. The arbitrator agreed that the asset was a long-term asset. The court refused to hear the case as it had been settled in arbitration. Therefore, the buyer received a $5.6 million reduction to the purchase price, and still kept the real property – a significant win. To avoid this type of result, it is important to ensure that the calculation of the estimated and actual working capital is based on consistent calculation metrics.

Double Recovery

In drafting a working capital provision, it is important not to draft in isolation but to consider the impact of the provision on the other provisions of the purchase agreement. Unintended double counting can otherwise result. In *Brim Holding Company, Inc. v. Province Healthcare Company* (2008 WL 2220683 (Tenn. Ct. App. May 28, 2008)), Brim Holding Company, Inc. acquired Brim Healthcare, Inc. from Province Healthcare Company. The seller agreed to indemnify the purchaser for a piece of outstanding litigation. The purchaser paid $50,000 to settle the litigation, and demanded that amount under the indemnity. However, the seller had included a $50,000 reserve in the balance sheet for the litigation and therefore defended the claim on the basis that the amount had already been covered. While agreeing that the seller's approach was logical, the court found that the documents supported the double recovery as the indemnity was drafted to cover all damages and not just for any amount not otherwise reserved.

Disputes

There are more likely to be disputes around working capital adjustments where the adjustment is perceived to be used to alter the purchase price for matters which may have not been contemplated by one or both parties. Lack of certainty in the drafting and significant adjustment amounts may create the desire and opportunity for dispute. Many lessons may be learned with respect to disputes from the longstanding dispute detailed in *Re Ivaco Inc.* (2007), 86 O.R. (3d) 450 (S.C.J.), leave to appeal denied (2007), 87 O.R. (3d) 561 (C.A.). In September 2003, the Ivaco companies were granted protection under the *Companies' Creditors Arrangement Act (Canada)* and in December 2004, the businesses were sold to Heico pursuant to three asset purchase agreements, each of which contained a working capital adjustment. It would take almost three and half years to receive the disputed funds under the working capital adjustment, with Heico being ordered to pay $53 million. Most of the points at issue (and there were many) had to do with the process and procedural elements involved in the dispute, including (for example) whether or not the expert had the ability to make changes to both the final working capital number and the peg. The lessons learned from Ivaco include delegating procedural matters in conducting the dispute to the determination of the expert, in order to avoid a multitude of motions in court, as well as being careful to clearly limit the issues that may be subject to dispute.

Accountants as Experts vs. Arbitrators

Many working capital dispute mechanisms contemplate a third party expert to resolve any dispute that the parties are unable to resolve themselves. It may be important to consider whether you wish the expert to act as an expert or an arbitrator in resolving disputes. An arbitrator would typically ask for each side to present its arguments, and then select the winning argument. An expert would

typically ask for each side to present its arguments, and then come to a conclusion which may accept some or all of the arguments of either party, with reliance also placed on his or her own expertise. Because parties presenting arguments tend (in our experience) to take a very one-sided approach, an expert's determination may be more equitable than a choice between two starkly opposing approaches, leaving more flexibility for a solution that reconciles the parties' respective positions.

Best Practices

Consider the following best practices when negotiating working capital adjustment provisions in M&A transactions:

- Define all accounting terms that are used in the definition of working capital, taking care to ensure they are properly applicable to the business being bought or sold.
- Include a reference balance sheet outlining the calculation and specifically identifying what is to be included and excluded, including zero balances for line items to be included but which may not be applicable in calculating the peg. Ensure the reference balance sheet is used to calculate both the peg and the final working capital number.
- Consider whether or not the statement should be audited.
- Consider whether GAAP should trump or consistency with prior statements should trump. Ensure that calculation of target or estimate and final working capital are consistent. Bear in mind that being GAAP compliant may not be specific enough in the context of the treatment of certain items.
- Be mindful of the interplay between the working capital adjustment and other clauses in your agreement, ensuring (for example) that there is no double counting. If specific issues arise, a specific indemnity may be a better solution than including the matter as a working capital adjustment.
- Draft the provision so as to limit the matters in dispute, and consider if the expert should have the authority to determine procedural matters with respect to the dispute.

DISCLAIMER: This publication is intended to convey general information about legal issues and developments as of the indicated date. It does not constitute legal advice and must not be treated or relied on as such.