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Compare Apples to Apples – Delaware Supreme Court Guidance on Working Capital Adjustments

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Most private company acquisitions include a mechanism for adjusting the purchase price to ensure that the net working capital of the acquired company is a normalized amount at the time of closing, accounting for the operation of the business between the signing of the purchase agreement and the closing of the transaction. This can create an opportunity for a buyer to try to recoup some of the purchase price paid or seek post-closing reimbursement outside of its indemnity rights if the provision is not carefully drafted.

In a recent case, the Delaware Supreme Court reviewed a net working capital adjustment provision and determined that it did not provide the buyer an opportunity to challenge the seller's historical compliance with generally accepted accounting principles (GAAP) in the preparation of its financial statements. In *Chicago Bridge v. Westinghouse Electric*, the buyer, Westinghouse, claimed it was entitled to a $2 billion working capital adjustment, alleging that Chicago Bridge's working capital calculations were incorrect because the historical accounting practices used by Chicago Bridge to prepare its financial statements failed to comply with GAAP. On the other side, Chicago Bridge claimed that Westinghouse owed it $428 million based on Chicago Bridge's calculation of net working capital at closing, which was consistent with the accounting principles it used to prepare its financial statements.

The purchase agreement required that the net working capital calculation be prepared in accordance with GAAP applied on a consistent basis throughout the periods indicated. The court

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reasoned that the adjustment mechanism was not intended to provide a means for Westinghouse to assert that Chicago Bridge's closing calculations were inconsistent with GAAP. The intent of the provision, in other words, was to "compare apples to apples" – net working capital at signing and net working capital at closing, in each case calculated in the same manner. To allow changes to the accounting approach between the two calculations would be akin to comparing apples to oranges.

As a result of this reasoning, the court determined that the independent auditor reviewing the net working capital calculation dispute was limited to a review of the facts and circumstances impacting changes to net working capital between signing and closing, and not whether the seller's calculation complied with GAAP.

What does this mean for parties to M&A transactions involving net working capital adjustments? The case confirms the view that the general purpose of a net working capital adjustment is to be a narrow remedy to address any change in the value of the target between signing and closing, and not to provide a backdoor mechanism for claims about the accuracy of financial statements or as a means to re-negotiate the purchase price. Additionally, this case highlights the importance of careful drafting in purchase agreements, as the court focused on the exact wording of the contract to reach its conclusion that the net working capital adjustment provided a narrow, cabined remedy for the buyer. As in other contexts, precise drafting to reflect the intent of both parties is the best way to avoid future disputes.

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