

Earnouts: A Siren Song?

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An earnout—under which a portion of a purchase price is deferred and dependent on future events—is a regularly discussed and somewhat less often implemented tool to bridge the final purchase price gap in negotiations for the sale of a business. Particularly where the disparity results from a seller and buyer holding differing expectations of future performance or the outlook for a new product or initiative, an earnout offers an appealing alternative to the typical “split the difference” compromise by tying the payment of the “disputed” portion of the purchase price to the actual outcome in the future.

Dealmakers are surely aware that negotiating an earnout is never as easy as it seems, *What metric should be used? How long is the earnout period? What happens if the buyer sells the business? What costs are allocated to the business? Who controls the business during the earnout period? Should there be a cap on the earnout, especially if paid in buyer shares?* are but a few examples of the hard issues that need to be settled at the outset, with increased importance in cases where the earnout represents a meaningful portion of the overall consideration.

In fact, many parties end up abandoning a proposed earnout before implementation when the weight of these issues—and the resulting tense negotiations—threatens to overwhelm the overall sale process. While much has been written about the intricacies of drafting and negotiating earnouts, a few recent cases highlight the sobering practical reality that the disputes often don’t end upon implementation and that earnouts frequently are mere recipes for future disagreements regardless of the time and care expended on their creation.

In an October 2009 decision, the United States Court of Appeals for the First Circuit found that Massachusetts law, like California, recognizes an implied obligation on the part of a buyer “to exert reasonable efforts to develop and promote [seller’s] technology” where the seller was the beneficiary of an earnout based on the future sales stemming from the technology. The court found such an obligation to be implicit in the purchase agreement under which PerkinElmer acquired Sonoran, noting in particular the absence of any disclaimer of such an obligation or the reservation to PerkinElmer of sole discretion in this regard (in fact, the earnout provision was very short and had no detail at all about how the business would be operated post-closing). As such, the buyer was potentially liable for failing to invest sufficiently in the acquired business in order to facilitate achievement of the earnout targets.

A recent Delaware case involving the purchase of Squid Soap by Airborne Health reached a somewhat analogous result by suggesting that the extra-contractual implied covenant of good faith and fair dealing could, in the absence of specific contractual guidelines, require the buyer’s discretion to conduct the acquired business that was the subject of the earnout “reasonably and in good faith” (although in this case the court did not find any arbitrary or bad faith behavior by the buyer).

While the risk of implied duties being read into a contract can be mitigated by including more explicit and detailed provisions in the purchase agreement, a string of recent Delaware cases underlines the frequent futility of attempting to draft an earnout provision that covers all eventualities. In 2008, the Delaware Supreme Court upheld a decision that awarded the former shareholders of Bridge Medical \$21 million in damages resulting from a disputed earn-out with Amerisourcebergen (ABC). In this case, the parties negotiated elaborate provisions relating to the post-closing operation of the acquired business and the calculation of the earnout targets. The agreement included a special rule applicable to “bundled sales” that adjusted upwards the sales credit assigned for earnout purposes if the Bridge product was discounted more than normal as a result of being sold in a bundle with other ABC products. The court found that this adjustment should apply to a situation where another ABC product was included free with the Bridge product because it (very) technically represented a “bundling” of customer offerings.

While, as the court admitted, logic suggests that arguably no adjustment should be applied (*i.e.*, including free ABC products could only have increased the price the customer would be willing to pay for the Bridge product), the court read the bundling provision literally, resulting in a significant adjustment that generated the \$21 million award. The court noted that the contract could have—but did not (somewhat understandably)—expressly address and exclude from the general rule this unanticipated and unprecipitated circumstance. Separately, but equally notable, the court found that ABC’s post-closing conduct

had breached its obligation to “exclusively and actively” promote the Bridge products; nevertheless, the sellers were probably somewhat surprised to only be awarded nominal damages for this breach because of their inability to convincingly prove the impact that this breach had on the earnout metrics.

A similar issue was addressed in an October 2008 Delaware Chancery Court decision. In this case, the parties’ dispute centered around whether merger-related bonuses paid to seller employees qualified as a “one-time, non-recurring expense” that, per the purchase agreement, therefore should be excluded from costs in calculating the post-closing performance of the acquired business. The court rejected MIVA, Inc.’s argument that bonuses were a recurring and ordinary feature of this business and therefore the transaction bonuses were non-excludable.

Rather, the court, while acknowledging that the merger bonuses and “recurring” annual bonuses serve the same “metaphysical purpose” (*i.e.*, retention), accepted the arguments of the former shareholders of Comet Software that the retention element of the merger bonus was of a different nature (*i.e.*, compensation for “the risk of job-loss and dislocation that often accompanies a corporate acquisition” vs. compensation for “revenue generating work”). While the outcome in this case can be defended on the facts, the decision again highlights the challenge of reaching a sufficient degree of precision and breadth in earnout terms to address all potential facts that may arise.

As the economy and the M&A market recover, earnouts will continue to be a tool for bridging valuation gaps. If parties are able to reach agreement on an earnout structure, the cases described above (a small sample) highlight the pitfalls that may await dealmakers at the end of the earnout period. Implied duties, failures to address unforeseen circumstances, disappointed expectations, etc. are all too common features of earnout litigation. Moreover, the fact that sellers often continue to work for the buyer means that an (important) employment relationship may further complicate earnout litigation.

VC Laster neatly summed up the predicament in his Airborne Health decision: “an earn-out often converts today’s disagreement over price into tomorrow’s litigation over outcome.”

Contingent Value Rights

Contingent value rights, or CVRs, represent an increasingly popular version of an earnout in public company sales, especially in the pharmaceutical industry. The ability of CVR structures to often sidestep some of the earnout challenges described above offers some instructional insight on potentially improving earnouts in non-public transactions. As compared to traditional earnouts, CVRs are usually of shorter duration and tied to the objectively verifiable outcome of one specific event (*e.g.*, the FDA approval of a drug, the outcome of IP litigation, etc.)—such a structure reduces, but of course does not eliminate, the opportunities and subjects for post-closing disputes between the buyer and seller.

Impact of New Accounting Requirements

It also bears brief mention that the financial attractiveness of earnouts to buyers may be adversely affected by the new accounting requirements for contingent payments under FAS 141(R) (now, Accounting Standards Codification Topic 805), which became effective in 2009. Historically, contingent consideration was generally recognized as additional purchase price when the contingency was resolved and recorded as an increase to goodwill. Earnouts are now required to be recorded at fair value at the acquisition date with the changes in that value (*e.g.*, the contingency being more or less likely to be satisfied) usually being recorded through earnings, resulting in future earnings volatility (with the volatility often appearing counterintuitive—*e.g.*, if the acquired business performs well, the fair value of the contingency increases with a resulting charge to earnings as an expense).

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