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Earnouts raise issues over control

What's at stake is how to strike a balance between seller's lingering interest and buyer's autonomy.

By Gerald T. Nowak,
Theodore A. Peto
and Matthew J. Nolan
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THE FUNDAMENTAL TERM that must be agreed upon in any purchase and sale transaction is the price. This is as true in a complicated business acquisition as it is in the purchase and sale of a small trinket in a local flea market. One method that is sometimes used to resolve disagreements over price in a business acquisition is to include a provision for additional consideration to be paid to the seller based on the performance of the business in the post-acquisition period. These provisions are called "earnouts" and can be very useful when employed under the right circumstances.

The basic issue that an earnout provision raises, in various guises and forms, is how to strike the right balance between protecting the seller's lingering interest in the performance of the business and protecting the buyer's legitimate interest in maintaining control of the business during the earnout period and beyond. How to strike that balance is part of the art of negotiating the deal.

There are two reasons typically articulated for using an earnout. The first, as described above, is to bridge a valuation gap. Buyers and sellers often have a differing perspective on the value of a business. The seller will be convinced that, given the rosy projections for the business, the company must be worth "X." The buyer, who will be putting actual money at risk, might be inclined to say that the company is worth "X" only if it, in fact, meets the projections, and therefore, after adjusting for the risk of actually achieving the projections, the business is only worth "X - 1." An earnout is a way of allowing the seller to prove the value of the business by actually delivering on those projections before getting paid full value for the projected earnings stream, while allowing the buyer to reduce the risk of overpaying for an underperforming business.

Gerald T. Nowak is a partner, and Theodore A. Peto is an associate, at Chicago's Kirkland & Ellis, where they are members of the corporate transactions practice. Matthew J. Nolan, who was a summer associate at the firm, is a law student at the University of Michigan Law School.

The second reason often articulated for using an earnout is to provide an incentive for future performance. This is probably misguided. True, the target company management often has a large pre-existing equity stake and will profit as a seller if the earnout is achieved. Equally true, the buyer will typically prefer that the earnout be achieved rather than not, as the achievement of the earnout will mean that the buyer has purchased a well-performing business. Nonetheless, there are other, just as effective, ways of providing management with appropriate incentives, such as implementing a well-designed bonus plan and/or providing a new or rolled-over equity stake in the company going forward.

Another decision is how much money should be at risk.

Negotiating the earnout

There are a host of questions to be answered when thinking about how the earnout will be drafted and negotiated. The following are the principal issues to be considered:

■ What is the performance metric? On the theory that you get what you measure, the selection of the performance metric is the most important issue for buyers and sellers to consider. Types of performance metrics include relatively easily calculated financial measures such as revenues based upon generally accepted accounting principles (GAAP); more complex financial measures such as earnings before interest, taxes, depreciation and amortization (EBITDA) or GAAP net income; operational measures such as subscriber base or monthly recurring revenues; and objective, event-driven measures such as the execution of a particular contract.

In each case, the buyer will want to carefully match the performance metric to its goals for the target company, while the buyer and the seller will both want to keep a close eye on the susceptibility of that measure to manipulation or disagreement over its calculation.

■ How much money is at risk? Next to the selection of the performance metric, the most important question in an earnout is how much money is put at risk under the earnout payment. There are a number of subsidiary questions—for example: How often is it paid? (Annually? Quarterly?) Is there a minimum? (Probably not—otherwise it would not really be an earnout.) Is there a maximum? (Typically yes, particularly from a buyer's perspective.)

In considering how much of the deal to put in the earnout, both parties should want to make sure the buyer has some skin in the game. As discussed above, there is a management-incentive effect to an earnout (although this is probably best achieved through other methods). Conversely, there is also a buyer incentive. To the extent that the buyer is paying all, or substantially all, of the earnings of the business to the seller during the earnout period, the buyer has no incentive to manage the business for current earnings. This is a dysfunctional incentive structure and can lead to anomalous behavior. The buyer should always have more to gain than the seller from the current operations of the business.

■ What is the target? The starting point for setting the performance target will almost certainly be the seller's own projections. In setting the final targets, however, the buyer will want to look not at the past operation of the business but how the business will operate when owned by the buyer. This will be controversial for the seller, which will want protection against missing the targets as a result of the new ownership. The buyer should look at that same effect on the upside: What if the opportunities created make the performance targets easily achieved? In that regard, is there any point to having an earnout provision in the first place if the target is easily achieved?

■ How is the target measured? The easy answer to that question would be "under GAAP, of course." The fact is, however, that there are a range of acceptable methodologies under GAAP for many accounting questions. Thus, that easy answer to a seemingly easy question is not quite so easy after all. Whose accounting methods will govern, the buyer's or the seller's? What methodologies will be used, the target's historical methods, or the buyer's methods as used going forward? What if there are changes in GAAP during the earnout period? These are all questions for which there is no right or wrong answer. The most common answer, however, will be to default to the historical accounting practices on which the performance target is based.

Primary among them is selection of the performance metric.

■ How long will the earnout last? From the seller's perspective, the answer is easy: The shorter the better. But the buyer is purchasing an income stream that is expected to last longer than a year or two, so longer might be better from a buyer's perspective. There is a downside for the buyer, however, to extending the earnout period: The longer the earnout, the longer the buyer will continue dealing with—in a sense, reporting to—the seller. With that in mind, the earnout period should last no longer than needed to prove the business case for the acquisition. No longer, no shorter. There is a fairness element to this as well: The further out from the acquisition date, the more likely the business's performance results from current, not prior, management's efforts. The buyer shouldn't have to pay for, and the seller should not profit from, those efforts.

■ Who will receive the earnout payment? This question goes to the core function of the earnout. If the function is to prove the value of the business, the buyer should not care who gets the payment. If the function is to provide management incentives, then the buyer will want continuing managers to share in the earnout.

■ What about the fine print? Like any feature of a complex business deal, an earnout will have some additional subtleties to be discussed among the parties. Among the questions presented are: Can performance carry forward or back from one period to the next? Can the earnout payments be set off against the seller's indemnity obligation? What about a set-off against other payments owing to the buyer? Will the buyer's lenders require the earnout payment to be subordinated to their claims against the company? How will the earnout payment be taxed? These and other questions will need to be answered before the parties finally agree on the existence and structure of an earnout provision.

Who's in charge here?

One of the most significant difficulties in structuring an earnout is that it interferes at some level with the fundamental proposition of an acquisition: that the buyer is buying the business to run as it sees fit, for the benefit of the buyer and no one else. An earnout creates a situation in which the seller has a lingering interest in the company's financial performance, and it is an interest that may conflict with the buyer's long-term interests as owner of the business. This issue will come up in the negotiation when the seller requests some degree of control over the business during the earnout period.

So what will the seller ask for by way of protecting its interests? The seller will likely start with a provision requiring the buyer to continue funding the business during the earnout period. A seemingly less pernicious clause that the seller may ask for would require the buyer to continue to operate the company in the "ordinary course of business consistent with past practice." This may be coupled with more specific prohibitions, such as a prohibition on raising (or reducing) prices. Further down the risk continuum would be a provision requiring the buyer to consult with the seller on extraordinary decisions or corporate actions.

The parties also have to settle on a performance target.

A seller may ask for the earnout to be paid in full in connection with a subsequent sale of the business. This may seem fair, but what if the business is sold at a loss? If this clause is accepted, buyers should be cautioned to provide that the earnout will only be paid on the sale of the business if the business was in fact performing such that it was "on track" to reach the earnout targets.

One covenant that the buyer should be prepared to live with is a covenant to maintain separate books and records for financial reporting purposes. It is fair to require the buyer to be able to accurately report whether the earnout was in fact earned. Note that this is to be distinguished from a requirement to maintain separate legal existence. There are plenty of legitimate reasons why a buyer may choose to discontinue the separate legal existence of the company. The seller may also ask for periodic reporting, so that it can monitor progress toward the earnout.

Lessons learned from cases

As prudent stewards of their clients' interests, lawyers should always ask that age-old question: "And then what?" In the case of an earnout provision, the answer is, far too frequently, litigation. The first impression one gets from a quick review of the case law is that there is a lot of it. The second impression one gets is that there are a host of theories, not always written into the agreement, upon which plaintiffs sue.

In addition to straight contract claims, these theories can include implied partnership/joint venture/ agency theories, fiduciary duty theories and theories of implied duties of good faith and fair dealing. See, e.g., *Double Sunrise Inc. v. Morrison Management Specialists Inc.*, 149 F. Supp. 2d 1039 (N.D. Ill. 2001); *Hydra-Stop Inc. v. Severn Trent Environmental Services Inc.*, No. 03 C 4843, 2003 WL 22872137 (N.D. Ill. Dec. 3, 2003); *Horizon Holdings LLC v. Genmar Holdings Inc.*, 244 F. Supp. 2d 1250 (D. Kan. 2003). The common theme is a certain malleability of the theory, which is suitable for raising claims that are not contained within the four corners of the contract.

In sum, an earnout provision can be a useful tool in the dealmaker's toolkit, particularly when, as is often the case, a valuation gap exists between the buyer's and seller's estimation of the value of the business to be sold. It can be deceptively complex in its application and, as seen from the case law, in its interpretation after the fact. Practitioners employing this device are well advised to consider, and counsel their clients regarding, an earnout's wider implications, particularly as they relate to the seller's lingering interest in a business it no longer controls. What is true of dealmaking generally is doubly true of the earnout provision: The only bad deal is the deal you don't understand.