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Delaware Case Exemplifies Typical Weaknesses In Earnout Provisions

David M. Grinberg, Partner

Earnout provisions are often utilized when a buyer and seller disagree on valuation. A portion of the purchase price is contingent upon certain financial milestones during a specified period of time after closing of the transaction. Earnout provisions reward the seller if its projections about the future financial performance of the business are accurate, while they protect a buyer from overpaying if the projections are not. Earnout provisions seem to embody a fair compromise between buyer and seller, yet these structures often end up triggering conflicts and, in some cases, litigation.

There are generally two key areas of debate during the negotiation of earnout provisions: the calculation of the financial metrics to be used; and structuring the earnout to account for the seller's loss of control of the business post-closing. Often the computation of the threshold includes a reference to United States Generally Accepted Accounting Principles (GAAP) and the seller' s past practice. The difficulty is that GAAP embraces a wide range of acceptable accounting practices and is also constantly in flux, with bulletins issued by the Financial Accounting Standards Board presenting new guidelines on an ongoing basis. Meanwhile, "past practice" is often difficult to ascertain after the fact. Furthermore, if the seller loses control of the business and the financial threshold is not met (and therefore no earnout is paid to the seller), the seller often claims that the buyer intentionally curtailed the success of the business in an attempt to minimize the earnout payment.

A recent case in the Delaware Chancery Court exemplifies the type of controversy that can arise from earnout provisions. In its ruling, the court stated, "[t]his case falls into an archetypal pattern of doomed corporate romances… After some time, the

NEWSLETTER EDITORS

David Grinberg
Partner
dgrinberg@manatt.com
310.312.4238
Matthew S. O'Loughlin
Associate
moloughlin@manatt.com
714.338.2710

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initial romance fades, the relationship consequently sours, and both parties find themselves before the court loudly disputing what the merger agreement 'really meant' back in the halcyon days. If this case is different, it is only in the speed with which the ardor faded."

The case centers on Amerisource Corp.'s acquisition of Bridge Medical in 2002 for $27 million. The deal included an earnout clause that provided for as much as a $55 million payout to Bridge shareholders if the post-closing business achieved certain financial benchmarks, including an additional $21 million if Bridge's EBITDA exceeded $4.29 million for the 2003 fiscal year, and an additional $34 million if EBITDA exceeded $11.83 million in 2004.

Subsequently, in 2005, Amerisource sold Bridge to Cerner for $10 million, which represented a more than 60% discount to the price paid by Amerisource barely three years before.

The court awarded the former shareholders of Bridge $21 million based on its finding that 2003 EBITDA had exceeded $4.29 million after taking into account certain disputed adjustments. In addition, the court stated that while Amerisource owned Bridge, it "promoted Bridge only where it was in [its] interests to do so." The court then concluded that when it wasn't in its best interest "skullduggery and obfuscation became the order of the day."

The Amerisource/Bridge dispute is a perfect example why many M&A dealmakers dislike earnout provisions. That disdain notwithstanding, when a seller and buyer cannot come to terms on the value of the target, the only alternative to not doing the deal is often the inclusion of an earnout provision in the acquisition agreement. However, what seems a fair compromise during the negotiation should be weighed against the complexities of the earnout post-closing.

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FOR ADDITIONAL INFORMATION ON THIS ISSUE, CONTACT:

David M. Grinberg Mr. Grinberg's practice focuses on mergers and acquisitions, including tender offers, proxy contests, hostile takeovers and special committee representation, and underwritten securities offerings, including initial public offerings and public and private offerings of equity and debt.