THE USE OF EARNOUTS IN MERGERS AND ACQUISITIONS

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The purchase price is an integral component of any purchase and sale of an operating business, if not the integral component. As in the purchase and sale of anything, the seller and the buyer often have different opinions about a fair and agreeable price. In the context of the sale of a business, the parties will sometimes bridge those differences through a technique commonly referred to as an earnout. While at first glance an earnout may seem to be an ideal solution to the purchase price dilemma, transactional attorneys need to be aware of the many pitfalls inherent in the structure, documentation and implementation of an earnout.

What is an Earnout?

Essentially, an earnout is a portion of the purchase price for a business that is contingent on some post-closing events or criteria, typically the performance of the business that was sold during a defined period of time after the closing. An earnout can be used in asset purchase, stock purchase and merger transactions but as discussed below it is imperative to identify the post-closing business to which the earnout applies, and the structure of the deal as an asset, stock or merger transaction may impact that issue.

An earnout should be distinguished from a deferred purchase price where the buyer is obligated to pay a sum certain over time after the closing, often evidenced by a promissory note. In those situations, the payment is due regardless of the performance of the business, and subject only to the creditworthiness of the buyer. However, not unlike the situation with a deferred purchase price, counsel to a seller in a sale involving an earnout should consider whether the earnout payment, if earned, shall be secured by collateral or subject to third-party guarantees.

In most situations, the seller will incur income tax on the earnout payment at the time it is earned and paid, not at the closing, but the income tax aspects of an earnout payment should be considered along with the other issues discussed below.

In most sale transactions with an earnout, there is also a portion of the purchase price payable at the closing so the earnout is not the entire purchase price. There are rare transactions where the total purchase price is in the earnout, for example, in an early-stage company that has yet to generate revenue. In the more typical case where the earnout supplements a base purchase price, the earnout can constitute a substantial percentage of the total price if the earnout is maximized.

Purpose of an Earnout

Earnouts are used to bridge the gap between the opinions of the seller and the buyer as to the value of the business being sold. As a general rule, the value is a function of the revenue and earnings the business generates. While historical revenue and earnings can be useful in that regard, the buyer is most interested in what those amounts will be. As with any ongoing business, a number of factors both internal and external to the business will impact future results. Many of them may be unexpected and challenging to resolve by even the best managers, the COVID-19 pandemic being an obvious example. Sellers will naturally extol the bright future the business will enjoy, perhaps because of new products about to be rolled out. Buyers will counter by saying they do not want to pay for hopes and dreams, but only for actual results. This may lead to an earnout to resolve the different perspectives. In its most simplistic formulation, the buyer says to the seller "If the business does this post-closing, I'll pay you that." Defining and implementing "this" and "that" in the previous sentence is a large part of what follows in this article.

While earnout payments are often based upon financial metrics, they can instead be triggered by other objective measures. For example, customer retention is often a key concern of a buyer, particularly where a significant percentage of the business' sales are concentrated in a small number of customers. That could lead to an earnout in which the buyer pays an additional sum if a particular group of customers continues to purchase products at a defined minimum level for somewhere between 12 and 24 months after the closing. Other earnouts could be realized based upon employee retention, obtaining regulatory approval for a new product, for example from the Food and Drug Administration, or integration of the seller's business into the buyer's operations, however that is defined. However, financial performance is the most common type of earnout, and we will turn our attention to the issues this raises for the transactional attorney.

Terms of the Earnout

An earnout that is premised upon financial performance raises the following definitional questions:

- What is being measured: sales, gross profit, EBITDA (earnings before interest times depreciation and amortization, net income?
- What is the business unit subject to measurement?
- Over what time period will this measurement occur?
- How does the measurement lead to the earnout payment calculation?
- How much control does the seller have over the business during the measurement period?
- What reporting requirements does the buyer have to the seller and what rights does the seller have to examine the buyer's records?
- How are disputes resolved?

We will discuss each of these questions in order. Starting with the issue of what is being measured, an understanding of basic accounting concepts is imperative. Nevertheless, the transactional attorney should work closely with the client's accountants on this, regardless of whether the client is the seller or the buyer. The correct terminology is crucial to a well-crafted earnout provision, and accounting is necessarily implicated. While earnings or net profits are the ultimate goal for buyers, the earnings generated from a particular volume of sales can differ dramatically from what the seller may have expected, or from what the seller would have achieved based on that level of sales. The buyer, very often a larger company

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than the seller, may have substantially greater corporate overhead expenses than the seller. The buyer may have different accounting policies regarding revenue recognition, cost allocation and other concepts that reduce net income. Thus, a seller will frequently negotiate for an earnout tied to sales as to not to be concerned about the impact of the buyer's accounting methodology on the earnout. Even so, measuring net sales does not remove all subjectivity from the accounting process, and seller's counsel needs to be diligent in defining exactly how financial results will be measured, working closely with the seller's accountants.

The next item to consider is what business unit is subject to measurement for earnout purposes. The natural response to this is that is the same business that the seller sold. However, businesses are dynamic and evolving organizations, in particular following a change in ownership. If the buyer is a so-called financial buyer, meaning a private equity firm, it may be feasible to keep the business segregated from the rest of the buyer's portfolio and maintain the separate identity of the business that was sold. On the other hand, if the buyer is a competitor or in a complementary business, it will quite likely integrate the acquired business with its existing operations, thereby making it a challenge to reach the sales or, worse yet, the profits of the acquired business. Other concerns for the seller may be the buyer's ability to shift customers from the acquired business to other areas of the buyer's operations, thereby depleting the earnout while the buyer still enjoys those sales. Buyers will tell sellers that the buyer has a vested interest in the seller maximizing the earnout, but that is typically much too simplistic. Another area to be addressed on this topic is the treatment of the seller's products being sold to the buyer's pre-existing customers and the buyer's existing products being sold to the seller's customers. It is imperative that these issues be discussed, negotiated and documented.

The period of time being measured for the earnout is less challenging but still requires attention. While there is no set limit, most earnouts cover at least one year and at most three years. In a longer earnout period, the documents should address what units or units of time are subject to the calculation, whether monthly, quarterly, annually or just the entire earnout period. For instance, in a three-year earnout period measured annually, will carryforward and carryback concepts be employed?

Similarly, calculating the earnout payment once the criteria have been measured and agreed upon should not be too challenging. A typical formula would simply apply a percentage to the resulting number, whether sales, net profit or whatever, so that is simply arithmetic.

On the other hand, the issue of the seller's control over the operation of the business during the earnout period is often heavily negotiated. Sellers may enter into earnout negotiations with the expectation that the buyer will operate the business more or less the same way the seller did. Buyers may enter the same negotiations with the attitude that they bought the business and now own it and are free to operate it as they choose. While no reported decision in New Jersey has addressed this question in the earnout context, the Delaware case law is clear that buyers have no obligation to operate the acquired business to maximize an earnout.[1] Moreover, the Delaware courts have held that the implied covenant of good faith and fair dealing in contract law does not equate to an implied covenant to maximize an earnout. Without debating the merits of the case law on this issue, it is incumbent on the seller's attorney to be aware of and negotiate the best possible post-closing covenants for the seller. Since those negotiations may result in fairly weak covenants or no covenants at all, seller's counsel should advise the seller of the pitfalls and risks associated with that result.

The next item to consider in negotiating earnout language is the buyer's obligation to report relevant results to the seller and the seller's right to review the buyer's records and supporting data. Of course, the seller will expect frequent updates, depending on the nature of the earnout criteria. This is not ordinarily a contentious issue in negotiating the purchase agreement, but can sometimes be challenging for a seller trying to implement its contractual rights.

The final topic covered in a properly crafted earnout provision is dispute resolution. Most such provisions employ alternative dispute resolution (ADR) mechanisms rather than litigation. When the earnout criteria are financial, as is often the case, the decision maker or neutral is usually an accountant or accounting firm and not an attorney or retired judge. If the issues revolve around accounting, this makes sense. If there are issues regarding an alleged breach of the buyer's covenants to operate the business a particular way, question whether it's appropriate for an accountant to resolve. Also consider whether to employ so-called baseball arbitration where the arbitrator can only choose the seller's position or the buyer's and no other. As in Major League Baseball salary arbitration, that structure frequently leads to a negotiated settlement without the need for a hearing or other proceeding.

In conclusion, properly structured earnouts can be useful in bridging valuation gaps between a buyer and seller. However, they are complicated mechanisms that must be carefully thought through, discussed with clients and meticulously documented to avoid problems in their implementation.

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[1] See, e.g., *Edinburgh Holdings, Inc. v. Education Affiliates, Inc.,* 2018 WL 2727542 (Del. Ch. June 6, 2018) and *Collab9, LLC v. En Pointe Technologies Sales, LLC and PMC, Inc.,* 2019 WL 4454412 (Del. Ch. September 17, 2019). An excellent article discussing the Delaware case law on this topic is *The Enduring Allure and Perennial Pitfalls of Earnouts* (January 2018), https://corpgov.law.harvard.edu/2018/02/10/the-enduring-allure-and-perennial-pitfalls-of-earnouts/ by Gail Weinstein, Robert C. Schwenkel, and David L. Shaw, Fried, Frank, Harris, Shriver & Jacobson LLP (February 10, 2018).

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