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Purchase price adjustments warrant scrutiny

Experienced counsel can help structure working capital adjustments

By Jeffrey A. Fickes


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With the growth and influence of private equity during the last 20-plus years, post-closing purchase price adjustments in mergers and acquisitions have become the norm.

Today, more than three-fourths of middle market transactions include price adjustment mechanisms based on the actual amount of working capital delivered by the seller at closing relative to an agreed-upon target amount.
This adjustment mechanism is used for a very simple reason: Businesses require a certain amount of working capital to meet ongoing cash flow needs.

If a seller delivers less-than-adequate working capital, the buyer will be required to make an additional investment in the business. On the other hand, if the seller delivers more-than-adequate working capital, the seller will be leaving money on the table.

If this is so simple, then why do approximately two-thirds of transactions with working capital adjustment mechanisms result in downward price adjustments? And why is the average downward adjustment approximately 1% of purchase price ($1 million on a $100 million deal)?

It is generally not because buyers game the system or sellers intentionally pull working capital out of the business before closing.

For the most part, parties conduct themselves in good faith, especially when they will continue working together after closing (including equity rollovers or executive employment relationships).

Maybe the lawyers are to blame. This is a provocative suggestion coming from a lawyer for sure, but it just may be true.

Although simple in theory, structuring working capital adjustment mechanisms is not simple in practice. There are many complex variables that involve the disciplines of law, accounting and finance. Investment bankers and CPAs cannot do this all on their own.

Deal counsel must first possess adequate knowledge of accounting and finance in general. They need to understand the business, the numbers and the accounting methods so the working capital calculation and target are properly established.

Finally, deal counsel can help reduce the likelihood of material price adjustments and related disputes by being proactively involved in structuring adjustment mechanisms that meet the parties' objectives and ensure adequate working capital for the business.

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