

Purchaser cannot use purchase price adjustment procedure to end-run contractual limitations on indemnity

Imagine the following facts: Buyer purchases a business from seller for a base price of \$57.4 million. The purchase agreement contains a procedure in which the base price is to be adjusted based on seller's pre-closing estimate of the difference between the closing date working capital and the working capital of the business on a reference date. The purchase price is subject to further adjustment after the closing by comparing buyer's calculations to seller's pre-closing estimate.

The purchase agreement provides that seller is to prepare its pre-closing estimate using GAAP and that buyer is to apply the same principles in a consistent manner. Instead, buyer changes many of seller's principles on the basis that they do not comply with GAAP and buyer's calculations result in a reduction in the purchase price of \$30.0 million more than seller's estimate. The proposed reduction substantially exceeds the 25% cap of the purchase price imposed under the indemnity provisions of the purchase agreement for breaches of representations and warranties.

The relationship between the adjustment mechanism and the indemnification provisions in a purchase agreement was the issue before Vice Chancellor Strine in the recent Delaware case of *OSI v. Instrumentarium*. In this case, the Vice Chancellor rejected the two arguments raised by buyer in support of its position.

First, the Vice Chancellor rejected buyer's argument that it was only by changing seller's accounting principles that buyer could comply with the contractual requirement that the closing date working capital be calculated in accordance with GAAP. The court found that this argument conflicted with the plain language of the agreement, which required the use of consistent principles and was essentially a claim that seller had breached its representation and warranty which fell under the indemnity.

Second, the Vice Chancellor rejected buyer's argument that the purchase agreement specifically excluded the reference statement from seller's GAAP representation and warranty and, by implication, from the indemnity. The Vice Chancellor determined that, in context, it was evident that the parties intended that claims with respect to the reference statement were to be resolved under the indemnity provisions.

The Vice Chancellor's arguments based on the language of the agreement are unconvincing and he does not explain why the requirement of consistency in the application of accounting principles trump the equally plain contractual requirement that the closing balance sheets be prepared in accordance with GAAP, particularly where, as in this case, the GAAP representation and warranty specifically excluded the reference statement.

The Vice Chancellor's reasoning in the case clearly rests on the premise that to hold otherwise “would undermine the limitations on liability and the core dispute resolution mechanism contained in the purchase agreement”. But this reasoning is circular and already assumes the answer to the question of whether the adjustment mechanism was intended to provide an independent means of recourse for the buyer, separate from indemnification claims for breaches of representations and warranties.

The Vice Chancellor's opinion contains the following warnings for buyers:

- A purchase price adjustment mechanism does not guarantee that buyer will receive a stated level of working capital defined by reference to the amount presented in a reference date balance sheet.
- The purchase price adjustment mechanism does not provide a remedy for the failure of the reference statement to be prepared in accordance with the accounting principles that the parties agreed would govern the calculation of the purchase price.
- Defects in accounting principles are the subject matter of representations and warranties.
- Any shortfall in the level of working capital expected to be received by buyer based on the amounts contained in the reference statement may not be recoverable due to the operation of indemnity baskets and caps which typically qualify buyer's right to monetary relief.

Buyers would be well advised to negotiate specific exceptions to these principles if a specific level of working capital is a material inducement for their bargain.

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