Working Capital Adjustments in M&A Transactions

Mike Miller

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Holland & Knight

Thinking About Working Capital: An Analogy

Introduction to Working Capital

- Assume a customary “cash-free/debt-free” transaction structure.

- What is Working Capital?
  - Working capital = current assets <u>minus</u> current liabilities

- Balance sheet items specifically included as a current asset or current liability in this calculation are often subject to heavy negotiation and accountant input (e.g., based on a quality of earnings, negotiated reserves, etc.).

Introduction to Working Capital

- Current Assets = all assets that are expected to turn into cash or actual realized value within one year. Examples:
  - Cash (usually excluded in “cash-free/debt-free” deals)
  - Marketable securities (usually excluded in “cash-free/debt-free” deals)
  - Accounts receivable
  - Inventory
  - Prepaid expenses

Introduction to Working Capital

- Current Liabilities = all liabilities that are required to be paid within one year. Examples:
  - Short term debt/current portion of long-term debt
  - Accounts payable
  - Accruals (e.g., payroll, year-end bonuses, etc.)
  - Deferred revenue

- Consider whether line items are more appropriate as “Debt”
  - This results in a true purchase price deduction rather than contribution to a normalized calculation
    - For example, if a business normally has $1m of deferred revenue on its balance sheet at a given time, that $1m liability would be taken into account in the calculation of the working capital peg rather than deducted from the purchase price as indebtedness – this is $1m in value up for grabs.

Working Capital Adjustments: Why?

- Purpose of Working Capital Adjustments?
  - Ensure that a target business has sufficient working capital at the closing of an acquisition to operate normally
  - To account for changes in Working Capital between signing and closing
  - There needs to be gas in the car to get it home from the dealership; otherwise the Buyer is paying more for the asset to function as a going concern.

- Why is Working Capital important?
  - To pay ordinary operating expenses as they come due without the need for a Buyer to inject cash (whether from equity or debt)

Working Capital Adjustments: Why?

- Buyer worries that Seller will strip Working Capital out of the business by stretching out payables, accelerating receivables and deferring capital expenditures (capex)
  - If Seller does this, Seller will get more cash out of the deal (a purchase price increase) and Buyer may have to borrow money/inject equity to pay expenses, thus increasing the total "out of pocket" amount the Buyer extends
- There is real money at stake here — clients and accountants (who have done financial and tax diligence) need to focus on language, especially in particular definitions
- This is an area where business-minded lawyers can distinguish themselves.

Working Capital Adjustments: Why?

DO NOT "YADA, YADA, YADA…" WORKING CAPITAL!

Target Working Capital

- Actual amount of Working Capital at closing is difficult to determine, so an adjustment mechanism is necessary
  - Receivables and payables are being created and paid daily; accruals change by the day
- Buyer and Seller typically negotiate an agreed upon Working Capital level that Seller must deliver at closing — Target Working Capital (or a Working Capital Peg)
  - Informed by accountant diligence and negotiations
- Cash, Debt and Transaction Expenses/Costs are often excluded and dealt with through separate adjustment mechanisms
- Taxes are often excluded and dealt with through a tax indemnity or definition of Debt (e.g., accrued taxes payable)
- At the end of the day, setting the Target Working Capital *can be* a second bite at the purchase price negotiation

Target Working Capital

- Target Working Capital should represent the parties' agreed upon level of Working Capital necessary to operate the business as of the closing
  - Average of last 3, 6, 12, 24 months?
    - In some scenarios where the business is valued based on forward projections, Target Working Capital will need to be altered to be in line with the business that is represented by those forward projections.
  - Remember that a growing business typically needs more Working Capital
  - Consider weighting recent months more heavily
  - Adjust for seasonality and industry (e.g., software companies and deferred revenue; HVAC distributors and seasonal inventory)
  - Understand the business and adjust for erratic working capital
  - Negotiate inclusion and exclusion of specific line items from the balance sheet

Working Capital Adjustments

- Two basic approaches
  - One-step post-closing adjustment
    - Settle up Working Capital post-closing based on final Working Capital to be determined later (no closing date adjustment)
  - Two-step post-closing adjustment
    - Adjust purchase price at closing based on estimated Working Capital delivered by Seller
    - Settle up post-closing based on final Working Capital

Working Capital Adjustments

- Two-step Working Capital adjusters
  - Seller provides good faith estimate of Working Capital a few days prior closing
    - Buyer sometimes seeks review and approval right
      - If simultaneous sign-and-close, you do not need an approval right because Buyer just doesn’t sign/close if it disagrees
    - If Buyer does not agree with Seller's estimate, solution is often no closing date adjustment (becomes a one step adjustment, though this is not usually drafted as a contingency)
  - At closing:
    - If actual Working Capital is less than target, purchase price is reduced on a dollar-for-dollar basis by the shortfall
    - If actual Working Capital exceeds target, purchase price is increased on a dollar-for-dollar basis by the overage
  - Initial adjustment at closing should theoretically reduce the size of the post-closing adjustment

Working Capital Adjustments: Escrow

- Decrease in purchase price as a result of a Working Capital downward adjustment settled directly by Sellers or through an escrow

- Separate post-closing adjustment escrow offers protection for the Buyer against collectability risk, otherwise Buyer must rely on Seller to write a check for any shortfall
  - Indemnity escrow still available to Buyer, but depletes indemnification recourse

- Amount of escrow based on financial diligence and anticipated swings in Working Capital as opposed to percentage of purchase price
  - In "walkaway" deals, always aim high on the escrow size when representing the Buyer, as they only get one pot of money to collect from (i.e., no indemnity escrow, no Seller backstop)
    - Given the short period during which the post-closing adjustment takes place (often 60-120 days), less reason for Sellers to protest in a walkaway deal as they'll get their money quickly.

Working Capital Adjustments: Mechanics

- Post Closing Adjustment Considerations
  - Who prepares the post closing calculation of Working Capital - Buyer or Seller?
    - The preparer makes estimates and judgment calls about important matters such as bad debt allowances and litigation reserves
    - Can post-closing events be used to modify closing date financials?
      - Bad debt reserves were 5% of A/R, but before adjustment is calculated largest client representing 50% of A/R as of close goes bankrupt
        - Depends on what the parties can prove about that client's status at the closing
    - Buyer should be over inclusive and should push to prepare the post-closing settlement as it will own the books, records and account data

Working Capital Adjustments: Mechanics

- Accounting Standards
  - Seller wants to use its past practices
    - Seller wants apples-to-apples comparison based on past accounting practices with which it is familiar
  - Buyer wants GAAP standard
    - More objective; less subject to gaming; Buyer not familiar with Seller's past accounting practices
    - GAAP standard includes subjectivity on certain items (e.g., reserves) so Seller needs to protect against Buyer manipulation within GAAP
  - Consider using an example or attaching detailed accounting principles as an exhibit to the purchase agreement
    - This can often take the form of the balance sheet used to calculate the Target Working Capital

Working Capital Adjustments: Issues

- Issues to be aware of
  - Effect of the transaction on working capital, i.e., assets and liabilities created or disposed of by the deal
  - Deferred Revenue
  - Treatment of Taxes
  - Asset Deals — only current assets and current liabilities that are included in the transaction should be included in Working Capital
    - <u>but</u>, when a business is purchased as a going concern through an asset deal structure, it is customary to include a working capital adjustment

Working Capital Adjustments: Issues

- Interplay with Indemnification
  - If a reserve is booked for a contingent liability for which a Buyer is specifically indemnified, then Buyer's right to indemnification should be limited to the amount in excess of the reserve
  - If Seller is giving a direct indemnity in respect of a contingent liability, consider eliminating the reserve from Working Capital
  - Where an agreement includes a limitation on Buyer's right to indemnification in respect of adjustments taken into account in working capital, be careful on the wording of this limitation as to not unduly limit Buyer's protection

Working Capital Adjustments: Process

- Procedures
  - Buyer delivers Working Capital calculation within 60/90/120 days of close
  - Seller has 15/30 days to respond
    - Seller will want access to Buyer's accounting paperwork and personnel
  - What if the Parties Don't Agree?
    - Typically parties agree to negotiate in good faith for a set period of time
    - Dispute submitted to an independent accountant
      - Designed to be more streamlined than general arbitration provision
      - Accounting expert is decision maker

Working Capital Adjustments: Process

- Basis for decision
  - Consider limitations on accountant's scope of review
    - Not over/under initial positions
    - Limit review only to remaining disputed items
    - No consideration of claims not asserted at outset
    - Oral presentation or just written submissions

Working Capital Adjustments

- Additional Considerations
  - May require interest on any amounts due so no incentive to stall
  - Equal sharing of accountant's fee or allocated based on adjustment?
  - Provide that decision is final and binding to ensure no challenge to decision of arbitrator (other than for "manifest error")
  - Consider variations on traditional adjustment:
    - Thresholds / bands / collars
    - One-way adjustment