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A Primer On 'Locked-Box' Deals

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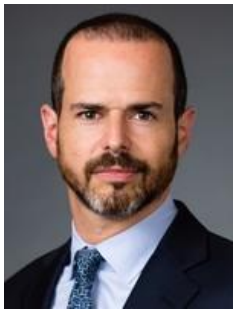

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It is customary in U.S. private mergers and acquisitions for the parties to agree on a headline purchase price and then adjust it at closing for debt, cash and normalized working capital. This is an accepted practice (sometimes referred to as a "closing accounts" approach) even though it can lead to lengthy post-closing disputes on, among other things, the closing working capital calculation.

In the United Kingdom, it is common to adjust the purchase price based on a "locked-box" approach. The target is sold at a fixed price based on a presigning balance sheet, which is either audited or otherwise agreed by the parties (with unaudited financial statements sometimes being the subject of warranties given by the seller). As a result, the economic ownership of the target effectively passes to the buyer as of the date of such balance sheet, known as the "locked-box" date. There is no purchase price adjustment at closing, except for any "leakage" — dividends, distributions, management fees, payment of seller transaction expenses, or other transfers of value from the target company to its owners — after the "locked-box" date. Therefore, a key advantage of the "locked-box" approach is that the parties are in agreement in advance on the relevant values and their impact on the headline purchase price. As a result, the likelihood of a post-closing dispute on such calculations is drastically reduced, if not eliminated.

What is the "Locked-Box" Approach? How Does It Compare to the More Typical "Closing-Accounts" Approach?

Locked-Box	Closing Accounts
• Purchase price is determined based on agreed-upon presigning balance sheet as of "locked-box" date. • Economic interest passes to buyer on the "locked-box" date (as cash flow generated by the target after such date generally cannot be distributed to the seller and is	• Purchase price is determined based on the closing date balance sheet. • Economic interest passes to buyer at closing (as cash flow generated by the target prior to such date normally can be distributed to the seller and any closing

solely for the benefit of the target business and ultimately the buyer post-closing). • No adjustment at closing except in the case of leakage, and in certain cases, an upward adjustment for a ticking fee on the purchase price (to provide some value to seller for foregoing the right to cash flow of the target business between the "locked-box" date and closing).	cash gets factored into the closing purchase price adjustments). • Adjustment at closing based on estimated closing-date balance sheet with a subsequent post-closing true-up (based on the actual closing balance sheet), and a dispute resolution mechanism (often involving a reputable accounting firm).

What are the Pros and Cons of the "Locked-Box" Approach?

Pros	Cons
• Permits the parties to agree on the relevant values and their impact on the headline purchase price in advance, which significantly reduces or eliminates the likelihood of post-closing dispute. • Streamlines "plain-vanilla" deals involving an acquisition of the entire business (where there is no room for significant leakage). • Attractive to private equity sellers who desire a clean exit with no post-closing adjustment or related escrow mechanism. • Simplifies and expedites negotiations on deal economics.	• Can result in a value shift to buyer if the target's performance improves considerably between the "locked-box" date and closing, or conversely, to seller, if the business underperforms during such period. • Problematic on carveout transactions, where the target business usually does not have a stand-alone historical balance sheet and the risk of leakage (e.g., via intracompany transfers) can be greater. • Requires thorough presigning diligence of the target's financials. • U.S. deal makers may be unaccustomed to this approach and prefer the "closing accounts" approach due to familiarity.

Strategies for Responding to a "Locked-Box" Proposal

If the other side of the transaction is proposing that the parties follow a "locked-box" approach, most likely your client is either (a) the seller and normalized working capital is trending up (i.e., the buyer wants the benefit of the growing working capital) or (b) your client is the buyer and the seller is British.

It is important that the U.S. client appreciates that the "locked-box" approach is accepted practice in the U.K., is becoming more and more accepted in the U.S., and that, all things being equal, there is nothing

inherently wrong with it. It can (and the client should assume it will, if the other side's proposing it) represent a value shift away from your client and to the other side.

- If your client is the seller, there are concepts that can make the "locked-box" approach more palatable, such as seeking a later "locked-box" date (to defer when economic interest passes to buyer), adding a ticking fee to the purchase price (to reduce the value shift) and introducing a tax make-whole provision if the target is a pass-through entity (so the seller is not paying taxes on income that is for the buyer's benefit).

- Similarly, if your client is the buyer, there are concepts to make the approach more palatable, such as having an earlier "locked-box" date (to capture more value), ensuring that the "locked-box" financial statements have been properly vetted and that target management has "skin in the game" (potentially through their post-closing equity or other compensation arrangements), and if the "locked-box" balance sheet is unaudited, getting appropriate representations from the seller on it.

Will the "Locked-Box" Approach Become the Norm in U.S. Private M&A Deals?

It is highly unlikely that the "locked-box" approach will become "market practice" in U.S. private M&A deals, but we expect to see its adoption more and more. It can be helpful in certain situations and, despite sometimes involving a painful learning curve for U.S. clients, can help facilitate certain deals.

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