

Purchase Price Adjustment Mechanisms in M&A Transactions – The Locked Box Mechanism

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The determination of the purchase price in a private M&A transaction is an integral part of the commercial negotiation and, as a result, the sale and purchase agreement. In the UK, the two approaches normally used for calculating the price of the target business are either a closing balance sheet adjustment or a locked box mechanism. While a closing balance sheet adjustment mechanism may be the most common approach, the locked box mechanism is increasingly becoming the preferred route from a seller's perspective, particularly with private equity or other financial seller's where being able to return value to stakeholders is critical. We are also increasingly seeing locked box mechanisms used on non-UK deals.

This briefing sets out how the locked box mechanism works, the key benefits and potential pitfalls of using this mechanism, together with some practical considerations to be aware of when using a locked box mechanism.

What is a locked box mechanism?

To illustrate, consider the following common structure for a private M&A transaction:

- the target is acquired on a 'debt free/cash free' basis, where the equity value equals enterprise value less net debt;
- the target is acquired with what the buyer considers to be a normal level of working capital; and
- the enterprise value of the target is determined as a multiple of what the buyer believes to be the target's sustainable earnings, often an EBITDA multiple.

Under a traditional closing balance sheet adjustment, the purchase price is paid as an estimate at closing. The purchase price is then adjusted after closing based on the difference in the working capital¹ of the business between the figure used in determining the estimated purchase price (or some other reference figure) and the actual figure calculated from a special purpose closing balance sheet prepared as at the closing date.

By contrast, if a locked box mechanism is used, the purchase price is calculated and negotiated by reference to a recent historic set of accounts dated prior to the date of signing of the SPA, commonly called the 'locked box date'. As the amount of cash, debt and working capital are therefore known by the parties at the time of signing of the

SPA, the agreed price of the target business is fixed and written into the SPA. Consequently, the buyer will have no ability to adjust the purchase price after closing and will have to rely on contractual protections (through warranties, which are usually supported by an indemnity) to ensure no value leaks from the box through to the closing date. A key effect of this approach is that economic exposure (benefit and risk) to the target effectively transfers from the seller to the buyer at the locked box date, rather than at the closing date.

The benefits of a locked box mechanism

The main benefits of a locked box mechanism are:

- the purchase price is fixed at signing – giving the parties price certainty;
- no provisions are required in the SPA to deal with a closing balance sheet, which can be lengthy and heavily negotiated, saving the parties time and costs; and
- the parties are not required to prepare a closing balance sheet and deal with subsequent disputes, again saving time and costs, and allowing management to focus on the target business.

In addition, a locked box approach can make it easier for a seller to compare bids in an auction, as the bidders will be asked to submit a fixed price based on a set of locked box date accounts supplied by the seller in the due diligence information.

Using a locked box mechanism

First and foremost, the buyer needs reliable locked box date accounts to commit to a locked box mechanism. The buyer will not have the chance to test the target's balance sheet through a closing balance sheet, as it would under a closing balance sheet mechanism. Consequently, the buyer will seek accounts that are not out of date at signing, and will want them to have been independently reviewed or audited. Given that it is not possible to adjust the purchase price, a well-advised buyer should also:

- undertake thorough financial due diligence on the locked box date accounts;
- require strong warranties relating to the locked box date accounts; and
- require strong warranties relating to the target's operations and performance since the locked box date.

Under a closing balance sheet approach, the buyer will typically be in control of preparing the closing balance sheet. Usually, this will put the buyer in a strong position to put forward its view of the appropriate value for certain items, like distressed inventory or doubtful debtors. However, with a locked box, the seller is in control of preparing the locked box date accounts. As a result, even after thorough financial due diligence the buyer may still be taking a risk on the value of the assets shown in the locked box date accounts.

A locked box will not provide the buyer with protection from ordinary course changes in the value of the business between the date of the reference accounts and closing. As noted above, once the SPA is signed (assuming no conditionality agreed separately), the buyer takes the economic risk and reward of the business on a retrospective basis from the locked box date until closing. As a result, such a mechanic is unlikely to be acceptable to a buyer where:

- the target business is of a seasonal nature and the values in a closing balance sheet will differ wildly from those in the reference accounts;
- the target business is highly integrated into the operations of the remainder of the seller's business. This will make the definitions around "leakage" extremely difficult as both parties will need to determine, on a case-by-case basis, which of the cash-flows are arms' length/ordinary course and which need to be trapped in the box; or
- there is a long period of time between the reference accounts and closing. This obviously affords a long period in which payments can leak between the target business and the retained group.

Summary of Pros and Cons for a Locked Box Mechanism

SELLER	BUYER
<p>Pros</p> <ul style="list-style-type: none"> • Price certainty • Simplicity – no closing adjustment mechanism • Lower cost – management time not tied up post-closing • Increased control of the process • Easier to compare bids in an auction 	<p>Pros</p> <ul style="list-style-type: none"> • Price certainty • Simplicity – no closing adjustment mechanism • Lower cost – management time not tied up post-closing
<p>Cons</p> <ul style="list-style-type: none"> • Will not get full benefit from operation of target business in interim period • Potential to lose out financially if interest/profit charge for the interim period is set too low 	<p>Cons</p> <ul style="list-style-type: none"> • No closing mechanism to exploit • Limited ability to get management on side for post-close disputes • Risk of business deteriorating between locked box date and closing • Need to debate purchase price adjustments earlier, and with potentially less knowledge about the target

Specific Issues

Leakage and permitted leakage

As mentioned above, a key aspect of a locked box mechanism is that no value leaks from the box through to the closing date. Leakage refers to the seller extracting value from the target in the period from the locked box date to the closing date. The parties will need to identify possible sources of leakage, with the seller's obligations to prevent any leakage usually being backed by a pound-for-pound indemnity.

However, not every transaction between the target and a member of the seller's group will be improper, and the parties will also need to identify possible items of 'permitted leakage'. There is ordinarily no reason why arm's length transactions between the target and the seller's group, which are priced fairly, should not be allowed to continue, at least until closing. Even leakage that is viewed by the buyer as being in excess of fair value or a value shift to the seller may be permitted by the buyer, provided it is visible and certain at signing, and there is a corresponding reduction in the purchase price.

If the target owes shareholder or intra-group loans, expect the buyer to control any increase in these loans during the gap period, not only for possible leakage but also to understand the proposed use of the funds.

POSSIBLE SOURCES OF 'LEAKAGE'

- Dividends, distributions, and returns of capital
- Non-ordinary course intra-group payments
- Waivers of rights or claims against members of the seller group or third parties
- Changes to any 'permitted' trading arrangements between the target and members of the seller group, or any new arrangements
- Transaction costs and expenses incurred by the target and deal bonuses paid to staff

POSSIBLE SOURCES OF 'PERMITTED LEAKAGE'

- Items which are pre-agreed and recorded in the SPA, with an appropriate purchase price reduction (e.g., dividend strips)
- Remuneration of staff in the ordinary course
- 'Permitted' trading arrangements between the target and members of the sellers group
- Payments provided for in the locked box account

Interest and profits

Given that the economic interest effectively passes to buyer from the locked box date, the buyer will have the benefit of the cash profits generated by the business from that date. In contrast, the seller incurs an opportunity cost as it does not receive payment at the locked box date but instead receives payment at closing. Accordingly, the seller will usually seek compensation for this. To achieve such compensation, the seller typically demands either:

- an interest charge on the purchase price between the locked box date and closing. This reflects the opportunity cost of the seller not receiving the proceeds from the buyer at the locked box date; or
- a proxy for the profits earned (e.g., daily profit rate) as they will not have been able to extract this from the business since the locked box date up to the closing date.

This charge whether proposed as compensation for the opportunity cost or proxy for profits, typically reflects the expected "cash profits" generated by the target after the locked box date.

Limitations

A locked box mechanism will typically include a time limit on the buyer's ability to bring a leakage claim. This is normally shorter than the warranty claim period in the SPA. Usually, there would be no de-minimis level of claims under the leakage indemnity (in contrast to the position for warranty claims). Whether there should be a cap on recovery for leakage and, if so, at what level, will be a matter of negotiation between the parties.

Conclusion

Locked box mechanisms are a useful alternative to a closing balance sheet approach, particularly for sellers. In the right circumstances, a locked box mechanism can save the parties time and costs, give the seller more certainty and allow the buyer to get on with the business post-closing. Notwithstanding this, locked box mechanisms give rise to their own problems, which means the benefits can be overstated. For these reasons, they are likely to be most useful to sellers seeking a quick sale, or exiting target companies that are sought after and will generate competitive tension through an auction process.

¹Sometimes the adjustment encompasses a movement in the value of all net assets, not just working capital. The extent of the adjustment will depend on the type of business carried on by the target. There may also be an adjustment for any difference in capital expenditure against budget, again depending on the target's business.

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