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Earnout: An essential tool for today's M&A lawyer

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In today's uncertain economic environment, it can be a tall task to accurately determine the true value of a seller's business in a private M&A transaction. The natural tendency for a heightened valuation by a seller and the pragmatic demands on the return on investment by a buyer serve as driving forces for the valuation gaps that are widespread in today's private transactions. This disconnect primarily stems from a disagreement on a seller's projected earnings post-closing due to a number of potential factors. Fortunately, the parties can turn to a well-crafted and thought-out earnout to resolve purchase price differences and bridge any such valuation gaps.

An earnout is best described as a contingent portion of the purchase price in an M&A transaction, which is determined post-closing and is based upon the acquired business achieving certain post-closing performance milestones (financial and non-financial) within an agreed period of time. An earnout protects a seller from failing to realize value in its business and protects a buyer from overpaying for an underperforming asset by allowing for lower upfront capital requirements in order to get a deal done. It also serves the function of incentivizing management post-closing if management is staying on board during the measuring period. A well-crafted earnout can lead to a win-win solution where a seller captures value from the future growth of the business and a buyer gets what it pays for.

Earnouts, however, have always had the potential for creating later disputes about the contingent payments. To prevent such disputes, a buyer and a seller must draft an unambiguous and thorough earnout and develop mechanisms that provide a framework on how these potential disputes are to be resolved.

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Studies suggest that there is an increase in the existence and use of earnouts in today's M&A climate. According to a recent American Bar Association study, almost 30 percent of transactions that closed in 2008 contained an earnout, compared to just 19 percent in 2006. Such increase is probably due to the fact that, during the so-called "seller's market" of the mid-2000s, the much greater number of qualified potential buyers fostered increased competition for deals, which in turn created hesitancy on a buyer's part in incorporating earnouts as part of the purchase price, since doing so would

have encouraged a seller to walk away from a deal. With the severe economic downturn, however, most companies experienced non-projected reductions in revenues and earnings and there were fewer qualified potential buyers. This made it more likely than not that valuation gaps between a seller and buyer would become widespread and require a creative solution in order to reach an agreement on price.

A well-crafted earnout will address appropriate milestones that trigger the earnout obligation, detail the process (accounting method) and framework that will be used to determine whether the milestones have been attained, and address the operation of the business post-closing. There are no "form" earnouts. Rather, issues arising during the due diligence process or those that relate to post-closing matters must be adequately understood by both the seller's and buyer's counsel, and included in the earnout.

Critical to a successful earnout is ensuring that the milestones are custom-tailored to the business being acquired. Earnout milestones can be financial, non-financial or a hybrid. These milestones can relate to a specific division or product line of the business if appropriate. Due to the significant possibility of a later dispute regarding whether or not the enumerated milestones were achieved, counsel should strive to have milestones that are easily measurable and comprehensively defined.

Common financial milestones in today's environment are derived from the business' net revenue, net income, EBIT (earnings before interest or tax) or EBITDA (earnings before interest, tax, depreciation and amortization). From a seller's perspective, the use of gross revenues would be ideal and the easiest to determine because it is not subject to costs and expenses of the business. From a buyer's perspective, a milestone based solely on gross revenues generally does not work because it does not take into account increased costs and expenses of running the business.

Non-financial milestones such as regulatory approval of drug applications, attainment of certain post-closing contracts or launch of certain product or product lines vary from deal to deal. The use of non-financial milestones is more prevalent in transactions that deal with technology, biotech and health care related industries. While, on its face, the achievement of non-financial milestones is easy to determine, the parties should anticipate and address variables that may be present post-closing that would effect the attainment of non-financial milestones.

The framework for determining whether the milestones have been attained must also be thought out. For financial milestones, the process usually entails having a buyer and its accountants make the initial determination as to whether the milestones have been met. A review period should then follow where a seller, if appropriate, can challenge the determination. The earnout should provide a seller with an auditing right, which should be coupled with a covenant requiring the buyer to maintain separate books and records for the business throughout the earnout period. There should also be a mechanism for resolving auditing disputes either by means of an independent auditor or other dispute resolution process by an independent person.

A seller and a buyer should agree on the precise accounting principles

that will be used to calculate whether the financial milestones have been achieved. These should address the treatment of administrative or general overhead expenses that a buyer will allocate to a business, the amortization of goodwill, post-closing recognition of transaction expenses, excess and obsolescence reserves and the like. Reaching consensus on the accounting principles will generally be more challenging if the business is to be integrated into the buyer's business post-closing.

Many disagreements that arise post-closing for earnouts can be traced back to the buyer's post-closing operation of the business. A seller would be well served to include a covenant that requires a buyer to operate the business consistent with past practice or in normal course. Imposing such a covenant restricts a strategic buyer's ability to move operations and capitalize on potential synergies. In fact, a buyer should be aware that, if the earnout is silent on the method of operating the business post-closing, some courts will impose the existence of a covenant of good faith and fair dealing requiring a buyer to operate the business so as to maximize the likelihood of an earnout.

A more aggressive position for a seller would entail negotiating seller approval rights for major decisions during the earnout period and requiring a buyer to adequately fund the business during the earnout period to ensure the business has the ability to capitalize on its opportunities during the earnout period. A post-closing sale of the business during the earnout period or another acquisition by the buyer might also occur, and the parties should address how such business transactions may effect an earnout. With the existence of an earnout, there is also a potential for excessive risk taking or a failure on management's part to "invest" in the business if a seller's management stays on board post-closing. As such, it is imperative for a buyer to ensure that management does not operate the business solely to maximize an earnout.

With so many potential pitfalls that can arise during an earnout period, it is no wonder that a party would want to limit the length of the earnout period. In 2008, nearly 70 percent of all private transactions containing an earnout had an earnout period of three years or less. Another important issue to consider is whether there will be multiple earnout payments in a transaction or whether there are multiple earnouts.

Given today's economic uncertainty, it is safe to say that earnouts in private M&A transactions are here to stay for the foreseeable future. In spite of the potential for disputes, the use of earnouts can have extremely positive ramifications as an effective tool for bridging valuation gaps and getting deals closed.

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