<u>Earn-Out Provisions in M&A Purchase Agreements</u>

In M&A transactions, one of the most fundamental issues faced by buyers and sellers concerns the value of target company. Sellers typically project increasing revenues/net income, while buyers believe that projections are extremely speculative. In order to give credit to a seller for projections that are achieved post-closing, or to mitigate future risks, parties can include earn-out provisions in purchase agreements.

1) Earn-Out Basics

An earn-out works as a mechanism that allows the buyer to defer a portion of the purchase price until the occurrence or failure of a predetermined metric. Earn-outs are typically tied to top line-related financial components such as revenue, gross profit, and assets under management. Parties may also choose to employ an earnings-related metric such as EBITDA, net-income, EBIT and EBT. Sometimes parties may even choose to use non-financial metrics relating to specific milestone events. These events may include regulatory approval by the relevant government agency, the retention of one or more key customers for a period of time after closing, or the retention of specified employees.

a) Earn-Out By Industry and Payment Periods

The frequency of earn-outs differs between industries. Over 80% of acquisitions of pharmaceutical and asset-management companies contain some type of earn-out.[1]

The period after which payments may be made pursuant to an earn-out vary depending on the agreement. About 80% of earn-out payments are made within one to three years of the closing of an acquisition.[2] The payment period may extend to five years or more, typically in

[1] BLOOMBERG LAW, *Make the Deal: M&A Terms and Market.*
[2] *Id.*

situations where the seller remains a manager of the target.[3] Between one-third and one-half of earn-outs accelerate payments upon a change of control.[4]

2) Post-Closing Business Management

The party managing the business post-closing can face perverse incentives depending on the type of metric used. If a revenue-based metric is used, a buyer-manager may be disincentivized from investing fully in the company's operations, while a seller-manager may be disincentivized from cutting costs. If an earnings-based metric is used, a buyer-manager may be incentivized to overspend or incur one-time costs during the earn-out period, especially where the fruits of the investment are borne after the earn-out period.

It is possible to include covenants in the purchase agreement designed to limit undesired incentives, but these covenants can be difficult to negotiate and must be precisely tailored to protect parties' interests. Approximately 10-20% of agreements that contain earn-out provisions include a covenant requiring the business to be run consistent with past practice, while another 10-20% contain a covenant requiring that the company be operated in a manner designed to maximize the likelihood/amount of the earn-out.[5]

a) Case Law

i) *Lazard Technology Partners, LLC v. QinetiQ North America Operations, LLC*, 114 A.3d 193 (Del. 2015) (en banc)

In *Lazard*, the parties agreed to an earn-out payment if revenues reached a specified level.[6] The merger agreement contained language that prohibited the buyer from taking any

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[3] *Id.*

[4] *Id.*

[5] *Id.*

[6] Lazard Technology Partners, LLC v. QinetiQ North America Operations, LLC, 114 A.3d 193, 194 (Del. 2015) (en banc).

action to divert or defer revenue with the intent of reducing or limiting the earn-out.[7] When the earn-out period ended, the revenues had not reached the level required to generate an earn-out payment.[8] The seller argued that the buyer had breached the merger agreement, and an implied covenant of good faith and fair dealing by failing to take certain actions that the seller contended would have resulted in the achievement of revenue sufficient to generate an earn-out.[9]

The court rejected these arguments and held that the buyer did not breach the merger agreement because the provision required the buyer to act with the "intent" of reducing or limiting the earn-out payment and the seller failed to prove that any of the buyer's business decisions were specifically motivated by a desire to avoid an earn-out payment.[10] The court reasoned that the provision specifically addressed the requirements for an earn-out payment and left the buyer free to conduct its business post-closing in any way it chose so long as the buyer did not act with the intent to reduce or limit the earn-out payment.[11] In addition, the court held that the buyer did not violate the merger agreement's implied covenant of good faith and fair dealing because the buyer did not act with the intent to deprive the seller of an earn-out payment.[12]

The holding in *Lazard* demonstrates that extreme care must be taken in negotiating earn-outs and protective covenants. Negotiating a protective covenant that contains an “intent” based standard may have unintended adverse consequences for a seller.

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[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.* at 195.

[11] *Id.*

[12] *Id.*

3) Payout Thresholds and Calculations

Parties negotiating an earn-out must carefully consider the circumstances in which an earn-out payment may be required to be made. If an earn-out is based upon a revenue target, and unexpected expenses are incurred by the target after closing, the buyer may well find itself making an earn-out payment to the seller while experiencing a reduction in free cash flow.

a) Case Law

i) *Deere & Co. v. Exelon Generation Acquisitions, LLC*, No. CVN13C07330MMJCCLD, 2016 WL 3546921, (*Del. Super. Ct. June 2, 2016*)

In *Deere*, the earn-out was contingent on success of a particular windfarm project.[13] The township in which the windfarm was located approved new zoning ordinances that, among other things, lowered sound limits and increased setbacks for new wind farms.[14] The buyer subsequently moved the windfarm to another county and incurred a great deal of expense.[15] The buyer argued that if it was obligated to pay the full amount of the earn-out, it should be able to reduce the payment by the amount of expenses incurred in moving the windfarm.[16]

The court held that the seller made adequate disclosures to place the buyer on notice of the resistance of the township to the windfarm and that the buyer was obligated to pay the full earn-out, and was not permitted to reduce the earn-out payment by the amount of the increased expenses incurred to achieve the earn-out metric.[17] The court reasoned that the definition of the

[13] Deere & Co. v. Exelon Generation Acquisitions, LLC, No. CVN13C07330MMJCCLD, 2016 WL 3546921, at *2 (Del. Super. Ct. June 2, 2016).

[14] *Id.*

[15] *Id.*

[16] *Id.* at 6.

[17] *Id.* at 9.

project was not linked to the location of the windfarm, and that buyer's expenditures for relocating the windfarm were discretionary development costs.[18]

4) Conclusion

While earn-outs can provide the buyer with a sense of security and ease negotiations between the parties, they can also cause a great deal of problems. Parties must be careful to negotiate them carefully and thoroughly. Some steps that parties can take to draft a thorough earn-out include: stating events or goals that trigger payment of earn-out; establishing a timeline for trigger events or financial goals; imposing covenants on post-closing operation of the target; explicitly defining acquirer's obligations under the earn-out; including an example calculation of the payment; prohibiting changes to the calculation method during the earn-out period; setting up earn-out payment procedures; and providing for a dispute resolution mechanism.

[18] *Id.*