Mergers & Acquisitions Alert

www.hf-law.com

HIRSCHLER FLEISCHER
ATTORNEYS AT LAW

The Edgeworth Building
2100 E. Cary Street
Richmond, Virginia 23223-7078
Phone: 804-771-9500
Fax: 804-644-0957

Mill Race North
725 Jackson Street, Suite 200
Fredericksburg, VA 22401-5720
Phone: 540-604-2100
Fax: 540-604-2101

M&A GROUP ATTORNEYS

Jennifer M. Becker
J. Benjamin English
S. Brian Farmer
Lisa J. Hedrick
Kathryn A. Lawrence
Andrew M. Lohmann
J. Kevin Muldowney
Gary M. Nuckols
J. Terry Parsley
Charles W. Payne
Katharine A. Schkloven
Roderick W. Simmons
C. Brandon Spalding, Jr.
William S. Tate
Janet (Jan) Singletary Thomas
W. Michael Walker
James L. Weinberg

This publication is intended for general information purposes only and does not constitute legal advice. The reader should consult legal counsel to determine how laws apply to specific facts and situations.

Copyright ©2010, Hirschler Fleischer

Buying or Selling a Business in 2010 and Beyond: Understanding an Earnout

An earnout is a type of contingent purchase price whereby a portion (typically a minority slice) of the overall purchase price for a company is contingent upon the post-closing performance/earnings of the business. Earnouts have traditionally been used in a relatively small percentage of deals, predominantly (but not exclusively) to bridge valuation gaps between a buyer and a seller – often in the context of an emerging company. To illustrate, assume a target company has TTM EBITDA of $2,000,000. A seller may assert that a 6x multiple is the appropriate valuation multiple (for a purchase price of $12,000,000). A buyer may counter with a 5x multiple ($10,000,000 purchase price). The parties could settle the impasse by agreeing to a $12,000,000 total purchase price, with $10,000,000 paid at closing and $2,000,000 payable post-closing contingent upon the target's meeting stipulated performance goals.

The use of earnouts has increased significantly during the recent economic downturn, principally as a result of (i) business valuation disagreements between buyers and sellers, which have only been exacerbated by the unstable performances of businesses during the recession, (ii) more restrictive debt arrangements and, consequently, reduced access to closing-date cash, and (iii) the desire of buyers to incorporate into the deal another term perceived as being buyer-friendly in this buyer-friendly market. (However, please note that earnouts also present certain disadvantages to a buyer. For example, (a) the earnout typically requires an ongoing relationship with the seller, which a buyer may not have envisioned from the outset; consequently a buyer may have less control over a target company in an earnout scenario than in a traditional sale; and (b) complicated negotiations are required to properly structure the earnout).

Because earnouts have traditionally appeared in a relatively small number of deals, many privately-held business owners are unfamiliar with the concept. For many sellers, the inclusion of an earnout in a letter of intent elicits a negative reaction. "What do you mean 25% of the purchase price is contingent upon the performance of the company post-closing?" The buyer's suggestion of an earnout can offend a proud founder or operator, as it may be perceived to indict both the historical

continued

operating performance of the company and the owner's projections. On the other hand, a seller can benefit greatly from an earnout, as an earnout often boosts payouts that would not have otherwise been achieved.

The negotiations surrounding an earnout are often contentious. An inherent conflict exists where the sales price for a business cultivated by the seller is contingent upon the performance of the business during the time it will be owned – and presumably managed – by the buyer. Although the terms and conditions of the earnout may occupy only a few paragraphs in a lengthy purchase agreement, the time and attention spent negotiating such provisions can often dwarf that spent on lengthier sections (and justifiably so).

The following sets forth a brief overview of some of the primary issues that must be addressed in an earnout. It is critical that buyers and sellers understand the implications of each of these issues in order to properly construct an earnout that balances the competing motivations of the parties.

- **Percentage of the purchase price subject to the earnout:** While a typical earnout comprises a relatively small percentage of the total purchase price (often 10 – 30%), an earnout can, on occasion, end up accounting for a significantly larger portion, particularly if the earnout is uncapped (as was the case with a 2003 acquisition by Liz Claiborne). The parties must also consider whether the earnout amount will be tiered based on the satisfaction of the earnout metrics, or whether it will be "all-or-nothing."

- **Duration:** How long will the earnout measurement period last? A buyer, of course, would prefer a longer measuring period to limit the impact of a short-term performance peak on the earnout amount. A seller, on the other hand, often demands a shorter period. A one- or two-year measurement period is fairly typical. Additionally, what happens if there are multiple measurement periods (for example, a seller can earn up to $1,000,000 in each of the two years following the closing), and the performance target for the first year is not met but the second year performance more than makes up for the first year deficiency? A seller can negotiate the right to "make up" the entire $2,000,000 earnout if the aggregate milestones are met. A buyer, on the other hand, would want to isolate each one-year earnout period/payment.

- **Performance Metrics:** How will post-closing performance be evaluated? What will be the appropriate milestone(s)? Typical metrics include gross profit, EBITDA, revenue growth and the occurrence of a specific event (e.g., renewal of a significant customer contract). The concerns of each party with respect to these metrics will differ. For example, a buyer may not want a revenue metric if margins are shrinking. On the other hand, a seller may object to an EBITDA milestone if it fears the buyer will front-load post-closing expenses (although a seller also wants to ensure the buyer is obligated to provide adequate capital for both existing operations and any anticipated company expansion). In any event, the earnout should be based on a measure that minimizes any subjective interpretation, and the accounting terms need to be clearly spelled out.

- **Tracking the Metrics:** The parties must ensure there is an accurate way of tracking whatever metric is utilized. Therefore, a seller will often demand that the target company remain a separate entity during the entire earnout period, rather than being merged in with a member of the buyer group. In contrast, a

HIRSCHLER FLEISCHER
ATTORNEYS AT LAW

continued

buyer will want autonomy to reorganize the target as it sees fit. One solution is to require that the target (whether it remains a separate entity or becomes a division of a member of the buyer group) remain subject to separate financial reporting during the earnout period.

- **Control / Limitations over Post-Closing Operations:** If part of the purchase price is contingent upon post-closing performance, a seller will typically want as much control as possible over management decisions in order to maximize the chances of reaching earnout targets and to minimize the buyer's ability to adversely impact the earnout. This is in conflict with the objectives of a buyer who has just obtained control of the target and wants the ability to limit the seller-operator's focus on initiatives aimed at helping the target hit short-term earnout targets at the long-term expense of the company.
- **Subordination; Payment Security.** An issue that often arises late in the purchase agreement negotiations – namely, when the buyer's credit agreement is being drafted – involves subordination of the earnout payment(s). The buyer's lender may restrict the ability of the buyer to make the earnout payments. The terms and conditions of such subordination are subject to intense negotiations. A seller may require a payment guaranty from an affiliate of the buyer.
- **Triggers for early payment.** What happens if the target is sold or a seller's employment is terminated during the earnout period? Alternatively, a buyer may want the ability to accelerate the payment of the earnout if any operational restrictions are hamstringing the buyer's overall post-closing plans. In such an event, will the full earnout amount be discounted to present value?

HIRSCHLER FLEISCHER
ATTORNEYS AT LAW

Andrew M. Lohmann
804.771.9572
alohmann@hf-law.com

This is just a partial list of earnout considerations. Please contact Andrew, Kathy or one of our other mergers & acquisitions attorneys for further information or for assistance with the sale of your business or the acquisition of another.

Kathy A. Lawrence
804.771.9579
klawrence@hf-law.com

http://www.hf-law.com/practice_areas/business/mergers_acquisitions.html