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Controlling purchase prices: the locked box mechanism

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From the seller's perspective, knowing the outcome of the sale process in terms of the price that it will obtain for a company is always of great importance. Usually, a buyer will make an offer to buy a company on a 'cash and debt-free' basis, meaning that the purchase price offered (ie, the enterprise value) will be adjusted up or down depending on the company's financial position at a given time to reach the actual purchase price. Simply put, any cash or cash equivalents owned by the company will increase the purchase price, while any debt will decrease the purchase price. How the purchase price should be determined is an integral part of the share purchase agreement and is often intensively negotiated between the buyer and the seller. Two different approaches prevail: the closing balance sheet adjustment and the fixed purchase price or locked box mechanism. While the closing balance-sheet adjustment may be the most common approach in the current market environment, the locked box mechanism can be the preferred route from the seller's perspective.

Locked box mechanism

The 'locked box' mechanism can be defined as the buyer and seller agreeing on a fixed purchase price in the sense that no changes will be made to the purchase price after completion of the transaction. Instead, the purchase price is calculated based on a balance sheet – the locked box balance sheet – at a date agreed between the buyer and the seller before entering into the share purchase agreement. Ideally, the locked box balance sheet should be drawn up fairly close to the signing of the share purchase agreement. A buyer will then determine the purchase price based on the locked box balance sheet, taking into account both the company's cash/debt position and its working capital. Once the seller has accepted the purchase price offered by the buyer, the purchase price is entered into the share purchase agreement as a fixed amount and becomes the amount payable by the buyer at completion.

The locked box mechanism has advantages and disadvantages. One obvious advantage of this approach for both the buyer and the seller is that they do not risk negotiating the purchase price after completion of the transaction. Although the closing balance-sheet adjustment is often a transparent and straightforward concept, the actual process involved when adjusting and determining the closing balance sheet, and thus the purchase price adjustment, often takes time and becomes costly for both parties.

Further, from a seller's perspective, it is valuable to know the exact amount that it will receive for the sale of the company. Clearly, the locked box mechanism is advantageous for the seller in this regard, since it eliminates the uncertainty regarding the size of the actual purchase price. From a buyer's perspective, knowing the amount that it will actually pay at completion may also be advantageous. However, certain requirements must be fulfilled in order for a buyer to feel confident enough to commit to a fixed purchase price based on the numbers drawn up by the seller. This poses a problem; if a buyer is to rely on the balance sheet provided by the seller, it must conduct a thorough financial due diligence to ensure that the balance sheet provided is correct. This is even more important if the balance sheet provided has not been audited (although often the buyer will request that the locked box balance sheet be audited or at least reviewed and signed off by the target's auditors). In addition to financial due diligence, a buyer will require sufficient contractual protection in relation to the locked box balance sheet and the company's operations from the date on which the locked box balance sheet is drawn up until completion of the transaction. As regards the locked box balance sheet, the buyer must negotiate adequate warranties – for example, that the balance sheet has been prepared in accordance with generally accepted accounting principles as if it was a year-end audited account, and gives a true and fair view of the financial position and the results of the operations of the company at the time it is drawn up. In addition, a buyer will often require a hard indemnity in relation to the target's indebtedness as at the locked box date.

While sufficient warranties, in combination with thorough financial due diligence, will protect the buyer from actual flaws in the locked box balance sheet, the buyer must also make sure that the company conducts its business in its ordinary course between the locked box balance sheet date and the completion date to prevent leakage of value from the company. Since the buyer in practice assumes the risk and benefit of the company's financial performance as from the locked box date (ie, before becoming the legal owner of the company), the share purchase agreement must contain provisions that prevent the seller from withdrawing funds or assets from the company in a way that diminishes the company's value. Therefore, in relation to the operations of the company, the buyer must negotiate:

· adequate warranties from the locked box balance sheet date until signing of the share purchase agreement; and

· adequate covenants from signing until completion of the transaction.

Warranties protecting the buyer against value leakage during the period between the locked box balance sheet date and the signing, as well as covenants protecting the buyer during the period between signing and closing, are often jointly categorised in the share purchase agreement as warranties and covenants on 'absence of certain events'. Practically, these warranties and covenants are intended to ensure that the business of the company is conducted in its ordinary course and consistent with past practice during such periods. For example, the buyer may require the seller to warrant and covenant that:

· no dividends or other distributions have been made, or will be made, by the company to the seller;

· the company has not waived any claims or rights on any third party;

· the company has not made, or will not make, any capital expenditures exceeding a certain amount; and

· the company has not paid, or will not pay, any extraordinary payment to the seller or its affiliates or management.

While these types of warranty and covenant are standard in any type of share purchase agreement, they are usually expanded in a locked box scenario.

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