

Delaware Court of Chancery Rules Dispute over Accounting Methodology Must Be Resolved through Purchase Price Adjustment Procedure and not as Claim for Indemnification

May 5, 2015

A recent case in Delaware provides a cautionary tale for sellers who carefully negotiate limitations on their indemnification liability to buyers for claims that the financial statements of the target business fail to comply with GAAP. Sellers should be aware that language in the purchase price adjustment procedure may allow buyers (at least with respect to the closing balance sheet) to assert claims without regard to these limitations based on the seller's failure to determine its working capital in accordance with GAAP.

This was the issue before the Delaware Court of Chancery In *Alliant Techsystems, Inc. v. Midocean Bushnell Holdings, L.P.* (C.A. No.9813-CB). In this case the court examined the relationship between the purchase price adjustment procedure and the indemnification provisions in a stock purchase agreement and ruled that a dispute concerning the accounting methodology used to determine working capital must be resolved by an accounting expert through the purchase price adjustment procedure rather than by a court as a claim for breach of representation of warranty.

Background

Alliant Techsystems, Inc. agreed to acquire Bushnell Group Holdings, Inc. for a purchase price of \$985 million. The purchase price was subject to a standard post-closing adjustment procedure that would take into account the difference between a target level of net working capital and actual net working capital on the closing date. The purchase agreement stated that the purchase price adjustment procedure was the exclusive method for resolving any disputed items in working capital and that any adjustment would be limited to amounts held in an adjustment escrow account of \$5 million and an indemnity escrow account of approximately \$7.4 million.

Net working capital was defined in the purchase agreement as the sum of all current assets minus the sum of all current liabilities "calculated in accordance with GAAP and otherwise in a manner consistent with the practice and methodologies used in the preparation of" certain financial statements of the company. The adjustment would be equal to the amount by which net working capital at closing was greater or less than \$188.1 million.

The purchase agreement also contained provisions that indemnified the buyer for any representation and warranty breach by the seller including a representation that the company's financial statements were prepared in accordance with GAAP applied on a consistent basis. Claims for indemnity were subject to a threshold of up to \$4.9 million and limited to the indemnity escrow account of approximately \$7.4 million. The agreement provided that indemnification was the sole and exclusive remedy with respect to all claims relating to the transaction but contained a carve-out for adjustments of the purchase price which would be pursuant resolved to the adjustment procedure.

Prior to the closing the seller delivered its estimate of net working capital of \$192.4 million which was \$4.3 million higher than the assumed amount of \$188.1 million. The buyer paid the adjusted purchase price at closing based on this amount. After the closing the buyer delivered to the seller its calculation of net working capital as of closing in the amount of \$166.4 million and claimed, based on this calculation, that seller owed it a net amount of \$25.9 million. The seller disputed the buyer's closing calculation because it "ignored the requirement that the proposed closing date calculations are determined based on the practices and methodologies used by the company in the preparation of the financial statements referenced in the representation and warranty." The seller argued that buyer was in fact alleging a breach of representation and should have brought the claim pursuant to the indemnification provisions of the purchase agreement.

Court's Analysis

The court examined the terms of the purchase agreement and agreed with the buyer that disagreements over the calculation of net working capital fell within the scope of the purchase price adjustment procedure even though they implicated issues concerning compliance with GAAP that could form the basis for an indemnification claim.

The court noted that the purchase agreement required both the seller and the buyer to prepare their net working capital calculations in accordance with the definitions contained in the agreement. Net working capital was defined as the sum of all current assets less the sum of all current liabilities "calculated in accordance with GAAP and otherwise in a manner consistent with the practices and methodologies used in the preparation of the company's financial statements."

Noting that GAAP tolerated a range of reasonable treatments, the court stated that if the seller was following GAAP when it submitted its net working capital estimate, the buyer could not seek to adjust net working capital when it prepared its closing date calculations by selecting another GAAP-compliant accounting treatment different from the seller's historical accounting practices and methodologies. "On the other hand, if [the seller] was not following GAAP when it submitted its good faith estimate of net working capital, then...[the purchase agreement permitted the buyer] to put forward a calculation of net working capital it believes complies with GAAP when it prepared its proposed closing date calculations."

The court expressly rejected the argument that the purchase agreement should be read to require the buyer to calculate net working capital in the same manner as the seller had done historically even if that methodology did not comply with GAAP. To do so would be to read the words "calculated in accordance with GAAP" out of the definition of net working capital and to ignore the requirement articulated throughout the purchase price adjustment procedure to adhere to the definitions. Such a reading would contravene basic principles of contract construction requiring that contracts be read as a whole and that meaning be given to all the provisions of the contract whenever possible.

The court said it would have been easy for the parties to prescribe the buyer from challenging the seller's estimate of net working capital on the basis that it failed to comply with GAAP. The agreement could simply have required the buyer to apply the same accounting methodologies the seller had used historically without the additional requirement that the calculations be made in accordance with GAAP. That it did not do so left open the opportunity for the buyer to challenge the seller's calculations based on a failure to comply with GAAP.

The court also rejected seller's argument that the role of the accounting firm was limited to considering questions of "pure mathematics." Although the purchase agreement provided that the function of the accounting firm is not to serve as an "arbitrator," in the court's view, that does not rule out that it may be called upon to apply normal accounting principles (i.e., GAAP) when serving the function of an expert. "[T]he parties would not have selected an "independent accounting firm of national reputation" to serve as an "expert" if all they wanted that firm to do was to engage in a bean-counting exercise. Instead, such a selection supports the notion that they intended the expert to consider each side's position and to apply genuine expertise to resolve purchase price adjustment disputes promptly." The phrase "items or amounts" as used in the adjustment procedure is sufficiently broad to encompass accounting methodology and the accounting firm may make an expert determination of each component of net working capital as well as the quantity, or dollar value, of those entries.

Lessons Learned

From the seller's point of view, the importation of GAAP standards into the purchase price adjustment procedure risks undermining any limitations of liability that are negotiated for breach of the financial statements representation and warranty, at least with respect to any adjustment of the purchase price based on the calculation of the closing working capital amounts. To avoid this result, sellers should resist the inclusion of GAAP as a standard in the adjustment procedure which should instead be limited to application of the same principles and methodologies as historically employed by seller in the preparation of its financial statements.

From the buyer's point of view, the court's holding is precedent to support the position that a purchase price adjustment procedure that incorporates the GAAP standard permits the buyer to apply GAAP in determining the closing working capital even if the seller had used different accounting principles in its preparation of the assumed level of working capital and pre-closing estimate. It is an important holding since it reaches a contrary result to that reached by then-Vice Chancellor Strine in *OSI Systems, Inc. v. Instrumentarium Corp.* (892 A.2d 1086 (Del. Ch. 2006)). In that case the court rejected a buyer's argument that it was only by changing seller's accounting principles to GAAP that buyer could comply with the contractual requirement that the closing date working capital be calculated in accordance with GAAP.

M&A practitioners predictably will take different sides of this argument depending on which party they represent. The case highlights the importance of focusing on the defined terms in the purchase price adjustment procedure and understanding how they may be used in the context of disputes regarding the level of working capital deployed in the business at closing. Given that buyers are typically basing the purchase price in part on receiving at closing an agreed upon level of working capital, the court's holding in *Alliant Techsystems* is a reminder that GAAP principles must be included specifically if they are relying on that standard. Sellers, on the other hand, should beware that the standard exposes them to claims they may think have been effectively limited by the indemnity process.



Please contact any of the following attorneys in our mergers and acquisitions practice for further information or if you have any questions concerning this topic.

Mark Stabile
(412) 297-4966
mstabile@cohenlaw.com

Michael Winterhalter
(412) 297-4968
mwinterhalter@cohenlaw.com

Christopher Carson
(412) 297-4824
ccarson@cohenlaw.com

Paul De Rosa
(412) 297-4821
pderosa@cohenlaw.com

Jeff Peters
(412) 297-4868
jpeters@cohenlaw.com

Michael Dougherty
(412) 297-4808
mdougherty@cohenlaw.com

Christopher Thel
(412) 297-4929
cthel@cohenlaw.com

John Wingerter
(412) 297-4981
jwingerter@cohenlaw.com

Andrew Flowers
(412) 297-4835
aflowers@cohenlaw.com

Andrea Steiner
(412) 297-4736
asteiner@cohenlaw.com

The contents of this publication are for informational purposes only and do not constitute legal or other professional advice. Cohen & Grigsby, P.C. assumes no liability in connection with the use of this publication. The hiring of a lawyer is an important decision that should not be based solely on advertisements. Before you decide, ask us to send you free written information about Cohen & Grigsby's qualifications and experience.