



# LOCKING THE BOX

Buyout houses are attempting to avoid post-completion haggling on exit through “locked-box” mechanisms, says **Bobby Reddy** of **Latham & Watkins**.



Where the share capital of a target is being valued pursuant to locked-box principles, the shares in that target company are being sold at a fixed price. This is based upon a pre-signing balance sheet, which may be audited, or may be a balance sheet drawn and settled between the parties prior to signing, and there is no post-completion adjustment.

Any cash identified in the pre-signing balance sheet will be added to the enterprise value, while any debt will be deducted from the enterprise value to determine the purchase price payable on completion. However, the purchaser takes the risk, and possible reward, of the target's performance in the period between the balance sheet date and completion.

Locked-box mechanisms are becoming widespread in the secondary buyout market. Private equity sellers wish to maintain control over the pricing process – whereas it is usual for the purchaser to control post-completion processes – and ensure clarity as to the purchase price on completion.

The locked-box mechanism allows a seller to avoid the potential disputes that often arise with the preparation of completion accounts post-completion, and release the full proceeds of a sale to its investors. Furthermore, it is difficult for a private equity purchaser to resist a locked-box mechanism if it is also insisting on fixed-price deals where it is the seller.

## PROTECT THE PURCHASER

If a locked-box mechanism is accepted by a purchaser, it is essential that no “leakage” of value has occurred from the company during the period between the balance sheet date and completion.

Therefore, the purchaser will ask for undertakings from the seller that since the balance sheet date, apart

from leakage expressly permitted and factored into the purchase price, no value has been extracted from the company. The purchaser will seek to establish that the business has been conducted in its ordinary course; no distributions, dividends, payments or returns have been made to the seller; no transactions have been entered into other than on arm's-length terms; no third-party debts have been waived; no shareholder loans have been repaid; and no payments of fees or expenses relating to the acquisition have been made.

It is problematic for a purchaser to agree to a locked-box mechanism where the target is part of a larger group, some of which is not being purchased, since it is easier for the seller to manipulate leakage from the box – for example, by hedging agreements, allocation of group overheads and intra-group trading.

Since the purchaser takes the risk of performance of the target in the interim period, it is critical that the balance sheet date is not historic, and that the target's performance in the interim is not unpredictable. The purchaser must also be aware that a downturn in performance during the period may have a bearing on financing structure.

On the other hand, in a seller-friendly environment, the seller may argue that the purchaser is taking advantage of upside during this period, and therefore may ask for interest on the purchase price, or payment of a daily earnings price.

It should also be ensured that any breach of the locked-box is subject to a seller indemnity such that the purchaser is remedied on an “all-in” basis. Furthermore, it could be argued that the balance sheet, on which the purchase price is determined, be warranted by the seller – however, this will be resisted by private equity house vendors.

Some advantages and

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disadvantages of locked-box mechanisms from a purchaser's perspective are as follows:

## ADVANTAGES

- Provides clarity as to the purchase price at completion, with no post-completion adjustments.
- Provides an incentive to both parties to agree to the balance sheet on which the purchase price is based prior to completion; often this incentive is lacking for one side.
- In an auction scenario, the ability to offer a fixed purchase price payable on completion offers a significant competitive advantage.

## DISADVANTAGES

- The seller has control over the preparation of the balance sheet and an informational advantage. The purchaser must engage in extensive pre-completion financial due diligence with respect to the balance sheet, particularly where the balance sheet is not audited, since there is no possibility of post-completion adjustment.
- It is more difficult to “lock the box” and prevent leakage of value between balance sheet date and completion where the target is part of a wider group.
- Locked-box mechanisms are not appropriate where the working capital or performance of the target is subject to volatility.

## BOXING CLEVER

In a seller-friendly secondary buyout market, locked-box mechanisms will be a common method of pricing companies, and can be attractive to not only the seller but also the purchaser, as long as the purchaser can undertake satisfactory financial due diligence and negotiate that the box is effectively locked. ●

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