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Earn-outs in M&A Transactions

Key Structures and Recent Developments

An earn-out is a mechanism used in an M&A transaction whereby a portion of the purchase price is contingent and is calculated based on the performance of the acquired business over a specified time period following the closing. Earn-outs are intended to bridge a valuation gap between an optimistic seller and a skeptical, or cash strapped, buyer. Earn-outs allow sellers potentially to facilitate a higher price and provide buyers with an additional financing option to pay for the acquisition with future profits of the acquired business. The use of earn-outs is becoming more prevalent in the current economic climate.[1]

An earn-out can also serve as a form of incentive-based compensation to the sellers continuing on as management, and thereby allow buyers to retain and motivate management with aligned interests of maximizing profit. An earn-out used for these purposes, it might be argued, can help facilitate a smooth transition of the acquired business to the buyer even though the seller's management may no longer have traditional equity in the acquired business.

Key Earn-out Provisions

Although no standard earn-out model exists, there are several principal considerations that should be addressed in the negotiation and drafting of an earn-out provision: (1) the definition and the scope of the acquired business, the performance of which will determine whether the earn-out is achieved; (2) the selection of the performance metric; (3) the selection of appropriate accounting measurement standard; (4) the establishment of the earn-out period and determination of the payout structure; and (5) the allocation of control of the acquired business between the buyer and the seller during the earn-out period, and the level of support (if any) that the buyer will commit to give the acquired business in attempting to achieve its earn-out objectives.

Defining the Acquired Business. Since it is the performance of the acquired business that will determine whether the earn-out requirements are satisfied, this business should be clearly defined. If the acquired business will be operated as a separate, stand-alone subsidiary or a segregated, independent operating division of the buyer, measuring performance and achievement of the earn-out requirement should be fairly straightforward. The measurement becomes more difficult in cases in which the acquired business will be integrated with the buyer's existing business. The parties will need to determine a way to segregate and measure the performance of the acquired business.

Earn-Outs ➔

1 See American Bar Association's Business Law Section, 2009 Private Target Mergers & Acquisitions Deal Points Study (2009), which found that in a sample of M&A transactions involving a private target, the percentage of deals utilizing some form of earn-out had increased from 19% for deals completed in 2006 to 29% for deals completed in 2008.

Earn-Outs

continued

To the extent special accounting allocations are required to achieve this, the parties will need to include conforming adjustments to any governing accounting standard, such as GAAP. The parties should consider establishing segregated financials for the acquired business to measure performance. The seller will normally require access to these books and records, with possibly an audit right.

The buyer needs to ensure that the seller's structural concerns do not become the "tail wagging the dog," dictating the buyer's integration of the acquired business. The buyer will also want to ensure that the acquired business revenues are not inflated artificially (for purposes of the earn-out) by revenues derived on support received or business referred from the buyer's other business units.

In particular, the following matters should be considered in determining the agreed definition (scope) of the acquired business for purposes of the earn-out:

- The defined line of business (in particular, crafting the definition in terms of product line, service line, product or service functionality, customer type, pricing point and geographic regions);
- whether expansion by the acquired business beyond the defined line of business will count toward the earn-out, and how next generation products or services will be treated; and
- the treatment of sales to common customers (i.e., customers purchasing the same product or service from both the acquired business and the buyer prior to closing).

Metric to Measure Performance. The performance goals on which an earn-out is based are usually stated in financial metrics, such as revenues, net income or earnings before interest, taxes, depreciation and amortization (EBITDA).[2] Performance goals can also be based on a non-financial metric, such as the number of products sold or the launch of a new product. When a financial metric is used to measure performance, sellers often prefer to use revenue because the achievement of a top line revenue target is not affected by expenses and certain other adjustments, is not tied to profits, and therefore is perceived to be less easily manipulated by the buyer.

In contrast, buyers may often prefer to use net income because it provides a more complete picture of the acquired business' performance and provides an incentive to the seller's management to control expenses and to price products and services appropriately. As a compromise, the parties will frequently settle on the use of EBITDA, which reflects the cost of goods, selling expenses and general and administrative expenses, but does not further reduce earnings by interest, taxes, depreciation and amortization.

Accounting Measurement Standards. It is advisable to establish specific accounting guidelines for measuring performance to avoid future disputes. A reference to GAAP in and of itself may not be sufficient due to the range of accounting practices that are permitted under GAAP. The buyer might require that GAAP be applied consistent with the buyer's historic practices or practices at other portfolio companies of the buyer. The seller should resist this, though, because a general imposition of the buyer's policies could result in unintended additional hurdles to the acquired business' achievement of the revenue goals. If a generic GAAP standard is included, the seller will generally prefer GAAP applied consistent with the prior practices of the acquired business.

In light of the foregoing, it is normally advisable for the parties to develop and stipulate a specific set of accounting principles to be applied during the earn-out period as a supplement (or an exception) to generally governing standards, such as GAAP. In particular, the following matters might be considered in determining the appropriate accounting measurement standards:

- whether revenues will be measured on a cash or an accrual basis;
- revenue and expense allocation (including allocations of overhead);
- the timing of revenue and expense recognition;
- the treatment of expenses and other payments (e.g., retention bonuses) resulting from the acquisition;
- the treatment of extraordinary or non-recurring expenses;
- the treatment of intercompany transactions between the acquired business; and

2 See American Bar Association's Business Law Section, 2009 Private Target Mergers & Acquisitions Deal Points Study (2009), a study which found that 32% of a sample of M&A transactions completed in 2008 involving a private target and employing an earn-out used either earnings or EBITDA as the performance metric.

- the treatment of uncollectible receivables (to the extent previously included in revenue for purposes of the earn-out).

Earn-out Period and Payout Structure. The buyer and the seller should agree on an earn-out period that is sufficient to adequately assess the performance of the acquired business. A typical earn-out period is between one and five years,[3] but in certain circumstances the parties might require a longer period. An earn-out period that is too short carries with it the risk that the performance of the acquired business may be distorted by temporary short-term factors, such as force majeure events or a transitory increase in sales. An earn-out period that is too short might incentivize the seller's management to sacrifice the long-term interests of the business for short-term profits, although buyers may also prefer a shorter period to the extent that their operation of the business is restricted during the earn-out period. The length of the earn-out period will vary depending on the nature of the products involved, the target market and the business plan upon which the earn-out formula was based.

It is also important for the parties to consider whether any events will terminate the earn-out period and trigger immediate payment of the earn-out. Sellers will want to include a provision that accelerates the earn-out payment upon the occurrence of certain events that might negatively impact the seller's ability to achieve the earn-out targets, such as the buyer's sale of the acquired business, a change in control of the buyer or termination of a seller's employment without cause.

Allocation of Control; Level of Support. Two of the most difficult but most important aspects of structuring an earn-out are determining (1) the degree of control (if any) that the seller will have over the acquired business during the earn-out period and (2) the level of support (if any) that the buyer will be obligated to provide to the acquired business. The acquisition agreement might provide that the seller will retain control over certain matters (e.g., sales strategy) or might provide a set of limitations regarding the buyer's operation of the acquired business. In many earn-out transactions, however, the seller retains no control of the acquired business whatsoever. Although theoretically the interests of the buyer and seller are aligned in that they both want the acquired business to succeed, there are several areas where their interests will diverge. Finding a balance between the desire of the buyer to run the business it owns as it sees fit (especially in cases where the acquired business is only part of a larger business serving a common base), and the desire of the seller to protect its ability to achieve the earn-out can be very difficult and often leads to disputes.

The seller's primary objective with respect to control of the acquired business will be to prevent the buyer from making significant changes in the business during the earn-out period, such as discontinuing products, reducing the sales force, altering production, shifting sales from the acquired business to another portion of the buyer's business or shifting costs from the buyer's other business units to the acquired business. In light of these considerations, a prudent seller will attempt to negotiate provisions that require the buyer to operate the business in a manner substantially similar to seller's past practice, prohibit the buyer from making certain major decisions (such as discontinuing a product) without the approval of the seller and require the buyer to adequately capitalize and support the acquired business. Sellers will often seek to require that the acquired business be protected from competition by buyer's other businesses that provide the same or complimentary products.

Acquisition agreements may contain affirmative requirements that the buyer support the acquired business in terms of marketing, capitalization or sales force. In addition, there may be a requirement that the buyer use a specified level of efforts to maximize the earn-out. The buyer's primary objective will be to minimize its contractual or other obligations to the seller in respect of the earn-out and to retain the right to operate the acquired business in its sole discretion without regard to the earn-out. Determining payout structure is also an important component of earn-out negotiations. The following considerations should be addressed in structuring the payment terms:

- whether the seller will receive a percentage of the payment if the performance of the acquired business only partially satisfies the performance metric or whether payment will be conditioned on complete achievement of the performance metric;
- whether payment will be made in periodic

Earn-Outs ➔

[3] See American Bar Association's Business Law Section, 2009 Private Target Mergers & Acquisitions Deal Points Study (2009), which found that approximately 91% of a sample of M&A transactions completed in 2008 involving a private target and employing an earn-out had an earn-out period between one and five years).

Earn-Outs

continued

installments or in one lump sum;

- whether subsequent performance should require that adjustments should be made with respect to payments made (or missed) in previous installments;
- whether the earn-out payments should be capped;
- whether the buyer's indemnification claims will offset earn-out payments;
- whether continued participation by the seller in the acquired business will be a condition to the earn-out (if so, the parties will have to address situations in which the buyer will be permitted to terminate the seller's employment for cause and consider employment compensation and related tax issues).

Case Law: EmergingThemes and Principles

Even where all of the issues discussed above are carefully considered, parties to earn-out transactions often find themselves in disputes. As the Delaware Chancery Court has noted, "Earn-outs all too often transform current disagreements over price into future litigation over outcome."[4] One of the most commonly litigated disputes (at least by reference to reported decisions) relates to the post-closing operation and control of the acquired business (including disputes over the level of support that the buyer is required to use to assist the acquired business in achieving its earn-out objectives). In reliance on the implied duty of good faith and fair dealing and the new doctrine of implied obligation to use reasonable efforts, courts have in certain cases imposed liability on buyers for failing to support acquired businesses. In drafting appropriate earn-out provisions, buyers and sellers should consider the case law applying these implied duties.

The Implied Covenant of Good Faith and Fair Dealing. One theory commonly invoked by unsatisfied sellers in earn-out transactions is that buyer breached the implied covenant of good faith and fair dealing, causing seller to miss the earn-out. Frequently, such sellers will argue that buyers breached the implied covenant by operating the acquired business in a manner that frustrated the achievement of the earn-out, even where such actions were not expressly restricted in the acquisition agreement. Courts have, in some cases, been receptive to this argument.

One of the most widely-cited cases is *O'Tool v. Genmar Holdings, Inc.*,[5] in which the 10th Circuit, applying Delaware law, upheld a jury verdict in favor of the sellers of a boat manufacturing business. This case was significant in that the court concluded that regardless of the lack of any contractual provisions requiring or restricting certain actions, the implied covenant of good faith and fair dealing prevented the buyer from taking actions to the extent such actions would impair the achievement of the earn-out benchmarks. In *O'Tool*, the buyer, one of the nation's largest boat manufacturers, purchased the sellers' startup boat manufacturing company. The acquisition agreement provided for the retention of the seller's management as employees of the business and included the possibility of earn-out payments of more than twice the up-front payment.

When the earn-out benchmarks were later not achieved, the sellers brought suit. The court found that a jury could have reasonably found that the buyer had breached the implied covenant of good faith and fair dealing by immediately changing product names, requiring the acquired business to give priority to sales of products not subject to the earn-out, forcing the acquired business to bear the design and production costs of another of the buyer's product lines that was not subject to the earn-out, discontinuing certain products and, in general, failing to give the sellers necessary operational control over the acquired business. The court reasoned that despite the absence of express contractual provisions, the "obvious spirit of the earn-out arrangement was to give the sellers a fair opportunity to operate the acquired business in a manner to maximize the earn-out." Importantly, the court also pointed to evidence at trial that demonstrated the buyers had acted with "dishonest purpose" or "furtive design" and suggested that the buyer had ulterior motives for acquiring the business, in particular, that it desired to remove a competitor from the market while obtaining an initial foothold in a new market.

Similarly, in *Hodges v. Medassets Net Revenues, LLC*,[6] the sellers claimed that the buyer of their healthcare management software business breached the implied covenant of good faith and fair dealing by developing products not subject to the earn-out and converting the sellers' contracts to those products, despite the fact that it was not clear that such actions were expressly prohibited

4 *Airborne Health, Inc. v. Squid Soap, LP*, 984 A.2d 126 (Del. Ch. 2009).
5 387 F.3d 1188 (10th Cir. 2004).
6 2008 WL 476140 (N.D. Ga. 2008).

by the agreement. Although, unlike the sellers in *O'Tool*, the sellers in *Hodges* were not promised an opportunity to operate the acquired business, the court found that this difference did not limit the application of the *O'Tool* reasoning to the facts presented. Applying Delaware law, the court held that the question of whether the buyer inhibited the sale and marketability of products in an effort to subvert the earn-out in breach of the implied covenant could not be resolved as a matter of law.

Other case law, however, demonstrates that sellers should not assume that they will be able to rely on the implied covenant of good faith and fair dealing as a substitute for negotiating express provisions in the acquisition agreement. Courts have denied claims for breach of the implied covenant of good faith and fair dealing based on fact patterns that are somewhat similar to those in *O'Tool* and *Hodges*. In making their determinations, courts generally look to whether the buyer has taken affirmative steps to impede the achievement of the earn-out (as opposed to simply not supporting the acquired business at a level the sellers would prefer). For example, in *Rubin Squared, Inc. v. Camber Corp.*,[7] the court held that there was no evidence that the buyer took affirmative actions to impede the seller's achievement of the earn-out and denied seller's claim. The court so held even though there were disputes as to whether the seller's management was given adequate control, whether the acquired business was adequately funded and whether resources were diverted to other businesses of the buyer.

Additionally, in *Fireman v. News America Marketing In-store, Inc.*,[8] the District Court of Massachusetts, applying New York law, held that the buyer of a marketing business did not breach the implied covenant of good faith and fair dealing. In this case, the sellers alleged that the business did not meet certain earn-out benchmarks because the buyer, among other things, rebranded the product of the acquired business, removed and marginalized key talent from the acquired business and refused to use the buyer's sales force to promote the product at trade shows. The court reasoned that the merit of the sellers' claim "depends on whether [the buyer] intentionally or recklessly caused [the acquired business] to lose money." Here, however, the court found that the buyer's actions were legitimate business decisions, and that the sellers' allegations amounted to nothing more than a "dispute concerning strategy between sophisticated business people." The court noted that buyer had invested significant funds into new technology for the acquired business, hired additional sales people to retail its products and came up with unique marketing strategies for the business. In light of these facts, the court found that there was no dispute of material fact as to whether the defendant buyer had breached the implied covenant of good faith and fair dealing and granted the buyer's motion for summary judgment.

Finally, the Delaware Chancery Court appears to have applied the similar reasoning in the recent decision of *Airborne v. Squid Soap*.[9] In that case, the plaintiff-seller had sold its soap business to the buyer for a purchase price consisting of a $1 million up front payment and $26.5 million in possible earn-out payments. After the closing, the buyer suffered from crippling litigation and negative publicity with respect to an unrelated product, and the earn-out benchmarks were not achieved. The seller alleged that the buyer had breached the implied covenant of good faith and fair dealing by failing to expend resources to market the acquired business's product. The court acknowledged that a buyer cannot "arbitrarily or in bad faith refuse to expend resources and thereby deprive [a seller] of the prospects for the earn-out" but found that the buyer's failure to do so was not "arbitrar[y], in bad faith, or for no reason." To the contrary, the court recognized that the buyer had suffered a "corporate crisis" and was restrained by legal and financial burdens. Ultimately, the court concluded that this was not a case in which the seller had been deprived of the fruits of its bargain in a manner where the implied covenant of good faith and fair dealing should be invoked, and granted the buyer's motion for judgment on the pleadings.

As discussed above, courts generally hold that there is no breach of the implied covenant of good faith and fair dealing unless a buyer takes affirmative steps to impede the seller's achievement of the earn-out. If a buyer can show its actions were legitimate business decisions, a court will be unlikely to find such actions were in breach of the implied covenant. Nevertheless, *O'Tool* and *Hodges* demonstrate the importance to buyers of specifically reserving rights with respect to the operation of the acquired business during the earn-out period. To the extent post-closing operational issues are left unaddressed, courts may be willing to use the implied covenant of good faith

Earn-Outs ➔

7 2007 WL 2428485 (S.D.N.Y. 2007).
8 2009 U.S. Dist. LEXIS 91236 (D. Mass. 2009).
9 984 A.2d 126 (Del. Ch. 2009).

Earn-Outs

continued

and fair dealing to impose terms that it believes the parties would (or should) have negotiated had such terms been addressed.

To avoid successful claims by sellers of breach of the implied duty of good faith and fair dealing, buyers should seek to add contractual language to an acquisition agreement that (1) negates or disclaims any implied obligations with respect to the achievement of the earn-out and operation of the acquired business and (2) gives the buyer sole and absolute discretion over the operation of the acquired business. The wisdom of including such language is illustrated by *Yarborough v. Devilbiss Airpower, Inc.*, [10] a case in which the acquisition agreement granted the buyer 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." The court rejected the seller's claim for breach of the implied covenant of good faith and fair dealing on grounds that the buyer discontinued doing business with one customer to which sales counted towards the earn-out benchmarks in favor of another customer to which sales did not count. The Court held that the buyer had expressly and unambiguously contracted for absolute power over its ability to make sales in order to foreclose the seller's claim of breach of the implied covenant of good faith and fair dealing.

Sellers should seek to negotiate specific provisions that limit the manner in which the buyer is permitted to operate the acquired business to avoid the need to resort to arguments over implied obligations. This may be accomplished by (1) restrictive covenants that explicitly prohibit certain actions (e.g., firing personnel or imposing additional costs on the acquired business), (2) affirmative covenants obligating the buyer to take certain actions, such as including amounts that the buyer must invest in technology or R&D for the acquired business, requiring certain marketing efforts, or even specifying a level of efforts the buyer must undertake to maximize the earn-out payment or (3) contracting for a certain level of control over the operations of the acquired business during the earn-out period (e.g., approval rights over certain major decisions and ability to elect a certain number of directors).

The Implied Obligation of Reasonable Efforts. Until recently, the implied covenant of good faith and fair dealing was the plaintiff's main theory if the seller was not able to rely on a breach an express covenant of an acquisition agreement. The recent case of *Sonoran Scanners, Inc. v. PerkinElmer, Inc.*,[11] has given sellers a possible additional theory for recovery. In that case, applying Massachusetts law, the court found that the buyer had not breached the implied covenant of good faith and fair dealing, but held that the contract pursuant to which the seller sold its printing technology business contained an implied obligation to use reasonable efforts to develop and promote the seller's technology.

In reaching its decision, the court listed the following factors that supported the conclusion that a reasonable efforts term was implicit in the acquisition agreement: (i) that the earn-out compensation was substantial in relation to the upfront payment, (ii) that the bulk of the upfront payment went to the seller's creditors and not to its shareholders directly, (iii) that the purchase agreement contemplated a campaign to market the business's technology for five years, and (iv) that there was no language in the contract negating an obligation to use reasonable efforts. Ultimately, the court remanded the case to the district court to determine if the buyers had in fact breached its obligation to use reasonable efforts in its operation of the acquired business.

Massachusetts is currently the only jurisdiction to have recognized an implied obligation of the buyer to use reasonable efforts to achieve earn-out targets. Case law from other jurisdictions, including Delaware and New York, seems to suggest that no such obligation would be implied in the earn-out context. *See e.g., Airborne* (supra) (noting that the plaintiff's breach of implied covenant of good faith and fair dealing claim was undercut by the ease with which it could have insisted on specific contractual commitments from the buyer for some "efforts" obligation, and therefore suggesting one should not be implied). It is unclear at this time, however, whether or not other jurisdictions will follow the rationale of the Sonoran court.

The implication of a reasonable efforts obligation alters the liability standard imposed on a buyer in an earn-out transaction. Whereas the implied covenant of good faith and fair dealing generally only requires buyers to refrain from taking intentional or reckless actions that impede the achievement of the earn-out, the reasonable efforts obligation might impose on buyers an

10 321 F. 3d 728 (8th Cir. 2003).
11 585 F.3d 535 (1st Cir. 2009).

implied obligation to take additional affirmative stops to promote and develop the products of the acquired business. In certain situations, even where the best overall business decision for a buyer may be to discontinue or decrease efforts in regards to the acquired business, buyer may not be freely entitled to make such a decision. This potential shift in standards provides additional recourse for buyers to disclaim any obligation to take actions toward achieving or maximizing the earn-out, including the obligation to use any level of efforts.

The Problem of Damages. Even where a seller is successful in proving a breach of an acquisition agreement in relation to an earn-out, the seller will not receive damages unless it can prove that that it would have met its earn-out targets but for the buyer's breach. This problem for sellers is illustrated by *LaPoint v. Amerisourcebergen Corp.*,[12] a case in which the Delaware Chancery Court found that, although the buyer "frequently and intentionally" breached the merger agreement by failing to support the acquired business' products, the seller was not able to prove that this breach had any impact on the acquired business' ability to meet the earn-out targets. Therefore, the court awarded only nominal damages. Similarly, in *Hydra-Stop, Inc. v. Severn Trent Environmental Services*,[13] a case where the court did not ultimately find a breach, the court noted that any damages (even if a breach were found) based on the claim that seller was not granted the requisite level of control over the operation of the acquired business would be "pure speculation." Due to the inherent difficulty for a seller to prove damages in the earn-out context, sellers may wish to consider including some type of liquidated damages provision.

Other Considerations

Accounting Treatment (FAS 141R). In addition to the considerations discussed above, parties to an earn-outs transaction should also consider the effects of a new accounting standard. Statement of Financial Accounting Standards 141 (revised 2007), Business Combinations (FAS 141R). FAS 141R changed accounting and reporting requirements for business acquisitions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Prior to the issuance of FAS 141R, earn-out consideration was recognized in the buyer's financial statements only when such consideration was actually incurred (which resulted in an increase to goodwill). However, under FAS 141R, an earn-out is required to be recorded at fair value as of the date of closing and the recorded fair value is then subject to periodic adjustment (based on probability that earn-out payments will be made) until all potential payments have been made. Any such adjustments must be recorded as gain or loss on the buyer's income statement. The FAS 141R changes may make the use of earn-outs less attractive to buyers because they result in an acceleration of the recording of liabilities and might also affect the buyer's reported earnings. It is important to note, however, that FAS 141R does not apply to earn-out payments that are characterized as compensation rather than purchase price.

Earn-outs as a Security. In certain cases an earn-out might be properly characterized as a security that is subject to federal or state securities laws. In such cases, the offering of an earn-out right to the seller could be required to be registered under the Securities Act of 1933, and give an aggrieved seller an additional remedy of rescission and possibly and additional theory based on the anti-fraud provisions of Section 10-b-5. The Securities and Exchange Commission has issued multiple no-action letters on the subject of whether an earn-out is a security and considers many factors when making this determination, including (1) whether the earn-out is an integral part of the consideration to be received in the transaction, (2) whether the earn-out right is represented by any form of certificate or instrument, (3) whether the holders of the earn-out have any rights in common with shareholders (e.g., voting and dividend rights), (4) whether the earn-out represents an equity or ownership interest in the surviving entity and (5) whether an earn-out is transferable. To avoid a burdensome registration process, the parties should be sure to structure the earn-out in such a way that it is not classified as a security. To that end, the parties may wish to include in the acquisition agreement a provision intended to ensure that the earn-out is not treated as a security (i.e., a provision stating that the earn-out right will not be represented by a certificate, will not represent an ownership interest and will not entitle the seller to any rights

Earn-Outs ➔

12 2007 WL 2565709 (Del. Ch. 2007).

13 2995 WL 2035584 (N.D. Ill. 2005).

14 See American Bar Association's Business Law Section, 2009 Private Target Mergers & Acquisitions Deal Points Study (2009), a study which found that in a sample of M&A transactions completed in 2008 involving a private target and employing an earn-out, 6% of the acquisition agreements included such a provision intended to ensure that the earn-out was not treated as a security.

Earn-Outs

continued

common to equity holders of the buyer).[14]

Conclusion

Earn-outs may be a useful method for parties to M&A transactions to bridge valuation differences. Earn-outs are complicated, however, and parties to an M&A transaction may find that earn-outs may simply delay disputes rather than resolve them. To minimize the risk of disputes, it is essential that the earn-out provisions be carefully negotiated and documented. It is particularly important that the parties attempt to mitigate the risk of the most common sources of earn-out-related litigation by considering whether to clearly and comprehensively specifying the degree of control the buyer and seller will have over the acquired business during the earn-out period and the level of support that the buyer will be obligated to provide to the acquired business.

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