Paul|Weiss

Private Equity Digest

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Working Capital Adjustments – Part II

As discussed in Part I of our working capital adjustment article series, these provisions are "issue-rich" areas where parties must develop a clear and precise accounting methodology to ensure that working capital is calculated as intended and to avoid post-closing disputes. In Part II, we examine in more detail issues related to cash, debt and tax line items, although we note that many of the same negotiation, analytical and drafting concepts will carry over to other line items, such as accounts payable or receivable. For Part I of this article series, click here.

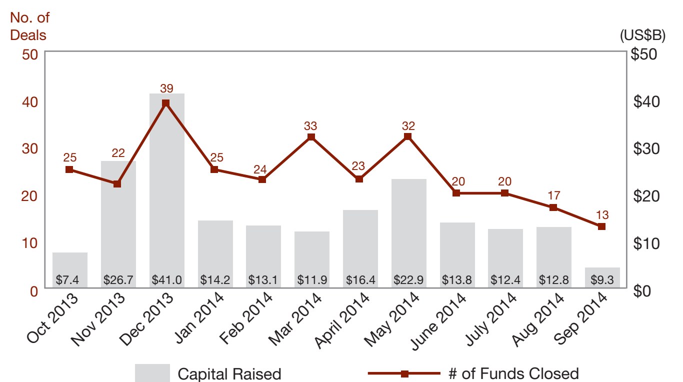
As part of defining the methodology for calculating the working capital adjustment, the parties should define what constitutes "working capital" itself. The simple GAAP definition is current assets (e.g., cash and cash equivalents, accounts receivable, inventory and, in some instances, prepaid expenses) minus current liabilities (e.g., compensation and benefits accrued, accounts payable and income taxes and other liabilities accrued, all to be paid within one year of the balance sheet date). Rather than relying on this general definition, however, the parties should consider specifying the line items to be included (in some cases, refining further to reference the general ledger accounts may also be appropriate) and the manner in which they are calculated and then expressly state that the working-capital definition will not include assets or liabilities other than those enumerated line items (as calculated in accordance with the agreed upon accounting methodology).

Cash

While "cash and cash equivalents" appears a simple concept, buyers and sellers should consider refining that general GAAP definition to specify the inclusion or exclusion of certain accounts as needed based on the particular circumstances of the target and its business. For example, the parties may wish to exclude restricted cash (because that cash is required to be held for a special purpose) or "cash in till" (since that cash may be needed for operations immediately after closing). The parties should also identify circumstances that may require special treatment or a separate negotiation, such as any significant costs (e.g., taxes) associated with the repatriation of cash into the U.S. from non-U.S. jurisdictions or if there is any significant deferred revenue.

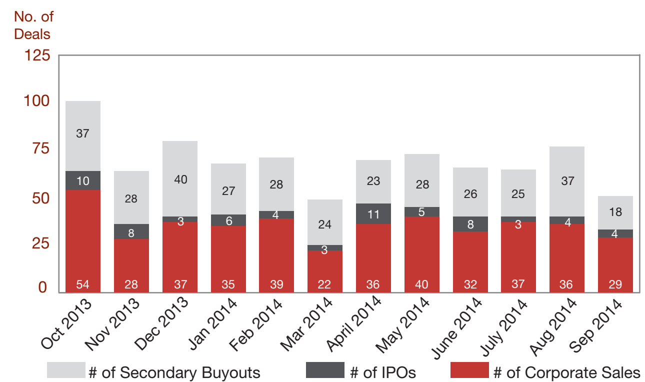
The parties should also consider whether there is a need to define how certain cash accounts should be calculated. For example, if there is significant cash in non-U.S. currencies, what exchange rates should be used to translate those funds into U.S. dollars and at what relevant measurement date? If the target has non-wholly owned subsidiaries, the buyer should consider whether it is appropriate to include non-distributed cash and cash equivalents at those subsidiaries in the target's working capital calculation. Indeed, this consideration and analysis would apply to all current asset and liability accounts if there are any non-wholly owned subsidiaries. Presumably, only the portion of cash or other amounts in the subsidiary accounts that is proportionate to the target's ownership percentage (and in the case of cash, unrestricted) should be included in the working capital calculation, but the parties should specify the methodology to avoid any disputes at or following closing.

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

We should also note, that as an initial matter, parties may decide to exclude cash and cash equivalents completely from the working capital adjustment and address those items in a standalone adjustment, a practice that is also common. Buyers may prefer a working capital adjustment to include cash because there is a perception that excluding cash allows sellers to manipulate expenditures to increase their cash take-home in a cash-free, debt-free transaction, whereas sellers may prefer a separate cash adjustment for its specificity as to what cash sellers can and cannot take, particularly where there is a complex cash accounting system. If neutrally drafted and evenly negotiated, these two approaches ought not to provide any significant, built-in benefits to either side, but advantages may arise if issues are missed.

Take, for example, the "float" issue. The float is the difference that exists at any time between the accrual cash balance (the check-book cash balance) and the bank cash balance (the bank-statement cash balance) and reflects the time that it takes for incoming checks (receivables) to clear and convert to cash and for outgoing checks (accounts payable) to clear after being cashed by third parties. When the seller writes a check to pay an account payable, GAAP requires a reduction in cash and a corresponding reduction of the amount payable. If working capital includes cash, the transaction is a non-event because there are offsetting entries on the liability and asset side of the balance sheet. If there is a standalone cash adjustment, the same result can be replicated by specifying that cash shall be reduced by the amount of any outstanding checks or other deposits in transit and not yet reflected in the bank accounts. If the working capital adjustment were to exclude cash without an appropriately drafted standalone cash adjustment, then buyer might be disadvantaged. So for buyer, including cash in the working capital adjustment would immediately remedy the float issue, whereas a standalone cash adjustment would have required a bit more drafting.

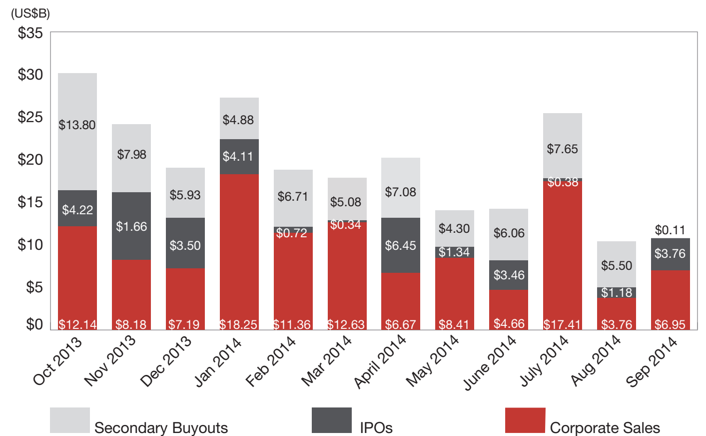
As a final note, regardless of whether the parties include cash in the working capital adjustment or have a standalone cash adjustment, the purchase agreement will still need tailored, ordinary-course covenants to prevent any attempts to alter target behavior to game the post-closing adjustment mechanism.

Debt

Indebtedness has two components: current indebtedness, which is due within twelve months of the balance-sheet date, and non-current (or long-term) indebtedness, which is not due within the twelve-month period. Because most private deals are done on a debt-free basis, the purchase agreement should provide that the relevant party repay all debt with the purchase price proceeds at closing and that no "indebtedness" (which could be more broadly defined to include both traditional borrowed funds and interest and debt-like items, such as pension liabilities, customer advances or capital lease liabilities) will be included in the working capital calculation. The effect on working capital is that indebtedness will be paid at closing, and the closing calculation must exclude all indebtedness so as to avoid double dipping relative to the repayment of indebtedness. To maintain consistency between the target and the closing calculations, the target working-capital calculation must also exclude all indebtedness. Further, the parties should account for breakage and other costs that may be accrued with the payment of such indebtedness.

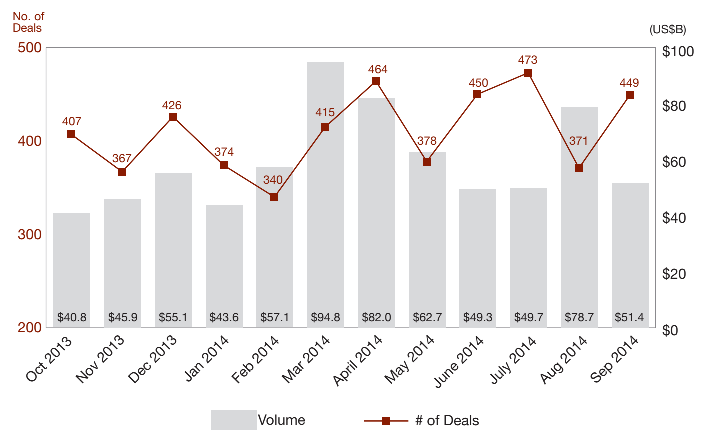
Unfortunately, the debt-free concept is not always as clear cut as it sounds. It is common for some debt to remain outstanding after closing. Low interest-rate industrial revenue bonds, capitalized leases

U.S. Sponsor-Backed Exits By Dollar Volume



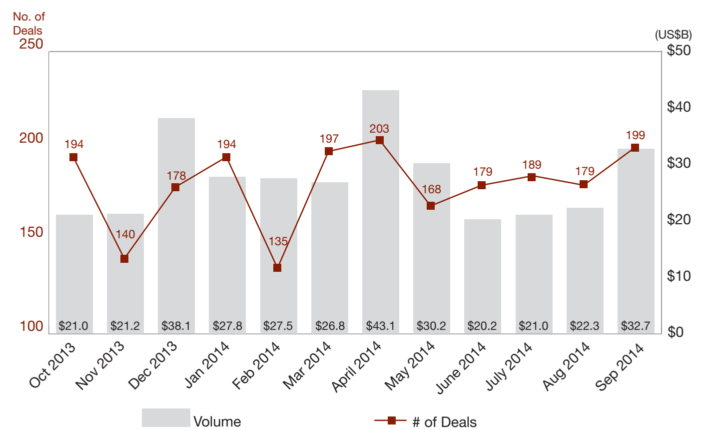
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

and lines of credit are some examples. If the purchase agreement does not provide for a retained indebtedness-adjustment to the purchase price, the parties normally will account for any such retained indebtedness in setting the initial amount of the purchase price at the outset. The agreement should also include the accrued interest portion of the retained indebtedness as a current liability for working-capital purposes, to reflect accurately the cost of the business between signing and closing.

As with cash accounts, the parties could also use a standalone debt adjustment if needed to account for a complex capital structure or other aspects of the transaction.

Taxes

Taxes also need special consideration. Tax benefits, such as those created by the repayment of debt, the cash out of options, the payment of bonuses or other such transactions, may reduce current tax liability or carryback refund claims, thereby increasing working capital. These items are also occasionally addressed directly in purchase price, i.e., the purchase price can be increased by the tax asset created by option cash-outs. Alternatively, the parties can agree that such assets will be used first as security for the seller's tax obligations under the tax indemnity. If buyer has negotiated for the benefit of those tax assets, then those amounts should be excluded from working capital (and appropriately handled by the tax indemnity) so that buyer gets the full value of such assets. Sometimes, buyer may not need the tax asset or be sure that those assets will ultimately redound to buyer's benefit. If the post-closing capital structure of the target is highly leveraged and future interest or amortization deductions will provide a sufficient tax shield, no buyer would want the excess deductions to increase the purchase price. Thus, buyer may again argue that working capital should exclude such tax benefits. A buyer could agree to provide a separate post-closing adjustment for tax benefits when they are realized. But this approach means that the seller remains interested in the buyer's affairs, although buyer could limit the time period in which the deduction will be applicable for the tax adjustment paid so as to avoid sellers in their business affairs and tax planning for unknown periods post-closing.

Another tax area that requires special consideration is deferred taxes. The parties will generally exclude deferred taxes from their calculations because deferred taxes are the result of the difference between tax and financial accounting, and are not normal working-capital items.

Finally, we note that the working capital adjustment can also be used for immediate payment of tax liabilities by the seller to buyer, instead of using other mechanisms (such as the tax indemnity) to have the seller pay those amounts as the relevant returns are filed and applicable taxes paid.

As a process matter, after the parties have determined the line items, accounting methodology and special balance-sheet rules for calculating the target and closing working capital, they should attach a mock working-capital calculation to the purchase agreement. It will be an excellent reference point if disputes arise, particularly because business people often find visual representations more accessible than prose.

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