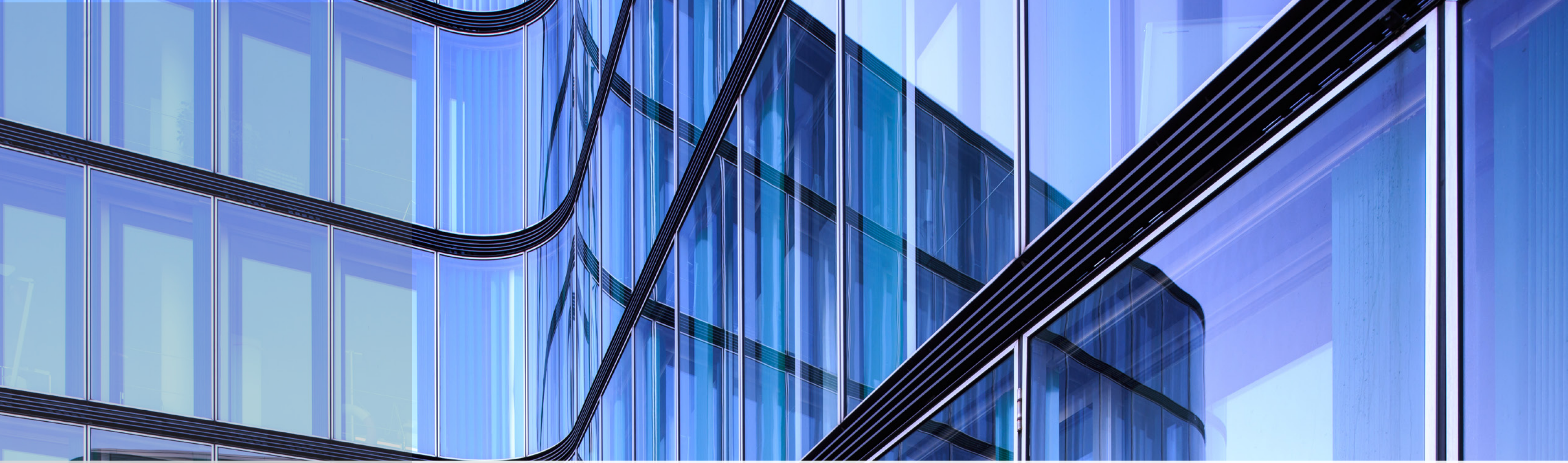

MERGERS & ACQUISITIONS

Kutak Rock Client Alert

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Services

[Mergers & Acquisitions]

[Business, Corporate & Securities]

What Does "Cash-Free, Debt-Free" Mean in the Sale of a Business?

When businesses are sold, bankers often market the deals as "cash-free, debt-free." In *Deluxe Entertainment Services, Inc. vs. DLX Acquisition Corporation and Deluxe Media Inc.* (Del. Civil Action No 2020-0618-MTX, March 29, 2021) ("Deluxe Media"), the Delaware Chancery Court was recently asked to interpret one such deal. Many M&A practitioners were surprised to learn that "cash-free" can mean "cash-for-free."

On June 30, 2020, Deluxe Entertainment Services, Inc. (the seller) sold the stock of its subsidiary, Deluxe Media, Inc. (the target) to DLX Acquisition Corporation (the buyer), who was an affiliate of private equity firm Platinum Equity. The purchase price was calculated as a base amount of $195 million, plus or minus adjustments for net working capital, closing indebtedness, two escrows, unpaid transaction bonuses, a holdback and unpaid income taxes. One important adjustment was missing: cash held in the target's bank accounts at closing.

Prior to closing, the seller had the right to sweep and retain all cash on hand, but the seller failed to do so at closing due to "various practical and technical reasons." On the day after closing, the seller's controller recognized the error and requested that the buyer return over $9 million in cash. The controller claimed that the cash was improperly transferred, and invoked the "wrong pocket" provision to demand the return of the disputed cash. Based on the Delaware Chancery Court's opinion, however, the seller may never see this disputed cash.

In an M&A transaction, the treatment of cash should be relatively easy, with two basic outcomes:

1. Cash transfers with the business and is *added* to the purchase price; or
2. Cash is retained by the seller and is *not added* to the purchase price.

The problem in *Deluxe Media* was the purchase agreement's transferal of cash with no increase in purchase price. The seller argued that the buyer was required to return the cash, but the court rejected those arguments with the following line of reasoning:

- All assets (including cash) were transferred as a result of the sale-of-stock structure.
- Certain assets were excluded, but cash was not an excluded item.
- The "wrong pocket" provision required the buyer to return only excluded assets, which by definition did not include cash.
- Excluding cash from net working capital affected only the purchase price, and it was "asking too much" to use net working capital to redefine the scope of assets transferred.

Although this issue was not before the court, the seller could also not correct the error through the post-closing process to calculate net working capital at closing because the definitions of net working capital and purchase price clearly excluded cash.

It is hard to know exactly how the seller got the transaction structure wrong, but one key factor may have contributed to the error. The purchase agreement defined the asset prong of net working capital as "the sum of current assets . . . set forth on the line items *and subject to the adjustments set forth in Schedule 2.4"* [emphasis added]. One had to read the attached Schedule 2.4 to find a "definitional adjustment" that excluded cash from current assets. In reading the definition of net working capital without reviewing the related schedule, one could easily conclude that net working capital included all current assets including cash. This "definitional adjustment" likely contributed to the disconnect between the transaction structure (cash included) and purchase price (cash excluded).

The Delaware Chancery Court's opinion may be reversed on appeal, but at a minimum, the seller has spent nine months and significant legal expense in an up-to-now failed attempt to recover over $9 million in cash that should have been retained at closing. The case highlights a few takeaways for M&A practitioners:

- Do not underestimate the difficulty of translating intricate purchase price formulas into contractual language, especially when the formulas incorporate accounting concepts.
- Prior to signing an M&A agreement, require your specialists (i.e., legal, accounting, and finance) to perform a detailed walk-through of all key value terms to confirm all additions (or exclusions) to purchase price are aligned with the transaction structure.
- Ensure the closing checklist addresses all key value steps, including operational matters like sweeping bank accounts at closing.
- Use disclosure schedules to illustrate, but not define, complex calculations.

If your M&A agreement gets a transaction structure "unambiguously" wrong, do not expect the courts to correct the error. That is the case even if the outcome violates fundamental concepts like what constitutes a "cash-free, debt-free" deal.

Additional Information

This legal update is a summary of a recent Delaware state court decision and does not purport to be a complete discussion of Delaware law. If you have questions about the issues discussed above, please contact your Kutak Rock attorney or one of the attorneys in Kutak Rock's Mergers and Acquisitions Group. For more information regarding our practices, please visit us at www.kutakrock.com.

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