The Working Capital Adjustment Dispute That Never Was

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August 4 (Law360) - For those interested in working capital adjustment disputes (who isn't?), the Delaware Supreme Court recently issued a decision that offers guidance on several important issues, including:

- The interplay between working capital adjustments and breaches of representations regarding historical financial statements
- The scope of authority granted to the person selected to adjudicate a working capital dispute
- The meaning of "GAAP consistently applied" and similar phrases in working capital provisions

Before getting to the takeaways from Chicago Bridge & Iron v. Westinghouse Electric Co. LLC, No. 573, 2016 (2017 Del. LEXIS 265, June 28, 2017), there are two important facts to understand about the parties' purchase agreement. First, the purchase agreement contained a "liability bar," which provided that the buyer's sole remedy for breaches of representations and warranties was to refuse to close. The buyer had expressly agreed it could not bring a post-closing claim for monetary damages for breaches of representations and warranties. Second, the purchase agreement contained a working capital adjustment mechanism, which called for a true-up of target working capital and closing working capital, using generally accepted accounting principles consistently applied, and which required any disputes thereunder to be decided by an independent auditor whose role was described as "an expert and not an arbitrator."

After closing, the buyer questioned whether the business' historical financial statements had been prepared in compliance with GAAP and asserted a nearly $2 billion claim, not as a breach of representation claim, but as part of the working capital adjustment process. The seller went to court and objected that the buyer was trying to get around the liability bar via the working capital adjustment process. The trial court ruled in the buyer's favor, but the Delaware Supreme Court reversed, holding rather decisively (including with exclamation points!) that the buyer could not avoid the liability bar by couching its concerns over the historical financial statements as a working capital adjustment dispute.

There are some important takeaways from the court's ruling:

1. Don't count on being able to shoehorn claims for breaches of representations and warranties into a working capital adjustment dispute.

The buyer's main grievance after closing was with the business's historical financial statements, particularly whether they had been prepared in compliance with GAAP. The court recognized that a seller's "financial statement representation is the most important representation in a typical purchase agreement." But here, the buyer had agreed that its sole remedy for breach of representations and warranties was to refuse to close — and the transaction had already closed.

The court concluded that allowing the buyer to challenge the historical financial statements as part of the post-closing working capital adjustment process would "largely render the Liability Bar meaningless." In the court's view, the seller had won a great concession in obtaining the liability bar, and the buyer was trying to undo that concession via the "narrow, subordinate and cabined" process for adjusting working capital. The court held the working capital adjustment provision could be used only to resolve disputes arising from changes in facts or circumstances of the purchased business between signing and closing; it could not be used to revive claims for breach of representations and warranties that had expired at closing.

- *Practice Pointer:* If you want to make sure that you can pursue post-closing claims for breaches of representations and warranties, do not rely on the working capital adjustment provision as a means for doing so. Rather, focus on the representations and warranties themselves (e.g., nature, duration, remedies, etc.). As a corollary, if your goal is to bar claims for breaches of representations and warranties as of closing, make sure the working capital adjustment dispute provision does not create an unexpected loophole. It is possible to draft language that would lead to a different result than the one in this case, as explained below.

2. Be thoughtful in describing the dispute resolution procedure in a working capital adjustment provision.

In the court's view, the "narrow" scope of the working capital adjustment process was buttressed by the "limited" nature of the accompanying dispute resolution provision. The purchase agreement called for any disputes concerning the working capital adjustment to be adjudicated by an independent auditor, who would function solely as an expert and not an arbitrator.

The opinion drilled down on the differences between an "arbitrator" (who usually has broader decision-making power, sometimes even the power to decide the scope of its own power) and an "expert" (who usually addresses a narrower set of disputes). Given the limited role ascribed to an expert, the court held the independent auditor's authority did not include adjudicating a $2 billion claim about whether the historical financial statements complied with GAAP.

- *Practice Pointer:* If you want to limit the scope of working capital adjustment disputes as much as possible, consider using language describing the decision maker as an expert and not an arbitrator. On a separate note, you may wish to identify a particular expert by name in the purchase agreement. Postponing that decision until a dispute has materialized can lead to jockeying, delays and waste as each party tries to gain an advantage in selecting an expert they view as favorable.

There is another lesson to be learned when it comes to dispute resolution procedures in a working capital adjustment: When parties agree to a nonjudicial resolution procedure, they usually give up any right of appeal. This can be acceptable when getting a quick and final decision is more important than getting the right decision. But the higher the stakes, the more one might value having the right to appeal a loss.

Here, the seller could see that the buyer was planning to use the independent auditor (whose decision would be "final" and "nonappealable") to try to adjudicate a $2 billion dispute in a manner the seller felt was inconsistent with the purchase agreement. From a procedural perspective, the seller could have presented its concerns to the independent auditor, but that would have posed two challenges. First, the independent auditor would be deciding the scope of its own authority. Second, the independent auditor's decisions would be final, binding and nonappealable.

The seller chose to initiate a declaratory judgment proceeding in court to challenge the buyer's efforts to submit a $2 billion claim to the independent auditor. The seller's aggressive move paid off in the end — but only after it lost at the trial court level and then lodged a successful appeal. Having a right of appeal turned out to be outcome-determinative for the buyer here. The court decided the important issue of the liability bar (the bulk of the $2 billion claim) and sent the much narrower matter of changes in working capital back to be decided by the independent auditor.

- *Practice Pointer:* A senior practitioner who had been burned in a high-profile arbitration once said, "Never agree to arbitrate anything that really matters," citing the lack of an

effective right to appeal a negative result. In working capital adjustment provisions, whether called an arbitrator, expert or something else, the adjudicator is frequently given the power to decide the dispute with finality — the loser has no right of appeal. This can be efficient when the dollar amounts involved are not expected to be huge in relation to the transaction. But this transaction shows why having the right to be in court, with attendant rights of appeal, is important for issues that "really matter."

3. "Consistent" means "one approach to GAAP" throughout the transaction.

As is common, the purchase agreement used "consistency" language when addressing how working capital was to be determined in relation to GAAP. For example, the closing statement was to be prepared and determined from the company's books and records in accordance with GAAP "applied on a consistent basis through the periods indicated and with the Agreed Principles." The agreed principles, in turn, provided: "Working Capital ... will be determined in a manner consistent with GAAP, consistently applied ... in the preparation of the financial statements of the Business, as in effect on the Closing Date." And "Working Capital ... shall be based on the past practices and accounting principles, methodologies and policies" of the business in the ordinary course of preparing its historical financial statements.

The buyer argued that working capital had been improperly presented in the target schedule before closing, and thus, both the target schedule and closing schedule needed to be presented anew, this time using proper GAAP.

The court was having none of it. Taken as a whole, the court held, the consistency terms in the purchase agreement require the use of the business' past accounting practices, rather than a new assessment of whether those historical practices complied with GAAP. The purpose of the working capital adjustment is not to aid the buyer's investigation of the business, but rather to account for changes in the business between signing and closing. In doing so, "keeping all other variables constant in terms of accounting is critical." As the court concluded, the consistency language in the purchase agreement "emphasizes that there is one approach to GAAP and one set of statements that are appropriate for use throughout the transaction."

The court noted that it is possible to draft a working capital adjustment provision that imposes on closing statements not only a consistency requirement, but also a separate and additional requirement of compliance with GAAP. The court said the language here could not be read to create such a separate requirement of compliance with GAAP.

- *Practice Pointer:* Using phrases like "GAAP consistently applied" and "consistent with past practices" in the working capital adjustment provision and related schedules reinforces the notion that there will be only one approach to GAAP. But many working capital provisions use some variation of consistency language. The key for negotiators and drafters is whether the purchase agreement will make consistency the only requirement for the closing schedules, or whether there will be an additional requirement that the closing schedules also must comply with GAAP, regardless of past practices. Call it consistency plus GAAP. The language here was all about consistency alone. If a buyer wants to be able to challenge historical financial statements after taking control of the business, it should focus attention on the drafting of the representations and warranties (to avoid this issue altogether) and/or use language in the working capital provisions indicating an agreement to make GAAP compliance an independent and additional requirement for closing statements, on top of a consistency requirement.

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