Post-Acquisition Disputes: Working Capital Adjustments and Working Capital Disputes

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Working capital adjustments are a typical feature in merger and acquisition ("M&A") transactions. The working capital adjustment mechanism ensures that both the buyer and the seller in an M&A transaction are made whole. That is, the buyer realizes the value of the purchase price. And, the seller does not transfer any excess cash and assets to the seller—beyond what was paid for in the purchase price. This discussion examines the mechanics of working capital adjustments. This discussion considers working capital disputes, and it describes multiple financial accounting considerations in the dispute process. This discussion provides perspective on the interaction between working capital disputes and the target company valuation. Finally, this discussion analyzes the implications of an important Delaware Supreme Court decision involving a working capital adjustment. An understanding of the financial accounting, valuation, and legal considerations associated with working capital adjustments and working capital disputes is important to both the transaction buyer and the transaction seller.

Introduction

In the United States, merger and acquisition ("M&A") transactions are a frequent occurrence. Over a long-term 30-year period, M&A trends demonstrate increasing deal volume and increasing deal size. This trend is only reinforced by the strong deal volume in the last 2-year period.[1]

As M&A transactions remain prevalent, innovations and complexities arise and change the way that parties do business. To address the typical complexities in M&A transactions, there are multiple contract provisions to ensure that both transaction parties are made whole. Of particular importance to the buyer and the seller in the M&A transaction is what occurs after the transaction closes.

One typical provision in M&A transaction agreements is the working capital adjustment. The working capital adjustment addresses the post-closing working capital balance target.

Working capital adjustments are adjustments that are made to the M&A transaction purchase price. Working capital adjustments help ensure that:

1. the buyer and the seller arrive at the agreed-upon purchase price and
2. there is sufficient working capital available for the buyer as of the transaction closing.

When the transaction participants cannot mutually agree on the level of working capital, a working capital dispute ensues. These disputes are typically settled in arbitration. This discussion focuses on the working capital adjustment and the working capital dispute, as well as on the related accounting, valuation, and legal considerations.

Working Capital Adjustments

Working capital adjustments are a typical mechanism that serve multiple purposes in M&A transactions. In a business acquisition, value is typically established on a debt-free, cash-free basis by calculating the so-called enterprise value (or long-term debt plus owners' equity) of the company.

The value of the target company is also often estimated on a going-concern basis. In other words, the value of the company includes the assumption that it continues to operate after the purchase transaction.

Fundamental to the operation of the target company is its working capital, defined as (1) current assets less (2) current liabilities.

Achieving the agreed-upon level of working capital at the closing of an M&A transaction is important so the buyer may realize the value of the purchase price. Likewise, for the seller, achieving the agreed-upon level of working capital at closing is important to ensure that excess cash and assets above the value of the purchase price are not left to the buyer.

In addition to these competing interests, other factors make working capital adjustments a challenging issue to navigate in an acquisition. Working capital can fluctuate for numerous macroeconomic, industry-specific, and firm-specific reasons. These reasons include seasonality, irregular transactions or large capital expenditures, changes in firm credit or purchasing policies, economic downturns, and the financial strength of customers.

Working capital adjustments are frequently included in purchase agreements to make the parties whole in order to ensure that both parties (1) arrive at an agreed-upon purchase price and (2) are not adversely affected by working capital fluctuations.

Mechanics of the Working Capital Adjustment

Working capital adjustments are frequently applied as purchase agreement provisions to adjust the purchase price for the exact amount of the working capital balance at the closing. These contract provisions allow the buyer and the seller to establish a targeted level of working capital ("Targeted Working Capital") immediately following the transaction.

The Targeted Working Capital is then compared to the actual working capital balance at closing ("Closing Working Capital"). Finally, the working capital adjustment typically adjusts the purchase price to reflect the difference between the Targeted Working Capital and the Closing Working Capital.

If Closing Working Capital is less than Targeted Working Capital, then the purchase price is decreased by the difference. This decrease reflects the deficiency in the value of net current assets below the specified Targeted Working Capital and in the purchase documents.

If Closing Working Capital exceeds Targeted Working Capital, the purchase price is increased by the difference. This increase reflects the excess value of the net current assets above the specified Targeted Working Capital and in the purchase.

The typical issues when dealing with working capital adjustments include the following:

1. Determining how the Targeted Working Capital is calculated
2. Determining how the Closing Working Capital is calculated
3. Adjusting the agreed-upon purchase price

Calculating Targeted Working Capital

The considerations for Targeted Working Capital typically include defining which accounts comprise the working capital. Other considerations include the determination of the optimal level of working capital.

The Targeted Working Capital specified in the purchase agreement indicates the amount of net current assets required for the buyer to continue operations unconstrained by working capital concerns. Targeted Working Capital typically begins at the conventional definition of working capital—that is (1) current assets minus (2) current liabilities.

Targeted Working Capital is then adjusted to reflect any number of considerations, including industry-specific considerations, firm-specific considerations, and deal-specific considerations.

If the purchase price is calculated on a cash-free, debt-free basis, then the parties may remove the cash and debt accounts in the Targeted Working Capital calculation.

Unearned revenue may or may not be excluded from Targeted Working Capital, depending on the firm-specific or industry-specific context. Items included in Targeted Working Capital are typically normalized, with nonrecurring transactions and nonrecurring events removed from the balances.

The optimal level of Targeted Working Capital is frequently determined by analyzing working capital over a period—as compared to at one point in time. The time period may be an average over the latest 12-month period. Using an average working capital level allows the buyer and seller to review historical working capital and determine the necessary amount of working capital needed to continue operations, as working capital frequently fluctuates.

Several other factors—such as growth (fast growing companies typically require more working capital to scale operations) or seasonality—may also be considered when determining the optimal amount of Targeted Working Capital.

Calculating Closing Working Capital

The calculation of Closing Working Capital has considerations that may play a role in the M&A dispute. Significant issues such as how to calculate working capital may become important to the working capital adjustment. Calculating Closing Working Capital in accordance with U.S. generally accepted accounting principles ("GAAP")—as opposed to in a manner consistent with historical practice—is often an important consideration.

Buyers typically favor calculating working capital on a GAAP basis, while sellers typically favor calculating working capital in a manner consistent with historical practice. This issue is typically addressed in the purchase agreement. The purchase agreement should establish which objective, GAAP or consistency, takes priority.

The process by which Closing Working Capital is calculated can also be negotiated in an M&A transaction. The purchase agreement typically specifies (1) whether the buyer or the seller is to initially calculate the Closing Working Capital and (2) the time frame for preparing the calculation. The other contract party will then review the Closing Working Capital calculation and agree with—or dispute—the initial Closing Working Capital calculation.

The purchase agreement frequently specifies that both parties settle disputes in Closing Working Capital mutually, or if that is unachievable, in arbitration. Settling working capital disputes in an arbitration will be examined in the following sections.

Adjusting the Purchase Price

There are numerous considerations related to executing the working capital adjustment. Purchase agreements often limit upward or downward adjustments by establishing a "ceiling" or a "floor," respectively, for any purchase price adjustments.

More often than not, purchase agreements include both "ceilings" and "floors" for the purchase price, creating what is known as a "collar." In addition to limiting adjustments that are too large, purchase agreements may also call for de minimis thresholds. These thresholds are effectively the minimum amount required to make an adjustment to the purchase price.

Working Capital Disputes

Frequently, the buyer and the seller are unable to agree on the value of Closing Working Capital. In these instances, the buyer and the seller may resolve their differences through the dispute resolution process.

In a working capital dispute, both parties calculate disputed items in Closing Working Capital. Disputed items are the components and amounts of Closing Working Capital where the parties disagree.

To calculate disputed items in Closing Working Capital, the parties (1) evaluate the underlying working capital accounts in dispute and (2) support working capital account calculations with evidence and reasonable assumptions.

Typically, working capital adjustments are resolved through arbitration according to the resolution process outlined in the purchase agreement. The arbitration process differs from the traditional litigation process in several ways. Arbitration is typically cheaper and faster than the litigation process.

Accounting-type arbitrations typically emphasize accounting considerations in addition to legal considerations. Disputed items and the scope of what will be considered in an accounting arbitration may be outlined in the purchase agreement.

The primary considerations for calculating the amount of working capital in an arbitration setting are discussed in the sections below.

Primary Considerations for Calculating Working Capital

GAAP versus Consistency

A frequent theme in working capital disputes is the framework used to value the disputed items, as well as the hierarchy of multiple and conflicting frameworks used to value disputed items by the opposing parties.

The buyer may argue that disputed items should be calculated in accordance with GAAP, while the seller may argue that disputed items should be calculated in a manner consistent with historical practice. In order to justify their calculation of the disputed items, the parties may use evidence including management assertions, existing policies and procedures, and actual historical data.

Management Assertions

Certain financial statement accounts, including some accounts related to working capital, are subjective and require the use of accounting estimates. Accounting estimates are used to calculate financial statement accounts when there is no precise measurement and approximation is necessary.

Accounting estimates are typically used in practice and are called for by GAAP. Examples of working capital accounts subject to accounting

estimates include accounts receivable and allowance for doubtful accounts; inventory and corresponding reserves for obsolescence, excess and quality issues; and accrued liabilities such as accrued warranty liabilities.

Since these accounting estimates are called for by GAAP, the assertions made by management to develop these accounting estimates may be important supporting information in the dispute process.

Both the buyer and the seller may obtain management assertions supporting their assumptions for calculating the accounting estimates. And, both parties may use this information to support their calculations and conclusions for the working capital accounts.

Policies and Procedures

More evidence to support the position in a working capital dispute may be found in the existing policies and procedures for calculating financial statement accounts.

While management may make assertions about how financial statement accounts were calculated in relation to disputed items, it is often easy to discover how financial statement accounts were effectively calculated by observing and analyzing company information, policies, and procedures.

Opposing parties use company information, policies, and procedures to support their calculations of disputed items. Like management assertions, the evidence from company information and policies and procedures may be used to support the arguments that disputed items were or were not in conformance with GAAP.

Historical Data

Evidence to determine whether financial statement accounts are calculated in accordance with GAAP may be provided by both (1) company management assertions and (2) company policies and procedures. However, management assertions should also be comparable to what occurred; that is, the management assertions should be reasonable.

Similarly, effective policies and procedures need to reflect stated policies and procedures; a stated procedure on its face may be considered GAAP, but if the application of the procedure is different and not in line with GAAP, then it is not GAAP.

To address this issue, opposing parties may support their claims by analyzing historical data, which supports or refutes their claims relating to disputed items. For example, allowance for doubtful accounts assumptions will be compared with historical collections data, inventory reserve assertions will be analyzed against sales and cost data, and accrued liabilities estimates will be compared with actual expenses incurred.

Historical data can reveal whether revenue recognition and lease classification were applied properly. Finally, parties may claim or deny that the assertions and policies used to calculate working capital are in line with actual outcomes.

Considerations for the Adjustment

Once disputed amounts are settled and a conclusion about the adjustment is reached, applying the adjustment is fairly straightforward. Typically, the adjustment is applied to the purchase price on a dollar-for-dollar basis. Occasionally, the dollar-for-dollar adjustment will include interest.

Dollar-for-dollar adjustments make sense in the context of working capital adjustments. Working capital disputes are disagreements over the value of working capital at the time of closing, not of working capital in the valuation of the target company.

Targeted Working Capital is a normalized working capital figure adjusted for nonrecurring items, seasonality, growth, and other factors. It represents an approximation of the working capital needed to operate the target company to realize its value as a going concern.

The difference between Targeted Working Capital and Closing Working Capital is either an excess or a deficiency in the net current assets necessary to operate the target company and is a correction to arrive at the Targeted Working Capital figure.

In a working capital dispute, the value of working capital as it pertains to the target company valuation is not in dispute. No adjustments to the purchase price should typically arise due to the target company's valuation in a working capital adjustment.

The application of interest for the dollar-for-dollar adjustment can also be justified to compensate the buyer or the seller for the return that would have been realized had the adjustment amount been disbursed at closing.

It is noteworthy that while working capital adjustments and working capital disputes result in dollar-for-dollar adjustments to correct Closing Working Capital to Targeted Working Capital, the conclusions reached in a working capital dispute can imply other adjustments beyond the dollar-for-dollar difference of Targeted Working Capital and Closing Working Capital. Most glaring are the conclusions relating to the GAAP compliance of working capital accounts.

If Closing Working Capital is adjusted due to a working capital recalculation made by applying methods more closely aligned to GAAP, then such adjustments may have implications beyond the working capital adjustment.

The relationship of working capital in the working capital dispute and in the target valuation is examined in the following section.

Relationship of Working Capital in a Working Capital Dispute and in Target Company Valuation

The relationship of (1) the working capital measurement in a working capital dispute and (2) the working capital measurement in the target company valuation is an important consideration. The outcome of the working capital dispute may have implications regarding the target company valuation.

Working Capital in a Working Capital Dispute Context

In a working capital dispute, both parties calculate disputed items in Closing Working Capital. This process involves evaluating the underlying disputed working capital accounts. The arguments made to support the calculations of working capital accounts often involve whether the historical methods of calculating these working capital accounts were GAAP-compliant.

As a result, it could be concluded in a working capital dispute that historical methods for calculating working capital accounts were not calculated in accordance with GAAP. According to the conclusion reached in the working capital dispute, certain working capital accounts are calculated using methods other than what were historically used.

In other words, it could be interpreted from a working capital dispute that certain working capital accounts were incorrectly calculated in the past.

Working Capital in a Target Valuation Context

Working capital, defined as current assets less current liabilities, may have an important impact on the valuation of a target company. Working capital considerations affect the generally accepted business valuation approaches—the income approach, the market approach, and the asset-based approach—analysts apply to estimate the value of the target company.

Working capital directly affects cash flow in the income approach. Working capital also affects the income measures used in both the income approach and the market approach.

The income approach evaluates the sum of future cash flow discounted to the present using a present value discount rate. One income approach method is the discounted cash flow ("DCF"). In the DCF method, net cash flow to invested capital may be evaluated. Net cash flow is a calculation that begins with net operating income, adds back non-cash expenditures, subtracts capital expenditures, and subtracts (or adds) increases (or decreases) to working capital.

Therefore, working capital directly affects net cash flow to invested capital, and, as a result, directly affects the value calculated in the DCF method.

Working capital changes can also affect income measures used in the income and market approaches such as net income, debt-free net income ("DFNI"); earnings before interest, taxes, depreciation and amortization ("EBITDA"); and earnings before interest and taxes ("EBIT").

Working capital changes can affect these income measures. This is because various working capital accounts are inherently tied to income statement revenue and expense items. For example, accounts receivable and unearned revenue are tied to revenue, inventory is tied to cost of goods sold, prepaid expenses and accounts payable are tied to selling, general and administrative expenses ("SG&A"), and accrued liabilities can be tied to cost of goods sold or SG&A.

Therefore, changes in working capital accounts may affect the income measures applied to value a target company.

How Do Working Capital Disputes Affect the Value of a Target Company?

It is important to note two facts regarding the relationship between working capital as it relates to working capital disputes and valuation:

1. The conclusions reached in working capital disputes can imply that historical working capital accounts were incorrect
2. Working capital accounts can have direct and indirect effects on the target company valuation

If it is implied in a working capital dispute that historical working capital accounts were not GAAP-compliant, then the target company valuation (relying on historical working capital accounts) could also be incorrect. As a result, the analyst should inquire about the results of a post-acquisition working capital dispute and their resolutions, as historical normalizing adjustments may be required in the valuation analysis.

Chicago Bridge & Iron Co. NV v. Westinghouse Electric

The working capital adjustment and working capital dispute processes are defined terms and concept in the typical purchase transaction agreement. Distinguishing between—and interpreting—purchase agreement provisions are nuanced legal considerations. These legal considerations are largely determined by the structure and details of the purchase agreement.

To better understand the legal aspects of working capital adjustments, a judicial decision relating to working capital disputes is discussed in the next section.

Background of the Case

In the *Chicago Bridge & Iron Co. NV v. Westinghouse Electric* ("*CBI*") matter, Chicago Bridge & Iron Co. NV ("Chicago Bridge") sold a subsidiary company, CB&I Stone & Webster Inc. ("Stone"), to Westinghouse Electric Co., LLC ("Westinghouse Electric").[2]

In the purchase agreement, there was a working capital adjustment provision that called for a change in purchase price related to the difference between Closing Net Working Capital and Targeted Working Capital.

In the purchase agreement, Targeted Working Capital was calculated to be $1.2 billion. Chicago Bridge calculated Closing Working Capital as $1.6 billion, which implied a $0.4 billion payment from Westinghouse Electric to Chicago Bridge.

Westinghouse Electric concluded Closing Working Capital to be negative $1.0 billion, implying a $2.2 billion payment from Chicago Bridge to Westinghouse Electric. Westinghouse Electric, to arrive at their Closing Working Capital figure, argued that the seller did not calculate working capital accounts on a GAAP basis.

The parties attempted to settle the discrepancies over Closing Working Capital, but they were unable to arrive at a resolution. Westinghouse Electric then moved to initiate a review of the Chicago Bridge calculations by the independent auditor, as was called for in the purchase agreement to resolve disputes involving the final purchase price.

Chicago Bridge then filed a court action seeking a declaration that the Westinghouse Electric claims concerning the GAAP compliance of Closing Working Capital constituted indemnification claims. That is, a claim for compensation from the seller due to misrepresentations the seller made. According to the purchase agreement, indemnification claims were barred.[3]

Westinghouse Electric maintained that GAAP issues surrounding working capital accounts were not indemnification claims but were a part of the working capital dispute process. The primary decision in *CBI* involved the examination of whether the scope of the working capital dispute process, as outlined in the purchase agreement, was wide-ranging enough to address significant GAAP compliance issues.

The *CBI* Treatment of the Working Capital Dispute

On December 2, 2016, the Delaware Court of Chancery ("Chancery Court") ruled in favor of Westinghouse. The Chancery Court observed that the working capital adjustment process outlined in the purchase agreement could address significant GAAP compliance issues.[4]

The Chancery Court concluded that the significant GAAP issues Westinghouse Electric raised were indeed within the scope of the working capital adjustment process and were not an indemnification claim.

On June 27, 2017, the Delaware Supreme Court overturned the Chancery Court decision,

concluding that the working capital adjustment provision must be considered in the context of the broader purchase agreement.[5]

According to the Delaware Supreme Court, on its face, the working capital adjustment provision appeared to be the avenue to address the GAAP issues that Westinghouse raised.

However, when considering the contract as a whole, allowing Westinghouse to address GAAP issues in the working capital dispute would have violated the bar on indemnification in the purchase agreement and, therefore, would have changed a fundamental component of the contract.

As a result, the GAAP issues Westinghouse raised in their Closing Working Capital calculation could not be addressed in the working capital dispute process.

Important Working Capital Adjustment Decisions in *CBI*

In *CBI*, an important subject in the working capital adjustment provision was whether Closing Working Capital should be calculated in accordance with GAAP or in accordance with historical practice. The purchase agreement specified that the statements be "prepared and determined from the books and records of [Stone] and in accordance with United States [GAAP] applied on a consistent basis throughout the period indicated and with the [agreed principles]."[6]

It is clear from the purchase agreement that the frameworks used to calculate Closing Working Capital are GAAP and consistency. Ultimately, however, the hierarchy of applying the GAAP and consistency frameworks is ambiguous in the purchase agreement. Although it is generally understood in the accounting profession that GAAP compliance prevails over historical consistency, such an assumption is insufficient when drafting a purchase agreement.

The Delaware Supreme Court ultimately interpreted this passage to be a representation that historical financials were GAAP-compliant, and Closing Working Capital should, therefore, be calculated in a manner consistent with historical practice.

As a result, claims by Westinghouse Electric that Closing Working Capital accounts were not GAAP compliant would, therefore, constitute an indemnification claim, which was barred in the purchase agreement.

It is also important to consider the interplay between the indemnification provision and the purchase price adjustment provision. In the *Chicago Bridge* case, the purchase agreement barred the buyer from seeking indemnification.

While GAAP-compliance issues in working capital adjustment calculations are not always interpreted as indemnification claims, in the case of *Chicago Bridge*, the indemnification provision limiting the buyer from seeking indemnification was significant enough to affect the scope of the working capital adjustment and working capital dispute.

Summary and Conclusion

The working capital adjustment and the working capital dispute may appear to be a mere accounting issue—or true-up—associated with M&A transactions. Upon further examination, however, working capital adjustments and working capital disputes involve other considerations as well.

While accounting considerations guide the working capital adjustment process and the arbitration process in a working capital dispute, the working capital adjustment affects—and is affected by—legal considerations and valuation considerations.

The way that the purchase agreement is drafted has implications in working capital disputes. And, the calculations in working capital disputes can have implications on the valuation of the target company. An understanding of the interaction between these considerations can allow the M&A transaction counterparties to be more prepared, and such an understanding may prevent unexpected outcomes.

Notes:

1. https://imaa-institute.org/mergers-and-acquisitions-statistics/ accessed January 10, 2019.
2. Chicago Bridge & Iron Company N.V. v. Westinghouse Electric Company LLC, 166 A.3d 912 (Del. 2017).
3. Id.
4. Chicago Bridge & Iron Company N.V. v. Westinghouse Electric Company, LLC, C.A. No. 12585-VCL, 2016 WL 7048031 (Del. Ch. Dec. 2, 2016).
5. Chicago Bridge & Iron Company N.V. v. Westinghouse Electric Company LLC, 166 A.3d 912.
6. "M&A Report: Two Sides to Working Capital Adjustments," Gibson Dunn (November 2017), https://www.gibsondunn.com/wp-content/uploads/2018/01/MA-Report-Two-Sides-to-Working-Capital-Adjustments.pdf

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