BRIDGING THE VALUATION GAP: TEN KEY ISSUES TO CONSIDER WHEN STRUCTURING AN EARNOUT

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Ten Key Issues to Consider When Structuring an Earnout

An earnout is a form of contingent payment, which may be a useful method of determining a purchase price when a buyer and seller cannot agree on the value of the business to be sold. Sometimes a seller expects to be paid based upon its expectations as to the future value of the target business, while the buyer is not convinced that such future value will be attained. Particularly in a difficult deal environment, earnouts help bridge this gap and can mean the difference between the parties reaching agreement or walking away from a potential deal.

Earnouts are as varied as the deals that give rise to them; there is no set formula to structuring and drafting an earnout. Furthermore, earnouts raise complicated business, financial, legal, accounting and tax issues that require an integrated and thorough approach. This article surveys the key issues that should be considered when using an earnout in connection with the acquisition of a privately held business.

1. Earnout Amount

The amount of the earnout is the subject of negotiation between the buyer and seller. While the precise amount will vary depending upon the situation, the amount of an earnout is typically calculated either as a percentage of the amount in excess of a performance target, or as one or more fixed payments made upon reaching agreed-upon benchmarks. If an earnout involves multiple potential payments, the parties may agree to limit the total amount of the earnout.
Where the earnout recipients remain as employees of the buyer, it is important to set achievable targets, to help ensure that the earnout successfully incentivizes the employees.

2. **Term of Earnout**

Earnouts can be structured as a one-year arrangement, or span several years. Payouts can be made based on performance for the year calculated, or based on the average performance over the life of a multi-year term.

One area of intense negotiation is the question of whether the earnout can be terminated early, providing the seller with accelerated payment upon a sale of the earnout business, a buyer change of control or other negotiated triggering events.

3. **Business Subject to the Earnout**

Earnouts work more smoothly when the business subject to the earnout will be held by the buyer as a separate subsidiary or operating division. An earnout is more complicated when the earnout business is to be combined with other businesses of the buyer. In addition, because it is difficult to separate out the performance attributable to the seller’s original business from that of the combined business, one party may benefit disproportionately from the combination when the earnout is determined.

4. **Base Performance Measure**

Earnouts may be based upon standard financial metrics, such as EBIT/EBITDA, revenues or net income. Each measure gives rise to certain potential adjustment issues that should be considered. (For example, a seller may want to adjust for certain expenses if a net income measure is
employed. See “Adjustments to Base Performance Measure” below.)

Earnouts can also be based upon specific numerical targets, such as number of customers. In other instances, earnouts may be based upon non-financial, project-oriented goals, such as the launch of a new product or execution of a material agreement. This type of earnout would be more commonly found in a start-up company situation.

Whichever a measure is used, the relevant defined terms are critical. It is important that they be as precise as possible, and input should be solicited from the business, accounting, financial, legal and tax members of the deal team. Failure to fully consider and negotiate all relevant issues can give rise to post-closing disputes in connection with the operation of the business and the ultimate calculation and payout of the earnout. In addition, where financial measures are used, the agreement should provide that the calculations be made in accordance with generally accepted accounting principles consistent with past practices, with only such modifications as may be specifically negotiated.

5. Adjustments to Base Performance Measure

Once the parties have settled upon a base performance measure, they should consider possible adjustments. The negotiations over such adjustments are often closely related to the discussions of the post-closing operation of the earnout business. (See “Operating the Business During the Earnout Term – Control Issues” below.)

The appropriate types of adjustments, if any, will depend upon the business deal, the type of business and other factors, such as whether the earnout participants will remain with and manage the business post-closing. Again, input
from the business, financial, accounting and tax experts is critical.

Areas of potential adjustments to consider include: expenses and overhead allocations; businesses or product lines that may be acquired or disposed of by the earnout business following the closing; reserves; taxes; changes in operational policies or accounting practices; extraordinary or non-recurring items; force majeure events; business risks/contingencies associated with the earnout business; and industry or economic trends that may impact the earnout.

6. **Operating the Business During the Earnout Term - Control Issues**

Post-closing, the parties to an earnout can find themselves in an adversarial situation. While the earnout business is owned and controlled by the buyer, oftentimes the seller or the seller's executives remain with and manage the business. A successful earnout provision addresses these issues, whether by adjustments to the performance measure as discussed above, or through post-closing covenants.

Examples of covenants to consider include: an agreement that the business will be operated in a manner consistent with past practices; an agreement on the business and funding plan to be followed during the earnout term; veto rights of the earnout participants with respect to specific operational decisions or accounting changes; and audit and informational rights for the earnout participants. These types of issues can also be addressed through the company’s general governance arrangements.

The seller should also understand how the operational issues may be impacted by covenants in the buyer’s financing agreements, such as limitations on capital expenditures.
Two difficult post-closing control issues are whether the buyer has an obligation to run the business to maximize the earnout or to retain employees who may be necessary for the business to achieve the full earnout payment.

7. Operating the Business During the Earnout Term - Effects

When considering and structuring an earnout, the parties should consider a few general questions as to the effect the earnout will have on the operation of the business: Will the earnout terms properly incentivize the participants managing the earnout business? Or, rather, will the earnout distract them (and the rest of management) from integrating and growing the combined business by unduly focusing them on an arbitrary performance measure?

Furthermore, the parties should bear in mind the ability of both sides to manipulate the earnout business post-closing in order to impact the measurement, positively or negatively.

8. Payment of Earnout

An earnout can be paid in cash or securities. If stock is used, there will be valuation issues (both amount and timing, such as the time of calculation or payment or the closing), anti-dilution issues and issues regarding the approvals required to issue the shares.

The parties should also consider the procedures they will use to determine whether the earnout performance measures have been met. Typically, the buyer’s auditors will make the calculation in the first instance, and the earnout participants are granted a limited period to review and challenge the determination. (This may not be as one-sided as it may first appear, where the earnout participants have been in control of the day-to-day management of the business
during the earnout term.) In addition, it is important to have a dispute resolution mechanism in place prior to closing, in the event that the parties can not reach agreement. (See “Dispute Resolution Issues” below.)

The buyer may seek to time its obligation to calculate and make earnout payments to coincide with post-closing obligations of the seller. In particular, the buyer may seek a right of set-off against any seller indemnification obligations, in the event that the buyer is obligated to make an earnout payment at a point in time when the buyer may owe reimbursements for indemnifiable damages. Again, the tax and accounting specialists should be involved in these issues.

The seller should also carefully review the terms of the buyer’s financing documents to determine how any earnout payments will be treated. For example, the payment may be limited to the extent there is insufficient free cash flow to make the payment, if other financial covenants are not met, or if there is a default under the loan documents.

9. Securities Law Issues

Depending upon how an earnout is structured, the right to receive payments could be characterized as a “security” under the Securities Act of 1933, as amended. To minimize this risk, the parties will typically include the terms of the earnout in the acquisition agreement or a related contract, and provide that the right to the earnout is non-transferable. On the other hand, such an approach means that the earnout participants will not have the rights of a creditor or equity holder.

Additional securities law issues arise if the earnout is paid in stock or other securities. Depending upon the number and sophistication of the earnout participants, it may be necessary to register the shares being issued under the Securities Act.
10. **Dispute Resolution Issues**

The agreement should provide a method for resolving disputes, whether arising in connection with the calculation and payment of the earnout, the operation of the business post-closing or otherwise. For calculation and payment issues, the buyer may want the right to have an independent accountant conduct an audit and an agreed-upon procedure to challenge the seller’s numbers. The contract may also require the parties to first negotiate in good faith, and then submit any dispute to arbitration.