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Negotiating Earnout Provisions in Acquisition Pacts

So-called "earnout" provisions are a common feature of business acquisition agreements. Under an earnout provision, the purchase price for the acquired business is increased if the business meets certain financial performance targets over a specified period following the purchase.

A recent North Carolina decision highlights the importance of thoughtful planning and careful drafting in incorporating such a provision in an acquisition agreement.

'Avesair Inc. v. InPhonic'

Avesair Inc. v. InPhonic Inc.[1] concerned a transaction in which the defendant, InPhonic, a distributor of mobile phones and provider of wireless services to consumers, purchased the business and assets of the plaintiff, Avesair, a company that had developed technology for delivering targeted marketing messages to mobile devices.

The purchase price, payable in the form of shares of buyer's stock, was $7 million, subject to possible increase under an earnout provision. The terms of the earnout were that buyer would issue up to an additional $4 million of its shares to seller if buyer's gross revenues from the acquired business exceeded $2 million during a 12-month period ending after the closing. The actual number of additional shares to be issued was to be computed on a sliding scale, based on how far such gross revenues exceeded the $2 million threshold during the earnout period.

In addition to those rather unremarkable earnout terms, however, the purchase agreement also included a more unusual, default-type provision. The agreement provided that, regardless of whether the $2 million gross revenue threshold was attained during the earnout period, seller would be entitled to the maximum possible earnout amount ($4 million in shares), if buyer either (1) failed to use "commercially reasonable efforts" during the earnout period to sell products or services derived from seller's intellectual property, or (2) terminated certain of seller's employees whom buyer hired at the closing or (3) failed to provide "outside audited financial information" at the end of the earnout period.

It was this default provision that was the subject of the lawsuit in *Avesair,* in which seller sued buyer for payment of the entire earnout amount. Seller claimed that it was entitled to the entire $4 million

additional payment on the grounds: first, that the buyer had not used the required commercially reasonable efforts to sell the products and services and, second, that buyer had not provided seller with the required audited financial information.[2]

The decision in *Avesair* was a ruling by the trial court on summary judgment motions by the parties solely on the issue of whether seller was entitled to the full earnout amount under the default provision because of buyer's alleged failure to provide the post-closing financial information contemplated by the purchase agreement.

Applying Delaware law, the court ruled in favor of seller and awarded seller the full $4 million additional amount it sought. In reaching that result, the court addressed two major issues, one a question of contract construction and the other a question of the enforceability of a supposed liquidated damages clause. Both issues could have been anticipated—and perhaps avoided—by more careful contract drafting.

First Issue

• The first issue the court addressed was whether buyer had provided seller with the "outside audited financial information" referred to in the contract. The contract was unclear, however, as to just what kind of financial information that was supposed to be. The section of the agreement most immediately at issue in the dispute simply said that seller would be entitled to the additional $4 million "if outside audited financial information is not provided" at the end of the earnout period, without specifying exactly what kind of financial information buyer was supposed to provide or even what was meant by an "outside audit."

Further confusing matters, the next section of the agreement provided that "[f]or purposes of determining whether Seller is entitled" to the additional $4 million payment (either under the earnout section or the alternative, default provision described above) buyer was required at the end of the earnout period to deliver to seller a statement "signed by an officer of Buyer setting forth the actual amount of the gross revenues and the basis for such calculation." The agreement did not, however, require that this revenue statement be audited.

As to the question of what kind of financial information the phrase "outside audited financial information" was meant to refer, one might reasonably suppose that it was the dollar amount of buyer's gross revenues from the sale of seller's products and services. This is both because the earnout formula in the agreement referred only to those gross revenues and because buyer's post-closing revenue report was only required to report gross revenues. That is not, however, what the court concluded.

Instead, the court found the phrase "outside audited financial information" to be ambiguous, permitting it to consider extrinsic evidence as to what the parties intended by that phrase. The court also noted that the agreement had been drafted by the buyer's lawyers and cited the well-established principle of contract construction that ambiguities in a contract are to be construed against the drafter (in this case, buyer and its counsel).

The court then quoted at length, as extrinsic evidence of the parties' supposed intention, an affidavit from one of seller's directors. In the affidavit, the director said that the default provision was "designed to avoid litigation over the earnout agreement" and claimed that buyer's revenues would exceed the $2 million threshold and trigger an earnout only if buyer used "commercially reasonable efforts."

From this, the court agreed with seller that the purpose of the provision calling for "outside audited financial information" was to provide seller with the kind of information the court said seller "would need" not simply to verify the amount of gross sales but also the reasonableness of buyer's commercial efforts in achieving those sales.

The failure of buyer and its counsel to include in the agreement a clear description of what kind of financial information buyer was expected to provide thus invited the court to accept uncritically seller's claim that a fundamental purpose of the provision was to allow seller to determine the reasonableness

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of buyer's post-closing marketing efforts. Such an interpretation is questionable, however, in light of usual practice in negotiating earnout provisions and in light of the contract language itself.

Any financial evaluation of the reasonableness of a buyer's commercial efforts in promoting an acquired line of business clearly requires not just information about buyer's post-closing gross sales from the acquired product line but information as well about the expenses it incurred in achieving those sales—information, in other words, concerning its net sales. But if that is the additional kind of "financial information" the parties in *Avesair* intended that buyer provide, it is curious that the purchase contract's earnout provisions refer only to gross sales and do not even mention net sales.

Indeed, there are several reasons why in most acquisition agreements (especially those involving a strategic buyer) both buyer and seller prefer to refer only to post-closing gross sales and do not even mention net sales. Sellers recognize that, once the business is sold, they will no longer have the ability to control the cost structure of the business being sold and that net sales amounts can therefore easily be manipulated by a buyer.

For their part, buyers typically do not want sellers to be in a position to monitor their cost structure or expenditures. Furthermore, one of the most frequent advantages of an acquisition to a buyer is that it will permit the buyer to increase the profitability of the combined enterprises through the integration of their previously independent manufacturing, sales and administrative organizations, making it practically impossible to segregate those expenses following the acquisition between its existing business and the one it has just acquired.

Interestingly, the court in *Avesair* never did resolve the question of precisely what kind of "financial information" beyond gross sales the parties had in mind when they used the expression "outside audited financial information." It extricated itself from that thicket by turning instead to another question: What did the parties mean by adding "outside audited" before "financial information"? After reviewing various long-standing principles of contract construction and citing a dictionary of business terms, the court concluded that "outside audited" was intended to mean that the financial information was supposed to be reviewed through an independent (rather than an internal) audit. Because not even the limited financial information buyer provided relating to the earnout period had been independently audited, the court concluded on that ground alone that seller was entitled under the express provisions of the contract to the maximum $4 million amount.

Second Issue

• Another major issue the court addressed was the question of whether the default provision under which seller was thus entitled to the full $4 million additional payment was a legally permissible liquidated damages clause or was instead, as buyer argued, so unreasonable as to impose an unenforceable penalty on buyer.

While expressing qualms that awarding seller the full $4 million on the basis of a technical "breach" seemed to confer on seller an undeserved "windfall" amounting to more than half the base purchase price, the court decided to enforce the default provision. It noted that the parties had negotiated the provision with full understanding of the consequences and were represented by counsel and that buyer could have avoided such a harsh result had it simply provided audited financial information concerning the earnout period (which it had still not done even at the time of the court's ruling).

It is ironic that a contractual provision supposedly intended to avoid litigation in fact ended up as itself the subject of litigation. The litigation in *Avesair* is all the more unfortunate because much, if not all, of the dispute would likely have been avoided by more careful drafting.

Had the default provision in the agreement specifically referred, for example, to "the amount of gross sales, as certified by a firm of independent certified public accountants," much of the subject of the lawsuit could have been avoided.

> *Lawyers on both sides are usually under time constraints to "get the deal done," which can result in last-minute provisions not integrated with other provisions or even lead both sides to "punt" certain issues in the hope that the parties will work out ambiguous provisions after closing.*

Similarly, the question of whether the default provision was an unenforceable penalty could well have been avoided altogether had the relevant provisions been drafted instead as a kind of "clawback." The agreement could simply have provided, for example, that the nominal purchase price was $11 million, subject to a reduction of up to $4 million, if, despite its commercially reasonable efforts, buyer's gross revenues from the business during the "earnout" period fell below a specified target amount, as shown by audited gross revenue figures. In that case, buyer's failure to deliver the audited financial information would not have been a "breach" entitling seller to a windfall but, instead, the failure of a condition that would have entitled buyer to a purchase price reduction.

I mention "breach" in quotations, because nothing in the agreement actually obligated buyer to provide audited post-closing financial information of any kind whatsoever, a point neither party seemed to notice in the course of the litigation.[3] All the agreement said was that if buyer failed to provide audited information, then seller would be entitled to the maximum earnout amount. The provision at issue in *Avesair* was thus not a liquidated damages clause at all, because buyer's failure to provide audited financial information was not, in fact, a breach of the agreement.

Indeed, the absence of any contractual obligation for buyer to provide audited financial statements may have actually placed buyer at a disadvantage. Had the agreement contained such a requirement, seller would presumably have been limited to asserting a breach-of-contract claim, allowing buyer to present evidence that seller suffered no damage as a result of the breach because of poor sales during the earnout period. In the course of the acquisition negotiations, buyer may have understandably thought it would be in its own interest to resist as much as possible any post-closing obligations to seller. In this case, however, such an attitude may have backfired.

It could also have been helpful to buyer had the purchase agreement included a clause stating that the agreement was fully negotiated by counsel for both parties and that any ambiguities should therefore not be construed against either party.

Such a provision would have limited seller's ability in *Avesair* to argue that its understanding of what kind of financial information buyer was to provide should prevail.

Conclusion

In light of the confused and confusing language in the *Avesair* agreement, it seems likely that both parties (each represented by a sophisticated law firm) were heavily involved in negotiating the agreement. Furthermore, in acquisition transactions lawyers on both sides are usually under heavy pressure and time constraints to "get the deal done," which demands can result in last-minute, poorly formulated provisions being added that are not fully integrated with the other contract provisions or even lead the parties on both sides simply to "punt" certain difficult issues in the hope that the parties will amicably work out any such ambiguous provisions after the closing.

Avesair highlights some of the dangers of such pressures.

1. *Avesair Inc. v. InPhonic Inc.*, 2007 NCBC 32.
2. Earnout period sales apparently did not meet the $2 million threshold that would otherwise have been required for an earnout payment.
3. The *Avesair* agreement can be viewed online at http://contracts.onecle.com/inphonic/avesair.apa.2003.05.13.shtml.

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