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M&A Newsletter Series

Part 3: Purchase Price Clauses

The purpose of this Baker McKenzie M&A Newsletter Series is to give an insight to prospective sellers or purchasers into some key legal documents and/or provisions they will most likely be confronted with when entering into any sale or acquisition process concerning a Luxembourg commercial company.

Part 3: Purchase Price Clauses

This third newsletter deals with purchase price mechanisms in share sale and purchase agreements, which are certainly among the most important and technical provisions thereunder.

There are two main types of purchase price mechanisms used in share deal transactions in Luxembourg:

- so-called closing accounts mechanism; and
- the so-called locked box mechanism.

In addition to these two fundamental mechanisms, practitioners will encounter from time to time a third complementary pricing mechanism — the earn out mechanism — used in combination with any of the first two.

However, earn out mechanisms will not be discussed here.

To better understand how the closing accounts mechanism and the locked box mechanism work, it should be remembered that the purchase price (or equity value) of a target is fixed in many transactions according to the following standard formula [1] :

Purchase price = enterprise value [2] - financial debt + cash +/- net working capital variation

1. Closing accounts mechanism

Under a closing accounts mechanism (also known as a completion accounts mechanism or price adjustment mechanism), the purchase price of the target is typically calculated pursuant to the above standard formula (or another one) on the basis of accounts closed at the closing date of the transaction (the "closing accounts").

[1] Other formula may of course be used to fix the purchase price of a target.
[2] Being calculated for example based on a market approach (such as the public company comparable method or the precedent transactions method) or an income approach (such as the discounted cash flow method or the capitalization of earnings or cash flows method).

However, as (a) closing accounts are never available on the closing date [3] and (b) the purchase price can therefore not be determined on the closing date, the seller and purchaser agree on a provisional purchase price calculated (pursuant to the same standard formula) on the basis of accounts closed prior to the signing date of the transaction.

WITH A CLOSING ACCOUNTS MECHANISM, THE ENTERPRISE VALUE OF THE TARGET IS AGREED BETWEEN THE PARTIES PRIOR TO SIGNING, BUT THE EQUITY PRICE OF THE TARGET REMAINS SUBJECT TO POST-CLOSING ADJUSTMENTS

This provisional purchase price — determined prior to, and paid on, the closing date — is then adjusted post-closing for actual financial debt, cash and net working capital variation (if any) as of the closing date, when the closing accounts finally become available.

In other words, with a closing accounts mechanism, the enterprise value of the target is agreed between the parties prior to signing, but the equity price of the target remains subject to post-closing adjustments.

A closing accounts mechanism is generally considered as purchaser-friendly.

Indeed, when using a closing accounts mechanism in a share deal, the economic risks and rewards relating to the target continue to be borne by the seller until the closing date. Thereby, a closing accounts mechanism protects the purchaser against value erosion and leakage until such closing date. In addition, as the final purchase price of the target is ultimately based on closing accounts that the purchaser should normally have reasonable time to audit in full details post-closing,[4] a closing accounts mechanism may sometimes lift some pressure off the purchaser's shoulders concerning the performance of its presigning financial due diligence of the target.

Finally, a closing accounts mechanism can also indirectly protect the purchaser against any loss of interest from the seller in the proper management of the target between signing date and closing date, as any deterioration of the debt, cash or net working capital position(s) of the target will mechanically result in a reduction of the final purchase price to be paid to the seller.

In light of the above key characteristics, a closing accounts mechanism is particularly appropriate when a target, for example, has no stable and/or reliable accounts history, has no audited accounts, carries out a business subject to high volatility, will be subject to complex carve-out between the signing date and the closing date, or also when a long waiting period is anticipated between the signing date and the closing date of the contemplated transaction.

However, using a closing accounts mechanism has some disadvantages, too.

First, a closing accounts mechanism, prior to signing, usually leads to long, complex and expensive discussions between the parties and their professional advisers with respect to the definitions of financial debt, cash and cash-like items; net working capital; and/or other components of the purchase price such as CAPEX underspend, etc.

Second, a closing accounts mechanism will require the parties to agree on :

- the principles and accounting methods and/or policies according to which the closing accounts will be prepared,
- the party who should prepare them,
- the timing for their preparation, and
- the procedure pursuant to which the other party will be set in a position to validate or object to them, etc.

Third, a closing accounts mechanism leads systematically to increased professional advisers costs, and purchaser's management involvement, in the transaction after the closing date with respect to the preparation and new audit of the closing accounts to be prepared post-closing. Fourth, a closing accounts mechanism can be manipulated to some extent, especially when improperly drafted. Finally, a closing accounts mechanism leads quite regularly to time-consuming post-closing disputes concerning the closing accounts and the adjustment amount, with related independent expert costs.[5]

[3] Except in totally exceptional circumstances.
[4] When being in control of the Target at the time of such audit and thereby in a better position to audit the relevant accounts.
[5] Closing accounts mechanisms being, according to some studies, the leading cause of disputes between buyer and seller in private share deals, with one out of 10 closing accounts mechanisms ending with an expert determination.

CLOSING ACCOUNTS MECHANISM REMAINS BASICALLY THE "DEFAULT" AND THE MOST COMMONLY USED PRICING MECHANISM IN SHARE DEAL TRANSACTIONS AROUND THE WORLD EVEN IF, FOR THE LAST TWO DECADES, IT HAS BECOME INCREASINGLY CHALLENGED BY THE LOCKED BOX MECHANISM

Nevertheless, the closing accounts mechanism remains basically the "default" and the most commonly used pricing mechanism in share deal transactions around the world even if, for the last two decades, it has become increasingly challenged by the locked box mechanism on the European and UK M&A markets.

2. Locked box mechanism

Under a locked box mechanism, the purchase price of the target is calculated pursuant to the above standard formula (or another one) on the basis of accounts closed at a date prior to the signing date (the "locked box date").

These so-called locked box accounts are usually the last available annual accounts, or the last available interim accounts, of the target. They usually need to be audited by an independent auditor, as they will serve for establishing the final purchase price under the transaction, without possibility for the purchaser to revert thereon post-closing.

WITH A LOCKED BOX MECHANISM, THE EQUITY PRICE OF THE TARGET IS KNOWN AND DEFINITIVELY FIXED PRIOR TO SIGNING, WHICH PROVIDES APPRECIATED CERTAINTY TO THE SELLER AND THE PURCHASER IN THIS RESPECT

As in these circumstances, the purchase price can be calculated prior to the signing date of the transaction, there is no need for any provisional purchase price calculation nor for any post-closing adjustment thereof. In other words, with a locked box mechanism, the equity price of the target is known and definitively fixed prior to signing, which provides appreciated certainty to the seller and the purchaser in this respect.

A locked box mechanism is usually considered as seller-friendly.

Indeed, when using such an alternative pricing mechanism in a share deal, the financial risks relating to the target are transferred to the purchaser as from the locked box date. However, the same principle applies mutatis mutandis for the rewards of owning the target in economic terms.

[6] With leakage comprising basically any form of value extraction from the target to the benefit of the seller and/or its affiliates between the locked box date and the closing date, e.g. any dividend or other form of distribution, any transfer of assets at an underestimate value, any waivers of amount owned by the seller to the target, any abnormal bonuses to the employees, any transaction fees…

[7] With permitted leakage comprising a limited number of leakage agreed between the seller and the purchaser in the share purchase agreement as, for example, any management fees (at fair market value) paid to the seller for the effective management of the company, any rent (at fair market value) paid by the target to the seller for the use of its offices (as applicable), any salary payment and bonuses paid to the target's employees within ordinary course of business…

Indeed, under a locked box deal, the seller will continue to own and manage the target between the locked box date and the closing date, but it should no longer collect the fruits thereof. During this gap period, the seller should, from an economical perspective, continue to act as some sort of a "purchaser's agent" only. This explains why, in many locked box transactions, the seller tries to negotiate, with more or less success, either a proxy for interests on the purchase price between the locked box date and the closing date or a proxy for the forecast profit to be generated by the target between the locked box date and the closing date.

A locked box mechanism may present some significant advantages for the parties.

First, it may spare the seller and the purchaser the pain of negotiating the complex legal definitions of financial debt, cash and cash-like items and net working capital in their transaction documents.

Second, it can further spare the parties the costs of preparation, audit and discussions of closing accounts after the completion of the transaction.

However, the parties to a locked box transaction will need to agree instead on
(a) definitions of what constitutes "leakage"[6] and/or "permitted leakage"[7] under the locked box mechanism and
(b) a reduction of the purchase price mechanism, or an indemnification mechanism, to the benefit of the purchaser in the event of any such leakage.

Indeed, as the purchaser will acquire the target based on a value thereof established on the locked box date, the purchaser will want to ensure that the seller and/or its affiliates did not extract any such value (essentially in the form of cash, assets or other benefits) from the target to their profit between the locked box date and the closing date.

In light of its above key characteristics, a locked box mechanism is usually deemed particularly appropriate for an auction process deal (as it permits to compare bids more easily) and/or a deal with a private equity fund acting as seller (looking for certainty).

From a purchaser perspective, a locked box mechanism will not always be reasonably acceptable. According to generally admitted practice, a locked box mechanism should probably be avoided, or at least carefully reconsidered, by a purchaser any time (a) the locked box date is more than three months before the signing date; (b) the locked box accounts are not audited by an independent auditor or may not be subject to a thorough financial due diligence prior to signing; (c) the target has no historical stand-alone balance sheet and is being, or was recently, restructured or has a highly volatile business activity; (d) the period between the signing date and the locked box date is expected to be rather long; or (e) carve-out actions or restructuring need to be implemented between signing and closing dates.

Finally, entering into a locked box transaction can usually lead to stronger demands from the purchaser under the transaction documents in terms of (a) negative covenants from the seller concerning the management of the target between the signing date and the closing date; (b) representations and warranties of the seller concerning the proper management of the target between the locked box date and the closing date (as the seller will no longer be financially interested therein); and (c) representations and warranties concerning the quality of the locked box accounts. It can also usually lead to a requirement of the purchaser to be set by the seller in a position to perform an extensive financial due diligence of the locked box accounts in terms of timing and information made available.

Jean-Philippe Smeets
Partner

+352 26 18 44 241
jean-philippe.smeets
@bakermckenzie.com

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[7] With permitted leakage comprising a limited number of leakage agreed between the seller and the purchaser in the share purchase agreement as, for example, any management fees (at fair market value) paid to the seller for the effective management of the company, any rent (at fair market value) paid by the target to the seller for the use of its offices (as applicable), any salary payment and bonuses paid to the target's employees within ordinary course of business…