

A photograph of the San Francisco skyline at sunset, featuring prominent skyscrapers like the Transamerica Pyramid and the Salesforce Tower. The image is overlaid with a semi-transparent white geometric shape that serves as a background for the text.

ADVOCATUS RESEARCH

TRANSATLANTIC M&A: PART ONE

PURCHASE PRICE MECHANISMS:
LOCKED BOX VS COMPLETION
ACCOUNTS

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Introduction

During recent months, a myriad of different factors have greatly improved the outlook for would-be US acquirers of European target companies. With the dollar recently achieving parity against the euro for the first time in twenty years, US buyers have benefitted from greater acquisition power, meaning foreign targets have been available to purchase at a relative discount.¹ The outlook for US buyers has been further buoyed by the valuation gap which persists between US and European-listed stock indices, which reached its highest level in over a decade during 2023.² This trend has been particularly notable when comparing the US and the UK; by March 2023, companies on the MSCI UK Index were trading at a record 40% discount compared to the US, based on a 12-month forward earnings-based valuation.³

Notwithstanding these tailwinds, the many challenges associated with conducting transatlantic M&A remain. Many of these challenges for US buyers are regulatory in nature, such as ensuring that any transaction fully complies with European antitrust and foreign direct investment rules to name just two examples. Alongside navigating regulatory divergence, potential buyers must also be acutely aware of the deal term preferences that exist in foreign jurisdictions. Once again, these differences are particularly notable when comparing the US and UK markets, with the former generally regarded as buyer-friendly in contrast with the more seller-friendly perception of the UK. Owing to the valuation gap contemplated above, UK-bound M&A activity will likely be on the rise in the short-term, meaning the deal term preferences of US buyers are likely to collide with UK sellers' conventional expectations.⁴ Without appreciating these nuances, dealmakers on both sides of the table risk entering M&A negotiations at a disadvantage, unable to establish common ground and agree terms with their transatlantic counterparties. In this multi-part series, the foremost areas of deal terms divergence between the US and the UK will be considered, alongside providing practical guidance for buyers and sellers on how these gaps may be bridged. We begin our series by discussing purchase price mechanisms, which have represented an area of historic divergence between these two jurisdictions.

Completion Accounts vs Locked Box Mechanisms

As expanded upon further below, two main pricing methodologies are available to parties negotiating an M&A deal: (i) the completion accounts mechanism, which remains the dominant methodology in the US, or (ii) the locked box mechanism, which has become comparatively prevalent in the UK. The crucial difference between these methodologies is that, whereas the locked box mechanism fixes the purchase price at the signing stage of the transaction, the completion accounts mechanism enables the initial price agreed at signing to be adjusted at the closing stage. As a precursor to this distinction, the 'signing stage' in an M&A context refers to the point at which the buyer and seller sign the relevant transaction documents, including the Sale and Purchase Agreement (SPA), thereby undertaking to transfer the ownership of the target. Comparatively, the 'closing date' represents the point at which the actual transfer of ownership of the shares or assets is executed. It should be noted that absent any specific reasons to the contrary, signing and closing generally occur on the same date; however, for more complex deals, the gap between signing and closing may range from a matter of days to several months, allowing the parties to fulfil any 'conditions precedent' to closing. Such conditions ordinarily include obtaining the consent of various third parties affected by the transaction, including shareholders and contractual partners, as well as official approvals, such as from relevant antitrust authorities.

Under the completion accounts mechanism, the buyer agrees to pay a preliminary purchase price at the signing stage, which is ordinarily based on the target company's enterprise value (which measures a company's total value

¹ Jorge Liboreiro, 'Euro reaches parity with dollar for the first time in 20 years' (*Euronews*, July 2022). Available at: <https://www.euronews.com/business/2022/07/12/euro-reaches-parity-with-dollar-for-the-first-time-in-20-years> (Accessed: July 4, 2023)

² Sharon Bell, 'European stocks may give US equities a run for their money' (*Goldman Sachs*, June 2023). Available at: <https://www.goldmansachs.com/intelligence/pages/european-stocks-may-give-us-equities-a-run-for-their-money.html> (Accessed: July 9, 2023)

³ Abhishek Vishnoi, 'UK Stocks Valuation Gap to US Driving Listings Abroad, Citi Says' (*Bloomberg*, March 2023). Available at: <https://www.bloomberg.com/news/articles/2023-03-06/uk-stocks-gap-to-us-driving-listings-abroad-citi-s-manthey-says> (Accessed: July 6, 2023)

⁴ Joshua M. Dubofsky et al. 'Rise in Transatlantic Transactions Puts M&A Deal Terms in Focus' (*Latham & Watkins*, February 2023). Available at: <https://www.latham.london/2023/02/rise-in-transatlantic-transactions-puts-ma-deal-terms-in-focus/> (Accessed: July 9, 2023)

by including not only market capitalisation but also short-term and long-term debt and any cash on the company's balance sheet). Subsequently, once ownership of the company transfers on the closing date, one of the parties is obliged to draw up completion accounts. These completion accounts operate by first comparing the target's enterprise value at signing to the target's enterprise value at closing. Subsequently, the target's equity value or market capitalisation (which equals the final purchase price) is determined by adjusting for cash, debt, and any changes in working capital. If any cash remains on the target's balance sheet, this figure is accounted for through an increase in the purchase price, whereas any remaining debt has the opposite effect, reducing the price. With respect to the working capital adjustment, the party preparing the accounts will simply adjust the purchase price to reflect any difference between the *target* working capital amount stated within the SPA and the *actual* amount calculated post-closing. Once a debt-free, cash-free, working capital-adjusted price has been confirmed, either the buyer or seller settles the difference in price between the enterprise value at signing compared with the equity value at closing.⁵

Where this mechanism is utilised, the exact nature of the adjustments to be made, along with the preferred accounting methodologies, should all be detailed within the SPA, as well as identifying a chosen dispute resolution mechanism if the reviewing counterparty wishes to challenge the calculations made. Contrastingly, as alluded to above, the locked box mechanism is notable for the fact that it avoids any post-closing adjustments, fixing the final purchase price at the point at which the SPA is signed. The equity value here is established solely through reference to a recent, historical balance sheet, with the cash, debt, and working capital positions not subject to any future adjustment. These structural differences open up a number of practical considerations for both buyers and sellers when determining which pricing mechanism will best suit their needs, which this note will now turn to discuss.

Considerations for Buyers

From the perspective of buyers, perhaps their key motivation in this scenario is ensuring the accuracy of the purchase price, and from this standpoint, the completion accounts mechanism often represents the most favourable option. Precisely calculating the transaction consideration at the closing date can be particularly attractive for buyers as it protects against the risk of (i) over-reliance on the target's historical financial statements presented by the seller at signing and (ii) adverse events occurring between signing and closing, such as an economic downturn, which may substantially reduce the target's value.⁶

For the very same reason, the locked box is less preferable for buyers as the economic interest passes from seller to buyer at a far earlier point in time under this mechanism, amplifying the two risks outlined above. Although the formal change of control occurs as normal on the closing date, the economic interest here effectively transfers to the buyer once the SPA has been signed, due to the purchase price being fixed as of that point. With little scope for post-closing adjustment, acquirers in this context are left exposed to the risk that the target's value may depreciate between signing and closing. To hedge against this so-called 'value leakage' risk, buyers who agree to a locked box mechanism often conduct far more detailed due diligence on the target's financial statements which are used to fix the purchase price, as any potential inaccuracies cannot be later corrected by a price adjustment.⁷ Buyers are also generally advised to, where possible, minimise the time between signing and closing to no more than two to three months so as to minimise the time in which leakage can occur, whilst equally ensuring that there is adequate time to review the target's financials. Alongside greater diligence and timing considerations, acquirers should also consider negotiating a range of applicable representations and warranties within the SPA, such as seeking indemnification from the seller for any undue leakage or extraction of value from the target that occurs during the locked box period, as well as identifying permitted leakages, such as salaries and expenses. Although in many cases value leakage can be mitigated through implementing the aforementioned steps, such SPA

⁵ Claire Jolly & Matthew Odams, 'Completion accounts: a science or an art?' (Deloitte, January 2023). Available at: <https://www2.deloitte.com/uk/en/blog/economic-crime/2023/completion-accounts-a-science-or-an-art.html> (Accessed: July 7, 2023)

⁶ Maximilian Menges & Markus Frohm, 'Five considerations of completion accounts vs. locked box mechanisms' (Ernst & Young, April 2022). Available at: https://www.ey.com/en_gl/law/locked-box-vs-completion-accounts (Accessed: July 2, 2023)

⁷ Jennifer L. Chu et al. 'Locked Boxes in U.S. Practice: An Underused Tool?' (Debevoise & Plimpton, May 2021). Available at: <https://www.debevoise.com/insights/publications/2021/05/locked-boxes-in-us-practice-an-underused-tool> (Accessed: July 9, 2023)

provisions may not fully protect buyers contemplating the purchase of a target company with volatile performance or working capital, suggesting that the locked box mechanism is best avoided in these circumstances.

Considerations for Sellers

From the standpoint of sellers, the chief benefit of the locked box structure is its capacity to maximise the certainty and speed of the transaction. In particular, agreeing on a fixed purchase price at signing often represents a clean break by minimising the scope for any post-closing disputes, which are disproportionately more common where a price adjustment is contemplated. Indeed, in 10% of cases, buyers and sellers who utilise a completion accounts mechanism have been found to refer themselves to expert determination proceedings in order to resolve the disputes that arise.⁸ Even leaving aside the risk of disputes, the very act of preparing and reviewing completion accounts can be a lengthy, complex process (particularly for the target company which must allocate resources towards preparing the accounts alongside continuing day-to-day management of the business), simply adding further steps to the calculation of the purchase price. Due to the lack of any post-closing adjustments, the locked box structure is particularly attractive for private equity sellers who are keen to rapidly distribute the returns from a sale after closing. Whilst this does, in some instances, prevent sellers from benefitting from any improvement in the target's financial condition between signing and closing, this can be partially addressed by incorporating a 'ticking fee' provision within the SPA, which rewards the seller with incremental compensation the longer it takes for the transaction to close.⁹

Implications for UK-bound M&A activity

Notwithstanding the discussion above, it is important to stress that where buyers and sellers alike are primarily concerned with ensuring the swiftness of completion and limiting the risk of disputes, the locked box mechanism may often represent the mutually preferred option for both parties. These drivers explain the dominance of this pricing mechanism today in the UK, which has traditionally been regarded as a seller's market and which has also witnessed an influx of transactions involving private equity firms, further increasing the desire for swifter completions and clean-cut exits.¹⁰

Assuming that these forces remain strong, the locked box structure looks set to remain the pricing mechanism of choice for UK sellers where any inbound M&A activity is being contemplated. US acquirers, by contrast, will likely be persistent in their preference for the completion accounts mechanism with which they are far more familiar. Such buyers may attempt to convince UK sellers of the front-end convenience of this approach, emphasising that (i) at the point of signing, only the pricing methodology needs to be agreed upon rather than the final purchase price and (ii) the less detailed due diligence required on the target's financials leads to a quicker, more streamlined transaction for both parties. From the opposite perspective, UK sellers intent on a locked box structure should be prepared to provide audited financial statements to prospective buyers and be subjected to comprehensive financial due diligence if they are to convince their US counterparts of their chosen mechanism.

As with many other facets of the negotiation process during an M&A transaction, buyers and sellers negotiating the purchase price mechanism must consider broader market dynamics, individual deal dynamics and their relative bargaining power in order to decide on the aggressiveness of their negotiation strategy. For example, although buyers with stronger bargaining power may afford to be more reticent about agreeing to a locked box structure, potential acquirers within an auction scenario may likely be more open-minded to this approach for strategic reasons. Here, bidders looking to distinguish themselves may commit to paying a fixed purchase price in order to

⁸ Nick Andrews & Patrick O'Brien, 'International Survey: A smarter way to get deals done' (*Grant Thornton*, November 2017). Available at: <https://www.grantthornton.co.uk/globalassets/1.-member-firms/united-kingdom/pdf/publication/a-smarter-way-to-get-deals-done-international-survey.pdf> (Accessed: July 6, 2023)

⁹ John Pollack & Pavel Shaitanoff, 'A Primer on 'Locked-Box' Deals' (*Gibson Dunn & Crutcher*, November 2017). Available at: <https://www.gibsondunn.com/wp-content/uploads/2017/12/Pollack-Shaitanoff-A-Primer-On-Locked-Box-Deals-Law360-11-15-2017.pdf> (Accessed: July 6, 2023)

¹⁰ Sandro De Bernardini & Simon Rootsey, 'Popularity of Locked-Box Deals in the UK: Price Certainty, Other Benefits for Buyers' (*Skadden, Arps, Slate, Meagher & Flom*, September 2015). Available at: <https://www.skadden.com/media/files/publications/2015/09/popularityoflockedboxdealsintheuk-pricecertaintyot.pdf> (Accessed: July 10, 2023)

gain a competitive advantage in the hopes of winning the relevant auction. Ultimately, irrespective of the mechanism on which the parties agree, ensuring that appropriate safeguards are drafted into the SPA at signing is clearly of crucial importance for both buyers and sellers.

With the issue of purchase price mechanisms considered, Part Two of this multi-part series will move to examine the disclosure process and how it differs in the UK and US M&A markets, particularly with respect to the treatment of representations, warranties and indemnities, as well as providing practical guidance for transatlantic dealmakers on how those gaps may best be bridged in negotiations.