The most highly negotiated provision of most transactions is price. Sellers want to maximize the value of the deal, putting the most optimistic spin on recent and projected results – revenue, income, customer or transactional growth, or other metrics. Sellers, understandably, take a more skeptical view, questioning the sustainability of growth and the accuracy of forecasts. When differences over valuation and price cannot be bridged, the parties may take a “wait and see” or “show me” approach, agreeing to a lower price than the seller wants now but agreeing to additional post-closing payments from the buyer if the company meets certain forecasts or metrics over time. These so-called “earnouts” can be effective mechanisms for splitting the difference, putting off ultimate disposition, and closing a deal. But they can also – and often are – be fertile sources of lengthy litigation. This program will provide you with a practical guide to effective drafting of “earnouts” in business sales and a guide to avoiding litigation traps.

- “Splitting the difference” – using “earnouts” to defer ultimate sales price and yet close a deal now
- Review of most highly negotiated – and litigated – provisions in earnout agreements
- Post-closing operations – control by buyer, but informational access to seller
- Defining key metrics – objective, measurable and potential traps
- Relationship of earnouts to senior debt and other preferential returns
- Debt issues and how it impacts financial results – and post-closing payments
- How earnouts are different than escrow and holdbacks
- Spotting litigation red flags
- Talking to clients about the real risks of earnouts

Speaker:

Robert Wollfarth is of counsel in the New Orleans office of Baker, Donelson, Bearman, Caldwell & Berkowitz P.C, where he represents large and small clients across the country with a wide variety of business matters. His practice includes start-up formation, mergers and acquisitions, federal, state and local tax planning and controversy, financing projects and operations, restructuring, buy-outs and dissolution. He has written and spoken extensively on business and tax planning topics. Mr. Wollfarth received his B.S. from Tulane University and his J.D. and LL.M. from New York University School of Law.
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Splitting the Difference: "Earnouts" in Business Sales

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Presentation Topics

Earnouts used in mergers and acquisitions to defer until after closing the payment of part of all of the acquisition price including, specifically,

I. What is an earnout and what is an earnout used for?
II. Advantages and disadvantages of using earnouts
III. Structuring and drafting the earnout in the acquisition agreement
IV. Tax consequence of using earnouts
What is an Earnout?

• An "earnout" consists of one or more contingent payments made by the buyer after the acquisition closing that makes up a portion of the total acquisition price.

• Typically the payments are due to seller when the target achieves certain specified performance targets in certain specified periods.

• If the target fails to achieve these specified performance targets within the specified periods, the buyer is relieved from making the contingent payments or only required to pay a lesser amount.
What is an Earnout Used for?

- Most often, to provide a mechanism for more accurately determining the acquisition price when the buyer and seller cannot agree on the target’s value as of closing.

- When the target’s employment of the seller after the closing is critical to ensuring target's successful transition to buyer and profitability, the earnout can be used to motivate seller to maximize target's performance post-closing.

- To help buyer finance the acquisition when buyer has limited access to funds necessary to pay the full purchase price at closing, for example, when debt financing is not available.
Advantages and Disadvantages of Earnouts

- The ones to be discussed are really just some of the potential advantages and disadvantages. What might be an advantage or disadvantage in one set of circumstances may not be in another. Certainly, how the earnout is drafted will largely determine the extent to which these materialize.

- In some acquisitions, the disadvantages may be so significant and unavoidable that an earnout is not practical.

- Regardless of how it shakes out in a particular acquisition, this discussion will help you identify issues that should be addressed in the drafting.
Potential Advantages to Seller

- Opportunity to get a higher price for the target than it would have otherwise received

- Immediate cash while preserving some of the upside of the target

- Opportunity to benefit from synergies achieved by the target being integrated with the buyer's business
Potential Disadvantages to Seller

- Prevents a clean break
- Makes the seller vulnerable to the buyer's actions
- Can be used by the buyer to offset indemnification claims it has under the purchase agreement against the seller
- Subject to limitations imposed by third parties including buyer’s lenders and investors
- May be impaired by buyer’s lack of creditworthiness
- How will buyer's combination of target with other businesses distort the earnout target?
- What if buyer seeks to compete with the target business through affiliated entities following the closing?
Potential Advantages to Buyer

- Values the target company more accurately and protects the buyer from overpaying
- Defers payment of part of the purchase price for a period after closing
- Apportions risk
- If all or some of the sellers are key to the success of the target (such as a founding stockholder), motivates those sellers to stay on and maximize the profitability of the target
- Can be used to offset indemnification claims under the acquisition agreement
Potential Disadvantages to Buyer

• Restricts the buyer's ability to direct the business strategy of the target and to fully integrate the target with the rest of its business. In some cases, the buyer may also be restricted from selling the target or certain of its assets.

• If the seller is managing the target during the earnout period, it could attempt to manage the target solely to achieve the earnout targets which may have an adverse effect on the long-term performance of the target.

• Buyer may end up paying more for the target than it originally intended.

• Earnout targets and formula may become outdated or inappropriate as the business develops or as a result of changing market conditions.
Potential Disadvantages to both Buyer and Seller

- Earn-outs often lead to disputes between the buyer and seller after the closing.

- The profitability of the target after the closing can be affected by many factors unrelated to its performance or intrinsic value, some of which are difficult to exclude from earnout calculations. For example:
  - the buyer may make other acquisitions or changes to its business plan after the closing which can cause the target to be more profitable and achieve an earnout target it may not otherwise have been able to achieve; and
  - a downturn in the economy can cause the target to be less profitable and fail to achieve an earnout target it would have been able to achieve in a better economy.

- Negotiating and drafting earnout provisions can be difficult and require additional time and cost.

- Earnouts require post-closing monitoring and measuring of the target 's performance.

- An earnout may lead to adverse accounting and tax treatment.
Structuring and Drafting the Earnout

Topics include structuring and drafting the various components of the earnout provision including:

- Target Performance Measure
- Earnout Period
- Earnout Threshold
- Earnout Payment Amount
- Earnout Payment Calculation Statement
- Dispute Resolution Mechanism
- Independence of Earnout Payments
- Timing of Earnout Payment
- Acceleration of Earnout Payments
- Post-closing Operational Covenants
- Buyer’s Right of Setoff
- Seller’s Security for Earnout Payments
Target Performance Measure

Sample provision:

"Adjusted EBITDA" means, with respect to any Calculation Period, the net income before interest, income taxes, depreciation and amortization of the target for such period, determined in accordance with GAAP but applied and calculated in a manner consistent with the EBITDA calculation derived from the Audited Financial Statements for the most recent fiscal year end, adjusted to [include/exclude] [LIST SPECIFIC ITEMS TO BE INCLUDED OR EXCLUDED FROM THE CALCULATION OF ADJUSTED EBITDA].
Other Kinds of Performance Measures

- Buyers generally prefer net income/earnings measures especially if the seller will continue to operate the target after the closing because gross revenue/sales measures do not motivate the seller to control costs and expenses.

- Sellers generally prefer gross revenue/sales measures because they are less affected by costs and expenses and there is less chance for the buyer to manipulate the results.

- Depending on the circumstances a non-financial measure may be the best indicator of performance or a combination of financial and non-financial measures.
Excluding Items that do not Reflect Target Value

Parties often want to adjust the chosen measure of performance so that it does not reflect extraordinary or non-recurring items and items unrelated to the performance of the target such as:

- Extraordinary, unusual, infrequent or nonrecurring items of gain or loss
- Gains or losses resulting from the sale of assets other than in the ordinary course of business consistent with past practice
- Allocation of revenues, costs and expenses between the target and the buyer's other businesses
- Revenues, costs and expenses resulting from the acquisition of any other entity
- Revenues, costs and expenses from any new lines of business that the target launches during the earnout period and that were not expressly contemplated by the buyer or seller
- Costs and expenses incurred in connection with the transactions contemplated by the agreement
- Costs and expenses associated with changes to employee compensation inconsistent with historical practices
- Revenue generated by affiliate transactions
Earnout Period

Sample provision:

"Calculation Periods" means (a) the period beginning on the Closing Date and ending on [LAST DAY OF CURRENT CALENDAR/FISCAL YEAR], and (b) each of the [calendar/fiscal] years ending on [DATE], [YEAR], [YEAR] and [YEAR], respectively.
Earnout Period: Buyer and Seller Preferences

- Generally, buyers prefer shorter earnout periods if there are significant restrictions on their post-closing operation of the target and longer earnout periods when there are minimal restrictions.

- Some sellers, especially if they are not operating the target after the closing, may prefer a shorter earnout period so they can receive their payment sooner; but if they are managing the target after closing a longer earnout period so they have more time to achieve the earnout targets.
Earnout Threshold

Sample language:

• "EBITDA Threshold" means, with respect to any Calculation Period, the EBITDA threshold amount for such Calculation Period set forth on Schedule [XX].
Other Types of Earnout Thresholds

- **Moving threshold.** A moving threshold establishes a "baseline" equal to the highest earnings (or other performance measure) achieved during any calculation period. The amount of payment with respect to a calculation period would depend on the extent to which results exceed this baseline during the earnout period. A moving threshold is more demanding of the seller because it requires steady growth.

- **Cumulative threshold.** A cumulative threshold depends on aggregate performance during the earnout period. The amount of earnout payment would depend on the extent to which the aggregate results during the entire earnout period exceed the specified cumulative threshold. A cumulative approach overlooks annual fluctuations in performance and encourages the seller to focus on the entire earnout period rather than successive calculation periods.
Earnout Payment Amount

Sample provision:

As additional [consideration for the [Shares/Purchased Assets]/merger consideration], at such times as provided in Section [x], Buyer [(or, at the direction of Buyer, [the Company or another/a] designee of Buyer so long as Buyer remains an obligor thereof)] shall pay to Seller with respect to each Calculation Period within the Earnout Period an amount, if any (each, an "Earnout Payment"), equal to the product of (i) an amount equal to (A) the Adjusted EBITDA for such Calculation Period, minus (B) the EBITDA Threshold for such Calculation Period; multiplied by (ii) the Earnout Multiple; provided, that in no event shall Buyer be obligated to pay Seller more than $[MAXIMUM EARNOUT PAYMENT AMOUNT] [for any Calculation Period/in the aggregate for all Calculation Periods during the Earnout Period]. If the Adjusted EBITDA for a particular Calculation Period does not exceed the applicable EBITDA Threshold, no Earnout Payment shall be due for such Calculation Period.
Alternative Earnout Payment Amount Formulas

• Flat amount. Flat amount of additional consideration to be paid if the earnout threshold is achieved

• Percentage. Most commonly, the buyer will pay the seller an agreed-upon percentage of the amount by which the target exceeds the earnout threshold.

• Sliding scale. No earnout payment will be made until some minimum threshold is achieved; and once that threshold is achieved, a sliding scale or proration will apply.
Buyer and Seller Preferences Regarding Caps

- **Buyer perspective**
  - If the earnout payment is based on a formula, it can potentially become quite large if actual adjusted EBITDA exceeds the target by a significant amount.
  - The buyer should try to protect itself by placing a cap on the amount of each earnout payment in each calculation period or the aggregate amount of all earnout payments during the entire earnout period.

- **Seller perspective**
  - The seller should try to eliminate any cap on the amount of earnout payments it can be paid.
  - In certain cases, a cap on earnout payments can have negative tax consequences for the seller.
  - If the seller has enough negotiating leverage, it can try to negotiate a minimum amount that each earnout payment can be if the EBITDA target is achieved.
Sample provision:

On or before the date which is [NUMBER] days after the last day of each Calculation Period [(or [NUMBER] days in the case of the final Calculation Period)] (each such date, an "Earnout Calculation Delivery Date"), Buyer shall prepare and deliver to Seller a written statement (in each case, an "Earnout Calculation Statement") setting forth in reasonable detail its determination of Adjusted EBITDA for the applicable Calculation Period and its calculation of the resulting Earnout Payment (in each case, an "Earnout Calculation").
Earnout Payment Calculation Terms to Consider

- Who prepares the calculation and delivers the statement?

- How much time is given to deliver the statement following the calculation period?

- What is the standard for calculating the earnout payment?

- What work papers should be delivered in support of calculation?
Dispute Resolution Mechanism

Sample provision:

Seller shall have [NUMBER] days after receipt of the Earnout Calculation Statement for each Calculation Period (in each case, the "Review Period") to review the Earnout Calculation Statement and the Earnout Calculation set forth therein.

During the Review Period, Seller and its [accountants/representatives] shall have the right to inspect [Buyer's/the Company's] books and records during normal business hours at [Buyer's/the Company's] offices, upon reasonable prior notice and solely for purposes reasonably related to the determinations of Adjusted EBITDA and the resulting Earnout Payment.

Prior to the expiration of the Review Period, Seller may object to the Earnout Calculation set forth in the Earnout Calculation Statement for the applicable Calculation Period by delivering a written notice of objection (an "Earnout Calculation Objection Notice") to Buyer[; provided, that the only [basis/bases] on which Seller may dispute any matter in the Earnout Calculation [is/are] [SPECIFY ANY LIMITS ON SCOPE OF OBJECTIONS]]. Any Earnout Calculation Objection Notice shall specify the items in the applicable Earnout Calculation disputed by Seller and shall describe in reasonable detail the basis for such objection, as well as the amount in dispute. If Seller fails to deliver an Earnout Calculation Objection Notice to Buyer prior to the expiration of the Review Period, then the Earnout Calculation set forth in the Earnout Calculation Statement shall be final and binding on the parties hereto.
If Seller timely delivers an Earnout Calculation Objection Notice, Buyer and Seller shall negotiate in good faith to resolve the disputed items and agree upon the resulting amount of the Adjusted EBITDA and the Earnout Payment for the applicable Calculation Period. If Buyer and Seller are unable to reach agreement within [NUMBER] days after such an Earnout Calculation Objection Notice has been given, all unresolved disputed items shall be promptly referred to [the Independent Accountant/an impartial nationally recognized firm of independent certified public accountants, other than Seller's Accountants or Buyer's Accountants, appointed by mutual agreement of Buyer and Seller (the "Independent Accountant")].

The Independent Accountant shall be directed to render a written report on the unresolved disputed items with respect to the applicable Earnout Calculation as promptly as practicable, but in no event greater than [NUMBER] days after such submission to the Independent Accountant, and to resolve only those unresolved disputed items set forth in the Earnout Calculation Objection Notice. If unresolved disputed items are submitted to the Independent Accountant, Buyer and Seller shall each furnish to the Independent Accountant such work papers, schedules and other documents and information relating to the unresolved disputed items as the Independent Accountant may reasonably request. The Independent Accountant shall resolve the disputed items based solely on the applicable definitions and other terms in this Agreement and the presentations by Buyer and Seller, and not by independent review. The resolution of the dispute and the calculation of Adjusted EBITDA that is the subject of the applicable Earn-out Calculation Objection Notice by the Independent Accountant shall be final and binding on the parties hereto. The fees and expenses of the Independent Accountant shall be borne by Seller and Buyer in proportion to the amounts by which their respective calculations of Adjusted EBITDA differ from Adjusted EBITDA as finally determined by the Independent Accountant.
Other Key Dispute Resolution Mechanism Terms

- Buyer may want to include language that limits seller's scope of objections, for example, to
  - factual or numerical inaccuracies
  - claims that adjusted EBITDA was not prepared in accordance with the terms of the agreement

- If I am representing the buyer, I always rather designate the accountant by name because leaving that subject to the parties’ agreement provides the opportunity for the seller to delay payment by refusing to agree on the accountant.

- To minimize the time and expense of engaging the independent accountant to resolve the dispute, parties may want to strictly limit accountant’s review

- Buyer may want the party whose calculation is furthest from the determination of the independent accountant to pay all of the independent accountant's fees and expenses

- Seller may want fee shared equally
Independence of Earnout Payments

Sample provision:

Buyer's obligation to pay each of the Earnout Payments to Seller in accordance with [Section ___________] is an independent obligation of Buyer and is not otherwise conditioned or contingent upon the satisfaction of any conditions precedent to any preceding or subsequent Earnout Payment and the obligation to pay an Earnout Payment to Seller shall not obligate Buyer to pay any preceding or subsequent Earnout Payment. For the avoidance of doubt and by way of example, if the conditions precedent to the payment of the Earnout Payment for the first Calculation Period are not satisfied, but the conditions precedent to the payment of the Earnout Payment for the second Calculation Period are satisfied, then Buyer would be obligated to pay such Earnout Payment for the second Calculation Period for which the corresponding conditions precedent have been satisfied, and not the Earnout Payment for the first Calculation Period.
Independence of Earnout Payments Alternatives

- The buyer may want to include a "clawback" provision that allows it to recover portions of earnout payments it makes in earlier periods if the target fails to achieve the earnout targets in later periods.

- Unlike the sample language above, if a seller receives a fixed payment regardless of how much target’s performance exceeds the threshold, the seller will want to be able to make up any deficiencies in performance in one calculation period with excesses in any prior or later calculation period to achieve the earnout target for the deficient period.
Timing of Earnout Payment

Sample provision:

Subject to Section [_____], any Earnout Payment that Buyer is required to pay pursuant to Section [_____] hereof shall be paid in full no later than [NUMBER] Business Days following the date upon which the determination of Adjusted EBITDA for the applicable Calculation Period becomes final and binding upon the parties as provided in Section [_____] (including any final resolution of any dispute raised by Seller in an Earnout Calculation Objection Notice). Buyer shall pay to Seller the applicable Earnout Payment in cash by wire transfer of immediately available funds to the bank account for Seller set forth on Schedule [XX].
Timing of Earnout Payment Alternatives

- Seller may want to add language that requires buyer to pay any undisputed amounts before the disputes are resolved.

- Buyer may want to withhold all payments until disputes are resolved as a means of discouraging seller from disputing its earnout payment calculations.

- Seller may also want to require that interest be paid on late payments.
Acceleration of Earnout Payments: Buyer Election

Sample provision:

At any time after the Closing Date, Buyer may, in its sole discretion, elect to make a payment (the "Acceleration Payment") to Seller in the amount set forth on Schedule [XX] that corresponds to the Calculation Period in which Buyer has elected to make such payment which, upon payment thereof, shall fully release and discharge Buyer, its successors and assigns from any further liability or obligation pursuant to this Section [____].
Acceleration: Buyer Perspective

- Useful if the buyer wants to sell the target before the end of the earnout period

- The acceleration payment is often set at the net present value of the future earnout payments.

- The fact that the earnout payment is based on a formula in which adjusted EBITDA is a factor makes calculating the present value of the earnout payments difficult.

- Seller is happy to get payments sooner but will probably push back on discounting.
Sample provision:

In the event that after the Closing Date (i) there occurs a sale or other disposition of all or substantially all of the assets of Buyer, or a merger, consolidation, recapitalization or other transaction in which any Person who is not an owner of an interest in Buyer on the Closing Date becomes the beneficial owner, directly or indirectly, of 50% or more of the combined voting power of all interests in Buyer, or (ii) Buyer makes a general assignment for the benefit of creditors, or any proceeding shall be instituted by or against Buyer seeking to adjudicate it as bankrupt or insolvent, or seeking liquidation, winding up or reorganization, arrangement, adjustment, protection, relief or composition of its debts under any Law relating to bankruptcy, insolvency, or reorganization (each, a "Triggering Event"), Seller may, in either case in its sole discretion, upon notice to Buyer (such notice, the "Acceleration Notice"), elect to have paid in full by Buyer the remaining Earnout Payments to be paid pursuant to Section [____] by payment to Seller of the amount set forth on Schedule [XX] that corresponds to the Calculation Period in which the Triggering Event has occurred.
Acceleration: Seller Perspective

- Acceleration may be necessary after the occurrence of certain events that can affect the buyer's ability to make the earnout payments or the ability of the target to achieve the earnout targets.

- The sample provision may also address buyer's breaches of post-closing operational covenants, termination of key employees and the sale of target assets that does not result in a change of control.

- As with acceleration at buyer's election, a formula-based earnout payment may make it difficult for the parties to determine what the accelerated earnout payment should be thus making agreement on this type of provision or at least the drafting of it with any specificity unlikely.
Post-closing Operational Covenants

Sample provision:

Subject to the terms of this Agreement [and the other Transaction Documents], subsequent to the Closing, Buyer shall have sole discretion with regard to all matters relating to the operation of the [Company/Business], including, but not limited to, [LIST ANY PERMITTED ACTIONS BUYER WANTS TO SPECIFY][; provided, that Buyer shall not, directly or indirectly, take any actions in bad faith that would have the purpose of avoiding or reducing any of the Earnout Payments hereunder.] [Notwithstanding the foregoing,] Buyer has no obligation to operate the [Company/Business] in order to achieve any Earnout Payment or to maximize the amount of any Earnout Payment.
Post-closing Covenants in Buyer’s Favor

• If buyer manages the target post-closing, buyer will want to ensure that the seller does not do anything in the short term to achieve the earnout that will jeopardize the target’s long-term prospects.

• Buyer will want to disclaim any obligation to maximize or achieve the earnout.
Post-closing Covenants in Seller’s Favor

If the seller is depending on the buyer's operation of the target, it should request that certain covenants be imposed on the buyer:

- Requiring that the buyer operate the target consistent with seller’s historic practices
- Restricting the buyer from making any changes to the target that would materially affect its ability to achieve the earnout targets
- Requiring the buyer to maintain separate books and records for the target and separate financial statements
- Requiring the buyer to use its best efforts to achieve or maximize the earnout.
- Restricting the buyer from disposing of any portion of the target outside the ordinary course of business
- Requiring the buyer to maintain the target as a separate business unit
- Restricting the buyer from competing with or soliciting employees or clients of the target
- Restricting the buyer from diverting any revenues away from the target and to the buyer or any of its other affiliates or subsidiaries
Buyer’s Right of Setoff

- Sample provision:

Buyer shall have the right to withhold and set off against any amount otherwise due to be paid pursuant to this Section [_____] the amount of [(i) any [Purchase Price Adjustment] owed to it pursuant to Section [_____] and (ii)] any [Losses] to which any [Buyer Indemnified Party] may be entitled under Article [XX] of this Agreement or any other [Transaction Document].
Buyer’s Right of Setoff cont’d

- It is typical for the parties to include this type of provision.

- The seller should try to limit this right to only allow the buyer to set off amounts which are specifically identified and only after they are finally determined.
The seller usually wants some assurances that the buyer will be able to make the earnout payment if and when due and may request that the buyer provide security in one of the following forms:

- Escrow

- Affiliate guaranty

- A security interest in the assets or equity of the target

The seller should also ensure there are no third-party restrictions imposed on buyer’s ability to make the earnout payments
Taxation of Earnout Payments

Key buyer tax issue:
- When is earnout payment included in basis?

Key seller tax issues:
- Will the earnout payments give rise to compensation or deferred purchase price?
- When must the compensation income or gain be recognized?