Working Capital Adjustment and Earnout Disputes

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I. Introduction

While the closing of an M&A transaction is typically cause for celebration and marks the end of months of arduous work, it all too frequently also marks the beginning of a new period of disputes between buyer and seller. This article discusses two common types of M&A post-closing economic disputes: working capital adjustment disputes and earnout disputes. This article provides an overview of working capital adjustment provisions and earnout provisions and how they work, examples of issues that can arise in litigation, and suggestions for the drafter of an M&A agreement to attempt to limit the likelihood of litigation over these issues.

II. Working Capital Adjustment Disputes

A. What Is a Working Capital Adjustment Provision?

A working capital adjustment provision is a mechanism in an M&A agreement that allows parties to an M&A transaction to estimate pre-closing the working capital of a company being sold as of the closing date for purposes of fixing the sale price to be paid at closing, and then determine, post-closing, the actual working capital of the company as of the closing date, with a post-closing "true-up" payment following determination of actual working capital.

"Working capital" is defined as current assets minus current liabilities of a company. Current assets are those which can be converted into cash within one year, such as accounts receivable ("AR"), prepaid expenses and inventory. Current liabilities are debts or obligations due within one year, such as accounts payable and accrued liabilities. In many businesses, such as retail or businesses with seasonal demand, working capital may fluctuate significantly from month to month.

Working capital adjustment provisions are often necessary because there may be a considerable period of time – perhaps two or three months – between the date on which a purchase agreement is entered (and a sales price agreed upon) and the date on which the transaction closes and money is paid. The agreed upon purchase price reflected in the purchase agreement typically includes (and is thus based upon) an assumed dollar amount of working capital that will pass from seller to buyer with the acquired company at closing. Because this assumed working capital amount is determined sometimes months before closing, it is necessarily merely an estimate. This assumed working capital amount, of course, may turn out to have been greater or less than the amount of actual working capital of the target as of the closing date as determined after the closing and after the target's books for the previous month have been closed and actual working capital as of the closing date can be determined accurately.

Some purchase agreements insert an additional pre-closing step in the process: The purchase price in the purchase agreement is based on an "assumed" working capital amount, but the purchase agreement provides that the seller estimates working capital shortly (typically a few days) before closing. These purchase agreements provide that the purchase price paid at closing is adjusted up or down in an amount equal to the difference between the "assumed" working capital and the days-before-closing estimated working capital. While this procedure is generally intended to reduce the magnitude of any potential post-closing working capital adjustment, its efficacy in fulfilling this purpose is only as good as the estimate of working capital. Where the target's working capital varies significantly from month to month, this pre-closing estimate may not always be terribly accurate. Moreover, parties sometimes fail to devote sufficient attention to this pre-closing estimate because they are overwhelmed by a multitude of other matters that require attention in the final few days before closing.

Following closing, working capital adjustment provisions typically operate as follows: within a set number of days after the closing (anywhere from 60 to 120 days), the buyer prepares

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