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Earnouts in M&A Transactions

Key Structures and Recent Developments

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What is an Earnout?

- **Basic Definition:** An earnout is a risk-allocation mechanism used in an M&A transaction whereby a portion of the purchase price is deferred and is calculated based on the performance of the acquired business over a specified time period following the closing.

Reasons for Use of Earnouts

- **Valuation Gap**: Earnouts can bridge the business valuation gap between an optimistic seller and a skeptical buyer.
 - Allows asset to prove its worth.
- **Financing**: Use of an earnout in structuring an acquisition provides buyer with an additional option to finance the acquisition (i.e., buyer may be able to pay for the acquisition with future profits of the target business).
 - This attribute is particularly important in economic climates where third-party financing can be difficult to obtain on favorable terms.
- **Incentive-Based Compensation**: Earnouts can also be used as a form of incentive-based compensation to sellers who are continuing as employees of the acquired company.
- **Startups**: Earnouts are often used for companies with little operating history but significant growth potential (which are not easily valued).

Key Structural Considerations

- **Principal considerations when negotiating and drafting an earnout:**
 - (1) the definition and scope of the target business;
 - (2) the selection of the performance metric;
 - (3) the selection of appropriate accounting measurement standards;
 - (4) the determination of the payout structure and establishment of the earnout period;
 - (5) post-closing operation (i.e., the allocation of control between buyer and seller and the level of support, if any, that buyer will commit to assist the target business in achieving its earnout objectives); and
 - (6) disputes and resolution.

Key Structural Considerations (cont'd)

1) Defining the Target Business

- The scope of the target business should be clearly defined since it is the performance of this business that will determine whether earnout requirements are satisfied.
 - Relatively easy when acquired business will be operated as an independent subsidiary or division, but more difficult when the target is to be integrated into buyer's existing business. In such situations, the performance of the business may be more difficult to track and special accounting allocations may be required.
 - Segregated financials to measure performance of the acquired business should be established.
 - Particular matters to be addressed include: (i) the defined line of business, (ii) whether expansion of the business beyond the defined line will count toward the earnout and (iii) sales to common customers.

Key Structural Considerations (cont'd)

2) Performance Metric

- Financial Metrics: The most common financial metrics are (i) revenue, (ii) net income, (iii) EBITDA and (iv) earnings per share. Sellers often prefer revenue and buyers often prefer net income.
 - Sellers prefer revenue because it is less easily manipulated by buyer (and easier to achieve). Using revenue as the metric may incentivize seller's management to grant unprofitable deals to customers.
 - Buyers prefer net income because it provides a more complete picture of performance and incentivizes seller's management to control costs.
 - Parties often compromise on EBITDA (which factors in operational costs but excludes certain non-operational costs).
- Non-Financial Targets: In certain cases, non-financial metrics are more appropriate because there is no historical information to use as a basis for financial projections. In these cases, product development milestones, number of customers, number of products sold or launch of a new product may be used as the metric. In general, non-financial metrics can lead to fewer disputes regarding calculations of benchmarks.

Key Structural Considerations (cont'd)

3) Accounting Principles

- It is important to establish appropriate accounting principles for measuring the performance metric.
- Reference to GAAP in and of itself is usually not sufficient.
 - Parties should, at a minimum, stipulate that GAAP will be applied consistent with either buyer's or seller's historic practices.
 - Parties should also consider stipulating a specific set of accounting principles as a supplement (or exception) to the general GAAP provision.
- Some specific accounting matters to be considered are (i) use of cash or accrual revenue basis, (ii) revenue and expense allocation, (iii) timing of revenue recognition, (iv) treatment of acquisition expenses, (v) treatment of other non-recurring items, (vi) treatment of intercompany transactions and (vii) treatment of uncollected receivables.

Key Structural Considerations (cont'd)

4) Payout Structure and Earnout Period

– Structure Alternatives:

- Installments vs. lump sum
- Percentage of earnout payment upon partial satisfaction of benchmarks vs. all-or-nothing approach
- Earnout conditioned on participation by seller in acquired business
- Cap on earnout payments
- Offset of indemnification claims
- Adjustments with respect to payments made (or missed) in previous installments based on subsequent performance (e.g., carry back/carry forward of EBITDA from one measurement period to other measurement periods)

Key Structural Considerations (cont'd)

- Earnout period:
 - An earnout period that is too short risks performance distortion by short-term factors or that sellers will sacrifice the long-term interests of the business. Sellers may seek a shorter period in order to receive full payment sooner and mitigate risk.
 - A longer earnout period will allow time to ensure that the acquired business proves to be a worthy long-term investment.
 - Parties should consider including acceleration rights, which result in an immediate payment and termination of the earnout arrangement.
 - Seller may have acceleration right upon certain events that negatively impact seller's ability to satisfy earnout targets (e.g., buyer's subsequent sale of acquired business, bankruptcy or change of control).

Key Structural Considerations (cont'd)

5) Post-Closing Operation of Acquired Business

- Two important questions that must be addressed are (i) how will post-acquisition control be allocated between buyer and seller and (ii) what level of support (if any) will buyer be obligated to provide the acquired business?
- **(i) Allocation of Control over Operations**
 - Seller will sometimes retain a level of control over the operations of the acquired business (e.g., approval rights over major decisions).
 - At minimum, seller will want restrictive covenants that set limitations on how the acquired business may be operated to prevent buyer from making significant changes that reduce the earnout amount, such as (a) discontinuing products, (b) reducing sales force or (c) shifting sales and costs.
 - Buyer may be required to operate the business consistently with how it was operated prior to closing.

Key Structural Considerations (cont'd)

- The parties should address the treatment of buyer's existing competing businesses and after-acquired businesses.
- **(ii) Level of Support**
 - Affirmative requirements for buyer in supporting the target business (e.g., marketing, sales force increases, adequate capitalization).
 - Requirement that buyer use a specified level of efforts to maximize the earnout.
 - Buyer's objective will be to obtain the right to operate the acquired business in its sole discretion and not be obligated to achieve the earnout.
 - Buyer should include language in the acquisition agreement that (i) gives buyer absolute discretion over operation and (ii) negates any obligation (express or implied) toward supporting the acquired business or achieving the earnout.

Key Structural Considerations (cont'd)

6) Disputes and Resolution

- Financial statements and earnout calculations are typically prepared by buyer and its accountants.
- Seller is afforded opportunity to review and challenge the financial statements and earnout calculation.
- Arbitration procedures should be established in advance to resolve future disagreements concerning the earnout calculation in a fair and expeditious manner.
- Often an independent accountant serves as the arbitrator.

Earnouts Case Law

- **The Earnout: A Dispute Postponed?**

- Due to the complexities of structuring an earnout, earnouts often lead to future disagreements and litigation.
- As Vice Chancellor Laster stated in the recent *Airborne Health* decision, “. . . an earnout often converts today’s disagreement over price into tomorrow’s litigation over outcome.”
- Notably, courts have been willing to use the implied covenant of good faith to impose obligations or restrictions on buyer with respect to its post-closing operation of the acquired business in the absence of express contractual terms.

Implied Covenant of Good Faith

- ***O'Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188 (10th Cir. 2004)**
 - The 10th Circuit, applying **Delaware** law, upheld a jury verdict in favor of sellers of a boat manufacturing business. The opinion was significant in that it was not based on a breach of express provisions in the purchase agreement, but on the implied duty of good faith and fair dealing.
 - The implied covenant of good faith and fair dealing inheres in every contract. The implied covenant protects the spirit of an agreement when, without violating the express terms of the agreement, one side uses oppressive or underhanded tactics to deny the other side the fruits of the parties' bargain. The implied covenant, however, cannot contravene the parties' express agreement and cannot be used to forge a new agreement beyond the scope of the written contract.

Implied Covenant of Good Faith (cont'd)

- *O'Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188 (10th Cir. 2004) (cont'd)

- Specifically, the court held that the buyer breached the implied covenant of good faith by (i) immediately changing known product names, (ii) requiring the acquired business to prioritize sales of products not subject to the earnout, (iii) discontinuing certain products and shutting down manufacturing facilities, (iv) forcing the acquired business to bear the design and production costs of another line of buyer's business and (v) failing to give the sellers the necessary operational control over the acquired business. The court reasoned that despite the lack of express provisions restricting the buyer's actions, the obvious spirit of the contract was to give the sellers **“a fair opportunity to operate the [acquired business] in such a fashion as to maximize the earn-out,”** and upheld the jury's finding that such an opportunity had not been given.
- A significant factor in this decision was the fact that the court strongly suggested the buyer had an ulterior motive and that the buyer's strategy was not to grow the business but to eliminate a competitor and gain a production facility for its other brands.

Implied Covenant of Good Faith (cont'd)

- ***Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126 (Del. Ch. 2009)**
 - The Delaware Chancery Court recently reached a different result in *Airborne*.
 - Buyer purchased seller's Squid Soap business for \$1 million plus up to \$26.5 million in earnout payments.
 - Importantly, the acquisition agreement had a provision requiring buyer to return the sold assets if certain business targets, such as advertising spending and sales, were not achieved.
 - Shortly after the acquisition, buyer suffered from crippling litigation and negative publicity with regard to an unrelated product, and the earnout targets were not achieved.
 - Seller alleged that buyer breached the implied covenant of good faith and fair dealing by not spending on marketing of the Squid Soap product.

Implied Covenant of Good Faith (cont'd)

- ***Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126 (Del. Ch. 2009) (cont'd)**
 - The agreement contained no requirement for buyer to spend funds on marketing so there was no express breach of contract. In addition, the agreement contemplated that the assets would be returned if buyer failed to achieve certain targets.
 - The court agreed that buyer could not arbitrarily or in bad faith refuse to expend resources and thereby deprive seller of the earnout. However, the court found seller's claim to be lacking because "[seller] does not contend that [buyer] failed to expend funds to make the business a success arbitrarily, in bad faith, or for no reason." To the contrary, the court recognized that buyer had "suffered a corporate crisis" and "was undoubtedly restrained by the legal and financial burdens of the settlement and systemic market damage." The court noted that seller's position was also undercut by the ease with which it could have contracted for an expenditure of resources.
 - Buyer's motion for summary judgment was granted.

Implied Covenant of Good Faith (cont'd)

- ***Fireman v. News America Marketing In-Store, Inc.*, 2009 U.S. Dist. LEXIS 91236 (D. Mass. 2009).**
 - In *Fireman*, sellers sold their marketing business to defendant for \$2.8 million in cash plus the possibility of additional earnout payments over five years. When the acquired business did not meet the maximum earnout targets, sellers alleged buyer breached the implied covenant by rebranding the product, removing and marginalizing key talent from the business and refusing to use its sales force to promote the product at trade shows.
 - Applying **New York** law, the court held that “the merit of [sellers’] claim depends on whether [buyer] intentionally or recklessly caused [the acquired business] to lose money.” The court found that buyer’s actions were legitimate business decisions, and that plaintiffs’ allegations amounted to nothing more than “disputes concerning strategy between sophisticated business people.” Therefore, the court held that there was no dispute of material fact as to whether defendant buyer breached the implied covenant of good faith, and granted buyer’s motion for summary judgment.
 - Takeaway: If seller wants buyer to take certain actions when operating the business, it should negotiate for such provisions in the contract.

Implied Obligation to use Reasonable Efforts

- ***Sonoran Scanners, Inc. v. PerkinElmer, Inc.*, 585 F.3d 535 (1st Cir. 2009)**
 - The 1st Circuit, applying **Massachusetts** law, did not find a breach of the implied covenant of good faith. Nevertheless, it reversed the lower court’s grant of summary judgment to buyer by holding that buyer had an **implied obligation to use reasonable efforts** to develop and promote seller’s technology.
 - The court relied on a series of cases dealing with exclusive licenses.
 - The following factors were important in finding that an obligation of reasonable efforts applied: (i) the earnout was substantial in relation to the up-front payment (\$3.5 million up-front and \$3.5 million in potential earnouts); (ii) that most of the up-front payment went to creditors; (iii) that the purchase agreement contemplated a campaign to market seller’s technology and (iv) that “[t]here was no language in the agreement negating an obligation . . . to use reasonable efforts or conferring absolute discretion on [buyer] as to the operation of the business.”
 - Remanded to district court to determine if buyer breached this obligation.

Implied Obligation to use Reasonable Efforts

- *Sonoran Scanners* seems to be an outlier.
- Little other case law implies a reasonable efforts obligation in the context of earnouts.
 - Delaware courts have suggested there is no implied obligation to use reasonable efforts. *Airborne*: “Squid Soap’s position is also undercut by the ease with which Squid Soap could have insisted on specific contractual commitments from Airborne regarding the expenditure of resources, **or some form of ‘efforts’ obligation for Airborne.**”
 - It remains to be seen, however, if other courts will follow the lead of the 1st Circuit.

Buyer's Points: Disclaimers

- **In light of the case law, buyers should focus on including disclaimer provisions in any earnouts contract.**
- Buyer should add contractual language that negates any implied covenant of good faith and any implied obligation of reasonable efforts.
 - Disclaim obligations to operate the post-acquisition business in any specified manner.
 - Implied obligation of good faith can only be disclaimed if done specifically.
 - Include specific contractual language acknowledging that, with the exception of any specifically negotiated restrictive covenants in the agreement, buyer has no express or implied obligations in regards to the earnout.
 - Include provisions waiving a seller's right to sue under an implied covenant or implied obligation.
- Buyer should also include no reliance provisions and integration clauses.

Buyer's Points

- Buyer should also add contractual provisions reserving the right to take certain actions.
 - Buyer should include an acknowledgment from seller in the acquisition agreement that buyer has absolute discretion to operate the business.
- ***Yarborough v. DeVilbiss Air Power Inc.*, 321 F.3d 728 (8th Cir. 2003)**
 - Earnout payment was based only on sales to certain specified customers. Buyer discontinued doing business with one specified customer and transferred that portion of its business to another, non-specified customer.
 - Agreement stated that buyer “has the right, in its sole discretion, to determine the terms and conditions of any and all relevant sales, including the decision to make or not make any such sales.”
 - 8th Circuit found buyer had “expressly and unambiguously contracted for absolute power over its ability to make sales in order” to foreclose seller’s claim of breach of the implied covenant of good faith. The court affirmed the grant of summary judgment for buyer.

Seller's Points

- **Affirmative Covenants**: Seller should negotiate for affirmative covenants requiring buyer to act in good faith, use reasonable efforts and take every action necessary to maximize the earnout payment.
- **Restrictive Covenants**: Seller should also negotiate for covenants explicitly restricting certain actions, including, for example: transferring fixed costs to the acquired business, firing or relocating key personnel and undercapitalizing the business or the R&D needed for growth.
- **Control**: Seller may also want to contract for a certain level of control over the operations of the acquired business during the length of the earnout period (e.g., approval rights over certain major decisions, ability to elect a certain number of directors).

Seller's Points: The Problem of Damages

- **Self Executing Remedies:**

- In earnouts cases, damages can often be hard to prove.
- *LaPoint v. Amerisourcebergen Corp.*, 2007 Del. Ch. LEXIS 131 (Del. Ch. 2007), illustrates this problem for sellers.
 - The Delaware Chancery Court held that buyer breached a covenant requiring it to exclusively and actively promote the acquired business's products, but it did not find that seller satisfied its burden in proving damages. Thus, the court awarded only nominal damages on that count.
- To avoid this type of outcome, the parties should specify remedies for breaches of the agreement (e.g., liquidated damages).
- It is difficult to prove that specific benchmarks would have been achieved but for breaches by buyer.
- Breach of contractual provision allowing seller to retain control of the acquired business's operations creates even more uncertainty as to damages.

Seller's Points: The Problem of Damages

- **Possible Self-Executing Remedies:**

- Liquidated damages.
- Breach of any express covenant results in damages of maximum or partial earnout payment.
 - Can result in windfall for the seller. See *Avesair, Inc. v. InPhonic, Inc.*, **2007 NCBC 32 (N.C. Super. Ct. 2007)**. In that case, the acquisition agreement provided that regardless of whether the earnout threshold was met, the maximum earnout would be due if buyer (i) failed to use commercially reasonable efforts to sell acquired business products, (ii) terminated certain employees or (iii) failed to provide outside audited financial information at the end of the earnout period. The court concluded that because outside audited financial information was not provided, seller was entitled to maximum earnout payment.

Seller's Points: The Problem of Damages

- **Possible Self-Executing Remedies (cont'd):**

- Breach of any (i) express obligation of buyer to use a certain level of efforts to maximize the earnout or (ii) implied covenant or obligation results in damages of maximum or partial earnout payment.
- Specific remedies: Breach of covenant to make expenditure or other required action results in an adjustment to the financial metric used for the earnout calculation.

Additional Consideration: Accounting Treatment (FAS 141(R))

- Historically, earnout consideration was recognized in buyer's financial statements if and when the conditions to payment of the earnout were satisfied.
- Under FAS 141(R), effective in 2009, earnouts are now required to be recorded at fair value at the date of closing. The recorded fair value is then subject to periodic adjustments based on the likelihood of payment or actual earnout payments that have occurred.
 - Any such adjustment must be recorded as gain or loss on buyer's income statement.
- Result of this rule is to accelerate the recording of liabilities related to the earnout and could also cause future earnings volatility.
- This may make the use of earnouts less attractive to buyers or cause buyers to negotiate for a shorter earnout period.
- FAS 141(R) does not apply to earnout payments characterized as compensation rather than purchase price.

Additional Consideration: Earnouts as a Security?

- **Is the right to an earnout a security?** An earnout can be a security under certain circumstances. The SEC has issued multiple no-action letters on the subject and has created a multiple factor test:
 - Is the earnout right an integral part of the consideration to be received in the transaction?
 - Is the earnout right represented by any form of certificate or instrument?
 - Do the holders of the earnout have any right in common with shareholders such as voting and dividend rights?
 - Does the earnout represent an equity or ownership interest in the surviving entity?
 - Is the earnout assignable or transferable, except by operation of law?