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Delaware Court of Chancery Rejects Proposition That Accounting Principles Must Be Consistently Applied during True-up Process in the Absence of Express Language Requiring Consistency

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The Delaware Court of Chancery rejected a purchaser's efforts to prevent a seller from adopting a method of calculating the post-closing purchase price adjustment that was inconsistent with the seller's pre-closing accounting practices. In lieu of an apples-to-apples comparison, the court interpreted the purchase agreement to require the purchaser to calculate the company's tangible net worth in accordance with specific accounting principles, even though the seller failed to correctly apply such principles in its pre-closing financial statements. The *Golden Rule* court concluded that a correct or accurate application of accounting principles fell within the ordinary meaning of a provision requiring the parties to calculate post-closing purchase price adjustments in accordance with specific accounting principles unless they provided otherwise within the four corners of the agreement.

Golden Rule Financial Corporation purchased USHEALTH Group, Inc., for a base purchase price of $750 million, subject to a post-closing purchase price adjustment. The post-closing adjustment was necessary to assess certain metrics at closing, and the purchase agreement established a three-step process for calculating tangible net worth. In the first step, the seller must estimate its own tangible net worth as of closing. Within 90 days of closing, the purchaser must prepare a separate calculation. In the event that the seller disputed the purchaser's calculation, the seller must notify the purchaser in writing, and if the parties could not resolve the dispute, they must engage a third-party firm to calculate the tangible net worth.

Both parties were required to calculate the tangible net worth in accordance with specific accounting principles. The accounting principles were explained, in detail, in a two-page annex—including a three-tier hierarchy—to the purchase agreement. The first tier set forth specific accounting principles and policies. To the extent that an issue was not addressed under the first tier, the parties were to employ the principles and policies used to prepare the seller's audited generally accepted accounting principles (GAAP) annual consolidated balance sheet dated December 31,

2018. To the extent that the first and second tiers did not resolve the issue, the parties were to apply GAAP. The specific accounting principles and policies in the first tier included ASC 606, which was a new standard for determining how and when a company treats revenue from long-term customer contracts. The seller purportedly told the purchaser that its financial statements complied with ASC 606 and provided the purchaser with documents that suggested the seller's adherence to this standard.

At closing, the seller reported a tangible net worth of $40.75 million. The purchaser subsequently found that the seller did not correctly follow ASC 606 in its pre-closing financial statements. Nevertheless, the purchaser applied ASC 606 in the same manner and calculated a tangible net worth of $35 million. The purchaser also calculated the company's tangible net worth according to the purchaser's understanding of ASC 606, which resulted in a tangible net worth of $73.8 million. The purchaser informed the seller of both calculations, in which the lower calculation required a refund of approximately $17 million, while the higher calculation obligated the purchaser to pay an additional $21.8 million. The seller disputed the purchaser's use of the lower calculation. The parties did not resolve the dispute, and they retained KPMG as an independent third party. Rather than allow KPMG to render a decision, the purchaser filed suit.

The Court of Chancery dismissed the purchaser's breach of contract claim based on the express language of the purchase agreement. Although the agreement mandated the calculation of the seller's tangible net worth in accordance with ASC 606, the purchaser argued that it should be calculated in accordance with the company's prior misapplication of ASC 606. The court rejected this argument, finding that the agreement required the parties to apply ASC 606 correctly. The correct application of ASC 606 is inherent in the ordinary meaning of the provision, and the court refused to "compel a concededly incorrect implementation of ASC 606 as a contractually agreed-upon implementation of ASC 606."

In response to the purchaser's reliance on contractual language requiring calculations to be "prepared in accordance with the accounting principles, consistently applied[,]" the court ruled that the purchaser's interpretation of the agreement was unreasonable. Under the purchaser's interpretation, the principles employed in the seller's pre-closing financial statements eliminated the ASC 606 requirement. Because the agreement expressly mandated the application of ASC 606, the more specific terms trump the general language that accounting principles be consistently applied.

Finally, the purchaser cited to the Delaware Supreme Court's opinion in *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co., LLC*, 166 A.3d 912 (Del. 2017), as legal authority for the incorrect application of ASC 606. While a more detailed analysis of *Chicago Bridge* can be found here, the Court of Chancery ruled that the prior opinion was distinguishable. There, the purchase price adjustment established the entire price, while the amount in dispute between the parties in this case was approximately 5 percent of the purchase price. Further, the Delaware Supreme Court held that the express language of the agreement in *Chicago Bridge* required the application of the seller's past accounting practices to complete the price adjustment. Although consistency is preferred, the Court of Chancery found that the parties in *Golden Rule* agreed to one standard at signing and a different standard at closing.

Golden Rule highlights how merger and acquisition transactions can be structured to allocate risk (sometimes unevenly) between the parties. In conducting due diligence, the purchaser should have used its legal and accounting professionals during legal and financial due diligence to confirm that the seller correctly applied ASC 606. In the event that the purchaser had flagged an issue with the seller's application of ASC 606, the purchaser's advisors could have developed an alternative strategy for addressing these issues within the framework of the transaction. In the context of a post-closing true-up, while the court may prefer an apples-to-apples comparison, it will not require consistency unless the parties expressly bargained for consistent treatment. *Golden Rule* instructs transaction parties that a Delaware court will interpret true-up provisions, which require parties to calculate post-closing adjustments in accordance with certain standards, to be calculated correctly, even though financial statements prepared at or prior to closing were incorrect and/or did not follow the same agreed-upon post-closing standard.

Golden Rule Fin. Corp. v. S'holder Rep. Servs., LLC, C.A. No. 2020-0378-PAF (Del. Ch. Jan. 29, 2021), Fioravanti, V.C.

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