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EARN-OUTS: A Useful Tool In M&A Transactions for Bridging Gaps In Perceptions of Business Value

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Earn-outs are a useful tool in M&A transactions to bridge disagreements between buyers and sellers about a company's valuation. Where such disagreement exists, an earn-out provides "deal insurance" for both the optimistic seller and the cautious buyer by agreeing that a portion of the deal consideration will be contingent upon the performance of the company after the deal has closed. In a down economy, disagreements about the valuation of businesses will likely increase as buyers' bargaining power relative to sellers' bargaining power increases, buyer caution abounds, and access to capital is limited. Sellers can potentially use an earn-out to get closer to what they believe the business would be worth in a better economic climate.

The following article provides a summary of earn-outs, certain advantages and disadvantages of including an earn-out mechanism in deals, and some important considerations in choosing how to structure earn-outs.

Earn-Outs Defined

An earn-out is a payment for performance after the deal is closed. It is a contractual arrangement where, if the business, after its sale, reaches or exceeds certain agreed-upon financial targets or other milestones, the buyer will pay the seller additional consideration pursuant to an agreed-upon formula. For example, if the seller believes the value of its company is $35 million or more, but the buyer believes the seller's company is worth at most $30 million, the "purchase consideration gap" can be bridged by the buyer offering a fixed purchase price of $30 million or less, with an earn-out

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mechanism. Under such example, the earn-out could allow the seller to earn up to a maximum aggregate purchase price of $35 million (or more) if the business, after its sale, performs in a manner in which a certain agreed-upon financial or nonfinancial target is met or exceeded over an agreed-upon period of time.

Earn-outs arguably protect buyers that do not want to overpay, and sellers that do not want to leave money on the table. In appropriate transactions, earn-outs frequently create a win-win situation that enables deals to get done. They also, however, add deal complexity and additional risk if not structured and implemented properly.

Benefits and Detriments of Earn-Outs

Benefits and Advantages

Earn-outs essentially allow parties to agree to disagree, and allow deals to move forward that otherwise might get stuck over lack of agreement about the purchase consideration. For buyers, offering sellers an earn-out can be a means to potentially "trump" competing offers to purchase the target business. Earn-outs can reduce a buyer's initial cash payment and provide a level of insurance by minimizing the risk of overpaying for future revenues and profits. An earn-out also provides a means for buyers to motivate key seller-manager personnel operating the business post-closing, and to align such personnel with the buyer's interests. An earn-out can act as a retention device, holding seller-managers in place in a positive way, in a manner in which employment and/or consulting agreements often cannot. Also, earn-outs can often be internally financed through the earnings of the acquired business after the closing without the need for buyers to obtain additional financing for such portion of the purchase price. In addition, buyers pay the earn-out portion of the purchase consideration (if any earn-out payment ever actually needs to be paid) in tomorrow's dollars, which typically are worth less than today's dollars and may be paid in an economic climate potentially better than that at the time of closing.

For sellers, agreeing to an earn-out can be a great "signaling" benefit as part of the acquisition negotiation. It can indicate to the buyer that the seller will stand behind the seller's view of the value of its business (i.e., the seller will wait to be fully paid until the business performs positively post-closing, as the seller indicates it expects the business should), giving the buyer confidence to proceed forward with the M&A transaction. An earn-out may allow the seller to obtain a higher price for its business than it might get through a traditional sale. In a down economy, sellers can potentially use an earn-out to get closer to what the business is worth in a better economic climate. If a seller is receiving significant up-front value and the earn-out is viewed by the seller as essentially pure "upside," the earn-out is clearly good for the seller.

Detriments and Disadvantages

Sellers should generally be wary of performance-based earn-outs unless they get significant value up-front and the earn-out mechanism is appropriately structured. This cautious viewpoint is particularly true since there are many ways for sellers to be harmed and lose some or all of a potential earn-out payment. Indeed, buyers may be tempted to hinder performance of the business post-closing, or manipulate the correct measurement of such performance, to reduce or eliminate the buyer's potential earn-out payment obligation to the seller.

If earn-out targets are not realistic and consequently targets are missed, the incentive for seller-management personnel goes away and morale often declines. New incentives must then sometimes be put in place by the buyer to positively motivate seller-management personnel on a going-forward basis. In addition, if structured poorly, earn-outs can lead to opportunistic behavior by seller-managers as they try to trigger and maximize earn-out payments (distorting post-closing business performance). Accordingly, it is risky to structure an earn-out for a short period of time (e.g., one year or less). An eighteen month to five year period is a typical and less risky time horizon.

Earn-outs can become litigation fodder when earn-out stakeholders can allege that the buyer interfered with their ability to meet earn-out targets. (See, e.g., *Horizon Holdings, LLC v. Genmar Holdings, Inc.*, 244 F. Supp. 2d 1250 (D. Kan. 2003) ("*Horizon*"). This risk may be greatly minimized and potentially avoided by permitting the seller to either retain some control over the business post-closing or establishing in advance parameters for its post-closing operation. Examples of this include, without limitation, requirements for minimum marketing expenditures or adherence to an existing business model until the time frame for achievement of the earn-out is complete. Earn-outs involve a significant continued relationship between the buyer and the seller, which is not always good.

Appropriate Transactions for Earn-Outs

Clearly, earn-outs are not appropriate for all M&A transactions and they are more frequently used in smaller-sized deals and middle-market transactions (e.g., business valuations of $5 million to $500 million). It would not be prudent to use an earn-out if the business being acquired will be quickly and completely integrated into the buyer's business. In such circumstances, post-closing performance of the business itself will be hard to gauge. Earn-outs work best in situations in which the buyer plans to hold the acquired company as a separate entity and pursue a hands-off management approach.

Earn-outs are most often used where there is great uncertainty about the future of the economy or the target business. In an uncertain economic climate, there is more willingness to take the wait-and-see option offered by an earn-out structured acquisition. Indeed, earn-outs are sometimes the sole basis of payment for distressed properties.

Proper Structuring and Implementing of Earn-Outs

Deals with earn-outs are complex, demand precise drafting, and hold increased potential for conflict. Earn-outs typically succeed only when the details, terms and metrics of the deal are clearly documented and mutually understood. Rules must be clear and easy to carry out. Triggers must be specific, precise and capable of easy measurement. Ambiguity simply delays agreement.

There is tremendous flexibility in structuring earn-outs. That said, earn-out formulas must be properly defined. No detail is too small. Earn-outs are typically based on financial metrics (e.g., revenues, EBITDA, net income) and/or nonfinancial metrics (e.g., product development milestones). In addition, earn-outs may be limited, for example, to (i) the post-closing performance of only products and services of the business prior to the closing, (ii) a smaller group of products and services, or (iii) the performance of a division rather than the acquired business generally. It is in both the buyer's and the seller's interest that the metrics of the earn-out be as clear and comprehensive as possible, including the use of several written hypothetical examples, to avoid potential post-closing disputes. Objective and easily measurable targets are very important.

The *Horizon* case should inform buyers, in a cautionary manner, of the need to draft earn-out mechanisms very carefully and to include specific statements about control of the post-closing entity, method of operation of the business post-closing, and the method of accounting for profits, losses and expenses. All earn-out provisions drafted in acquisition agreements should, at a minimum, include language regarding, (i) control issues relating to the business against which the earn-out performance will be measured, (ii) performance metrics or milestones for the earn-out and the manner of determining if the metrics and/or milestones have been obtained, and (iii) the time frame for achievement of the earn-out metrics and/or milestones. Precise drafting should greatly narrow the potential for future disputes and eliminate many issues that could cause future problems.

Sellers typically want to obtain maximum control of the business against which the earn-out will be measured. This may only be feasible if someone with a seller-side financial interest will continue to manage and operate the business post-closing. Such control includes, for example, budgets, hiring authority, and marketing. Alternatively, and less desirable for the seller, the seller may exercise control by causing the buyer to act within certain parameters in running the business.

Buyers, while wanting the business to perform as well as possible, also want to retain control and flexibility to guard against potentially short-sighted and harmful seller behavior that may help achieve earn-out targets at the expense of the long-term health of the business. Buyers need to maintain a delicate balance in managing the business as they deem appropriate, while not undermining the ability of sellers to obtain negotiated earn-out payments. Appropriate checks and balances are ideal, although the outcome of negotiations by parties on these points typically ends up being a reflection of the relative bargaining position of the parties.

Earn-out performance metrics and milestones may include, without limitation, revenue growth of the business, net profits, cash flow measures, increase in earnings per share, new product launches, level of capacity utilization, or new clients signed on by the business. Gross sales or revenues are better earn-out metrics for sellers than net sales, since expenses are easy to manipulate and distort. After agreeing on the earn-out metrics and milestones, the parties (particularly the seller) may want to address potential post-closing contingencies that could impair the ability of the business to reach the earn-out targets. Further, the parties may wish to set forth in writing precisely how earn-out performance will be measured, including specifying who will be reviewing the books of the business, to avoid any potential post-closing disagreement on this matter.

The main issue in determining the proper earn-out period is how long the parties think it will take to properly assess the performance of the business. If the earn-out time frame is too short, the earn-out incentive may promote actions that result in achieving the short-term earn-out goals at the expense of the longer-term health of the business. If the earn-out time frame is too long, it will fail to achieve the primary earn-out purpose, which is to properly assess the value of the business (as opposed to creating a de facto joint venture).

If the buyer uses different financial standards than the seller used prior to the deal closing, the numbers in the earn-out formula may change. In preparing the earn-out formula, parties must guard against such potential problems.

Some earn-out provisions allow the buyer to essentially buy out the earn-out to accelerate a payoff, subject to different discounting formulas. Other provisions provide for sellers to accelerate earn-out payments upon the occurrence of certain events, such as the uncured breach of certain terms and conditions contained in certain contracts or buyer's subsequent sale of the business.

Tax and Accounting Treatment

Earn-outs can qualify for the installment method of taxation, pursuant to which tax is not paid by the seller on earn-out payments until the payments to the seller are actually received; provided, however, the seller should be aware that the IRS may recharacterize a portion of each earn-out payment it receives as interest on a delayed payment of the purchase consideration, using interest rates set by the IRS. In addition, recent changes in accounting rules have impacted the treatment of earn-outs. Earn-outs will now generally be recorded at their fair value as of the closing date of the transaction rather than delaying recognition until when payment is reasonably assured.

There are many additional tax and accounting issues associated with structuring and recording earn-outs that are beyond the scope of this article. Parties should consult with their tax and accounting professionals early to fully understand the relevant tax and accounting aspects of earn-out agreements.

Conclusion

Earn-outs can be a useful tool in M&A transactions in bridging gaps in perceptions of business value to get deals done. The key to earn-outs that are successful for both parties involves (i) using them in appropriate transactions (typically smaller-sized and middle-market deals in which there is uncertainty about the value of the business being purchased and sold and/or the general economy) and (ii) the parties having a realistic understanding of the primary purpose of an earn-out (i.e., properly assessing the value of the business) and the need for careful drafting of the earn-out provision so that it includes adequate detail and appropriate checks and balances for the benefit and protection of both buyers and sellers.

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