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Watch out for earn-out

By Neill May

Some of us are blessed to be good with tools, others less so. When we bought our first house, our agent gave me a tool kit for household repairs, which gave all of us the gift of laughter. Efforts to maintain a façade diplomatically endure: When something is wrong in our home, my wife has the grace to wait for me to go downstairs, count down what would seem to be a reasonable time for a semi-intelligent assessment of the problem (probably while superficially investigating a piece of machinery that has been disconnected for decades), and then return invariably without a solution (or, frankly, the remotest clue) before calling someone actually capable.

There is some form of salvation for me and those similarly situated: Corporate lawyers have their own tools of the trade. A number of recent studies have highlighted the increasing use of a classic lawyers' tool, the earn-out, a provision to vary all (or, more typically, a portion) of the purchase price paid by an acquirer for a business based on the post-acquisition performance of the business. The utility and reasons for the appeal of the earn-out are apparent: If the seller is confident (or, at a minimum, speaking confidently) about the future and prospects of the business, and the purchaser is reluctant to pay full price for uncertain future economics, the earn-out is well suited to bridge the divide. The purchaser will only pay, and the seller will only receive, the higher price if post-closing successes are realized (proving out a high value for the purchased business).

While they are certainly useful, the problem with earn-outs is they are not panaceas, and they can fail to achieve the intended result if their use is not carefully and capably considered (I was going to say that the tools are only as good as those using them, but that would have been too Dr. Ruth).

At a high level, there should be alignment where earn-outs are concerned, with both parties hoping for the purchased business to succeed, the seller for the earn-out, and the buyer for the increased value of its business. But the alignment is far from perfect, and that is the core source of complications for earn-outs.

At a simple level, the buyer would, of course, prefer to have the purchased business succeed and not make the earn-out payment, which in itself makes the drafting and practical considerations about the enforceability of earn-out provisions important (particularly for the seller). More complicated issues arise because the purchaser on completion of the acquisition has purchased the right to run the business in the way that it sees fit, which may not align with achievement of the earn-out metrics or be consistent with the seller's views about how to best operate the business.

These issues occasionally get intertwined. For example, if earn-out payments are triggered based on the profitability of the business, the parties may have very different views about expenses. The buyer may be concerned about expenses being too high (so as to dampen profitability), or too low (such as insufficient investment in profit-generating expenses like advertising), or about the timing of such expenses relative to the earn-out measurement periods.

Combining the purchased business with the purchaser's own businesses raises its own complexities. Most obviously, the purchaser may seek to realize benefits from the combination; measuring the success of the purchased business for the purposes of applying the earn-out is certainly messier where businesses are intermingled.

These are some of the challenges of earn-out provisions. They require thoughtful consideration of issues like how best to measure the success of the purchased business, what approvals (if any) the seller will have over changes to the business during the earn-out period, and how the businesses may be integrated.

In a recent Delaware case, *Lazard v. Qinetiq*, the Delaware Supreme Court considered a dispute over an earn-out provision that prohibited the buyer from taking any action to divert or defer revenue with the intent of reducing or limiting the earn-out payment. The case illustrates one approach to addressing the potential for misalignment between buyers and sellers: the subjective standard (focused on the buyer's subjective intentions).

In that case, the drafting allowed the buyer to take actions that would adversely affect revenue, as long as in doing so it did not have the subjective intention of reducing the earn-out payment. The court upheld the agreement as drafted and allowed the earn-out not to be paid, because the seller could not show that the buyer intended to adversely affect the seller's earn-out entitlement in taking actions that led to that result.

Disputes concerning earn-outs can be disappointing to the parties if the effect of the provision does not align with expectations (or apparent fairness). Those disputes can also be costly, both in terms of expenses incurred but also in terms of relationships if there are (or were expected to be) ongoing dealings between the parties. All of which again highlights the importance of thinking through earn-out provisions carefully, and also makes me feel marginally better about paying steeply for service calls that result in the equivalent of "Is there some reason you didn't plug it in?" (which also is not meant to be too Dr. Ruth). CL

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