Popularity of Locked-Box Deals in the UK: Price Certainty, Other Benefits for Buyers

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In the U.K. M&A market, the continuing trend in recent years has been an increase in the number of deals being completed on the basis of a locked-box pricing mechanism. In a locked-box transaction, as opposed to the completion accounts mechanism, the target's equity value is determined prior to signing and is not subject to any post-completion adjustment.

Locked-box pricing mechanisms generally are considered to be, on balance, more seller-friendly than a completion accounts mechanism, in which parties agree on a price that may be adjusted at completion based on the target's levels of cash, debt and working capital at completion. It is this post-completion adjustment that creates price uncertainty for a seller on completion account deals. However, in our experience, insofar as the "box" is tightly "locked," a locked-box price mechanism also can be an effective price mechanism for buyers as a result of greater price certainty.

Overview

In its simplest incarnation, a locked-box transaction is a fixed-price deal. The price is determined from a historical set of locked-box accounts and is not subject to any post-completion adjustment. These accounts constitute the box, *i.e.*, they represent what the buyer is acquiring. Any benefit or liability that accrues after the locked-box date (that is, the reference date of the locked-box accounts) is the buyer's, such that the buyer assumes the risk or reward of the target's performance from the locked-box date, *i.e.*, it essentially buys the target on that date.

The box is locked by a "no leakage" covenant or indemnity, whereby the buyer is made whole for any value "leaked" from the box after the locked-box date for the benefit of the seller or its related parties.

Locked-Box Accounts

The locked-box accounts may be audited or unaudited. There are two fundamental aspects for a buyer that go to the heart of whether such accounts are good enough to rely on as locked-box accounts: proximity to signing and independent review. Buyers typically are wary of locked-box accounts that have not been completed within six months of signing. The longer the gap, (i) the more likely it is that the performance of the target's business may have fundamentally changed or that something may leak out of the box, and (ii) the greater the financial due diligence buyers will have to carry out to make themselves comfortable.

An audit, or some lesser form of independent review, can be important to address any concern about locked-box accounts being prepared by the seller. In recent years, buyers in the U.K. M&A market have been more accepting of unaudited locked-box accounts due to the sellers' trend of mandating that independent accounting firms prepare vendor financial due diligence reports on these accounts upon which buyers rely. Necessity also has played a role, since appropriate audited accounts often are not available, particularly when only part of a corporate group is being sold or certain assets are being excluded from the transaction.

Leakage

Leakage protection is the lock that protects the buyer from the seller extracting value from the business after the locked-box date. For the buyer to be adequately protected, leakage should be defined to catch the different ways the seller can extract value from the target, from the most obvious (*e.g.*, dividends or by having the target incur sell-side or transaction-related costs/expenses) to others that are not as evident (*e.g.*, assumption/discharge of seller's liabilities or waiver of liabilities seller owes the target, management fees, transaction-related bonuses to employees, or transfer of assets at an undervalue). It also is important that the recipient of such benefit include the seller's related parties, and that the related parties be defined broadly enough to capture any mechanisms by which a seller could indirectly extract value from the business. The leakage indemnity generally is not subject to any limitations (monetary or otherwise) on a buyer's ability to make a claim against the seller, save for the time period for such claims typically being between three and 12 months post-completion.

Interest

In a locked-box deal, although the buyer essentially acquires the target as of the locked-box date, sellers do not receive the consideration until completion. Therefore, they often demand to be compensated for this opportunity cost by applying interest on the equity value from the locked-box date to completion. Buyers should measure risk against: (i) the (expected) gap between signing and completion, and (ii) the volatility of the business. If the business is volatile or particularly sensitive to seasonality and completion is a long way off, a locked box may not be ideal. Buyers should be clear in any letters of intent or bid letters whether they are prepared to pay such interest.

Share Purchase Agreement

A locked-box share purchase agreement (SPA) tends to be simpler than a completion accounts agreement. The latter entails lengthy and often very difficult and technical negotiations around the provisions, accounting policies and principles governing the preparation of the completion accounts. In addition, there are customary provisions that assume a different role and possibly are of greater importance depending on whether the deal is locked-box or completion-accounts based.

The main example is interim covenants and warranties. In a locked box, interim covenants — especially restrictions attached to the conduct of business and the type of transactions and amounts the target can undertake — become paramount to ensure the contents of the box do not fundamentally change. First, because the buyer would want to retain greater control over a business that for all intents and purposes it has already acquired, buyers in the U.K. tend to get a stronger set of interim covenants than they would on a completion accounts deal. Second, and more specifically, the buyer would want more stringent limits on incurrence of debt/expenditure because there won't be any post-completion adjustments. Similarly, there are warranties that are more significant in a locked-box deal. For example, the "events since the accounts date" warranty that, in a locked box, is conceived to bridge the gap between the locked-box date and the signing date is key, and buyers generally seek audit-standard warranties on the locked-box accounts even if they are unaudited.

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The popularity of locked-box deals in the U.K. is continuing to rise, and we believe this trend will continue as buyers (and sellers) appreciate the benefits of price certainty, speed of execution and simplicity. Buyers also are getting more comfortable addressing concerns over locked-box deals through enhanced due diligence on the relevant accounts (including unaudited locked-box accounts) and reliance on available interim covenants/warranties under SPAs.