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Merger Agreements

Earn-Outs: Bridge the Gap, With Caution

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Consider this: you have worked for years to build a business and are ready to retire. You hire an investment banker to market your business but find that potential buyers are unwilling to pay your asking price. One buyer offers you less than you want to accept but promises that if the business performs as represented, an additional payment will be made to you a year after the closing of the acquisition. This is known as an earn-out.

Earn-outs—also called deferred payment arrangements or contingent purchase prices—close the value gap between Buyer and Seller. An earn-out usually takes the form of an additional post-closing payment to the Seller predicated on the achievement of pre-defined benchmarks during a measurement period. For example, the parties may agree that the Seller will receive an earn-out payment if gross sales during the measurement period exceed a defined baseline amount. The benchmark need not necessarily be a financial target. For example, it could be obtaining a certain number of new customers or bringing a new product to market within a specified timeframe.

Earn-outs are being offered more and more in the current uncertain economic environment. Today's buyers are likely to highly scrutinize the Seller's projections and be less optimistic about future prospects for the target given today's market instability. Earn-outs, if structured properly, can work to the benefit of both parties, minimizing risk and incentivizing management to continue to work diligently to achieve the agreed upon benchmarks. Ultimately, the Seller has the opportunity to realize full value for his or her business, and the Buyer has the ability to protect itself and ensure that it has received the bargained for value of the target.

How can you ensure that your former business will run on track and meet performance metrics following an acquisition? What can be done to keep the motivations of Buyer and Seller on a common path? What if a worst case scenario develops: you come into the office the week following the closing with the goal of achieving the targets to earn the additional payment – only to find that the Buyer is no longer interested in funding your operations, has reassigned your top salespeople to its existing operations, or sold off key assets leaving you with little more than a desk and a phone to run the business?

Litigation: Courts Reluctant

Failure to carefully draft earn-out provisions can often lead to litigation. Sellers have found that in the absence of specific protections in the acquisition agreement, courts have been reluctant to intercede on the Seller's behalf. Even in cases where an express covenant was deemed to have been breached by the Buyer, in the absence of a liquidated damages provision the courts have found damages to be speculative and have been unwilling to project the earn-out. For example, in *LaPoint v. AmeriSourceBergen Corporation*[1], the Seller claimed that the Buyer breached a covenant to ''exclusively and actively'' promote the Seller's products dur-

[1] No. 327-CC (Del. Ch. Sept. 4, 2007)

ing the measurement period. The court held that the Buyer had breached the covenant, but that it was the Seller's burden to prove damages. The Seller was unable to prove the amount by which the calculation of the earn-out was impaired by the Buyer's breach, and as a result the court awarded only nominal damages.

Another example is the case of *Hydra-Stop, Inc. v. Severn Trent Environmental Services*[2]. There, the president of the Seller was retained as a consultant to the Buyer during the measurement period. Although the acquisition agreement provided that the consultant ''would have the same control and authority as a chief executive officer,'' the Seller contended that the Buyer would not cede control over certain hiring, branding and management decisions that prevented Seller from achieving the earn-out. The court found that the Buyer had not breached the express language of the covenant and further, that because there was no way to quantify the earn-out if the consultant had been granted full autonomy, any claimed damages were ''pure speculation.''

Heading to court can be risky for Buyers as well. In *Horizon Holdings v. Genmar Holdings*[3], the Seller was a specialty boat manufacturer that was acquired by a mass-market boat manufacturer. Following the acquisition, the Buyer directed the Seller to cease the production of the specialty boats and to retool the factory to make multiple types of boats. The result was longer production times and higher development costs per boat, which caused the Seller's gross profits to shrink and the Seller to fail to achieve the earn-out.

The lesson to be learned from these real-life cases is that much of the ambiguity that caused these matters to end up in court could have been avoided if the earn-out had been carefully drafted.

When the Seller complained to the Buyer, the Seller's management team was fired. The Seller's principal argument in court was that the Buyer breached the implied covenant of good faith and fair dealing. While the court would not rewrite the provisions of the acquisition agreement, it was noted that the jury was appropriately instructed to consider ''what the parties likely would have [drafted] if they had considered the Buyer's issue involved.'' The jury's determination that the Buyer's conduct was inconsistent with its legal obligation pursuant to the earn-out provision (but not any express provision of the acquisition agreement) was upheld by the court.

Conversely, in *Yarborough v. Devilbliss Air Power, Inc.*[4], the Seller made a similar argument when the Buyer frustrated the Seller's ability to achieve the earn-out by discontinuing business with one of the Seller's key customers post-closing. The court found that the Buyer had negotiated for language in the acquisition agreement that permitted the Buyer to determine the terms and conditions of all sales, including the decision to make or not make any such sales – and that the court would not imply the parties intentions when there was specific language to the contrary.

Avoid Amiguity

The lesson to be learned from these real-life cases is that much of the ambiguity that caused these matters to end up in court could have been avoided if the earn-out had been carefully drafted, specifying both the rules that would govern the Buyer and Seller during the measurement period and the specific consequences of non-compliance with those rules. The following are key aspects of an earn-out that should be addressed during the negotiation of the acquisition agreement.

- ***Determination and Methodology of Benchmarks***

To avoid the potential for disputes regarding the calculation of the actual amount of any earn-out payment, the parties must structure the earn-out in the acquisition agreement to clearly define the earn-out benchmarks and the methodology of calculation in advance. Determination of the actual earn-out benchmark, be it financial or otherwise, needs to be realistically achievable if the Buyer desires to incentivize the Seller to be focused on the target company's business post-closing. If the Seller feels that the benchmarks are unattainable, the Seller will not be motivated to continue to work towards their achievement. The Buyer should set the benchmark at an amount at which the Buyer would be satisfied with the results of the target corporation and be pleased to make the earn-out payment to the Seller.

The most common financial earn-out benchmarks are based on the target company's gross earnings (sales less cost of goods sold) or earnings before interest, taxes, depreciation and amortization (EBITDA). A gross earnings benchmark is the easier of the two benchmarks to administer as neither party needs to be concerned with the allocation of costs and expenses between the Buyer and Seller (such as overhead and marketing expenses). Gross earnings is also a fairly easy number to determine and audit.

However, EBITDA targets are often favored by Buyers as being a more accurate picture of the financial performance of the target company. EBITDA targets also prevent the situation where the Seller spends excessively, albeit inefficiently, to generate revenue solely for the purposes of achieving the earn-out target. If an EBITDA target is chosen, both parties need to carefully negotiate and draft accounting principles that will properly assess EBITDA with little chance of manipulation. Best practices require the preparation of a sample EBITDA calculation that will be incorporated into the acquisition agreement to ensure that there will not be a dispute regarding its calculation post-closing.

Regardless of whether a gross earnings or EBITDA target is used, the earn-out can be structured several different ways. For example, will the earn-out be paid only once EBITDA exceeds the target, or will the amount of the earn-out be variable based on amount by which EBITDA varies from the target? For an earn-out with a long measurement period, will each year of the measurement period be considered on a stand-alone basis, or will all years be aggregated to determine whether the target has been achieved? If the Seller fails to achieve the target in the first year of the earn-out, should performance in excess of the target in following years result in ''make-up'' of the missed earn-out payment in year one?

[2] 2005 WL 2035584 (N.D. Ill. 2005)
[3] 244 F. Supp. 2d (D. Kansas 2003)
[4] 231 F.3d 728 (8th Cir. 2003)

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If the target company is to be integrated in the Buyer's operations upon the closing of the acquisition, additional concerns will need to be addressed. Will the performance of the target company still be measurable on a stand-alone basis once the entities have been combined? If not, an additional methodology must be agreed upon to determine how income and overhead will be allocated between the parties. For example, if the target company's products will be marketed alongside Buyer's existing products, how much marketing expense will be charged to each party in the determination of EBITDA? The Seller will need to have access to the financial data regarding the performance of the target during the measurement period and the right to receive period reports from the Buyer in order to track progress towards achievement of the earn-out. Buyer and Seller should also consider whether the definitive agreement should provide for binding arbitration by an accountant if there is a dispute regarding the calculation of the earn-out.

■ *Control of the Target Company During the Earn-Out Period*

Following the consummation of the acquisition, the Buyer will have legal ownership of the target company but will need to allow the Seller to retain some control over the operation of the target company during the measurement period. This dichotomy can result in divergent interests of the Buyer and Seller—for example, the Seller may be focused on short-term results and revenue growth to achieve the earn-out benchmark, while the Buyer may be more focused on long term growth and synergies. For this reason, Buyer and Seller will need to negotiate and agree how much control the Seller will retain during the earn-out period.

Typical operating covenants that may be negotiated include (i) an agreement between the parties that the Seller shall be permitted to continue to operate the target company in accordance with a pre-approved budget during the earn-out period (and a covenant by the Buyer to fund the business in accordance with such budget), (ii) the ability to hire and fire employees, (iii) the Seller's ability to continue to make strategic business decisions, (iv) the ability of the Buyer to sell the target company, merge the target company into other Buyer subsidiaries or require the target company to acquire a third party, and (v) a requirement that Buyer and the target keep separate financial records until such time as the earn-out has been fully determined. These covenants work best when they only apply for a short period of time, such as one year. The Buyer will eventually want to take operational control of the target company, and the longer the covenants run the greater the potential for dispute becomes.

■ *Liquidated Damages; Remedy for Breach*

From the Seller's perspective, it will be important that there are liquidated damages if the Buyer breaches the operating covenants. In this context, liquidated damages are a fixed dollar amount of damages negotiated by the parties to be paid by Buyer to Seller if Buyer breaches specific provisions of the operating covenants. As illustrated by the aforementioned cases, courts will not intervene to try and ascertain what the earn-out would have been 'but for' the Buyer's breach of a covenant. It is not unusual that if the Buyer breaches a fundamental covenant, such as re-selling the target company or firing a key employee, that the full amount of the earn-out immediately becomes payable to the Seller. The liquidated damages are the only real leverage the Seller has to enforce the operational covenants it negotiated with the Buyer; without the liquidated damages, the only real remedy would be litigation. For breaches of other, less fundamental covenants, the damages may be limited to incremental damages (which again, may be difficult to ascertain with certainty). The key management personnel of the Seller should each have employment agreements with the Buyer to ensure that they cannot be terminated during the measurement period without appropriate compensation.

■ *Best Practices*

A Seller should not agree to an earn-out unless the Seller is willing to accept the risk that the purchase price paid at closing will turn out to be the sole consideration to be received in connection with the transaction. Likewise, a Buyer should not enter into an acquisition agreement with an earn-out provision unless the Buyer is actually willing to allow the Seller to "stick around" and maximize the earn-out. If the parties do decide to enter into an earn-out, the terms should be drafted as detailed as possible with the assistance of legal counsel to avoid potential disputes down the road. Each of the key points listed above should be addressed, along with any additional deal-specific points.

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