

WORKING CAPITAL

By Christopher J. Hewitt

ARE YOU PROPERLY ADDRESSING WORKING CAPITAL IN YOUR PURCHASE AGREEMENT? *A different perspective on working capital true-ups in M&A transactions*

Almost every M&A transaction includes some form of working capital true-up, and yet many practitioners, including attorneys, accountants, and business development professionals, seem to struggle with this provision. In this article, I will discuss my perspective on the objective the working capital true-up should attempt to accomplish, and identify and explain some of the most common problems that I have seen in my practice with this provision. First, I will address the purpose of working capital and how that purpose relates, if at all, to target working capital in a transaction. I will then examine some of the issues in the mechanics of a working capital true-up, rollover equity, and the concept of a “cash-free” business.

THE PURPOSE OF WORKING CAPITAL

I think I can safely say that everyone who has encountered a working capital provision at least once knows that the accounting definition of working capital is current assets minus current liabilities. For many practitioners, however, that is where the attempt to understand working capital begins and ends.

Working capital represents the operating liquidity available to the business. Stated differently, it is the amount of capital required by an organization to meet its day-to-day expenses without the infusion of outside capital.

Working capital management is one of the most important issues facing an organization. Organizations can reduce their financing costs, increase the funds available to expand the business, or increase the return to shareholders by effectively managing working capital. To the extent that management is able to generate cash that exceeds the amount required to operate the

business on a daily basis, it can use those excess proceeds to pay down debt, invest in the business, return excess funds to shareholders, or some combination thereof.

Similarly, the purpose of requiring that a certain amount of working capital be left in an acquired business should be to make sure that working capital is sufficient for the buyer to operate the business post-closing so that it need not inject cash into the business. Stated differently, the current

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assets purchased by the buyer—e.g., inventory, accounts receivable, prepaid expenses, and, yes, even cash—should be sufficient to pay off the current liabilities assumed by the buyer—e.g., accounts payable—as well as to produce more inventory, make payroll, and pay other daily expenses of the business.

TARGET WORKING CAPITAL

With this backdrop in mind, the first critical issue to consider in the working capital true-up is the amount of working capital necessary to accomplish the foregoing objective, called the target working capital.

Probably the most common method parties use to calculate target working capital is the trailing twelve month (TTM) average of the actual working capital of the business being acquired, adjusted for items the buyer is not taking, e.g., the current portion of long-term debt and taxes. While this approach may have appeal in its simplicity, it completely fails to consider the purpose of working capital as discussed above. It also fails to consider how the parties arrived at the headline purchase price, whether or not the business is growing, or seasonal fluctuations in working capital.

If the purpose of working capital is to pay the day-to-day expenses of the business, the business generates more cash than is necessary to run the business, and the seller neither reinvests that extra cash nor distributes it to shareholders, one can see how the TTM average would overstate required target working capital. This scenario is actually very common in privately held companies where the shareholders are not concerned about managing working capital or taking money out of the business.

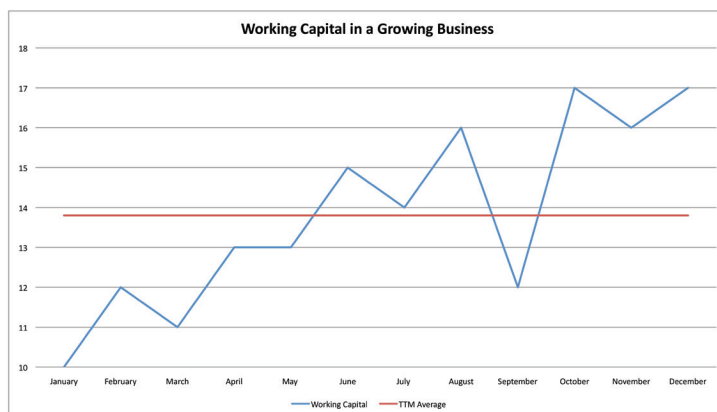
Conversely, if the business does not generate enough working capital to fund the daily operations of the business, and the business needs to borrow or receive an equity infusion, the TTM average would understate what should be the target working capital. Thus, an analysis of the amount of cash it actually takes to operate the business, and not calculating some mathematical average, is the effort that should be put forth to determine the

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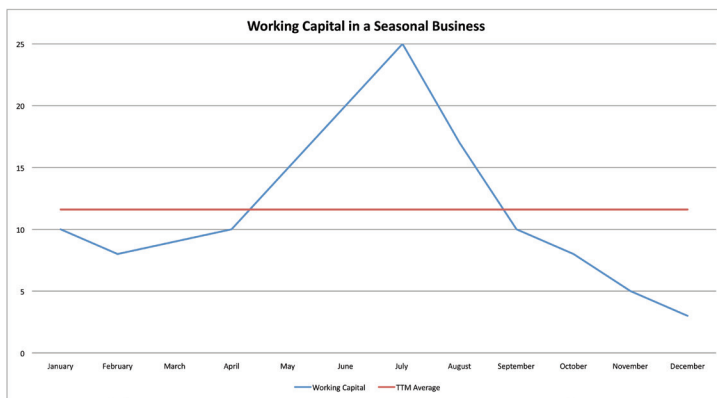
target working capital. Admittedly, this could be a difficult task in many situations, especially where a seller is trying to convince a buyer to pay seller for the working capital in excess of “normalized” working capital.

Another aspect to consider is how the parties, or at least the buyer, arrived at the purchase price. If the buyer based its purchase price on historical earnings or EBITDA, then looking at an historical average of working capital may work. Even in that case, however, the parties should look to see what working capital is necessary to operate the business as the seller operated the business over the preceding periods. It would be coincidental at best if this amount were the TTM average.

Conversely, if the business sold is growing and the buyer paid for that growth, i.e., the prospects of the business, then the target working capital should be the amount necessary to run the business as anticipated to be run to generate that growth. In this situation, a TTM average will in all likelihood be below the amount of working capital necessary to generate the growth paid for. The following graph highlights how the TTM average would significantly understate required working capital in a growing business, assuming a year-end closing date. In this case the buyer would be paying the seller for the “extra” working capital, which is really necessary to operate the growing business.



Similarly, in a business with seasonal fluctuations in working capital, using the TTM average may either understate or overstate target working capital depending on when during the year the business is acquired. As depicted in the following graph, assuming each year looks similar, using the TTM average results in an increase or decrease in the amount paid at closing based simply on when the business is acquired due to seasonality. While there is an argument to be made here that the TTM average smoothes out seasonality, I think it would again be purely coincidental if the TTM average equaled the true working capital requirements of the business.



As part of the financial due diligence, the parties and their advisors should strive to understand the working capital necessary to operate the acquired business, as it is currently run or is anticipated to be run, in determining the purchase price. Otherwise, the seller could be leaving money on the table in the form of excess returns that it had not previously paid to itself, or the buyer may not be receiving the full value of its purchase price in that it may need to inject capital into the business shortly after acquiring it.

TRUE-UP MECHANICS

While variations exist, the following seems to be the most common working capital true-up mechanism. A few days prior to the proposed closing, the seller will deliver to the buyer the seller's estimate of the amount of working capital that it expects to deliver at closing. In many cases, this estimate will be calculated by both parties as they are working to arrive at target working capital, and thus this estimate should very rarely be a surprise.

At the closing, the estimated working capital is compared to the target. If the estimate is higher than the target, the buyer will pay the seller for the additional working capital, or it will be paid out of the business. If the estimate is less than the target, the buyer will reduce the amount paid at closing to seller. Presumably, the buyer would then inject that difference into the business as, again, the target working capital is supposed to be the amount necessary to fund the daily operations of the business.

Sometime after the closing, after the accounts of the business for the pre-closing period have settled out, the buyer will calculate the working capital actually delivered by the seller at closing. Typically, the buyer will be given 60 to 90 days to complete this calculation. Once the buyer delivers its calculation of actual closing working capital, the seller will

have some period of time (between 30 and 60 days after buyer delivers its calculation) to review buyer's calculation and dispute or accept its accuracy. If the seller disputes the buyer's calculation of closing working capital and the parties cannot resolve this dispute, they may engage an independent accounting firm to arbitrate the dispute.

Ultimately, a closing working capital drops out of this process and is compared to the estimate. If closing working capital is higher than seller's estimate, buyer will pay to seller the amount of that difference, or it will be paid out of the business. If closing working capital is less than seller's estimate, the seller will pay to buyer the amount of that difference. Again, presumably buyer would inject that payment into the business. Once working capital is finally determined, the parties typically may not revisit this topic, and the working capital true-up is complete.

While this process seems straight forward in theory, in practice it rarely is. The remainder of this article will describe some common issues that arise in this true-up process and provide some suggestions on how these problems might be avoided.

WORKING CAPITAL IS NOT PURCHASE PRICE

In describing the mechanics of the working capital true-up, I deliberately avoided characterizing the payments of the differences between the closing estimate to target and the final working capital to the closing estimate as purchase price adjustments. Only the headline purchase price should properly be considered the purchase price when the parties calculate the target working capital and run through the true-up mechanics.

The adjustments made at closing for the working capital true-up, as well as to pay off debt or transaction expenses or to pay the seller for excess cash, are simply for funds flow purposes. While debt and transactions expenses may be paid out of the purchase price proceeds, their payment doesn't lower the enterprise value of the business. (I do appreciate that for tax and accounting purposes, these payments, as well as other expenses outside of the purchase agreement, could affect what seller and buyer will report as purchase price on their books and records, and that they will likely report different purchase prices.)

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Let's view these payments a different way to illustrate the point I'm trying to make. For simplicity, let's first just consider debt and transaction expenses. The buyer could pay the seller the headline purchase price, and then the seller could take these funds and pay off debt and transaction expenses. For efficiency purposes, and because the buyer wants to make sure these amounts are actually paid, however, the purchase agreement will call for these amounts to be paid out of the purchase price proceeds, thus reducing the amount paid to seller. But this isn't a purchase price reduction.

The same is true for the working capital adjustment. If the seller doesn't leave enough working capital in the business, the working capital adjustment will be treated like debt or transaction expenses as discussed above. If the buyer pays the headline price to seller, seller would then have to make a payment of the working capital shortfall into the business, which is a capital contribution, thus increasing seller's basis in the business. If the buyer pays the net amount to seller, which is typical, it again is just for funds flow simplicity. It does not change the purchase price.

If the seller leaves too much working capital in the business at close, the buyer, either directly or from the acquired business, pays the seller for that excess working capital. If the buyer pays it directly, that payment will increase purchase price, i.e., buyer's basis in the business, because it can be viewed as buyer making a capital contribution in that amount to the business. If it's paid out of the business, the buyer's purchase price is the headline price. The seller's perspective is different, however, as seller has now received a return of capital, i.e., the excess working capital, from the business, plus the purchase price from the buyer.

The point of this discussion is that a shortfall or excess of working capital is just that, it should not be considered purchase price. Having arrived at an enterprise value for the business, neither

party should then try to use the working capital mechanism to recut the deal price. The working capital adjustment, up or down, is just a mechanism to make sure the business has sufficient capital for the daily operation of the business without infusing outside capital. If it's a positive adjustment, buyer should not feel as though it has paid a higher purchase price, and vice versa. If it's a negative adjustment, seller should not feel as though it has been paid less. Seller sold a business with deficient working capital (maybe because it paid itself too much out of the business) and is simply making the business whole.

Similarly, because the target working capital is supposed to reflect the amount of capital necessary to operate the business, the goal of the working capital adjustment should be to make sure that amount of capital is in the business at closing. So, for example, while a collar around the target working capital may make sense to short circuit disputes over immaterial amounts, once the collar is exceeded, the adjustment should be to target. The collar should not act as a deductible and thus affect purchase price. Similarly, a cap on the working capital adjustment just makes no sense as this truly would be a purchase price reduction. Any similar limitations on the working capital adjustment should also be viewed with a jaundiced eye.

CALCULATING WORKING CAPITAL

In many purchase agreements, the parties will define working capital simply as current assets minus current liabilities. Not all businesses, however, have the same current assets or current liabilities. Companies that provide services, e.g., consulting firms, may not have any inventory. By simply defining working capital as any possible current asset under GAAP minus any possible current liability under GAAP, the parties are allowing for unnecessary disputes to arise.

Given that target and estimated working capital are prepared from the seller's financial statements, it is much more precise to look at the balance sheet of the business and to specifically list out the appropriate line items that encompass current assets and current liabilities of the business being sold. (As discussed above, the parties may disregard items like cash, taxes payable and the current portion of long-term debt.) By doing so, the parties minimize the possibility of a dispute if, for example, the buyer tries to introduce some current liability line item that was not used in calculating the target or estimated working capital. Conversely, specifically listing out the appropriate current asset line items eliminates the ability of the seller to dispute buyer's calculation of closing working capital by introducing some current asset that wasn't used in calculating target or estimated working capital.

The other aspect of calculating working capital that can be provided with precision and rarely is—thus leading to unnecessary disputes—is the accounting principles used to calculate the value of the applicable current assets and current liabilities. Many purchase agreements default to “calculated in accordance with GAAP.” The problem is that GAAP allows a fair amount of discretion. One easy example to illustrate this point is how inventory is calculated, which can be done by using either LIFO or FIFO. Depending on the method used, the value of the inventory on the closing statement can vary significantly.

Some agreements attempt to avoid this problem by stating that the items of working capital will be “calculated in accordance with GAAP applied consistently with the Seller’s past practice.” This formulation is certainly better than simply “in accordance with GAAP” but still is not as precise as identifying exactly which GAAP principle, including whether it’s a year-end or interim accounting principle, was used to calculate each agreed-upon line item of working capital. In fact, if you specifically identify the accounting principle used, it doesn’t even need to be in accordance with GAAP.

In short, many, if not most, working capital disputes can be eliminated if the parties simply define working capital to be “the Current Assets of the Business set forth on Exhibit X minus the Current Liabilities of the Business set forth on Exhibit X, in each

case as determined in accordance with the accounting principles set forth on Exhibit X.” Then, the parties create Exhibit X and specify exactly what line items of current assets and current liabilities will be used and exactly what accounting principles will be used to calculate the values of those line items.

WHAT CAN BE DISPUTED

If the parties don’t particularly identify the components of working capital or the accounting principles to use, then obviously those items can be disputed by either party in arriving at actual working capital. Once those variables are eliminated by the careful drafting suggested above, however, very little is left to dispute.

Therefore, I add (or try to add) to my purchase agreements the concept that while reviewing the closing working capital statement delivered by buyer, the seller may only dispute either (1) that final working capital was not prepared in accordance with the agreed-upon accounting principles or, (2) whether any of the calculations prepared by buyer contain mathematical errors on its face. A necessary subcomponent of these disputable items is that the buyer has all the relevant information in calculating any item of working capital. Thus, for example, if buyer just completely missed an outstanding account receivable, that of course can be disputed as either a failure to use the appropriate



accounting principle or a mathematical error.

Other than a negative visceral reaction to being limited on what can be disputed, no opposing counsel representing a seller has ever identified what else could be disputed if the components of working capital and the accounting principles are locked down. That said, as buyer's counsel, if everything is locked down as suggested, you may not need this additional provision as there is nothing else to dispute.

SELLER DISPUTE

So far, we have posited a situation where the seller prepares the estimate of closing working capital, the buyer calculates the closing working capital true-up and delivers that calculation to the seller, and the seller either accepts or disputes that calculation. Some agreements will even provide that if the buyer does not provide a closing working capital statement within the agreed-upon timeframe after closing, the seller's estimate becomes final.

One special circumstance to consider is where the seller's pre-closing estimate understates working capital. If the buyer's post-closing calculation of working capital shows that the seller underestimated working capital at closing, the buyer may either submit a statement that agrees with seller's calculation or simply not provide any calculation, hoping the seller's estimate becomes final. A seller should consider providing in the purchase agreement that if buyer fails to deliver its post-closing calculation of working capital, the seller can provide its own post-closing calculation, which would then be treated as if seller disputed a calculation delivered by buyer. If the parties are truly trying to ensure that the appropriate amount of working capital is delivered at closing, i.e., the target working capital, this type of provision is only fair so as to encourage the seller to be as careful as possible in leaving the correct amount of working capital. Otherwise, a seller will always be motivated to under deliver working capital at closing and have to pay a true-up to buyer.

ROLLOVER EQUITY

Up to this point in this article, I have been considering the most common situation where a buyer acquires 100% of the business being sold. In this situation, if there is a working capital true-up payment to be made, the buyer pays the seller, or the seller pays the buyer. In a stock purchase transaction where the sellers will maintain an equity ownership in the company being sold, the parties should reconsider who makes the payment to whom. This



will often be the case where a private equity firm buys from the founding shareholders. In this situation, it makes more sense for the company to pay the sellers if too much working capital is left in the business than for the sellers to pay the company if they don't leave enough working capital in the business.

Let's first consider a working capital shortfall. Again, the underlying premise is that the working capital to be left in the business should be the amount of working capital necessary to continue to operate the business post-closing without the infusion of outside capital. If there is a working capital shortfall, by definition then, the business needs an infusion of capital. This infusion is accomplished by the sellers paying into the company the amount of the shortfall. Then, the company has the appropriate amount of working capital. What I typically see, however, is the standard provision that any shortfall in working capital is paid by the sellers to the buyer. This outcome has at least two flaws.

First, the company still does not have adequate working capital to operate the business without the infusion of outside capital. Second, had the sellers left adequate working capital in the business, they would have owned some percentage of that working capital equal to the amount of equity they rolled over. If the seller pays the amount of the shortfall directly to buyer and not into the company, the buyer owns 100% of that amount and the seller owns zero.

The converse is true with a working capital excess. In this situation, the sellers have left more working capital in the business than is necessary for the daily operations of the

business. Thus, they have not distributed to themselves these excess funds as a return on their investment in the business. In this situation, therefore, the company should distribute out this excess to the sellers, not the buyer. If the buyer pays to the sellers the amount of this excess, the sellers are receiving 100% of the excess and would also enjoy a percentage of the excess working capital equal to the amount of equity they rolled over. In other words the sellers would receive more than 100 cents on the dollar for each dollar of excess working capital.

The same analysis holds true for each component of purchase price. If there is indebtedness or transaction expenses that are not paid at closing, the sellers should pay that amount into the company so the company can pay it off. The sellers should not pay those amounts to the buyer, in particular because the company then doesn't have the cash to pay off these amounts. If there is excess cash in the business, the company should pay that cash out to the sellers, not the buyer to the sellers. And because this analysis applies to each component of purchase price, when you net all these amounts together—working capital excess/shortfall, excess or shortfall of cash, or overpaid or underpaid debt or selling expenses—that too should either be paid by sellers to the company or the company to sellers. The buyer should have no part in these payments.

CASH AS PART OF WORKING CAPITAL

The parties in most, if not all, transactions characterize the purchase price to be paid for a business as being paid on “debt free, cash free basis.” In other words, any indebtedness of the company being acquired needs to be paid off out of the purchase price. Similarly, the buyer doesn't want to pay cash for cash, so the purchase price assumes the sellers will sweep the cash out of the business, and working capital will be adjusted to remove cash as a current asset. With respect to debt and transaction expenses, this all makes sense. When it comes to cash, however, the logic seems to break down.

Returning once again to the underlying premise of this article—the working capital to be left in the business should be the amount of working capital necessary to continue to operate the business post-closing without the infusion of outside capital—adjusting either the target working capital or actual working capital to remove cash makes little sense. As discussed, however, target working capital is almost always set as the TTM average of the working capital of the business, adjusting out certain items, including cash. Sometimes, cash is a very large component of the working capital of the business. The parties should not categorically exclude cash to arrive at a simple TTM average

calculation and ignore the actual working capital necessary to operate the business post close. Rather, the parties should examine the business's operating cash needs and determine what is excess cash. Also, in all likelihood, the business needs actual cash to operate and cannot wait to liquidate inventory or accounts receivable.

If the parties to a transaction arrive at the target working capital by determining the proper amount of working capital to operate the business without outside capital, cash should be taken into account in arriving at working capital. If there is excess working capital, then the excess cash can be paid directly by the buyer to seller or as a return of capital to seller out of the cash of the business. And, if the sellers have rollover equity, as discussed above, the payment should certainly be made out of the company's cash, not the buyer's cash. Then, the company is left with the proper amount of working capital to operate the business post-closing.

CONCLUSION

Many of the ideas expressed in this article present a novel way to reconsider working capital in transactions. As with many provisions in today's purchase agreements, the treatment of working capital in purchase agreements seems to have evolved haphazardly and without a comprehensive evaluation of the issue. Transaction professionals should take a fresh look at working capital and the purpose it serves as discussed in this article and start drafting working capital true-up provisions to serve that purpose.



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This article originally appeared as a series on our firm's corporate law blog, “Lingua Negoti.” Lingua Negoti means “the language of business,” and the purpose of the blog is to transform the practice of corporate law so that legal issues do not get in the way of moving business and transactions forward.

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