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Earnouts: Bridging the Valuation Gap in Mergers and Acquisitions

An earnout is a mechanism used in business acquisitions that allows seller to receive additional post-closing payments over time depending on the performance of the company, business unit or asset transferred to buyer (the "Acquired Asset"). Earnouts allow a transaction to move forward when seller places a higher valuation on the Acquired Assets than buyer.

Generally, sellers prefer to maximize the cash they receive at closing to avoid the risk of not being paid in an earnout while buyers prefer earnouts which not only allow them to conserve cash at closing but protect them from overpaying for an Acquired Asset that fails to grow and prosper. However, earnouts may benefit sellers as well as buyers (assuming seller receives a satisfactory cash payment at closing). Earnouts allow sellers to obtain potentially greater aggregate consideration than would be the case if everything had to be paid at once. Moreover, if seller's management will continue to work with the Acquired Assets post-closing, earnouts can help align seller and buyer interests.

There is no established earnout model, and all terms are subject to negotiation, including the following:

Performance Metric: Usually earnouts are measured based on financial performance of the Acquired Assets. Sellers will likely want to use gross revenues since they are the simplest to measure and are not reduced by discretionary expenses or overhead allocations. Buyers will probably prefer some type of profitability measurement such as EBITDA which not only allows deductibility of expenses but may also more accurately reflect the Acquired Assets' value to buyer. Since sellers usually have little control over a buyer's dividend policy or capital structure, sellers are often wary of use of 'bottom line figures'. Seller and buyer need not necessarily use a financial measurement but may use number of new customers or some other non-financial yardstick.

Length: Generally, earnouts are measured for three-to-five years but a longer period may be appropriate if there is a new business or innovative technology whose true value may take several years to determine.

Payment Frequency: Earnout payments are most commonly made on a semi-annual or annual basis.

Payment Caps: The parties need to determine if an aggregate earnout payment will be capped, whether each installment payment will be capped and how to handle installment payment shortfalls. For example, an earnout might have a cap of $100,000, consisting of four annual payments of no more than $25,000 each with shortfalls subject to catch-up. In such situation, if an annual payment were only $20,000, subsequent annual payments may exceed $25,000 until the $5,000 shortfall has been erased.

Accounting/Audit Rights: Buyer payments to seller should be accompanied with some type of financial information backing up the calculation of the payment. Seller should also obtain the right to inspect the books and records of buyer to facilitate investigation of payments that appear unduly low. If the parties wish to use any non-GAAP accounting to calculate payments, their agreement to do so should be stated explicitly in the

acquisition agreement. To resolve accounting disputes, a customized mechanism utilizing persons versed in accounting and the particular industry is highly recommended.

Best Efforts/Adequate Support: Seller should insist on the buyer agreeing to use best efforts to exploit the Acquired Asset, to give adequate marketing, financial and other support to the Acquired Asset, and to avoid discrimination against them and in favor of other businesses or product lines of buyer. Buyer will want to fight sellers being too involved in buyer's business post-closing.

Extraordinary Events: From seller's perspective, earnout provisions should specify that if the Acquired Asset is sold or there is a change in control or sale of buyer, the acquirer of the Acquired Asset and/or buyer will assume responsibility for the earnout. Seller may also want the right to reacquire the Acquired Asset if a buyer bankruptcy appears imminent.

Earnouts may be deemed securities, so when a transaction includes an earnout, the parties should take care to comply with applicable federal and state securities law.

Finally, earnouts can spark disputes. Generally, earnout claims are brought by sellers alleging that buyer violated the implied covenant of good faith and fair dealing or express covenants regarding business operation. In addition, one court ruled that a buyer had an implied obligation "to use reasonable efforts" with respect to an earnout. Sellers face challenges in disputes, too, since proving damages can be difficult even if a buyer is found liable.

FisherBroyles corporate partners have extensive experience advising both sellers and buyers in negotiating, structuring and documenting earnouts.

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