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Earnouts: Pitfalls and Uneasy Compromises

By Steven R. Kamen

Sellers and buyers will often structure a portion of the consideration in an acquisition transaction as an "earnout" so that the sellers can realize upon the future performance of the target company or business if certain milestones — typically financial milestones — are met. In the simplest terms, earnouts are post-closing contingent consideration payments. Many transactions involving private company targets would not get done if historical financial performance was the only valuation methodology employed, particularly transactions involving start-ups, turnarounds, hot-market sectors and transactions where the buyer seeks the continuity of and incentivizing of the management team. With earnouts, sellers can be paid more for their business and buyers are protected since they will only pay more for the acquired business if it performs as projected. A win-win situation? Maybe. Earnout provisions are fertile ground for post-closing disputes and pitfalls for both sellers and buyers. Therefore, thoughtful and well-negotiated earnout provisions are essential.

Financial Metrics and Milestones: How do parties measure financial performance and related milestones for purposes of an earnout? A typical earnout financial metric and the related milestones might be keyed to gross revenue, net revenue, EBIT, EBITDA, net income or cash flow. Several factors may influence the parties as to which financial metric and related milestones they may elect to use, including the valuation methodology used to price the transaction, and whether the senior management of the seller will (a) have significant control of day-to-day operations of the target post-closing and (b) have a significant interest in the earnout. Sellers often prefer revenue-based metrics because these types of metrics are less affected by buyers' operating expenses and post-closing accounting practices. Buyers are frequently concerned about the possibility that the financial metrics for the earnout may adversely impact incentives for long-term success of the business. In this regard, buyers may not want revenue-based metrics because they can skew incentives towards making unprofitable sales and reduce incentives to control costs. Instead, buyers may prefer net income, EBIT or EBITDA metrics, but must still be concerned that any of these may encourage short-sighted cost-cutting. EBIT or EBITDA are widely used as metrics because they can reduce issues that sellers may have with net income metrics, in that they reflect basic income and expense components of the business operations (cost of goods and services, selling expenses and general and administrative expenses) and also exclude other financial costs (such as interest, taxes and depreciation) which can be affected by the buyer's capital structure and how it financed the acquisition. In all events, the parties should be careful to specify what accounting practices will be used in calculating the earnout milestones and any prenegotiated adjustments to the metrics and/or associated calculations.

Source to Which the Financial Metrics May Apply: In conjunction with determining a suitable financial metric, the parties should also carefully delineate the business, division, product line, customer base or other source to which the financial metric will be applied. The final outcome of an earnout could be markedly different if, for example, customers or product lines that are newly acquired during the earnout period are included or excluded from the earnout calculation.

Length of Earnout Period; Early Termination Events: The expiration of a specified time period often serves as the end of the earnout period, with payment of the earnout due at that time and sometimes also at stated intervals such as the end of each fiscal year. The parties should also consider other events that result in an early termination of the earnout period, such as a payment default under the earnout provisions, subsequent sale or reorganization of the business, a change of control, bankruptcy events and/or cessation of employment of key senior management. Some or all of these early termination events could be "events of default" under the earnout provisions, and the amount of the earnout payment due upon each type of early termination

Kamen is a member of Sills Cummis & Gross in Newark and is the co-chair of its corporate practice group. The views and opinions expressed in this article are those of the author and do not necessarily reflect those of the firm.

(and/or the modification of the earnout provisions if the earnout continues beyond any such event, such as the sale of all or a significant part of the business) should be negotiated and specified. A buyer may also seek to negotiate for a termination right at a prenegotiated amount in order to preserve its flexibility, particularly if the seller is insisting on operational or protective provisions.

Operation of the Business During the Earnout Period: The post-closing financial performance of an acquired company depends on many factors outside the control of the seller. Worse for the seller, it will likely not control operations of the business post-closing. Sellers therefore often negotiate covenants to protect their earnout. For example, a seller might require that the buyer (a) continue to operate the business in the ordinary course of business consistent with past practice (possibly with some negotiated exceptions), (b) obtain the consent of the seller for certain major actions and/or (c) operate the business as a separate unit and fund the business to certain minimum levels. Buyers naturally may resist any restraint on their ability to freely operate the target post-closing and often for good reasons. For legal practitioners, this is often a delicate area to navigate. Certain courts have found implied covenants of "good faith and fair dealing" with respect to earnout provisions, and accordingly, the absence of operational or protective provisions does not in all cases necessarily mean that the buyer is free from these types of restraints.

Payments: In negotiating an earnout, the issue can arise as to whether partial payment of an earnout will be made if a milestone is partially achieved, or if the entire milestone must be achieved before any amount is payable. While the outcome of this issue may depend on the strength of the different parties' negotiating positions, one resolution often reached is to establish a minimum level that must be achieved before any payment is made, and then have a sliding scale or pro rated payments above that level. Tax and accounting issues must be carefully considered in structuring the transaction and the earnout provisions. Of course, the parties should consult with their own accounting and tax advisors as to the specific accounting and tax treatment of the earnout provisions contemplated for their specific transaction.

Sellers should also consider whether and how earnout payments should be secured and appropriate remedies for defaults on earnout payments. Buyers often consider agreeing to default interest and less frequently to partial or full acceleration in the case of a payment default. On the other hand, Buyer are often less amenable to securing earnout payments with guarantees, stand-by letters of credit and security grants particularly if a third-party lender is funding the transaction or is otherwise providing credit to the buyer.

Dispute Resolution: Since disputes often arise with respect to earnouts, the parties should carefully consider and specify the applicable dispute resolution mechanism. Where the nature of the dispute is the computation of the applied financial metric, the parties will frequently agree to refer the matter to an independent accounting firm for final determination. Practitioners, however, should be careful to distinguish between these computational disputes and other types of disputes, such as a breach of an operational or protective covenant. These types of disputes are more suitable for arbitration or courts.

The earnout structure can and should be a win-win proposition for buyers and sellers, but buyers and sellers should not expect to have perfectly aligned interests. Sellers want to maximize their earnout. While buyers certainly want their newly acquired business to perform well financially, the time line for that financial performance may be far longer than the earnout period. Buyers also need the flexibility to be able to reposition their newly acquired business if market, industry or other general business conditions change. Sellers can be expected to be reluctant to bear all that risk, particularly if their earnout potentially represents a large portion of the purchase price. All this and more makes earnouts complicated, rife with pitfalls, and often the subject of the most spirited part of presigning negotiations and post-closing disputes. It is said that a good negotiation is one where both parties are equally unhappy. While this is especially true for earnouts, this purchase price construct is and will remain an essential feature of the M&A landscape. ■