PRICING MECHANISMS IN MERGERS AND ACQUISITIONS: THINKING INSIDE THE BOX

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INTRODUCTION

Where transactions require the delicate management of perfectly imperfect information, simplifying complexity can lead to significant gains in efficiency and effectiveness. The process of merging or acquiring a business is such a transaction. The imprecise art of integrating two companies' histories, cultures, processes, and strategies is intricate. But before companies can integrate their businesses, they must reach an agreement to either buy, sell, or merge. The process leading up to signing and closing includes, among other things, financial due diligence, pricing, and negotiation of terms and covenants. Inevitably, this comes with

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complexities that can lead to wasted time and money.

This Comment focuses on the executory period of M&A transactions. Specifically, it focuses on the pricing process. There are two main methodologies for pricing a deal: (1) the closing accounts mechanism and (2) the locked box mechanism. Through the closing accounts mechanism, parties agree to an enterprise value and then adjust post-closing for actual Cash, Debt, and Working Capital as of the closing date.[1] Through the locked box mechanism, parties agree to an equity price based on historic balance sheets that are fixed at signing.[2] Because the locked box mechanism eliminates the need for post-closing financial adjustments, it can be a more efficient and effective means to price deals.

The locked box mechanism is used widely in the United Kingdom but less frequently in the United States, where the closing accounts mechanism dominates.[3] This Comment argues that the United States should capitalize

1. *To Lock or Not to Lock: An Introduction to the Locked Box Closing Mechanism*, PRICEWATERHOUSECOOPERS LLP 1, 2 (Sept. 2013), http://download.pwc.com/ie/pubs/2013_an_introduction_to_the_locked_box.pdf [https://perma.cc/Y4TB-XA3A].

2. *Id.* at 3.

3. William G. Lawlor & Eric S. Siegel, *Assessing the Locked Box Approach to Purchase Price Adjustments*, 6 DEAL LAWYERS 1 (Mar.-Apr. 2012), https://www.dechert.com/files/Publication/5c0046f0-600f-4215-b5ac-0829b868326d/Presentation/PublicationAttachment/1289a486-2749-4ed4-9caa-c46abd71412b/deallawyers-updated.pdf [https://perma.cc/6HXK-DUL8] ("Whether the locked box achieves critical mass in the U.S. is yet to be determined, ..."); Samantha McGonigle & Michael Weisser, *Q2 2014 Global Private Equity Update*: Unlocking "Locked Box" Deals, WEIL, GOTSHAL & MANGES LLP: GLOBAL PRIVATE EQUITY WATCH 1 (July 24, 2014), http://privateequity.weil.com/wp-content/uploads/2014/10/Global-PE-Update-1H-2014.pdf [https://perma.cc/3Z4H-3FG6] (stating that the locked box mechanism has been popular in Europe for its simplicity, but slow to catch on in the United States market where it only represents a small minority of deals). *See also* James D. Epstein, *Acquiring European Businesses–Differences Between the U.S. and U.K. Practices*, 5 CORP. & M&A L. (BNA) No. 33, at 12 (Nov. 7, 2011) (comparing the differences between the United States closing accounts mechanism with the United Kingdom locked box mechanism, suggesting the prevalence of each respective mechanism to each region); *CMS European M&A Study 2014*, CMS HASCHE SIGLE 1, 5 (Mar. 2014), http://www.cms-hs.com/newsmedia/publications/pages/default.aspx (follow "Corporate/M&A" hyperlink; then follow "CMS European M&A Study 2014" hyperlink under "Publications M&A"; then follow "Preview – CMS European M&A Study 2014" under "Publication") [https://perma.cc/U3R5-HFM9] (finding that the closing accounts mechanism is used in roughly 85% of United States M&A deals and 43% of United Kingdom M&A deals, suggesting that the locked box mechanism or some other pricing mechanism is used in *15% of United States M&A deals* and *57% of United Kingdom M&A deals*); Sandro de Bernardini & Simon Rootsey, *Popularity of Locked-Box Deals in the UK: Price Certainty, Other Benefits for Buyers*, SKADDEN: INSIGHTS (Sept. 29, 2015), https://www.skadden.com/insights/popularity-locked-box-deals-uk-price-certainty-other-benefits-buyers [https://perma.cc/2X4J-KQ6K] (discussing the rise in locked box deals in the United Kingdom).

on the benefits of the locked box mechanism and use it more frequently.[4] It prevents post-closing disagreements that can frustrate a deal, it is more time and cost efficient, it is simpler, it promotes price certainty, and it increases the number of available pricing mechanisms that parties can use, which can better satisfy party preferences. Because the benefits of the locked box mechanism are generally undisputed, this Comment evaluates possible explanations for the mechanism's lack of popularity in the United States and suggests a means to increase its usage among American parties.

Parts I and II provide an overview and comparison of the two pricing mechanisms. Part III is the heart of this Comment. It begins by evaluating three primary factors that may have prevented the locked box mechanism from gaining popularity in the United States: (1) the volatility of the financial market, (2) the rise of carve-out M&A deals, and (3) the educational and cultural familiarity with the closing accounts mechanism as compared to the locked box mechanism. For reasons that will later be discussed, the United States' lack of familiarity with the locked box mechanism appears to be the most persuasive. Therefore, this Comment suggests structuring the locked box mechanism to conform to the expectations of American companies—namely, by including materially adverse change (MAC) and earnout clauses by default.

I. THE CLOSING ACCOUNTS MECHANISM AND THE LOCKED BOX MECHANISM

A. *Closing Accounts Mechanism*

The closing accounts mechanism ("CAM") has traditionally been the default pricing mechanism for deals around the world.[5] In the CAM, there are two important dates: the sales purchase agreement ("SPA") signing date and the closing date. The parties first agree to an enterprise value for the target company as of the SPA signing date and then adjust this value post-

4. In order to improve processes, whether in law, business, medicine, design, or other fields, the author believes that experimentation and exploration with existing—yet unfamiliar—processes can be insightful and inspiring. For instance, it may be helpful to adapt cross-disciplinary processes to one's research or, as here, adapt cross-cultural M&A mechanisms. *See* Eva Boxenbaum & Julie Battilana, *Importation as Innovation: Transposing Managerial Practices Across Fields*, 3 STRATEGIC ORG. 355, 356 (2005) (defining one process of innovation known as translation, which "occurs when actors adapt a foreign practice to their own . . . context, modifying it or combining it with local practices").

5. Ronan O'Sullivan et al., *Pricing Mechanisms: Locked Box vs Completion Accounts*, PLC MAG., Jan. 25, 2012, at 1; PRICEWATERHOUSECOOPERS, *supra* note 1, at 2.

closing for "actual Cash, Debt, and Working Capital"[6] to derive the equity value.

The enterprise value is determined through an agreed-upon valuation methodology that factors in Cash, Debt, and Working Capital.[7] This calculation is the first step in determining the equity value, which is the actual price the buyer pays to the seller after post-closing adjustments have been made.[8] In some instances, there is an intermediary step where the parties create an estimated calculation of the equity value after signing, but before closing.[9] Then, the buyer makes post-closing adjustments based on the accounting methodologies set forth in the negotiated SPA to determine the equity value.[10] Because the balance sheet that is used for post-closing adjustments is not prepared until after the closing date, the equity value may not be known for several months or years after closing.[11] With the CAM, economic interest and risk pass from the seller to the buyer at closing because this is the point at which the buyer becomes financially responsible for the acquired company.

B. *Locked Box Mechanism*

In the past few years, the locked box mechanism ("LBM") has become a popular alternative to the CAM in the United Kingdom.[12] In the LBM, there are three important dates: the Locked Box Date, the SPA signing date, and the closing date.[13] The parties agree to a fixed equity value for the target company at the SPA signing date.[14] The equity value is calculated based on an agreed-upon historic balance sheet ("Locked Box Balance Sheet"), which is fixed at the pre-signing date (the "Locked Box Date").[15] Between the Locked Box Date and the SPA signing date, the

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6. PRICEWATERHOUSECOOPERS, *supra* note 1, at 2.

7. For instance, enterprise value can be calculated with the following equation: "market value of common stock + market value of preferred equity + market value of debt + minority interest – cash and investments." *Enterprise Value*, INVESTOPEDIA, http://www.investopedia.com/terms/e/enterprisevalue.asp [https://perma.cc/TTA3-6R7W] (last visited Mar. 23, 2016).

8. O'Sullivan et al., *supra* note 5, at 2.

9. O'Sullivan et al., *supra* note 5, at 4 ("This use of estimates does not affect the ultimate equity price but attempts (in theory, at least) to ensure that the consideration actually paid by the buyer at completion is a reasonable approximation of the ultimate equity price").

10. O'Sullivan et al., *supra* note 5, at 4.

11. O'Sullivan et al., *supra* note 5, at 5.

12. de Bernardini & Rootsey, *supra* note 3.

13. Please note that these dates are listed in chronological order.

14. PRICEWATERHOUSECOOPERS, *supra* note 1, at 3.

15. PRICEWATERHOUSECOOPERS, *supra* note 1, at 3.

seller performs due diligence on the Locked Box Balance Sheet and projected cash flows to determine the equity value.[16] That equity value is fixed at the SPA signing date and does not get adjusted post-closing.[17] Notice that the LBM does not require a determination of enterprise value because the actual levels of Cash, Debt, and Working Capital are cognizable through the historic Locked Box Balance Sheet.

Because there are no post-closing adjustments, the buyer receives protection from any "Leakage," which is the unpermitted extraction of value from the target business in the form of representations and warranty indemnity ("W&I") insurance and covenants between the Locked Box Date and closing dates.[18] Permitted Leakage is agreed upon in the SPA and may not lead to a reduction in price or trigger any W&I insurance. Unpermitted Leakage includes "dividends (whether actual or deemed), management fees, transfer of assets at an under-value and the waiver of amounts owed/liabilities."[19] Should any unpermitted Leakage occur, the W&I insurance will reimburse the buyer for the loss value exceeding the seller's negotiated liability cap (the maximum amount the seller is responsible for out-of-pocket before insurance kicks in).[20] The W&I provisions in LBM deals are generally more stringent than those in CAM deals because they are the buyer's sole form of protection from any unpermitted Leakage in the target business between the Locked Box Date and closing.[21]

With the LBM, the economic interest and risk transfer from buyer to seller is set at the Locked Box Date, the date at which the historic balance sheet is fixed, because the buyer receives the "benefit of the cash profits generated by the business from that date"[22] and the seller "incurs an opportunity cost as they do not receive payment at the Locked Box Date

16. Jeff Mansfield & Kieren Parker, *M&A Purchase Price Calculations–The Locked Box Mechanism*, ADDISONS 1, 2 (Nov. 13, 2012), http://www.addisonslawyers.com.au/knowledge/assetdoc/c430522a5ccba60f/M&A%20Purchase%20Price%20Calculations%20-%20the%20Locked%20Box%20Mechanism.pdf [https://perma.cc/874A-6Y5C].

17 PRICEWATERHOUSECOOPERS, *supra* note 1, at 3.

18. PRICEWATERHOUSECOOPERS, *supra* note 1, at 5.

19. PRICEWATERHOUSECOOPERS, *supra* note 1, at 5.

20. *Warranty and Indemnity Insurance in UK M&A Deals*, WINSTON & STRAWN LLP: CORP. PRACTICE (July 2015), http://interact.winston.com/reaction/Corporate/ClientBriefingNewsletter/2015/Warranty_Indemnity_Insurance_JUL2015/Warranty_Indemnity_Insurance_JUL2015.pdf [https://perma.cc/22S5-GH65]; Jay Rittberg et al., *M&A in 2015: Reps and Warranties Insurance*, NORTON ROSE FULBRIGHT & AIG 17 (Mar. 26, 2015), http://www.nortonrosefulbright.com/files/20150326-ma-in-2015-reps-and-warranties-insurance-127162.pdf [https://perma.cc/AN62-42QU].

21. Lawlor & Seigel, *supra* note 3, at 2.

22. In effect, the buyer is running the company on behalf of the seller during this period. This idea will be discussed further in subsequent sections.

but instead . . . at Closing."[23] To compensate the seller for this opportunity cost and for not receiving the cash profits between the Locked Box Date and closing, the buyer either pays the seller interest on the equity value or an agreed-upon proxy for profits.[24]

II. THE MECHANISMS COMPARED

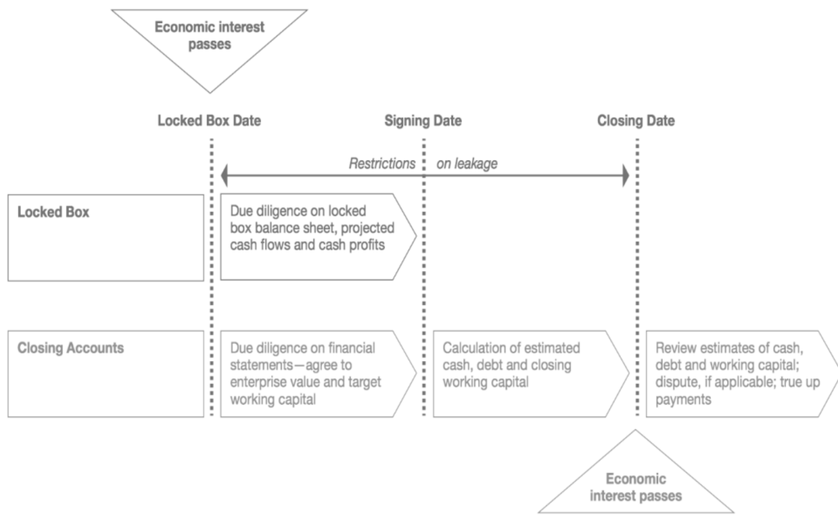

FIGURE 1.[25]

A. *The CAM*

The CAM has the primary benefit of "more accurately captur[ing] changes in the target's valuation between the initial valuation . . . date and the closing date."[26] Because the CAM considers post-closing adjustments, the equity value directly reflects the financial condition of the target business at closing.[27] Additionally, the CAM is known to be buyer-friendly because the seller bears the economic risk until closing and the buyer has control over the post-closing adjustments process (and thus, the ability to renegotiate for a lower equity price).[28] Another benefit of the CAM is its

23. PRICEWATERHOUSECOOPERS, *supra* note 1, at 7.
24. PRICEWATERHOUSECOOPERS, *supra* note 1, at 7.
25. PRICEWATERHOUSECOOPERS, *supra* note 1, at 3 fig.1.
26. Lawlor & Seigel, *supra* note 3, at 2.
27 O'Sullivan et al., *supra* note 5, at 3.
28 O'Sullivan et al., *supra* note 5; PRICEWATERHOUSECOOPERS, *supra* note 1, at 4, 8.

flexibility across multiple deal types, such as strategic, financial, complex carve-out,[29] corporate, and startup deals. This flexibility derives from the CAM's ability to capture an accurate financial snapshot of the target company at closing.

However, the CAM leads to "heavy negotiation" (and potential "manipulation and abuse") between the buyer and seller during the post-closing adjustments period that is "complex, time consuming and expensive."[30] Disputes normally occur over pricing, accounting methods, and/or policies.[31] The buyer has the benefit of conducting due diligence for post-closing adjustments and may take advantage of this opportunity to renegotiate a lower equity price,[32] while the seller may be motivated to exploit loopholes in the post-closing adjustments process by, for instance, "delaying capex to boost cash."[33] These negotiations also require management involvement to agree upon a final purchase price,[34] which diverts their focus from the intricate task of integrating both companies. These drawn-out debates can come at great economic cost to the parties in the form of fees to attorneys, bankers, and accountants.[35] They can also result in significant delays, with disputes lasting anywhere from months[36]

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29. McGonigle & Weisser, *supra* note 3, at 3.

30. McGonigle & Weisser, *supra* note 3, at 3.

31. Alexander B. Johnson et al., *Trends in Purchase Price Adjustment Formulations in US, UK and Cross-Border M&A Transactions*, FINANCIER WORLDWIDE (June 2013), http://www.financierworldwide.com/trends-in-purchase-price-adjustment-formulations-in-us-uk-and-cross-border-ma-transactions/#.VvQIHhIrLVo [https://perma.cc/9EV2-26SH].

32. *Lower Due Diligence in M&A Linked to Increase in Deal Success But Lower Premiums*, CASS BUS. SCH., CITY UNIV. LONDON (Nov. 14, 2013), http://www.cass.city.ac.uk/news-and-events/news/2013/november/longer-due-diligence-in-m-and-a-linked-to-increase-in-deal-success-but-lower-premiums [https://perma.cc/KS85-5EHS]. *See also* Jeffrey M. Lipshaw, *Law as Rationalization: Getting Beyond Reason to Business Ethics*, 37 U. TOL. L. REV. 959, 1017 (2006) (discussing an instance where a particular seller had to balance its leverage during post-closing adjustments with its distrust for the buyer's ability to "perform a fair post-closing adjustment").

33. Mansfield & Parker, *supra* note 16, at 2. This can have the effect of artificially raising the value of the target firm because delaying capital expenditures until the merger is complete will only boost cash in the short-term.

34. McGonigle & Weisser, *supra* note 3, at 3.

35. *See* McGonigle & Weisser, *supra* note 3, at 3 (noting how the locked box mechanism eliminates costs associated with negotiating post-closing adjustments); O'Sullivan et al., *supra* note 5, at 5-6 (noting how the locked box mechanism eliminates the costs involved with preparing and reviewing disputes caused by the closing adjustments mechanism); PRICEWATERHOUSECOOPERS, *supra* note 1, at 4 (discussing how the locked box mechanism can result in "potentially significant time and cost savings" because it eliminates post-closing adjustments).

36. Press Release, Jon Greer, New M&A Study Lifts the Curtain on What Happens After Companies Are Sold (Apr. 6, 2011), http://www.businesswire.com/news/home/20110406005612/en/MA-Study-Lifts-Curtain-Companies-Sold [https://perma.cc/MQ3P-LBRS] (finding that disputes last an average of

to years.[37]

Lastly, the CAM is known as a buyer-friendly mechanism because economic interest passes at closing, which may be problematic for the seller.[38] The seller is liable for any possible downturn in the business, which would likely result in a decrease in purchase price. Additionally, the buyer controls the post-closing adjustments process, which gives the seller less control over the final purchase price.[39]

B. *The LBM*

The LBM has four primary benefits. First, the mechanism is more time and cost efficient because there are no risks or expenditures of money or time associated with renegotiating post-closing adjustments.[40] Speed is integral in determining the success of M&A deals,[41] so efficiency gains can materially benefit both parties to a transaction. For instance, the buyer's management team can allocate more time to planning and preparing for the integration of the target company rather than spending their efforts on post-closing adjustments under a CAM deal. Second, the LBM simplifies the SPA agreement because there is no need to negotiate or include complex post-closing calculation formulas.[42] The absence of these processes can further streamline the deal. Third, the fixed priced of the LBM promotes price certainty for both the buyer and seller.[43] This reduces the price uncertainty that a buyer may have with the CAM because there is no concern over the potential need to secure additional capital should the equity value increase beyond the initial enterprise value.[44] This also reduces the price uncertainty from the seller's perspective by eliminating

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eight months).

37. O'Sullivan et al., *supra* note 5, at 4.

38. O'Sullivan et al., *supra* note 5, at 4.

39. O'Sullivan et al., *supra* note 5, at 4.

40. McGonigle & Weisser, *supra* note 3, at 3; O'Sullivan et al., *supra* note 5, at 6. *See* Brian Vickrey et al., *An Introduction to the Locked Box Closing Mechanism: To Lock or Not to Lock,* TRANSACTION ADVISORS (Oct. 2013), https://www.transactionadvisors.com/insights/introduction-locked-box-closing-mechanism [https://perma.cc/9CR3-8GWS] (stating that the locked box mechanism is a good alternative for buyers and sellers looking for ways to reduce the lengthy process of preparing, reviewing, and disputing post-closing adjustments).

41. *See* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 472 (Vickie Been et al. eds., 4th ed. 2012) ("Speed is almost always desirable in acquisition transactions. In dynamic markets, the conditions that make an agreement advantageous may suddenly change . . . and . . . it is rational, once a deal is reached, for business people to be impatient to close it").

42. de Bernardini & Rootsey, *supra* note 3.

43. McGonigle & Weisser, *supra* note 3, at 3; O'Sullivan et al., *supra* note 5, at 6.

44. O'Sullivan et al., *supra* note 5, at 5.

concerns over a reduction in equity value through price-chipping post-closing.[45] The fixed price promotes certainty between both parties and allows the buyer and seller to better manage their financial futures. And fourth, the LBM provides an alternative pricing mechanism for companies to structure deals, which may better satisfy buyer and/or seller preferences or may be more effective for particular deal types. For instance, the LBM can be a beneficial tool for private equity sellers where price certainty "allows a PE ["private equity"] seller to make a full distribution to LPs shortly after closing and does not require the buyer to find additional cash to fund any upwards adjustment[.]"[46] This is one of the reasons why private equity firms in the United Kingdom favor the LBM.[47] Additionally, having the ability to choose between the LBM or CAM can help parties better manage market conditions. When markets are stable, parties can default to the efficiency of the LBM by relying on historic balance sheets. On the other hand, when markets are unstable, such as during the financial crisis, parties may opt for the CAM for a real-time snapshot of the target company's value at closing.[48] For corporate strategists, the power of choice is a valuable tool.

The LBM also has its limitations. It is less precise because it does not factor in post-closing adjustments. It is also not typically appropriate for three types of situations: where isolating the historic financial statements of a target business is difficult (e.g., certain types of carve-outs[49] or divestitures); where historic financial statements are limited (e.g., startups); or where the buyer does not trust the seller.[50] The CAM may be more appropriate in complex carve-out deals because the LBM may be difficult to apply "without an anchored balance sheet."[51] This will be discussed in greater detail in a subsequent section, but the main takeaway is that a seller may not be able to effectively isolate the carved-out business unit's financial statements from its other business units. With the CAM, the seller can begin to account for the carved-out business unit's financial

45. PRICEWATERHOUSECOOPERS, *supra* note 1, at 4.

46. McGonigle & Weisser, *supra* note 3, at 3.

47. Lawlor & Siegel, *supra* note 3, at 1.

48. *See* note 85 for a data-driven discussion on how the financial crisis affected the use of the LBM in the United Kingdom.

[49] McGonigle & Weisser, *supra* note 3, at 3.

[50] Mansfield & Parker, *supra* note 16, at 2.

51. PRICEWATERHOUSECOOPERS, *supra* note 1, at 8. For purposes of this Comment, complex carve-out deals refer to situations where a seller is unable to isolate the financial statements of the target business unit from those of its other businesses. For example, assume that Seller has three business units: A, B, and C (note that these are not distinct businesses and that Seller is not a holding company). Buyer contracts with Seller to purchase A, but Seller has not maintained separate financial statements for A, B, and C. As a result, information, such as revenues from A, are combined with revenues from B and C.

information when the agreement is signed and have the financial statements ready at closing for any adjustments. Note, however, that there are a number of carve-out deals where financial statements for individual business units exist. As such, the LBM has been used successfully in many carve-out deals in the United Kingdom.[52] The CAM may also be more appropriate in startup deals because young companies lack the necessary historic financial statements for the LBM, and the CAM allows the buyer to create an accurate snapshot of the company's value at closing. Lastly, in situations where the buyer does not trust the seller, the buyer would want more protection over unpermitted Leakage than W&I insurance. However, barring these three exceptions, the LBM can also be used in a number of deal types like private equity, strategic, corporate, and carve-out deals where an isolated balance sheet exists.[53]

Lastly, where the CAM is generally viewed as a buyer-friendly mechanism, the LBM is generally viewed to be "more seller-friendly"[54] because of its fixed price (and thus an inability for the buyer to renegotiate a lower price post-closing) and the fact that economic risk transfers at the Locked Box Date when the target company is still under seller management.[55] In other words, the buyer bears the risk of any downturn in the target company between the Locked Box Date and closing. The buyer also bears the risk of the seller lacking motivation to maximize the target company's profits between the Locked Box Date and closing because the buyer, and not the seller, is entitled to the target company's profits after the Locked Box Date.[56] Further, the buyer's primary protection from unpermitted Leakage is through carefully negotiated W&I insurance, which historically had been weak. However, in recent years, the W&I industry has strengthened, which has increased buyer confidence.[57]

On the other hand, the LBM also provides certain buyer-friendly benefits. For instance, the seller is not motivated to manipulate any post-closing accounts by delaying capital expenditures to boost cash because the

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52. Matthew F. Hermann, *Surveying the Landscape: Worldwide*, 15 M&A J. 1, 8 (Sept. 2014), http://www.freshfields.com/uploadedFiles/SiteWide/Profiles(1)/M/MAJ_v1502.pdf [https://perma.cc/9BUN-KGSY].

53. *Id.*; McGonigle & Weisser, *supra* note 3; Lawlor & Siegel, *supra* note 3, at 1.

54. de Bernardini & Rootsey, *supra* note 3.

55. O'Sullivan et al., *supra* note 5, at 4.

56. Mansfield & Parker, *supra* note 16, at 2.

57. Mergermarket Events, *Sellers See Appeal of "Locked Box" Mechanism–CMS*, YOUTUBE (July 8, 2013), https://www.youtube.com/watch?v=_CSyNcCUydw [https://perma.cc/U2SG-6G3Z] [hereinafter Interview with Mergermarket] (discussing the improved reliability of the W&I market and the reduced premiums of insurance in the United Kingdom); McGonigle & Weisser, *supra* note 3, at 4 (discussing how recent competition in the W&I market has improved the terms and premiums of insurance in the United States).

balance sheet at closing does not affect the equity value.[58] Even though a seller may be motivated to manipulate gaps in the Leakage protections or the representations and warranties set forth in the negotiated SPA, the seller may nevertheless be liable for any extraction of unpermitted Leakage or other value in the target company—W&I insurance aside—because the seller *may* be acting as a legal agent to the buyer between the Locked Box Date and closing.[59] If this is the case, the seller would have fiduciary duties to the buyer and would be subject to the duty of care, duty of loyalty, and good faith. According to one large accounting firm, Leakage claims are not common in practice—at least in the United Kingdom and across Europe.[60] Additionally, the seller assumes the risk of running the target company on behalf of the buyer until closing.[61] The seller does not receive any profits generated, and even though it receives proxy or interest payments for compensation, the payments may be set too low.[62]

In sum, the CAM is a buyer-friendly mechanism that is more accurate but comes at the heavy risk of lengthy and costly debates over post-closing adjustments. The LBM is a seller-friendly mechanism that fixes the purchase price up front, limits disputes over pricing, and is quicker to execute; but, it may not be appropriate for complex carve-out or startup deals. The LBM is a valuable alternative to the CAM due to its efficiency gains and cost savings, and American companies are leaving time and money on the table by not experimenting with the mechanism.

The United States should increasingly use the LBM as an alternative pricing mechanism, and the next section explores possible explanations for why the LBM has not gained popularity in the United States.

C. *Why the LBM has not Become Popular in the United States*

There are a number of complex, interconnected factors that may have prevented the LBM from gaining popularity in the United States. Three factors have been the most influential: (1) the volatility of the financial market, (2) the rise of carve-out M&A deals, and (3) the cultural and

58. Mansfield & Parker, *supra* note 16, at 2.

59. It is unclear whether the seller is considered a de jure agent of the buyer; however, it is briefly suggested so in Mansfield & Parker, *supra* note 16, at 2.

60. PRICEWATERHOUSECOOPERS, *supra* note 1, at 6.

61 *See* PRICEWATERHOUSECOOPERS, *supra* note 1, at 7 (discussing a seller's opportunity cost in running the company between the Locked Box Date and closing).

62. *Purchase Price Adjustment Mechanisms in M&A Transactions – The Locked Box Mechanism*, WINSTON & STRAWN LLP 4 (Nov. 2014), http://winston.com/en/where-we-are/europe/london.html#!/en/thought-leadership/purchase-price-adjustment-mechanisms-in-m-a-transactions-the.html?aj=ov&parent=282&idx=13 [https://perma.cc/3ULS-GHZV].

educational familiarity of the CAM as compared to the LBM in the United States. Before discussing these primary factors, two related inquiries are addressed: whether any explanations can be derived from either the relationship between the LBM and strategic and financial deals[63] or the litigious nature of the United States.

First, the LBM has traditionally been popular in private equity deals and has only recently spread to strategic deals in the United Kingdom.[64] This suggests that a discrepancy over the ratio of private equity deals to strategic deals between the United States and United Kingdom could be insightful. In other words, if there are more private equity than strategic deals in the United Kingdom but the converse is true in the United States, the prevalence of the LBM may be attributable to the distinction in deal type. However, no such discrepancy likely exists. One study suggests that there are significantly more strategic deals than private equity ones in the United States.[65] Another study shows significantly more strategic deals than private equity ones across Europe.[66] This study aggregated data from the United Kingdom, which represented half of the total deal volume analyzed, France, and Germany. Although this is not a perfect proxy because data from two additional countries are included, the general pattern and high proportion of data from the United Kingdom reasonably suggests that there are more strategic than financial deals in the United Kingdom. Thus, it seems likely that there are more strategic than private equity deals in both the United States and, by proxy, the United Kingdom, suggesting that the relationship between the number of strategic and financial deals has not influenced the prevalence of the LBM in the United States.

Second, American companies may have been concerned about using a new pricing mechanism because "working out the kinks" may lead to unwanted litigation over improper execution of the mechanism by, for example, allowing unpermitted Leakage to flow from the target company. However, parties can contract this issue away by including mediation or

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63. Financial deals are backed by private equity firms and will be used synonymously in this Comment.

64. Lawlor & Siegel, *supra* note 3, at 1.

65. *US M&A News and Trends*, FACTSET 4 (July 2016), https://www.factset.com/websitefiles/PDFs/flashwire/flashwire_7.16 [https://perma.cc/N8TV-GDPC]. *See also* Marc Martos-Vila et al., *Financial vs. Strategic Buyers* 1 (Harvard Bus. Sch., Working Paper No. 12-098, 2014), http://www.hbs.edu/faculty/Publication%20Files/12-098_dc44025a-785b-45c5-9d31-60e02f091b7d.pdf [https://perma.cc/QW5H-LDAM] (showing a greater volume of strategic versus financial deals in the United States).

66. *Europe M&A News and Trends*, FACTSET 4 (2nd Quarter 2016), http://www.factset.com/mergerstat_em/europe/Europe_Flashwire_Quarterly.pdf [https://perma.cc/7CX7-CR6C].

alternative dispute resolution in the SPA. Litigation would thus arise only under extenuating circumstances. It is even possible that the LBM would have actually been a way to reduce litigation because there are less financial variables for the parties to dispute. The most contentious aspect of a CAM transaction is handling post-closing adjustments, the point at which parties will attempt to renegotiate the purchase price. This leads to disagreement and potential litigation. With the LBM, the price is fixed at signing, which eliminates the potential for litigation on purchase price, and the primary point of concern is whether there has been any unpermitted Leakage extracted from the target firm, which is protected through W&I insurance—an industry that has strengthened in recent years, providing buyers with more confidence of proper protection in the case of unpermitted Leakage.[67] The ability to require mediation or alternative dispute resolution in place of litigation through the SPA and the idea that the LBM may actually reduce litigation rather than increase it suggest that the litigious nature of the United States may not be a primary cause of the LBM's lack of popularity in the United States.

As these factors do not appear to have had a significant influence over the prevalence of the LBM in the United States, the remaining discussion focuses on the three primary factors that have likely contributed most to the LBM's lack of popularity: the volatility of the financial market, the rise of carve-out M&A deals, and the educational and cultural familiarity with the CAM over the LBM.

First, the volatility of the financial market following the global financial crisis left companies pessimistic about the market. There was a 39.72% drop in the number of United States M&A deals between 2007 (pre-crisis) and 2009 (the year following the crisis that saw the lowest volumes and values of M&A activity), from 11,369 deals in 2007 to 6,853 deals in 2009.[68] In terms of deal value, there was a 54.26% drop from $1.23 trillion in 2007 to $568 billion in 2009.[69] Even though there has been "[c]heap and plentiful capital" since the crisis, "it has been so difficult [for companies] to see the far horizon through the wild waves of market turbulence."[70] Thus, the normal effect of low cost capital in increasing the

67. Interview with Mergermarket, *supra* note 57.

68. *2015 M&A Report*, WILMERHALE 2 (2015), https://www.wilmerhale.com/uploadedFiles/Shared_Content/Editorial/Publications/Documents/2015-WilmerHale-MA-Report.pdf [https://perma.cc/2JGJ-SW9Y] (citing FactSet Mergers).

69. *Id*.

70. Matthew Hermann, *M&A is Back*, THE M&A JOURNAL 1 (Sept. 2014), http://www.freshfields.com/uploadedFiles/SiteWide/Profiles(1)/M/MAJ_v1502.pdf [https://perma.cc/F23A-4C4V] (citing Rob Kindler, Vice Chairman and Global Head of M&A at Morgan Stanley).

amount of M&A deals was neutralized by uncertainty in the market. Even when the market began to rise in 2013, companies were still concerned with the fluctuations, as "there were daily swings of 500 or 750 points."[71]

With the uncertainty in the market, companies may have been less likely to experiment with new methods of pricing M&A deals following the crisis. However, the market is stabilizing and this possible barrier to the LBM in the United States is dissolving. In 2014, the number of United States M&A deals surpassed pre-crisis levels with 11,425 deals in 2014 compared to 11,369 deals in 2007.[72] The value of United States M&A activity also surpassed pre-crisis levels with $1.6 trillion worth of deals in 2014 compared to $1.2 trillion in 2007 (and $568 billion in 2009).[73] Additionally, buyers now are less concerned about the "macroeconomics of Fed manipulation" that may result in the "stock market . . . suffer[ing] some unforeseen calamity."[74] The "market now welcomes M&A deals with an enthusiasm not seen for some time" and "[s]hareholders now support M&A deals . . . ."[75] The psychology of M&A also supports more deals. CEOs are more confident and have a "renewed energy in M&A" as they no longer have to hold back an "actual launch" because of market uncertainty.[76] It has been said, "If your pal in the same industry is doing a transaction, then it's a good time for you to do a transaction because you won't look silly for being the only guy doing a deal, ... This is always a major part of the psychology of M&A."[77]

The volatile market may have played a significant role in preventing the LBM from gaining popularity in the United States, and the current revitalization in M&A suggests that the market may be well suited for companies to experiment with new ways to drive value like using the LBM in M&A deals.

The second possible barrier is the rise in the carve-out deals in the United States. When a company undertakes a carve-out, it divests one of its business units by selling an equity stake in that business or by spinning the business off into its own.[78] A company may choose to undertake a carve-out for any of the following reasons: to focus the company's attention on a particular business with "greater potential . . . growth," "to

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71. *Id.*
72. WILMERHALE, *supra* note 68.
73. *Id.*
74. Hermann, *supra* note 70, at 3 (citing Alan Klein, Co-Administrative Partner at Simpson Thacher).
75. *Id.* at 2.
76. *Id.*
77. *Id.* at 4.
78. *Carve-Out*, INVESTOPEDIA, http://www.investopedia.com/terms/c/carveout.asp [https://perma.cc/Z6FC-X8KB] (last updated 2015).

dispose of non-core businesses," to "[u]nlock [s]hareholder [v]alue," to "[m]anage [c]apital [n]eeds," to "[e]liminate [c]onflicts," or to meet other financial pressures.[79]

The number of carve-out deals valued at over $100 million has been on the rise since 2009[80] and one study found that 39% of corporate respondents will pursue carve-outs as part of their strategy to focus on core assets (up from 31% in 2014).[81] This rise may have played a role in preventing the LBM from gaining popularity in the United States because the mechanism requires historic balance sheets to determine an equity price. For a complex carve-out deal, it may be difficult to isolate the divested business unit's particularized financial data, as distinct from the seller's other business lines.[82] Thus, the LBM may not be the best mechanism to gauge a business's value because it does rely on pricing adjustments.[83]

Although the rise in carve-outs may have played a role in preventing some companies from using the LBM, there is still a greater number of non-carve-out deals in the United States.[84] This means that there are still ample deals where the LBM is appropriate. Moreover, the LBM can still be effective when isolated financial statements for the carved-out business unit exists. For instance, the LBM has spread readily to carve-out deals across Europe.[85] This suggests that its use may only be limited in complex deals.

The third barrier, which is perhaps the most significant, is cultural and educational. The CAM is part of the M&A culture in the United States and the concept of the LBM is novel to the majority of American companies.[86] Companies that have made overseas mergers or acquisitions in the United Kingdom may have a loose familiarity with the LBM, but there has not

79. Michael Flynn et al., *The Art of Carving: Carve-Out Transactions – Sales of Divisions and Subsidiaries*, GIBSON DUNN 10 (Feb. 5, 2015), http://www.gibsondunn.com/publications/Documents/WebcastSlides-Carve-Outs-2.5.2015.pdf [https://perma.cc/LQG9-39FJ].

80. *Id*. at 5.

81. Russell Thomson et al., *M&A Trends Report 2015: Our Annual Comprehensive Look at the M&A Market*, DELOITTE 13 (2015), http://www2.deloitte.com/content/dam/Deloitte/us/Documents/mergers-acqisitions/us-ma-trends-report15-042115.pdf [https://perma.cc/GAQ3-F5KB].

82. McGonigle & Weisser, *supra* note 3, at 2.

83. See footnote 6 for a discussion on why the CAM may be more appropriate for complex carve-out deals.

84. Flynn et al., *supra* note 79, at 5-6.

85. Hermann, *supra* note 52, at 9.

86. *See* McGonigle & Weisser, *supra* note 3, at 2 (stating that the LBM is still not used with any frequency in the United States but that some companies have started using the mechanism after "becoming educated on the pros and cons" of the it).

been a LBM spark in the United States as there has been in the United Kingdom and across Europe.[87] Thus, the rational American company, especially in light of the recent economic environment, would not necessarily experiment with a new M&A pricing mechanism. However, now that the market has improved and the number of M&A deals is reaching pre-crisis 2007 levels, companies may be more willing to experiment with deal structures that can generate more value and facilitate the merger or acquisition process.

This Comment suspects that culture and education is one of the main reasons why the United Kingdom has seen such growth with the LBM. The mechanism has existed there for a number of years prior to gaining popularity.[88] For instance, the LBM was used in approximately 40% of M&A transactions in the United Kingdom in 2007.[89] The use then dramatically dropped following the global financial crisis from 2008 to early 2009, dropping to about 12% of deals.[90] From 2009 to 2010, the LBM reached pre-crisis levels[91] and today is used in approximately 57% of deals in the United Kingdom.[92] In comparison, the LBM is used in only

87. The LBM has also become popular in New Zealand and Australia. Nick Kovacevich, *Trends in M&A*, WYNN WILLIAMS, (Dec. 3, 2015), http://www.wynnwilliams.co.nz/Publications/Articles/Current-Trends-in-M-A [https://perma.cc/7UV5-6Q77]; Mansfield & Parker, *supra* note 16.

88. Mansfield & Parker, *supra* note 16, at 1 (stating that the "locked box mechanism[] rose in popularity in the United Kingdom in the mid-2000's").

89. O'Sullivan et al., *supra* note 5, at 2.

90. O'Sullivan et al., *supra* note 5, at 2. This decline is likely explained by the high levels of economic uncertainty resulting from the financial crisis. Economic risk passes from the seller to the buyer at an earlier date with the LBM than with the CAM. This means that the buyer would absorb any losses in the target following the Locked Box Date without having the ability to adjust the purchase price post-closing. In contrast, economic risk passes from the seller to the buyer at closing with the CAM. This means that the buyer is able to adjust the purchase price post-closing to reflect any losses of the target. During the financial crisis, the value of a firm could drop drastically overnight. Companies in the United Kingdom would have preferred to sacrifice simplicity and efficiency for precision in times of economic uncertainty. Once the market began to stabilize, the LBM began rose to pre-crisis levels just a year later. The LBM and CAM are strategic tools for companies to create value during deal formation, and the companies in the United Kingdom perfectly reflect the benefits of having alternative pricing mechanisms.

91. O'Sullivan et al., *supra* note 5, at 2.

92. *See CMS European M&A Study 2014*, CMS HASCHE SIGLE 5 (2015), http://www.cms-hs.com/Hubbard.FileSystem/files/Publication/43087c2d-6be1-4dd7-acc9-010374c3a216/7483b893-e478-44a4-8fed-f49aa917d8cf/Presentation/PublicationAttachment/0dbf534b-1daa-464a-b13d-1b0eeef47619/MA_Study_2014_ExecutiveSummary.pdf [https://perma.cc/NZ6V-KGW8] (finding that the closing accounts mechanism is used in roughly 85% of United States M&A deals and 43% of United Kingdom M&A deals, suggesting that the locked box mechanism or some other pricing mechanism is used in 15% of United States M&A deals and 57% of United Kingdom M&A deals).

about 15% of deals in the United States.[93]

One justification for the increased use of the LBM in the United Kingdom is that the flight-to-quality assets caused low deal activity, an environment where sellers could better dictate sale terms and rely on the LBM to fix the price of and expedite the deal.[94] This was especially true in private equity deals, and sellers have been able to "resist a shift to the more traditional [CAM] which is perceived as offering a buyer more protection."[95] Additionally, it is important to note that the LBM has spread beyond private equity deals to corporate deals as well, where parties have been able to better tailor the mechanism to their needs.[96]

Following the global financial crisis, the United States market also suffered from low deal activity driven, in part, by a flight-to-quality assets.[97] During this time, the United States and Europe shared similar M&A deal fluctuations post crisis.[98] Where the number of M&A deals in Europe fell by 44.95% during 2007 and 2009 (13,389 deals in 2007 and 7,371 deals in 2009),[99] the United States experienced a 39.72% drop.[100] Where deal value in Europe fell by 72.89% between 2007 and 2009 ($1.4 trillion in 2007 and $379 billion in 2009),[101] the United States experienced a 54.26% drop.[102] If flight-to-quality was the driver for the increased use of the LBM, a parallel phenomenon should have occurred in the United States. However, this was not the case.

This is why the cultural and educational factor was most impactful. Because companies in the United Kingdom were already familiar with the LBM, they could recognize the benefits that came with fixing the price and expediting transactions post crisis. If American companies had this familiarity, they may have also increased their usage of the LBM. But the volatility of the market did not create appropriate conditions for companies to experiment with deal structures that companies were unfamiliar with—

93. *Id*.

94. McGonigle & Weisser, *supra* note 3, at 2. In the context of M&A, flight-to-quality refers to buyers shifting their targets to high-quality, low-risk companies and is the result of uncertainty about the financial markets. By nature, there are less high-quality, low-risk targets than medium- to high-risk ones. Paired with the increased concentration of demand for these targets, the volume of M&A deals during a flight-to-quality market decreases.

95. McGonigle & Weisser, *supra* note 3, at 2.

96. McGonigle & Weisser, *supra* note 3, at 2.

97. *Capital M&A Newsletter: M&A Market Activity Remains Strong Despite Economic Uncertainty*, MACIAS, GINI & O'CONNELL, LLP (2011), http://www.mgocpa.com/idea/capital-ma-newsletter/ [https://perma.cc/E6HS-DBJD].

98. Note that this data compares M&A deals in the United States and Europe generally.

99. WILMERHALE, *supra* note 68, at 3.

100. WILMERHALE, *supra* note 68.

101. WILMERHALE, *supra* note 68, at 3.

102. WILMERHALE, *supra* note 68.

that would have only injected more uncertainty into the chaos. Prudent shareholders and activist investors during this time period may not have been as willing to test new deal structures, but rely instead on structures they were familiar with to reduce risk. Additionally, institutional shareholders represent "more than 70% of the largest 1,000 companies in United States in 2009."[103] Getting them to approve a LBM may have been challenging because savvy institutional shareholders may be more inclined to take the second opportunity to renegotiate a lower price with the CAM. Without being properly educated or having executed an LBM deal before, these institutional shareholders may not have been able to appropriately consider the LBM's efficiency gains and cost savings. On the other hand, there is also high institutional ownership in the United Kingdom and the LBM has continued to remain popular.[104] This suggests that investors in the United Kingdom have not resisted and are comfortable with the benefits of the mechanism. Thus, the cultural unfamiliarity with the LBM is likely the largest factor contributing to its minimal usage in the United States.

With market conditions stabilizing, executives and shareholders favoring M&A transactions, and M&A deal volume increasing, the United States is ready for a new pricing mechanism. Therefore, this Comment addresses what may be the largest hurdle in increasing LBM usage in the United States: the educational and cultural familiarity with the mechanism.

From an educational perspective, this Comment, as a whole, serves to shed light on the LBM. It is difficult to introduce a new system domestically based on international norms. But the more the concept of the LBM is discussed, the more likely a company will experiment with it, and the more frequently the LBM will be used to drive value for companies.

From the cultural perspective, there are noticeable differences between American and British transactions. Specifically, the United States has many more earnout and MAC clauses than the United Kingdom. Earnout clauses appear in roughly 38% of transactions in the United States and only 16% of deals in the United Kingdom,[105] and MAC clauses appear in nearly

103. Ben W. Heineman, Jr. & Stephen Davis, *Are Institutional Investors Part of the Problem or Part of the Solution?: Key Descriptive and Prescriptive Questions About Shareholders' Role in U.S. Public Equity Markets*, COMM. FOR ECON. DEV. & YALE SCH. OF MGMT. 4 (Oct. 2011), http://web.law.columbia.edu/sites/default/files/microsites/millstein-center/80235_CED_WEB.pdf [https://perma.cc/W279-ALFS].

104. Similar to the United States, the United Kingdom also has high institutional ownership. *See* Serdar Çelik & Mats Isaksson, *Institutional Investors and Ownership Engagement*, OECD J.: FIN. MARKET TRENDS 93, 94 (2013), http://www.oecd.org/corporate/Institutional-investors-ownership-engagement.pdf [https://perma.cc/9944-HW8T] (suggesting that 90% of public equity is held by institutional investors).

105. Interview with Mergermarket, *supra* note 57 (discussing the difference in the

all (93%) transactions in the United States, but are rare in the United Kingdom.[106]

First, earnout clauses are contractual solutions to valuation gaps between the buyer and seller that aid the parties in reaching a deal.[107] They allow a seller to receive additional compensation, or part of the purchase price, by meeting certain economic and non-economic benchmarks post-closing.[108] Economic benchmarks may be based on performance indicators, such as "revenue, EBITDA, EBIT, net profit and cash flow from operating activities."[109] Non-economic benchmarks may be based on "official product approval or licensing, total incoming orders or the number of customers."[110] Earnout clauses require the seller to participate in the success of the firm even after economic interest has transferred.[111] A typical earnout period is between one and five years, but may be longer depending on the specific deal.[112]

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prevalence of earnout clauses between the United States and the United Kingdom).

106. WILMERHALE, *supra* note 68, at 17.

107. *See* Brian JM Quinn, *Putting Your Money Where Your Mouth Is: The Performance of Earnouts in Corporate Acquisitions*, 81 U. CIN. L. REV. 127, 130 (2012) (evaluating two theories behind the motivation for earnouts—the adverse selection theory, which states that earnouts help parties uncover hidden information from sellers, and the uncertainty theory, which states that earnouts manage uncertainty by allocating risk to the seller, thereby helping parties reach an agreement—ultimately finding that the uncertainty theory likely prevails).

108. *Share Purchase Agreements: Purchase Price Mechanisms and Current Trends in Practice*, ERNST & YOUNG 4 (2d ed. 2012), http://www.ey.com/Publication/vwLUAssets/EY_TAS_-_Share_Purchase_Agreements_spring_2012/$FILE/EY-SPA%20brochure-spring-2012_eng.pdf [https://perma.cc/T6E7-HCKY]; *Earnout*, INVESTOPEDIA, http://www.investopedia.com/terms/e/earnout.asp?layout=infini.http://www.ey.com/Publication/vwLUAssets/EY_TAS_-_Share_Purchase_Agreements_spring_2012/$FILE/EY-SPA%20brochure-spring-2012_eng.pdf [https://perma.cc/XFV3-KG3N] (last updated 2015); Erik Lopez, *Introduction to M&A Earnouts*, THE M&A LAWYER BLOG (July 10, 2015), https://www.themalawyer.com/introduction-to-earnouts-in-ma-deals/ [https://perma.cc/QTG7-TN6R].

109. ERNST & YOUNG, *supra* note 108. EBITDA refers to earnings before interest, taxes, depreciation and amortization. *EBITDA – Earnings Before Interest, Taxes, Depreciation and Amortization*, INVESTOPEDIA, http://www.investopedia.com/terms/e/ebitda.asp [https://perma.cc/LJ3L-VRA7] (last visited July 27, 2016). EBIT refers to earnings before interest and tax. *Earnings Before Interest & Tax – EBIT*, INVESTOPEDIA, http://www.investopedia.com/terms/e/ebit.asp [https://perma.cc/RXW5-MNUZ] (last visited July 27, 2016).

110. ERNST & YOUNG, *supra* note 108.

111. ERNST & YOUNG, *supra* note 108, at 2.

112. Paul M. Crimmins et al., *Earn-outs in M&A Transactions: Key Structures and Recent Developments*, 10 THE M&A J. 1, 3 (Oct. 2010), https://www.mayerbrown.com/Files/Publication/5b829276-5f8b-4a5a-ad5f-a492e73d6574/Presentation/PublicationAttachment/a5e9717d-c9d1-4c00-be87-828ef83e4776/Earn-outs_MA.pdf [https://perma.cc/Y5XJ-NSY7].

Financially, earnout clauses can be important in striking a balance between what the buyer and seller believe are reasonable purchase prices; they are "a good way of bridging valuation-gaps and different opinions as to how the target company will develop."[113] For instance, imagine a company that is interested in acquiring a privately-held startup. The founder is optimistic about his business and wants to sell today to acquire more capital to fund his expansion.[114] The founder wants $100 million for the company, but the buyer is not convinced of that value even though it is intrigued by the business. The buyer believes the company is worth around $75 million.[115] To strike a balance of interests between both parties, an earnout clause allows the buyer to pay $50 million up front and up to $50 million contingent on the acquired company meeting certain financial benchmarks. Earnout clauses may be particularly valuable for financial deals where the buyer (i.e. a private equity firm) may not necessarily have the expertise to best manage the acquired company by keeping the sellers interested in the acquired company's short-term performance post-closing.[116] This is not to say that economically-based earnout clauses are any less important for strategic transactions as well, as the earnout can motivate managers and directors from the acquired company to ensure its economic health.

Earnouts with non-economic benchmarks are equally important. For instance, in a strategic transaction, a buyer may be interested in particular purchase orders to expand its influence over a particular geographic market.[117] Striking a deal contingent on the fulfillment of these purchase orders would have a significant impact on the purchase price. Agreeing to an earnout clause helps alleviate disagreements over purchase price because of such non-economic factors, and it structures a more complete transaction.

Moreover, earnout clauses must be drafted carefully as both the buyer and seller have competing incentives. During the earnout phase, the seller wants the acquired company to hit the agreed-upon economic or non-

113. ERNST & YOUNG, *supra* note 103, at 8. *See Paul Crimmins et al., Earnouts in M&A Transactions*, MAYER BROWN 3 (June 22, 2011), https://www.mayerbrown.com/public_docs/06-22-11_CorpSec_Webinar_Earnouts.pdf [https://perma.cc/NPJ9-5G6L] (stating that "[e]arnouts can bridge . . . valuation gap[s] between an optimistic seller and a skeptical buyer").

114. Lopez, *supra* note 108.

115. Lopez, *supra* note 108.

116. Anne Field, *How to Survive an Earnout*, BLOOMBERG (June 20, 2005 12:00 AM), http://www.bloomberg.com/bw/stories/2005-06-19/how-to-survive-an-earnout [https://perma.cc/WK7Q-XE67].

117. *See* ERNST & YOUNG, *supra* note 108 at 4 (noting that incoming orders may be used as a non-economic benchmark).

economic benchmarks so that it can receive the additional payments. The buyer, on the other hand, does not want these benchmarks to be reached in order to minimize its payments to the seller. To address this concern, covenants play an important role in protecting the interests of the parties. For instance, the seller will want to negotiate a covenant that prevents the buyer from diverting revenue from the acquired company that would prevent the benchmark from being met.[118]

Second, a MAC clause[119] is a way for parties to "allocate who will bear the risk" in a transaction should a materially adverse change occur between signing and closing.[120] A MAC clause "is the catchall provision"[121] that "permits an acquirer to refuse to complete the transaction if a material and adverse change, as defined in the acquisition agreement, occurs to an acquiree prior to the time of completion of the acquisition."[122] Buyers may also invoke MAC by "taking advantage of either changed market conditions or adverse events affecting the target company"[123] to renegotiate the deal, which may lead to a lowered price or restructuring.[124] When buyers invoke a MAC clause, sellers have an incentive to settle at a lower price because they do not want to go through the hassle of litigation and because "the seller and its shareholders are typically happy to take the lower premium than risk litigation and an adverse decision resulting in no

118. It is important for the seller to draft these covenants carefully. For instance, a seller would not want to include language requiring the buyer to have "intent" to divert revenues for the purpose of reducing the earnout payments. A seller would prefer to maintain a lower standard and eliminate reference to buyer intent because intent is difficult to prove in litigation. Lazard Tech. Partners, LLC v. Qinetiq N. Am. Operations LLC, 114 A.3d 193, 194 (Del. 2015) (finding that the buyer had not breached the covenant preventing the buyer from "divert[ing] or defer[ing] [revenue] with the intent of reducing . . . the Earn-Out Payment" because the covenant required proof that the buyer acted "with the intent" to reduce the payment—a high standard that the seller failed to prove).

119. Also referred to as a materially adverse event (MAE) clause.

120. Steven Davidoff Solomon, *The MAC Is Back, but Does It Kill a Deal?*, N.Y. TIMES: DEALBOOK (Aug. 23, 2011 3:45 PM), http://dealbook.nytimes.com/2011/08/23/the-big-mac-is-back-but-does-it-kill-a-deal/ [https://perma.cc/23N4-W8AY]. *See also* Robert T. Miller, *The Economics of Deal Risk: Allocating Risk Through MAC Clauses in Business Combination Agreements*, 50 WM. & MARY L. REV. 2007, 2012 (2009) (evaluating how parties use MAC clauses to allocate deal risk based on existing theories of risk like the Gilson and Schwartz Investment Theory and a new theory proposed by the author, Professor Miller).

121. STEVEN M. DAVIDOFF, GODS AT WAR: SHOTGUN TAKEOVERS, GOVERNMENT BY DEAL, AND THE PRIVATE EQUITY IMPLOSION 56 (2009).

122. Steven M. Davidoff, *The Failure of Private Equity*, 82 S. CAL. L. REV. 481, 499 (2009)(internal citation omitted).

123. Solomon, *supra* note 120.

124. Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions*, 119 YALE L.J. 848, 869 (2010).

deal at all."[125] The buyer is also pushed to settle because it does not want to risk losing litigation (and thus the cost of litigating) and paying the original purchase price.[126] Thus, the MAC clause is actually a powerful "renegotiation tool"[127] rather than a get-out-of-jail-free card, a point reinforced by the rarity of court enforcement.[128]

MAC clauses, like earnouts, must be drafted carefully. They typically "describe (1) what must be materially adversely affected to constitute a MAC and (2) which effects will be disregarded in assessing whether a MAC has occurred."[129] Defining a materially adverse change, in practice, is difficult. The buyer will try to negotiate a broad definition of a materially adverse change to provide "leeway" to get out of a deal.[130] The seller will conversely try to negotiate a narrow definition to shift as much risk as possible on the buyer.[131] Generally, parties should negotiate a definition that specifies particularized conditions that may affect the business and include carve-outs for general changes in the economy or the target's industry—risks that are traditionally born by the buyer.[132] Even though MAC clauses have become rather standardized over the last few years and less time has been spent negotiating over terms,[133] defining materially adverse remains a challenge. For example, Delaware courts, where most MAC clause litigation is brought,[134] have never found a materially adverse change[135] and require such change to be in a "durationally-significant manner," a high standard to meet.[136] However, this understanding still provides little guidance. Is one year enough or must it be two? Even with the challenges in defining materially adverse changes, MAC clauses appear in "virtually all [American] acquisition agreements"[137] and are an important part of agreements in the United States.

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125. Solomon, *supra* note 120.
126. Solomon, *supra* note 120.
127. Solomon, *supra* note 120.
128. Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008) ("Many commentators have noted that Delaware courts have never found a materially adverse [change] to have occurred in the context of a merger agreement.").
129. Katherine Ashton et al., *MAC Clauses in the UK and U.S.: Much Ado About Nothing?*, DEBEVOISE & PLIMPTON: INSIGHTS & NEWS (2013), http://www.debevoise.com/insights/publications/2013/12/mac-clauses-in-the-uk-and-us——-——much-ado-abo__ [https://perma.cc/4L7T-KQ7V].
130. DAVIDOFF, *supra* note 121.
131. DAVIDOFF, *supra* note 121.
132. Ashton et al., *supra* note 129.
133. Ashton et al., *supra* note 129.
134. Solomon, *supra* note 120.
135. *Supra* note 128.
136. In re IBP, Inc. S'holders Litig., 789 A.2d 14, 68 (Del. Ch. 2001).
137. Ashton et al., *supra* note 129.

Earnout clauses and MAC clauses are important to the culture of M&A deals in the United States, but are less so in the United Kingdom,[138] which may be part of the reason why the LBM has not gained popularity in the United States. However, the LBM can be modified to better meet the expectations of buyers and sellers.[139] Thus, modifying the LBM to reflect transactions in the United States can increase the use of the LBM domestically.

III. MODIFYING THE LBM FOR THE UNITED STATES

The market is ready for a new pricing mechanism. To persuade more American companies to use the LBM and reap the benefits that British companies have been enjoying for years (i.e. time and cost efficiency, price certainty, simplicity, and the ability to better meet party preferences), the mechanism must conform to the cultural deal expectations of American companies. The LBM structure is flexible and has already been modified in the United Kingdom to better meet party preferences.[140] Therefore, the LBM can be adapted for use in the United States, specifically, by structuring in MAC and earnout clauses.

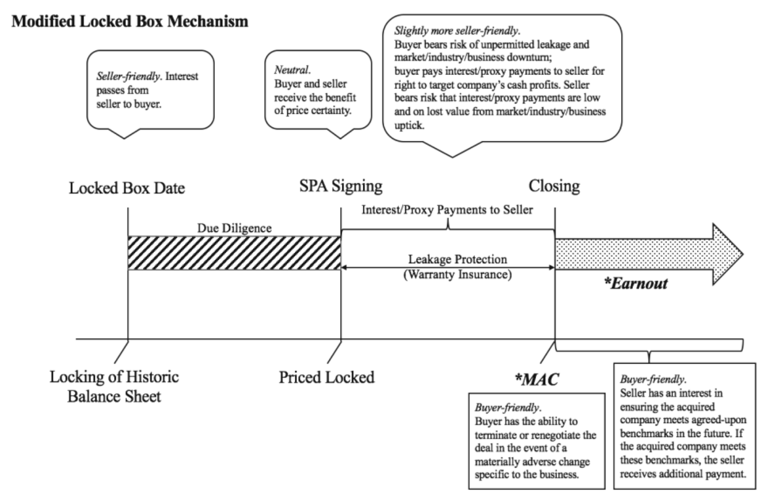

FIGURE 2.[141]

138. CMS HASCHE SIGLE, *supra* note 3, at 5; Interview with Mergermarket, *supra* note 57.
139. McGonigle & Weisser, *supra* note 3, at 2.
140. McGonigle & Weisser, *supra* note 3, at 2.
141. Created by author.

As previously stated, the M&A deals in the United Kingdom rarely have MAC clauses and include earnouts less frequently than in the United States. Structuring the LBM to include these two provisions would better represent transactions in the United States. The foundation of M&A pricing mechanisms in the United States is the CAM, which allows the buyer to make post-closing adjustments to reflect financial changes in the target company. This leaves the control in the buyer's hands, giving the buyer the opportunity to renegotiate a lower purchase price. As a result, the CAM is generally viewed as buyer-friendly.

Because the United States M&A market is accustomed to a buyer-friendly mechanism, buyers may be reluctant to give up control through the use of a seller-friendly mechanism. Even when the flight-to-quality in the United Kingdom likely caused an increase in the use of the LBM, the LBM was not readily adopted in the United States. This left sellers in the United States, who would have had more negotiating power due to the mismatch between the number of buyers and the scarce amount of quality assets they were willing to purchase, with only the ability to negotiate better terms under a CAM rather than allowing them to negotiate a stronger fixed-price position.

To get more parties to use the LBM in the United States, it would seem appropriate to address buyer concerns over the seller-friendly aspects of the LBM. This is where the inclusions of MAC and earnout clauses serve a double purpose: they both structure the LBM to conform to the expectations of American companies and, in doing so, they balance out the seller-friendly nature of the mechanism.

For a buyer, fixing the price at the SPA signing date can be risky. Should the business suffer a downturn between signing and closing, the buyer is unable to adjust the purchase price to reflect the then-current value at closing.[142] Structuring in a MAC clause allows the buyer to walk away from the deal or renegotiate the price should a pre-defined materially adverse change occur to the company. This is an important failsafe and negotiation tool for the buyer and provides the buyer with some leverage. This is not a perfect solution, as non-materially adverse changes that negatively impact the target company will still be borne by the buyer. However, if the target company is performing better after the Locked Box Date, the buyer will reap both the cash profits and the benefit of a lower relative purchase price because it was fixed at signing. As with any choice, there will be tradeoffs. Further, if a buyer in a particular deal values the efficiency of the LBM and does not want the hassle of potential post-

142. See *supra* text accompanying note 90 for a related discussion on the real-world implications of being unable to adjust the purchase price post-closing.

closing adjustment disputes, the MAC clause can be a valuable tool for the buyer to retain more control over the deal—swinging the pendulum a little further away from the seller-friendly end of the spectrum towards the neutral center.

Some argue that the MAC clause is at odds with the theory behind the LBM, which is a possible reason why MAC clauses are rare in the United Kingdom.[143] Because risk passes from the seller to buyer at the Locked Box Date and the buyer is entitled to the cash profits of the target business during the executory period, "it arguably follows that the buyer should bear the risk of a MAC occurring in that period."[144]

The buyer should bear the risk of downturns in the target business during this period, but the buyer should not bear the risk of a materially adverse change occurring. First, typical MAC clauses in the United States carve out downturns in the target business's industry or in the market as a whole. This risk is still borne by the buyer. This makes sense because the buyer receives the benefit of price certainty (i.e. no need to raise additional capital should the purchase price increase,[145] less disputes over post-closing adjustments, less time spent drafting the SPA, etc.) and the benefit of cash profits during the period. If the buyer bore no financial risk of any downturn in the target business, the mechanism would be unfair and no seller would agree to it. This conforms to the classic notion of *caveat emptor*.[146] Second, although the buyer should bear some risk, it should not bear all the risk. If there were no MAC clause in an agreement and the target company underwent a materially adverse change, there could be virtually no value to the target company, and thus, no purpose in the acquisition or merger. The buyer would incur monumental losses in an unfair transaction. As a matter of policy, the MAC clause prevents two companies in an M&A agreement from failing should one party fail. Third, a materially adverse change is rarely found even when a MAC clause is present. Recall that the Delaware courts have *never* found a materially adverse change.[147] Only in dire circumstances will a court find that a MAC has occurred. But this is not a clause without teeth. If a major event happens to the target company, a buyer may use the MAC clause as a renegotiation tool to get to a fairer purchase price. Thus, the MAC clause

143. Ashton et al., *supra* note 129.
144. Ashton et al., *supra* note 129.
145. O'Sullivan et al., *supra* note 5, at 5.
146. *Caveat emptor* translates to "let the buyer beware" and is a commonly referred to adage in contract law. It suggests that the buyer should assume the risk associated with his purchase. *Caveat Emptor*, CORNELL UNIVERSITY LAW SCHOOL, https://www.law.cornell.edu/wex/caveat_emptor [https://perma.cc/5BF2-YL8T] (last visited June 26, 2016).
147. Solomon, *supra* note 120.

protects the buyer or gives the buyer breathing room in extreme cases; the buyer still bears the risk of loss under normal operating conditions.

In addition to including a MAC clause, structuring in an earnout clause can better reflect the expectations of American parties and shift the pendulum even closer toward neutral ground between buyer- and seller-friendliness. The earnout clause provides the buyer with the comfort that the acquired company will trend toward the projections the original purchase price was based off of. This clause keeps the seller honest. The seller may be able to upsell or hide certain weaknesses during negotiation, but the earnout provides additional incentive for the seller to maintain an interest in the progress of the acquired company. The earnout also provides a balance to the price fixing at SPA signing. If a buyer believes the seller is overvaluing the company unreasonably, the buyer can rely on the earnout to structure a fair price for both parties. The buyer would negotiate a lower initial purchase price and pay additional compensation to the seller contingent on the subsequent performance of the acquired company.[148] This shifts more control and assurance to the buyer and can make an upfront fixed price seem more reasonable.

It can be argued that an earnout clause complicates what is supposed to be a simpler pricing mechanism. Where the LBM seeks to reduce disputes based on post-closing adjustments, the earnout can be effectively seen as the same: adjustments to the purchase price are made after closing and disputes may arise over how to calculate or whether certain benchmarks have been met. This may also suggest that the net effect of the earnout clause is the same as having post-closing adjustments: the total cost to purchase a target company is amended based on performance.

This concern does not exist for non-economic benchmarks, where payment is contingent on conditions like licensing or purchase orders being met. This is pretty straightforward because the condition is either met or it is not met. The situation gets complicated when discussing economic benchmarks. There are parallels between the earnout and post-closing adjustments, but these parallels only go so far. First, it is important to consider the potential effects of both post-closing adjustments and earnout clauses. The net effect of post-closing adjustments is more material to the overall transaction than an earnout clause. A dispute over post-closing adjustments can significantly delay a deal because it affects the final closing price of a transaction. A dispute over whether a target company has reached a projected benchmark does not delay a deal because the deal has already closed at a set purchase price. The contingent payments are an opportunity for the seller to receive more money based on the continued

148. See previous example, *supra* page 45.

performance of the acquired business; disputes have nothing to do with whether or not a deal closes. Second, it is true that including an earnout clause adds an extra degree of complexity to the LBM. However, in order to customize the mechanism to meet American expectations, modifications must be made. The LBM, in its simplest form, has not spread across the United States, and American companies are missing out on the benefits the mechanism has to offer. To make the mechanism more appealing to American parties requires a bespoke approach. Modifications will inevitably add a degree of complexity to the LBM template, but the benefits of the mechanism remain the same when compared to a CAM deal that also has an earnout clause, which further complicates an already complex mechanism. And third, I believe that the buyer should work to negotiate a shorter earnout period with the seller unless inappropriate (a short earnout period may not be possible for certain non-economic benchmarks like patent approval). The spirit of the LBM is to facilitate deals. Keeping a seller on the hook for greater than five years is a long time to await potential payment.

An earnout clause may not be appropriate in every deal and it may be more appropriate in certain types of deals than others. For instance, earnouts are especially popular with private equity transactions where the private equity buyer may not have the expertise at the time of purchase to run the company.[149] However, earnouts also exist in strategic deals as well. This discussion does not fix an earnout clause in every modified LBM deal in the United States; it simply suggests that an earnout clause come standard in the agreement. Parties can choose to negotiate the clause out if needed.

A modified LBM for the United States would include both MAC and earnout clauses as standard. This shifts some control back towards the buyer's perspective, making the LBM more neutral rather than seller-friendly. These clauses will make the LBM more reflective of transactions in the United States and provide more comfort to buyers who are accustomed to a more buyer-friendly pricing mechanism. The LBM, as popularized in the United Kingdom, has not become popular in the United States. Hopefully, these suggestions will help companies consider using the modified LBM as a value-creating mechanism in future M&A transactions.

IV. CONCLUSION

The LBM is not used with any frequency in the United States but is

149. Field, *supra* note 116.

popular in the United Kingdom. Many factors have contributed to this discrepancy including unstable market conditions and cultural unfamiliarity with the mechanism. Because the market has stabilized, American companies are well positioned to explore the benefits of the LBM: time and cost efficiency, price certainty, simplicity, and the ability to better meet party preferences. Thus, this Comment sought to familiarize readers with the LBM and suggest modifications to the mechanism that would better meet the expectations of American companies, which will hopefully have the effect of increasing LBM usage in M&A deals in the United States. In an industry steeped in complexity, a method based on efficiency and simplicity can have profound transactional benefits; all that is required is some "in the box" thinking.