Company acquisitions: completion accounts and locked box

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Fundamental to any M&A deal is the pricing mechanism on which the target company or business has been valued and agreed. The detail of each mechanism, together with their respective pros and cons, is considered in this article.

Overview of Topic

1. The two most common structures of pricing mechanisms used are:
   a. a valuation based on the target's accounts at completion and adjusted through a completion accounts process (completion accounts), and
   b. a target valuation based on historic reference accounts, which is fixed as at a historic reference date and where all subsequent economic upside (and downside) in the business since that date is for the account of the buyer (a locked box).

2. **Background**: Determining and agreeing the value to be ascribed to a particular target business goes to the heart of any M&A deal and forms the basis of significant commercial discussion and negotiation, supported by financial and other due diligence. In many cases the target valuation itself will be derived from the target's accounts and based on a series of assumptions and adjustments, for example to reflect the underlying financing structure and net asset or working capital position of the business. Making sure that the valuation model and calculations of the ultimate price payable are robust is clearly a key financial and commercial consideration for both sellers and buyers.

3. From a lawyer's perspective, understanding how the contractual framework interacts with the valuation mechanics and is properly reflected in the sale agreement is therefore critical to any M&A deal. In this regard, there are two contractual structures in particular that are available to support the valuation methodology: completion accounts and the locked box.

4. Under a completion accounts structure, the purchase price is calculated and agreed by reference to the target's accounts as at completion. This gives the buyer the opportunity to test its valuation by reference to the balance sheet of the target as actually delivered at completion. Under this structure, and as further detailed below, the key consideration from a contractual perspective is to ensure that the framework under which the completion accounts will be drawn up and agreed is set out in the sale agreement with as much certainty as possible.

5. Under a locked box structure, on the other hand, where the price is calculated off historic
reference accounts, there is no opportunity to adjust the price after signing (absent any warranty or indemnity claims), or, in other words, the box is locked. As such, it is incumbent on the buyer to ensure that it has had the opportunity to carry out sufficient due diligence on the reference accounts before committing to a price. Here, as the buyer would be on risk for the economic performance of the business from the locked box reference date to completion and the key consideration for the buyer’s lawyers will be to ensure that no value is unduly taken out of (or "leaked" from) the target between that reference date and completion.

6. **Completion Accounts**: As suggested above, the fundamental difference between a completion accounts and locked box structure is the reference date at which the target valuation is struck. The reference date for completion accounts is the date of completion itself.

7. As such, under a completion accounts mechanism, the buyer would only pay for the level of prescribed assets that is delivered to it at completion. However, as there is a certain lead time involved in preparing accounts, the completion accounts will necessarily not be ready on completion itself, and accordingly the sale agreement will provide for a pre-agreed process under which they would be drawn up and stipulate how any subsequent true-up or adjustments are to be undertaken and agreed. In these circumstances, the parties would also usually agree the estimated level of prescribed assets that are anticipated to be delivered (from which the initial purchase price to be paid at completion can be determined), and to the extent that the level of prescribed assets is greater or lower than expected, the parties would adjust the purchase price accordingly.

8. Given the importance of the completion accounts and the fact that they go directly to the purchase price, they are rife for dispute. For this reason, it is critical that the sale agreement sets out the process, principles and terms on which the completion accounts will be prepared and agreed with as much specificity as possible. It is worth noting:

a. Form of accounts - there are no statutory or other bases dictating how completion accounts should look and be made up (unlike statutory accounts), and the form and content of the accounts is therefore open to the parties to determine and agree in advance. It is possible that the completion accounts may comprise a full profit and loss and balance sheet, a balance sheet only or a statement of net assets. In considering this, the parties should consider and agree the line items that will form part of the completion accounts on which the accounts would be prepared. It is worth noting that it used to be common practice for completion accounts to be audited, though this is now rare.

b. Applicable accounting policies - as noted above, the parties will need to agree the basis and accounting principles on which the accounts would be prepared. It is common for the parties to agree that the completion accounts would be prepared consistent with past practice and in accordance with generally accepted accounting principles. In addition, given the inherent scope for subjective judgment and interpretation within certain accounting principles, the parties will also commonly consider whether there is scope for agreeing the principles and methodology upon which the accounts will be prepared and, for example, whether there are any specific line items (such as contract prepayments, stock valuations or one-off liabilities) that can be specifically agreed or excluded up-front. At this point it is critical that the lawyers and accountants are working closely to determine and agree in the sale agreement how this will work.

c. Who prepares? - often the first draft completion accounts will be prepared by the buyer, as the pre-conception is that the buyer would be in the best position to do so as it will own the target and control the financial records at that time, although this is not always the case (for example, a financial buyer who receives certain accounting-related
services from the seller on a transitional basis post-closing may not be as well placed as the seller to prepare the first draft). The sale agreement would likely provide for a period of two to three months post-completion whereby the preparing party would prepare the set of accounts (although it may be longer for larger, more complex target businesses).

d. Agreeing the accounts - the sale agreement will then set out the prescribed process for agreeing the accounts and any corresponding purchase price adjustment. On receipt of the draft accounts, the receiving party would have the opportunity to review them and raise any disputes within a set period of time (of, say a month). To the extent the reviewing party disagreed with any part of the first draft accounts, the parties would then have a prescribed period of time to resolve their disputes or appoint a third party to adjudicate. If (as would be common) the sale agreement provides for prescribed timings for delivery by the parties of the draft accounts and notification of any disputes, then the court is likely to hold those parties strictly to those timings. Equally the parties will need to adhere to other aspects of the process strictly (e.g. obligations to act reasonably), particularly if the expert or court has the power to award costs.

e. Appointment of expert - in the event it is not possible for the parties to agree the completion accounts between them it is common for the dispute to be referred to a third party accounting firm for determination as expert (rather than arbitrator). The sale agreement will often provide that the expert's decision will be final, except in the case of manifest error, and sometimes will provide that the expert will also give reasons for its decision (though in that case the parties should be aware of the possibility for one party to withhold payment in the event it did not agree with the expert's analysis and determination, see [Invensys plc v Automotive Sealing Systems Ltd](https://www.legal54.com/guides/judge0136)). Often the expert will determine what it thinks the appropriate adjustment should be and the parties would be held to this, although occasionally there may be some variations to this. For example, in what is known as "baseball arbitration", the parties may decide that in the event of dispute the expert would determine the claim, but instead of the final completion accounts reflecting the expert's determination as to what the proper valuation should be, the expert would instead choose which of the parties is closest to his valuation and the parties would be bound by that, though such variances are comparatively uncommon.

9. At the end of the process, if the balance sheet that was delivered is greater than expected (as per the agreed target figure in the sale agreement) the buyer would pay an additional amount to the seller, and the seller would repay some of the sale proceeds to the extent it was smaller.

10. Occasionally, the parties may agree that an amount will be set aside in escrow to satisfy any post-completion adjustment claims.

11. **Locked Box**: With a locked box structure, on the other hand, the valuation of the target business or company is based on an historic set of reference accounts (sometimes, but not always, the last audited accounts of the target). From that moment, the valuation of the business is set (locked), and there would be no further adjustments to the valuation model or purchase price itself. Accordingly, under this structure both parties will know as at the moment they enter into the sale agreement exactly how much they will pay and receive for the business. It also means that the buyer is on risk for the economic performance of the target business or company after that reference time.

12. The principal benefit of this mechanism, which can make it particularly appealing to sellers, is that the purchase price is fixed, and there will be no subsequent purchase price adjustment (subject to any claim for leakage - see below). In theory this can make the entire sale process simpler and more cost effective, although as the price and any valuation adjustments would be hard-wired as at the reference date in the sale agreement, the seller
can expect that the buyer will likely want to undertake more financial due diligence on the reference accounts than as may be the case under a completion accounts structure.

13. As there will be a period of time between the reference date and completion (which may often be lengthy) when the buyer is on risk for the economic performance of the business, but when the target remains under the control of the seller, the buyer and its lawyers will seek to ensure that there are a series of covenants and indemnities in the sale agreement to ensure that there has been and will be no untoward or unauthorised payments or value extraction (commonly known as "leakage") from the target business or company to the seller's group during that time.

14. Examples of leakage can include dividends and other distributions, returns of capital, bonus share issues, payments to directors and staff and deal-led bonuses, transaction costs put through the target, debt waivers or forgiveness and other non-ordinary course payments from the target to the seller's group. The parties will recognise and agree however that there may be some ordinary course payments to the seller's group that are bona fide and on arm's length terms, which are required to keep the business operating in the intervening period, and in addition there may also be other specifically identified items or items that are priced into the locked box accounts, that are accordingly permitted to be paid out ("permitted leakage").

15. Any leakage claims would be backed by an indemnity from the seller. It is worth noting that the contractual time limitation on the ability for the buyer to claim under the leakage indemnity is typically relatively short (at least as compared to other time limitations imposed on general warranty or indemnity claims) and is usually between three and 18 months.

16. Finally, it is also worth noting that to compensate the seller for the fact that the target is effectively sold as at a historic period in time, but that it will not receive the purchase consideration until completion, the parties may sometimes agree that interest will accrue retrospectively from the reference date and applied to the purchase price payable on completion.

17. **Stamp Duty Treatment:** In a sale involving shares in a UK company, stamp duty will be payable at 0.5% of the deal consideration. The buyer is generally obliged to pay this stamp duty within thirty days of the share transfer (i.e. completion) and from the buyer's perspective it will wish to do this as soon as possible so that is can be entered into the register of members and take legal title of the shares (it is an offence to update the register of members until the stock transfer form has been stamped (s.17 Stamp Act 1891)).

18. With a completion accounts structure it is very unlikely that the final consideration (i.e. after adjustment) will be determined within that thirty day period, and, in cases where the consideration is ascertainable but not yet ascertained, HMRC is generally willing to adopt the "wait and see" principle, whereby the buyer will submit the stock transfer form to HMRC for provisional stamping shortly after completion has occurred. Stamp duty will then be paid on the initial consideration (and the stock transfer form stamped, after which the register of members can be updated) with HMRC usually requiring an undertaking for any additional stamp duty due once the final consideration has been determined. If the determination of the final consideration results in a purchase price reduction (i.e. the seller pays money back to the buyer), then the excess stamp duty paid up front can usually be reclaimed from HRMC (in certain cases, with interest).

19. Clearly, on a locked box structure, the stamp duty position is much more straightforward as the definitive purchase price is known as at completion.

20. **Which Structure to Use?** In theory, it should not make a difference to any particular
valuation which pricing mechanism is used. However, very often this is not the case and depending on how it is used on any particular deal the chosen mechanism can be a means by which either of the parties may gain (or lose) value.

21. Completion accounts have traditionally been the default mechanism of choice favoured by buyers, who are attracted by the fact that they only pay for the balance sheet that they actually acquire and they are able to check and verify the financial exemption underlying their valuation model after completion when they are in full control of the business. This structure can also be attractive to both parties if it means that the financial due diligence on a target can be short circuited and the deal can proceed to execution quickly.

22. On the other hand, locked boxes have traditionally tended to be the favoured structures of choice for sellers, particularly private equity, as they not only imply certainty as to sale proceeds (subject to any claims for leakage), but any adjustments required to the valuation model would be determined and agreed up front before the deal is struck, at which point the sellers are in control and typically have a better knowledge of the financial position of the target than the buyer (thereby putting them in a better negotiating position). As a result locked boxes have also tended to be more prevalent in seller-friendly environments and are often put forward in auction processes.

23. However, with a well-performing target, on a locked box structure the seller would lose out on the upside of the economic performance of the business after the reference date and, even if an interest rate on the purchase price is agreed to by the buyer, typically it would not compensate for the loss of net earnings throughout that period. That said, the apparent simplicity of a locked box mechanism, and absence of any post-completion adjustments and associated costs, can also be equally attractive to buyers, and to the extent they have the time and information available to be able to carry out sufficient financial due diligence on the reference accounts (backed with appropriate warranty and other protection in the sale agreement), then many buyers do find themselves able to get comfortable with this structure.

24. **Sample case 1:** Denware Ltd v Rosewild Ltd [2002] EWCA Civ 2003 - Court of Appeal decision in relation to the purchase by Rosewild of the entire issued share capital of Handella Ltd from Denware. Dispute as to whether a post-completion tax refund due to the target (that neither party contemplated as being due as at the time of signing) was an asset of the company that was to be taken into account in the completion accounts. The expert's opinion (which the parties agreed would be final and binding save in the manifest error) held that it was, as did subsequent correspondence between the parties. The Court of Appeal held that the tax refund was an asset of the company that was ultimately to be paid for by the buyer.

25. **Sample case 2:** Dixons Group Plc v Murray-Obodynski (Breach of Warranties) [2000] 1 B.C.L.C. 1 - High Court decision in relation to the acquisition by Dixons of the PC World group of companies from Murray-Obodynski. A claim was brought for breach of certain accounting warranties, which the parties had agreed would not be recoverable to the extent that a specific provision or reserve had been made for those losses in the completion accounts. Part of the issue in contention was that the expert that had determined the completion accounts and net assets was in breach of his instructions and had prepared his determination on the wrong basis. However, the judge found this to be incorrect and that the completion accounts had been prepared correctly. Certain matters in relation to the breach of warranty claim also were appealed to the Court of Appeal (and were subject to the separate judgment of that court).

26. **Sample case 3:** Invensys Plc v Automotive Sealing Systems Ltd [2002] 1 All E.R. (Comm) 222 - High Court decision in relation to the sale by Invensys of several companies involved in the production of automotive sealing systems to Automotive Sealing. The companies were sold on a cash free/debt free basis with a post-completion working capital adjustment.
An expert was appointed to determine the level of working capital; whilst the parties had agreed that its determination would be final and binding (save for manifest error), the buyer did not agree with the expert's statement and wrote to the expert twice for clarification, in each case receiving a short (and to its mind unsatisfactory) response. After withholding payment Invensys (as the seller) brought a claim to recover. The issues for determination was:

a. whether the expert determination as to the final consideration payable under a sale agreement was subject to manifest error and

b. what material the court was entitled to consider in making that determination. It was held that there was no manifest error in these circumstances (and so the expert's determination stood), and that the court was entitled to review all materials put before it (and not just the expert's written determination itself).

27. **Sample case 4:** Try Build Ltd v Blue Star Garages Ltd 66 Con. L.R. 90 - High Court decision in relation to the guarantee given by Blue Star in respect of liabilities owed by Portsmouth Football Club to Try Build in relation to the construction of a new north stand and terrace by Try Build at Fratton Park. The amounts guarantees were subject to a certificate from Try Build certifying as to the amount due to it from Portsmouth, which was (in the absence of manifest error) to be conclusive. The court held that in this case there was no manifest error that would exonerate Blue Star from its obligation to honour the guarantee.

28. **Sample case 5:** Veba Oil Supply & Trading GmbH v Petrotrade Inc (The Robin) [2001] EWCA Civ 1832; [2002] 1 All E.R. 703 - Court of Appeal decision in respect of the sale of 25,000 plus metric tons of gasoil by Petrotrade to Veba Oil. The quantity and quality of the cargo was to be determined by an independent inspector in the manner customary to such installation, whose determination was to be final and binding for both parties save for fraud or manifest error. The appeal turned on when a departure by the independent expert from his instructions would constitute a material respect that would render his determination non-binding. It was held that a departure from instructions would be material unless it could truly be characterised as trivial or de minimis such that it could make no possible difference to either party. In this instance the departure was deemed to be material and the determination non-binding.

**Key Acts**

*Stamp Act 1891*

**Key Subordinate Legislation**

None.

**Key Quasi-legislation**

None.
Key European Union Legislation

None.

Key Cases

Denware Ltd v Rosewild Ltd [2002] EWCA Civ 2003

Dixons Group Plc v Murray-Obodynski (Breach of Warranties) [2000] 1 B.C.L.C. 1

Invensys Plc v Automotive Sealing Systems Ltd [2002] 1 All E.R. (Comm) 222

Mentmore International Ltd v Abbey Healthcare (Festival) Ltd [2009] EWHC 2109 (Ch)

Danka Business Systems Plc (In Liquidation), Re [2012] EWHC 579 (Ch)

Try Build Ltd v Blue Star Garages Ltd 66 Con. L.R. 90

Key Texts

None.

Further Reading

None.