

How To Structure Contingent Purchase Price Provisions (Earnouts)



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If you structure the contingent purchase price properly, you can avoid bad blood — and litigation.

“**EARNOUTS,**” or contingent purchase price provisions, have become an increasingly popular feature of mid-market private merger and acquisition transactions over the past several years. The use of earnouts has recently intensified in light of the financial tsunami creating wider divergences of perceptions of a business’s actual value and earnings power. Earnouts, however, raise significant complexities and nuances that parties often fail to address adequately. Post-closing complexities over earnouts therefore frequently create the most fertile ground for tension and dispute.

While business people may devise any number of earnout concepts to meet their respective economic goals, lawyers need to assure that their clients have considered the many complexities and hidden issues lurking beneath the simple formulaic surface. Earnout provisions that are not clearly crafted raise the specter of not meeting the parties’ expectations and sow the seeds for unrealized expectations and future conflict. While the theoretical rationale for earnouts is laudatory, their practical implementation sometimes is wrought with peril and invites post-closing uncertainty and contention. This article highlights several of the key structural elements of earnouts and sug-

gests means to protect both parties to minimize cost and controversy.

RATIONALE • Parties to a business sale transaction utilize earnouts for several reasons. Solving valuation gaps is typically both parties' prime motivation. The buyer may only be willing to meet and justify the seller's price if the seller's business performs after the closing at or above the level promised or hoped for. A buyer may also want a seller to stay focused, energized, and active in the business post-closing, and earnouts often provide significant financial motivation to do so.

The seller, on the other hand, may be more willing to accept a lower nominal purchase price at closing if it is confident that the business can attain significantly greater post-closing performance goals or if it sees no other practical choice to extract a higher payment from the buyer.

Crafty lawyers representing buyers can often get unwary or unprepared sellers into serious trouble during preliminary discussions on pricing. A seller may often boast (or be goaded into boasting), especially early in the negotiations, about the great potential and likely explosive growth awaiting its business. A savvy buyer might try to hold the seller to these injudicious outbursts to meet an earnout target and a seller cannot easily squirm away from its previous optimistic assertions.

Allocation Between Up-Front And Earnout Payments

While the parties may share similar goals underlying the existence of an earnout, their views on allocations between the up-front cash payment at closing and the deferred earnout payment usually dramatically differ. Buyers typically desire to defer as much of the price to an earnout for both cash preservation reasons and to validate the wisdom of the purchase. A buyer's risk is obviously substantially reduced to the extent that there is a greater portion of the price contingent on realiza-

tion through an earnout. Not surprisingly, sellers normally prefer a substantial portion of the price up front. The risk of the business not generating a large portion of the earnout thus enables a seller to reduce its risk and provide it certainty. The greater upfront payment also allows the seller to diversify its net worth at an earlier point in time and reduce the risk of not getting paid.

High profile anecdotes illustrate the unintended consequences of allocation between upfront and post-closing payments. From a buyer's perspective, eBay Inc. purchased Skype Technologies S.A. a few years ago with 40 percent of the aggregate consideration subject to an earnout. Due to a variety of factors such as disappointing financial performance together with culture clashes between the two organizations (which were not well integrated after closing), only a little over 30 percent of the earnout was ultimately realized. While the buyer would probably have actually been pleased to pay a larger portion of the earnout for it would have meant better performance had occurred, the lower upfront payment protected its downside in this example of underperformance.

Google Inc.'s purchase of dMarc Broadcasting Inc. represents an illustration of a happier buyer paying an earnout which turned out to be 92 percent of the total purchase price! The sale of the Juicy Couture fashion line to Liz Claiborne contained an uncapped earnout. This resulted in a surprising windfall of \$75 million to the sellers before the exasperated buyer sought a negotiation and termination of the earnout.

METRICS FOR CALCULATING EARN-OUTS • The appropriate metric for calculating the earnout is key from the standpoint of both valuation as well as integrity of the parties and alignment of their interests. Lawyers should assure that their clients have considered different computational approaches and whether the approaches maximize the proper alignment of the parties' motivations

and interests. Many different determining metric approaches abound and here are a few:

Revenue Growth

This is obviously the easiest metric to measure and most difficult to manipulate. This metric is most typically used in early stage pre-positive EBITDA (earnings before interest, taxes, depreciation, and amortization) deals. From the buyer's perspective, a revenue-only formula takes away any consideration of whether the revenues are non-recurring, profitable or of a good quality. This should be less of a concern to a buyer who has not hired the seller or seller's management team, since the buyer would be in control of the revenue generation. From the seller's perspective, this target is preferable for these enumerated reasons. The seller could be concerned, however, if it does not have complete confidence in the buyer's team and distribution strategy. Both parties should be comfortable with appropriate revenue recognition policies and procedures. For example, does the seller recognize revenue when a product is shipped and a buyer only when the product is accepted? If the business uses percentage-of-completion accounting, do both parties view that metric the same way? Realistically, revenue target or growth metrics do not comprise a large percentage of earnout formulas.

EBITDA

The quantum of EBITDA or the increase of EBITDA over target level is a frequently used metric to calculate earnouts. The logic for employing this method is straightforward. Valuations of businesses are frequently based on some multiple of EBITDA. The proper multiple is as much an art as a science, and much give and take and compromise between the parties underlies reaching the appropriate multiple. If the seller feels the multiple should have been 6x EBITDA of \$1 million of EBITDA, and the buyer feels it should have been a 5x multiple, then a common compromise would be

to pay the \$5 million purchase price at closing and give the seller the chance to earn the extra \$1 million, and perhaps more, based on the future attainment of EBITDA. From a valuation standpoint, a buyer may prefer to use an EBITDA threshold because the earnout will not materialize if that target is not penetrated. A threshold before which no earnout may be realized can be further justified on the grounds that attainment is strategic and long-term oriented and better approximates the valuation of a business. A seller, in contrast, may only care about short-term sales and therefore prefer gross revenues or gross profit as the benchmark.

From a seller's perspective, it would prefer to structure the EBITDA metric so that it receives a certain percentage of all future EBITDA for a certain number of years. A buyer, on the other hand, will try to impose a hurdle on an earnout formula so that the seller is only entitled to receive an earnout to the extent that the year's EBITDA exceeds a certain target level. A buyer will also try to put a ceiling on the aggregate earnout a seller could receive to mitigate some of the potential windfalls discussed above. A seller would retort that it should not be penalized for the business doing well and its interest in the business doing well properly aligns the interests of the parties.

The major objection to an EBITDA earnout-based metric from a seller's perspective is the ability for a buyer to manipulate the earnings component. A seller will be concerned that it managed the business one way and buyer is actually incentivized, at least during the earnout period, to front load or accelerate costs into the business. For example, if a seller typically spent five percent of sales on advertising or only employed 10 sales personnel, a buyer may feel that it is entitled to make larger investments in those items as it sees fit and does not want to have its business micromanaged by a seller. A buyer might feel that its short-term expenditures might inure to the long term benefit of the business, even to the benefit of a later period of the earnout,

and should continually be second-guessed. A buyer might also feel that a seller may have dressed up its EBITDA statement in the years before a sale by, for example, deferring maintenance to maximize the sale price and buyer's spending levels are more appropriate.

Capping selling, general, and administrative expenses at some level for the sole purpose of the earnout calculation sometimes puts both parties at ease. A buyer knows that it can incur expenses as it sees fit yet seller knows that such excess spending will not affect the earnout. Alternatively, the parties may agree that for purposes of calculating the earnout, these expenses will be a fixed percentage of gross revenues.

Gross Profit

Use of gross profit as a metric is a compromise between the seller's desire for both simplicity and reduced opportunities for manipulation with the buyer's goal of predicating the earnout in replicating its fundamental EBITDA target for valuation purposes. The same issues with proper measurement discussed under EBITDA still arise but less controversial components exist. The parties will also have the same debate over triggering the earnout formula from the first dollar or only after a threshold has been exceeded and then whether any cap should apply on the total sum. The parties will need to be comfortable with the understanding of the components of costs of good sold used to arrive at the gross profit figure. For example, a seller may have not allocated as much overhead, or not had as much overhead to allocate to and include in cost of goods sold, as a buyer. A buyer may retort that, even if this is true, a buyer may be able to purchase component costs cheaper so seller is receiving cost savings in this component.

Occurrence Of Specific Event

The execution, maintenance, or renewal of certain key contracts is often a driver of the earnings

power of a seller's business on which the purchase price is predicated. Therefore, earnouts are often conferred or negated based on the attainment or renewal of one or more of those key agreements within the earnout period. While simply stated, the details can be exasperating to negotiate. If a key contract is not renewed, the seller may blame the buyer for not succeeding in providing the requisite comfort to the customer. Exogenous factors such as the customer's changing needs or changed procurement practices or personnel may be a neutral and no-fault rationale for not renewing. A seller would not want to be responsible in this no-fault situation but a buyer would logically retort that regardless of fault it is not receiving the benefit of its bargain. Buyers might also place other conditions on whether a contract renewal satisfied the earnout. For example, the contract must have a certain term and a certain profit margin otherwise its renewal does not confer the same level of earnings power to the buyer.

Increase In Target

Regardless of the formula adopted, the parties frequently discuss whether a certain target figure should increase each year. For example, a buyer will often insist that it is expected to grow EBITDA or gross profit in its other business lines and seller's business should not be treated differently.

COMPUTING THE EARNOUT • Regardless of which metric is used for determining the earnout, the parties should then carefully analyze how this will be mechanically computed. Precise and careful drafting is key to minimizing if not eliminating disputes and is frequently the subject of intense negotiating. Buyers will often prefer as much silence on this subject and rely simply on contractual provisions specifying that its accountants will make the determination using generally accepted accounting principles (GAAP). This vagueness will enable the buyer to calculate the earnout under its interpreta-

tion of GAAP or its methodology for determining this inherently subjective standard. The seller, on the other hand, would prefer as much certainty and specificity as possible to assure either that the parties will utilize its version of GAAP or at a minimum that no computational surprises arise. Therefore, the parties should carefully consider various areas in which disputes frequently arise.

Whose GAAP?

The seller will often insist on its methodology, reasoning that the purchase price was predicated on that approach. The buyer will rejoin that such methodology may have been the starting point for analysis but the buyer re-adjusted seller's figures to buyer's own methodology. Further, buyer cannot have two sets of books and accounting approaches. The parties will often meet somewhere in the middle after making specific adjustments or reaching specific accommodations for purposes of calculating the earnout but not necessarily for purposes of buyer's actual financial statements.

Extraordinary Events

Earnout computations should address that these items, whether related to a purchase or sale of a division or product line, receipt of insurance proceeds from a catastrophic loss, or other unexpected loss, are properly addressed. For example, if a seller's business had multiple divisions or product lines before closing and one of those is sold, the earnout formula will often both ascribe a certain value to that business and assure that the EBITDA or other target metric is appropriately adjusted after the divisional sale closes.

Consistency

The parties will often debate how sales discounts will affect one of the formulas discussed above. A buyer will not want its business methods and policies challenged. A seller sees room for great mischief in subsidizing a buyer acquiring market

share at the expense of the earnout during the earnout period. Inventory accounting policies are sometimes a source of controversy. For example, the seller may not have capitalized certain overhead items or rarely written off overstock or obsolete items. Buyer may take a more aggressive or prudent approach which would affect gross profit or EBITDA calculations.

Specific Focus Areas

Great computational ingenuity as well as honest differences of opinion abound in calculating earnouts. In the unlikely event that the clients are not already several steps ahead of the lawyers on these areas, they should consider proper and consistent treatment of many items such as the following to minimize subjectivity and abuse of discretion conferred under GAAP:

- Excluding any goodwill or other amortization resulting from the purchase price;
- Non-recurring expenses related to the integration of the seller such as announcements, new business cards, placement and investment banking fees;
- Subjective allocations of overhead from other buyer operations such as allocation of home office services (legal, accounting, image advertising) and other items that do not directly and unmistakably benefit the business which is measuring the earnout;
- Changing depreciation policy to start expensing equipment instead of depreciating it or accelerating the depreciation instead of taking it on a straight-line basis;
- Accelerating receivable bad debt policy;
- Accelerating inventory valuation methodology;
- Proper treatment of insurance expense if seller has been self-insured and the buyer procures insurance; and
- Overall control of budgets and other expenses. As discussed above, this last item is critical to properly align the parties' interests. In sum,

buyers may in good faith want one level of spending to grow the business for the future and sellers may prefer to deflate expenses during the earnout period.

The Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR), requires pre-closing notification of the Department of Justice or Federal Trade Commission and then either early termination or expiration of the waiting period. The size threshold of the transaction varies over time but currently no filing needs to be made if the transaction is less than \$63.4 million. What happens if the fixed portion of the price is less than this \$63.4 million threshold but if all or a portion of the earnout is earned, you will exceed the threshold? The statute is unclear and regulations on this subject are very vague. In practice, the buyer's board of directors should evaluate whether it is reasonably probable or likely that the \$63.4 million threshold will be reached. This analysis raises many practical considerations. If the buyer's board determines that this threshold is unlikely to be reached, the seller might question the underlying merits of the transaction or the buyer's earnestness about collaborating with the seller to make the earnout feasible.

TIME PERIOD FOR EVALUATING AND PAYMENT • A seller will often have conflicting considerations in evaluating the proper time period for computing the earnout. On the one hand, a seller would like to know that its earnout will be attained once it has hit a specific target and will perhaps ask for a few years to make up the EBITDA gap that give rise to the need for the earnout in the first place. On the other hand, the seller may not want to be penalized if it has a disappointing year or two, especially since transitions to new owners are rarely smooth and predictable. Further, a seller will desire to be paid each year or quarter if and when it has succeeded in attaining the earnout target. Once its cap or the final time period for de-

termination has been met the earnout would end. If the earnout is structured so that payments are made on a year-by-year basis only if that year's target is met, a seller will often ask that if it fell short one year, and exceeded both the target and the cap in the next year or years, then seller has the ability to be paid the portion of the earnout for the year which it was not attained.

A buyer often desires a longer earnout measuring period to assure not just the quantity of the EBITDA, gross profit, or other metric but also their quality. Therefore a buyer will often insist on an earnout period of several years to assure that the seller did not have one great year which was perhaps aberrational or the result of excessive and unduplicatable effort. A buyer might also insist that the earnout be limited to a certain number on a year-by-year basis to avoid excessive attainments of success in one year. Buyers sometimes require a seller to return all or portion of an earnout that was earned in one year to reflect shortfalls in a subsequent year. A buyer may also desire to make the payment of all or a portion of the earnout to an independent escrow to assure that if it overpaid the earnout in one year, it would not have to chase the seller for this overpayment in the event of a subsequent later year shortfall.

Middle grounds often involve measuring the earnout over a multi-year period to avoid bunching of earnout metrics in one period to the detriment of another period and carryforwards or carrybacks if earnouts are exceeded or missed being limited to a relatively short period.

DISPUTE RESOLUTION • Carefully drafted dispute resolution provisions are key to minimizing cost and time as well as preventing extraneous issues from polarizing the parties or needlessly harming the business or its relationship with key employees, customers, vendors, and financing sources. Typically a buyer will prepare, or have its independent public accountants prepare, and present to the sell-

er a computation of the earnout for the earnout period. The seller will have a specified period to accept or raise objections. If the seller raises objections, the parties then typically have a finite period of time to resolve the dispute. This resolution may be more delicate than it appears on the surface if the seller has become a key employee of the buyer. In that case, a buyer may be overly deferential to a seller if such seller's skill and talent is still perceived to be critical to the business.

In the event that the parties cannot resolve any dispute, they frequently designate an independent accounting firm to serve as the ultimate arbiter. The independent accountants must be carefully guided to enable them to accurately and clearly implement the parties' intent. Nuances abound. Can the accountant offer a figure not proposed by a party? Must the accountant only choose one of the parties' figures (the "baseball" approach) or may the accountant meet the parties between those figures? Can the accountant use a different methodology than that which the parties employed? Will the accountant understand some of the terms it is being asked to judge? If the independent accountant resolving the dispute is not pre-selected and therefore able to read and accept the contract language in advance, the parties need to involve their own accountants at the drafting stage to obtain their imprimatur.

The costs and expenses of the independent accountant are typically equally split between the parties in order to assure that the accountant is not unduly beholden to the paying party. However, agreements frequently confer on the accountant the opportunity to require the non-prevailing party to pay the accountant's fees and expenses and sometimes in egregious cases the fees and expenses of the prevailing party as well.

Any payments of the earnout that may be owed as a result of the independent accountant's determination sometimes bear interest to compensate the seller for the time value of the money and also

to discourage buyer from being on the wrong side of the dispute. The interest rate and when it starts to accrue (from the date the payment was due or the date the independent accountant made its determination or somewhere in between) should be addressed.

Finally, a seller should insist that, regardless of whether any dispute exists, the buyer should promptly pay any undisputed portion. Sellers reason that buyers should not be incentivized by receiving the float on the undisputed sum since buyer would have been required to pay the sum if the dispute did not exist in the first place. Conversely, buyers often retort that immediate payment provides an incentive for a determined seller to raise unwarranted disputes since there is not much to lose and also claim that perhaps the independent accountant will detect that buyer in fact overpaid. Middle ground approaches include requiring the buyer to pay some portion of the undisputed sum to the seller and some portion to an independent escrow.

FORM OF PAYMENT • If the earnout is required to be paid in cash, the issues are fairly straightforward. If the cash payment is in a currency other than U.S. dollars, one side or the other might consider hedging protection products.

Greater complexities arise when the form of earnout payment includes buyer's stock. The future value of buyer's stock is a corollary of seller's rosy vision of its future business performance and a savvy seller's lawyer might be able to hold an overly optimistic or naïve buyer to its rosy projections of growth. If the buyer stock is publicly traded and the closing price is \$10 per share, the parties should agree on what happens if the price goes to \$5 per share or \$20 per share at the time payment is due. If the price has gone down by half, can the buyer simply pay as if it had not plummeted or can it pay in cash instead of stock? If seller insists on receiving buyer stock to assure that the transaction

retains its tax-free reorganization character, seller's ownership percentage of buyer may exceed buyer's desired level or may result in stock exchange or poison-pill triggers. Parties sometimes also use collars on stock prices. In that case, if the closing stock price was at \$10 per share, then buyer would not be required to pay more shares unless the stock price dropped below, say, \$8 per share, and could issue less shares as payment if the stock appreciated more than 20 percent from the \$10 level.

If buyer has gone private subsequent to the closing of the transaction or has been private all along, the form of stock payment fluctuates with the value of buyer. In that case, the parties need to devise an agreeable valuation methodology for buyer's shares as a form of earnout payment. Further, if significant corporate events occur post-closing such as a split in the buyer stock, special dividends, a sale of a significant division or subsequent sales of buyer shares below the agreed-upon buyer stock price, appropriate adjustments to the number of buyer shares to which seller is entitled is crucial. Buyers should strenuously resist, however, any anti-dilution protection for future stock issuances at lower prices. Buyers should argue that seller is a shareholder and should take the risks of ownership just as it enjoys the benefits.

Finally, a seller who receives buyer stock in an earnout should negotiate all of the normal protections of any equity holder. Attainment of these will vary based on the parties' relative negotiating positions and seller's overall ownership interest in the buyer. Items to consider include preemptive rights, exit rights, protective provisions, board or observer representation, information rights, registration rights, and tag- and drag-along provisions.

TAX CONSIDERATIONS • This article will only sketch a few salient tax and accounting considerations of an earnout. The most notable considerations are as follows.

Seller's Federal Income Tax Consequences

For federal income tax purposes, the buyer's obligation to pay the seller an earnout is treated by the seller as the receipt of an installment obligation that can be reported on the installment method. As a result, the seller's income tax obligation on the earnout component is deferred until the payment is actually received.

The earnout component is commonly referred to in the income tax parlance as a "contingent payment obligation," and whether the earnout can be described as having a "stated maximum" price or a "fixed period" (or end date for payment) will have implications for the timing of the recognition of the seller's gain and the amount and timing of imputed interest on the sale. For instance, with an earnout that will pay no more than a specified dollar amount, the stated maximum amount will be used to determine the allocation of the seller's income tax basis to the various payments received in the sale transaction and to determine the amount of the imputed interest to seller during the earnout period until such time as it is established that some lesser amount will be paid pursuant to the terms of the earnout.

Simply stated, a seller will allocate its total tax basis for the transferred assets as an offset against the various payments received in the transaction based upon the relative amounts of the various payments, including those received in the year of sale. For these purposes, the seller is presumed to be entitled to receive the stated maximum earnout proceeds until the facts dictate otherwise. Likewise, for purposes of determining the amount of un-stated interest on an earnout, it is presumed that the seller will receive the stated maximum until circumstances dictate otherwise.

One trap: if the earnout is not ultimately fully earned, the tax shelter of the unallocated basis can in effect be lost or severely limited. For example, assume the basis is \$10 million and total purchase price is \$20 million, and the earnout is up to \$2

million. In that example, at closing, since 90 percent of the purchase price (i.e. \$18 million of \$20 million) is paid, then 90 percent of the basis or \$9 million will be offset against that \$18 million. If the earnout is not earned, then what happens to the other \$1 million of basis? That basis could be used to offset other capital gains, but not the capital gains from the sale transaction! If no other capital gains exist, the seller would be limited to just \$3000 per year of long-term capital loss.

Buyer's Federal Income Tax Consequences

The converse treatment applies to a buyer. Until an earnout has been “earned,” the buyer will not generate additional depreciable basis to be added to the acquired assets. After the earnout has been determined and paid for, a buyer will be able to increase its basis in the assets or stock of seller by the amount of the earnout and allocate the increased purchase price attributable to the earnout. Frequently, this payment will be considered goodwill and amortized on a straight-line basis over the remaining amortizable 15-year life of the acquired intangibles.

Potential For “Imputed Interest” On Earnout

Since the earnout obligation is treated as an installment obligation for federal income tax purposes, each deferred payment made with respect to the earnout obligation will either require the payment of an interest element under the terms of the relevant agreement or the Internal Revenue Code will serve to recharacterize a part of each payment as in part interest and in part principal. The amount recharacterized as interest is commonly referred to as “imputed interest.” The imputed interest amount will be included in the seller’s tax return (as ordinary interest income as opposed to proceeds on the sale of a capital asset for instance) and will be deductible by the buyer. This income inclusion and deduction rule will apply each year until the

earnout is completely retired; whether or not any payment is actually made in such year. The parties therefore have contrary tax motivations as the seller would prefer to impute the lowest permissible rate to reduce its receipt of ordinary income which is taxed at higher rates than long-term capital gains. A buyer, on the other hand, prefers an imputation of the highest interest rate on the deferred earnout payment since the interest payment is expensed in one year instead of being amortized over 15. The parties should negotiate an imputed rate to avoid the IRS imputing one for them.

Tax-Free Acquisition Transactions

If the transaction is intended to be all or a portion tax-free under the reorganization provisions of the federal income tax code, the form of payment needs to be at least 50 percent in buyer or related party stock. Therefore, the earnout payment should assure that if it is in cash, it will not be in such an amount of cash as to jeopardize the maintenance of this ratio.

SECURITY FOR PAYMENT • The good news for the seller may be actually earning the earnout. The bad news, however, might be that the buyer is unable to honor its commitment to pay it. Most typically, a buyer may have purchased seller’s business in a leveraged buyout and been required to pledge the assets of that business (if not other buyer assets as well) as security for the loan that financed the purchase price. In that case, the buyer’s bank typically prohibits subordinated obligations, including the earnout, while any senior debt is outstanding. Moreover, situations often arise in which the earnout is made, yet the buyer has insufficient free cash flow, whether due to taxes, working capital timing, or reinvestment needs. Therefore, sellers often insist on receiving third-party guarantees and other collateral to assure the integrity of the payment of the earnout. The creditworthiness of the guarantor requires a seller to underwrite and

assess the risk of payment. A buyer will sometimes offer a seller a second security interest in the seller's sold business as additional collateral. This gesture may be cosmetically and emotionally appealing. However, a second security interest may be of little practical significance since the second lien remains subordinated to the bank's first collateral position. Further, a senior lender will frequently restrict payments to seller on the earnout (as it would to any junior lender) and certainly prohibit them if there is a default or bankruptcy. The bank and seller often clash over the terms of the bank's subordination agreement, which typically seeks to block any payment to the seller until the bank's loan is repaid or certainly while a default exists. Sellers, on the other hand, will counter that they should be paid as long as no material monetary or perhaps financial covenant default exists or even unless the loan has been accelerated.

CONTROL OF POST-CLOSING OPERATIONS

• A major area of potential confrontation frequently erupts over the control over and integration of seller's operations into buyer during the earnout period. Buyers prefer to leave the agreement silent to maintain as much discretion and latitude as possible. They will often attempt to comfort an anxious seller with the assurances of "trust me," "we know what's best," and "we both share the same interests in growing the business."

This buyer response tests sellers' political skills. Of course a seller trusts the buyer and has complete confidence in buyer's innate sense of fairness. However, to quote Ronald Reagan's retort to Gorbachev during an intense summit conference, the seller will want to "trust but verify." Therefore, seller will suggest various devices to assure that the integrity of the earnout is not compromised by buyer's artifices, whether real or imagined, whether intentional or not. For example, a seller may often insist that, during the earnout measuring period, its business be held in a separate legal entity and its

assets and operations not commingled with buyer's. Further, seller will want assurances that it will receive a certain level of working capital to have a chance to achieve the earnout targets and will have ultimate authority over key personnel decisions. Sellers will also want the best of both worlds of integration — buyer's platform and infrastructure (central personnel, shipping, procurement, management information systems, insurance, employee benefits, etc.) with little of the passed-on costs applied to the earnout calculation. Buyers will usually tolerate a considerable degree of autonomy for a seller as long as seller is acting in good faith to perform. Tensions arise, however, if seller is arguably not using its agreed to efforts to perform, and buyers feel the need to address the issue before it intensifies. The potential for a significant flare-up increases exponentially as a function of the duration of the earnout.

EVENTS FOR ACCELERATION OF THE EARNOUT

• As discussed above, the period in which the earnout is measured is of limited duration. However, if the buyer's business is sold before the ending point for determining the earnout or the seller is unjustifiably or constructively terminated (assuming the seller has remained as a key employee of the buyer), or if the buyer has not met its commitment to fund or promote the business, then the seller will be deprived of an opportunity to actually earn the earnout. A seller might feel that it tied its fate with a particular group of buyer management personnel and if that personnel is no longer in charge due to a sale of buyer, the underlying premise of the transaction is no longer valid. Moreover, if buyer made specific commitments to a seller, whether operational or budgetary, and did not honor them, the seller may likewise contend that the buyer's conduct prevented the earnout from being realized. Finally, to the extent that the seller or a specific group of its personnel are contemplated to constitute key portions of the man-

agement team during the earnout period and are terminated without cause or do not have the managerial authority or resources that were promised, a seller will often assert that the buyer has interfered with the ability to earn the earnout and the earnout should therefore be accelerated.

Conversely, the buyer might claim that the earnout would not likely have been met regardless of buyer's actions or that it needs the flexibility to terminate the seller whether it is with or without cause. A buyer will further remind the seller that buyer has a motivation to see that the earnout is earned since those results imply that buyer has also done well. A seller also needs to separate its right to an earnout from the severance provisions of its employment agreement with the buyer. A seller will be compensated for its early termination without cause under the severance provisions and needs to rely on the buyer's self-interest in exercising its fiduciary duties to its shareholders to maximize value and therefore the earnout. In other words, the earnout may still be earned even without the presence of the seller and let time determine this eventuality.

Therefore, the parties need to anticipate some compromise and possible full or partial acceleration of the earnout to deal with these contingencies and conflicting considerations. A buyer might agree, for example, not to terminate a seller or key members of its team during the earnout period except for cause. A buyer might also agree to accelerate the earnout in the event of the sale of the buyer where the purchaser of the buyer is less creditworthy or terminates buyer's key personnel. The parties might also agree to a partial acceleration and buyout of the earnout in the case of a sale. This formula might recognize the remaining earnout potential (i.e. if there is only half the earnout remaining to be potentially earned, then only that portion would be potentially subject to acceleration) and then provide that some portion will be deemed earned and some deemed not earned

or, alternatively, annualize the appropriate earnout metric and then measure whether the earnout has been met based on that annualized figure. The parties should also discuss some form of escrow of the earnout in these circumstances to assure payment.

EVENTS FOR BUYER WITHHOLDING PAYMENT

• The converse of a seller accelerating payment of the earnout is buyer's refusal to pay an earnout due to its contention that contractual or other rights of offset exist. A buyer will occasionally refuse to pay amounts due under an earnout and insist on an offset due to its good faith belief that seller has breached one or more of its representations and warranties under the purchase agreement or seller owes some amount under another agreement such as a lease or supply agreement or that seller has failed to perform under its employment or consulting agreement. A seller may refute those assertions and contend that the buyer is simply trying to delay payment or renegotiate. Earnout provisions therefore should address an appropriate means to assure the buyer that it is not needlessly paying the earnout when the seller actually owes buyer monies due to specific transgressions and at the same time assuring seller that buyer is sincere in its belief that bona fide offsets exist and is not using the assertions of offset as a pretext for renegotiation or cash flow preservation. Middle ground compromises often involve requiring the buyer to deliver the earnout payment to an independent escrow pending resolution of the buyer's claim for offset.

CONCLUSION • In conclusion, earnouts often solve valuation differences between the parties to allow the transaction to be consummated in the first place. However, while earnouts may solve one problem, they at the same time cook up a recipe for future confrontation. If parties feel they really need an earnout, they need to carefully think through and address these critical areas.