

Understanding the Concept of the “Lock-Box”/“Locked Box” Mechanism in the Mergers and Acquisitions Space

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"Lock-box" mechanism vs closing date account mechanism

Parties to M&A deals usually have a particular price and/or valuation methodology in mind for the acquisition of shares in a target company. To calculate the purchase price, parties may agree to a price determination mechanism, such as the closing date account mechanism or the “lock-box” mechanism. The decision as to which of these to use could depend on a number of factors, including the commercial realities associated with a target company's business or the industry in which it operates, the identity of the seller or the purchaser (i.e. whether it is a private equity fund), or the preferences of the parties.

Traditionally, the closing date accounts mechanism has been more popular, whereby parties agree to an initial purchase price on the signature date using the most recent financial statements or management accounts of the target company. The initial purchase price is then adjusted after the closing date of the transaction based on the difference between the initial purchase price and the adjusted purchase price as at the closing date (i.e. the “actual” purchase price based on the closing date accounts prepared with reference to the financial position and performance of the target company as at the closing date when the purchaser becomes the owner of the shares in the target company). With the closing date accounts mechanism, the economic interest, being the risk and benefit of the financial performance of the target, passes to the purchaser on the closing date.

The completion of the closing date accounts and determination of the adjusted purchase price may be subject to a dispute between the parties which may need to be referred to expert determination. This can cause delays during the post-closing period and can lead to the purchaser and the management of the target company being pre-occupied with the process of determining the purchase price adjustments, which prevents them from focussing their full attention on managing the business of the target company.

The “lock-box” mechanism addresses this pitfall by providing an alternative price determination mechanism, where the purchase price is based on a historical financial position on an agreed “effective date” rather than the financial position of the target company on the closing date. The purchase price is therefore fixed and final and no provision is made for any price adjustment based on changes to the company's financial position during the period between the effective date and the closing date. This effective date will typically be the last day of the recent financial year-end of the target company and is often referred to as the “Locked Box Date” or “Warranted Accounts Date”. The purchase price is determined as at the Locked Box Date based on the financial position and performance of the target company as reflected in the audited annual financial statements of the target company for such financial year. With the “lock-box” mechanism, the economic interest (i.e. the risk and benefit in the financial performance) in the shares of the target company passes to the purchaser on the Locked Box Date, despite ownership of the shares only transferring to the purchaser upon the actual transfer of the shares on the closing date.

The parties agree to effectively “lock” the purchase price of the shares based on the target company's financial position at an agreed historical date.

Concepts used in a "lock-box" mechanism

Given the departure from the traditional pricing mechanism, the following concepts are generally used in a "lock-box" transaction in order to deal with certain risks and issues which are inherent in such a transaction.

Leakage

Since the purchase price is fixed based on the historic financial position of the target company at the Locked Box Date, the purchaser would want to be protected against a scenario where assets (such as working capital) which underpin that historic valuation (and therefore the purchase price) are "leaked" or disposed of by the target company to the seller or a third party. Examples of these would include dividends, management fees and bonuses or the conclusion of agreements between related parties which would result in payment of money by the target company ("Leakage"). To guard against this, the parties will typically record in their transaction agreement that the seller and the target company shall not allow any Leakages during the period between the Locked Box Date and the closing date.

If it found that a Leakage has occurred, the parties will typically agree that such amount will be deducted from the purchase price which is to be paid by the purchaser on the closing date.

Permitted leakage

Notwithstanding the prohibition of Leakages, it is usually necessary for the parties to agree that certain types of Leakages are permissible ("Permitted Leakages"). Certain examples of Permitted Leakages include certain related party transactions which are viewed by both parties as being for the benefit of the target company or which have regularly occurred in the ordinary course of business between the target company and the seller.

Both parties would want to ensure that the agreement clearly describes what constitutes Permitted Leakages because such transactions would not be deducted from the purchase price.

Interim period undertakings

Due to the fact that the risk and benefit in the shares of the target company passes to the purchaser on the Locked Box Date, it could be said that the seller is "effectively" operating the business of the target company at the risk and benefit of the purchaser during the period between the Locked Box Date and the closing date ("Interim Period"). In order to adequately protect the purchaser during the Interim Period, the purchaser will typically require that the seller and the target company agree to various undertakings ("Interim Period Undertakings") in regard to the operation of the business of the target company during the Interim Period. Some examples of Interim Period Undertakings which may be included in the transaction agreement are undertakings that the target company will not –

- incur capital expenditure which is not contemplated in the target company's existing budget;
- encumber any of the assets of the target company;
- conclude any transaction which is not in the ordinary course of the target company's business (having regard to, for example, the nature and size of transactions concluded during the 12-month period prior to the Locked Box Date);
- modify any rights attached to the shares of the target company or create or issue any new shares or classes of shares.

When formulating Interim Period Undertakings it is important to seek advice from a competition lawyer to ensure that the Interim Period Undertakings do not go further than protecting the purchaser's interest in maintaining the value of the subject matter of the transaction, i.e. the value of the shares in the target company. Where a transaction requires the approval of the competition authorities before it is implemented, the parties may not grant the purchaser the ability to control or influence the operation and management of the target company's business prior to merger approval being granted. Therefore, it is important to ensure that the scope of the Interim Period Undertakings do not result in the conferring of such control to the purchaser, otherwise the parties may be at risk of the competition authorities' finding that the parties have "jumped the gun". An example of an Interim Period Undertaking which could give rise to a pre-implementation risk would be where the target company undertakes not to amend its pricing and marketing strategies without the prior input or consent of the purchaser.

Advantages of the "lock-box" mechanism

The "lock-box" mechanism provides price certainty, which is useful for private equity funds who need to know the amount of funds to be drawn from their limited partners or who need to exit an investment at a certain return. It also ensures a "clean" exit, as no further price adjustments are required after implementation, as opposed to the closing date account mechanism.

Moreover, the mechanism frees up management of the target company to attend to post-closing transition of ownership and the running of the business (as opposed to being involved in determining adjustments to the purchase price in terms of the closing date accounts mechanism).

Potential pitfalls to keep in mind with "lock-box" mechanisms

The "lock-box" mechanism requires the purchaser to place greater reliance on its financial due diligence of the target company, which means that significant time and cost will usually need to be incurred in order to give the purchaser the necessary "comfort" that it is paying the correct purchase price.

There is the possibility that the purchaser may pay too much or too little for the target company, when compared to the financial position of the target company on the closing date (when the ownership of the shares are transferred) due to the fluctuation in the financial performance of the target company during the Interim Period which may not have been in the contemplation of the parties when concluding their agreement. The risk of this disconnect between the purchase price paid and the value of the target company is exacerbated where there is a long Interim Period.

Conclusion

A party who is considering a "lock-box" transaction for its price determination mechanism in an M&A or private equity transaction, should seek legal advice to ensure that it is adequately protected and has a complete understanding of the various considerations which impact on these types of transactions.

Please note that this article is intended for information purposes only and should not be considered legal advice. This article is not comprehensive exposition of all of the issues, risks and considerations which apply to "lock-box" transactions.



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