Jasso Lopez PLLC

EARNOUT PROVISIONS

Bridging the Valuation Gap

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AGENDA

Earnout Provisions

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I. Introduction

What is an Earnout?

A financing vehicle that produces future payments to the seller, which are contingent upon the achievement of predefined financial or operating objectives after the target is under new ownership.

- The future payments are usually in addition to the initial payments and may be in cash, stock, notes or a combination of these acquisition currencies.
- The performance target is typically based on the future earnings or sales of the acquired firm in the one to five years following the acquisition.
- Example: The Purchase of Miro Computer Products, AG, by Pinnacle Systems Inc. included an earnout that provided for the payment to the seller of an amount equal to 50% of sales generated in excess of $37 million and 85% of sales in excess of $59 million during the year following the acquisition.

Relevance:

Earnouts can be useful if the parties' views on the value of the business are too divergent for the parties to reach agreement on a fixed purchase price.

- Most often, this situation arises when the seller's information about the value of the business is superior to the information available to the buyer, such as when the target is a smaller, private company in a different industry from the acquirer.

Risks:

Although the basic concept is relatively straightforward, an earnout, if not carefully structured, can lead to major disagreements between the parties when it becomes time to make the pay-outs.

II. Determining Whether to Use an Earnout

The General Rule

As a general rule, earnouts should be avoided, as they present a host of challenges to the parties employing them. However, under the right circumstances they can be a useful tool in structuring a transaction.

A Shared Disadvantage

Disputes. The most common disadvantage to employing earnouts is their tendency to result in disputes with respect to the earnout payment amount due to the seller and the calculation thereof as well as the running of the business during the earnout period. Other disadvantages will be discussed from the perspective of each party below.

II. Determining Whether to Use an Earnout

A Shared Advantage

Alleviating the Problem of Valuation Discrepancies. As mentioned, earnouts can be useful if the parties' views on the value of the business are too divergent for the parties to reach agreement on a fixed purchase price. This is more likely to be the case under any of the following circumstances:

- *The target has experienced a recent drop in earnings or expects an unusual increase in earnings.* Naturally, the buyer will hesitate to accept the seller's likely assurances of higher future earnings.

- *The target does not possess a meaningful history of operations.* It may be newly formed but have exciting prospects, such as the patent rights to an unexploited invention or a new product under development. Because the company has no record on which to base meaningful projections, the buyer may be unwilling to pay a significant amount in an outright acquisition.

- *The target is highly dependent on one or relatively few customers.* The buyer may discount anticipated earnings if there is a perceived risk of losing key customers.

- *The target has a small asset base.* Example: a service business.

- *The seller is closely held.* The seller may claim not to have endeavored to maximize earnings or minimize expenses. For example, if the seller is an individual, he or she may have been causing the target to pay him or her a salary that exceeded the level that would have been given to a third party employee in the same position.

II. Determining Whether to Use an Earnout

Advantages to the Buyer

Reducing Risk of Overpayment. The buyer can offer to pay more because earnouts reduce the risk of overpaying that exists when the entire purchase price is paid up front.

Deferred Payment. The buyer is able to finance in part an acquisition effected today with tomorrow's dollars, allowing the buyer to pay out a portion of the consideration when it may be easier to do so.

- *Target Financing.* One reason it may be easier for the buyer to pay the purchase price in the future may be the target's own earnings.

Goodwill Deferral. Although goodwill on the buyer's balance sheet is an asset, it does not impart additional borrowing power. Because the acquisition-minded company may desire high leverage, anything that will soften the impact of goodwill on its books is very attractive. In an outright purchase, all the goodwill of the target is booked immediately, but in a contingent payout scenario the buyer can gradually increase the goodwill from the transaction as payments are made over the life of the contract.

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II. Determining Whether to Use an Earnout

Advantages to the Buyer (cont'd)

Management Performance Incentive. If the seller participates in management post-closing, the earnout can be a powerful incentive tool because the seller is paid on the basis of performance. Furthermore, since the seller is on view not only by top management but also by the other subsidiary or division heads, pride may motivate him or her to perform well.

Grace Period. If the seller participates in management post-closing, the contingent payout allows the buyer a time to learn the seller's business. It also gives the buyer time to evaluate the seller's executives and decide if they should be retained after the earnout period. If the decision is negative, the buyer can use the interval to search for and prepare new management.

Limited Fraud Protection. It is often much more difficult for the buyer to assess the accuracy of the financial statements and projections of a closely held company than of a publicly owned company. If the seller has misrepresented its earnings or projections, the use of an earnout protects the buyer by forcing the seller to use its financial statements as the standard against which the business will be measured later.

Indemnity Protection. Rather than require the seller to deposit a portion of the purchase price into an escrow account for the purpose of guaranteeing the seller's indemnification obligations, the buyer with a high degree of confidence that a certain earnout payment will be made may elect to negotiate for the right to withhold a portion or all of any earnout payments that would be payable to reimburse it for any indemnifiable losses it has suffered.

II. Determining Whether to Use an Earnout

Advantages to the Seller

Increased Purchase Price. The most significant benefit to the seller is that the contingent payout generally enables the seller to receive a larger total payment for its business than it would receive in an outright purchase.

Autonomy. Generally, when an earnout is used, if the seller participates in management post-closing, the acquired company remains a relatively autonomous unit within the buyer's organization so that the performance of the target can be accurately measured. This autonomy may be important to the managers who get satisfaction from exercising their entrepreneurial instincts and retaining control over profit-and-loss responsibility.

Tax Free Exchange. If the seller complies with certain conditions imposed by the Internal Revenue Service ("IRS"), an exchange of stock can remain tax free.

II. Determining Whether to Use an Earnout

Disadvantages to the Buyer

Interference with Synergies. While separation of the seller's operations for the duration of the earnout period facilitates performance measurement and enables the buyer to avoid paying for performance or benefits it has actually generated, it also may preclude the buyer from providing assistance to the extent that it might in an outright acquisition or gaining synergistic benefits from the combination of the target business with its own business.

- The need for autonomy of the target can also reduce flexibility in the event that the buyer later acquires another company in the industry and wants to integrate the operations of the two entities.

Incentive Myopia. If the seller participates in management post-closing, members of the seller's management may focus on earning the contingent payments to the detriment of the long-term objectives of the business.

Complex Contracts. Trying to anticipate all of the eventualities that may arise during the earnout period frequently results in a complex contract and protracted negotiations that may deter a seller. Furthermore, complex contracts may generate "loophole negotiating". If the one party is adept at such bargaining, the other party could find itself faced with unanticipated problems during the earnout period.

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II. Determining Whether to Use an Earnout

Disadvantages to the Buyer (cont'd)

Increased Purchase Price. If the acquisition is successful, the buyer will often pay more for a company than it would have had such buyer bought it outright.

Limits of Tax Free Exchanges. If the seller participates in management post-closing, the IRS requirements of a 50% down payment and the fixing of the maximum number of issuable shares to obtain a tax-free exchange may blunt the seller's incentive. Having performed well in the early part of the incentive period, and aware that he or she can receive only a specified total number of shares in any event, he or she may be disincentivized for the duration of the period.

Separate Accounting. The future earnings of the buyer — whether a subsidiary or a division — must be separately accounted for.

Allocation of Overhead. The segregation and allocation of general overhead costs is a problem under normal circumstances. When contingent payments are at stake, however, the importance of overhead allocation increases if the seller is rewarded on the basis of annual earnings. Improper overhead allocation could result in overpaying the seller.

Control Dilution. The contract may permit the acquired company's owner-managers to receive a substantial block of the buyer's stock. This holding may present control problems for the buyer if there is no maximum placed on the shares potentially issuable.

II. Determining Whether to Use an Earnout

Disadvantages to the Seller

Continued Risk. The seller expects that it will end up with increased consideration for its business than it would have in an outright sale. However, if the business does not reach the performance thresholds because of management mistakes or adverse business conditions, the seller will receive reduced consideration.

Limits of Tax Free Exchanges. The seller's potential compensation in the form of stock is limited if the deal was made in accordance with the tax-free exchange requirements of the IRS, so, if the company records unexpectedly high earnings, the former entrepreneur might not be rewarded enough even under the terms of the agreement.

- However, if the transaction had been structured as an outright sale, the seller would not have benefited at all from the improved performance during the earnout period.

Close Scrutiny. Often, if the seller participates in management post-closing, to obtain the maximum payment the seller must perform according to formula yardsticks. An entrepreneur may dislike this kind of pressure and may be uncomfortable "living under a microscope" where his or her conduct is subject to close scrutiny.

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II. Determining Whether to Use an Earnout

Disadvantages to the Seller (cont'd)

Alienation. If the seller participates in management post-closing, the seller's management may also feel somewhat alienated from that of the buyer. The feeling of alienation may become actual alienation at the end of the earnout period, for there is no certainty that seller's management will be retained. If the target's executives have met or exceeded the buyer's projections, they may not want to be severed from their success.

Diminished Autonomy. Further, if the seller participates in management post-closing, during the earnout period the managerial discretion of the seller's executives may be limited. For example, they may be required to spend a given amount per year — no more, no less — on research and development.

III. How to Measure Performance

General: The most important aspect of any earnout provision is the specific formula developed by the parties to determine the payments to be made. The parties must first agree on the appropriate measurement of performance.

Alternatives: The earnout formula may be based upon, among other things:

- revenue;
- sales (gross or net);
- gross profit;
- operating income (EBIT);
- operating cash flow (EBITDA);
- net income;
- environmental costs;
- cost savings from synergies;
- reduction of debt;
- occurrence of specific contingencies; and
- derivatives of any of the above.

The simplest measurements are gross sales and, depending upon their nature, the occurrence of specific contingencies. The most complex measurement is net income. The earnout formula is often based on the valuation method used by the parties in negotiating the base consideration.

Multiple Periods: If multiple periods are measured, the parties should consider whether the earnout calculation will be cumulative or per period.

III. How to Measure Performance

Considerations

Accounting Policies:	Both the buyer and the seller, working in good faith, can make accounting calculations that result in significant differences in revenue, earnings, cash flow or other agreed-upon measurement criteria even if the financial statements are prepared in accordance with generally accepting accounting principles ("GAAP").
Susceptibility to Manipulation:	The farther down the income statement the line items included in the earnout formula appear, the more susceptible the results are to accounting judgments and possible manipulation. Formulas tied to sales revenue or unit volumes are typically less suspect than those dealing with net income or cash flow.
Reflecting Benefits to Buyer:	On the other hand, the farther down the income statement the line items included in the earnout formula appear, the better the line items reflect the actual financial benefit to the buyer of the acquired business.
Audited Financials:	If practicable, the use of audited financial statements will serve to reduce potential disagreements.
Well-Defined Formulas:	Limiting both parties' ability to manipulate future financial results while enabling the parties to rely on performance measures that reflect real benefits to the buyer requires the negotiation and legal documentation of detailed, well-defined formulas.

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III. How to Measure Performance

Considerations (cont'd)

Specificity in the Earnout Formula. Thus, to protect themselves from manipulated earnings amounts, the parties usually request that the treatment of certain items be specified in the earnout formula, often including one or more of the following:

- amortization of the goodwill incurred in the transaction;
- the amount of overhead (i.e., expenses arising from "home office" services such as accounting, legal, public relations, advertising, etc.) charged to the entity that is the subject of the earnout;
- depreciation of fixed assets;
- interest on funds advanced to the earnout entity by the parent company;
- the capitalization of expenses policy of the entity;
- research and development expenses;
- pension costs;
- transactions with affiliates;
- capital gains;
- income from extraordinary or non-recurring items; and
- income derived from newly acquired operations financed by the buyer.

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III. How to Measure Performance

Considerations (cont'd)

Treatment of Contingencies: Other matters that should be addressed in creating the earnout formula include (i) the consequences of a force majeure event and (ii) the effect of a sale by the buyer of the acquired company

Non-GAAP Treatment: Note that the manner in which the items on the preceding page are to be treated for purposes of the earnout calculation need not be the way they are treated in the buyer's financial statements or even necessarily be in accordance with GAAP.

Consistent Accounting: As discussed in more detail in "VI. Accounting Considerations" below, to help avoid future disagreements, accounting methodologies should be consistent with those historically used by the seller. In particular, it may be appropriate to exclude the effects of purchase accounting, buyer perquisites and increased capital expenditures from the earnout calculation.

IV. Payment of the Earnout

When Will Payments be Made?

An earnout provision may last for a period of years after the closing or may terminate once an agreed-upon ceiling is reached. Typically, the measurement will be made annually, as will the payment, although this is a matter of negotiation. As an alternative to annual payments, a buyer may suggest that a single earnout payment at the end of the earnout period is more appropriate. Such a payment may, for example, be based on (i) average annual earnings during the period or (ii) aggregate earnings throughout the period.

Annual Payment Issues:

If the earnout is paid annually (as a seller would prefer), the parties must consider whether:

- the "target" amounts should increase annually and, if so, how much;
- in the event earnings increase in early years but decrease in later years, the buyer should be able to "recover" excess payments;
- in the event earnings are deficient in early years but increase in later years, the seller must "make up" a prior deficiency before it becomes entitled to receive a payment; and
- the earnout payments are reduced over time.
  - Example: 10 times excess earnings in the first year; 8 times excess in the second year; 6 times excess in the third year; 4 times excess in the fourth year; and 2 times excess in the fifth year.

IV. Payment of the Earnout

Payments of Stock: If the earnout payment is to be in the form of stock, it is important to determine:

- how the stock is to be valued;
- by whom the stock is to be valued;
- as of what time the stock is to be valued; and
- the seller's rights and obligations as a stockholder.

Floors and Caps: With respect to earnout payments, parties often negotiate minimum payment amounts as well as "caps" on payments.

Other Payment Issues: Other payment issues include whether:

- the earnout payments are to earn interest;
- the earnout payments may be offset for breaches of the acquisition agreement or other agreements;
- a certain portion of the expected earnout payments should be placed in escrow for the seller's benefit; and
- the occurrence of certain events (e.g., the sale of the parent company or the purchase by the parent company of a business that competes with the seller's business) should trigger the payment of certain minimum amounts.

Ability to Pay: The seller will demand a high degree of confidence that the entity making the payment will be able to do so. If there is any doubt, a seller may demand: (i) a guarantee from an appropriate parent or affiliated entity; (ii) a prohibition against the acquired company making any distributions to shareholders during the earnout period and/or (iii) a security interest in the assets of the acquired company.

V. Operation of the Business

Issue:

Because the ultimate price payable pursuant to an earnout provision depends on future performance, the seller would like to retain at least some control of the business during the earnout period. Ordinarily, the buyer will manage the business post-closing, but in that circumstance the seller will demand that the buyer operate the business in the ordinary course consistent with past practice.

Seller's Perspective:

The seller that is not managing the acquired company during the earnout period will typically also seek participation in significant decisions affecting the business during the earnout period through:

- contractual restrictions in such areas as:
  - the expansion of the business,
  - the hiring or firing of key personnel (such as provisions prohibiting the termination of key employees other than for cause after a judicial or arbitrator's decision to that effect has been rendered),
  - the capitalization of the business,
  - dividend policies, and
  - the combination of the business with other businesses; and/or
- a seat on the buyer's board of directors.

Buyer's Perspective:

The buyer, of course, often resists vigorously any restriction on its ability to run the business after the closing.

VI. Accounting Considerations

Who Performs the Calculation: The first accounting issue to be determined is that of control: which party's accountants are to (i) prepare the balance sheets or earnings statements upon which the earnout formula is based and (ii) calculate the amount of the earnout payment due to the seller under the agreement?

- *Importance of Judgment.* The identity of the person who is to perform the calculation is extremely important because accounting is not a science, and GAAP leaves considerable room for judgmental factors and variance in the resulting numbers. Even where all parties are operating in total good faith (which is not always a reasonable expectation), the spread between a conservative and liberal posture can be quite significant.

- *Cost Effectiveness of Buyer's Accountants.* It will be difficult for even an aggressive seller to argue that its accountants should prepare the target's financial statements post-closing, and to provide that the seller's accountants should perform this function for this limited purpose leads to a duplication of cost and efforts that is hard to justify and, under the earnout formula, will hurt both parties.

- *Identification of Critical Accounting Practices.* If the buyer's accountants are to perform this function, the seller's challenge is to identify the accounting practices it believes are critical to its understanding of the earnout formula and document them with a view toward obtaining the buyer's agreement that these are the principles to be consistently applied during the earnout period.

VI. Accounting Considerations

Reaching Agreement:

- *Seller Review and Third Party Dispute Resolution.* Usually, the initial computation will be done by the buyer's independent accountants. The figures will then be submitted to the seller, which may elect within a prescribed period of time to have them reviewed by a second firm of independent accountants selected by the seller. If the two firms cannot reach agreement, they will jointly select a third auditing firm, whose determination will be final. All of this can be very time-consuming and expensive, with each party bearing the cost of its accountants and usually one-half of the deadlock-breaking firm.

- *Payment of Undisputed Amounts.*

  – If you represent the seller and adopt this type of procedure, try to insert a clause into the agreement providing that the minimum amount of earnings not in dispute should form the basis for an immediate pay-out to the seller, on the grounds that your client should not be required to await the conclusion of protracted proceedings among the accounting firms in order to obtain what it has rightfully earned. You might also ask for interest on any payments delayed because of the review procedure.

  – If you represent the buyer and the seller asks for accelerated payment and interest, respond with a resounding negative — since your client's interests are best served, for obvious reasons, by keeping the pressure on the seller.

VI. Accounting Considerations

Accounting Procedures: As mentioned, the buyer typically would argue that a net-income based earnout should be calculated in accordance with GAAP. However, the seller would be reluctant to permit the use of GAAP because (i) GAAP changes as accounting promulgations are passed and (ii) GAAP provides various options in the treatment of certain items. Accordingly, the seller is likely to suggest that the formula be calculated on the basis of GAAP in accordance with past practices but with certain exceptions (i.e., the specific components of the formula).

Separate Accounting: As an earnout is usually contemplated solely for the results of operations of the acquired business, it is necessary to consider whether it is practical to account for such operations on a stand-alone basis. That is, there must be a way in which the future earnings of the purchased business, whether a subsidiary or a division, may be accounted for separately.

Purchase Price vs. Compensation: The contingent consideration paid to selling shareholders who are employed by the buyer may not be accounted for as an adjustment of the purchase price of the acquired company, but may instead be treated as compensation, depending upon the absence or existence of certain factors, including (i) the link between continuing employment by the selling shareholders and the contingent consideration, (ii) the duration of continuing employment, (iii) the level of compensation, (iv) differential payments, (v) relative stock ownership, (vi) the reasons for the contingent payment provisions, (vii) the formula for determining contingent consideration, and (viii) other agreements and issues.

VI. Accounting Considerations

Imputed Interest:

- *Definition.* Imputed interest is interest that is not actually paid to a debt-holder but which the IRS may nonetheless tax.
- *Relevance.* The seller must pay ordinary income tax on a percentage of the contingent purchase price equal to the number of years payment is deferred multiplied by the applicable interest rate and compounded.
  - The subject of imputed interest arises in all contingent acquisitions, including where payment is in shares and the transaction is a tax-free reorganization.
  - Unlike deals involving a fixed but deferred price, earnout provisions do not typically provide for actual interest on the contingent installments of the purchase price.
  - Imputed interest can mount up. If the final settlement is in five years, for example, approximately 30% of the contingent payments will be ordinary income rather than the capital gain presumably otherwise payable in a taxable transaction.
  - The buyer benefits from an interest deduction equal to the seller's ordinary income.

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VI. Accounting Considerations

Imputed Interest (cont'd):

- *Treatment.*
  - From the seller's perspective, at the very least a provision should be included in the agreement deeming each deferred payment to consist of principal and simple interest at a stated rate of interest per annum (the safe harbor for stated interest under the IRS regulations), for purposes of determining the taxable income of the seller.
  - More aggressively, the seller could seek to increase the amount of the earnout payments or modify the method under which they are made, such as issuing contingent shares in escrow at the outset, which would eliminate the imputed interest issue.
  - More often than not (since the tax deduction creates an appropriate "slush fund" for the buyer), an additional amount ends up being tacked onto the contingent purchase price as full or at least partial compensation for the seller's tax situation.

VI. Accounting Considerations

Valuing Earnout Shares:

- If an earnout is payable in stock, how should the shares that are deliverable several years after the closing be valued?
  - Buyers generally opt for using the market price existing at the time the shares are to be issued.
  - Occasionally, a buyer will seek to utilize the higher of the present market price utilized in the fixed part of the contract and the market price at the time of eventual issuance.
  - The seller should certainly resist this, perhaps by demanding the lower of the two prices, which ought to cause a standoff that tilts the negotiations back to a single criterion.
  - If the share valuation is based on the market price at the time the shares are ultimately issued, obviously there is no need for anti-dilution protection. If, however, the price of the stock is fixed in the-agreement, the seller is entitled to anti-dilution protection against stock splits and stock dividends.

Calculation of Goodwill:

- Relevant accounting rules value the earnout shares (regardless of the value agreed upon by the parties) for purposes of calculating the goodwill subject to amortization on the basis of the market value of the shares when ultimately issued, thereby exposing the buyer to a potentially significant problem.

VII. Tax Considerations

Installment Sale Rules

General Rule. The contingent payment installment sale rules apply where at least one payment is to be received after the taxable year in which the sale occurs.***** Generally, the installment sale provisions of the tax law allow a taxpayer to defer recognition of gain until actual payment is received.

- *Pro-Rata Allocation of Basis to Each Payment.* Usually, these rules determine the portion of each payment that should be treated as gain by multiplying each payment by a percentage (referred to as the “gross profit percentage”) that is equal to the ratio of the total gross profit on the entire transaction to the total proceeds to be paid with respect to the transaction. The remaining portion of each payment is treated as the recovery of basis. This actually has the effect of allocating (on a pro-rata basis) a portion of the taxpayer’s basis in the property sold to each payment received.

- *Consult with a Tax Expert.* A detailed review of the installment sale rules is beyond the scope of this presentation, as they are complex and provide for different treatments for different contingent sale situations. Accordingly, you are advised to consult with a tax specialist for an understanding of their application to the specific fact pattern of a given transaction.

***** In rare circumstances, where a taxpayer either elects out of the installment method or is not eligible to use the installment method, the “open transaction” method may still be available. The open transaction method allows taxpayers to recover basis before reporting gain.

VIII. Other Considerations

Psychology:

- *Post-Closing Collaboration.* As the foregoing discussion illustrates, earnout provisions give rise to numerous issues between a buyer and seller, which typically result in protracted negotiations. Thereafter, an earn-put provision may require that a buyer and seller collaborate closely over a period of time after a closing. Once a buyer and seller have endured the negotiation and closing of a complex transaction, such collaboration may be problematic. As a result, many proposed earnouts are eliminated or "bought out" prior to the closing.

- *Need for Continued Involvement.* Earnouts are generally used (and seem most applicable) when there are only a few shareholders of the entity to be sold and such shareholders will continue to be involved in the management of the business. (If such management benefits from the earnout and has control of or influence over the factors in the formula, the buyer may be concerned about a conflict-of-interest.) Institutional shareholders that are not involved in the management of the business are typically reluctant to agree to contingent earnout payments. Such investors feel that they have no control over the earnout process.

Arbitration:

- Because of the tendency for earnout provisions to result in disputes between the parties, the parties should incorporate into the transaction documents a provision establishing a binding arbitration procedure for the exclusive resolution of disputes relating to the earnout (taking into account the above-described involvement of independent accounting firms in calculating the earnout).

VIII. Other Considerations

The "Kick-Out" Clause:

- *Definition.* A provision that grants the buyer the authority to replace the seller's management of the acquired company if the acquired company fails to perform to a certain standard while under the direction of the seller-managers.

- *Criteria for "Kick-Out".* The most difficult aspect to designing a kick-out clause is establishing the criteria by which failure is to be judged.

  – As one would expect, the buyer will prefer the kick-out trigger to be a relatively minor failure to meet or exceed earnings expectations over a relatively brief period. The problem with this approach is that, even with the best of managers, outside economic factors may cause such a failure.

  – Presuming the seller agrees to the provision at all, the seller will prefer the kick-out trigger to be a substantial loss sustained over a period of years. However, the more the provision is based on an aggregate concept and the longer the applicable measurement period, the less good it does the buyer.

- *Effect on Contingent Purchase Price.* If the buyer's kick-out right has been triggered and exercised, the seller may still be entitled to contingent payments if, for example, the earnout formula was based on average or aggregate earnings. In that case, the buyer should try to factor a deduction into the formula for losses incurred on the buyer's original investment in the acquired company, particularly in the case where the target business has to be disposed of or liquidated.