

## **“THE PRICE IS RIGHT,” OR DO WE NEED A PURCHASE PRICE ADJUSTMENT? A GUIDE**

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### **Introduction**

In addition to setting forth the principal financial terms of a transaction, the agreement (the “Agreement”) for the acquisition of a private company (the “Company”) also allocates the risks associated with the Company’s business among the parties to the Agreement.

Such allocation is accomplished through the representations and warranties, covenants, conditions, indemnification provisions, and purchase price adjustments (“PPAs”) contained in the Agreement.

Although the parties would usually prefer to sign the Agreement and immediately close the transaction, there are often long delays between the signing of the Agreement and the closing of the transaction (the “Closing”) for reasons such as the need for:

- antitrust and other regulatory approvals,
- third-party consents,
- continuing due diligence,
- shareholder approval, and
- financing.

The purpose of a PPA is to protect the parties to the transaction against fluctuations in the Company’s business during the period between the signing of the Agreement and the Closing (the “Interim Period”). A PPA achieves this purpose by allocating the risks and rewards of the business between the buyer of the Company (the “Buyer”) and the seller (the “Seller”) during the Interim Period.

In its simplest form, a PPA compares a specified Company financial metric as of the Closing against a negotiated target level of the same financial metric as set forth in the Agreement. If that metric at Closing is higher or lower than the negotiated target metric amount, the purchase price is adjusted up or down accordingly.

A significant majority of Agreements involving a private company target contain a post-closing PPA.<sup>1</sup> According to the American Bar Association’s Private Target Mergers & Acquisitions Deal Points Study (the “[ABA Study](#)”), 93% of the Agreements executed and/or transactions completed between 2020 and 1Q2021 included a PPA. Similarly, in the SRS Acquiom 2021 M&A Deal Terms Study (the “SRS Study”), 90% of the 2020 vintage transactions reviewed included a PPA.

PPAs are not intended to be neutral between the parties. The Buyer is protected by ensuring that the level of assets required to run the Company’s business (as represented by the Seller in the Agreement) is

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<sup>1</sup> PPAs are uncommon in public company acquisitions due to the complexities of making post-Closing payments to public stockholders.

delivered at Closing and is not appropriated by the Seller through out-of-the-ordinary course actions, such as, e.g.:

- aggressively pursuing accounts receivable or offering discounts for quick payment so as to collect more cash prior to Closing;
- failing to make needed capital expenditures; or
- failing to pay creditors on a timely basis (thereby running the risk of damaging supplier relationships).

Alternatively, a PPA enables the Seller to capture any additional value created by the Company during the Interim Period and protects the Seller if, e.g., additional capital is needed in the business due to unforeseen circumstances arising during the Interim Period, or there are slower customer payments during the Interim Period (which would result in a windfall for the Buyer).

Despite their intended neutrality, PPAs are fertile ground for disagreement at the negotiation and enforcement phases of an acquisition because they involve complex legal and accounting concepts. Disagreements over PPAs often arise from imprecise or vague language in the Agreement and the latitude afforded by generally accepted accounting principles (“GAAP”).

PPAs can be complex and may require intricate drafting. In that regard, attorneys need to memorialize three aspects of a PPA:

- the particular financial metric to be used in the adjustment;
- the target metric against which the corresponding Closing amount is to be measured; and
- the specific procedures by which the adjustment is to be determined (whether before and/or after Closing) and enforced.

## **Working Capital and the Purchase Price**

Although other financial metrics (e.g., sales, book value, stockholders’ equity) are sometimes used, the most common PPA metric is changes in net working capital.

Working capital was the chosen PPA metric in 87% of the transactions reviewed in the ABA Study. Similarly, working capital was the chosen metric in 90% of the PPAs reviewed in the SRS Study. Given its ubiquity, this guide focuses upon working capital as the relevant PPA metric.

In practical terms, working capital is the minimum capital needed by the Company to maintain its current day-to-day operations through activities such as revenue collection, accounts receivable, and inventory management. Working capital accounts are the balance sheet items that are most likely to change over the Interim Period. They may fluctuate daily as the Company purchases/sells inventory, creates/collects receivables, and pays employees and vendors. Working capital-based PPAs do not consider long-term balance sheet accounts such as Property, Plant & Equipment, or Intangible Assets, as these are unlikely to fluctuate significantly during the Interim Period.

The purchase price the Buyer is willing to pay to acquire the Company takes into account both the Company’s future cash flows and a measure of the working capital required to generate those cash flows. Therefore, the Buyer typically bases its offer price on the enterprise value of the Company “on a cash-free, debt-free basis, assuming a normal level of working capital.”

The amount of cash the Seller receives at closing is determined by deducting from the purchase price the debt that must be repaid by the Seller, offset by the cash the Seller retains. Accordingly, in a “cash-free, debt-free transaction,” the definition of working capital typically excludes cash, cash equivalents, and debt.

The “normal” level of working capital is the average working capital required to generate the level of earnings before interest, taxes, and depreciation, and amortization (“EBITDA”) that was the basis of the enterprise value reflected in the Buyer’s offer to purchase. The amount determined to be “normal” is the amount described in the Agreement as the “Target Working Capital.”

The Target Working Capital should approximate the expected level of working capital that will be reflected on the Company’s balance sheet as of the Closing (the “Closing Balance Sheet”). If the Company’s working capital on the Closing Balance Sheet is less than the Target Working Capital, then the Buyer has effectively paid for a level of working capital it did not receive.

### **Setting the Target Working Capital**

The purchase price for the Company is likely to be based on the Company’s enterprise value expressed as a multiple of its EBITDA. Although not a term recognized under GAAP, EBITDA is a commonly used measurement of a company’s basic cash profitability and ability to service debt.

Inasmuch as the level of EBITDA underlying the Buyer’s offer price is frequently measured over the most recent twelve months (“LTM”), the parties will often set a level of Target Working Capital based on the Company’s average working capital over the LTM period.

The use of an LTM average helps to mitigate the typical effects of any seasonality in the Company’s business. However, if the Company is growing rapidly and the Buyer’s offer price was based on the business’s forecasted EBITDA, then the Target Working Capital should ideally be based on the forecasted average working capital over the same period. Conversely, the parties might agree on a short average period (e.g., the latest six months) if these periods are believed to better represent the current or even short-term future state of the Company’s business.

A PPA is typically based on a comparison of (i) the amount of the net working capital on the Company’s balance sheet at Closing (the “Closing Working Capital”) to (ii) the Target Working Capital specified in the Agreement. The purchase price will be reduced if the Closing Working Capital is less than the Target Working Capital, and the Buyer will pay the Seller additional consideration to the extent Closing Working Capital exceeds the Target Working Capital.

From an accounting point of view, net working capital is the difference between the Company’s current assets and current liabilities.

Current assets generally represent assets that can be converted into cash within one year, and typically include:

- cash and cash equivalents,
- short-term investments,
- accounts receivable,
- inventories, and
- prepaid expenses.

Current liabilities represent all liabilities that are due within one year, and typically include:

- accounts payable,
- trade notes payable,
- accrued expenses,
- dividends payable, and
- current portion of long-term debt.

Importantly, using the simplistic definition of working capital in drafting the PPA may import into it certain asset or liability balances that are already otherwise addressed in the Agreement, potentially resulting in a “double count” of the same item.

To ensure an “apples-to-apples” comparison, such items should be excluded in calculating the Target Working Capital. Examples include, among other things:

- Cash or debt (which may be the subject of a separate adjustment if the acquisition is structured on a “cash-free, debt-free” basis);
- income tax assets or liabilities (which are often allocated to the parties on a pre-Closing/post-Closing basis);
- litigation and other reserves (the liability for which is often addressed in the Agreement’s indemnification provisions); and
- assets and liabilities not assumed in an asset purchase.

In analyzing the Company’s balance sheet, the parties need to understand that individual account balances are not one homogeneous item. There may be individual components that need to be considered separately.

In lieu of a generic definition, the definition of Target Working Capital should specify the particular accounts (including accounting general ledger references) that are included in current assets and current liabilities and should specify accounts that are excluded. Attaching a sample calculation as a schedule to the Agreement is a helpful means of narrowing the range of any misunderstanding. The example of how working capital should be calculated should go to the trial balance account level of detail to show which accounts should be included.

Another factor that the parties need to understand and address is the interrelationship between the nature of the Company’s business and its working capital needs.

- **Seasonal business:** Working capital may vary significantly over the course of the year. At Closing, working capital may be very different than it was when the Agreement was signed.
- **Growth businesses:** A growing business often has increasing needs for working capital as sales grow. With growth, receivables and inventories may increase each month, requiring working capital to grow as well.
- **Subscription business:** If the Company receives payment before a product or service is delivered (e.g., as in the software business), the Company may operate with negative working capital. As the business grows, it generates working capital. In a cash-free, debt-free transaction, the Buyer will

have the obligation to provide services to customers post-transaction while the related cash remains with the Seller.

- **Volatile business:** Working capital can be erratic when customers payments are large and infrequent, or in a commodity driven business where commodity valuations may be subject to unpredictable swings.

Before setting the Target Working Capital, the Buyer should engage in due diligence to understand the accounting policies, judgments, and estimates that are implicit in the Company's financial statements. The focus should be on those areas most likely to create an unanticipated result. If the Buyer disagrees with the Company, the disagreement should be resolved and addressed in the Agreement.

Things to consider in establishing the Target Working Capital include:

- What is normal for the industry?
- What is working capital as a percentage of sales?
- What special terms cause the Company's working capital to vary?
- How significantly does inventory vary on a month-to-month basis?
- Do seasonal sales affect working capital?
- Are the business and its working capital needs growing?

## The Adjustment Process

A gating issue in the adjustment process is agreeing upon which party will prepare the Closing Statement (defined below).

The Seller argues that it has better knowledge of the Company's business and financials and, therefore, should calculate the Closing Working Capital. The Buyer will want to do the calculation because it is buying the Company and will be running it post-Closing.

Typically, the Buyer (which, post-Closing, will have access to the Company's books and records) wins the negotiation and prepares a closing statement within a set time frame (e.g., sixty or ninety days after Closing) (the "Closing Statement"). The timing for the preparation of the Closing Statement should accommodate the need for physical inventories and the challenges and time required to coordinate multi-location businesses or warehouse sites.

In 94% of the transactions reviewed in the ABA Study, the Buyer prepared the Closing Statement.

In *Schillinger Genetics v. Benson Hill Seeds, Inc.*, the Delaware Court of Chancery (the "Court") held that the Buyer's failure to timely provide a Closing Statement resulted in a waiver of the Buyer's right to a PPA and that the Seller was entitled to the escrow funds that secured the Seller's obligation to fund any negative post-Closing adjustment.<sup>2</sup>

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<sup>2</sup> [Schillinger Genetics, Inc. v. Benson Hill Seeds, Inc.](#), No. 2020-0260-MTZ, 2021 WL 320723 (Del. Ch. Feb. 1, 2021).

Following delivery of the Closing Statement, the Seller generally has a set period of time (generally, thirty to sixty days) to review the Closing Statement and send to the Buyer a notice of objection (an “Objection Notice”).

However, if, before Closing, the parties believe that the Closing Working Capital is likely to be materially different than the Target Working Capital, they may agree to a two-step process.

In a two-step process, one of the parties—typically the Seller—will deliver an estimate of the expected Closing Working Capital (the “Estimated Working Capital”) shortly before Closing, and the amount the Buyer pays at Closing will be adjusted to account for deviations between the Estimated Working Capital and the Target Working Capital. After Closing (and the Buyer’s review of the Company’s books and records), the Buyer will deliver a Closing Statement that compares the Closing Working Capital against the Estimated Working Capital, and a true-up payment is then made by the Buyer or Seller.

Two-step adjustments are prevalent because they reduce the likelihood of large true-up payments. 82% of the transactions reviewed in the ABA Study featured a two-step process, and in 94% of those transactions the Buyer did not have an express right to approve the Estimated Working Capital amount.

Depending on the relative bargaining position of the parties, the Agreement may sometimes provide for an upper limit (a “cap” or “ceiling”) to the amount a Buyer will be obligated to pay the Seller pursuant to the PPA. Alternatively, the parties may agree upon a cap to the amount the Seller will be obligated to pay or give back to the Buyer post-Closing, thereby reducing the final purchase price paid by the Buyer to a floor.

The Agreement may further provide for a cap and a floor on the adjustment amount to be received or paid by the Seller and Buyer, respectively (a “collar”). The parties may also agree to a *de minimis* threshold below which neither party is liable for an adjustment. However, 90% of the transactions in the ABA Study, and 87% of the transactions in the SRS Study, did not have such a threshold.

Because it is simple and protects the parties equally, most transactions feature a simple dollar-for-dollar, up or down, adjustment.

Agreements often specify that the Objection Notice must identify and explain each item in dispute and require the objecting party to indicate the individual dollar amounts of each of its objections. Some agreements limit the types of objections that can be raised.

Typically, the parties are required by the Agreement to negotiate in good faith for a period of time to try to resolve any disputes. If the disputes cannot be resolved, the parties submit the unresolved issues to an independent accounting professional for final and binding resolution (See “Disputes and Arbitration” below).

## **Common Areas of Controversy in Purchase Price Adjustments**

### *Generally Accepted Accounting Principles (“GAAP”) Versus Consistency*

Possibly the most significant negotiation point between the parties is the methodology used to measure the Closing Working Capital.

A Seller will want to ensure that the comparison between the Target Working Capital and the Closing Working Capital is made on an “apples-to-apples” basis in reliance on the Company’s historical accounting policies, practices, and assumptions (which may or may not have been in compliance with GAAP).

- The Seller will argue that the PPA is only intended to measure the change between the Target and Closing Working Capital.
- The Buyer will want to rely on GAAP to ensure against deviations from GAAP in the Company's historical accounting practices.

Parties will often default to GAAP, assuming that it represents objective principles for calculating the Closing Working Capital balance. However, GAAP recognizes a wide range of acceptable bases for accounting for the same item, and the preparation of the Company's financial statements involves the application of management judgment.

Importantly, apart from the PPA, the Agreement will generally include a representation by the Seller that the financial statements provided to the Buyer are in compliance with GAAP, consistently applied (the "GAAP Rep"). For example, while GAAP requires a company to have a reserve for bad debts, it does not elaborate on how the reserve is calculated. A Buyer could claim that the reserve has not historically been adequate and needs to be increased, thus reducing Closing Working Capital and leading to a price adjustment in the Buyer's favor.

The GAAP Rep, and the Company's auditor's opinion, only address whether the Company's financial statements, taken as a whole, are in conformity with GAAP, not whether specific balances or methodologies are in accordance with GAAP. In contrast, the PPA is concerned with specific balances on a dollar-for-dollar basis.

Another issue is that GAAP includes the pervasive concept of materiality.

The Seller will argue that the Company's GAAP financial statements reflect the concept of materiality. To the extent that the Buyer's proposed adjustments are immaterial, either individually or in the aggregate, the Seller can argue that they do not violate the Agreement's GAAP Rep. The Buyer usually will claim that all adjustments should be awarded to it regardless of materiality, unless the Agreement contains a threshold, basket, or similar provision.

Complications can also arise when the Company follows GAAP in its year-end accounting but not on an interim basis, or when the Company has never closed its books on an intra-month basis and the transaction closes mid-month.

Generally, a GAAP-compliant presentation considers what is known or knowable at the date of the preparation/delivery of the Closing Working Capital balance.

To address the differing positions of the Buyer and Seller, various alternative formulations are often used, including that the Closing Working Capital be determined:

- "in accordance with GAAP applied in a manner consistent with the methodologies and principles used to determine the Company's most recent balance sheet,"
- "in accordance with GAAP applied in a manner consistent with the Company's historical practices,"
- "in accordance with GAAP applied in a manner consistent with the methodologies and principles used to determine the Target Working Capital," and
- by subtracting current liabilities from current assets (with each defined by reference to a list of included and excluded general ledger accounts).

50% of the transactions reviewed in the ABA Study referenced either “GAAP consistent with past practices” (25%) or “GAAP with specified modifications” (25%). 64% of the transactions in the SRS Study used “GAAP consistent with past practices.”

While some uncertainties can be addressed by qualifying the basic GAAP standard with a reference to “consistently applied with the Company’s historical financial statements,” disagreements can still arise (as described below under “Common Areas of Controversy: Illustrative Cases”). Therefore, Sellers will often negotiate for a separate exhibit of specific accounting methodologies and principles to be used when calculating the Closing Working Capital. Sometimes parties will also attach a sample calculation of Closing Working Capital as an exhibit to the Agreement to minimize disputes later about the way the calculation is to be performed.

### *Illustrative Cases*

#### *Alliant Techsystems, Inc. v. MidOcean Bushnell Holdings, L.P. (“MidOcean”)*

- The Agreement in *MidOcean* provided that, for purposes of its PPA provision, “net working capital” was the sum of all current assets minus the sum of all current liabilities “calculated in accordance with GAAP and otherwise in a manner consistent with the practice and methodologies used in the preparation of” the historical financial statements of the Seller.<sup>3</sup>
- The Agreement also contained a customary GAAP Rep.
- Under the Agreement, a claim styled as a PPA was recoverable without any deductible with a cap of approximately \$12.4 million, while an indemnity claim for breach of the GAAP Rep was subject to a deductible of approximately \$4.9 million and a cap of approximately \$7.4 million.
- The Seller argued that the Buyer’s claim for a deficiency in working capital should be treated as a breach of the GAAP Rep and that Closing Working Capital should be determined consistently with the way the Target Working Capital was established—regardless of whether it was compliant with the GAAP Rep.
- The Buyer argued that compliance with GAAP was a fundamental requirement of the PPA provision and that where a dispute implicates both the PPA provision and the indemnification provision, the exclusive remedy clause of the Agreement gave precedence to the exclusivity of the PPA.
- The Delaware Court of Chancery (the “Court”) agreed with the Buyer, finding that the two prongs of the PPA were each independent and would not be satisfied by a Closing Working Capital calculation that was not in accordance with GAAP, even if consistent with the Seller’s historical practices and principles.
- As such, the Court held that any disputes with respect to the PPA had to be referred to an accounting professional for resolution.

#### *Golden Rule Financial Corp. v. Shareholder Representative Services, LLC (“Golden Rule”)*

- The Agreement in *Golden Rule* provided that the PPA would specifically reflect ASC 606, which was already incorporated in the target company’s financial statements.<sup>4</sup> The Agreement in *Golden Rule* also stated that the PPA would be prepared using “consistently applied” accounting principles.
- In calculating the Closing Working Capital, the Buyer determined that the Seller had been consistently, but incorrectly, applying ASC 606 in its financial statements and that the correct application would increase the purchase price by several million dollars. Using the incorrect methodology would decrease the purchase price by a similar amount.

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<sup>3</sup> [Alliant Techsys., Inc. v. MidOcean Bushnell Holdings, L.P.](#), No. 9813-CB, 2015 WL 1897659 (Del. Ch. Apr. 24, 2015).

<sup>4</sup> [Golden Rule Fin. Corp. v. S’holder Representative Servs. LLC](#), No. 2020-0378-PAF, 2021 WL 5754866 (Del. Dec. 3, 2021).

- The Seller argued that the correct application should be used, and the Buyer requested the Court to find that the PPA required a consistent, but incorrect, application of ASC 606.
- The Court agreed with the Seller, finding that the specific reference to ASC 606 in the Agreement, as opposed to the more general reference to the consistent application of accounting principles, better reflected the parties' intention to utilize ASC 606.
- In affirming the Court's decision, the Delaware Supreme Court (the "DSC") explained that blessing an incorrect application of ASC 606 would result in that standard "being left unapplied, despite the parties' express agreement to apply ASC 606." Allowing the parties to continue to incorrectly apply ASC 606, even if consistent with prior treatment, would result in its not being applied at all.
- The DSC considered *Chicago Bridge* (see "Interplay with Other Agreement Provisions—Illustrative Cases" below) but found it distinguishable on the basis that the Agreement in *Golden Rule* specifically required application of ASC 606.

### *Current Assets*

#### Cash and cash equivalents

Common areas of controversy regarding cash and cash equivalents include:

- Will the Seller retain any "excess cash" not needed in the ordinary operations of the Company?
- How will cash in transit at closing be treated?
- Cash equivalents are generally marketable securities, and GAAP requires that they be recorded at the lower of cost or market value. If this is a material item, the parties may want to specify when the market value of the securities will be tested or may agree to deviate from GAAP and allow the securities to be booked at market value even if it exceeds cost.
- Will a revolving line of credit be included, and if so, how will it be treated? Revolving lines of credit are typically excluded from the definition of working capital as they generally reduce the purchase price (on a debt-free basis). However, certain revolvers take the place of payables and, therefore, should be treated as working capital rather than debt.

#### Accounts receivable

Accounts receivable are often the single largest component of working capital assets, and the quality of receivables can vary.

- Deductions (contra accounts) for sales returns and allowances, rebates, and discounts can be material, and the methodology for establishing them can be complex.
- There can be controversy regarding the methodology used to estimate the allowance for doubtful accounts and bad debt reserves.
- A Buyer may be concerned that the Seller (i) has been unrealistic about the collectability of its receivables (resulting in lower allowances for doubtful accounts and a higher working capital balance) and (ii) is incentivized to use less stringent credit standards during the Interim Period (also resulting in a higher working capital balance).

A good practice is to provide in the Agreement that any receivable not collected within a specified period (e.g., ninety days) will be deducted from the receivable balance.

Other common points of controversy include:

- Treatment of intercompany receivables among entities affiliated with the Seller

- Treatment and valuation of receivables subject to litigation or dispute

### Inventory

Inventory can include raw materials, finished goods available for sale, and goods in the process of being manufactured.

There may be different approaches to valuing inventory at the lower of cost or market. For example, parties using a GAAP-based standard might disagree whether a Buyer violated that requirement by applying a last in, first out (“LIFO”) method to value inventory in calculating the Closing Working Capital, as compared to the Seller’s use of first in, first out (“FIFO”), as both methods are recognized as valid under GAAP.

There may also be disagreement over reasonableness of the reserves for shrinkage, inventory obsolescence, and excess inventory. The setting of these reserves involves a fair amount of discretion that can lead to disputes.

Treatment of consignment inventory, inventory in transit, or inventory that has the right to be returned at the end of the selling season can also be a source of controversy.

### Prepaid Expenses

Prepaid expenses represent an asset created by using cash now to pay for an expense that will be incurred in the future, and which may, or may not, benefit the Buyer in the future.

For example, the fact that the Seller has paid an annual insurance premium in full does not necessarily give rise to an asset that will benefit the Buyer if the Buyer self-insures or the policy lapses upon a change-in-control of the Company.

## *Current Liabilities*

### Accounts Payable

Accounts payable, like accounts receivable, are usually a major working capital item and present an issue as to whether and how much the Company believes it will have to pay for disputed payables.

There may be dispute over cut-off principles for services performed or products shipped but not yet billed.

### Accrued Expenses and Accrued Liabilities

Accrued expenses or liabilities arise because GAAP requires the current recognition of an obligation when it is incurred even though payment will not be due until a future date. Common examples are commissions, bonuses, payroll taxes, vacation pay and bonuses, health and welfare benefits, and warranty reserves, which are often subject to estimates.

The adjustments to accruals typically occur at the end of an accounting period and may not occur until the end of the annual accounting period.

### Deferred revenue

Deferred revenue represents revenue collected in cash but not yet earned. It is recorded in the current period as a liability representing the obligation of the Company to perform in a future period.

Common examples of deferred revenue include rent or license fees paid in advance, paid subscriptions, and deposits made by customers prior to delivery of products sold to them.

## **Interplay with Other Agreement Provisions**

In the Agreement, the Buyer will seek to shift Interim Period risks to the Seller through (i) representations, (ii) provisions that condition the Buyer's obligation to close upon the correctness of those representations, (iii) provisions that obligate the Seller to indemnify the Buyer for losses resulting from the Seller's breaches of its representations, and (iv) covenants that regulate the Seller's ability to operate the business during the Interim Period.

The parties need to understand the relationship between the PPA provisions and the representations, warranties, and covenants contained in the Agreement.

### *Covenants*

In focusing on net working capital, a PPA does not address changes in the Company's business with respect to long-term assets and liabilities, thus allowing a Seller to change the conduct of the business during the Interim Period.

For example, the Seller might defer buying needed inventory, because doing so would result in a downward PPA. Similarly, the Buyer may want to prevent the Seller from selling fixed assets so as to increase the cash available to the Seller.

Such issues need to be addressed through Interim Period operating covenants. However, the Buyer should not place undue reliance on covenants that require the Seller to operate the Company's business in the ordinary course of business inasmuch as proving that a practice does not comport with the Seller's ordinary course of business can be difficult.

### *Indemnification*

Conflicts often arise when disputes can be characterized as PPAs or as indemnification claims or both. To avoid a potential double recovery, if the Seller has agreed to indemnify the Buyer against specific losses, any reserve with respect to such losses should be excluded from the PPA calculation, and, instead, should be covered by the Agreement's indemnification provisions.

Conversely, the Agreement should have an express exclusion from the indemnity for matters addressed by a PPA, as well as an express exclusion from the PPA of items for which the Seller retains responsibility.

While indemnification seeks to compensate the Buyer for the absolute amount of a loss, the PPA only addresses the difference in the balance related to such loss between the Target and Closing measurements.

The practical significance is that an indemnification claim may not provide a Buyer with as full a recovery as a PPA, since indemnification claims are typically subject to dollar thresholds, caps, and limitations on the types of damages that may be recovered. In addition, indemnification claims usually require the Buyer to bear the additional time, expense, and burden of proof challenges attendant to a litigation (as compared to the relative efficiency of an arbitrator's determination of a PPA dispute).

Buyers frequently try to characterize indemnification claims as being subject to the PPA dispute resolution process. The Court has resisted attempts to use a PPA to address wider arguments over financial statement accuracy or integrity (especially where such matters are expressly covered in the Agreement's reps and warranties).

## Illustrative Cases

### OSI Systems v. Instrumentarium Corp. (“OSI Systems”)

- In *OSI Systems*, the Court held that a Buyer’s claim that the Target Working Capital was improperly calculated in accordance with GAAP should instead be brought as an indemnification claim as to the accuracy of the Seller’s GAAP Rep.<sup>5</sup>
- The Court was concerned that the Buyer was trying to circumvent the damages limitation cap for indemnification claims by “funneling” them into the PPA dispute resolution process.
- Specifically, the Court found that the Agreement in *OSI Systems* required the arbitrating accountant to apply the accounting principles used in setting the Target Working Capital to the Closing Working Capital, even though those principles were not compliant with GAAP.
- In contrast to *MidOcean*, the Agreement required the application of the same accounting principles to the PPA as those used by the Seller historically, rather than the two-pronged requirement in *MidOcean*.

### Matria Healthcare v. Coral SR, LLC (“Matria Healthcare”)

- Similarly, the Agreement in *Matria Healthcare* included both a PPA process that required disputes to be submitted to an arbitrating accountant and a separate arbitration provision for claims for breaches of representations and warranties.<sup>6</sup>
- Recovery for representation claims was limited to an escrow fund and specifically excluded matters related to the PPA process.
- The Court found that the exclusion required that the dispute over the accounting treatment of a settlement with one of the Seller’s customers be resolved by the accountant pursuant to the PPA, even if it could also be considered a breach of a representation.

### Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC (“Chicago Bridge”)

- In *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC* (“*Chicago Bridge*”), the DSC reversed the Court and prevented the Buyer (Westinghouse) from recovering for a PPA based on a Closing Working Capital calculation that did not comply with GAAP.<sup>7</sup>
- Under the Agreement, there was no post-closing indemnification for breaches of the Seller’s representations and warranties.
- The DSC also held that the Buyer’s claims regarding non-compliance with GAAP, when considered in the context of the PPA, were barred by the express language of the Agreement, which only required consistency with the Seller’s past practice (in contrast to the two-pronged provision in *MidOcean*).

## Dispute Resolution

Invariably, the Agreement will set out a process for resolving PPA disputes. In order to expedite dispute resolution in a cost-effective manner relative to litigation, most Agreements provide for an independent accounting professional to resolve such disputes (the “Neutral”).

Considerations in selecting a Neutral include:

- industry experience and knowledge regarding industry-specific accounting policies, practices, and assumptions;

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<sup>5</sup> [OSI Sys., Inc. v. Instrumentarium Corp.](#), 892 A.2d 1086 (Del. Ch. 2006).

<sup>6</sup> [Matria Healthcare, Inc. v. Coral SR LLC](#), No. 2513-VCN, 2008 WL 401125 (Del. Ch. Feb. 14, 2008).

<sup>7</sup> [Chi. Bridge & Iron Co. N.V. v. Westinghouse Elec. Co. LLC](#), 166 A.3d 912 (Del. 2017).

- arbitration or litigation experience (preferably including PPA disputes); and
- independence (no prior business relations with Buyer or Seller).

The Agreement should include all material terms of the dispute resolution process, including:

- the forum;
- the number of Neutrals;
- the qualifications of the Neutral (unless the parties identify by name one or more particular individuals [and if so, identify alternates if the original party is unable or unwilling to participate]);
- the process to be followed by the Neutral; and
- the binding nature of the dispute resolution process.

In the event the parties cannot agree on a Neutral, the Agreement should include a procedure for determining an acceptable Neutral (e.g., each party picks an accounting professional, and the two professionals work together to select a third party to resolve the dispute).

The Agreement should also address:

- the scope of the information that will be made available to the Neutral;
- whether the Neutral is limited to the parties' submissions or whether the Neutral will have the ability to request clarifying information, interview/depose witnesses, request briefings, and conduct hearings; and
- the time period available to the Neutral to render a decision (e.g., "as promptly as possible" or "within 30–60 days after submission").

The parties will also want to agree upon who is responsible for the fees and costs associated with any arbitration. Alternatives include:

- The parties split the cost 50/50.
- Each party pays proportionally to the Neutral's resolution of the items in dispute as compared to its position—the party whose position is closer to the Neutral's decision pays a smaller percentage.
- The party whose position is furthest from the Neutral's decision pays all expenses (thus motivating the parties to take reasonable positions).
- The Neutral decides.

As many Agreements with PPAs contemplate an escrow agreement to fund any PPA obligation, the parties will also need to address the terms and conditions of the escrow agreement and the escrow agent's obligations with respect to any arbitration proceeding.

47% of the transactions in the ABA Study and 68% of the 2020 transactions reviewed in the SRS Study featured an escrow.

Typically, the duration of a PPA escrow is relatively short (e.g., sixty to 120 days) because it only reflects the time needed post-Closing to complete the PPA process (in contrast to an indemnification escrow, the duration of which is usually twelve to twenty-four months after Closing).

One of the key considerations is identifying what, exactly, is subject to review by the Neutral. In this regard, the Agreement should address:

- whether the Neutral can undertake a wholesale review of the parties' accounting calculations or is limited to addressing solely the specific "items in dispute," which should be a defined term in the Agreement;
- whether the Neutral can resolve procedural disputes (e.g., whether requirements relating to specificity of the Objection Notice, access to information, and/or time deadlines have been met, and the consequences of noncompliance);
- whether the Neutral can consider subsequent events that indicate the Buyer's or Seller's position is unreasonable given what was "known or knowable" when the Closing Working Capital was calculated; and
- whether there are any limitations on the Neutral's decision, such as (i) it cannot be higher or lower than the parties' respective positions on the item in dispute or (ii) the Neutral must pick one party's position or the other in its entirety (so-called "baseball arbitration").

The Seller will want to limit the Neutral's scope to assessing whether amounts were calculated in accordance with the Agreement. The Buyer may want the Neutral to have the discretion to decide that the Target Working Capital was not determined in accordance with GAAP or was otherwise incorrectly determined.

The Agreement should detail the principles, policies, and practices to be followed by the Neutral. Some contracts may refer to third-party guidelines, such as the American Arbitration Association rules.

The Agreement should also specify the circumstances, if any, under which the Neutral's decision can be appealed (e.g., the decision is "final and binding on the parties absent fraud or manifest error") and whether the Neutral's decision should be enforced by arbitration or the Court.

There is a well-developed body of law in Delaware that addresses the scope of a Neutral's authority. Generally, issues of substantive arbitrability (e.g., scope of an arbitration clause) are for the Court to decide. Issues of procedural arbitrability (e.g., satisfaction of conditions precedent, information to be considered) are for the Neutral.

Procedures for enforcement of, or challenges to, awards by Neutrals depend on whether the Neutral is an arbitrator or an expert.

- Arbitrator: Delaware has a specific expedited procedure for enforcement of an arbitration award, and very limited grounds for challenging such awards.
- Expert: Enforcement is via an action for specific performance.

Many Agreements provide that the Neutral shall act as an expert and not as an arbitrator, thereby shifting contractual interpretation to the Court and limiting the Neutral strictly to the functions provided by the Agreement. As a result, litigation can arise regarding:

- whether the parties negotiated in good faith prior to commencing the dispute resolution process;
- whether the Buyer has provided the Seller with adequate information in response to requests, and whether that is a condition precedent to the PPA process; and

- what information the Neutral can consider.

### *Illustrative Cases*

#### *Penton Business Media Holdings LLC v. Informa PLC* (“Penton”)

- In *Penton*, the parties disagreed as to whether the Neutral could consider extrinsic evidence to resolve a dispute over the allocation of certain tax benefits.<sup>8</sup> The Agreement in *Penton* provided that the Neutral “shall be acting as an accounting expert only and not as an arbitrator and shall not import or take into account usage, custom or otherwise extrinsic factors.”
- The Seller (Penton) wanted to provide the Neutral with extrinsic evidence and filed a suit seeking a declaration by the Court that the Neutral had the authority to determine what information it could consider.
- The Court’s analysis began with an analysis of whether, pursuant to the Agreement, the Neutral was acting as an expert or an arbitrator. If the latter, the doctrines of substantive and procedural arbitrability would apply, under which it is presumed that arbitrators have the authority to decide procedural issues such as questions about what evidence can be considered. In contrast, if the Agreement called for an expert determination, the Court must interpret and apply the Agreement, in which case the Court would determine what evidence the Neutral could consider.
- Based on the plain language of the Agreement, the Court determined that the Neutral was acting as an expert and that, as a matter of law, “an expert charged with making a narrow determination will not have authority to interpret the governing agreement unless the [C]ourt says so.”
- The Court found that the Agreement expressly provided that the Neutral could not consider extrinsic evidence.

#### *Agilience, Inc. v. Resolver SOAR, LLC* (“Agilience”)

- In contrast to *Penton*, in *Agilience*, the Court held that the parties had agreed to arbitration and not to an expert determination based on, among other things, the use of the words “arbitration,” “arbitrate,” and “arbitral” in the Agreement.<sup>9</sup>

#### *Ray Beyond v. Trimaran Fund Management* (“Ray Beyond”)

- In *Ray Beyond*, a dispute arose over whether a particular contract was a “qualifying contract” under the Agreement (which would entail the release of escrowed purchase price funds). The relevant Agreement provided that “in the event the...escrow amount is not fully distributed prior to July 1, 2018...and [the parties] are not able in good faith to agree upon an appropriate distribution of the...escrow amount, the matter shall be referred to the settlement accountant.”<sup>10</sup>
- The Agreement in *Ray Beyond* further provided that the settlement accountant would serve as “an expert, not an arbitrator.”
- The Court focused on whether “the matter” of the “appropriate distribution” should be interpreted to delegate to the settlement accountant and held that such an interpretation was unwarranted inasmuch as it was “inconsistent with the parties’ intent to narrow the [s]ettlement [a]ccountant’s role to that of an ‘expert, not an arbitrator.’”

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<sup>8</sup> [Penton Bus. Media Holdings, LLC v. Informa PLC](#), 252 A.3d 445 (Del. Ch. 2018), *judgment entered*, No. 2017-0847-JTL, 2018 WL 3845737 (Del. Ch. Aug. 10, 2018).

<sup>9</sup> [Agilience, Inc. v. Resolver SOAR, LLC](#), No. 2018-0389-TMR, 2019 WL 343668 (Del. Ch. Jan. 25, 2019).

<sup>10</sup> [Ray Beyond Corp. v. Trimaran Fund Mgmt., LLC](#), No. 2018-0497-KSJM, 2019 WL 366614 (Del. Ch. Jan. 29, 2019).

Stone v. Nationstar Mortgage, LLC (“Stone”)

- In *Stone*, any unresolved disputes were to be referred to a particular independent accounting firm; if such firm refused or was otherwise unable to act as the independent accounting firm, the parties were to cooperate in good faith to appoint another firm that would make a final determination as to the dispute item.<sup>11</sup>
- The Seller objected to certain of the Buyer’s calculations in determining “the Final Closing Payment Amount,” and the Buyer argued that the chosen accounting firm did not meet the independence requirement set forth in the *Stone* Agreement.
- The Court found that the parties’ accounting disputes were to be referred to an independent accountant (who was to act as an expert and not as an arbitrator).
  - Although the Agreement did not expressly state that the settlement accountant was “an expert not an arbitrator,” the dispute resolution provisions of the Agreement did not “bear the hallmarks of an arbitration provision” in that they did not include procedural rules “mimicking the judicial process” or reference “issues typically resolved by legal professionals.” Accordingly, the Court held that “it is safe to conclude that a contractually-designated accountant is intended to serve as an expert, not an arbitrator.”
    - The Court explained that “Delaware courts have rejected contractual parties’ efforts to plead around the scope of a third-party decision-maker’s authority by couching delegable disputes in questions of law.”
- The Court also held that the independence requirements under the Agreement were ambiguous, and the assessment of the original settlement accountant’s independence implicated legal questions to be answered by the Court.

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<sup>11</sup> [Evan M. Stone v. Nationstar Mortg. LLC](#), No. 2019-0878-KSJM, 2020 WL 4037337 (Del. Ch. July 6, 2020).

## Appendix: Disclaimer

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