

M&A REPORT - TWO SIDES TO WORKING CAPITAL ADJUSTMENTS

To Our Clients and Friends:

Buyers and sellers often agree that a target company's valuation assumes that the target will be sold on a cash-free, debt-free basis, with a normalized level of working capital. With respect to working capital, which is typically defined as current assets minus current liabilities, the buyer wants to ensure that the target has a sufficient amount of working capital to operate in the ordinary course after closing without requiring an infusion of capital.

Accordingly, the buyer and seller will typically agree upon a target for the amount of working capital the acquired company should have at closing. Prior to closing, the seller will deliver an estimate of the amount of working capital it believes the acquired company will actually have at closing. If the seller's estimate exceeds the working capital target, the seller will receive an amount equal to such excess as an increase in the purchase price. If, however, the seller's estimate is less than the working capital target, the buyer will receive the shortfall as a purchase price reduction. In the period immediately following closing, the buyer will perform its own calculation to determine the amount of working capital the acquired company actually had at closing. If the amount resulting from the buyer's calculation differs from the amount of the seller's estimate, the purchase price will be further adjusted. This process is often referred to as a "true-up."

Occasionally disputes between the parties regarding the working capital calculation will arise in the true-up process. Often in these disputes the buyer's and seller's differing viewpoints regarding the purpose of the working capital adjustment are revealed. On the one hand, sellers often argue that working capital must be calculated consistently with the methodology used to calculate the working capital target amount. In other words, the seller will argue that the purpose of the working capital adjustment is to compensate for deviations from the target working capital amount, and in order for such changes to be calculated equitably, the closing amount of working capital must be calculated using the same methodology that was used in calculating the working capital target amount.

On the other hand, the buyer may argue that the purpose of the working capital adjustment is to ensure that the acquired company is delivered at closing with sufficient working capital, and that determination should be made by calculating working capital in accordance with GAAP (*i.e.*, if the closing working capital amount, calculated in accordance with GAAP, results in a deviation from the target and the estimate, which were not calculated in accordance with GAAP, then the GAAP-compliant calculation should control). Both of these divergent viewpoints sometimes make their way into the M&A purchase agreement in the form of convoluted and unclear language regarding how working capital is to be

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calculated. In contrast, at times, one side's preferred viewpoint may be reflected in the purchase agreement without the other side's realizing the full implications of the language.

At first blush, a recent Delaware case, *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC*, 2017 WL 2774563 (Del. June 27, 2017), would seem to provide support for the seller's viewpoint. However, the case had highly unusual facts that ultimately limit its utility at the negotiating table for either the buyer or seller. In the case, the Delaware Supreme Court reversed the decision of the Chancery Court, which had upheld the right of Westinghouse, as buyer, to use the post-closing working capital true-up process to claim that the financial statements of Chicago Bridge, as seller, were not based on a proper application of GAAP. The Delaware Supreme Court stated that the true-up process is a "narrow, subordinate, and cabined remedy" only intended to account for changes in the target's business between signing and closing of the transaction.[1]

In October 2015, Chicago Bridge and Westinghouse entered into a purchase agreement pursuant to which Westinghouse agreed to acquire a wholly owned subsidiary of Chicago Bridge, CB&I Stone & Webster Inc. ("Stone").[2] Chicago Bridge agreed to sell Stone to Westinghouse for, *inter alia*, a purchase price of zero dollars and certain limitations on liability that were intended to give Chicago Bridge a clean break from the spiraling costs of the nuclear projects in which Stone was principally involved.[3] The parties agreed that Westinghouse's sole remedy, in the absence of actual fraud, for Chicago Bridge's breach of the agreement's representations and warranties was to refuse to close the transaction.[4] In other words, for example, Westinghouse agreed that it would have no recourse for a breach of Chicago Bridge's representation in the purchase agreement that Stone's financial statements complied with GAAP. Westinghouse also agreed to broad indemnification of Chicago Bridge for all future claims related to Stone and to obtain liability releases, for the benefit of Chicago Bridge, from the power utilities that would ultimately own the nuclear plants being built by Stone.[5]

The agreement also contained a post-closing purchase price adjustment true-up process whereby the parties would reconcile a working capital estimate with the actual working capital of Stone at closing.[6] This multi-step true-up process required Chicago Bridge to deliver an estimate of working capital to Westinghouse at least three days prior to closing and, subsequently, Westinghouse to deliver a similar statement to Chicago Bridge no later than 90 days after closing.[7] The agreement required the statements to be "prepared and determined from the books and records of [Chicago Stone] and in accordance with United States [GAAP] applied on a consistent basis throughout the period indicated and with the [agreed principles]."[8] At the conclusion of the true-up process, Westinghouse alleged that Chicago Bridge's historical financial statements, from which Chicago Bridge's true-up estimates were based, were not GAAP compliant and, as a result, Chicago Bridge owed it a working capital adjustment of over \$2 billion.[9]

The agreement also contained a dispute resolution mechanism to address disputes in the true-up process which referred the parties to an independent auditor.[10] Prior to Westinghouse invoking the independent auditor to arbitrate its working capital adjustment claim, Chicago Bridge filed a claim with the Court of Chancery seeking a declaration that Westinghouse's claim was not appropriate for the true-up dispute resolution mechanism because it was based principally on the allegation that Chicago Bridge's historical financial statements were not GAAP compliant and, therefore, was barred by the limitation on

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liability contained in the agreement.^[11] The Court of Chancery held in favor of Westinghouse, holding that the dispute resolution mechanism established a mandatory path for resolving the parties' disagreements over the post-closing purchase price adjustment, including disagreements as to whether Stone's historical financial statements were GAAP compliant.^[12]

The Delaware Supreme Court reversed the Court of Chancery's decision and held that the Court of Chancery must enjoin Westinghouse from submitting claims to the independent auditor or continuing to pursue already-submitted claims regarding Chicago Bridge's historical financial statements because such claims were barred by the limitation on liability contained in the agreement.^[13] In his decision, Chief Justice Strine leaned heavily on the facts, including the limitation on liability, which he described as "unusual."^[14] The opinion began with the declaration that "[i]n giving sensible life to a real-world contract, courts must read the specific provisions of the contract in light of the entire contract" and later stated that, although the true-up process has an important role to play, its role is "limited and informed by its function in the overall Purchase Agreement."^[15] Chief Justice Strine further justified his decision by arguing that a ruling to the contrary would "render the [limitation on liability] meaningless and eviscerate the basic bargain" struck by the parties.^[16]

This decision leaves open the question of whether the Delaware courts would view the true-up process contained in traditional agreements, where the buyer is not subject to a liability bar, in the same limited way. Some buyers will be tempted to argue that this case represents a narrow holding that does not preclude buyers in the traditional context from bringing claims regarding GAAP compliance in the post-closing purchase price adjustment true-up process. In contrast, some sellers will be tempted to argue that Chief Justice Strine's pronouncement that the true-up process is only intended to account for changes in the target's business between signing and closing forecloses buyers from asserting that the working capital calculation was not performed in accordance with GAAP. Certainly the deal terms at issue in this case were unusual, and the imposition of a liability bar seems to have weighed heavily on the outcome. It is unclear whether a purchase agreement without a liability bar, and with unambiguous language subjecting the working capital calculation to a GAAP standard, would lead to a different result.

In any event, this case should serve as a reminder that, even in a traditional acquisition agreement, post-closing purchase price adjustments should be drafted with specificity and with the buyer's and seller's divergent viewpoints on the purpose of the working capital adjustment in mind.

[1] *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC*, 2017 WL 2774563 at *3 (Del. June 27, 2017) ("*Chicago Bridge*").

[2] *Id.* At *1.

[3] *Id.*

[4] *Id.* at *2.

[5] *Id.*

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- [6] *Id.* at *4.
- [7] *Id.* at 7-8.
- [8] *Id.* at *8.
- [9] *Id.*
- [10] *Id.* at *9.
- [11] *Id.*
- [12] *Id.*; *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC and WSW Acquisition Co., LLC*, 2016 WL 7048031 at *1 (Del. Ch. Dec. 5, 2016).
- [13] *Chicago Bridge* at 16.
- [14] *Id.* at *5-*6.
- [15] *Id.* at *1, *11.
- [16] *Id.* at *14.



Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work or the authors of this alert:

*Robert B. Little - Dallas (+1 214-698-3260, rlittle@gibsondunn.com)
Eric B. Pacifici - Dallas (+1 214-698-3401, epacifici@gibsondunn.com)*

Please also feel free to contact any of the following practice group leaders:

Mergers and Acquisitions Group:

*Barbara L. Becker - New York (+1 212-351-4062, bbecker@gibsondunn.com)
Jeffrey A. Chapman - Dallas (+1 214-698-3120, jchapman@gibsondunn.com)
Stephen I. Glover - Washington, D.C. (+1 202-955-8593, siglover@gibsondunn.com)*

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Private Equity Group:

Sean P. Griffiths - New York (+1 212-351-3872, sgriffiths@gibsondunn.com)
Steven R. Shoemate - New York (+1 212-351-3879, sshoemate@gibsondunn.com)
Ari Lanin - Los Angeles (+1 310-552-8581, alanin@gibsondunn.com)
Charlie Geffen - London (+44 (0)20 7071 4225, cgeffen@gibsondunn.com)
Paul Harter - Dubai (+971 (0)4 318 4621, pharter@gibsondunn.com)

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