Using Earnouts to Create Solutions in Mergers & Acquisitions Transactions

Joel Weinstein, Rutter Hobbs & Davidoff Incorporated

Buyers and sellers in mergers and acquisitions (M&A) transactions often use earnouts to resolve pricing differences that occur during the negotiation process. An earnout is a contractual payment obligation that increases the amount of consideration paid for a business if certain performance milestones determined by the parties are met. The following article addresses some of the primary issues parties should consider when structuring an earnout for their transaction.

Earnouts Can Be Beneficial for Sellers and Buyers

A seller may consider an earnout a more acceptable form of consideration under a variety of circumstances. For instance:

- where the parties differ on a business' projected earnings or other valuation-related factors;
- where the transaction is a turnaround and there is insufficient historical information to aid a buyer's purchase price analysis;
- to resolve differences in the parties' valuations resulting from analyses of macroeconomic matters (e.g. general economic trends or trends in the seller's industry that impact projected sales growth (or sales decline); or
- when the seller is committed to a valuation that seems unrealistic to the purchaser, establishing the earnout's benchmarks based on the seller's projections may satisfy the objectives of the seller sufficiently to close the deal.

Similarly, an earnout can be beneficial to buyers. If the seller is committed to an unrealistic valuation, the buyer may be able to sufficiently satisfy the objectives of the seller and close the transaction by basing the earnout's benchmarks on the seller's projections. Earnouts also create an incentive for a seller that remains affiliated with an acquired business to remain active in the business post-closing and contribute to its continued success. This motivation is most effective when the seller has a finite period in which to achieve the performance targets required for receipt of the earnout and this period coincides with the seller's plan to reduce his or her involvement in the business. Earnouts can also be beneficial to a buyer in transactions involving software development companies or service firms where the target company's real assets, such as intellectual property knowledge, reside with the sellers or employees because the earnout can induce the sellers who are members of management to remain with the target company post-closing and take steps to maximize profit for the target company and buyer. However, an earnout typically will not be used where a seller retains a significant interest in the business and intends to benefit from a future sale of the business or other liquidity event. In such instances, the interests of the seller and the buyer are basically aligned because the seller has not relinquished its entire equity interest in the business and both parties would benefit from a sale or future liquidity event.

Terms of Earnout Should Be Specific

An earnout can be structured in a number of ways. Therefore, earnout provisions should be drafted carefully to establish the parameters of the earnout. It is important for the performance targets associated with the earnout to be set at a level that sellers feel is achievable and it is important that buyers are comfortable paying the earnout once those targets are met.

The following features of an earnout should be specified in detail in an earnout provision: (1) the performance goals that trigger the earnout obligation; (2) the accounting methods that will be used to determine whether the performance goals have been achieved; (3) the earnout calculation and any applicable exclusions and (4) the method for resolving disputes regarding the earnout calculation. Earnout provisions also should include an earnout period, or specified length of time over which the earnout payment will be paid to the sellers. An earnout period will typically range from two to five years post-closing. The appropriate earnout period will be determined by the period of time chosen by the parties to measure the target's performance that will set the final purchase price/value of the target or by how long the buyer desires to incentivize the sellers. The use of examples to illustrate the calculation of the earnout payment can provide the parties with guidance and clarity and minimize the chance of disputes over computations and definitions.

Parties can also use the terms of an earnout provision to address other transaction-related concerns. For instance, a buyer will typically want to avoid an earnout provision that hamstrings its efforts to restructure the acquired business or motivates the earnout's recipients to focus on short-term goals that may reward the sellers, but adversely impact the buyer and the acquired business. A buyer may want the earnout provision to allow for discounted earnout payments until the expiration of the earnout period to minimize the buyer's risk of future financial target shortfalls and the possibility that the sellers will not make the buyer whole for any earnout overpayments when the final earnout payment is calculated. Conversely, a seller will want an earnout provision to provide for a true-up between the annual earnout payments and the final payment at the end of the earnout period. A seller, however, may seek the opportunity to make up any earnout payment shortfall during the earnout period by averaging strong performances with weak performances. In that case, the buyer may insist the earnout provision include a requirement that any prior shortfall adjust earnout payments due for the then-current year.

Calculation of Earnout Payments

Earnout payments can be based on a variety of measurable performance criteria, including EBIDTA (earnings before interest, depreciation, taxes and amortization), EBIT (earnings before interest and taxes), pre-tax net income, gross profit or sales.

Once the benchmark for the performance target is established, the parties can focus on the amounts in excess of the targets that will be paid to the sellers each earnout period.

EBITDA is often used as a benchmark for earnout calculations because the accounting treatment is well understood. EBITDA reflects the cost of goods and services, selling expenses and general and administrative expenses.[1] Each of those components is a widely recognized financial term with established accounting principles that are typically subject to adjustment based upon the parties' negotiations. For example, parties using EBITDA as a benchmark will negotiate how general and administrative expenses will impact post-closing figures or whether exclusions for certain executive compensation expenses, extraordinary gains and losses and transaction expenses will be allowed. EBITDA is also a desirable benchmark because it excludes interest, taxes, depreciation and amortization, which may vary based on the buyer's capital structure or the way in which the acquisition is financed. EBITDA is also frequently used as the benchmark in M&A transactions where the purchase price is based on a multiple of the target's EBITDA. In that situation, seller will use the valuation methodology of the buyer to negotiate the desired target purchase price.

Regardless of the financial measure chosen, the parties should carefully analyze the potential for the earnout to distort the incentive to produce long-term, sustainable growth for the acquired business and the buyer. For example, use of a revenue-based performance target may tempt the recipients of an earnout to book unprofitable sales. An earnout based on cash flow or income could incentivize earnout recipients to slash expenses (e.g. marketing and advertising costs) to bolster short-term profitability at the expense of long-term growth.

Potential Areas of Dispute for Earnouts

Despite attempts to clearly structure earnout provisions, there are several potential areas of dispute that should be considered by the parties and addressed during negotiations.

- *Maintenance of Records*. The seller should insist that the buyer maintain separate books and records for the target, division, or other source of the earnout calculation throughout the earnout period. Additionally, the buyer should covenant that these financial records will be made available for review upon reasonable notice.
- *Accounting Issues*. For financial milestones, the parties should stipulate the precise accounting principles that will be used to calculate whether the thresholds have been met. Particular care should be used in delineating the calculation principles if the earnout measure is EBIT or EBITDA. The measure used may impact an earnout calculation due to the varied treatment of certain accounting factors, including inventory obsolescence, doubtful accounts receivable, returns and allowances, estimated liability amounts, the buyer's general and administrative expenses and post-closing recognition of transaction expenses and extraordinary gains and losses.
- *Consistency of Practice and Post-Closing Accounting*. A problem may arise in the form of movement of revenue and expenses by the buyer post-closing. Due diligence into the pre-sale accounting policies of the seller will clarify past practice

and reveal any areas of potential dispute.

- *Exclusions in Calculating Payout and Other Adjustments*. If the parties use a net income, EBIT or EBITDA measure to calculate the earnout, the seller should seek to exclude all transaction and capital/financing expenses that are charged against the earnings upon which the earnout is calculated because such expenses will reduce the earnings amount, unless specifically excluded.
- *Uncertainty of Operational Procedures*. The parties also may wish to include detailed post-closing operational procedures in the acquisition agreement in order to avoid uncertainty. Such operational procedures may include requiring the buyer to operate the target company in a manner consistent with the sellers' past practices of the seller, granting the sellers approval rights with respect to major decisions impacting the target company during the earnout period, or establishing minimum funding levels for the buyer to enable the target to avail itself of future business opportunities.
- *Post-Closing Sale of Target*. The parties should determine whether the target or a portion thereof may be sold to a third party during the earnout period and the effect of such a sale on the earnout should it take place.
- *Strategic Buyer or Rollup Platform*. Strategic buyers often seek acquisitions to realize benefits from the consolidation of sales forces, manufacturing facilities, distribution systems and the like. A natural consequence of this consolidation may be to shift sales from the target to the purchaser, or vice versa. The parties should consider such transactions and their effect on an earnout.
- *Mismanagement During Earnout Period*. Both the buyer and seller may fear mismanagement of the target during the earnout period and should address the effect of such mismanagement on the payout.
- *Multiple Decision Makers for Seller*. In situations where the seller has several shareholders who continue to manage the target post-closing, the parties should consider establishing a single person or committee as the representative to act on behalf of the former shareholders.
- *Credit for Exceeding Goals*. The parties must decide whether performance well above threshold levels during a portion of the earnout period may be applied to supplement inadequate performance during another portion of the earnout period.
- *Targets Partially Achieved*. An often difficult negotiation occurs regarding the proration of earnout payments if performance targets are only partially achieved. Sometimes this point is resolved by establishing a minimum hurdle that has to be achieved before any earnout payment is made and providing a sliding scale or proration after the threshold is achieved.
- *Dispute Resolution*. Disputes regarding earnouts are commonplace and the lawyers drafting earnout provisions are advised to consider the appropriate form of dispute resolution under the circumstances.

Credit Crisis Has Increased Use of Earnouts

The economic downturn of 2008 and 2009 has caused buyers and sellers to be more accepting of earnouts as consideration in M&A transactions. Given the unwillingness of buyers to pay for unproven performance, sellers often believe earnouts will allow them to ultimately obtain adequate consideration once their business' flat or declining performance turns around with the improving economy. Also, the lack of senior debt acquisition financing and the reticence of capital sources such as private equity groups to accept the seller's earnings multiplier are driving buyers, sellers and their advisors to use earnouts to achieve the seller's price valuation while facilitating the buyer's ability to close the transaction with reduced up-front capital payments.

Conclusion

Earnouts can be beneficial for bridging disagreements as to the value of a target company. In addition, earnouts can incentivize sellers that remain affiliated with the target company post-closing to remain active in the business and contribute to its continued success. To avoid future conflicts and craft a workable earnout provision for the buyer and the seller, the parties should ensure that earnout provisions specify the hurdles, the accounting methods and all other terms material to the payment of the earnout.

Joel Weinstein is a corporate partner with Rutter Hobbs & Davidoff Incorporated in Los Angeles, where he specializes in mergers and acquisitions and financings. Mr. Weinstein is also the head of the firm's Corporate and Securities practice group. For more information, visit www.rutterhobbs.com or contact the author at 310-286-1700 or jweinstein@rutterhobbs.com.

---

[1] Investopedia, *available at* http://www.investopedia.com (last visited Apr. 7, 2010).