By Fred D. Tannenbaum

Bridging the gaps

While earnouts can bridge valuation differences and solve a problem, they can also create other problems

In the context of a sale of a business, earnouts are price-adjustment arrangements or contingent purchase-price provisions based on future economic events. They have become a popular feature of midmarket private merger and acquisition transactions for two reasons: economic and capital markets uncertainty and the related divergent perceptions between buyers and sellers of a business's fundamental value and earnings power; and to secure the focus of key individuals post-sale or account for specific events that do not lend themselves to fair lump-sum quantification.

Earnouts, however, raise significant complexity. While their theoretical rationale is laudatory, their practical implementation and resulting post-closing complexities frequently create dysfunctional behaviour, uncertainty, tension and dispute. The solution is often worse than the problem. And there are key structural elements of earnouts and common areas of controversy that should be addressed.

Rationale

Solving valuation gaps is the most frequent motivation of the parties to a sale. The buyer may only be willing to meet the seller's price if after the closing the seller's business performs at or above the level promised or hoped for.

The second principal motivation is the buyer's desire to keep the seller focused, energized and active in the business post-closing, and earnouts often provide significant financial motivation to do so.

The seller, on the other hand, may be more willing to accept a lower nominal purchase price at closing if it is confident that the business can attain significantly greater post-closing performance goals or if it sees no other practical choice to extract a higher payment from the buyer. For the seller, staying in control of the business's management is often crucial to the acceptance of an earnout — why else accept the holistic risk without the control?

While the parties may share similar goals for the earnout, their views on the allocation between the up-front cash payment at closing and the deferred earnout payment can differ dramatically. Buyers typically prefer longer and larger earnouts for cash preservation reasons, validation of the purchase and risk reduction. Not surprisingly, sellers normally prefer a substantial portion of the price up front and smaller earnouts over shorter time periods.

Generally, an earnout of more than 25% of the purchase price or one longer than three years is too complex to implement and/or presents too much risk to the vendor. If the vendor's ongoing interest is larger or the relationship anticipated for longer, it ceases to be an earnout but more of a partnership — those animals are not the same. If it is a partnership in spirit, call it such and organize accordingly.

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Ironically, the best earnout results are when there's a true partnership spirit between buyer and seller — a genuine alignment of interests post-sale during the earnout period. But an earnout arrangement "ain't a partnership." It is an incentive to a seller, a former owner, under the governance of the new owner and all the potentially conflicting objectives that that entails.

The following deals illustrate intended and unintended consequences of allocation between up-front and post-closing payments:

- eBay Inc. purchased Skype Technologies SA a few years ago with 40% of the aggregate consideration subject to an earnout. Due to a variety of factors such as disappointing financial performance together with culture clashes between the two organizations (which were not well integrated after closing), only a little more than 30% of the earnout was ultimately realized;
- Google Inc.'s purchase of dMarc Broadcasting Inc. represents an illustration of a happier buyer paying an earnout that turned out to be 92% of the total purchase price; and
- the sale of the Juicy Couture fashion line to Liz Claiborne contained an uncapped earnout. This resulted in a surprising windfall of US$75 million to the sellers before the exasperated buyer sought a negotiation and termination of the earnout.

Where the buyer's synergistic contribution is so large or potentially large, the earnout concept may be too favourable to the seller — however, if the parties believe that one plus one equals two, why not share some of that when it is realized, regardless of who is the more important contributor. After all, it takes two to make synergies. This is true in respect of cost and revenue synergies.

Metrics for calculating earnouts
The appropriate metric for calculating the earnout is key from the standpoint of valuation and alignment of the parties' interests. Many different determining metric approaches abound. The best are those that are tailored to the specific objectives and simple to compute. However, there can often be a genuine conflict between these two objectives.

The logic and pitfalls related to common metrics include:
Revenue This is typically used in early stage, pre-positive EBITDA transactions, and where profit is predominantly a function of revenue such as high fixed-cost businesses or ones where expense levels are at fixed percent levels. In these cases, profit is a predictable function of revenue. This is a simple and clean earnout basis.

Both parties need to be comfortable with the quality of the revenue and revenue-recognition policies. There needs to be a common understanding as to revenue-recognition policies — does the seller recognize revenue when a product is shipped or only when the product is accepted by the buyer? If the business uses percentage of completion accounting, do both parties interpret and apply that policy in the same manner?
EBITDA This metric typically refers to the quantum of EBITDA or the increase of EBITDA over target. It is arguably the most comprehensive measure of performance and the most important value driver. An EBITDA-based earnout might work as follows: if the seller feels the multiple should have been six times EBITDA of $10 million, and the buyer feels it should have been a five-times multiple, a common compromise would be to pay the $50-million purchase price at closing and give the seller the chance to earn the extra $10 million based on the attainment of, say, average EBITDA of $10 million over the two years post-closing EBITDA.

The major objection to an EBITDA earnout-based metric is the potential for the controlling board or management to manipulate EBITDA in its favour and contrary to the interest of the business in the long run. For example, if the seller spent 5% of sales on advertising or employed only 10 salespeople, a buyer may feel entitled to make larger investments in those items for a long-run benefit, at the cost of short-run profit, and does not want this initiative frustrated in pursuit of higher EBITDA. But, burdening the EBITDA with such long-run investments may not be fair to the seller.

Capping selling, general and administrative expenses at a percentage level for the purpose of the earnout calculation can put both parties at ease. A buyer knows it can incur expenses as it sees fit, the seller knows such excess spending won't affect the earnout.
EBIT and gross margin The closer to revenue the earnout basis, the simpler it is — though possibly less tailored to the specific objectives. If one were to use EBIT annual capex would of course be captured, and if one were to move up to gross margin there would be no concern about selling, general and administrative expenses and influence of same. One size does not fit all.
Occurrence of specific event Often the most focused earnouts are driven by the execution, maintenance or renewal of key relationships or contracts within the earnout period — the reciprocal is of course these are often the key drivers of the earnings power of the seller's business on which the purchase price is predicated.

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While simply stated, the details can be exasperating to negotiate. For example, if a key contract is not renewed, the seller may blame the buyer for not providing the requisite comfort to the customer. Defining predetermined conditions on whether a contract renewal occurred, such as having a certain term or attaining a certain profit margin, may reduce potential disagreements. In a service business or where there is key man risk, often the earnout paid out annually for the earnout period is based on retention of incumbent client revenue. In this case incumbent client revenue needs clear definition — which clients and what revenue?

Computing the earnout
Regardless of which metric is used for determining the earnout, precise and careful drafting is the key.

With the ongoing transition to IFRS and the continuance of crossborder transactions, it is imperative that the computation of earnouts be based on a mutually agreed-upon accounting standard. While the calculation of an earnout may be based on GAAP or IFRS, computational ingenuity as well as honest differences of opinion often arise. Parties should carefully consider the potential effects of the following in order to minimize subjectivity and abuse of discretion conferred under GAAP or IFRS:

- The treatment of extraordinary, unusual or nonrecurring items, such as sale- or integration-related costs in the context of the earnout. While the terms are sometimes used interchangeably in valuations (on which the original purchase price may have been

based), not all the terms are defined or used synonymously under GAAP, which can have more specific criteria.

• Accounting policies that can affect the timing and amount of revenue or a particular expense, such as revenue recognition, inventory valuation, capitalizing versus expensing significant expenditures or leasehold improvements, and bad debt provisions.

In addition to differences in accounting policies, the allocation of the buyer's overhead costs to the seller's P&L that may not have a direct impact on the seller's earnings power can be a source of contention in the earnout's computation.

Other earnout-related disputes or complications include:

• *IFRS 3R* requires valuation of contingent consideration at acquisition and on each subsequent reporting date. This requires development of base case cash flow and reasonable what-if scenarios to test range and probability of realization of the earnout. It is essential the valuator be alert to inconsistencies between the probability adjusted fair value of the earnout and other asset valuations.

• *Income taxes* can be complex and material to how an earnout is structured. The most common area of controversy is whether or not the earnout payments will be deductible to the payer, and will they be capital gains or normal income to the recipient. It's essential to resolve this early in the structuring with appropriate tax expertise in connection with the transaction.

• *Form of payment presents* both parties with opportunities. Cash is the most common earnout payment mechanism. At least in this case, risk to the parties, particularly the seller, pertains only to the earnout and not the consideration.

Use of stock as purchase consideration is a subject unto itself and not unique to earnouts. The passage of time and impact of external events create additional risk. Parties sometimes use collars on stock prices if the shares are publicly traded. If the buyer is private, the parties would need to devise an agreeable valuation methodology or process to value the buyer's stock.

Buyers should also consider anti-dilution protection for future stock issuances at lower prices, whereas sellers receiving such stock should negotiate the normal protections of any equity holder. These rights would include pre-emptive rights, exit rights, protective provisions, board or observer representation, information rights, registration rights and tag- and drag-along provisions.

• *Security for payment* can be troublesome for the seller who may actually earn the earnout but discover its earnout is subordinate to senior debt or loans that may prohibit such obligations from being satisfied while the senior debt is outstanding. Alternative scenarios include lack of funding available from the buyer due to working capital constraints, taxes, insufficient free cash flow or capital commitments. Sellers often insist on third-party guarantees and other collateral to assure the integrity of the earnout payment.

• *Dispute resolution* provisions are critical to minimizing cost and time as well as preventing extraneous issues from polarizing the parties or needlessly harming the business. Typically, a buyer will prepare, or have its independent business valuator (or accountant) prepare, and present to the seller a computation of the earnout at the time it is due and payable. The seller will have an opportunity to accept or raise objections. If the parties cannot resolve any dispute, an independent business valuator or other party or parties may be mutually retained to serve as the ultimate arbiter.

Nuances abound. Can the valuator offer a figure not proposed by a party? Must the valuator choose only one of the parties' figures (the baseball approach) or can the valuator meet the parties between those figures? Can the valuator use a different methodology than that which the parties employed?

The costs and expenses of the independent valuator are typically split between the parties to ensure the accountant is not unduly beholden to the paying party. Separately from the agreed-to amount of the earnout, the timing of payment of the disputed portion of the earnout is often contentious. Middle-ground approaches include requiring the buyer to pay some portion of the undisputed sum to the seller and sum portion to an independent escrow.

• *Events for acceleration of the earnout* may include the buyer's business being sold prior to the ending point for determining the earnout or the seller being dismissed unjustifiably or constructively. The parties might also agree to a partial acceleration and buyout of the earnout in the case of a sale. This formula might recognize the remaining earnout potential (i.e., if there is only half the earnout remaining to be potentially earned, only that portion would be potentially subject to acceleration) then provide that some portion will be deemed earned and some deemed not earned or, alternatively, annualize the appropriate earnout metric then measure whether the earnout has been met based on that annualized figure. The parties should also discuss some form of escrow of the earnout in these circumstances to ensure payment.

• *Events for buyer withholding payment* is the converse of a seller accelerating payment of the earnout due to a possible breach in a representation or warranty under the purchase agreement, or other rights of set-off where the seller owes the buyer funds for specific transgressions. Middle-ground compromises often involve requiring the buyer to deliver the earnout payment to an independent escrow pending resolution of the buyer's claim for offset.

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Conclusion

Earnouts can bridge valuation concerns about post-sale commitment between parties. But, while earnouts can solve a problem, they can cook up another for future confrontation. If the parties feel they need an earnout, they must carefully think through and address the issues raised to ensure the earnout isn't a bridge too far.

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