Earn-Outs: In Search of the “Win-Win” Scenario

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Earn-out provisions are commonly used in M&A transactions when the buyers and sellers cannot agree upon a specific purchase price before the date of closing. This discussion examines the typical components and characteristics of transactional earn-out provisions, the motivations of the buyers and sellers in transactions involving earn-outs, and some of the common areas of controversy that may arise in the use of earn-out provisions. Finally, this discussion looks at strategies that the transaction participants—and their professional advisers—can consider in structuring and administering earn-outs that can serve the goals of all parties and avoid disputes.

INTRODUCTION

How do you feel about earn-outs? No, really, how do you feel? The use of earn-outs in acquisition transactions can be an issue that invokes strong visceral reactions and deeply entrenched preferences based on professional experience. On a transaction-by-transaction basis, one’s position on earn-outs can depend on a number of factors.

Not surprisingly, whether a transaction participant is on the buy-side (the potential payor of the earn-out) or the sell-side (the potential recipient of the earn-out) can be the determining factor as to whether the earn-out is viewed as a creative solution or a necessary evil.

For the earn-out proponent, an earn-out facilitates the closing of the deal that may otherwise not come together. This point of view looks at the earn-out as a compromise, and often refers to the earn-out as a “bridge.” An earn-out can be the solution that brings the parties together when they are unable to agree on the company’s value before the closing.

Conversely, for those who disfavor the use of an earn-out, this bridge is a last resort. The earn-out is born of a disagreement, the product of the uncomfortable union of bid and ask, reluctantly and begrudgingly accepted in the spirit of completing the transaction.

To the detractor, an earn-out is simply a tool that delays, rather than avoids, a fight. An earn-out can operate to postpone—but not necessarily solve—the underlying disagreement about the appropriate purchase price.

No matter where one falls on this philosophical spectrum in a particular transaction, most can agree that a “successful” earn-out is one that is structured and administered in a way that avoids post-closing controversy.

This discussion attempts to explore the conceptual underpinnings and specific components of earn-outs from a neutral perspective, and to look at strategies that parties on either side of a transaction can employ to increase the chances of a controversy-free earn-out experience.

THEORETICAL ALIGNMENT OF INTERESTS

When an earn-out component of purchase price is being considered in a transaction, there is often a point of view advanced that the earn-out is an elegant solution. This is because the earn-out provision creates a “win-win” scenario. If the earn-out targets are met, then both the buyer and the seller will be happy. This is because the fruits of the company’s success will be shared.
This concept can be thought of as the “theoretical alignment of interests.” This basic theory is that an earn-out based on the success of the company creates an inextricable bond between buyer and seller during the earn-out period, where the parties share in both the upside of post-closing success and the disappointment of missed expectations.

However, both experience and common sense tell us that the calculus isn’t so simple. Earn-out consideration can, and often does, create competing and sometimes counterintuitive motivations.

It’s helpful to consider the motivations of the parties in a transaction without an earn-out component of purchase price. In a typical all-cash-at-closing scenario, the seller is essentially agnostic on the success of the company post-closing. They have received their value, and they have moved on.

In the same all-cash scenario, the buyer has an unquestioned interest in maximizing profits and all other measures of financial success after it gains control of the entity. The buyer is hoping to capture all the upside it identified when it made the initial decision to purchase the enterprise.

When an earn-out is in play, the seller finds itself in the precise philosophical position as the buyer in the all-cash scenario: the seller is rooting for the company’s post-closing financial success because that would trigger or increase the earn-out. This would seem, at first glance, to align the interests of the buyer and seller.

However, when an earn-out is payable to the seller, it operates to (somewhat) modify the motivation of the buyer. The buyer still wishes for the company to be successful, but this hope is tempered by the realization that success now comes with a cost—the obligation to pay the earn-out. The buyer is now faced with a potential paradox: how can it maximize post-closing success while minimizing the likelihood or amount of the earn-out payment?

Many earn-out disputes are based on allegations that the buyer’s post-closing actions intentionally and impermissibly minimized the earn-out payment to the seller. Although these disputes arise in a variety of factual backdrops and can focus on many different aspects of the earn-out structure, that basic theme is almost always the underrcurrent.

A DEFINITIONAL APPROACH

No matter what one’s existing opinion is with respect to earn-outs, or what one’s inclination is on the motivations and interests of the parties involved, it can be instructive to consider various definitions of earn-out in an examination of how disputes can be avoided.

Reliable sources provide several formulations of the basic concept of an earn-out:

An agreement for the sale of a business whereby the buyer first pays an agreed amount up front, leaving the final purchase price to be determined by the business's future profits.\(^1\)

A contingency component of an acquisition agreement in which the acquiring company agrees to additional payments in the event certain performance-based goals are achieved.\(^2\)

A mechanism used in private M&A transactions by which at least part of the purchase price is calculated by reference to the performance of the target company or business over a period of time after the closing. Typically, an earn-out is structured as one or more contingent payments of purchase price after the closing which are payable when specified targets (such as minimum earnings before the deduction of interest, taxes, depreciation and amortization (EBITDA) or a minimum number of new customers) are satisfied within specified periods. If the target company fails to achieve these targets within the set periods, the buyer is relieved from making the contingent payments (or, in some cases, only required to pay a lesser amount).\(^3\)

There is a fair amount of commonality among these (and other) earn-out definitions. While they vary in complexity, and differ in certain respects, the various definitions generally contain similar elements:

1. The contingent nature of the payment
2. The variability of the amount
3. The delayed nature of the payment
4. The determination of the amount of the payment by reference to a specific indicator of performance measured against a performance target

Considering each of these definitions and the common elements, a unified definition of “earn-out” emerges, and provides a framework for considering strategies for pursuing the win-win scenario and avoiding controversy:

Earn-out: A contingent portion of purchase price in an acquisition transaction, based on the performance of the company post-closing, objectively measured against a target over a specified period of time, and paid at a later date.
Breaking this definition into its major components, we are left with a list of six basic items:

1. Contingent purchase price (which is variable, and/or may or may not become due)
2. Performance metric (usually, but not always, earnings, profits, or some measure of financial performance)
3. Objective measurement (measurement of the performance metric by a formula)
4. An earn-out target (established after considering baseline)
5. Timing considerations (the length of the earn-out period)
6. Payment terms (the method and timing of payment, and the nature of the consideration to be paid)

Each of these six elements can be viewed through the prism of the theoretical alignment of interests and the frequent impediments and challenges to a win-win.

**Contingent Purchase Price**

An earn-out is contingent, meaning that the right to any payment and/or the amount of any payment is not typically guaranteed. This is a relatively simple proposition that is often cynically reduced to “earn-outs never pay.” Indeed, our instincts tell us that avoiding any earn-out payment whatsoever is in the buyer’s best interest.

Sellers are understandably wary of reliance on any payment that its counterparty would like to avoid. However, sellers often view the earn-out as already earned at the time of closing, although they may recognize that this payment may be beyond their immediate control.

Despite this fundamental difference in motivation, earn-outs are common in merger and acquisition transactions, and parties often rely on the theoretical alignment of interests in negotiations and in the quest for the win-win scenario. Frequently, controversies arise when the real-world financial motivations post-closing override the common hopes and dreams articulated at the closing table.

Whether through “creative accounting,” “sandbagging,” or outright chicanery, there is an undercurrent of fear of manipulation of financial results to minimize earn-out payments in certain transactions. When these disputes mature into litigation, the issues involved tend to fall into several main areas.

One frequent area of dispute centers on the level of resources or effort buyer must expend in trying to achieve the earn-out target. Again, the motivations of the parties at closing and the anticipated motivations of the parties after the closing provide the backdrop for controversies focused on post-closing efforts.

A seller hopes to hold the buyer to a very high standard of post-closing efforts to ensure that the buyer diligently pursues the performance that will lead to earn-out payments.

Buyers typically attempt to resist stricter standards or specific requirements regarding post-closing conduct. Aside from the questionable motive of minimizing the earn-out payment, a buyer may have a legitimate motivation to operate the business as it sees fit, and would generally prefer not to be limited by a contractual obligation to operate the business in a particular manner.

Striking the balance between the concerns of each party regarding post-closing efforts is difficult. Common legal standards such as “best efforts,” “reasonable efforts,” and covenants requiring operation of the business using “sound business practices” can be instructive, but often leave room for alternative interpretations of these standards that can lead to dispute.

More clarity can be achieved with more express post-closing obligations, such as specifically required expenditures (for example, the agreement can require certain marketing, advertising, or research and development expenditures). However, more specific covenants regarding post-closing efforts can be limiting and hard to agree upon.

Whether a specific transaction lends itself to a more general standard or a narrowly tailored set of conditions regarding efforts, parties should be aware that courts may tend to look primarily to the four-corners of the agreement when it comes to disputes regarding effort. Courts can be reluctant to impose generalized or implied duties or decide disputes based on theories that post-closing fiduciary duties exist between a buyer and a seller.

One particularly striking example can be found in a recent Delaware Court of Chancery decision, Airborne Health, Inc. v. Squid Soap. In that case, the purchase agreement was particularly scant on details regarding the buyer’s post-closing obligations. The Chancery Court noted that a “noteworthy aspect of the [Asset Purchase Agreement] is the absence of any specific commitments by [the buyer] regarding the level of efforts or resources that it would devote.”

In the absence of clear provisions in the relevant agreement (and in the absence of any earn-out payment), the seller in this case alleged that the buyer breached the implied covenant of good faith and
fair dealing by not taking steps to adequately pursue the financial targets that would result in earn-out payments.

The court was unsympathetic to this argument, finding that the seller could easily have insisted upon a contractual commitment regarding efforts. The court essentially pinned the risk of the contingent nature of the earn-out squarely on the seller, and did not allow the seller to “re-write the deal it cut in more optimistic days.”

This decision can serve as a cautionary tale that reliance on the theoretical alignment of interests on the front end can lead to disappointment at the back end. It also provides a stark reminder that the purchase agreement provides the best, and sometimes only, chance to set mutual expectations.

**Performance Metric**

Choosing the right performance metric is a critical step in the process of creating an effective earn-out framework. This is necessarily a case-by-case consideration, as certain industries and certain companies more easily lend themselves to particularly appropriate earn-out performance metrics.

As many of the traditional definitions suggest, revenue (a top-line metric) or profits (a bottom-line metric) are often selected. In some cases, sales figures or even nonfinancial benchmarks and other business milestones are used as the performance metric.

From a general standpoint then, it becomes important to identify the characteristics of appropriate performance metrics:

1. A performance metric should be easily measurable. A metric that is easily measured at closing and beyond provides the best starting point. Special care should be taken to define all parts of the performance metric, with consideration given to each constituent component of financial measures.

2. A performance metric should be durable. When more narrow or specific performance goals or milestones are used for the earn-out metric, it’s important to look at the possibility of obsolescence.

   As the company’s business plan evolves, what seems like an appropriate measure of success at closing may not be a particularly relevant measure in the future.

3. A performance metric should be understandable. Parties should ensure that the selected performance metric is not so complex or esoteric as to require deep understanding of the company’s business to understand the earn-out calculations. Clarity in this area can help avoid a dispute, and can make resolution of any dispute easier.

   Another important aspect of the performance question is how large a piece of the overall consideration package the earn-out should constitute. Often a function of bargaining power in the specific transaction or the industry in which the company operates, the percentage of purchase price that is structured as earn-out consideration can vary wildly.

   While the amount of the maximum earn-out is frequently in the range of 25 to 50 percent of total purchase price, in some situations, particularly in transactions involving emerging companies or more financially volatile industries, smaller payments at closing with greater potential earn-out payments are more common.

   Where earn-out consideration is more proportionally significant, all of the issues around formulation, calculation and administration of the earn-out are heightened.

**Objective Measurement**

One of the more frequent and significant points of negotiation and potential controversy is the measurement procedure for the earn-out. The questions of who measures the performance metric and the scope of the parties’ rights to review and potentially challenge such measurement are important.

As a starting point, buyers typically want to retain the sole responsibility of calculating the earn-out, and seek to minimize buyer’s rights in reviewing and objecting to earn-out calculations. Of course, sellers attempt to impose stricter standards...
for the calculations, with more visibility on the process, more access to the materials underlying the calculations, and greater ability to object.

Usually, the buyer does take the first cut at the calculation, with seller having a specified period to object. The parameters and time lines of the review and objection process can be comprehensive.

When larger earn-out amounts are involved, or if the parties are more acutely sensitive to the possibility of earn-out dispute, the parties can prospectively appoint a neutral third party to resolve disputes regarding the calculations after seller objects to the buyer’s initial calculation of the payment.

An independent certified public accounting firm or financial analysis firm can be brought in as an expert, with the power to review and correct any calculations that are at issue. The ultimate finding of the independent third party is often structured as a binding determination. This process can help to avoid further dispute.

However, even when parties strive for objectivity and agree on a third-party resolution process, problems can still arise. For example, in a recent decision by the Delaware Court of Chancery, Viacom International, Inc. v. Walter A. Winshall,8 the merger agreement in question set forth a reasonably comprehensive calculation and objection procedure, and appointed “resolution accountants” to determine the earn-out in the event of a dispute.

The resolution accountant’s findings were to be binding on the parties “in the absence of fraud or manifest error,” and the scope of the resolution accountants powers and responsibilities were further evidenced in an engagement letter. Even with these express terms in place, the dispute over an annual earn-out payment was aggressively litigated.9

Ultimately in that case, the court upheld the findings of the resolution accountants, and seemed to show a fair amount of deference to the parties’ heavily negotiated dispute resolutions provisions. Although protracted litigation in this transaction seems in retrospect to be unavoidable, one takeaway from the case is that the involvement of qualified third parties and the inclusion of comprehensive dispute resolution procedures are items that should be seriously considered and carefully crafted.

**EARNOUT TARGET**

In addition to the agreement upon the performance metric, and how and by whom the applicable metric is measured, it is necessary to establish the baseline upon which the performance is measured.

Here, parties have two basic choices. The first option is to measure the future performance against historical results. The second option is to use a projection of future performance as the baseline against which actual future performance is measured.

The advantage of using historical performance as the benchmark is that the Company’s past results are well-established at the time that the buyer and the seller set the future performance target or targets. With the front-end established, the negotiations can focus squarely on the back-end results and the associated payments. Essentially, using prior results as the starting point leaves the parties with only one thing to agree upon, as opposed to two.

On the other hand, using projections as the baseline has the advantage of flexibility. Factors like post-closing market conditions, anticipated growth, the probable effect of business combinations or future strategic partnerships can be taken into account in establishing the performance baseline.

Rather than a more static, prior results-based approach, using projections as a baseline can be a more sophisticated and nimble solution when used in the appropriate transaction. The problem, of course, is agreeing upon the projections. This is another area where the typical negotiation postures can be shifted.

The seller may find itself convincing the buyer of tremendous upside in the initial purchase price discussion, but may be advocating for somewhat reduced expectations and more modest projections in the context of negotiating the earn-out baseline.

From the buyer’s perspective, an earn-out baseline that is based on projections may be desirable because the post-closing value that the buyer adds to the company can be accounted for in the baseline, as well as in the earn-out targets. More robust expectations of success can work to the buyer’s advantage when a projection-based approach is employed.

**TIMING CONSIDERATIONS**

The period of time after closing during which the earn-out may be payable is another important area of negotiation between buyer and seller. A relatively short-term earn-out structure more closely mirrors the dynamic in a deal without an earn-out component—the buyer and seller go their separate ways earlier.

A longer term earn-out period extends the business relationship between buyer and seller and keeps both parties focused on the company’s post-closing financial condition for a longer period of time. This extension of the philosophical alignment of interests can carry with it additional stress, and
can also increase each parties’ expenditures of time and resources in administering—and potentially arguing about—the earn-out.

Longer time lines can enhance latent ambiguities as the parties move further away from closing. In addition, other players (business people and advisers) who were not involved in the negotiation stage may become involved in the process, and those people may be less familiar with the original intent and background of the earn-out provisions.

In some cases, however, a well-considered and well-structured earn-out over a longer period of time can help buyers and sellers achieve their earn-out objectives. From the buyer’s perspective, a longer earn-out period can serve to minimize the risk associated with the acquisition, and can ease the financial strain of a significant deal by stretching purchase price payments over a longer period of time.

On the seller’s side, a longer earn-out time line can give the company a longer runway to achieve its financial goals and can operate to maximize the probability and amount of earn-out payments payable to seller. A longer time frame can also provide time for the “smoothing” of results, which can reduce the likelihood of anomalies that could negatively affect either party.

**Payment Terms**

Much like the question of the time period for the calculation of the earn-out, the timing of the actual payment of an earn-out is an area in which the passage of time can be a factor in breeding controversy. The more time that goes by before the earn-out consideration is actually paid, the more opportunities there are in which a dispute can mature.

There are many other potential terms for the payment of earn-outs. Earn-out payments can be structured as a single lump-sum payment (all earn-out consideration is payable at the end of the earn-out period) or as staggered payments (with payments due at the end of specified measurement periods).

Other variations in payment terms include whether the earn-out is payable as a percentage of company’s actual results over and above the performance metric, or if the earn-out payments are in the form of set dollar amounts that become payable upon achievement of certain thresholds.

Earn-out floors or caps that guarantee an earn-out minimum or limit the overall consideration paid are commonly included as part of earn-out provision. In some instances noncash consideration (e.g., stock) may be appropriate.

Additionally, agreements can contain acceleration or buyout options that can facilitate subsequent dispositions of the company or its assets before the earn-out period expires, without complications involved with the transfer of the earn-out obligations from the buyer to a third party.

**Final Thoughts**

Creating a true win-win scenario can be difficult when earn-outs are a financially significant or otherwise meaningful portion of the purchase price. By considering the likely motivations and perspectives of the parties, and by examining the definitional components of earn-outs, the hope is that companies and their advisers can avoid common pitfalls that can lead to disputes.

Addressing these challenges proactively and collaboratively can provide buyers and sellers with the best chance to avoid post-closing disagreements on the calculation and payment of an earn-out.

Some general strategies that may be helpful include the following:

1. Select an easily measured performance metric that isn’t susceptible to manipulation or differing interpretation. Avoiding ambiguity in the purchase agreement is the best way to avoid controversies surrounding earn-out payments.

   Careful consideration of each of the six basic components of the earn-out definition should be supplemented with clear and careful documentation in each of the key areas.

   In particular, using well-settled, universally understood, and easily defined metrics and definitions minimizes the possibility that parties can credibly advance alternative interpretations after the fact.

   For example, an inadequately defined measure of profits can invite differences of opinion, while a more carefully defined measure of profits and its specific constituent elements can provide a more solid benchmark for the earn-out.

2. Include specific provisions regarding the required level of resources or efforts to be expended by Seller post-closing. Many earn-out disputes center on whether buyer expended appropriate efforts post-closing to adequately pursue earn-out targets.

   By reaching an agreement on a standard of post-closing effort or agreeing upon specific and verifiable measures of
buyer’s efforts, the parties can go a long way in firming up expectations and avoiding disagreements.

Because judicial decisions in this area can be hard to predict, it is beneficial to all parties to avoid judicial resolution of questions surrounding post-closing efforts.

3. Consider using examples to illustrate the calculation of the earn-out formula. An exhibit or supplement to the purchase agreement that contains sample earn-out calculations under a number of hypothetical scenarios can be an effective way to reach consensus at closing, and a good stake in the ground that parties can revisit and rely upon after closing.

Specific examples are a useful tool in establishing and memorializing a common understanding of calculation and payment of earn-outs. Disputes alleging miscalculation or misapplication of the earn-out formula can be avoided when examples (with numbers) are employed in the drafting process and set forth in the definitive agreement between buyer and seller.

4. Engage and involve appropriate internal and external financial and legal resources in the formulation of the earn-out. An earn-out is a quintessential hybrid of business, accounting and legal issues.

Having investment bankers, lawyers, accountants and financial professionals engaged in the negotiation and documentation process can minimize the chances of needing to deploy those resources in the context of a dispute.

Further, there are complex tax and accounting ramifications associated with contingent payments of purchase price, and understanding these considerations up-front puts parties in the best position to avoid surprises down the road. An ounce of prevention can be worth a pound of cure in the sensitive area of earn-out formulation and documentation. In addition, cooperation among the experts in different disciplines is important.

5. Consider using specific nonjudicial resolution processes. In addition to establishing a customary alternative dispute resolution forum such as arbitration or formalized mediation, a purchase agreement can incorporate specific processes for the resolution of differences of opinion regarding earn-outs.

For example, the parties can agree upon an independent certified public accounting firm or financial analysis firm to assist with earn-out controversies. It can be useful to establish problem-solving mechanisms and involve mutually trusted third-party resources before the unfortunate specter of litigation arises. When the parties are already fighting, it is often difficult to agree upon a referee.

However, the instructions, scope of review and other parameters of the independent third-party review and the provisions and time lines around the dispute resolution processes should be comprehensive and clear.

6. Understand the expectations of the parties, and manage those expectations appropriately. During the course of an earn-out negotiation, it is important to establish and periodically revisit the expectations on both sides of the transaction.

Will the seller consider the transaction to be a failure if the earn-out doesn’t pay? Will the buyer view this as a bad deal if significant earn-out consideration results? Understanding what constitutes a “win” for either side is a necessary part of achieving the elusive “win-win.”

Notes:
7. See, e.g., Airborne. In that case, the up-front purchase price was $1 million, with an earn-out component of up to $26.5 million.
9. The annual earn-out in question was nearly $300 million, so the size of the payment was certainly a factor.

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