

# Insights and Commentary from Dentons

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This document was authored by representatives of McKenna Long & Aldridge prior to our combination's launch and continues to be offered to provide our clients with the information they need to do business in an increasingly complex, interconnected and competitive marketplace.

**Ann-Marie  
McGaughey**

McKenna Long &  
Aldridge, Atlanta  
amcgaughey@  
mckennalong.com

**Wayne Bradley**

McKenna Long &  
Aldridge, Atlanta  
wbradley@  
mckennalong.com

**Jonathan Picard**

McKenna Long &  
Aldridge, Atlanta  
jpicard@  
mckennalong.com

# A valuable alternative to the purchase price adjustment: the locked box method

**M**ost acquisitions of private targets in the United States include one or more post-closing adjustments to the purchase price. In contrast, European M&A dealmakers have found that using the locked box method to fix the purchase price can reduce disputes by eliminating adjustments post-closing.

## Purchase price adjustments and their advantages

Purchase price adjustments are commonly used for financial line items such as working capital, net assets, net worth and EBITDA. While these adjustments can be structured in many different ways, most adjustments typically require the buyer to review the relevant financial aspects of the acquired business within a specified time after closing (typically, within 90 days after closing) and then to compare its determination against a target, which may be set out in the agreement or in reference to a specific pre-closing financial statement. If the buyer's determination is less than the target amount, the seller must compensate the buyer; in the alternative, in some cases, the buyer will compensate the seller if the buyer's determination exceeds the target.

In theory, purchase price adjustments assure the buyer that it will acquire the financial aspects of the business it believes it is buying and compensate the seller for accessions in value between signing and closing. The adjustment mechanism causes the purchase price to reflect, for example, the actual level of current assets and current liabilities in the target business as of the closing. Adjustments are beneficial to buyers because they protect the buyer against the substantial information asymmetry that strongly favours sellers in negotiating the purchase price. Sellers also benefit from the adjustment in that the buyer will need to perform less diligence and the parties may quickly reach an agreement with the knowledge that an incorrect estimate may be adjusted after closing.

## Disadvantages of purchase price adjustments

In practice, an increasing number of purchase price adjustments result in post-closing disputes between the parties. These disputes result from inherently interested parties attempting to increase or decrease the purchase price after the transaction has been completed. Additionally, disputes may arise when the parties fail to sufficiently define the accounting methods that will be used in calculating the relevant financial item.

Purchase agreements typically provide for an independent dispute resolution mechanism for purchase price adjustments. Most commonly, the parties select an independent accountant to serve as an arbiter of the disagreement and provide procedures for the resolution of the dispute. Invariably, each party will need to commit internal resources to calculate the adjustment and engage accountants and attorneys to handle the dispute. Therefore, purchase price adjustments are often expensive for both parties, even though one may be 'victorious'.

## Locked box method and its benefits

As an alternative to the purchase price adjustment, European M&A transactions sometimes use the 'locked box' method. In this method, the parties agree to a fixed purchase price with no adjustments. The buyer takes into account all of the financial aspects of the company (including all of the balance sheet items) and adjusts for projected variation between signing and closing in determining the purchase price. The buyer is protected from seller actions that would diminish or extract value from the business through representations, warranties and covenants. Such assurances will be similar in type to those in agreements with purchase price adjustments, but generally much stricter. For example, the seller may be required to operate the business in the ordinary course and be prohibited from taking on new debt,

distributing property or paying management fees. The seller may be able to carve out certain expenditures, typically called ‘permitted leakage’.

The principal benefit of the locked box method is certainty and simplicity. The seller is assured that the proposed purchase price will not be eroded after closing, and the buyer can be confident that the price will not exceed the closing payment. At the negotiation stage, the parties avoid the necessity of negotiating long and complicated purchase price adjustment provisions. After closing, this method eliminates the need to engage key management and outside professionals in calculating and disputing an adjustment. The elimination of the purchase price adjustment can save substantial time and money that would otherwise be spent with a typical purchase price adjustment.

### **Disadvantages of locked box method**

While the locked box method provides certainty, it presents its own issues. First, buyers must engage in substantial due diligence before closing to ensure that they fully understand the financial position of the target. This added due diligence means additional costs for the buyer and potentially requires a greatly increased commitment of pre-signing time and resources, which can pose barriers to buyers entering into the transaction. Further, buyers must rely on representations, warranties and covenants for protections against misstatements of the financial condition of the target and any removal of value from the target by the seller before closing. Finally, the economic benefits and risks of the target are transferred from the seller to the buyer at the time of signing. This creates a risk for the buyer that the target’s business will decrease in value before closing even though the seller may be operating the target in the ordinary course. Further, since the purchase price is set, the seller will have no incentive to take any action for the benefit of the target that will reduce the seller’s profits from the transaction.

### **Deals when locked box method may be most advantageous**

Due to the prevalence of the use of purchase price adjustments and the issues in using the locked box method, it is unlikely that the locked box method will replace the purchase price adjustment in the US M&A landscape.

However, the locked box method should be considered a valuable tool to use in certain deals since it provides increased certainty to the parties and a substantial reduction in the risk of costly and time consuming post-closing disputes. The parties should especially consider the locked box method if one or more of the following factors are present in a transaction:

- First, the argument for using the locked box method may be most compelling when the value of the business is unlikely to change between signing and closing. This may be true because of the nature of the business or a short closing period. In this case, there is less risk either party will be harmed by the lack of a purchase price adjustment. Most importantly, the parties will not be at risk of being distracted by a costly purchase price adjustment dispute when they would have little potential upside from the adjustment.
- Second, the locked box method may be beneficial when the buyer will be obtaining reliable financial information about the target as part of the transaction. This may occur when the buyer is engaging in extensive due diligence for some reason other than using the locked box method or the target has recently completed audited financials. In that instance, the buyer may have sufficient information to evaluate the financial condition of the target before closing such that a purchase price adjustment is not necessary. The parties should take this fact as an opportunity to agree to the key financial aspects of the target.
- Third, the locked box method may be useful when a target’s balance sheet line items are relatively unimportant to the overall value of the target. For example, the target’s key management team or its relationship with key customers may represent the principal value of the target. In that situation, a purchase price adjustment may not be necessary and the locked box method may adequately protect the buyer’s interest.
- Fourth, the parties should consider the locked box method when the seller of the target is a private equity firm. The seller will benefit from the locked box method because it will be able to distribute the proceeds from the sale immediately upon closing, instead of after a purchase price adjustment. A buyer may be able to strengthen its bid to a private equity seller

## A VALUABLE ALTERNATIVE TO THE PURCHASE PRICE ADJUSTMENT: THE LOCKED BOX METHOD

by including the locked box method in an offer instead of contemplating a post-closing purchase price adjustment. The locked box method provides the substantial benefits of certainty and reduced risk of dispute and has become a frequent method of structuring purchase agreements in Europe. This method can be especially

beneficial: (i) when the parties have little need for an adjustment; (ii) when reliable information is being independently prepared; (iii) when a purchase price adjustment is not necessary; and (iv) for private equity sellers. Deal lawyers should consider the locked box method as a valuable alternative to the traditional purchase price adjustments.

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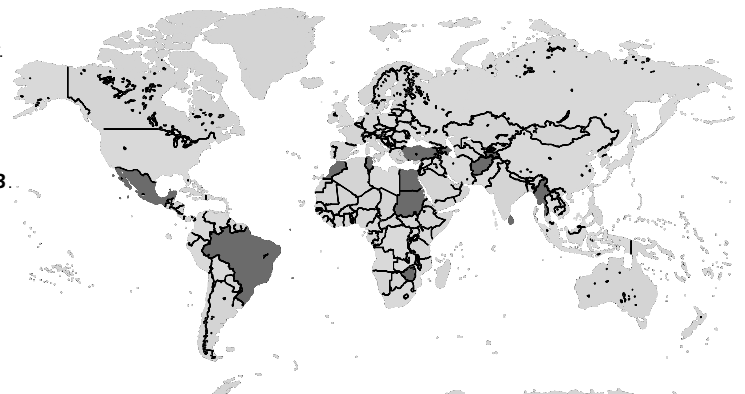
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