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Blocking and Tackling – Earn-Outs in M&A

Earn-Out provisions in acquisition agreements allow the seller or owners of a business to receive consideration after the deal closes, in the form of additional payments which are contingent upon the future performance of the target business or the achievement of specified milestones, or both. Performance objectives are often expressed in financial reporting terms, such as total revenue, gross margin, cash flow or net income, while non-financial milestones may include a product launch, research and development achievements, FDA approval and the like. If the target business fails to achieve those objectives, or the specified milestones are not met, the seller's consideration is limited to the acquisition consideration paid up front at closing, and the seller is not entitled to receive the additional, contingent consideration.

> **"Earn-Outs, however, are not for the faint at heart. An Earn-Out provision may create challenging conflicts of interest for seller management teams as they continue to operate the business after the deal closes."**

Conventional wisdom tells us that Earn-Outs have become a useful tool to use to bridge a valuation gap, for example where the seller is convinced its business should be valued at a higher level than the acquiring company is willing to pay, or the seller is convinced that its business has the potential to attract that higher value. Small companies, privately held companies, and new or high-growth businesses can be particularly difficult to value with a high degree of "bi-lateral" accuracy. Buyers don't like to be told they paid too much for a business, while Sellers prefer not to leave anything on the table or to give up too much of the upside of the business they have built.

Vaughn

Sources of valuation-based uncertainty include the early stage of undeveloped products, volatile market and competitive conditions, lack of reliable financial information, limited historical operations, relatively inexperienced or under-developed management, and, well, the uncertainty of the times in which we live. Buyers (or their lenders and investors) might simply prefer additional time to finance the acquisition, and to allow the business to perform to its promise to validate the amount to be paid for the business, while sellers may anticipate synergies of the combined company and business integration efforts to drive achievement of post-closing objectives.

Rather than allowing a valuation disparity to block an otherwise sensible transaction, the Earn-Out, therefore, is a useful means by which buyers and sellers can bridge the gap.

Earn-Outs, however, are not for the faint at heart. An Earn-Out provision may create challenging conflicts of interest for seller management teams as they continue to operate the business after the deal closes. Sellers, having developed their own financial reporting and operating procedures, should be concerned about how an acquiring company will exercise control or support the operations of the acquired business after closing.

Post-closing disputes relating to Earn-Out provisions often involve allegations that a buyer failed to operate an acquired business in a manner consistent with the effort required to generate the potential Earn-Out. The litigation outcomes often turn on whether the parties included specific management provisions in the acquisition agreement. Did the buyer satisfy its contractual obligations, if any, to the seller relating to post-closing operations? If the acquisition agreement was silent on the post-closing operating standards, did the acquiring company have an implied obligation to maximize the seller's Earn-Out payments, or at least to avoid shortfalls? Or will the seller have to rely on an implied duty of good faith and fair dealing to achieve a favorable litigation outcome.

For these reasons, Earn-Out provisions should be crafted with great care to strike a delicate balance between allowing the buyer operating flexibility to carry on and invest in the acquired business as well as rewarding the seller for post-closing performance and achievement consistent with valuation assumptions.

Post-closing Earn-Out disputes may ultimately be considered the can of a pre-closing valuation disagreement kicked down the road. But diligent drafting of Earn-Out provisions can be useful to avoid or narrow post-closing disagreements. Careful consideration of acquisition Earn-Out provisions can also be very useful in the pre-closing period to help the buyer's and seller's management teams agree on what steps will be taken to achieve their deal objectives. Sellers will need to anticipate the many risks that could impact their Earn-Out potential and seek contractual provisions to reserve or mandate some aspects of control over the acquired business. Buyers, in contrast, are interested in maintaining control over the business, typically to achieve optimum long term operating results.

Drafting guidelines and key considerations for Earn-Out provisions:

- The amount of the potential Earn-Out payment(s) should be clearly stated, including any minimum amounts or caps, and whether each payment involves an all-or-nothing or graduated approach. The amount should be enough to properly reward the seller for potential value, while allowing the buyer to gain from the acquired business operations.
- If the acquired business is going to be integrated with the buyer's operations, the buyer may wish to exclude synergistic benefits from Earn-Out calculations, if they can be quantified, or if not, to operate the acquired business on a stand-alone basis during the Earn-Out period.
- Metrics should be defined with great specificity; all parties should carefully consider the extent to which application or interpretation of accounting principles can impact Earn-Out calculations.
- If the acquiring company is likely to acquire additional businesses during the Earn-Out period, how will future acquisitions impact measurements of operating results of the target business for purposes of determining Earn-Out payments? If the acquiring company itself is acquired by another company during the Earn-Out period, how will that event impact the seller's Earn-Out potential?
- Buyers and sellers need to carefully consider describing the standards by which a buyer's performance will be measured. Using terms such as "best efforts" or "commercially reasonable efforts" may create more uncertainty than expected, as they don't specifically indicate the buyer's obligations.
- The length of the Earn-Out period and frequency of payments should be clearly indicated in the purchase agreement. Will Earn-Out payments be made annually, quarterly or monthly, and over how many months or years? Do operating results in one Earn-Out Period carry over to the next, or is each period considered on its own merits? May Earn-Out payments be off-set against the seller's indemnification obligations to the acquiring company?
- How will contingent Earn-Out payment obligations be treated (or limited) under the acquiring company's credit agreements? Will the acquiring company's lender require Earn-Out payments to be subordinated to the lender's claims against the buyer?
- Federal and state tax and securities law considerations may also affect the nature and structure of Earn-Out provisions.

Until buyers and sellers find a better way to bridge valuation gaps, Earn-Outs are expected to remain a useful tool, and should be carefully designed and constructed to meet buyers' and sellers' objectives.

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