



# Purchase Agreements: How One Common Flaw Can Cost You Big Money!

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If you are about to buy or sell a company, you should be aware of a seemingly innocuous, but potentially costly, drafting ambiguity that is common to many purchase agreements. The ambiguity arises because purchase agreements often fail to distinguish between two very different concepts: (1) purchase-price adjustments and (2) buyer indemnification claims that result from breaches of a seller's financial representations. Many purchase agreements contain this ambiguity, and most lawyers fail to recognize the danger it creates. Consequently, buyers and sellers, and their advisors, should ensure that their purchase agreements adequately address these two distinct concepts. This article will examine each of these provisions and describe the dangers that can arise if ambiguous drafting confuses the two.

## PURCHASE-PRICE ADJUSTMENT

The purpose of a purchase-price adjustment provision is to adjust for changes in particular balance-sheet accounts that occur

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between: (1) the balance sheet that the seller provides the buyer during the buyer's due diligence review (the "Recent Balance Sheet") and (2) the balance sheet dated as of the closing date (the "Closing Balance Sheet").

A purchase-price adjustment is typically based on changes in working capital, net worth, or similar balance sheet amounts. It is designed to ensure that the buyer and the seller each get the deal they bargained for, despite changes in the specified balance-sheet accounts between the Recent Balance Sheet date and the Closing Balance Sheet date. In addition, purchase-price adjustment provisions can serve a secondary role; that is, they motivate the seller to operate the business in the ordinary course.

Determining the adjustment amount is a straightforward process: one simply compares the amount of the specified accounts on the Recent Balance Sheet with those same accounts on the Clos-

ing Balance Sheet. To make such a comparison meaningful, however, it is imperative that the same accounting principles be used for both the Recent

Balance Sheet and the Closing Balance Sheet. In other words, the two balance sheets must be prepared on a consistent basis.

Assuming the seller continues to operate the business in the ordinary course, any purchase-price adjustment should be relatively small when compared to the overall purchase price. Disputes concerning purchase-price adjustments are normally resolved by binding arbitration between the parties.

## FINANCIAL REPRESENTATIONS AND INDEMNIFICATION

Purchase agreements normally contain various representations by the seller concerning, among other things, the seller's financial statements. Financial statement representations are among the most important representations a seller makes, because the buyer will typically use the seller's financial statements to determine the purchase

price. By means of these representations, the buyer attempts to ensure that the seller's financial statements—on which the buyer is relying—have been prepared appropriately, particularly with regard to the accounting principles used to prepare them. A typical financial statement representation might read:

Seller's financial statements have been prepared in accordance with generally accepted accounting principles, consistent with past practices; Seller's balance sheets fairly present the financial condition of Seller as of their respective dates; and Seller's income statements fairly present the results of operations of Seller for their respective periods.

If the seller breaches a financial representation like that one, then the buyer's remedy will typically be indemnification. For example, if a seller gives the representation above, but the seller's financial statements fail to comply with generally accepted accounting principles (GAAP), then the seller would be required to indemnify the buyer for any losses that the buyer incurs as a result of the deficient financial statements.

A buyer's potential recovery under the indemnification provision is typically limited by baskets, caps, time limits, and other negotiated features. A "basket" operates somewhat like a deductible on an insurance policy: it sets the amount of loss that the buyer must incur before seeking recovery from the seller under the

provision. A "cap" establishes the limit of the seller's liability under the indemnity provision. Absent fraud, the cap usually represents the maximum amount a buyer can recover under the indemnity. Time limits for making a claim can vary depending on the nature of the claim. For breaches of financial representations, the time limit is usually 12 to 24 months. Often, the indemnification provision is the buyer's exclusive remedy for a seller's breach of the financial representation.

Depending on the agreed-upon baskets, caps, time limits, and other features, an indemnification claim that is based on a

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breach of a financial representation could result in a large claim relative to the purchase price, conceivably up to 100 percent of the purchase price.<sup>1</sup> Consequently, the indemnification provision is extremely important to buyers and sellers alike and is the subject of significant negotiation. As discussed below, however, these heavily negotiated features of the indemnification provision can wind up being meaningless, with respect to the financial representation, if the purchase agreement fails to adequately address how the indemnification provision is to function *vis à vis* the purchase-price adjustment provision.

## THE PROBLEM

Although the concepts of the purchase-price adjustment provision on the one hand and the financial representation and indemnification on the other appear to be clear and distinct, they are often confused by poor drafting in the purchase agreement. The problem typically arises from the seemingly innocuous requirement in the purchase-price adjustment provision that requires the Closing Balance Sheet to be prepared in accordance with GAAP.

To most observers, it would seem logical to require that the Closing Balance Sheet be prepared in accordance with GAAP. Nevertheless, such a requirement is not only unnecessary, it is also harmful to the proper functioning of the purchase-price adjustment provision and the indemnification provision. Remember, the purpose of a purchase-price adjustment is only to adjust for changes in certain agreed-upon balance-sheet

accounts between the Recent Balance Sheet and the Closing Balance Sheet. Consequently, the accounting principles used to prepare each balance sheet must be consistent. Apples must be compared to apples, even if those apples might be a bit rotten.

Including a GAAP requirement in the purchase-price adjustment provision confuses that comparison. It blurs the line between the purchase-price adjustment provision and the financial representations and indemnification, thereby creating the potential for a significant and costly dispute between the parties.

Specifically, including a GAAP requirement in the pur-

chase-price adjustment provision creates confusion as to what remedies are available if the Closing Balance Sheet was not (or is alleged not to have been) prepared in accordance with GAAP. If a seller has represented that its financial statements were prepared in accordance with GAAP, and the buyer believes they were not, then the buyer might have an indemnification claim. But does the buyer also have a separate claim for a purchase-price adjustment? Should the Closing Balance Sheet be recalculated in accordance with GAAP? If the recalculated Closing Balance Sheet results in a decrease in working capital or net worth from the originally provided Recent Balance Sheet, should the buyer be able to make a claim for a purchase-price adjustment? Indemnity claims are typically limited by baskets, caps, and other features, while purchase-price adjustments often are not. Can the buyer pick the provision under which it seeks to recover? Can the buyer both obtain a purchase-price adjustment and make a claim for indemnification? If the buyer makes a purchase-price adjustment claim, based on a failure to comply with GAAP in the preparation of the Closing Balance Sheet, is the buyer bound by the result of any binding arbitration that takes place on that issue, or can the buyer bring a separate claim under the indemnity provision?

These are real questions that courts have struggled with, and the results have been anything but certain. For example, in the matter of *Westmoreland Coal Company v. Entech, Inc.*,<sup>2</sup> the buyer tried but failed to persuade the court that it should be

allowed to recover a purchase-price adjustment, instead of an indemnification claim, based on the seller's alleged failure to follow GAAP. There were no baskets or caps under the purchase price adjustment provision. Consequently, the buyer stood to recover significantly more by making a purchase-price adjustment claim, rather than a claim under the indemnity provision.

In contrast, in *McGraw-Hill Companies, Inc. v. School Specialty, Inc.*,<sup>3</sup> the court held that the seller's alleged failure to prepare its final balance sheet (i.e., the Closing Balance Sheet) in accordance with GAAP was subject to arbitration under the purchase-price adjustment provision.

In *Lincoln Snack Holding Co., Inc. v. Brynwood Partners III L.P.*,<sup>4</sup> the court permitted the buyer to seek both a purchase-price adjustment in arbitration and a claim in court for indemnification.

Each of these decisions was based on a careful interpretation of the language of the respective purchase agreements, and in each case the language was anything but clear. Despite the court's attempt to discern the original intent of the parties in these cases, it is likely that the parties had never really considered the interplay between these two provisions. In none of these cases were the purchase-price adjustment provisions and the financial representations and indemnification provisions drafted in a way that clearly captured the respective parties' intent.

## THE SOLUTION

The solution to this problem is for the parties to understand

and agree up front to the separate and distinct purposes of the purchase-price adjustment on the one hand and the financial representations and indemnification on the other. A purchase-price adjustment provision should cover only the changes in certain agreed-upon accounts, such as working capital or net worth, between the Recent Balance Sheet and the Closing Balance Sheet. The only accounting issue to be addressed under the purchase-price adjustment provision should be the consistency of the accounting principles used for the two balance sheets. Issues with respect to the seller's adherence to GAAP should be the exclusive province of the seller's financial representations and the indemnification provision.

The distinctions between these two provisions should be addressed with careful drafting that keeps the two concepts separate and distinct but ensures that each of them works together as a whole to achieve the mutually desired effect. Keeping these concepts separate and distinct will reduce the probability that ambiguity will lead to a dispute. Clarity in drafting will achieve certainty with respect to which remedies are available and will reflect a true "meeting of the minds" between the buyer and seller on these issues.

## NOTES

1. Some states employ a "benefit-of-the-bargain" analysis rather than an "out-of-pocket" analysis. Under a benefit-of-the-bargain analysis, if there is no indemnification cap (or if there was fraud on the part of the seller), it is theoretically possible for a buyer to recover in excess of the purchase price.
2. 100 N.Y.2d 352 (2003).
3. 814 N.Y.S.2d 562 (2006).
4. 803 N.Y.S.2d 19 (2005).

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