

## Earn-out clauses: advantages and pitfalls

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The road to a successful acquisition holds a wide variety of challenges for both acquirer and target. A common area of concern arises from the unavailability of private information, which may lead the parties to assess the target's intrinsic value very differently. Bridging the gap between different estimates of the target's value is a fundamental step towards a successful outcome.

### Contractual solution to market questions

A possible contractual answer to the problem is to postpone the final assessment of the target's value until a time when the acquirer has direct knowledge of the target's actual profitability (ie, once it has assumed ownership and management on a day-to-day basis). Under this solution, one or more future and contingent payments are agreed, subject to the achievement of certain milestones or the satisfaction of certain conditions (eg, revenue from certain products, cash flow, the outcome of a pending dispute or a licence release). These payments are generally known as earn-outs.

### Earn-out market

Earn-out provisions have become increasingly common in recent years, particularly in the US market. They are especially useful in certain sectors or for certain types of company (eg, pharmaceutical companies, start-ups and technology and media companies), where the problem of target valuation may be greater because of the uncertainty in the market or because the company is too young to allow for an accurate prediction of its future performance. Thus, earn-outs make the information gap between the parties less significant, as acquirers are more willing to pay an

additional amount when the corresponding value can be directly observed.

In choosing a measure of performance, it is vital to take into account, and correctly assess, the amount of information about the target's profitability that the attainment of a performance benchmark provides and the extent to which such a measure can be verified by the parties. If the verification of the target's performance leaves room for uncertainty, the parties' initial disagreement over price may simply become a future litigation over outcome.

Another significant aspect of the use of such clauses is the length of delay in payment of the additional price (if it falls due). Reducing the economic pressure on the acquirer at closing may make the negotiation process easier - the acquirer may well agree to a lower price, potentially obviating the need to find additional financing, and be willing to pay a further amount that is contingent on the target's future profits. Conversely, the vendor is likely to sell the target more quickly and easily, since the fixed, upfront price is lower than the average market price and the additional amount is to be paid in future (if at all). Thus, the global price may meet both parties' expectations.

#### **Types of clause**

M&A practice has led to the development of a number of different earn-out clauses, each adapted to the needs of specific deals:

- Economic earn-outs are based on parameters determined by measuring profitability in accounting terms - they include cash-flow benchmarks, pre-tax income or gross profit amounts, and net income milestones.
- Performance earn-outs are based on goals that are not directly linked to an accounting benchmark, but relate instead to the successful outcome of one or more specific activities (eg, product development milestones, patent approvals and contracts with government bodies or other specific customers).
- Reverse earn-outs are triggered by failure to reach a certain milestone (either in financial or non-financial terms), leading to a reduction of the price agreed or paid. This type of clause differs from an indemnity clause, since the right to reduce the purchase price does not arise from a breach of the vendor's contractual representations and warranties, nor from one of its contractual obligations; rather, the lower payment reflects a specific agreement between the parties over the due consideration of the acquisition in view of certain benchmarks.

#### **Contingent value rights**

Recent M&A deals involving public companies have demonstrated that a vendor's right to obtain a

further payment based on a certain milestone or benchmark can be turned into a security right, termed a contingent value right. This form of security has its own right of circulation and may be transferred to third parties according to the provisions on security transfer. Although widespread in certain markets, particularly in the United States, the use of contingent value rights remains relatively rare in Europe. Many experts have questioned the exact nature of such rights, which may appear to be simply an earn-out attached to securities.

### **Duration and size of earn-outs**

If the parties agree to structure the acquisition agreement with an earn-out clause, they must determine the respective proportions of the consideration that will be paid at closing and deferred for payment upon contingent performance. This decision is affected by the unpredictability of the target's value. Thus, vendors with a high level of confidence in the target's true value are more likely to accept a deal whereby a larger proportion of the price will be covered by an earn-out clause. The vendor of a start-up which is confident that the company will rise in value is likely to approach the question in the same way. Another variable is the duration of the earn-out clause.

Research has shown<sup>(1)</sup> that the period may range from between one and 10 years after the closing date, and that the question of what the earn-out clause will cover is influenced mainly by information asymmetry and future growth drivers. The same research shows that the average duration of an earn-out is 36 months.

### **Avoiding pitfalls**

The parties on both sides of a deal have a strong interest in avoiding incomplete or inadequate clauses, which may lead to disputes in future.

### ***Unduly onerous obligations***

Since an earn-out clause makes the additional payments subject to the inherent unpredictability of future performance parameters, both parties should consider whether to exclude any terms of the applicable law<sup>(2)</sup> which grant the right to terminate an agreement if the price to be paid thereunder is rendered excessive by extraordinary and unforeseeable events. The parties should consider the elements of the deal (eg, the total purchase price and the duration and size of the earn-out) in deciding whether to derogate from such a provision.

### ***Economic parameters***

Agreements should specify as precisely as possible the economic parameters to be used when calculating a payment under an economic earn-out clause. Economic parameters that appear unambiguous often prove much less clear in practice. In particular, parties should avoid referring to undefined or non-shared concepts that are not specifically regulated by law or another

authoritative source (even if they are in common commercial use). Moreover, the agreement should explicitly set out the accounting principles that will apply to the target's financial statements for the purpose of assessing earn-outs.

### ***Conditions for post-acquisition management***

Particularly in economic earn-outs, the vendor may try to protect its future revenue by setting binding provisions for the target's post-acquisition management. For instance, if the additional price is based on a product sales milestone, the vendor may require that the company's management or its sales policy remain unchanged for the duration of the earn-out period. Such specific obligations tacitly acknowledge the fact that, in the post-acquisition period, parties to an earn-out agreement have conflicting interests as to the fulfilment of the conditions precedent.

Such agreements may even provide for the administrative body of the post-acquisition target to include a representative chosen by the vendor, so that the latter can monitor the ways in which the target's new management may seek to influence the fulfilment of such conditions. To this end, earn-out clauses may be implemented with collateral provisions on external controls over the target's new management - for example, the parties may choose an external auditing company to monitor the implementation of the contractual obligations undertaken by the acquirer.

### ***Indemnities***

Another negotiating point is likely to be the question of how earn-out clauses may interfere with indemnity clauses within the acquisition agreement. Vendors and acquirers should consider carefully which position they wish to take in negotiations.

It is in the vendor's interest to ensure that the occurrence of an event is not linked to both an earn-out and an indemnity. In such cases the vendor effectively loses out twice: it must pay the indemnity, but does not receive the payment of the price linked to the earn-out. For example, a target's loss due to a dispute may breach a representation made by the vendor and lead to the economic benchmark for an earn-out being missed. The vendor should protect itself by ensuring that the agreement includes a clause to the effect that the same event cannot be considered relevant to both earn-outs and indemnities, and reserving the right to indicate at the time the clause to which the event must be referred.

### ***Future acquisitions***

When drafting the agreement, parties should consider the future of the earn-out parameters if the target is subsequently involved in a further acquisition or merger. If the acquirer transfers the shares or the business, who pays the earn-out to the original vendor? Will a subsequent deal affect the achievement of a threshold set in the earn-out clause? Solutions vary depending on the position of the parties and the circumstances of the deal. However, in many cases the parties may opt for

one of the following solutions:

- The parties may agree that mergers and acquisitions involving the target are explicitly excluded for the duration of the earn-out period. However, this in turn may have an impact on the size and duration of the earn-out, since M&A activity may be instrumental in reaching the benchmarks set in the earn-out agreement.
- The agreement may stipulate that the target may be involved in M&A activity, but provide for payment, on the date of such activity, of the missing earn-out price as a way of mitigating the potentially conflicting positions of the parties. Alternatively, the vendor may require accelerated earn-out payments.
- If the target is to merge with another company and the earn-out provision relates to an economic earn-out, the parties may wish to consider a specific provision that requires separate accounting for the former target.

### Endnotes

(1) American Bar Association statistics on European private deals closed in 2010.

(2) For example, Article 1467 of Italy's Civil Code, which provides that a party whose obligation has become "unduly onerous" as a consequence of extraordinary and unexpected events may seek the termination of the agreement to which it is a party.