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STRUCTURING EARN-OUTS IN THE CURRENT CLIMATE

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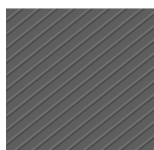

FW moderates a discussion on structuring earn-outs between Andrew M. Ross, chair of the China Practice at Cozen O'Connor's, John Amorosi, a partner at Davis Polk & Wardwell LLP, and Jeffrey J. Mordaunt, a managing director at Stout Risius Ross, Inc.

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FW: What trends have you seen regarding the use of earn-outs in the past few years? What is the appetite for using earn-outs in today's M&A transactions?

Ross: Seller's interests in earn-outs remains limited since under them the seller bears the risk of future performance. Regardless, their use has been increasing as a result of factors otherwise inhibiting deals, such as the reluctance of buyers to risk cash and, in general, buyers having a greater choice of deals to pick among. This trend does not apply to acquisitions of public companies for which earn outs remain very rare for many reasons, including potential tax consequences. One trend is some increase by private equity firms selling portfolio companies to accept at least a portion of the purchase price via an earn-out.

Amorosi: Given market volatility and buyers' and sellers' divergent perspectives on fair market value, it is becoming more common for parties to discuss earn-outs as a means of bridging value gaps in M&A transactions. However, earn-outs are far more often talked about than they are actually used, as they can present meaningful impediments to integration, from a buyer's perspective, and the risk of manipulation, particularly if tied to any metric other than top-line revenue, from a seller's perspective. That being said, earn-outs have been used with some frequency in certain industries, such as pharmaceuticals and so-called 'people businesses' where the principal assets take the elevator out of the office every day. Particularly in today's environment, earn-outs need to be in your M&A toolbox.

Mordaunt: Over the past few years, a substantially greater portion of the deals I have been involved with were consummated utilising an earn-out. This is due to a proliferation of factors that have been present the past number of years, including but not limited to national and global economic issues, eager, motivated or desperate sellers, strategic and cautious buyers, and a tightened financial borrowing or funding base. Consequently, earn-outs are necessarily utilised to bridge the valuation gap between the buyer and seller. The appetite for earn-outs remains strong and will be prevalent in transactions for the foreseeable future, as these factors are still in place today and an earn-out is a mechanism the parties can utilise to address these issues.

FW: What are the primary advantages that earn-outs provide?

Amorosi: Earn-outs are principally a means of sharing some pricing risk with the seller which can be particularly useful in early stage companies where operational prospects are not reliably predictable. In addition, they can help bridge value gaps in the sale of traditional later-stage businesses by providing for additional consideration based on the achievement of financial or operating metrics – for instance, gross revenues or net sales over a specified period of time – or the outcome of known contingencies, such as regulatory approval of a new product or the outcome of a particular litigation. They can also serve as a retention tool and a means of preserving the value in a professional services businesses, where the risk of rapid business deterioration in a target business is arguably much higher if key employees are lost shortly after closing.

Mordaunt: Earn-outs provide advantages to both the sellers and buyers in a transaction. From the seller's viewpoint, an earn-out provides the opportunity to realise their perspective of the value of their business or perhaps an even greater amount. If the owners continue to work in the business during the earn-out period, it may provide them with some level of control over the achievability of the earn-out. The use of an earn-out also increases the ability of the seller to actually consummate a transaction during challenging economic times. From the buyer's perspective, the earn-out aligns the risk inherent in the transaction: the seller's optimistic view on value with the buyer's view on the value received. It also reduces the capital due from the buyer

at close, and provides the buyer with some assurance that it received the bargained-for value of the target company.

Ross: First and foremost an earn-out is a means to bridge the gap between the expectations of buyer and seller as to the performance over the next few years of the business being acquired. As part of this, for a seller that thinks it is on an upward trend, it is a way not to be paid only on the historical results. For a buyer it is a way to pay for results rather than expectations. Also, if the seller's management are significant shareholders, it is a means for buyer to enhance the likelihood of management staying, as management will generally be of the view that they are best suited to maximise the business' performance. Finally, note that earn-outs generally only make up a portion of the purchase price and the fixed portion can vary from as low as 40 percent to as high as 90 percent.

FW: What common challenges arise when structuring earn-outs, and what are the consequences of handling them poorly?

Mordaunt: Since I often serve as a financial expert or neutral in earn-out disputes, I see first-hand the challenges inherent in structuring an earn-out. Some of these challenges result from the financial basis of measurement. Often earn-outs are computed on EBITDA, which leads to sellers claiming the buyer manipulated the post-acquisition financial results if the earn-out is achieved only in part or not at all. Utilising a provision that the financial results will be based on GAAP, 'consistently applied', is another issue that is often challenged. GAAP can be interpreted differently by the parties, and consistently applied to the seller may not be interpreted the same way by the buyer. Other challenges include the time period of the earn-out, the level of integration of personnel and the business as a whole into the buyer's organisation, and the financial reporting of actual results. Not properly thinking through the basis of measurement, the measurement process and the specific language in the agreement often leads to litigation.

Ross: One challenge is that an earn-out, as versus a fixed price, requires the parties to agree on the proper method to value the company. For example the parties have to agree on the earn-out term –for example, one year or sometimes as many as four or five years – whether to base it on revenues, profits or EBITDA, and with or without various adjustments, what multiple or percentage to use and whether to calculate it on a year by year approach. By contrast, while a fixed purchase price requires mutual agreement, the parties do not have to reach this number in the same way and in fact may not even fully share with each other their methods and logic in accepting a specific price. One consequence of handling them poorly is that the earn-out – perhaps even more than a fixed price deal – can prove not to be the best or right way to have measured the value of the business for one of the parties. The earn-out must be drafted carefully and have appropriate protective provisions so as to reduce either party's opportunity to manipulate business operations and tilt the earn-out in its favour. From a seller's perspective this can mean, for example, maintaining maximum control over the business and restricting the extent or terms on which the buyer can charge the business for services and apply these against the earn-out calculation. A common example is for the buyer to assume various back office and support services for the business and seek to charge the seller a higher fee for this than the seller spent pre-deal. Conversely, to the extent the buyer can provide these services for less, the parties have to agree how to split the savings.

Amorosi: Earn-outs are one of the more frequent sources of disputes in M&A transactions, in large part because the very nature of an earn-out allows a disappointed seller to argue that some post-closing failure on the part of the buyer resulted in lower payments to the seller. As a result it is critical to utilise metrics that are verifiable and objective and to be clear on what level of investment a buyer agrees

to make into the acquired business in connection with helping the business achieve those targets. For earn-outs based on financial or operational performance, the choice of metric – for example, gross sales v. net sales or EBITDA – can help reduce concerns that the buyer will be able to unfairly minimize its payment obligations, for example, by making aggressive allocations of SG&A or other overhead expenses. For earn-outs based on events or milestones, sellers typically seek some sort of 'diligence' obligation to achieve the specified event that increase the exposure the buyer will have to a disappointed seller. In addition, since earn-outs are generally tied to the performance of the target business only, they can act as an impediment or disincentive to integrating the target's operations into the buyer and therefore depriving the buyer – or at least reducing the value to the buyer – of the synergies and other perceived benefits of the acquisition. These considerations are almost always in tension and can be difficult to resolve without one or both of the parties taking some risk – or adopting a 'trust me' approach – on some or all of these issues. Special care also needs to be paid to structuring earn-outs in the public company context. Depending on their terms, these 'contingent value rights' can be securities that must be issued in compliance with the federal securities laws and can subject the issuer to the SEC's public company reporting obligations if transferable.

FW: In your opinion, is it truly possible to ensure a 'win-win' scenario when structuring earn-out provisions? Can you provide examples of situation where earn-outs were beneficial to both parties?

Ross: Earn-outs can absolutely produce 'win-win' scenarios but I don't think they can be 'ensured'. A win-win scenario occurs when the post-closing performance exceeds the amount of projected future results on which the buyer would base a fixed price deal, and the business' success has an overall positive result for the buyer, such as increasing its earnings per share, and results in payments which exceed what the seller would have received under a fixed price deal.

Amorosi: A 'win-win' scenario is possible in certain limited circumstances that don't apply to many businesses. One example of a win-win would be an earn-out tied to the sales of a new development-stage drug. In those scenarios where the product is a blockbuster, both parties benefit without either party taking undue risk or being disincentivised by virtue of the earn-out to promote the sales of that product. Unfortunately, this is not an example that is readily transferable to most fact-patterns where the earnings potential of a target business can be harder to ring-fence or otherwise appropriately reflect through an earn-out.

Mordaunt: It is possible to create a win-win scenario in structuring an earn-out. The parties, however, must be realistic in their value perspectives and the achievability of the agreed upon metrics. A good example was a start-up biotech company I was involved with. It had created a new product that was being readied for the FDA approval process. The investor group, primarily angel and venture capital investors, decided it was time to sell the business. The buyer was very interested in the product and had the ability to readily commercialise and distribute the product assuming FDA approval was achieved. The parties structured the transaction utilizing a very sizable earn-out, approximately 200 percent of the value of the transaction. Seventy-five percent of the earn-out was contingent upon achieving a milestone of FDA approval, and 25 percent was based on the first two years of actual sales following a six month start-up period. The product received FDA approval and was a financial success once it was commercialised. All the parties involved were very happy with the outcome.

FW: What are the key issues that parties should consider when structuring an earn-out, such as the financial metrics to be used, the earn-out period, and limitations on the earn-out payment?

Amorosi: Most of the issues in negotiating earn-outs revolve around, first, how, whether and to what extent the parties will agree to 'ring fence' the target business in order to best reflect its stand-alone earnings potential for the life of the earn-out period; and second, the protections that the parties are willing to agree to in order to guard against the risk of accounting or other manipulation by an acquirer – or the failure of an acquirer to invest in the acquired business at some level – in order to reduce or eliminate the value to sellers of their earn-out. There is no right answer to the first question with the results usually driven by negotiating leverage and the relative sophistication of the respective parties and their advisors. On the second question, the use of top-line revenue as a metric – and the adoption of some prescriptive rules regarding matters like SG&A allocation or goodwill or other asset write-offs – can limit, but will likely not eliminate, the risk of accounting manipulation. Put another way, it is much harder to resolve successfully the former issue than the latter one.

Mordaunt: I advise both the buyers and sellers in transactions to base the earn-out on the financial basis that is least susceptible to interpretation or manipulation – gross sales. However, gross sales still needs to be specifically defined, and other non-financial metrics need to be considered, such as sales personnel, marketing efforts, and so on. I also suggest a term of not more than 18 months, allowing for a six month integration period. Last, I typically recommend a tiered payment approach – for instance for gross sales of $25-30m, a $2m earn-out, for $30-35m, a $3m earn-out and so forth. These are recommended to minimise the level of potential challenges in the measurement of the earn-out. The more items that could impact the basis of earn-out measurement in the income statement, it increases the likelihood it will be challenged. For instance, many earn-outs are structured on a measurement basis of gross margin, operating income or EBITDA. A substantially greater number of financial impacts and categories affect these measurements as compared to a measurement based on gross sales. A similar issue applies to the time period – the longer the period, the more likely other factors will impact the business. Lastly, the tiered approach is recommended as it provides a flat amount for a range of success, so, even if there is a disputed issue, it may not be significant enough to change the earn-out payment.

Ross: In some industries earn-outs are common so the metrics and other terms are easier to agree upon, although of course the parties still need to agree on how to apply them. For instance, in a particular industry a typical earn-out formula might be a multiple of EBITDA, but still the multiple varies depending upon factors ranging from the size of the seller, especially relative to the buyer, and the business' profit margin. Generally, one looks at comparable deals as potential guides to the purchase price, but in a field where earn-outs are less common, applying comparables to a proposed earn-out deal can be difficult. Also, especially in such cases, a seller is likely to argue for a larger upside in the earn-out because it is taking the risk of the business not performing, as opposed to if it were a fixed price deal. Other key issues include items such as the earn-out period, how much of the total price is based on the earn-out and appropriate protective provisions. Buyers which must account for the earn-out from day one, have a reason to cap it; otherwise there is an argument that there should be no cap.

FW: How important are 'milestones' in structuring earn-out provisions? What methods or measures might firms establish to clearly demonstrate that a milestone has been achieved?

Mordaunt: Milestones are very important depending on the nature of the business being sold. If the products are in the R&D phase, have not received regulatory approval or have not been commercialised, milestones are often times a more appropriate mechanism to realize the potential value of the transaction. Other milestones can be financial in

nature, such as cost savings, increased market share or the formation of a new product line. Some milestones are clear cut, such as FDA or regulatory approval. However other milestones, including financial ones, are more difficult to measure. Methods and measurements can be somewhat discretionary, but the buyer and seller must agree on the methodology, and it should be detailed with specificity in the purchase or earn-out agreement. For instance, if increased market share is the milestone, the measurement basis must be specifically defined and address items such as how it will be measured, what the marketing efforts will consist of, who the competitors are, and whether it is a fixed market or new entrants or products can change the measurement basis.

Ross: In my experience, financial milestones – other than as a floor – are used less than linear or step calculations or bands. For example, generally a seller will acknowledge that a lesser financial performance deserves a lesser earn-out, oppose to the notion that until a financial milestone is met it is not entitled to any earn-out. One financial milestone sometimes used is based on whether the business operates either cash flow neutral to the buyer, including the costs of capital, or is accretive to the buyer's earnings per share. Milestones are more commonly applied to non-financial matters – for example, a drug business entering the next phase of clinical trials or receiving FDA approval; or a business launching a new product or new product version. Some non-financial milestones can be easy to prove – such as a government approval - while others require more care in drafting such as if a new product launch is a milestone, avoiding the product being brought to market prematurely or delayed for purposes of achieving or not achieving the milestone.

Amorosi: Milestones can make a great deal of sense where there is business uncertainty as to the outcome of specific identifiable events, such as the results of a clinical trial of a new drug, the receipt of a particular regulatory approval or the outcome of a litigation. In other circumstances, for example when sales of a product are being measured, they can magnify the impact of divergent incentives and give rise to allegations of misconduct or manipulation – to give an extreme example, where the deferral of the sale of one unit by one day results in a materially different earn-out payment.

FW: What guidance can you give to firms on negotiating an earn-out structure? What are the majors concerns for each party during this process?

Ross: For a seller, some key points are having its management remain in charge and be able to use their expertise to enhance the likelihood of maximising the earn-out; the seller does not want the buyer to interfere with the business; and the seller does not want the buyer to take actions which can impede the earn-out. Conversely, the buyer now owns the business and views it as its right and duty to make sure that the business is operated in the best interests of its shareholders and seller's efforts to maximise the earn-out do not harm the business. Examples include, in a revenue-based earn-out, management running up expenses for just minimal revenue results. On a net profit or EBITDA test, the buyer wants to preclude management from operating the business in a manner so as to maximise bottom line results at the expense of the future of the business, such as by entering into deals which front load revenues or defer expenses. Also, management will often resist incurring costs which will benefit the business over the long term but will reduce the earn-out. Contractual provisions should seek to negate the foregoing.

Amorosi: Both buyers and sellers need to give a great deal of thought to a number of issues. First, are the contingencies involved in the business being sold susceptible to measurement in a clearly defined and objective way that is unlikely to result in a post-closing dispute? Second, parties need to be careful in outlining the prescriptive accounting

rules that will govern the earn-out's calculation – that is, not just GAAP, but how to limit the flexibility afforded a firm in applying GAAP in a manner that affects that calculation. Third, firms should consider the degree to which a business can be kept separate from an acquirer's business in order to preserve the value of the earn-out without unduly limiting an acquirer's ability to obtain the synergies and other benefits of the contemplated acquisition. Finally, they must consider the level of investment that an acquirer must make in a target business – particularly if it is an early stage business – in order to enable the target to achieve the earn-out hurdles.

Mordaunt: Start by having an open discussion that addresses the concerns of both the buyer and seller. Identify what each party expects to get out of the earn-out and how realistic is it. Financial professionals representing the interests of both the buyer and seller need to be involved, as does legal counsel. Document everything that transpires throughout the negotiation in case disputes arise at a later date. The major concern for the seller is not getting paid what it believes the company is worth, and the buyer doesn't want to overpay, but wants the company to be successful on a long-term basis. Therefore the earn-out structure is one that needs to be defined with clarity, and be concretely measurable and attainable. Determine the measurement basis – a milestone or financial measurement or a combination of both – then define it as best as possible, including thinking through a number of but-for scenarios. Then document in the agreement how those scenarios are handled. This includes the level of control the seller will maintain, whether the company will be kept 'separate' from the buyer for purposes of quantifying the earn-out, and the measurement basis and related items that could impact the quantification of the earn-out such as cost structure and allocation, marketing, staffing and additional funding.

FW: Is there any further advice that you can offer to firms considering incorporating earn-out provisions into their M &A transaction?

Amorosi: Earn-outs are often proposed at a point in the negotiations where the parties feel they have reached a deadlock on price. While simple in concept, earn-outs can be difficult to negotiate and implement, and this complexity can side-track the parties at a critical juncture in the negotiation process. Accordingly, we encourage careful consideration of how a potential earn-out would work in a particular situation as part of the up-front analysis of the transaction rather than a last-ditch attempt to bridge a valuation gap.

Mordaunt: While it is difficult to see the forest through the trees, the professionals involved in the transaction need to step back from the negotiating table periodically. Be open in your communications with the buyer or seller. Think through a middle ground where everyone would be content and get creative on different ways to create value for one another. When drafting the earn-out agreement, make sure all parties are in agreement on its structure, and that the language in the agreement contains as much specificity surrounding measurement of the earn-out as possible to minimise any differences of opinion at a later date. And last, hire competent professionals – both in the development of the deal and structuring the earn-out, and if an earn-out dispute arises.

Ross: The contractual language is critical in an earn-out, including how it is to be calculated, when paid and how to deal with possible adverse activities of the other party. In addition though, of critical importance is relevant due diligence, for example what do prior sellers think of how the buyer handled their earn-outs, and from a buyer's perspective what is the seller's reputation. Ultimately an earn-out is akin in many respects to a partnership and a key factor is trusting the other party within the context of the contract. ■