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MERGERS& ACQUISITIONS

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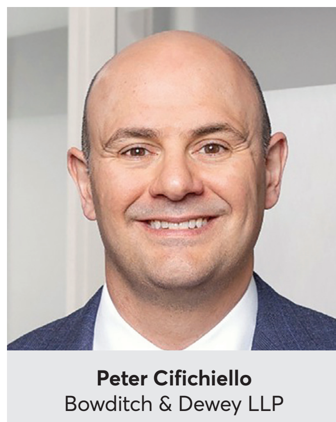
Handle Earnout Transactions with Care

Buyers and sellers need to pay attention to the details when structuring these deals.



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GIVEN MURKY market conditions, earnouts may seem like a great deal structuring tool in merger and acquisition transactions these days.

But these contingency payment plans can easily become short-term solutions that lead to long-term problems. Unless buyers and sellers pay close attention to the details of these complicated arrangements, they could wind up regretting that they agreed to these mechanics at all.

Certainly, there are many reasons for earnouts' increasing popularity. Perhaps most important, they give buyers and sellers a way to strike a deal without settling on the aggregate purchase price prior to the closing date. This can be especially helpful for buyers who are wary of a target business' economic outlook or trying to be judicious about future capital outlays. They offer certain comfort, knowing that if a company does not hit revenue targets, there will be some financial relief for the buyer.

For sellers, there are plenty of advantages, too. Earnouts give them a chance to maintain some control over their business' future success and offer the potential to generate additional deal proceeds post-closing. The arrangements can help soften the shock of what some call "identity foreclosure," (i.e. sellers suddenly not having their life's work to tend to). Sellers can also still help steer the companies, potentially safeguarding the livelihoods of some of their key employees, before moving into retirement.

This payment structure is especially appealing to smaller firms that want to sell to larger companies or private equity-backed buyers. And there are numerous such brick-and-mortar businesses with less than $10 million in the Ebitda range, mostly held by people older than 60.

Before closing a deal, buyers and sellers need to beware of costly pitfalls. When sellers sign new employment agreements to remain executives in their companies, they must ensure that earnouts, salaries and severance payments are properly differentiated between the purchase documents and their employment agreements.

During negotiations, sellers are obviously interested in getting

the highest sales prices for their companies, but they should be cautious around using the earnout milestones to optimize the sale. The more unrealistic the targets are, the less likely a seller will realize their earnout payments. Buyers will be relieved of their payment obligations if targets are missed.

Sellers need to be clear about what kind of support is needed to achieve financial targets. There may be capital expenditures, an additional headcount or simply an understood run-rate that the business requires to operate at full capacity. Ideally, these types of specific items should be contemplated in the purchase agreement. In addition, the purchase agreement should clearly describe a seller's recourse in the event a buyer breaches its support obligations under the purchase agreement which may affect whether a company misses its financial targets.

Clarity amongst the respective parties on such terms is essential, given that each side may have different goals. Buyers will be understandably reluctant to get too specific regarding minimum support and will want to maintain flexibility across different business units. But sellers will want certain baseline assurances that the buyers' time, support and management efforts will be commercially reasonable, consistent with previous business practices and ultimately in the firms' best interests. At a minimum, sellers will want to be notified in the event a buyers' support needs to change, and if the buyer is making a material change in support, sellers will want to push for a consent right.

Accounting principles used to calculate earnout targets should also be agreed to and make sure it creates practical mechanisms for calculations with the help of accountants or lawyers. Whether or not earnout targets are achieved sometimes depends on detailed accounting.

In 2008, the Delaware Court of Chancery ruling involving a software company acquisition is a cautionary tale about the need for detailed and forward-minded descriptions in accounting mechanics -- especially how to define different types of revenues and expenses in earnout calculations. The case, Comet Systems Inc. Shareholders' Agent v. MIVA, involved a dispute over a one-time bonus payment to employees following the transaction. The court ruled that the language in the purchase agreement of "one-time, non-recurring" excluded charges and costs that occur as a result of the merger. Since they are not expected to be representative of future costs in the business, the bonus payments made to employees as a result of the merger should be excluded from the cost calculations of the earnout. As a result, former stockholders received an additional $1.67 million under the earnout provision.

These involve both the conceptual as well as the practical, such as personnel headaches; especially the relationships between buyers and sellers. When deals involve earnouts, its uncommon for sellers to simply "go away" after these deals are closed. Since they typically work at their companies for years after the sale is complete, they must make the difficult transition from longstanding entrepreneur to sometimes answering to a "boss." These relationships can create management challenges for buyers, too, since they must depend on sellers to generate company revenue while being careful to manage the interpersonal aspect of this new relationship.

To alleviate some of the strain, the parties will want to negotiate certain guardrails, specifying when the buyer can terminate the seller executive(s) and what sort of severance payments will be required. Such arrangements may also extend to key employees and will likely only apply to terminations that are not for cause. Sellers will want to separate severance rights from their rights to receive earnouts. That way, as long as a termination is not for cause, sellers may still be entitled to receive earnout payments, even if they are no longer associated with the business.

These severance payments should be separate from any negotiated accelerated earnout payments, which may take effect if the company or the buyer is sold prior to the end of the earnout period. Generally speaking, if the buyer purchases a target and then later, the buyer is purchased prior to the end of an earnout period, a seller may be entitled to an accelerated earnout payment. The calculation for such may take into account past performance or future earnout potential whereby some or all of the earnout may be deemed earned at the closing of the buyer's sale.

Certainly, successful earnout transactions must consider a multitude of potential problems. But when properly executed, such mergers and acquisitions can effectively bridge the gaps between buyers and sellers and are a great way of getting a deal to move forward. **M&A**

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