



# Earn-Outs: Avoiding The Most Common Pitfalls

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# Overview and Agenda

- Introduction To Earn-Outs
- Metrics and Structure
- Accounting Principles
- Post-Closing: Control, Operation, Good Faith
- Damages and Causation

# Earn-Out Purposes

- earn-out
- noun: **earn-out**; plural noun: **earn-outs**
  - a provision written into some financial transactions whereby the seller of a business will receive additional payments based on the future performance of the business sold
- Why?
  - Bridge Valuation Gap
  - Retention and Alignment
  - Financing Tool
  - Protect Shareholders
  - Start-up

# Earn-Out Overview

- Delaware Court of Chancery observed:

[A]n earn-out . . . typically reflects disagreement over the value of the business that is bridged when the seller trades the certainty of less cash at closing for the prospect of more cash over time. In theory, the earn-out solves the disagreement over value by requiring the buyer to pay more only if the business proves that it is worth more. But since value is frequently debatable and the causes of underperformance equally so, an earn-out often converts today's disagreement over price into tomorrow's litigation over the outcome.

***Airborne Health, Inc. v. Squid Soap, LP***, C.A. No. 4410-VCL (Del. Ch., November 23, 2009)



*"I'm having my wedding ring melted  
down into a bullet."*

# Areas for Dispute

- Two categories of disputes:
  - Whether the Earn-out target was satisfied?
  - Why the Earn-out target was not satisfied?
- Intersection of Law, Business, and Human Emotion

# Whether the Earn-Out was Satisfied?

# Measuring Metric and Structure

- Metrics
  - Financial Metrics
    - Revenue
    - Net-Income / Profit / EBITDA
  - Non-financial Targets
    - Milestones
    - Customers / Launch / Approval
- Accounting
  - Baseline
  - Establish principles for measuring performance
  - General reference to GAAP is not sufficient

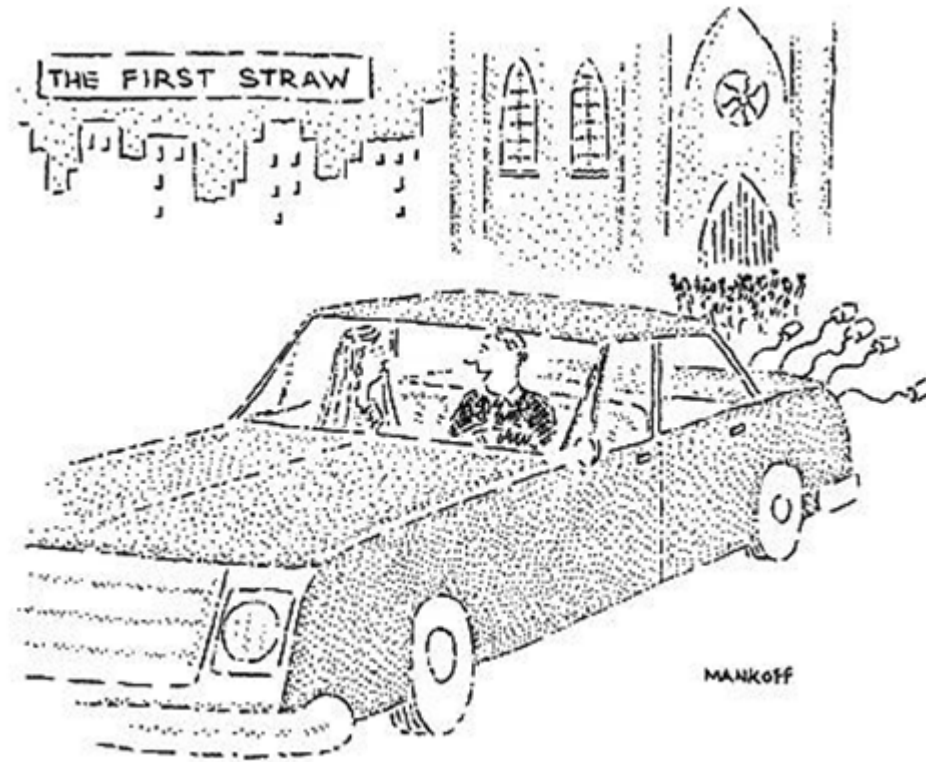
# Metric Challenges and Disputes

- Operational
- Accounting
- Parties
  - E.g., *Northbound Group, Inc. v. Norvax, Inc.* (7<sup>th</sup> Cir. 2015)
  - Not Parent or Sponsor

# Operational Challenges to Metric

- How?
  - Outside Changes in Business
  - Integration into Buyer
  - Roll-ups / Divestitures
- Why?
  - No Crystal Ball
  - Based on “old” business
  - Deal fatigue
  - Buyer needs flexibility to integrate and operate
  - Seller wants certainty

I love you, you're perfect. Now, change.



*"Mind if I put on the game?"*

# Operational Dispute Examples

- Ambulance Co. / Specialty Acquisition
  - Public Company buys specialty niche unit
  - Parent gets new and unforeseen FEMA opportunity
  - \$100mm / year
- Motorization Unit of Global Manufacturer
  - Finalize development of new product
  - Expect to market, cross sell to all international businesses
- Lessons
  - Isolate
  - Address covenants and control
  - Limit duration
  - Documentation

# Accounting Issues

- Delaware Court of Chancery
  - “There are always choices to be made in accounting treatment . . . and such choices can have a significant impact on the calculation of the earnout.”
- Issues
  - Revenue Recognition (Unique)
  - Integration and Transaction Expenses
  - Doubtful Accounts or Inventory (Viacom)
  - Allocation of Overhead, R&D, etc.
  - Inter-company Transactions or Discounts (LaPoint)
  - Debt, Tax, Impairment

# Examples of Accounting Disputes

- *Unique Software Solutions v. PureWorks, Inc.:*
  - Licensing model with license, set up, and training revenue
  - 2 year earn-out
  - APA contemplated conversion to GAAP
- **Covenant**
  - (vii)(C) shall operate and fund the business with a view towards maximizing revenues (consistent with Seller's past practices) . . .
- **Revenue Recognition Impact**
  - Converted
  - Subscription
    - Upfront training, installation, fees
    - Annual subscription (1 v. 5 years)

# Example of Accounting Dispute

- *LaPoint v. AmeriSourceBergen Corp.*, No. 327-CC (Del. Ch. May 1, 2007):
  - “When [Bridge's] products or services are bundled with other products or services of [ABC] . . . [Bridge] will receive revenue credit for such bundled sale at [Bridge]'s list price for such products and services . . . provided, however, that where products and services are discounted by more than 20%, the discount to be applied for purposes hereof shall be the **average** amount of the discount in the last (5) unbundled contracts (executed prior to the execution of the subject contract) for determining Adjusted EBITA attainment each year for comparison to the Earnout Payment objectives of each year.”
  - Discount rates in the comparison contracts ranged from 0 to 51.2%. ABC argued that "average" meant "weighted average" - the difference being an increase in the discount from 27.9% (unweighted) to 46.8% (weighted).

# Other Structural Items

- Installments
- Cap on payments
- Duration
- Adjustments or Carry Forward
- Change in Control

# Why The Earn-Out Was Not Satisfied?

# Post-Closing Conduct

- Post-Closing Operations
  - Obligations of Support and Integration
  - Reporting and Transparency of Financials
- Control
  - Seller Management or Approval Rights?
  - Restrictive Covenants?
  - Consistent with Historical / Past Practices?
- Levels of Support
  - Affirmative Requirements
  - Absolute Discretions
  - Disclaimers of Obligations

# Case Law Re Post-Closing

- Good Faith and Fair Dealing
- Disclaimers
- Pre-Closing Representations (Fraudulent Inducement)

# Implied Covenant of Good Faith and Fair Dealing

- Part of Every Contract
  - “That duty prevents one party to the contract to exercise judgment conferred by the express terms of agreement in such a manner as to evade the spirit of the transaction or so as to deny the other party the expected benefit of the contract.”
  - ***Reliance Bank v. Paramount Properties***, LLC (Mo. App. 2014).
- Purpose
  - Fills the gap
  - Protects the “spirit” of the agreement
  - Allows party the fruit of the bargain
- Limits
  - Cannot forge a new agreement beyond the scope of the written contract
  - Cannot contravene express terms
  - ***Can*** be disclaimed

# Good Faith / Fair Dealing Examples

- *LaPoint v. AmeriSourceBergen Corp.:*
  - Facts
    - Bridge Medical into ABC
    - \$27 mm cash; \$0 to \$55 mm Earn-Out
  - Agreement
    - “exclusively and actively” promote
    - “act in good faith”
    - “not undertake any actions . . . [which impede the ability of [Bridge] to earn the Earn-Out Payments

# LaPoint Evidence

## Email from VP of Strategic Development:

Just talked to our legal department and we need to make a call to someone at Utah and ask them for some assistance.

We want to use Omnicell's full solution including the SafetyMeds, but we have a post-acquisition of Bridge's ongoing obligation to exclusively promote and market their medication safety products. Under our legal agreement with Bridge, if we have the opportunity to present any medication safety product, we have to include Bridge.

Alternatively, if Utah should tell us that they have already seen the Omnicell product and do not want to see the Bridge product (in an e-mail for documentation), we can then proceed to show the Omnicell SafetyMed product. Legal is OK if we tell CSC or Utah that we have a 2 year earn-out that shows good faith to their shareholders that we will make every reasonable effort to promote their product in any automation technology offering.

Let me know if you think this is too risky to call and ask from Utah.

# Good Faith and Fair Dealing

- *O'Tool v. Genmar Holdings, Inc.* (10<sup>th</sup> Cir. 2004)(applying Del. Law):
  - Facts
    - Purchase of boat manufacturer
    - \$2.3 mm cash; 0 to \$5.3 mm Earn-Out
  - Conduct
    - Immediately changing known product names
    - Required acquired business to prioritize products not subject to Earn-Out
    - Discontinued certain products and shut down manufacturing plants
    - Forced acquired business to bear design and production costs of another line of buyer's business
    - Failed to give seller necessary operation control
  - Found Violation

# Good Faith and Fair Dealing

- *Airborne Health, Inc., v. Squid Soap, LP* (Del. Ch. 2009):
  - Facts
    - Buyer purchased Squid Soap business
    - \$1 mm cash; \$0 to \$26.5 mm in Earn-Out
    - Buyer suffered significant litigation immediately after closing, which materially restricted any ability to market or sell product
    - Seller alleged failure to spend funds on marketing
  - Holding
    - Recognized that buyer could not arbitrarily or in bad faith refuse to expend resources and thus deprive Earn-Out
    - But, court recognized that buyer did not refuse to expend funds arbitrarily, in bad faith, or for no reason. Corporate crisis prevented.
    - No violation

# Disclaimers and Limiting Clauses



*“Your Honor, my client pleads guilty to an overzealous but well-intentioned pursuit of the profit motive.”*

# Contractual Examples

- *Lazard Tech. Partners, LLC v. Qinetiq North America Operators, LLC* (Del. S.Ct. 2015):
  - \$40 mm in cash; \$0 to \$40 mm in Earn-Out
  - Subjective restriction: [B[uyer was prohibited from “tak[ing] any action to divert or defer [revenue] *with the intent of reducing or limiting the Earn-Out Payment.*”
- Lazard alleged Buyer breached contract and covenant of good faith by failing to take certain actions (such as signing of a reseller agreement) that would have resulted in an earn-out payment.
- Lazard argued covenant allowed objective standard of good faith, not just subjective intent.

# Lazard Holding

- “[T]he merger agreement meant what it said, which is that in order for the buyer to breach Section 5.4, it had to have acted with the ‘intent of reducing or limiting the Earn-out Payment’ [and] that the seller had not proven that any business decision of the buyer was motivated [at least in part] by a desire to avoid an earn-out payment.”
- Rejected seller’s argument that it could rely on the implied covenant of good faith and fair dealing to avoid the burden to prove that the buyer intentionally violated Section 5.4.
- “[the seller] attempted to negotiate for a range of additional affirmative post-closing obligations, but [the buyer] rejected all of them.”

# Limiting Clause

- Cohen v. Wrapsol Acquisition, Inc. (D. Utah 2016)

“Sellers . . . Acknowledge and agree that from Closing [OtterBox] owns and controls . . . The [Wrapsol] Business and, therefore, is entitled to operate the Business in whatever manner Purchaser determines to be in Purchaser’s best interest.”

## Changes:

- Change Marketing and Packaging
- Raise Prices
- Ended Contracts
- Shut down Business

# Absolute Right to Control

- *Yarborough v. DeVilbiss Air Power, Inc.*, (8<sup>th</sup> Cir. 2003)(applying Arkansas law):
  - Earn-Out based on sales to certain specified customers
  - Buyer discontinued doing business with one such customer and transferred that portion to another non-specified customer
  - Agreement stated buyer “has the right, in its sole discretion, to determine the terms and conditions of any and all relevant sales, including the decision to make or not make any such sales.”
  - 8<sup>th</sup> Circuit found buyer had “expressly and unambiguously contracted for the absolute power over its ability to make sales in order” in an “unmistakable” effort to avoid seller’s claim for breach of the implied covenant of good faith and fair dealing.
  - Affirmed summary judgment dismissing claim

# Fraud & Reps During Negotiations

- *FPP, LLC v. Xasis, LLC* (S.D.N.Y. 2015):
  - Denied motion to dismiss
  - Fraud and Fraudulent Inducement re meaning of contractual earn-out definitions during negotiations
  - Contractual interpretation that it knew to be different from the written definition
- *Yarborough v. DeVilbiss Air Power, Inc.*, (8<sup>th</sup> Cir. 2003):
  - Summary Judgment on alleged oral promise during negotiation
  - Certain modifications were expressly addressed in agreement, but claimed agreements were “quite obviously not included in the subsequent written draft”
  - Reliance was “not reasonable as a matter of law”
- *Reliance Bank v. Paramount Properties, LLC* (Mo. App. 2014):
  - No Oral Agreements or Commitments

# Lessons

- In light of risks and case law, buyers should consider disclaimers or narrowing provisions
  - Disclaim Duty of Good Faith and Fair Dealing
  - Restrictions on Conduct (e.g., Subjective Bad Intent)
  - Negotiate Absolute Right To Control Business
- Other provisions
  - “No Reliance”
  - Integration Clauses
  - No Oral Representations

# Damages

- Challenges
- Still must prove harm
- Liquidated Damages
- Windfall Allowed



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