Completion mechanisms: Completion Accounts or Locked Box?

The purpose of completion mechanisms

In a transaction, a completion mechanism is used to determine the final acquisition price that the buyer has to pay in order to acquire the shares of the target company.

There is more than one way of doing this and the outcome can be different depending on the mechanism used. There are two widely accepted mechanisms for adjusting the consideration: “Completion Accounts” and “Locked Box”.

Completion Accounts mechanism

In a Completion Accounts scenario, the “initial” acquisition price is defined in the signed Share Purchase Agreement (or SPA). However, the “final” acquisition price is only determined based on the actual balance sheet of the target entity prepared as at the date of completion of the transaction.

As a minimum, the Completion Accounts show the net assets of the acquired business as at the date of completion. Typically, they will comprise a closing balance sheet, and will usually include a profit and loss account showing the results for the period from the latest set of historical financial accounts up to the completion date.

The signed SPA will have to include, amongst others, the following elements:

- The principles according to which the Completion Accounts should be prepared;
- The party (buyer or seller) that will prepare the Completion Accounts;
- Time allowed to prepare the Completion Accounts;

Grant Thornton’s research has shown that Completion Accounts are the leading cause of disputes between buyers and sellers. One in ten Completion Accounts result in an expert determination.
• Time allowed for the other party to validate the Completion Accounts.

Subject to what is set out in the SPA, either party may prepare the draft Completion Accounts and it may be a matter of practicality as to who is best placed to do so given ease of access to accounting records and personnel, and how much time it is reasonable to allow for the preparation of a first draft. It is most common for the buyer to prepare the Completion Accounts, as it is the owner of the business at that time.

A major advantage of Completion Accounts approach is that it provides the possibility of the acquisition price being adjusted on a Euro-for-Euro basis. This simultaneously entails the mechanism’s major disadvantage, since major adjustments to the initial acquisition price often lead to time-consuming discussions between the buyer and the seller and generate uncertainty as to whether the takeover will succeed after all.

Locked Box mechanism

With a Locked Box mechanism, the final equity value adjustments are applied to a balance sheet prepared at a date prior to completion, which is termed the ‘locked box balance sheet’. Locked boxes are now commonplace in Europe. This may be because locked box mechanisms lend themselves well to multi-bidder sale processes: they avoid time being spent post-transaction on completion mechanisms and bring certainty for both parties on the final equity value at completion.

The term Locked Box refers to a key feature of this type of mechanism, which is that no value is permitted to leave the business between the Locked Box date until completion of the transaction – the ‘box’ is thereby ‘locked’.

The term ‘leakage’ is used to refer to extractions of value by the seller, such as dividends during the post-locked box period (unless mutually agreed). Such items diminish the balance sheet value in the period between locked box and completion which, if unadjusted, would mean the buyer receiving less value than they have paid for. The buyer will typically receive protection via the SPA against leakage.

A further concept termed ‘permitted leakage’ is also usually documented in the SPA. The intention of permitted leakage is to carve out certain items from the leakage protection. This covers known leakage both parties are aware of prior to completion, which is then factored into the calculation of the equity value at completion. Permitted leakage can also cover transactions between the business and the sellers such as agreed salary or management fees payable to the seller in this period.
The final important feature of the locked box mechanism is how to deal with the value movement in the balance sheet due to trading between the Locked Box date (i.e. the moment at which the Buyer de facto becomes the owner) and the Date of Closing (i.e. the date on which the acquisition price is paid). From a Seller’s perspective, they may still be managing the business to generate profit and will have capital tied up until the completion date when the consideration is paid. Sellers may therefore expect to be compensated for this via an upward adjustment to the consideration (assuming the business is profitable). This adjustment is often referred to as the “value accrual”.

In practice the cash flow generated by the company in the period between the Locked Box date and the Date of Closing is often taken as a basis for determining the “value accrual”. An alternative basis is an interest-based value accrual applied to the equity value using an agreed rate of return to the seller for the post-locked box period.

The date of the Locked Box should be considered carefully. Due to the absence of an adjustment mechanism, a buyer should carry out sufficient due diligence on the Locked Box balance sheet to be comfortable that it is accurate. The Locked Box date should not be too close to the completion date so as to allow time for the seller to prepare it and for the buyer to review it prior to completion. It is also advisable that the Locked Box date is not too far in the past, as this would increase the risk of leakage and the risk of actual profits being materially different from the value accrual. It is generally assumed that a period of two to three months is deemed appropriate.

An advantage of the Locked Box mechanism is the high degree of certainty of the acquisition price between the buyer and the seller, from an early stage in the buy-out plan. On the other hand, this mechanism is not recommended in circumstances where the buyer can only perform limited due diligence, since this mechanism offers few (if any) possibilities of making material adjustments to the acquisition price in the final phase of the buy-out plan.