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Trends in M&A Provisions: Earnout Provisions

July 10, 2018
Bloomberg Law

Introduction

In merger and acquisition ("M&A") purchase agreements (whether asset purchase agreement, stock purchase agreement, or merger agreement), provisions addressing the purchase price, and how it is to be paid, are, understandably, amongst the most critical to get right. The price to be paid to acquire the target[1] can take many different forms (e.g., cash, securities of the buyer, other non-cash consideration, and/or a buyer note—whereby the seller finances some or all of the purchase price). Additionally, a portion of the purchase price may consist of contingent payments that are payable after closing, commonly referred to as an "earnout." The typical earnout provision entitles the seller to further payments if the target, post-closing, meets prescribed (usually, but not always, financial-based) benchmarks. This article examines trends in the use and structuring of earnout provisions in private company M&A transactions.

Characteristics of Earnout Provisions

Unlike many aspects of an M&A purchase agreement, which have become fairly standardized with, in many cases, well-established market parameters and drafting conventions, earnout provisions are highly fact-specific and often heavily negotiated. As such, there is no "typical" earnout provision. However, there are some basic considerations that go into determining and negotiating an appropriate earnout provision:

- **Milestones**. The milestones which, if reached, trigger payment of an earnout need to be clearly set out in the purchase agreement. Often, these are financial milestones (e.g., EBITDA of $X for fiscal year 2020) but they can also be non-financial, such as procurement of a key government or regulatory approval or contract in the pipeline, or closing of a major strategic partnership. An issue related to achievement of milestones is whether the earnout should accelerate upon a change in control.
- **Measurement**. Because of the flexibility inherent under most accounting standards (e.g., GAAP) when determining financial terms, the parties should be specific about how the milestones are measured. Additionally, if the benchmark is profit-based, the parties must

determine which expenses are included in the profit calculation, particularly to ensure an appropriate allocation of the buyer's general and administrative expenses to the post-closing target business.

- **Length**. The parties must agree on the length of the earnout period. This includes determining whether there is a single earnout or multiple, staged earnout payments over time. The answers may well depend on the specific industry in question, taking into account seasonality and other aspects of potential volatility.
- **Control Over the Earnout Business**. The seller wants to maximize its control over decision-making that can impact the earnout. This control can run the spectrum from full business control replicating the seller's pre-closing operations to providing the buyer input (e.g., into hiring decisions) on specified decisions. The seller also usually asks the buyer for "commitments" to fund the earnout business properly or consistent with past practice, and even to take steps intended to maximize the ability to achieve the earnout benchmarks. The seller's rationale is that, in most cases, these commitments help align the interests of the seller and the buyer to achieve the benchmarks. Most buyers resist making some or all of these commitments. Although the seller and buyer interests may well be aligned, the buyer, as the new owner of the business, usually wants the freedom to run the business as it sees fit. Further, the buyer may need to make decisions that are not ideal for achieving the earnout but may be best for the buyer's businesses as a whole.
- **Tax and Accounting Treatment**. Depending upon the circumstances, the buyer may need to record the fair value of the earnout as of the closing date under GAAP. In addition, parties often use earnouts to retain selling shareholders as key employees for a time after closing. However, if the payments become linked to employment (e.g., the earnout payments are not made if a seller shareholder ceases to be a target employee on the payment date), the payment may be considered compensation instead of purchase price, which can have tax impacts for both buyer and seller.
- **Setoff Rights**. An earnout provision often is connected to the purchase agreement's indemnity, escrow, and related provisions. For example, the buyer may have a "setoff right." A setoff right allows the buyer to unilaterally reduce the amount of any earnout payment owed to the seller by the amount of any indemnity claim against the seller under the purchase agreement. A seller may well argue that any such right is, in effect, a "holdback" (albeit contingent) of the purchase price and, therefore, the indemnity escrow should be decreased or eliminated accordingly.

Views of Sellers and Buyers

Earnout provisions are so fact-specific and tailored to individual circumstances in a deal that, depending on the terms, either sellers or buyers may be for—or against—an earnout's inclusion. In other words, unlike many other provisions in purchase agreements, there is no set buyer or seller position in favor of or against an earnout.

Earnouts are often used to bridge “pricing gaps” between buyer and seller. For example, the seller wants $100 for its business, but the buyer is only willing to pay $75 at closing. However, the buyer is willing to pay an additional $25 after closing if certain post-closing milestones are met. All else being equal, the contingent nature of the earnout payment is not as favorable to the seller as cash at closing and the level of the buyer’s control over the business during the earnout period may increase that concern. On the other hand, speaking generally, buyers often like earnouts because it puts off some purchase price risk. This position is particularly true if the target is a younger company or has unproven products or business models.

Trends in Earnout Provisions

Every other year since 2005 the American Bar Association (“ABA”) has released its Private Target Mergers and Acquisitions Deal Point Studies (the “ABA studies”). The ABA studies examine purchase agreements of publicly available transactions involving private companies that occurred in the year prior to each study (and in the case of the 2017 study, including the first half of 2017). These transactions range in size but are generally considered as within the “middle market” for M&A transactions; the average transaction value within the 2017 study was $176.3 million.[2]

According to the ABA studies, earnout provisions were included in 28% of the deals reported in the 2017 study. The previous five studies noted inclusion of earnout provisions in 26%, 25%, 38%, 29%, and 19% of reported deals, respectively.

Approximately 60%-70% of earnout provisions reviewed as part of the ABA studies used either EBITDA or revenue as the principal earnout metric.

It remains somewhat rare for buyers to expressly agree to operate the post-closing target business consistent with past practice or to take actions to maximize the earnout (the first being more common than the second).

Further, well under one-quarter of the reported deals had earnouts that expressly accelerated upon a change in control.

Lastly, more than one-half of the agreements reviewed in the ABA studies that included an earnouts also included an indemnity setoff right. Although the inclusion of a setoff right has dropped significantly in the most recent study.

Conclusion

Earnout provisions are often heavily negotiated and fact-specific. As a result, their inclusion in M&A purchase agreements tends to be the exception rather than the rule. As a purchase price component, an earnout provision reflects "real dollars" to both the buyer and the seller. Thus, if lawyers negotiating earnouts on behalf of their clients must pay careful attention to the various earnout issues and options.

[1] Daniel Avery is a Director at Goulston & Storrs, in Boston, Massachusetts. Mr. Avery is a member of the ABA's working group which published the 2017 ABA private company M&A deal points study. This article is based on, and updates, the article of the same name co-authored by Mr. Avery and John Mariano, General Counsel and Senior Vice President at Precision for Medicine, a life sciences enterprise helping clients innovate, develop, and commercialize next generation medical products. That article was published in the Vol. 18, Number 41 edition of Bloomberg BNA's Mergers & Acquisitions Law Report (2015). This article is one of a series of over 20 articles co-authored by Mr. Avery looking at trends in private company M&A deal points. The series is currently being updated to reflect the 2017 ABA private company study and will be published throughout 2018. The articles can be found on Goulston & Storrs' "What's Market" web page at http://www.goulstonstorrs.com/WhatsMarket and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

[2] Note that within this article we use the terms "seller" and "company" in the context of a stock purchase transaction—the "seller" would be the selling shareholder(s) making the representations and warranties in the M&A purchase agreement, and the "company" would be the company being acquired. In an asset purchase transaction, the "seller" would be the target company itself but for consistency we are using "seller" in a stock purchase setting. We use the term "company" and "target" interchangeably.

[3] This article looks at the usage of earnout provisions in private company M&A transactions as reflected in the ABA studies. This article does not cover such provisions in other types of transactions or in public-to-public M&A transactions.