KIRKLAND & ELLIS LLP

KIRKLANDPEN
Private Equity Newsletter

February 2, 2010

Earnouts — A Siren Song?

INSIDE KIRKLANDPEN

PENpoints

A few recent cases highlight the sobering reality that earnouts, despite offering an appealing alternative to the typical "split the difference" compromise, are frequently recipes for future disagreements regardless of the time and care expended on their creation.

An earnout—under which a portion of a purchase price is deferred and dependent on future events—is a regularly discussed tool to bridge the 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. Negotiating an earnout is never easy, as the parties must decide (among others):

- what metrics to use,
- the length of the earnout period,
- what happens if the business is sold before the end of the earnout period, and
- what costs are allocated to the business.

In addition to the complexities of negotiating and drafting earnouts, a few recent cases highlight the sobering practical reality that earnouts frequently are recipes for future disagreements regardless of the time and care expended in their creation. This occurs sometimes because the parties do not anticipate every business eventuality, and other times because the courts impute obligations beyond the parties' express language. For example, in an October 2009 decision, the U.S. Court of Appeals for the First Circuit imposed on a buyer an implied obligation "to exert reasonable efforts to develop and promote [seller's] technology" where the seller was the beneficiary of a sparsely drafted earnout covering future sales based on the technology.

Contingent value rights, or CVRs, represent an increasingly popular version of an earnout in public company sales, especially in the pharmaceutical industry. 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.). These structures reduce, but do not eliminate, the opportunities and subjects for post-closing disputes between the buyer and seller.

As the economy and the M&A market recover, earnouts will continue to be a tool to bridge gaps between buyers' and sellers' views on the value of a business. However, implied duties, failures to address unforeseen circumstances, disappointed expectations, etc. are all too common features of earnout litigation. As a Delaware judge recently stated in his *Airborne Health* opinion, "…an earn-out often converts today's disagreement over price into tomorrow's litigation over outcome."

To learn more about recent court decisions involving earnouts and changes in accounting rules affecting the treatment of earnouts, please see our recent M&A Update.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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Hart-Scott-Rodino Act Thresholds Decrease

PENpoints

The Federal Trade Commission recently announced revisions to the Hart-Scott-Rodino Act filing thresholds. For the first time since the annual adjustments to the thresholds have been in effect, the thresholds will decrease from the prior year.

The Federal Trade Commission recently announced revisions to the Hart-Scott-Rodino (HSR) Act filing thresholds. The HSR Act requires annual adjustment of the jurisdictional thresholds based on the change in the U.S. gross national product. For the first time since the annual adjustments to the thresholds have been in effect, the thresholds will decrease from the prior year.

Effective February 22, 2010, subject to certain exemptions, an HSR Notification and Report Form must be filed when, as a result of an acquisition, the buyer will hold voting securities and/or assets valued in excess of $63.4 million, and the transaction involves parties with annual net sales or total assets valued at $12.7 million or more and $126.9 million or more, respectively. If the value of the voting securities and/or assets exceeds $253.7 million, then—again, subject to certain exemptions—the size of the parties is irrelevant and an HSR Notification and Report Form must be submitted. The revised thresholds will apply to all transactions that close on or after the February 22, 2010, effective date.

The chart below summarizes the original thresholds set forth in the HSR Act and regulations, as well as last year's and the new thresholds.

	Original Thresholds	2009 Thresholds	New Thresholds
Size of Transaction	$50.0 M	$65.2 M	$63.4 M
	$200.0 M	$260.7 M	$253.7 M
Size of Person	$10.0 M	$13.0 M	$12.7 M
	$100.0 M	$130.3 M	$126.9 M

Filing fees have not changed and apply to the new thresholds as follows:

Transaction Value	Filing Fee
Greater than $63.4 million but less than $126.9 million	$45,000
Greater than or equal to $126.9 million but less than $634.4 million	$125,000
$634.4 million or more	$280,000

Application of the HSR thresholds to a transaction involves detailed knowledge of the HSR Act and its implementing regulations.

If you have any questions regarding the HSR Act or its revised thresholds, please contact the following Kirkland authors or your regular Kirkland contact.

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PENbriefs

U.S. Department of Justice Arrests 22 in Unprecedented FCPA Sting Operation

In January, the U.S. Department of Justice unsealed the indictments of 22 executives and employees in the military and law enforcement products industry, signaling a new era in Foreign Corrupt Practices Act enforcement. These indictments clearly show that the DOJ intends to be even more aggressive in its prosecution of corruption crimes, especially against individual defendants.

To read more about these recent developments, please see our recent *Kirkland Alert*.

PENnotes

The 2010 Private Equity and Venture Capital Conference at Northwestern University's Kellogg School of Management
Chicago, Illinois
February 10, 2010

The 2010 Kellogg School of Management's Private Equity and Venture Capital conference will provide a forum for discussing the opportunities and challenges that are currently reshaping the private equity and venture capital industries. Kirkland partner Sanford Perl will participate in a panel discussion on "Evolving Strategies for Capital Appreciation."

Kirkland & Ellis International LLP's Private Fund Manager U.S. Investment Adviser Registration Seminar
London, United Kingdom
February 11, 2010

This Kirkland seminar will discuss proposed U.S. legislation that is likely to require European (and other non-U.S.) fund managers to register with the U.S. Securities and Exchange Commission beginning in 2011. Join Kirkland partners Scott Moehrke, Lisa Cawley and Richard Watkins as they discuss what SEC registration and supervision entails. This event will be held in Kirkland's London office.

The 16th Annual Harvard Business School 2010 Venture Capital and Private Equity Conference
Boston, Massachusetts
February 13, 2010

The 16th Annual Harvard Business School 2010 Venture Capital & Private Equity Conference aims to address issues and trends relevant to venture capitalists, private equity investors, entrepreneurs and those who support the venture capital and private equity communities. Kirkland partners Kirk Radke and Andrew Wright are scheduled to moderate the "Investing in the New World" and "Fundraising Corner" panels, respectively.

Beecken Petty O'Keefe & Company Private Equity Conference
Chicago, Illinois
February 19, 2010

This event, hosted by the University of Chicago's Booth School of Business, is designed to give students and friends of the school an opportunity to hear from professionals and alumni in the private equity industry. Kirkland partner Bruce Gelman will moderate a panel on "Infrastructure Investing."

GoldenNetworking.com's Distressed Investing Leaders Forum 2010
New York, New York
February 26, 2010

At GoldenNetworking.com's Distressed Investing Leaders Forum, panelists will evaluate the current distressed investing landscape, review recent regulatory developments promoting the role of private investors in the disposal of financial assets from the FDIC, and discuss opportunities and pitfalls in distressed financial assets. Kirkland partner Edwin del Hierro will speak on "Opportunities and Pitfalls in Distressed Financial Assets" and partner Jonathan Henes will present on "Extraordinary Opportunities Investors Cannot Afford to Pass," at this event, which will be held in Kirkland's New York office.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2009, Kirkland received the awards for Best Law Firm (Private Equity Deals) and Best Law Firm (Fund Formation) in North America from *Private Equity International*. Mergermarket has ranked Kirkland first by volume for Global and North American Buyouts in its "Global M&A Round-up for Year End 2008," and Pitchbook named Kirkland as one of the most active law firms representing private equity firms in its "Private Equity Breakdown" through Q3 2009.

For the second year in a row, *The Lawyer* magazine recently recognized Kirkland as one of the "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In addition, Kirkland's London office was named the 2008 "Banking Team of the Year" at the Dow Jones *Private Equity News* Awards for Excellence in Advisory Services.

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