The Concept of Earnout in Merger and Acquisition Transactions

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This research paper throws light on assessment on merger and acquisition (M&A) deals based on earnouts. It is often said that M&A transactions involving earnouts possess option-like features, and thus this research paper using a theoretic approach to model the value of such observations made. Moreover, the impact of uncertainty on the optimal timing of M&A using earnouts has been dealt with in this paper. This research paper shares a dynamic decision-making approach of the invest-to-learn option which is generated on account of investment made in an acquisition. This research paper also provides the implications of earnouts applied in M&A transactions.

It has been found that earnouts provide best hedge to the acquiring companies for minimizing the risk of adverse selection in acquisitions. The reason being earnouts enable an acquiring company resolve the problem of over-valuation and that of non-performance by making part payment contingent on the ex post performance of the target company as well as by retaining target company's managers respectively. The paper recommends earnouts as a valuable strategy for the acquiring companies in the emerging markets for their future global acquisitions as these companies usually end up overpaying the target companies due to lack of expertise in acquisitions. The paper has tried to fill the void in the existing literature by explicitly analyzing the impact of the different modes of payment on the risk profile of acquiring companies in the post acquisition period.

CHAPTER 1: INTRODUCTION

An earnout is a contractual provision which creates a contingent payment obligation upon the acquirer. This contingency is payable upon the seller on achieving certain targets, financial or non-financial, during the post closing period of the deal. To consider from the point of view of the buyer and seller the goal of the earnout provision instituted in the contract is to overcome significant valuation differences that might come in between the parties during the process of negotiations and prevent them from reaching an agreement.[1]

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[1] Victor P. Goldberg, *Framing Contract Law*, (Harvard University Press, 2006)

Thus it can be said that an earnout is "A contractual provision stating that the seller of a business is to obtain additional future compensation based on the business achieving certain future financial goals."[2]

Through a contingent payment structure the parties to contract agree to disagree and defer the ultimate valuation question until a later point in time where and when the uncertainties regarding valuation have been resolved beyond doubt.[3] The earnout provisions fall into a broad category of post-closing pricing adjustments which also include other devices like Contingent Value Rights (CVRs), escrows, indemnity funds, working capital adjustments etc.[4]

All these provisions modify the structure of consideration in the merger transaction to create some opportunity for an ex post settling up and this contingent obligation is the central feature of an earnout provision.[5]

This research paper shall focus on determining whether earnouts really serve to respond adverse selection or do they better address the problems which are created by symmetric uncertainty. This can be shown through a difference of mean tests for the fair value of estimates of earnouts at the time acquisitions and during the post closing period. The seller rely on the earnouts during the pre-contractual period so as to signal unobservable information of their own worth to a purchaser and then the post-closing fair value estimates should increase as the acquirers confirm the pre-signing statements which shows that the parties rely on earnouts principally to resolve the problem of uncertainty rather than adverse selection.[6]

The main reason behind this is that sellers have certain private information about themselves which they cannot credibly convey to the potential acquirers, and in such absence of information a high quality seller may be unable to overcome the acquirer's presumption that there is hidden

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[2] Definition of Earnout available at http://www.investopedia.com/terms/e/earnout.asp (Last Visited 15th October, 2013)

[3] Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing,* 94 YALE L. J. 230, Pg. 238-240 (1984)

[4] Christopher D. Dillion & Brad A. Pletcher, *The Acquisition and Sale of Emerging Growth Company: The M&A Exit*, 2008 Pg. 5-70 (2004)

[5] *Ibid.*

[6] Robert F. Bruner, *Applied Mergers and Acquisitions,* (Wiley 2004)

negative information about the seller. The seller's inability to demonstrate the value may hamper the consummation of a potentially value-enhancing transaction.[7]

Economists suggest that high quality sellers should rely on earnout as a mechanism for sellers to signal private information about their quality to potential acquirers.[8] Deferring the final valuation of the target until a point in time after the buyer is able to confirm pre-contractual statements made by the seller; a high quality seller may be able to rely on an earnout mechanism to demonstrate his confidence in the firm's value. Because an earnout provision is costly to sellers who know they are low quality sellers such sellers should be expected to avoid agreeing to receive contingent payments. In that way the earnout provision may permit a high quality seller to "*put the money where the mouth is*" and thus credibly convey hidden information about her quality to prospective buyers.[9]

A recent example illustrates this point. In April 2011, Sanofi, S.A. acquired Genzyme Corp.[10] During the merger negotiations; the parties had a fundamental disagreement over the Genyzme's valuation. Genzyme had previously experienced a number of difficulties in the production plants for its Cerezyme and Fabrazyme products. Genzyme management believed they resolved these serious production issues. These problems however had a materially negative impact on the valuation of the firm.[11] Genzyme's management believed that Lemtrada, a drug in their development pipeline, had the potential of being extremely profitable for the firm.[12] For its part, Sanofi was less sanguine about the prospects of these products to contribute to the firm's bottom line or that Genzyme had overcome its production problems. In order to bridge these differences, the parties structured the merger consideration in this transaction in the following manner:

The first component consisted of a cash payment equal to $74 per share payable at closing.[13] The second component was a contingent payment of up to $14 per share payable after the closing upon

[7] *Supra* note 1

[8] Matthew D. Cain, David J. Denis and Diane K. Denis, *Earnouts: A study of Financial Contracting in Acquisitions Agreements,* 51 J. ACCT. & ECON 151 (2011)

[9] James C. Freund, *Anatomy of a Merger,* Law Journal Press, 1976

[10] Genzyme Corp., Joint Sanofi/Genzyme Press Release, Form (425/8-K) (Feb. 16, 2011) available at http://sanofi.mediaroom.com/index.php?s=33507&item=118549 (Last visited on 16th October, 2013)

[11] Associated Press, *Genzyme Shares Fall on FDA Plant Inspection Plans*, Mar. 20, 2010 available at http://www.businesswire.com/news/genzyme/20110427006998/en (Last visited on 16th October, 2013)

[12] Reuters, *Timeline: Sanofi's Quest for US Biotech Genzyme*, Feb. 15, 2011

[13] *Supra* note 10

the achievement by Genzyme of certain regulatory and financial milestones.[14]

The contingent payment in this case helped resolve the parties' differences about production problems and revenue expectations for drugs in the Genzyme pipeline. To the extent the production issues had been resolved as Genzyme managers assured the acquirer they were, Genzyme shareholders would receive additional value. To the extent the pipeline drugs lived up to the expectations of Genzyme's management, such success would be reflected in an increase in the ex post valuation of the seller as demonstrated by an increase in the contingent payment obligation. If Genzyme failed to perform to expectations Sanofi would not be required to make additional payments. By deferring the ultimate determination of value until a point in the future, both the buyer and the seller were able to proceed with the deal notwithstanding unresolved differences with respect to valuation.[15]

CHAPTER 2: THE EARNOUT MECHANISM

Corporate acquisitions are highly complex transactions that require large amounts of private information relating to the future prospects of the seller or the status of the product of the seller that will be only know to the seller himself. The buyers though are involved in significant due diligence but it might be impossible without great effort for a buyer to uncover all the private information that a seller might possess.

Such information if it is negative there may be an incentive for the seller to downplay its importance and on the other hand they may find it difficult to convey positive information to the buyer in a way that is credible and apart from the informational problems, there may be fundamental disagreements over the future of the seller or the sellers industry that might negatively impact the acquirers valuation of the seller.[16]

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[14] *Ibid*, The contingent payment took the form of a contingent value right ("CVR"), a registered security. The CVR adopted in the Genzyme/Sanofi transaction is a form of earnout that is more common in the sale of public companies than in the sale of private companies. Sanofi contracted to make payments to security-holders contingent upon the following milestones:

1. $1/CVR if specified Cerezyme and Fabrazyme production thresholds are met for 2011;
2. $1/CVR upon final FDA approval of Lemtrada;
3. $2/CVR if global net sales revenue exceed $400 million;
4. $3/CVR if global net sales revenue exceed $1.8 billion;
5. $4/CVR if global net sales revenue exceed $2.3 billion; and
6. $3/CVR if global net sales revenue exceed $2.8 billion.

[15] American Bar Association, *Committee on Negotiated Acquisitions, Private target Mergers & Acquisitions Deal Points Study* (2006)

[16] John Farrell & Robert Gibbons, *Cheap Talk Can Matter in Bargaining*, 48 J. ECON. THEORY 221 (1989)

Hence, buyers and sellers find themselves unable to agree on an appropriate valuation for the seller and for this, the earnout provision, provides the parties with an ex post opportunity to settle up and fill in the gaps which are generated either due to information asymmetries or symmetrical uncertainties. In effect, the parties rely on the contingent payment mechanism to come to a final determination where post closing period the acquirer has had an opportunity to learn the seller's private information or the uncertainties have been resolved.

Deferring payments until post closing permits the drafters to closely align the valuation question with those sources of disagreement between the parties and they are able to generate incentives for sellers to be more conservative in their claims about the seller's post-closing prospects by, in effect, putting their money where their mouths are. Deferring the payments until a post-closing period where the seller's pre signing statements can be evaluated might resolve adverse selection because the contingent payment functions as a credible signalling device. If sellers have hidden information about their quality which suggests the seller is a low quality seller, then the seller does not have an incentive to agree to post-closing contingent payments as such a structure is costly to the low quality seller. Sellers with hidden information that suggests that the seller is a high quality seller are likely to agree to accept contingent payments because they are more confident to receive the payments during the post-closing period when the uncertainty is resolved.

Earnout provisions have certain common features that are found in such common provisions. First, earnout provisions tie the payment of additional merger consideration on the accomplishment of certain specified targets or milestones during the post closing period by the seller.[17] Earnout targets are often proxies for seller or seller product performance and fall into one of two general categories: financial or non-financial targets.[18] Financial targets include some measure of top-line revenues, cash-flow, EBITDA, profitability, or other costs that can directly prove the financial performance of the seller.[19] Non-financial targets may include some non-financial proxy for revenue, for example unit sales, licenses, market share targets, or specific customer-oriented goals. Non-financial targets may also include certain technological achievements or regulatory approvals, such as FDA approval for medical devices and

[17] *Supra* note 4
[18] *Supra* note 6
[19] *Supra* note 15

pharmaceutical products.[20]

Second, parties may negotiate triggers for contingent payments in a number of forms: sliding scale, cliffs, or binary. Binary triggers are common and relatively easy to administer which authorizes the payment of the earnout only upon the meeting of the stated milestone. Non-financial targets, like regulatory approval, are amenable to binary payment milestones. A product either, receives regulatory approval and is therefore valuable to the acquirer, or it does not and is therefore less valuable. For example, one of the payment triggers in the Genzyme earnout was related to the government approval for a new drug in the Genzyme pipeline.[21] The uncertainty about the prospect of receiving government approval had a material effect on the acquirer's valuation of the seller. The source of that uncertainty may have been endogenous – the seller had information about the likelihood of receiving government approval but was unable to credibly convey to the acquirer, or it may be exogenous, a result of symmetrical uncertainty.

Though binary milestones are appropriate in some circumstances, they may not be appropriate in all the time. Binary milestones may sometimes run afoul of other incentive issues. For example, if it becomes apparent to the seller that it will not be able to achieve the milestone, the seller may have little incentive to efforts to achieve the goal. In response to this potential problem, drafters sometimes rely on incremental milestones or sliding scale payments. Incremental milestones recognize that there may be negative incentive effects associated with a "cliff".[22] The Genzyme contingent payment also included a series of incremental milestones tied to various levels revenues achieved by the seller.[23]

Sliding scale payments do away with the potentially negative incentive effects of a cliff by acting like royalties, payable as a percentage of revenue, or profits or some other continuous variable that the parties have identified. However, the downside of this is that it rewards satisficing behavior by sellers rather than incentivizing maximization of the threshold targets by sellers.

Third, the length of earnouts typically varies anywhere between one and five years, but it should be long enough to resolve the uncertainty that caused the fundamental disagreement over

[20] *Supra* note 4
[21] *Supra* note 6
[22] Leigh Walton & Kevin D. Kreb, Purchase Price Adjustments, Earnouts, and Other Purchase Price Provisions (Dec. 2007)
[23] *Supra* note 6

valuation.[24]

Fourth, the size of an earnout relative to the total consideration in the transaction also varies. In general, the size typically reflects the degree of uncertainty between the parties with respect to the seller's value.[25] To the extent that the duration and size of the earnout are long and large enough to overcome the uncertainty giving rise to the valuation differences between the parties, the earnout mechanism is an appropriate device to address valuation disagreements.

Apart from the size and duration, the degree of autonomy and the control over the sellers business during the post-closing period is often central to the negotiation of the earnout provision because of the likelihood that shareholders of the seller will receive any contingent payments is co-related to the ability of continuing employees to take actions that will maximize the seller's value with respect to the earnout targets.[26] To the extent that the selling shareholders are not going to continue to be involved with the seller post-closing and to the degree buyers do not to keep the seller apart from the parent, buyers may face incentives to undermine the implementation of the earnout in an effort to reduce their payment obligations under the earnout provision (moral hazard).

CHAPTER 3: COMPETING HYPOTHESES: ADVERSE SELECTION & UNCERTAINITY

There are two hypotheses competing against each other in order to explain the use of earnouts in merger and acquisition agreements. Legal scholars and financial economists have held to believe that earnouts are a contractual response to an adverse selection. As per this theory, earnouts play a significant role in eliciting hidden information from acquirers and by deferring the ultimate valuation until a later point, the seller is able to signal their unobservable quality to the potential buyers.

However, the competing hypotheses provides that, earnouts do not play any role in conveying any information between parties, rather earnouts respond towards the problem of uncertainty prevalent in merger transactions and earnouts resolve the problem of uncertainty by assigning the risk of a negative outcome to the seller in such a way that can facilitate both the parties towards reaching

[24] *Supra* note 8
[25] *Ibid*
[26] *Supra* note 22

an agreement.

In various transactional situations where there is any divergence found in the information between the buyers and sellers to be more extreme, they are both likely to rely on an earnout provision in order to bridge the gap.[27] Empirical evidence supports the argument that the structure of terms of earnout is purposefully designed in order to address the critical issues of information asymmetries between the buyers and sellers.[28] This shows an inference that earnouts exist as to signal an unobservable quality in response to adverse selection and thus adverse selection hypotheses has become the dominant hypotheses for the role of contingent payments in merger agreements.

Recently, it was shown that post-closing data only related to earnouts that was extremely limited as the range of questions that earlier could be addressed was relatively narrow. Certain gaps in the data meant that there was no reliable assessment of the fact if the parties relied upon earnouts to generate any credible information signals. As a result, still there remain gaps in the understanding of the role of earnout provisions in resolving the problem of adverse selection in contracting. [29] Professor George Akerlof analyzed the problem of adverse selection in his well-known paper on the "lemons market."[30] A lemons market arises when, prior to contracting, it is expensive or otherwise difficult for acquirers to accurately distinguish between high quality and low quality sellers, since buyers are unable to distinguish between sellers, they offer only the average price for a pool including both high and low quality types. If left unresolved high quality sellers exit the market leaving only low quality sellers, and the lemons market collapses.

Prof. Akerlof illustrated this problem by proposing an experiment with a used car market where the sellers had information about the quality of the car they had available for sale that was unavailable to potential buyers.[31] Potential acquirers knew only that the pool of used cars available for sale included both high and low quality cars. Consequently, potential acquirers price their offers equal to the expected value of a pool of sellers that includes both low and high

[27] Srikant Datar, Richard Frankel & Mark Wolfson, *Earnouts: The Effects of Diverse Selection and Agency Costs on Acquisition Techniques*, 17 J.L.ECON. & ORG. 201(2001)

[28] *Supra* note 8

[29] Brian JM Quinn, *Putting Your Money Where Your Mouth Is: The Performance of Earnouts in Corporate Acquisitions*, 81 U. Cin. L. Rev. (2013)

[30] George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970)

[31] *Ibid.*

quality sellers. High quality sellers know their own valuations and withhold their cars from the market, leaving only low quality cars, or lemons, in the market.[32] In a market where high quality sellers are unable to distinguish themselves from low quality sellers, this information asymmetry can mean that otherwise socially valuable transactions do not go forward.

Sellers understand this problem and engage in signalling behavior to overcome adverse selection.[33] In order for signals to help buyers and sellers overcome the problem of adverse selection, the seller must convey information about its unobservable quality to the buyer. The distinguishing feature of a credible signal is the cost to low quality types who make the statement. This cost feature creates separation in the marketplace between high and low quality types.[34] Because signals are costly to low quality sellers, sellers who know they are a low quality type avoid making such statements.[35] High quality sellers are willing and able to make relatively costly contingent statements because they know it will not incur the costs associated with incorrect statements. The relative cost differences faced by high and low quality sellers leads to a separation in the market as high quality sellers reveal themselves to buyers in a way that buyers can believe.[36]

Another view on utility of earnouts is that buyers and sellers rely upon themselves to resolve the problem of uncertainty which can adversely affect the ability of buyers and sellers to reach agreement on valuation of an asset. Professor Frank Knight distinguished between “risk” and “uncertainty”.[37]

The first represents an unknown, but calculable outcome, while the second represents an outcome whose ex ante probabilities are essentially unknowable.[38] To the extent negative outcomes are tied to asymmetric information, including adverse selection, such outcomes are best categorized as “risks” in a Knightian sense. Where there are risks, the party with the structural information advantage is best positioned to accept the risks. The presence of an uncertainty can present different obstacle to parties wishing to engage in a transaction. A characteristic of uncertainty is that neither party has an ex ante structural advantage with respect to knowing whether or not the

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32 *Ibid.*
33 Eric Rasmussen, *Games and Information,*Q.J. ECON 2007
34 *Ibid*
35 *Supra* note 29
36 *Ibid*
37 Frank H. Knight, Risk, Uncertainty and Profit (Courier Dover Publications 2012)
38 Larry G. Epstein and Martin Schneider, *Learning Under Ambiguity*, 74 REV. ECON. STUD. 1275 (2006)

adverse outcome will come to pass. In that sense neither party is necessarily best positioned to accept the consequences of a negative outcome, as is the case when information is asymmetric.

Capital asset pricing theory assumes that buyers and sellers of a capital asset like a corporation share joint expectations about the future.[39] Expectations for the future are closely associated to risk preferences. Where parties do not share the same preferences for risk, which may also undermine efficient pricing. Entrepreneurs are, by their nature, more risk loving (*e.g.* they accept larger variances around the mean outcome) than acquirers. Where buyers and sellers have a different preference for risk, these differences may violate the assumption of joint expectations leading parties to find themselves unable to reach a pricing agreement. The issue is not asymmetric information as neither side necessarily has any informational advantage with respect to the underlying probabilities of future states of the world. The issue is, rather, uncertainty and the differences between the buyer's and the seller's risk preferences.

If the parties agree on a transaction structure that resolves uncertainty and distributes the relevant probability of an adverse event to the party with the larger preference for variation, then the parties will be able to create uniform assumptions and then generate an efficient price for the seller.[40] Earnout provision permits the buyers to reduce the likelihood that they will overpay for a seller in the event the future turns out not to be as predicted by sellers. Sellers bear the potential cost of their optimism. With an earnout, the sellers simply agree to bear the costs of being wrong without generating any information for a potential acquirer.[41]

In order for earnouts to function as a credible information signal, they should be able to generate a separating equilibrium. Where, the seller's choice of contract type, includes an earnout provision that conveys private information from sellers to buyers.[42] It is only the high quality sellers that should self-select into the group of sellers agreeing to earnout provisions in merger agreements. If, on the other hand, the equilibrium is pooled, with both low and high quality buyers choosing to rely on earnout provisions, then the earnout loses its value as an information signal. In that case, it is more likely that parties are become reliant on earnouts to resolve uncertainty and in such cases, the parties do not intend to convey information by their choice of contractual provision.

[39] Ronald J. Gilson & Bernard S. Black, The Law and Finance of Corporate Acquisitions (Found. Press 2003)
[40] *Ibid*
[41] *Supra* note 29
[42] Louis Phillips, *The Economics of imperfect Information,* 1989 at Pg. 122

Consequently, there is no expectation that contracts with earnouts in that case will or should reveal a separating equilibrium.[43]

CHAPTER 4: FAIR VALUE DISCLOSURES OF CONTINGENT PAYMENTS

Until recently, observers had relatively little information about performance of earnouts post-closing and if earnouts helped reveal private information, resolved uncertainty, or whether earnouts were ever actually paid largely, escaped analysis for lack of data.[44] Certain recent changes make it possible for the first time to gain insight into the post-closing performance of earnout provisions.[45]

Under previous accounting rules contingent payments, like earnouts, were not required to be disclosed at the time of the acquisition. Rather, were only accounted at a later point in the time when the contingency became due or was written off through an adjustment to the acquirer's accounting for goodwill. These adjustments being directly tied to the merger transaction, the acquirer's financial statements were not transparent with respect to the treatment of the contingent payments. The lack of transparency in the acquirer's financial statements made it difficult for outsiders to observe the actual performance of earnouts since contingent payments were only recorded if and when they were actually earned.[46] The lack of transparency made it difficult to identify whether a particular transaction included any component of contingent consideration at all.

Under the new SFAS 141(R)[47] contingent consideration must now be disclosed separately in the footnotes of the acquirer's financial disclosures and recognized at its "fair value" on the acquisition date. The fair value is the price to be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.[48]

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[43] This is because the results of uncertainty are necessarily a random distribution around a mean and not necessarily weighted in favor of positive results.

[44] Pamela Yanakopulos & Reto Micheluzzi, *Mergers & Acquisitions— A Snapshot: Accounting For Contingent Consideration—Don't Let Earnouts Lead To Earnings Surprises*, 1833 PLI/CORP 147 (2010)

[45] Ninon Kohers & James Ang, *Earnouts in Mergers: Agreeing to Disagree and Agreeing to Stay*, 73 J. BUS. 445 (2000)

[46] Marc Asbra and Karen Miles, *The Valuation of Earn-outs and Acquired Contingencies under SFAS 141(R)*, 2009 THE CPA JOURNAL 38 (March 2009)

[47] Purchase Price Allocation for Financial Reporting for Tax Purposes as provided under the Generally Accepted Accounting Principles (GAAP).

[48] This approach to establishing the fair value of an earnout is consistent with fair value accounting for other intangible (Level III) assets. It relies on an acquirer's forward looking estimate of probable cash flows associated with the earnout in order to determine a fair value for the contingent liability.

Acquirers are required to reevaluate that fair value periodically until the contingency is resolved. When the acquirer revisits its valuation of the earnout obligation, the fair value must represent the expected value to the acquirer of the earnout obligation coming due. Gains or losses in the fair value of contingent payments are recognized explicitly on the acquirer's income statement.

The new SFAS 141(R) brings a degree of transparency into the performance of earnouts and the acquisition of information by the acquirer. For example, post-closing of a transaction with an earnout, the acquirer learns private information that causes the seller to change the estimation of the earnout becoming payable, this new information must be incorporated into the then current fair value of the earnout. If the new information received indicates an increased likelihood of payment – because the target is meeting its objectives under the earnout provision or is otherwise on-line to meet those objectives -- the acquirer is required to increase the fair value of the earnout to reflect the increased likelihood that the acquirer will have to make payment. When the acquirer raises the fair value estimate it must reduce its goodwill by an equivalent amount. On the other hand, if the acquirer receives information about the closing of a transaction that indicates the target is less likely to meet the earnout objectives thus decreasing the likelihood that the acquirer will be required to make payment on the earnout, then the acquirer must reduce the fair value estimate of the earnout. When the acquirer reduces the fair value of a contingent obligation the acquirer records an equivalent increase in earnings, or a "bargain purchase" on its income statement.[49]

The result of these rule changes is to require acquirers to disclose to the marketplace whether they receive positive or negative information related to the seller's progress in achieving the earnout during the post-closing period.

The recent case study of OptionsXpress and Optionetics showed how these rules are put into practice.[50] In 2009, OptionsXpress acquired Optionetics in a merger transaction for $18.4 million plus contingent payments of up to $35 million payable in the event Optionetics met certain financial, technical, and other performance targets during the 2 year period following closing.

[49] The prospect that an acquirer might be able to engage in strategic behavior post-closing to undermine the seller's ability to meet earnout targets and thereby generate accounting profits is a real one.

[50] Available at http://www.businesswire.com/news/home/20090428005624/en/optionsXpress-Announces-Acquisition-Optionetics (Last visited on 20th October 2013)

Under previous accounting rules, the acquisition of Optionetics would be a kind of transaction that may receive less visibility. The general upfront price terms of the acquisition would be disclosed. But, there might be no disclosure of any contingent portion of the payment unless and until the contingency became payable. Even when the contingency arose and it became payable, it would be accounted for through an adjustment to OptionsXpress' goodwill and not tied to the Optionetics acquisition. The accounting for the transaction lacked transparency.

With SFAS 141R, the accounting treatment of the transaction became transparent an easier to observe the performance of the earnout term. For example, at the time of the acquisition OptionsXpress valued the likelihood that it would be required to make payment on earnout at $14.5 million, or 41% of the nominal earnout amount. During the course of the first eight quarters following the initial disclosure, OptionsXpress regularly updated its fair value measurements. By the end of the first year, the fair value of the earnout had declined to $12.13 million. As a result, one year after the merger, OptionsXpress recorded an increase in earnings on its income statement equal to the $2.04 million decrease in the fair value of the contingent payment obligation from the initial estimate of the fair value at time of acquisition. By the end of the second year, the fair value of the earnout declined to $4.81 million and OptionsXpress recorded an additional increase in earnings of $7.32 million. Ultimately, no earnout payment was made.

Thus showing that from the declines in the fair values found in the disclosures that OptionsXpress learned information about the seller and its business during the course of the first year. This new information reduced OptionsXpress' estimate of the seller's ability to achieve the earnout goals and thereby trigger a payment.

By examination of the fair value disclosures of a larger number of transactions one can develop a near real-time assessment about the performance of contingent earnout provisions. This assessment can provide further insights into the adequacy of earnouts as contractual responses to information asymmetries. If sellers use earnouts as information signals, positive information is learned during the post-closing period, one expects to see an increase in the fair value. This increase would reflect a confirmation of the seller's optimistic pre-signing statements. On the other hand, if sellers do not use the earnout mechanism to signal information to acquirers, then the pattern of post-closing fair-values should not reflect the separation pattern one expects with a credible signal.

In assessing the role played by earnout provisions, ideally one would like to directly observe a seller's private information but that is not possible. However, the new disclosure rules provide a reasonable approximation of the acquisition of private information during the post-closing period. Changes in the fair value of earnouts over time permit observers to make some assessments about the extent of private information present transactions, and the role of the earnout provision as a contractual response to adverse selection.

For example, if high quality sellers use earnouts to signal to potential acquirers their unobservable value, then post-closing, one expects the acquirer to confirm the seller's statements through the acquisition of private information during the earnouts measuring period. Confirmation of the seller statements can be observed by outsiders through regular increases in the fair value of the contingent payment. On the other hand, if the acquirers are unable to confirm pre-signing statements about the seller's hidden information during the measuring period, then fair values should not generate an obvious separating equilibrium.

Fair value data is a better proxy for assessing the role played by earnouts than simply payment data alone[51] and it includes two kinds of information. First, any payments made pursuant to the earnout provision are included in the fair value of the earnout. This payment is usually a backward looking assessment of whether the seller achieved the targets under the earnout provision. However, payment data alone can be misleading because the payment data by itself doesn't indicate whether the acquirer learned any previously hidden seller information prior to making the payment or even if the target achieved the stated earnout targets. The mere fact that a backward looking payment has been made does not confirm one way or the other the hypothesis that earnouts are contractual responses to the problem of adverse selection.

The second component of fair value data is the forward-looking estimate of the seller's future performance. Fair value estimates require a determination by the acquirer of the future likelihood that the seller might achieve the earnout targets. Accurate estimates about the future likelihood of an earnout payment become payable depending upon information. As the acquirer learns more information about the seller, including assimilating the seller's private information during the post-closing period, the acquirer is better placed to revise and make more accurate estimates of

[51] *Supra* note 45

the seller's likelihood to achieve the earnout targets. When, positive information is added to the acquirer's information, the fair value estimate of the earnout payment increases and when the acquirer learns new, negative information, the acquirer lowers the fair value estimate to reflect the new estimate of the seller meeting the earnout targets. As a result, changes to forward looking *"fair value data are a reasonable proxy for post-closing private information"*.

CHAPTER 5: IMPLICATIONS

The notion regarding earnout provisions is that it guards the acquirers against adverse selection in the context of an acquisition. The alternate view is that earnouts are a device to manage uncertainty. Although earlier studies found that earnouts are more likely to be used in situations where one expects information asymmetries to be more severe, but it is that sellers do not rely on earnouts to signal their unobservable quality to acquirers.

There are two important conclusions to draw. First, Sellers might intend to rely on earnouts to respond to the problem of adverse selection in pre-signing negotiations, earnouts appear to do a poor job of sorting high quality sellers from low quality sellers. During the post closing period, acquirers do not systematically report receiving private information to confirm the pre-signing optimism of sellers and thus a separating equilibrium couldn't be observed. Without a separation between high and low quality sellers earnouts cannot function as a credible information signal in response to adverse selection.[52]

Second, the fact that earnouts fails to serve the signalling function doesn't necessarily mean they're not valuable. It appears that sellers rely on earnouts for reasons other than sending signals about private information. Rather than signals, parties rely on earnouts to resolve problems of symmetric uncertainty during the pricing process. Indeed, resolving symmetric uncertainty, or "bridging the valuation gap", during the pre-contractual phase can assist parties in overcoming an important contracting challenge.[53] Contingent payment provisions do not elicit new information but simply allocate adverse costs of uncertain events to the seller, they undertake a distributive function.[54] By creating uniform expectations with respect to any number of uncertainties the earnout permits parties to normalize their joint expectations about the future and agree on a pricing formula for the seller where in the absence of uniform joint expectations parties might not be able to reach agreement.[55]

Earnout though distributive, permits parties to engage in a value enhancing transaction. The earnout distributes risk to the party with the higher tolerance for it and in that way helps to

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[52] In order for a signal to be valuable, sellers must all uniformly use the signal in the same manner. If sellers are not uniformly using the earnout mechanism to convey private information to potential acquirers, the earnout is unable to generate a separating equilibrium and loses its potential value as a credible information signal due to acquirer confusion.

[53] *Supra* note 15

[54] Robert H. Mnookin, Scott R. Peppet & Andrew S. Tulumello, *Beyond Winning* (Harvard Univ. Press 2000)

[55] *Supra* note 3

facilitate pricing and accomplishment of the transaction.[56] Because, sellers may have a higher tolerance for risk during the sale process, they may be willing to defer some portion of their compensation and accept the risk of adverse outcomes in order to accomplish the transaction. By resolving uncertainty in the pre-contracting phase in favour of the acquirer, earnouts help both parties reach efficient pricing and ensure that acquirers do not overpay without necessarily eliciting any private information about the seller.[57]

Although earnouts may be prevalent in circumstances where one might expect adverse selection to be a potential problem, there is little evidence to suggest that earnouts actually function to sort high-quality sellers from low-sellers. Rather, contingent payment provisions appear successful to resolve questions of uncertainty only which can be critical in ensuring parties are able to efficiently price the transactions where unknown future states of the world may make it impossible for parties to accomplish a transaction, it is less ambitious than the prospect of contingent payments resolving information problems that might present challenges to transactions. While this result does not suggest that an approach to the study of transactions based on transaction is unworthy, but there may be real limits to relying exclusively on this approach when thinking about contracting.

INDIAN CASE STUDIES

1. Ajay Guliya v. Assistant Commissioner of Income-tax[58]

The Delhi High Court held that deferred considerations from transfer of shares, linked to performance are liable to tax in the year of transfer irrespective of the year of receipt. However, the decision is silent on what would be the treatment if the performance related conditions were not satisfied and if whole or part of the balance consideration does not become payable thereafter. The decision is also silent on whether the taxpayer would be able to claim the amount offered to tax in the earlier year as a loss for the subsequent years or for the previous year in which the transfer took place (by revising the earlier return).

This decision assumes importance in the context of transactions involving non-resident sellers. In such cases, if the gains are not exempt under the applicable Double Taxation Avoidance Agreement, the buyer will have to deduct taxes on the entire gains on the

[56] *Supra* note 6
[57] Supra note 3
[58] ITA 423/2012

transfer of shares irrespective of the year in which the amounts become payable.

2. India Switch Company v. Assessee[59]

It was held Income Tax Appellate Tribunal, Chennai; that the earn out period income earned by the Appellant Company is an income which can only be classified as income from other sources, as the business of the company has already been transferred on the said date. The earnout income is under the contingent payment payable in the Business Transfer Agreement and the agreement does not speak about hardware upgradation charges to be payable, or borne by the company. Therefore these charges cannot be removed from the earnout income. Moreover as the entire business has been sold by the assessee company and the earnout income is to be assessed under the head "Income from Other Sources" and thus chargeable after a certain period of time.

3. Pinaki Das Gupta v. Maadhyam Advertising (P.) Ltd.[60]

This term of the agreement guaranteed payment of 2nd to 4th instalments to the shareholders depended upon generation of revenue and earnout. In terms of this agreement, the petitioner handed over all the shares certificates in respect of his shares together with share transfer forms. While the first instalment has been paid, the company has committed breach of the term of the agreement relating to the employment/consultant contract. Since the consideration for the shares would depend upon the revenue of the company in respect of payment of 2nd to 4th instalments, the association of the petitioner with the company was very essential to ensure that the company earns better revenue but he resigned in the capacity of the Director without a letter of resignation. The Company Law Board held that the other promoters shall faithfully and specifically perform all the terms and conditions of the agreement for sale of share and restrain the respondents, their agents, etc., from creating any hindrance, obstruction, inference, pressure tactics, dishonesty, fraud and/or forgery, etc., against the petitioner and in the control and powers of the petitioner over the functioning and management of the company to be able to make his optimum contribution to the growth of business company and ensure maximum generation of revenue and earnout in order to be able to recover the maximum amount towards instalments of the shares and per the terms of the agreement.

[59] I.T.A. No.1077/Mds/2012

[60] Available at http://indiankanoon.org/doc/1522386/ (Last visited on 23rd October 2013)

CHAPTER 6: CONCLUSION

Under uncertain economic environment, it’s a tough task to determine the true value of a sellers business involved in a M&A transaction. The main valuation gaps between the buyer and seller are the pragmatic demands and high valuation respectively. This gap leads to a disagreement on the sellers projected earnings in the post-closing period due to various factors. However, a well-crafted earnout provision can resolve these differences and valuation gaps.

An earnout can be held to be described as a contingent provision of the purchase price in an M&A transaction, which is based upon the acquired business achieving certain performance milestones in a stipulated time period. Earnout protects the seller from failing to realise the value of the business and also protects the buyer from overpaying for an underperforming asset by allowing certain lower upfront capital to get a deal done. Earnout can create a win-win situation for both the buyer and seller where the seller captures a higher from future growth of business and the buyer pays for what he gets in return.

Earnouts later lead to disputes over the contingent payments and to prevent these, the buyer and the seller should prepare such ambiguous and well researched earnout provision and mechanisms to provide a framework for resolving these potential disputes.

A well drafted earnout addresses the required milestones to trigger of the earnout obligation and the detailed process and framework of rules addresses the operation of the business post-closing and any issues during the due diligence should be understood by the counsels of the buyer and the seller, and to be incorporated in the earnout.

It is very important that the earnout provides the seller with an auditing right and the buyer should maintain separate books of accounts for the business throughout the earnout period. Both the parties should agree on certain accounting principles to determine whether the milestones have been achieved or not.

Given the economic uncertainty, it’s safe to say that the earnout provision in private M&A transactions shall stay for a long future period of time. Despite, there being always a cloud for disputes and uncertainties, the use for earnout provisions will and always be an effective tool for the purpose of bridging the gaps and closing of deals.