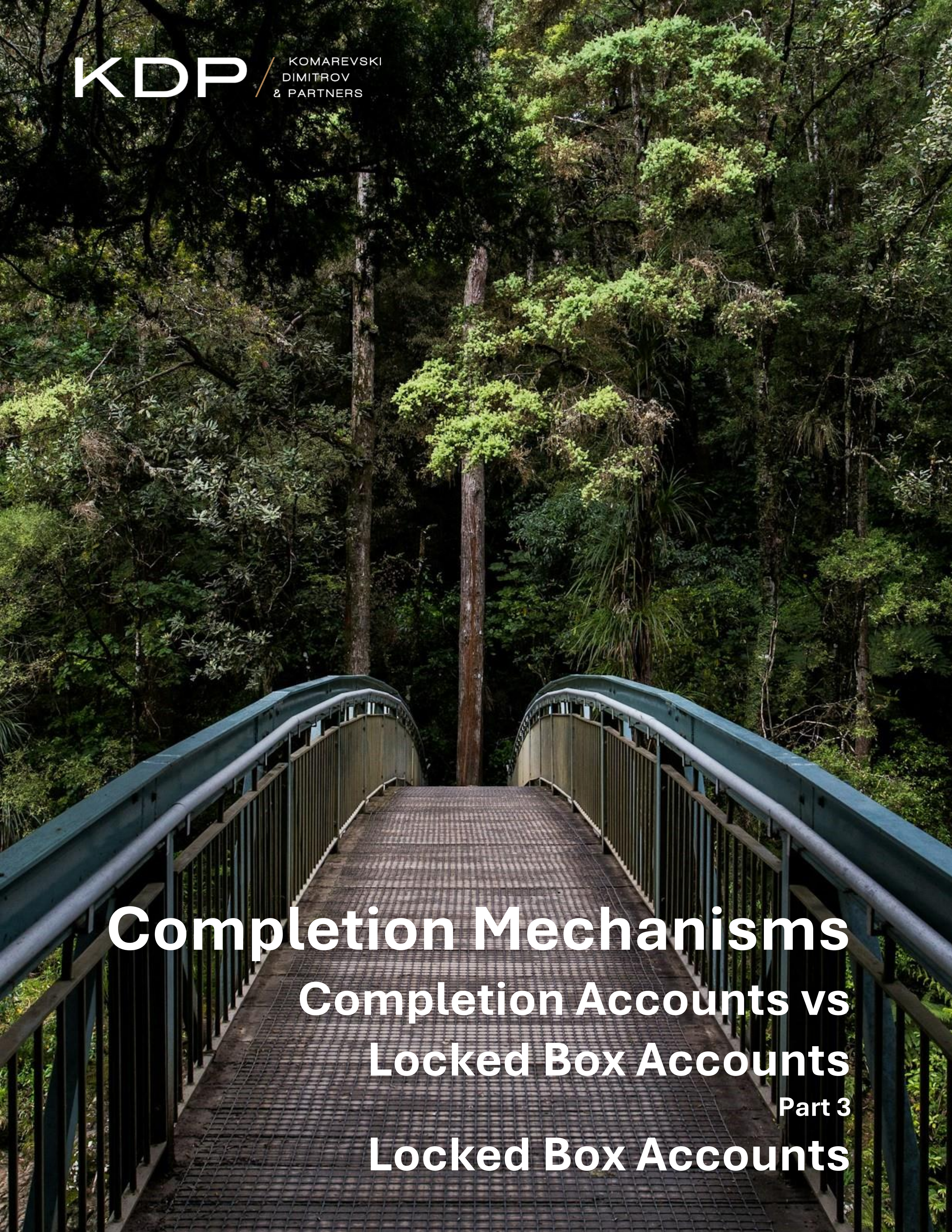

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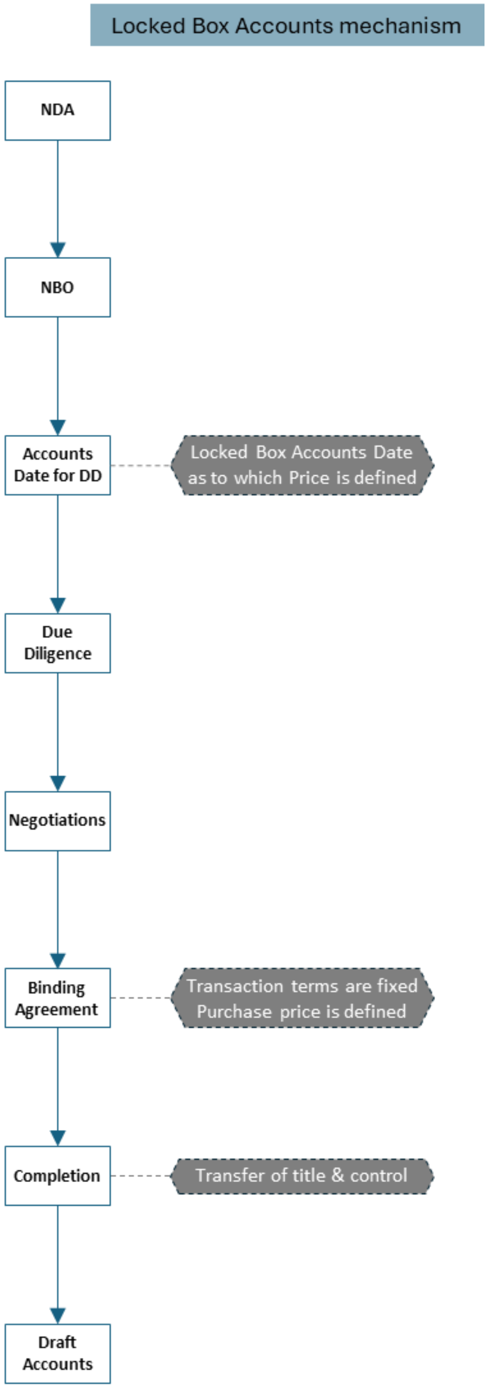
Completion Mechanisms

Completion Accounts vs Locked Box Accounts

Part 3

Locked Box Accounts

Figure 1



Part 1. Locked Box Accounts

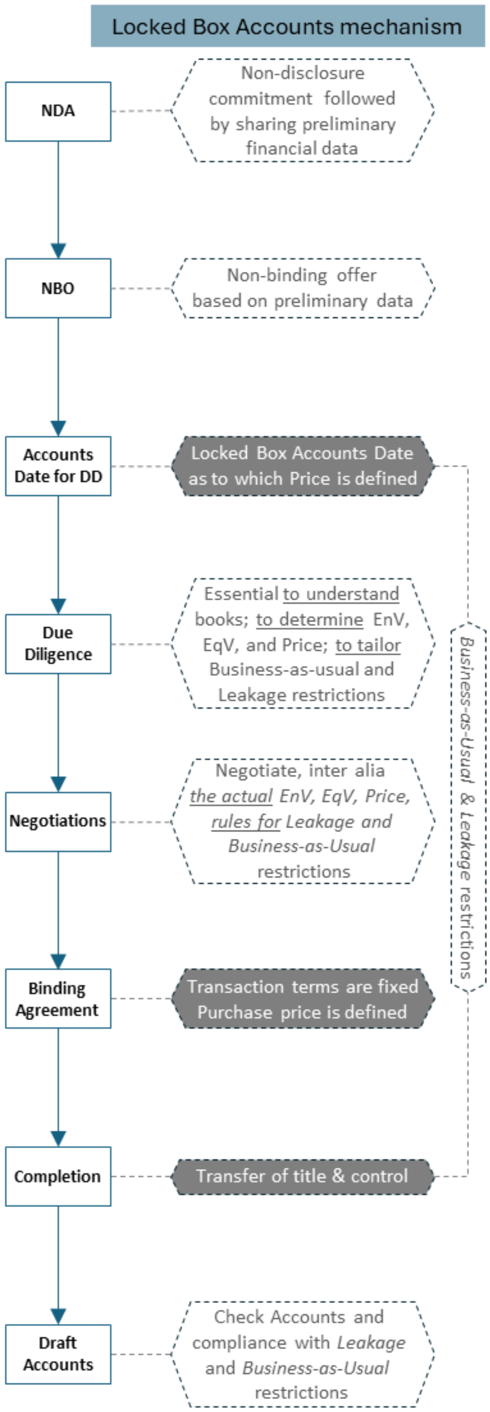
Unlike the Completion Accounts Mechanism, where the purchase price is finalized after Completion, in the *"pure"* Locked Box Accounts Mechanism, the purchase price is finalized prior to Signing, when the seller still holds title and control over the Target. Under the Locked Box Mechanism, the Equity Value is determined based typically on the accounts provided during the due diligence review. In its pure form this completion mechanism assumes the Equity Value will not fluctuate after the date of these accounts, and these accounts are therefore *"locked"*. Since Equity Value is *"locked"*, in practice any economic return from business operations of the Target passes on to the buyer virtually from the day following the Locked Box Accounts Date – see *Figure 5*.

Clearly, a purchase price finalized before Transaction Signing has its advantages for the seller, because the uncertainty as to final purchase price is eliminated and the risk of post-Completion disputes on price is limited (a risk that is inherent to the Completion Accounts Mechanism and which has triggered the existence of the Locked Box Accounts Mechanisms). To the above (over)simplified picture we add several practical aspects:

The due diligence of the Target's accounts: The Locked Box Accounts Mechanism calls for obtaining clarity on the Equity Value in a very early stage of the transaction process. In this situation a full due diligence and thorough understanding of Target's accounts is of utmost importance. The accounts provided for review will not only calibrate buyer's assessment of the Enterprise Value or its adjustment (as is the case under the Completion Accounts mechanism) but based on these accounts the parties will finalize the purchase price. The parties may consider enclosing the reviewed Target's accounts to the SPA, or an adjusted version thereof reflecting agreed reclassifications, to justify the formation of the final purchase price.

The Leakage concept: SPAs governing transactions using pure Locked Box Accounts Mechanism typically would not require provisions defining accounting treatment of debt, cash and working capital, because these should have been resolved prior to Signing to determined final purchase price. However, as the purchase price is finalized to date that precedes Completion, it is in the buyer's highest interest to prevent any form of value extraction from the Target that benefits the seller or its related parties ("**Leakage**"). Defining Leakages is among the very basic provisions in SPAs for transactions governed by the Locked Box Accounts Mechanism. Typical examples of Leakages are distribution of dividends, refund of capital, management and/or employees bonuses conditioned on occurrence of Completion, transfer of assets below their market value, undertaking of seller's or related parties' liabilities against no or below market consideration, waiving of rights against the seller or its related parties; other intra-group payments that are not under market terms to the benefit of the seller or its related parties, etc. There should be no Leakages after the Locked Box Accounts Date. Accordingly, the buyer would seek for a warranty against Leakages occurring from the Locked Box Accounts Date until Signing, and an undertaking against Leakages committed and/or occurring in the period from Signing until Completion. The parties may also agree to exceptions from the Leakage restrictions ("**Permitted Leakages**"). In practice undistributed profits from previous years are often defined as Permitted Leakages, but the parties are free to add also other specific items. The buyer checks for Leakages and for Permitted Leakages after Completion, when Target's Reference accounts are reviewed as a part of the integration process. Identified Leakages are reimbursed by the seller to the investor on a Euro for Euro basis, unless otherwise agreed in the SPA.

Figure 2



<u>The "Business as Usual" restrictions:</u> The Business-as-Usual Restrictions in the Locked Box Accounts Mechanism are similar to those under the Completion Accounts mechanism. These restrictions would be introduced in the SPA in the same way as the Leakage restrictions, i.e. as a combination of: (a) a warranty for compliance with these restrictions in the period from the Locked Box Accounts Date to Signing; and (b) an undertaking for compliance with the restrictions in the period from Signing to Completion. As with the Leakages, the check for compliance with the Business-as-Usual restrictions is made post Completion with the Reference Accounts. However, unlike the Leakages, (but just as in the Completion Accounts Mechanism) a breach of the Business-as-Usual restriction is not necessarily compensated on a Euro-for-Euro basis, because the actual impact on the Equity Value does not necessarily correspond one-on-one with the value of the transaction in breach of the Business-as-Usual restriction. Unlike the Leakage, which is always a value extraction, which benefits the seller or its related parties, the breach of the Business-as-Usual restrictions does not necessarily favor the seller or its related party. Rather, transactions that are in breach of the Business-as-Usual restriction are unwanted or of higher risk for the buyer and the latter can claim losses resulting from or in relation to such transactions.

Figure 6 contains the practical aspects of the Locked Box Accounts Mechanism added to the milestones in a typical Transaction Process.

<u>The Value Accrual:</u> Under the Locked Box Accounts Mechanism, the economic risks and benefits pass on from the seller to the buyer from the Locked Box Accounts Date. However, often the period from Locked Box Accounts Date to Completion Date comprises several months and throughout this period the business continues its operations and, therefore, its value will continue to fluctuate. If Target is profitable, then any day in delay of the planned Completion means lost profit for the seller. To compensate the seller against such lost profit, the parties can agree in the SPA on a compensation mechanism for the seller – "**Value Accrual**". If there is a need for adjustments of the purchase price based on performance of the business in the period after Completion, the parties may additionally agree on an earn out mechanism.

There are different models to calculate the Value Accrual, most common being:

(a) ticking interest rate over the finalized purchase price for the period:

(i) from:

- Signing of the binding Agreement, or
- the Locked Box Accounts Date (for the most aggressive sellers);

(ii) until:

- Completion Date; or
- until full payment of the purchase price (for the aggressive sellers);

(b) net cash generated from signing of the SPA up to latest possible date before Completion;

(c) percentage from the cash generated in the period until Completion.

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