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Robert S. Reder

William Pugh

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DELAWARE CORPORATE LAW BULLETIN

Delaware Supreme Court Bars Buyer From Using Narrowly-"Cabined" Working Capital Adjustment To Attack Seller's Alleged Non-Compliance With GAAP

Robert S. Reder

Professor of the Practice of Law at Vanderbilt University Law School. Professor Reder has been serving as a consulting attorney at Milbank, Tweed, Hadley & McCloy LLP in New York City since his retirement as a partner in April 2011.

William Pugh

Vanderbilt University Law School, J.D. Candidate, May 2019.

Focuses on both language of purchase agreement and underlying economic rationale in reversing lower court decision

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INTRODUCTION

When sellers and buyers successfully negotiate the terms for the sale of a significant business, they memorialize the fruits of their negotiations in a purchase agreement that typically contemplates a "delayed closing." In other words, buyer and seller *sign* the purchase agreement to create binding legal obligations when the negotiations are completed, but recognize they cannot consummate, or *close*, the transaction until certain specified conditions, such as receipt of necessary regulatory approvals and clearances, have been satisfied. Only then—at the "closing"—will ownership of the target business actually change hands.

In transactions subject to a "delayed closing," there is an interim period where buyer has a conditional purchase obligation while seller continues to operate the business. Because the purchase price is determined at signing, it is in buyer's interest to negotiate contractual provisions designed to ensure that the target business does not change materially while the parties await regulatory clearance and satisfaction of other closing conditions. For instance, sellers generally are required to operate the target business in a manner consistent with past practice.

In this connection, the parties often negotiate which of them is entitled to the benefits of, or bears responsibility for, unexpected profits or losses associated with these interim operations. Typically this is effectuated *via* a post-closing "working capital adjustment" providing for payment by one party to the other to the extent net working capital as of *the closing date* either exceeds or falls short of a targeted amount identified at *the time of signing*. Working capital serves as a proxy for the financial results of the target business for the interim period, and generally reflects the difference between the business's "current assets" (*i.e.*, cash and cash equivalents, accounts receivable, inventory, *etc.*) and "current liabilities" (*i.e.*, short-term debt, accounts payable, accrued expenses, *etc.*). The typical working capital adjustment includes a procedure for appointment of a neutral third party, usually an accountant, to resolve disputes arising from the process, typically referred to as a "true up."

It also is common in transactions of this nature for seller to make representations and warranties to buyer concerning the target business, including as to its historic financial statements and their compliance with "Generally Accepted Accounting Principles" ("GAAP"). These representations and warranties serve as enforceable promises as to the condition of the target business as of specified dates. The parties also typically negotiate provisions by which seller will indemnify buyer,

post-closing, if buyer incurs losses resulting from breach of any of these representations and warranties. While seller would prefer the representations and warranties not to survive closing, meaning there will be no opportunity for buyer to claim a breach if the transaction closes, generally the best seller can do is to negotiate limits on its post-closing indemnity obligations, such as duration, mini-baskets, thresholds and deductibles, caps, mitigation, *etc.*

No matter the degree of diligence exercised by corporate counsel in drafting working capital adjustments and indemnification limitations, disputes frequently arise, sometimes resulting in litigation. For instance, in June 2017 in *Chicago Bridge & Iron Company N.V. v. Westinghouse Electric Company LLC*, 166 A.3d 912 (Del. 2017) ("*Chicago Bridge*"), the Delaware Supreme Court considered what types of disputes a buyer could shoehorn into a true up negotiated as part of a post-closing working capital adjustment. Specifically, buyer, under the guise of a dispute relating to the calculation of working capital, sought to attack seller's compliance with GAAP in presenting the historic financial condition and results of operations of the target business. While this in not the first time questions of this nature have come before the Delaware courts, the issue addressed in *Chicago Bridge* was especially high stakes because the purchase agreement, atypically, barred buyer from pursuing seller, post-closing, for damages for breach of its representations and warranties, including financial statement compliance with GAAP.

Chicago Bridge provides a well-reasoned analysis, authored by Chief Justice Leo E. Strine, Jr., of the relationship between these elements of a purchase agreement between a sophisticated buyer and seller. The opinion's careful parsing of the language employed in the purchase agreement, as well as the close attention paid to the background and economic rationale for the transaction, demonstrates the premium placed on careful and complete drafting of commercial arrangements. Corporate counsel must not only understand the particular needs and viewpoints of their clients in negotiating a transaction, but carefully reflect the results of those negotiations in drafting the related documentation. Otherwise, unintended consequences are sure to follow.

II. FACTUAL BACKGROUND

A. The Transaction

The economic relationship underlying *Chicago Bridge* was "unusual in a few key respects." Chicago Bridge & Iron Company N.V.

("CB&I") and Westinghouse Electric Company LLC ("Westinghouse") were collaborating on the construction of two nuclear power plants, "the first new nuclear power plants built in the U.S. in over thirty years and the first to be built under a new regulatory regime." CB&I engaged in this collaboration largely through its engineering and construction subsidiary, CB&I Stone & Webster, Inc. ("Stone"), which constructed the plants based on designs prepared by Westinghouse. Due in part to "regulatory-driven design changes" to the power plants, the projects incurred significant cost overruns, time delays, and potential liabilities for both Westinghouse and Stone. Predictably, under the weight of these developments, the relationship between CB&I and Westinghouse soured. To settle their differences over who would bear ultimate responsibility for the cost overruns and potential liabilities, on October 27, 2015, CB&I agreed to sell Stone to Westinghouse pursuant to a Purchase Agreement (the "Agreement").

The Agreement did not adhere to the typical conventions between buyers and sellers, but rather reflected the unique economic arrangement the parties sought to achieve:

First, the Agreement provided for a purchase price of zero dollars ($0), reflecting that Stone had *both* operating assets *and* significant potential liabilities. To preserve the economics of the transaction between signing and closing, CB&I agreed to continue operating Stone in the ordinary course of business, thereby requiring CB&I to cover the costs of ongoing construction through a combination of cash injections or depletion of Stone's cash reserves. To account for changes in Stone's financial position between signing and closing, the Agreement included a working capital adjustment premised on a closing net working capital target of $1.174 billion (the "Target"). If Stone's closing net working capital exceeded the Target, then Westinghouse would owe such excess to CB&I, and *vice versa* if Stone's closing net working capital was less than the Target.

The Agreement defined working capital as "Stone's current assets less current liabilities '*solely* to the extent such assets and liabilities are described and set forth on <u>Schedule 1.4([f])</u>.'" Further, and presumably to avoid disputes over the accounting methodologies used to calculate closing net working capital, the Agreement directed that closing working capital statements be "prepared and determined from the books and records of [CB&I] and in accordance with United States generally accepted accounting principles ("<u>GAAP</u>") *applied on a consistent basis throughout the periods indicated and with the Agreed Principles* [set forth on <u>Schedule 1.4([f])</u>]." To resolve any disputes that might arise over calculation of the working capital adjustment, the Agreement provided for appointment of "an independent auditor who

was to act 'as an expert and not as an arbitrator.'" The auditor, in an expedited thirty-day timeframe for dispute resolution, was required "to rely on the parties' written submissions as the sole basis for its decisions." The contractually-agreed procedure for calculating the working capital adjustment was referred to as the "True Up."

Second, CB&I agreed to sell Stone for $0 in exchange for what it hoped would be a "clean break from the spiraling costs of the nuclear projects." This "clean break" was memorialized largely in two provisions of the Agreement: (i) a "Liability Bar" providing that the representations and warranties made by CB&I in the Agreement relating to Stone and its business and financial condition *would not survive* the closing and, consequently, CB&I would have no post-closing liability to Westinghouse for breaches of those representations and warranties, and (ii) indemnification by Westinghouse to for "all claims or demands against or Liabilities of [Stone]" incurred by CB&I. Westinghouse's sole contractual remedy for breach of CB&I's representations and warranties—at least to the extent any such breach was discovered before the transaction was completed—was to refuse to close. Section 10.3 of the Agreement further provided that the Liability Bar and indemnification provisions would not otherwise "limit the rights of [Westinghouse] under the Purchase Agreement."

B. The Dispute

Between signing and closing, consistent with the Agreement's requirement that it operate Stone in the ordinary course, CB&I invested approximately $1 billion in Stone. This resulted in a significant *increase* in Stone's working capital. Following closing on December 31, 2015, and as part of the True Up, Westinghouse notified CB&I that closing net working capital fell far short of the Target and, as a result, CB&I owed Westinghouse nearly $2 billion. The vast majority of this shortfall related to the "proposition that Chicago Bridge's historical financial statements—*i.e.*, the very ones on which Westinghouse could make no post-closing claim—were not based on a proper application of [GAAP]." Only approximately $70 million of this amount were "issues that involve[d] a change in fact or circumstance that arose between signing and closing . . . ."

CB&I rejected this claim to the extent it related to Westinghouse's assertion that CB&I was not GAAP-compliant, characterizing it as an attempt by Westinghouse to use the True Up as an end around the Liability Bar. Westinghouse countered that Section 10.3 of the Agreement's statement that the Liability Bar and related provisions shall not "interfere with or impede the operation of" the True

Up gave it a green light to argue to the auditor that CB&I's working capital calculation was not GAAP-compliant.

In anticipation that Westinghouse would urge the auditor to factor the GAAP non-compliance claims into the True Up, CB&I asked the Delaware Court of Chancery (the "Chancery Court") to issue a judgment declaring it inappropriate for the auditor to do so. To allow Westinghouse to challenge GAAP compliance would, in CB&I's view, "render[ ] meaningless the Purchase Agreement's Liability Bar." When the Chancery Court sided with Westinghouse and denied CB&I's requested relief, CB&I appealed.

II. CHIEF JUSTICE STRINE'S ANALYSIS

Chief Justice Strine began his analysis by summarizing the competing arguments before the Court:

For its part, CB&I "conceives of the True Up as a limited procedure ... to account for changes in Stone's business during the period from signing to closing and maintain the benefit of the deal they struck."

Westinghouse, on the other hand, "argues that the True Up is a process for resolving any disagreement over the calculation of the final purchase price, not limited to the calculation of the Net Working Capital Amount.... [T]he fact that Westinghouse's objections to Chicago Bridge's calculation of the Net Working Capital Amount could have also been claims for a breach of Chicago Bridge's GAAP representation ... is irrelevant...."

The Chief Justice sharply disagreed with Westinghouse's broad construction of the True Up and reversed the Chancery Court judgment. His brief but pointed characterization of Westinghouse's position is especially telling: "Put bluntly, Westinghouse alleges that it gave up nothing in the Liability Bar because, through the True Up, it could seek monetary payments by alleging that Chicago Bridge's historical accounting treatment wasn't GAAP compliant."

In so ruling, the Chief Justice focused *both* on the parties' economic rationale for the transaction as well as his interpretation of the specific language of the Agreement:

A. Economic Rationale

According to Chief Justice Strine, "the crux of this deal was that Chicago Bridge was done with the nuclear projects. It would get no profit for selling Stone—as of closing—but the Liability Bar [and] indemnity ... meant Chicago Bridge would at least be rid of liability for

the still-spiraling costs of the projects, a privilege that was valuable in this context."

Consistent with this view, the Chief Justice explained that the True Up should be "viewed in proper context [as an] important, but narrow, subordinate, and cabined remedy available to address any developments affecting Stone's working capital that occurred in the period between signing and closing." Thus, the True Up's role was to "address issues that might come up if Chicago Bridge tried to change accounting practices midway through the transaction or if it stopped work on the projects, rather than to continue to invest as expected."

The Chief Justice highlighted the provisions of the Agreement which memorialized CB&I's rationale for accepting a $0 purchase price for Stone:

The Liability Bar was "unusual [because] virtually all private deals provid[e] for some post-closing survival of representations and warranties." However, Chicago Bridge was supposed to have "no liability for monetary damages after Closing" and, accordingly, the "representations ... made by Chicago Bridge would not survive closing."

Rather than following the usual convention of seller indemnifying buyer for problems arising with the purchased business, "the Purchase Agreement required [the buyer] Westinghouse to indemnify [the seller] Chicago Bridge ... for claims related to Stone." Further, this broad and "unusual provision" required indemnification "regardless of where or when or against whom such claims, demands or other Liabilities are asserted or determined or whether asserted or determined prior to, on or after signing or closing."

Ultimately, "Westinghouse concedes [that], 'the majority' of its claims [did] not arise from changes in Stone's business between signing on October 27 and closing on December 31." Instead, the primary disputes related to GAAP-compliance of CB&I historic financial statements. In fact, the issues underlying the disputed items (*e.g.*, that Stone allegedly understated its contractual liabilities to complete the underlying nuclear projects) propelled CB&I to bargain for the Liability Bar and indemnity provisions.

The Chief Justice refused to allow Westinghouse effectively to argue "it gave up nothing in the Liability Bar" by using the "True Up [to] seek monetary payments by alleging that Chicago Bridge's historical accounting treatment wasn't GAAP compliant." There could be no "new assessment of ... historical practices' compliance with GAAP." Rather, Westinghouse's sole remedy for a disagreement over CB&I's past GAAP compliance was to refuse to close; *not* to use the True Up to raise that issue post-closing.

B. Interpretation of the Agreement

Chief Justice Strine concluded the Agreement was drafted consistent with the parties' economic rationale. He "agree[d] with both Chicago Bridge and Westinghouse that the Purchase Agreement is unambiguous when read in full and situated within the commercial context between the parties." However, he "conclude[d] that Chicago Bridge's reading of the contract is the proper one and that Westinghouse's interpretation of the True Up, which the Court of Chancery adopted, cannot be reconciled with [the] Purchase Agreement when interpreted consistently in its entirety."

Westinghouse argued the Agreement's requirement that working capital statements prepared in connection with the True Up be "prepared and determined from the books and records of [Stone] in accordance with [GAAP]" gave it grounds to challenge the GAAP-compliance of the working capital calculations. The Chief Justice disagreed, noting that the Agreement *also* required that (i) GAAP be "applied on a consistent basis throughout the periods indicated," and (ii) "Working Capital ... will be determined in a manner consistent with GAAP, consistently applied by [Stone] in preparation of the financial statements of the Business, as in effect on the Closing Date." Accordingly,

"when read together, these parts of the Purchase Agreement require Westinghouse and Chicago Bridge to continue using the accounting approach Chicago Bridge had been using in the normal course of business before the transaction for the calculations up to and through closing. This makes sense when considering the whole point of these statements. They are not to aid Westinghouse's investigation of the business or to otherwise provide a historical picture of Stone's operations. Rather, they account for changes in Stone's business from the time the Purchase Agreement was agreed on until closing. Thus, keeping all other variables constant in terms of accounting is crucial."

Chief Justice Strine also characterized the non-survival of representations and warranties—particularly "the financial statement representation ... the most important representation in a typical purchase agreement"—as an "unambiguous" provision clearly barring Westinghouse from using the True Up to challenge historic GAAP-compliance. Thus, "where [a] contract expressly provides that representations and warranties terminate upon closing ... the parties have made clear their intent that they can provide no basis for a post-closing suit seeking a remedy for an alleged misrepresentation. That is, when the representations and warranties terminate, so does any right to sue on them."

Chief Justice Strine also focused on "the limited role of the adjudicator" —that is, the independent accountant to be appointed under the True Up—who, under the terms of the Agreement, "does not have a mandate to address any dispute that might come from the Purchase Agreement." To the contrary, "those duties never included assessing if Chicago Bridge breached the representations and warranties it offered in the Purchase Agreement."

Next, the Chief Justice addressed Westinghouse's argument that Section 10.3 of the Agreement, by stating that the Liability Bar and indemnification provisions do not "limit the rights of [Westinghouse] under the Purchase Agreement," effectively allowed Westinghouse "to bring any claims it chooses post-closing despite the Liability Bar ...." The Chief Justice dismissed this argument as "strained," explaining instead that this section "plays its meaningful and expected, but confined, role" by "simply mak[ing] clear that the True Up has teeth for addressing changes in Stone's business between signing and closing," but does not give Westinghouse "a broad license ... to resuscitate claims covered by the Liability Bar in the True Up process ...."

Finally, the Chief Justice dissected an earlier Chancery Court decision in which a buyer was permitted to pursue a GAAP-compliance claim as part of a post-closing working capital adjustment process. In that decision, the Chief Justice noted, the relevant provision was drafted to include *two* tests, GAAP-compliance *and* consistency with historical accounting methodologies. By contrast, "the Purchase Agreement's plain terms do not establish two separate tests."

On this basis, Chief Justice Stine opined that "the Purchase Agreement's plain meaning does not allow claims that could not have been brought as breaches of representations and warranties to be brought as part of the True Up ... because to allow such claims would largely render the Liability Bar meaningless." This was a bridge too far for the Chief Justice.

CONCLUSION

Chief Justice Strine's analysis offers important tips for dealmakers and their counsel in negotiating and drafting post-closing purchase price adjustments in connection with purchase and sale transactions. For certain, even when a provision is found to be unambiguous, context and economic realities still count. If the parties intend to allow the buyer to make broad claims as to GAAP compliance in connection with a purchase price adjustment covering the period between signing and closing, they must explicitly so provide. From

seller's point of view, even if it cannot insist on non-survival of representations and warranties as in *Chicago Bridge*, it generally will prefer to force the buyer to bring GAAP-compliance claims under a fully-negotiated, and limited, indemnification provision rather than a more open-ended working capital adjustment procedure.