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# Purchase Price Adjustments: Avoiding Post-Closing Disputes

Disagreements over post-closing purchase price adjustments are common in private M&A transactions. This article provides an overview of post-closing purchase price adjustments and offers guidance for buyers and sellers on avoiding and resolving these costly and time-consuming disputes.



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Post-closing purchase price adjustment provisions are common in most private M&A transactions. These provisions are heavily negotiated and intended to ensure the value exchanged at closing reflects the deal struck at the time of signing the purchase agreement. Disagreements over post-closing purchase price adjustments can monopolize the time and attention of the former owners and employees, who are often the same people the buyer is relying on to manage the company and continue to build value.

This article provides an overview of post-closing purchase price adjustments and offers guidance for buyers and sellers on avoiding and resolving post-closing purchase price adjustment disputes. In particular, this article examines:

- Common disputes arising from closing balance sheet adjustments.
- Judicial interpretations of closing balance sheet adjustment provisions.

## OVERVIEW OF POST-CLOSING PURCHASE PRICE ADJUSTMENTS

The two types of post-closing purchase price adjustments are:

- Closing balance sheet adjustments.
- Earn-outs.

This article focuses on closing balance sheet adjustments.

### CLOSING BALANCE SHEET ADJUSTMENTS

Closing balance sheet adjustments are intended to account for the changes in the value of a business being sold between the signing of the purchase agreement and the closing of the deal, a time period which is often several months or more. Closing balance sheet adjustment provisions typically compare a closing balance sheet amount to a reference balance sheet amount, and true-up the purchase price for any difference. Net working capital (current assets minus current liabilities) is the most common balance sheet item compared, but in certain circumstances a post-closing comparison of debt, net assets, or even cash balances can be appropriate.

A preliminary closing balance sheet is typically prepared by the seller several days before closing. The parties review the preliminary closing balance sheet amount and compare it to the reference balance sheet amount (typically derived from the target's most recent quarterly or year-end balance sheet delivered to the buyer during the pre-signing due diligence process). Unless the comparison reveals a significant difference, the parties close the deal based on the preliminary closing balance sheet, knowing they have an opportunity to correct any inaccuracies after closing.

The seller usually prepares the preliminary closing balance sheet and, therefore, the preliminary closing balance sheet seldom differs significantly from the reference balance sheet. However, if a significant difference is revealed, the parties often have the right to refuse to close, leading to a pre-closing negotiation of an adjustment to the purchase price.

The final closing balance sheet is often prepared by the buyer within a 30- to 90-day period after closing using agreed on accounting principles. If the parties cannot agree on a final closing balance sheet, an independent expert (usually an accounting firm) is retained to resolve the matter, based on the specific mandate set out in the purchase agreement. The final closing balance sheet is then used to determine if a post-closing purchase price adjustment is necessary.



Search [Stock Purchase Agreement: Working Capital Purchase Price Adjustment Provision](#) for a model provision providing for the adjustment of the purchase price based on the target company's working capital as of the closing, with explanatory notes and drafting and negotiating tips.

Search [What's Market: Purchase Price Adjustments](#) for information on closing balance sheet adjustment provisions in recent transactions, including links to publicly filed private acquisition agreements.

### EARN-OUTS

An earn-out is a common purchase agreement provision that compensates the seller for a near future potential that cannot be captured in the closing purchase price because it depends on the performance of the business after the closing. Earn-out provisions typically provide that if certain income statement targets are met after closing, the seller is entitled to additional payments.



Search [Earn-Outs](#) for more on the use of earn-outs in private M&A transactions, including their advantages and disadvantages, issues to consider when structuring earn-out provisions, and the accounting and tax treatment of earn-out payments.

## RESOLVING POST-CLOSING PURCHASE PRICE DISPUTES

### DISPUTE RESOLUTION MECHANISMS

Before the substance of any disputes can be addressed, the parties must agree on the proper method for resolving disputes. A typical purchase agreement includes details regarding:

- How long each party has to dispute the balance sheet items.
- Which balance sheet items can be disputed.
- The selection of an independent expert (usually an independent accounting firm) to resolve any disagreements. The independent expert's determination is usually final and binding on the parties.

The threshold question of whether a certain dispute resolution mechanism applies may be raised by the party that believes it has the most to gain by a judicial process. A judicial process entails broader discovery and the opportunity for advocacy, compared to an independent expert determination. The issues raised usually relate to whether the disputed matter is covered by the narrow mandate of the independent expert. Courts are often the venue for interpreting the language of the purchase agreement to determine the outcome (see below *Independent Expert or Litigation*).

In some cases, the disagreement over the proper forum for resolving post-closing purchase price adjustment disputes is a loosely-veiled attempt to avoid or apply limitations that would otherwise govern the dispute if it were resolved as a claim for breach of representations. This interaction between the mechanism for resolving post-closing purchase price adjustment disputes and the detailed and heavily negotiated indemnification provision is another area where parties have

sought guidance in the courts. (See below *Indemnification Claim or Purchase Price Adjustment*.)

### COMMON DISPUTES: ACCOUNTING PRINCIPLES

The most common post-closing purchase price adjustment disputes involve accounting principles. Key issues include:

- **What accounting principles should apply.** These disputes relate to whether GAAP (generally accepted accounting principles) should be used in creating the closing balance sheet or whether some variation of GAAP that reflects the accounting principles used by the target company prior to the closing should be used.
- **How the accounting principles should be applied.** These disputes relate to how the parties should apply the applicable accounting principles to calculate the purchase price adjustment.

Determining the appropriate accounting principles to use often can be resolved by a close reading of the purchase agreement. Disputes over determining how to apply accounting principles, however, are more common. These disputes are usually more difficult to resolve because resolution requires reconciliation of different views on the proper application of specific accounting principles, which likely was not specifically addressed in the purchase agreement.

While GAAP provides guiding principles, management has discretion on how these principles are applied to the acquired company. Issues that are frequently disputed include the treatment of:

- Revenue recognition policies and the percentage of completion method of accounting.
- Cash on the books, as compared to cash in the bank, and the treatment of cash in transit on the closing day.
- Accounts receivable aging and bad debt reserves policies.
- Vacation, bonuses, and other employer-related accruals.
- Deferred tax assets on the closing balance sheet, as compared to separate covenants relating to pre-closing tax periods.
- Assumptions underlying pension plans (for example, discount rates and mortality assumptions).
- Tax costs and benefits resulting from the transaction.
- Contingent liability reserves on the closing balance sheet and how they relate to indemnifiable losses.
- Accounts payable cutoff principles for services performed or products shipped, but not yet billed.
- Intercompany receivables and payables between the buyer and seller or among affiliated entities.
- Transaction-related costs, including any transaction-related bonuses.
- Subsequent events that affect conditions that existed pre-closing (for example, resolution of litigation and sales of assets held for sale).

Depending on the timing of the closing, the post-closing purchase price adjustment may require comparison of quarterly

and year-end results. This creates challenges in applying GAAP concepts that typically only affect year-end results, such as resetting accruals and certain reserves.

Questions about how to apply GAAP are even more complicated in the context of a carve-out transaction (the sale of a subsidiary, division, or other part of a larger business enterprise). Principles applicable to a consolidated business as a whole may not be applicable to a division or line of business sold on a stand-alone basis.



Search [Carve-Out Transactions](#) for more on carve-out transactions.

Difficulties also arise in cross-border transactions, where the variations between GAAP applied in the US and GAAP applied in a foreign jurisdiction may differ widely in ways not readily apparent to US buyers or sellers.

### JUDICIAL INTERPRETATIONS

While post-closing purchase price adjustment provisions are common, there is limited case law on issues of interpretation. Post-closing purchase price adjustment disputes are often resolved in protracted negotiations between the buyer and seller, frequently extending beyond the period for resolution specified in the purchase agreement. These negotiations also often occur between the buyer and the members of management who came over with the acquired company and who may have a personal interest in the outcome of the dispute.

Much of the case law that does exist is from Delaware and New York courts and involves the interpretation of purchase agreement provisions to determine:

- Whether the dispute should be decided by an independent expert or by a court in litigation.
- Whether a claim arises under the purchase agreement's indemnification provision or is covered by the post-closing purchase price adjustment provision.
- The applicable accounting principles that govern the calculation of the post-closing purchase price adjustment.

### INDEPENDENT EXPERT OR LITIGATION

If a purchase agreement contains a provision that specifically identifies a mechanism for resolving post-closing purchase price adjustment disputes and a separate provision that generally requires arbitration or litigation of all disputes arising under the purchase agreement, courts have typically found that the more specific provision controls any post-closing purchase price adjustment dispute. In these cases, the key issue before the court is whether the subject matter of the dispute is covered by the more specific provision requiring resolution by an independent expert, in which case the independent expert, not the court, should make decisions about the facts, financial information, and circumstances that should be considered in resolving the dispute.

For example, in *Viacom International, Inc. v. Winshall*, the Delaware Supreme Court analyzed the distinction between matters related to “substantive arbitrability” and those related to “procedural arbitrability.” The court explained that issues of substantive arbitrability are “gateway questions relating to the scope of an arbitration provision and its applicability to a given dispute, and are presumptively decided by the court.” Procedural arbitrability issues, however, are presumptively handled by an arbitrator (or independent expert) and “concern whether the parties have complied with the terms of an arbitration provision ... includ[ing] whether prerequisites such as time limits, notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate have been met, as well as allegations of waiver, delay, or a like defense to arbitrability.” (72 A.3d 78, 82 (Del. 2013).) Therefore, once a court has determined that a purchase price adjustment dispute should be decided by an independent expert, the court will rarely interfere with the dispute resolution process.

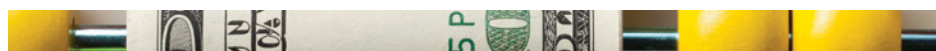
Courts, however, will not construe a specific post-closing purchase price adjustment provision to include claims clearly outside the scope of the provision. For example, in *E\*TRADE Financial Corp. v. Deutsche Bank AG*, the US Court of Appeals for the Second Circuit affirmed the district court’s authority to review the accuracy of a closing balance sheet, despite the appellant’s assertion that disputes regarding the closing balance sheet should only be resolved through the post-closing purchase price adjustment process, which provided for a final determination by an independent accountant. In that case, the closing balance sheet was required to be prepared in accordance with GAAP by a separate covenant in the purchase agreement subject to an exclusive indemnification remedy. The closing balance sheet contained certain entries that were not reflected in accordance with GAAP, a point effectively acknowledged by the buyer’s accountant. The Second Circuit determined that the specific provision requiring an expert to resolve purchase price adjustment disputes did not preclude the district court from analyzing whether the closing balance sheet failed to comply with GAAP as required by the separate covenant. (374 Fed. Appx. 119, 122 (2d Cir. 2010).)

## INDEMNIFICATION CLAIM OR PURCHASE PRICE ADJUSTMENT

Courts will generally construe indemnification provisions in a purchase agreement separately from any impact the underlying breach might have on the elements of a post-closing purchase price adjustment, unless the parties have explicitly agreed otherwise in the purchase agreement. When the financial statements that underlie the calculation of a purchase price adjustment are challenged as improperly prepared, and the purchase agreement contains representations about those financial statements, courts have found that the claim is for a breach of representation that is properly addressed through the indemnification provision, rather than through the post-closing purchase price adjustment provision. Recognizing that indemnification claims often are subject to specific limitations (such as caps and baskets), courts have been careful in these cases not to allow disputes about purchase price adjustments (which are typically not subject to the same limits) to be used as a back door to resolve disputes that are embodied in the seller’s financial statement GAAP-compliance representation.

The Delaware Supreme Court confirmed this approach in *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC*, preventing the buyer from recovering for a purchase price adjustment based on a net working capital calculation that did not comply with GAAP. In that case, the purchase agreement included some unusual terms because it was intended to settle prior liabilities resulting from the parties’ commercial relationship and give the seller a “clean break” from all related future liabilities. Specifically, the parties agreed to a purchase price of \$0 based on a specified target net working capital amount, there was no post-closing indemnification from the seller to the buyer for breaches of the target’s representations and warranties, and the buyer agreed to indemnify the seller for any liabilities of the target business. In preparing the post-closing balance sheet, the buyer challenged the GAAP compliance of certain items in the target’s financial statements.

In response, the seller brought a claim in the Delaware Court of Chancery seeking a declaratory judgment that the claims asserted by the buyer were outside the scope of the independent



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## Tips for Minimizing Post-Closing Purchase Price Adjustment Disputes

To minimize the potential for disagreement, the parties should:

- **Define the scope of the independent expert's review.**

The purchase agreement should specify whether the independent expert has the authority to determine if a dispute is within its mandate or if the determination is instead covered by the more general dispute resolution provisions governing disagreements that arise under the purchase agreement.

- **Use detailed accounting definitions.** Balance sheet items, such as current assets and current liabilities, should be defined in the purchase agreement as precisely as possible. The parties should establish a clear understanding of the historic components of each line item, and identify in the definitions which components are agreed to be reflected within the line item.

- **Avoid double counting.** The purchase price adjustment provision can be drafted to be the only provision governing questions about compliance with GAAP. If the purchase price adjustment provision requires both consistency and compliance with GAAP, the parties should eliminate from the indemnification provision any disputes related to compliance with GAAP. In addition, if the purchase agreement contains a specific indemnity for a particular liability, claim, or litigation, the parties should be sure that any reserves related to that matter are not counted in the purchase price adjustment. To avoid double counting, the purchase agreement can provide that:

- the reserves are specifically removed from the closing balance sheet adjustment; or
- the indemnification payment explicitly nets out any reserve taken into account in the closing balance sheet adjustment.

- **Attach a sample calculation.** The parties should conduct due diligence on each balance sheet line item that is important to the calculation of the post-closing purchase price adjustment, and document in the purchase agreement any specific applications of GAAP that are important, on a line-by-line basis, attaching a detailed exhibit showing the calculations.

- **Consider an interest accrual.** The parties should consider including an interest accrual in the dispute resolution process as an incentive to move things to conclusion.

- **Address related party transactions and transactions between the parties.** The parties should specifically exclude from the post-closing purchase price adjustment receivables and payables between:

- the seller's affiliated companies and the target company; and
- between the target company and the buyer.

The parties should instead consider a separate covenant that specifies the business understanding of the treatment of these accounts.

- **Specify cutoff dates for prepaid expenses.** The parties should specify cutoff dates for all prepaid expenses (for example, insurance, rent, and taxes) to avoid disagreements about which party is entitled to the benefit of those assets and any refunds or rebates.

- **Provide detailed procedures for preparing the closing balance sheet.** The buyer typically produces the closing balance sheet because the books, records, and personnel are then part of the business owned by the buyer. The purchase agreement should account for the real-world implications of preparing the closing balance sheet, including the management personnel who will produce the closing balance sheet and what access the seller will retain to books, records, and personnel to verify the buyer's calculations.

- **Consider and document any tax implications.** The parties should specify how all tax implications of the transaction are reflected in the closing balance sheet, if at all. The parties should consider a separate covenant that specifically addresses how tax deductions and tax costs arising from the transaction should be handled.

- **Specify treatment of debt.** The parties should exclude all short-term debt from the closing balance sheet and include a separate covenant that addresses the payment or assumption of indebtedness to third parties.

- **Use escrows.** Most private M&A transactions provide for an escrow of some of the proceeds to cover post-closing payments so the buyer does not have to pursue collection from the seller. The buyer should ensure that the escrow proceeds are adequate to cover both potential indemnity claims and the post-closing purchase price adjustment, and that the escrow remains available until the purchase price adjustment dispute is resolved. Sellers may also benefit from an escrow by making it an exclusive remedy, thereby capping their liability.

- **Resolve issues prior to closing.** If there is a disagreement about the preliminary closing balance sheet that could be significant, the parties should attempt to resolve it before closing. The parties may not have the same ability to do so after closing.

auditor's review. The seller argued that these claims were not post-closing purchase price adjustment claims, but rather claims for breach of the target's financial statement GAAP-compliance representation that were barred by the purchase agreement's lack of post-closing seller indemnification for breaches. The seller further argued that the buyer could not avoid the liability bar by couching a breach of representation claim as a post-closing purchase price adjustment and submitting it to the independent auditor. The Court of Chancery disagreed, but the Delaware Supreme Court overturned that decision, holding that the buyer could not make claims for breaches of representations because that would negate the liability bar. The Delaware Supreme Court also held that the buyer's claims regarding non-compliance with GAAP, when considered in the context of a post-closing purchase price adjustment, were barred by the express language of the purchase agreement (see below *Applicable Accounting Principles*). (166 A.3d 912 (Del. 2017), as revised (June 28, 2017).)



Search [Chicago Bridge v. Westinghouse: Delaware Supreme Court Reverses Chancery Court, Interprets Working-Capital Adjustment Narrowly](#) for more on the Delaware Supreme Court's decision.

To avoid unintended consequences, parties should draft the purchase agreement to ensure that the purchase price adjustment provision and the indemnification provision work well together, and to avoid double counting or excess recovery. For example, in *Brim Holding Co., Inc. v. Province Healthcare Co.*, a Tennessee court stressed the unequivocal nature of the indemnification provision, which expressly provided for indemnification of the buyer by the seller for any losses related to, or in connection with, a specified litigation matter. Finding that this specificity left no room for ambiguity, the court concluded that the seller was required to indemnify the buyer for settling the litigation, even though the parties had included a contingency reserve of the same amount in the closing balance sheet and that indemnification would result in double recovery by the buyer. (2008 WL 2220683 (Tenn. Ct. App. May 28, 2008).)

Similarly, in *Alliant Techsystems, Inc. v. MidOcean Bushnell Holdings, L.P.*, the Delaware Court of Chancery relied on the purchase agreement's post-closing purchase price adjustment provision to resolve a dispute about the calculation of net working capital, thereby resulting in the potential for recovery by the buyer in excess of a specifically negotiated indemnity cap that would have otherwise applied if it were a breach of representation claim (2015 WL 1897659 (Del. Ch. Apr. 24, 2015)).

#### APPLICABLE ACCOUNTING PRINCIPLES

Because purchase agreements normally provide that post-closing purchase price adjustments are to be calculated in accordance with GAAP, disputes over applicable accounting principles mainly concern whether the GAAP-compliance underlying the closing balance sheet calculation should be judged anew, or if it should be judged in the context of how the company applied GAAP historically. Given that GAAP is a

set of principles rather than discrete rules, two sets of financial statements accounting for the same transaction in two different ways could both conceivably be described as prepared in accordance with GAAP. To resolve these disputes, courts look to the specific language of the purchase agreement.

Where the language specifies that the purchase price adjustment should be calculated "in accordance with GAAP applied on a basis consistent with past practice," courts tend to reject arguments to broaden the post-closing purchase price adjustment provision beyond a test that measures the consistency of the financial statements to also include allegations that GAAP was not properly applied in preparing the pre-closing financial statements or the closing balance sheet. On the other hand, where the purchase agreement specifies that working capital should be applied "in accordance with GAAP and on a basis consistent with the historical financial statements," the argument that both consistency with past financial statements and GAAP compliance are two separate bases for attacking a working capital calculation has prevailed.

In *Chicago Bridge*, the Delaware Supreme Court relied on this distinction to bar the buyer from pursuing with the independent auditor assertions that the financial statements were not in compliance with GAAP, finding that consistency with past practice was all that was required by the purchase agreement's language. In contrast, in *Alliant Techsystems*, the Delaware Court of Chancery allowed claims of inconsistency with GAAP because the purchase agreement contained a net working capital definition that contemplated both compliance with GAAP and consistency (2015 WL 1897659, at \*8 (Del. Ch. Apr. 24, 2015)).

The importance of careful drafting to ensure consistency is also illustrated in *Vysyaraju v. Management Health Solutions, Inc.* While this case involved an earn-out adjustment, rather than a post-closing purchase price adjustment, it is notable for its harsh result. The court concluded that the more specific language (GAAP applied on a consistent basis), which was used in the representations, could not by its mere inclusion in the representations also be applied to the separate part of the purchase agreement that set out the earn-out adjustment, which simply referred to GAAP. Therefore, the buyer was allowed to apply its own version of GAAP to eliminate the entire earn-out otherwise payable to the seller if GAAP had been applied on a consistent basis. (2013 WL 4437236, at \*8 (S.D.N.Y. Aug. 19, 2013)).

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